Insights: The Corporate & Securities Law Advisor - Goodman, Surviving a Restatement, (Apr. 30, 2012)

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After comparing restatements of financial statements in 1987 to those of today, the authors provide an overview of the restatement process and discuss the players, processes, and legal and accounting guidance and implications associated with a restatement.

SECURITES DISCLOSURE

To paraphrase Star Wars, a long time ago in a financial reporting environment far, far away, restatements were rare and remembered. Why? Not just because they were few and far between or made headlines, but also because the executives involved frequently lost their jobs and failed to find comparable positions elsewhere. Restatements meant a drop in the company's stock price and a tarnished reputation. Perhaps most importantly, however, restatements, whether or not they reflected fraud or other misconduct, were viewed as exceptional events, not indicative of the moral fabric of corporate America and not reflective of accepted business practices. Another difference between then and now is that the entire restatement process—from filing amendments to periodic reports, to conducting investigations and settling litigation—used to be completed relatively quickly. That is rarely the case today.

Today, there are hundreds of restatements filed every year. [1] Generally accepted accounting and auditing principles (GAAP and GAAS) are arguably more complex and call much more frequently for the exercise of personal judgment. That increased reliance on personal judgment has led inevitably to persistent second-guessing of those decisions. Some see GAAP's endorsement of "fair-value" accounting as a reason for the increased complexity. While some had hoped that fair-value would eventually disappear, that is not what has happened. To the contrary, the use of fair-value accounting has spread throughout the financial standards system, both domestically and internationally, and has made adoption of judgment-based GAAP all the more complex. Others attribute GAAP's complexity to the development of sophisticated financial instruments, such as derivatives, and a stunning increase in the complexity of transactions, from acquisitions to leases.

All of this, coupled with increasing corporate and securities litigation, has resulted in a greater number of errors and a variety of new reasons for them. Moreover, narrative disclosure in financial statement footnotes as well as elsewhere in an SEC filing have resulted in more fodder for litigation. The time, effort and expense required to restate financial statements has increased, as has the time and expense needed to settle litigation for a "stock drop" case—not to mention the added cost of D & O insurance coverage.

In addition, technology has changed the way we communicate. The speed and ubiquity of the Internet has exacerbated the problem of potential leaks and premature disclosure, while social media has served to accelerate speculation and rumors regarding the why, who, when, what, and how of a restatement. All of this places intense pressure on a company to disclose, sometimes before much is really known. Today, strategic communications and public relations specialists are standard members of the "crisis management team," which previously only consisted of management, the board of directors, accountants, auditors, and counsel.

The last several decades also have seen significant changes in the way companies approach and structure financial reporting. Although the Foreign Corrupt Practices Act requiring companies to adopt internal controls became law in 1977, it was only with the enactment of the Sarbanes-Oxley Act (SOX) in 2002 that internal control over financial reporting became a reality for all publicly reporting companies in the United States. In 1977, management hired outside auditors who were subject to peer review and supervised by the Public

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Oversight Board (POB), a national self-regulatory organization. One Big 8 firm would review the audits of another Big 8 firm.

Under SOX, accounting firms are retained by and report to the audit committee of the board of directors. SOX also mandates that securities exchanges impose strict audit committee independence requirements as a condition of listing on those markets. The POB has been replaced with the Public Company Accounting Oversight Board (PCAOB), which is under the control of the SEC. [2] PCAOB inspectors provide reports that can become the subject of enforcement actions against the firm and against individual auditors at those firms. Some accounting firms, like the Big 4, are inspected annually. All of these changes have resulted in greater auditor independence, enhanced audit committee independence requirements, more checks and balances among the various actors and, predictably, increased conservatism. As a consequence, management may no longer be in control of various aspects associated with financial reporting oversight, restatements included.

