Financial Restatements

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Causes, Consequences, and Corrections

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In a case of real life imitating television reality shows, restatements have become the extreme makeovers of financial reporting. For a company living through the financial and operational pain, not to mention the damage to its reputation, the restatement experience is anything but elective surgery followed by a miraculous and quick recovery with perfect results.

Restatements range in seriousness from the straightforward nip and tuck of admitting a one-time error to the life-threatening exposition of widespread fraud and recurring mismanagement. In some cases, the company is so horribly disfigured that massive restatements aren't even considered. The firm is forced into extensive litigation and/or bankruptcy with a relatively dim hope of successfully restructuring itself. Selling off pieces of the business to the highest bidder can become the last viable alternative.

The number of restatements is on the rise. Common problems driving this recent increase are related largely to poor internal controls within core operations, basic accounting, and earnings management. Let's look at the major culprits that lead to restatements, the consequences when they happen, and what you can do to prevent them.

THE ROOTS OF RESTATEMENTS

Sources of potential internal controls weaknesses that can lead to restatements include human error, manual processes, and complexity and volume. At the relatively benign end of contributing factors is simple human error, and, in these cases, no one has intentionally set out to misstate the company's financial position. Spreadsheets, for instance, can compound human error quickly and quietly. An incorrect formula or "fat-fingered" data input into a highly complex spreadsheet has caused front-page news for some companies.

Accounting departments with high turnover can be particularly vulnerable to poorly documented spreadsheets that a new employee uses without adequate knowledge of the mathematical or logical linkage across cells and worksheets. Ideally, an integrated approach uses automated workflow tools to audit most basic financial information back to initial transactions and documents. But calculations produced in end-user spreadsheets are often reported in disclosures without the appropriate audit trail and management analysis. Finding the right balance among efficiency, effectiveness, and control is a real challenge for most companies when it comes to spreadsheets. In the end, even well-intentioned, well-trained employees make mistakes that can be very hard to avoid or find with nonintegrated tools.

Manual Processes

Despite extensive upgrades to Enterprise Resource Planning (ERP) systems spurred on by Y2K, many companies continue to struggle with the manually intensive accounting processes that are rife with internal controls problems. Companies might look at the number of manually generated journal entries and stratify these by dollar amount for a jaw-dropping awareness of poor controls.

Stranded technology, which may have been purchased with the ERP tool and not deployed immediately, is a place to look for near-term benefits. Automated workflow, for instance, requires a significant up-front investment to get it right across a broad population of transactions and approval hierarchies. When implemented well, these tools can add a measure of discipline and internal control to otherwise cumbersome and error-prone manual processes. Even the preliminary process of documenting the workflow for subsequent configuration can shed light on weaknesses in authority levels and separation of duties.

Complexity and Volume

In many recent high-profile restatements, complexity and transaction volumes were underlying factors in reporting problems. Deep knowledge of difficult financial accounting statements, such as derivative and hedge accounting, may be the domain of one or two high-ranking individuals within a company. Their direction regarding policy may even be written down and available on the intranet to those performing the actual transaction accounting. But those in the trenches may be left to figure out how to implement and maintain procedures without understanding the policy nuances enough to catch subtle anomalies in the data or intent of a transaction.

To add to the complexity, good product marketing people can be the Achilles heel for even great accountants, especially when internal controls around product development and rollout aren't defined. Well before the systems, policies, and procedures for a new product have been addressed, marketing brochures have hit the streets, and customers are clamoring for the latest deal. The trickle-down impact on provisioning, billing, receivables, and financial and regulatory reporting, to name a few, can overcome even the most disciplined accounting team. Undocumented and untested shortcuts borne of necessity become legacy procedures and systems. Months down the road, the newest employee in the group will say "I do it this way because that's the way they've always done it!" Like a virus, these shortcuts are incredibly adaptable to other new products, and the cycle of poor internal control continues.

Thanks to the Sarbanes-Oxley Act (SOX), companies are now looking closely at their processes and procedures. Although many CFOs and audit committees initially railed against the cost and time burdens imposed by SOX, many have found key internal controls missing from their basic processes. Take, for instance, the controller with 20 years of experience in a large company who disclosed that he was the only person in the company with knowledge of the monthly closing process checklist. With no backup plan in the event of his illness or departure, this company was at significant risk of restatement and the woes that follow.

Because human error, manual processes, and complexity and volume are undesired by-products of rapidly growing, highly profitable businesses, it's a tremendous balancing act to find the appropriate level of internal control around these common characteristics while still encouraging creativity and demanding efficiency and effectiveness. Significant reductions in the number of restatements could be expected if executives would focus on finding gaps in the day-to-day operations of the business and the accounting function.

