EASING THE PAIN DURING Financial Restatements

THESE SEVEN LESSONS CAN HELP

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In the September issue of *Strategic Finance*, my coauthor and I likened the rash of restatement activity to an extreme makeover reality show. We identified poor internal controls, manual processes, and the growing complexity of accounting and business environments as the usual precursors of restatement difficulties. Further, we highlighted training, policy development, and a well-communicated "tone at the top" as fundamental necessities to mitigate the possibility and ramifications of financial restatements.

Now I'd like to focus on some lessons that large and small companies facing significant to minor restatement issues have learned. When the Securities & Exchange Commission (SEC), other regulatory bodies, your board of directors, shareholders, and employees are pressing your company to take immediate and effective action, you can look at the following areas for some helpful guidelines.

LESSON 1:
Understand the Restatement Scope

Clarifying scope on a long list of accounting areas to be restated can be a daunting and time-consuming task. Defining the underlying accounting issues and remediation efforts will spawn policy, procedure, systems development, and human capital initiatives. Entire teams and departments emerge within companies that are restating their earnings whose sole purpose is to manage modifications to and communications around scope, roles and responsibilities, deliverables, and timelines.

Choose your cliché. The initial identification of the problem can be the "tip of the iceberg" or "peeling back the onion." Relatively straightforward situations caused by unintended human error can end up identifying myriad internal control issues. On the other end of the spectrum, complex accounting treatment changes rarely exist in simple silos of process and data. Consider the recent restatement experiences of leading secondary mortgage market providers, and note the interconnection of at least seven major accounting pronouncements from the Financial Accounting Standards Board (FASB): Statements of Financial Accounting Standards (SFAS) Nos. 91, 115, 46, 133, and 140; FASB Interpretation (Fin) 46; and Emerging Issues Task Force (EITF) Issue No. 99-20. Without going into the details of derivative accounting, hedge accounting, accounting for fees and expenses, credit ratings, or qualified special purpose entities (QSPEs), which are the subject of these particular standards, suffice it to say that nearly all are interconnected. The subject matter of policies, systems, and processes is linked by the nature of the business. Finding logical start and end points for the scope of work to be undertaken can be nearly impossible when almost nothing is discretely segregated.

A well-tested approach to scope determination starts with the logical grouping of issues at a macro level. Successful scoping efforts, however, must get to a list of action items well below the macro view. Revenue recognition, for instance, may be the macro area of concern, but the action area is revenue recognition at the product or segment level or perhaps even lower. In summary, scope your restatement project at a level that's specific enough to minimize broad, sweeping generalizations that clutter the discussion and decision process. Get very specific about the work you have to do. Start at a macro level ("I need to restate revenues"), and then get to an action level ("The problem with revenues is at the product level, and I need to fix product revenue recognition").

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LESSON 2:
Get the Right People Involved

Firms facing major restatement efforts need to have a realistic assessment of their full-time employees' ability to manage the extra workload demanded by the restatement. Sometimes the underlying cause of the restatement will be a clear indication of the need to swap out or supplement firm resources. For instance, is the accounting policy group deep and broad enough to be effective in their efforts to analyze complex GAAP guidelines and define new policies that are consistent with GAAP? Can the current accounting staff juggle their daily activities along with the question-and-answer barrage that will occur? Do the IT people have enough bandwidth and specific skills to recreate years of transaction-level data in a usable form? Consider the disruption that can be caused by annual audits, and multiply it by a factor that approximates the complexity of the restatement issues to get a sense of the demand that will be placed on your resources.

Once you've defined your resource gaps, you'll need to determine how many outside sources you can gracefully accommodate and how you can best use them. It's important to take the time to extensively plan your resource requirements and get your "game face" on before you reach out for help. Your bad fortune presents a very profitable Y2K-like opportunity for your auditors, policy advisors, process reengineering and systems consultants, and staff augmentation teams. You'll probably need each of these groups in various degrees depending on the depth of your restatement problems.

Your auditors will be actively involved in reviewing the methodology you've used to determine the restated financials before they *reaudit* the affected year(s). Because of the increased requirement for auditor independence, you can no longer go to your external auditors for policy advice. With changes in policy, you'll probably have changes to processes and systems that are used operationally to support policy. Consultancies with process and system reengineering acumen can help you determine the most efficient and effective changes to make—with the ultimate goal of supporting new policy. And, finally, your employees may need backup in their normal activities in order to carve out time to solve the restatement problems. Team members from staff augmentation sources act as additional "arms and legs" to keep the normal routine of the accounting and finance functions working effectively.