Along with an increase in the complexity of reporting, financial-related litigation also has become more complex. Document retention used to mean accumulating boxes of papers. Today, it also means gathering emails, thousands of which can be stored on disks and thumb drives. While a Department of Justice (DOJ) investigation of an accounting scandal used to be a truly rare and exceptional event, today Assistant U.S. Attorneys know the federal securities laws and routinely bring criminal cases in tandem with civil cases brought by the SEC's Division of Enforcement. [3]

It would be easy to conclude that things are indeed different in today's world of restatements than they were back in the 1980s. Despite those differences, many aspects of the restatement process have stayed the same, including the issues that demand counsel's attention. Now, as always, restatements involving material errors can be one of the more traumatic events in the life of a public company. The disclosure of errors often strains investor relations, raises credibility concerns, can precipitate a law suit, and attract the attention of securities regulators. Adding to these concerns is the complexity and degree of subjectivity that surround management's determination of whether a restatement is actually required, the expense and time necessary to make the restatement assessment, and the potential inability to file future SEC reports until the error is corrected, potentially implicating noncompliance with the listing standards of the exchange in which the company's stock is traded.

Preliminary Considerations

Errors can be brought to the attention of senior management through a variety of channels, including the company's own financial and/or internal control function, the SEC review process, a whistleblower complaint, or the company's independent accounting firm. Errors also can be brought to the public's attention by means of competitors' statements and analyst reports published on behalf of investment bankers or sponsored by short sellers. Once a potential error is raised, the first step is to determine whether it is, or is not, an error. If it is an error, it becomes necessary to determine whether the error is material, who needs to be informed, [4] and which steps should be taken next.

The exact choreography of the process, and its participants, will vary depending upon the type and severity of the error, the company's disclosure controls and internal reporting infrastructure, and whether misconduct or intentionality—particularly involving senior management—is alleged. Ensuring that senior financial management, the company's CEO, the chair of the audit committee, their respective counsel and the company's auditors agree on the steps in the process is critical to the timely and effective resolution of the error. The failure to align these groups [5] on a timeline and process creates the risk of triggering a disclosure requirement prematurely, missing a filing deadline, performing unnecessary work, and impairing credibility among and between senior financial management, the board of directors, and the company's outside auditors.

Close the Trading Window

Unless the error is clearly immaterial, concurrently with its discovery, the company's insider trading window —if open—should be closed. Put another way, if the error is material or materiality is uncertain, those who

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have been notified should not trade. To avoid having to later establish which members of management knew what and when they knew it, it may be advisable to close the trading window to everyone subject to the company's trading window and blackout policies, whether or not they are aware of the error. Caution must be exercised when closing the window to avoid signaling the information prematurely or precipitating a leak, which can accelerate a disclosure obligation. A restatement creates the risk of a securities and/or fiduciary duty lawsuit, as well as the potential for a government or SRO investigation. Trading in advance of the announcement of a restatement by company insiders exacerbates this risk, increases overall settlement costs, and attracts regulatory enforcement interest. The window should remain closed until disclosure of the error and its implications is made public, or until a determination has been made that the error is clearly immaterial.

Consider Other Disclosure Obligations

Consideration also should be given as early as possible and then on an ongoing basis to the company's general disclosure obligations under the federal securities laws, including the impact and timing on the company's periodic reporting obligations and all planned or in-progress marketing communications activity. Counsel will need to assess whether and when information becomes material and, if so, at what point a duty to disclose arises. [6] For example, until the error is characterized and disclosed, management and securities counsel likely will need to suspend share repurchases, offerings in process, and the issuance of press releases which, depending on the context and content, could prematurely trigger a duty to disclose the error.

Consider Implementing Document Retention Procedures

Whether and when to take steps to preserve key documents related to the error will depend on the circumstances. There are certain events—an audit committee investigation, for example—that should always trigger document retention procedures. Likewise, once an error is deemed material, a company should begin preserving related documents. However, in certain situations it might be premature to retain documents before a materiality determination has been made. For instance, errors due to clerical or bookkeeping mistakes, a misinterpretation of accounting literature, or changes in accounting methodologies are not usually the type of errors that result from wrongful acts. On the other hand, where an error's potential irregularity status is less clear, implementing document retention procedures early in the process can be a good idea. When faced with such a situation, companies that regularly delete their data on a rotating basis also should take steps to preserve that data until the nature and scope of the error is determined. For example, if a company deletes its data every four months and an error is discovered toward the end of that four-month period, a significant risk exists that important documents, such as key emails, will be lost before the company has a chance to figure out what went wrong.