Earnings Management

A major culprit, earnings management is the restatement category that regularly makes the news. Simply, earnings management can mean telling Wall Street what it wants to hear, when it wants to hear it—managing the message by managing earnings. Mundane examples exist such as booking or deferring reserves for large expenditures that happen around a quarter- or year-end to meet the guidance to the Street for that period.

In more cynical examples, the same reserves are made specifically to ensure that executives receive their maximum bonus payouts. Cases are now being documented that identify rolling changes to policy that modify earnings and result in better management payouts. The tangled web is bound tighter as undocumented system changes, made quickly to keep up with policy changes, transform and potentially undermine the integrity of underlying accounting entries. Years of unwinding and restating history coupled with the cost of repairing a company's reputation and shareholder confidence await those who resort lightly to earnings management.

Earlier, we suggested that companies look at their manual journal entries as a source of potential internal control weaknesses that can lead to errors and restatements. Accruals are often entered via manual journal entries, and bad accruals are a significant cause of restatements. Accruals are fine and acceptable techniques for matching revenues and expenses in the period in which they occurred. But the human element of estimations and judgment is where it gets tricky. Acting with only good intentions, junior resources with bad information can set the course for audit review and issues. "On-top" adjustments, often running into the millions of dollars, are far more suspect because they generally require senior-level intervention and direction. Auditors often run data-extraction routines specifically targeted to find large, rounded dollar amounts that accrue and reverse on a regular basis. These large on-top adjustments can be very easy to find, and it takes a lot of chutzpah to use them inappropriately.

CONSEQUENCES: BEYOND SHAREHOLDERS TO STAKEHOLDERS

Consequences of a restatement, both in terms of hard-number costs as well as effects on shareholders and stakeholders, can be huge.

As far as hard costs go, it's certainly a lot cheaper to comply with SOX than deal with a restatement. Sarbanes-Oxley was a direct response to the malfeasance of many large, high-profile companies that couldn't—or wouldn't—get their internal controls around financial reporting in check and ended up in restatement or bankruptcy. While nobody likes to bear the cost of regulations such as Sarbanes-Oxley, the cost of compliance can be a pittance when compared to the costs of a restatement in hard dollars. Four million dollars is commonly quoted as the average cost publicly traded companies incur to comply with SOX Section 404. Our experience with smaller regional companies facing relatively minor cleanup challenges is that the cost runs 10% to 15% of their net income.

Now consider the unpalatable alternative. Several high-profile companies have used 2,000 to 3,000 auditors and consultants for more than a year at a cost of over $4 million per day to help in their restatement efforts! Prevention costs a lot less than curing the illness.

Beyond the hard-number costs, another consequence of restatements is the effect on shareholders. To help protect shareholders, in June 2001, then SEC Chief Accountant Lynn E. Turner gave a speech to the Securities & Exchange Commission staff titled "The Investor's Bill of Rights: A Commitment for the Ages." His words were of fairness, fiscal responsibility, good management, transparent financial reporting and disclosures, and overall corporate governance, among other things. His message: The SEC's paramount charge is to protect investors.

But shareholders aren't the only ones who suffer from the scourge of financial restatements. Losses to portfolios ranging into the hundreds of billions of dollars are undeniably significant and often unrecoverable. Let's consider for a moment, however, the impact on other stakeholders.

SHARING THE PAIN

Boards and audit committees, senior executives, external auditors, the SEC and regulators, and employees all feel the pressure of restatements. But boards of directors and audit committee members feel the pain. Since they're held to higher levels of fiduciary responsibility, boards and audit committees must know enough about the business operations and the underlying financials to ask the right questions and be astute enough to know when they're being hoodwinked. Once a sought-after position, boards struggle to find capable individuals willing to risk being associated with a company tainted by restatements.

Senior executives come under tremendous pressure from all sides when faced with a financial restatement. Everyone is scrutinizing them—employees, the board, Wall Street, colleagues, the media—literally everyone. The restatement buck really does stop here, and an executive's credibility is at stake, if not his or her job, making it more challenging to manage and lead as well as to be taken seriously outside the company. Of course, in extreme cases like the ones that make headline news, executives are at risk of criminal charges that can lead to prison sentences.

External auditors are playing an incredible game of musical chairs as they manage the internal rotations of in-charge partners or are replaced by the board because restatements occurred on their watch. Independence issues may preclude them from taking on new clients while limiting the advisory services that they could once provide to their current clients. The second-tier external auditors are finding a wealth of opportunities to step through previously closed doors as companies seek more cost-effective sources of guidance and auditing. A cottage industry of advisors is evolving as well to fill the void left by the more narrowly focused Big 4.