The clearer your requirements, and the more you understand the competitive marketplace for those resources, the better positioned you'll be to negotiate with your suppliers in good faith. If you react desperately, you may lose any negotiation power you have. On the other hand, don't let cost be your only benchmark. Choose good, solid partners in each of the categories of support just mentioned, and be willing to pay them fairly for their work on your behalf. You need them if you can't complete all the work that needs to be done.

Beyond consulting resources, companies need to identify the key working relationships with their board of directors, auditors, regulators, internal auditors, and the investment community. You may even be forced to deal with new auditors if your board fires the previous team as a result of the restatement. Each of these groups has a stake in the process and agendas that need to be well understood and addressed. The board of directors wants to make sure you have a solid plan that will bring the company through restatement in a cost efficient and timely way. Auditors need to be convinced that your restatement methodology is reliable and that the new financials accurately reflect the financial condition of the company through the restated time periods. Auditors who have given clean opinions that are later determined to be invalid can literally have their own futures at stake (recall Andersen and Enron!). Your regulators need to be assured that you are fulfilling the mission of your organization, which includes fiscal responsibility and accurate representation of your financials. The work of the internal auditors can expand exponentially to auditing new processes, working with new policies, and using new systems. Finally, while the investment community has some tolerance for error, you really need to get your restatement right the first time. Continual restatement of previously restated financials, especially involving the same types of transactions, is a clear message to all that a company hasn't solved its problems and may not know how to solve them.

Restatements tend to be a lot about the numbers. Ignoring the complexities of identifying and working with the right people can be a costly and painful mistake. Each stakeholder must have a varying level of buy-in to your restatement approach and the outcomes of your efforts. Uncomfortable auditors delay opinions, which precludes the timely publishing of new financials, which may affect your ability to stay listed with the SEC. Uncomfortable regulators can demand changes to your operations or may impose additional oversight if they feel your company can't manage through the restatement. Boards of directors may make wholesale changes to management if they aren't certain current management can or is working through the restatement effectively. And, finally, "The Street" will lose confidence in the company, which means a resultant decrease in stock price, if the restatement effort isn't managed toward a reasonable closure.

LESSON 3: Communicate Appropriately

Restatements are public events that, depending on their size and complexity, get lots of regional and national coverage in the popular press as well as business news outlets. Financial reports, including 8-Ks and the 10s, are available for public consumption and should clearly disclose the nature and extent of any restatement activity. We've found that honesty about the situation and appropriately open communication to affected parties about the restatement plan are critical to establishing scope and buy-in to the effort.

As I said earlier, each party to a restatement will have a different view of the problem and most likely a very different solution. While some have your company's best interests in mind, others may take a more cynical approach to your situation, hoping for missteps and inconsistencies in your communication that can be made into big news. We advise our clients to have designated points of contact for each party and an oversight function that helps to ensure that a fair and accurate message is consistently provided—at the right level of detail—to the right people. For instance, your auditors should see only clean, restated data that has been fully vetted against new, approved policy. Avoid the tendency toward piecemeal information that may prove to be incorrect later when seen in a larger context. In defining the scope of your restatement, you should have determined the multiple touch points of various accounting guidelines. Make sure that your submissions to your auditors have been reviewed against those touch points to ensure that you are being consistent across them.

We caution our clients not to overcommit to remediation and reporting time frames that may be unattainable. Bad news, like dead fish, only smells worse with age. Come clean with as much as you know, and set the course for improvement as soon as possible.

Finally, keep good records of your communications with each party. Know what and when you've communicated, and keep the backup that substantiates your communication.

LESSON 4: Develop an Integrated Plan

Knowing your scope and the team you'll work with, you're now prepared to develop an integrated plan. We leverage our project planning methodology when assisting our clients. The phases involved include:

- Current-state analysis,
- Future design and gap analysis,
- Remediation plan approval,
- Implementation, and
- Monitoring.

In the Sarbanes-Oxley world, most companies have extensive current-state process documentation around their financial reporting processes. (Indeed, it may have been the SOX effort that identified the need to restate!) Leverage the available documentation for training or as a baseline for future design efforts. Further, realize that you're going to be dealing with policy, processes, people, and technology and probably at least three forms of them: pre-, during, and post-restatement. Be realistic about what you can take on and in what time frame. Companies often have to change previously prioritized initiatives to accommodate the restatement workload. In some cases, previously planned IT investments need to be scrapped and rescoped to meet the new business requirements. A deep and honest assessment of your current state and the roadblocks that may prevent you from moving toward the future will guide you toward a well-integrated plan.