The SEC and other regulators aren't immune to the effects of the growing number of restatements. Wage wars for CPAs of all levels and backgrounds have drained the public accounting resource pool in the Washington, D.C., area. The SEC has offered highly competitive compensation packages to those interested in reviewing companies with potential or actual restatement challenges.

And, finally, employees are last in line for just about any retribution from companies with large restatement issues. They bear an incredible weight. Many are faithful and long-tenured associates of companies whose mission they support and are proud to call their own. While some may or should be held personally accountable for their specific contributions to the underlying causes of restatements, a significant number probably feel betrayed and abandoned by their employers. To keep finances under control to pay for the new cost line item called "restatements," employees must give up bonuses, pay raises, and even jobs. Those who stay face months of long hours for reestablishing a credible operational baseline so they can buoy investor confidence and stock prices.

PREVENTATIVE MEDICINE

What can companies do to minimize the preexisting conditions that may result in large-scale restatements? We believe several basic elements of infrastructure within the finance organization and the corporation at large can certainly help.

Syncing Accounting with the Business

Training and employee competence in all relevant accounting standards and complex business arrangements specific to the company are a must. Off-the-shelf training should be brought to life in the real world of the company environment. And, as noted above, employees must have knowledge that's deep enough so they can ask the right questions about new and creative interpretations of accounting policy. Companies must avoid the silo effect, or key person dependency, around accounting policy to ensure that the touch points between and among highly complex accounting standards are adequately documented, understood, and addressed across functions.

We believe companies should spend a lot more time training employees on areas beyond their immediate purview and specific to the "business of the business." Good management accountants need to be good business people who truly understand the company's economics and underlying operations. New contractual arrangements should be fully vetted and the appropriate training put in place well before those arrangements are consummated. Leaving the management accountants and financial managers out of new business arrangements has led to some disastrous and costly restatements that more up-front communication and education could have avoided. Accounting must be kept informed and "up" on deals and their structure. In the lightning-fast domain of business development and marketing, accounting is often brought into the process too late and must play catch-up.

Even more than conventional training, accounting needs to be more closely linked and aligned with the business process before deals are signed. Consider what happens when management accountants aren't involved. In one recent high-profile case, a large financial services company established a separate entity specifically to bonus a subset of executives in part due to confidentiality issues that naturally arise from such compensation packages. The accounting department might not have fully understood the nature of the legal entity and, therefore, couldn't properly capture and reflect appropriate and accurate financial information. The result? A bruising restatement and the unseating of long-time executives.

Systems that Keep Up

Accounting and financial systems are evolutionary by definition and have to keep up with evolving technologies and accounting rules and with company-specific business changes such as the introduction of new products and business lines. Many companies don't routinely conduct regression testing to understand the impact of these changes. Algorithms can change, resulting in inaccurate numbers, so it's mandatory to continuously regression test against newly integrated information.

Well-Defined (and Implemented) Policies

Reams of paper and terabytes of data have been used to document policies in the Sarbanes-Oxley world. Companies that adopt tools and processes to keep their policies current and their operational procedures in line with those policies stand a better chance of avoiding accounting errors. Legacy and evolving document management tools are being integrated quickly by companies who recognize the dangers of policy or process creep—where the actual world may no longer resemble management intention.

Companies need to look at their policy development as a risk-management effort that spans multiple areas of risk, e.g., regulatory and financial. Viewing risk and policy at the enterprise level uncovers commonalities and can set the stage for more efficient end-to-end processes, testing, and compliance.

Creating an Open Culture that Doesn't "Roll Over"

But all of the training, systems, and business-process alignment in the world can be defeated if a handful of executives or even a single individual decides to work around the rules. That means it's critical to create an environment where accounting is able to question everything and raise red flags and where they have high levels of comfort in what they're being asked to do. They need to be able to object and have open discussions about complex issues.

Unfortunately, restatements aren't new, and no amount of reengineering of the internal controls around financial reporting will assure us that they're a thing of the past. The good news is that the symptoms leading to restatements are visible if you choose to look for them. Preventative medicine and "well company" care are attainable. Training, well-defined policies, good documentation, optimized systems and processes with a clear segregation of duties, and a tone from the top regarding the culture of internal controls are critical to the framework of risk awareness and management. With all these initiatives in place, as well as the cultural mind-set regarding internal controls, a company can minimize the need for restatement extreme makeovers. ■

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