Don't underestimate the time that will be required to gain approval for your remediation plan. While management owns and is responsible for the approved remediation plan, all stakeholders will be concerned that the planned improvements are well designed and attainable. Auditors, particularly, will be very demanding regarding their review of accounting adjustments and management responses. Accounting standards are rarely presented as black-and-white pronouncements, so stakeholders can have varying opinions regarding their implementation. Leading policy advisors may see issues differently, so you'll need time to understand their viewpoints and choose the one that results in the most appropriate reflection of your financial condition. Further, policies can be subject to review based on new information that comes to light. Perhaps a specific transaction wasn't fully considered during policy formation, and it may have changed the direction you took. In short, making policy work at the operational level can uncover unknowns. Each of these revelations takes time and money to fix and may require the original plan to be reapproved.

There may actually be a collective sigh of relief when implementation plans begin to take shape and move forward. There will probably be rolling starts to implementations of new policies, processes, and technology. At this point, more levels of the organization are going to be involved in making cross-functional project management and change management big priorities. Don't short-change documentation, training, and user acceptance testing. The best implementation efforts can be undermined by the urge to make new functionality available before its time.

Finally, plan for a robust monitoring process after your go-live dates. Identify critical success factors, and develop metrics around those factors that can be tested and reevaluated. If the intention was to minimize the number of nonstandard or manual journal entries, find out if you've been successful. If not, why not? Did a policy or process change during implementation and not get incorporated? Or, more simply, does the new functionality not serve the original design? The dynamics of a company undergoing restatement naturally cause a lot of moving parts. Post-implementation monitoring is a good test of your success in managing the fluidity of the environment.

LESSON 5: Smooth, Successful Restatements Require Appropriate Technology

Document management processes and systems can be expensive but necessary tools to keep the restatement effort clear and consistent. We've seen everything from overworked Excel spreadsheets, to Lotus Notes implementations, to full-blown document management installations. If their restatement is extensive and likely to take many years of remediation, we encourage our clients to consider ways to combine their document management needs with their Sarbanes-Oxley maintenance and compliance needs. SOX tools can be particularly effective if major overhauls to the financial accounting and reporting processes are undertaken.

If you'll be working with extensive data requirements, consider technology beyond Excel and Access. Tools that have self-documenting aspects and create activity logs can be used to substantiate the methodology you are using to select and analyze data. Enterprise-wide project management and change management tools also may be useful. They aren't implemented without time and cost consideration, but they may pay for themselves by giving you better coordination and communication.

LESSON 6: Be Creative about Cost Management

Restatements can be costly. Attorneys, auditors, consultants, and staff augmentation teams add easily identifiable expenses to the bottom line. The opportunity cost of moving full-time employees around to support the restatements can't be overlooked either. Here are a few tips that may help you manage costs.

Understand your resource requirements and the blend of high-cost expertise vs. "arms and legs" that you'll need. Acknowledging that there may be a significant amount of document copying that will be required, we've seen clients set up restatement copying centers that make use of high-volume copiers and lower-cost staff. This centralization can keep your higher-cost consultants away from the hallway copiers and focused on doing the analysis work for which you're paying a premium.

Also understand the sources that are available to fill your needs and the business model for each. If you need specific expertise, test the vendor's ability to bring it to you in the time frame needed. Companies with tens of thousands of employees (like the Big 4 public accounting firms) may have name recognition for you but in reality may not be able to bring any more people to meet your specific needs than a smaller or less-well-known regional or boutique firm. The smaller firms may have more local resources and more seasoned resources at more competitive prices than the national firms.

Finally, reevaluate previously existing priorities. Determine which ones can be delayed, which are now obsolete, and which can be critical to your successful survival through restatement. For instance, you may have anticipated the implementation of a new budgeting platform in the current year, but this now becomes a lower priority than the work required for your restatement.

LESSON 7: Pace Yourself

While some restatements can be done easily and quickly, many require long months of evaluation, planning, and remediation under the watchful eyes of many different constituencies. Several of our clients have referred to their restatement effort as a marathon rather than a sprint. We think this is an appropriate analogy. From the beginning, the tone from the top must honestly communicate the issues and the remediation approach. Plan to celebrate small successes, and reward those who finish with you in spite of long and frustrating workload demands.

There have been notable instances in which a company wasn't able to gracefully execute its restatement. Bankruptcy, SEC delisting, or sale of the company need not be your fate. An honest appraisal of your situation, a commitment to a well-scoped remediation plan, and the use of appropriate resources and technology form the foundation for success. ■

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