Designing the Process

It is critical that the company design and achieve working group consensus among management, the audit committee, outside auditors, securities counsel and the board of directors with respect to the process that will be followed, [7] the proposed steps in the process, and the estimated timing and work effort to be undertaken. At the center of this planning effort is the need to establish a game plan for: learning the scope and nature of the error; conducting the materiality analysis; and deciding who should determine whether previously filed financial statements can continue to be relied upon, and how that determination should be made. Ideally, the audit committee should review and approve the process including confirming by resolution which person or group is empowered to make the non-reliance decision. Restatements are a process. You have a choice: you can manage the process or it can manage you. Approach it like any other project with a beginning, middle, and end. Using a classic project management process enables supervisors and team members to keep track of schedules and progress as well as to promptly identify issues that need to be resolved.

The determination of non-reliance on financial statements will trigger the requirement to file an Item 4.02 Form 8-K report within four business days of the determination. [8] While management or other members of

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the working group may guide and inform the non-reliance decision, in many cases, the non-reliance decision will be made by the audit committee itself. A word of caution here: while setting up the correct process can enable a company to gain some control and predictability over the process and its timing, the process should not be used to delay a non-reliance determination which, in fact, has essentially been made or is obvious.

Retaining Independent Advisors

While the initial review of the facts and circumstances relating to the error is handled by management with the assistance of in-house counsel and possibly regular outside counsel, there typically comes a point when a decision has to be made as to whether the audit committee should retain independent advisors to conduct or supervise the review or investigation under its supervision. Making this determination can be complex. The analysis involves consideration of facts and optics in a situation where perception can be reality. These include: the personalities and how people are able or are not able to work together under pressure for a sustained period of time; compliance with fiduciary duties under state law as well as personal liability concerns; and weighing all the factors against the heightened credibility that selecting independent counsel brings from the perspective of regulators, judges, the media, shareholders, and the investing public.

For example, not every error merits the cost, complexity and delay an investigation by independent counsel might entail. The company's audit committee should make this determination, and the outside auditor, at the outset, should concur with the process and the parties conducting the investigation. The determination should be made after considering a variety of factors, including:

- How the error was identified. Did management or an outside auditor find it, or did an outside party such as a whistleblower bring it to the company's attention?
- Where the error is located—at headquarters or a distant subsidiary;
- Whether any fraud or misconduct is involved or can be alleged;
- Whether the persons known to be involved are managers, senior managers, or third parties with limited or no ties to the company;
- If managers are involved, whether they received performance-based compensation and if so, how and when they received it and who was involved in the process of awarding it;
- How the error affected earnings and whether, if the company provided earnings guidance, it would have met its earnings target if the error had not occurred; and
- What experience regular outside counsel has with accounting issues and investigations of this kind in general, restatements in particular, and securities law litigation.

Early consideration also should be given to retaining an independent forensic accounting firm experienced in all aspects of restatements. Too often, in-house accountants, who are good at their jobs, lack experience in restatements and view the task of reviewing restatement issues as a burden. Inexperience and increased workloads often lead to missed issues and, ultimately, delays. In addition to bringing critical experience to bear, an independent forensic accounting firm will provide added comfort to board members and regulators in situations where financial management would otherwise be reviewing and critiquing its own work product and judgment calls.

The Materiality Determination

Once the various actors have agreed to a process, the working group can proceed with gathering the facts and making the materiality determination. While this determination might be apparent at the beginning of the process, when facts need to be ascertained it may not be clear until the investigation or review is substantially completed. The determination of materiality will affect the mode of correcting the error and the likely timing of that process. Often, the first step in the materiality determination is an assessment in light of Staff Accounting Bulletin No. 99. SAB 99 provides guidance in applying materiality thresholds to the preparation of financial statements filed with the SEC, including assessing the materiality of errors in previously filed reports. One of SAB 99's principal purposes was to dispel the notion that it is appropriate to rely exclusively on quantitative benchmarks in determining materiality.

Simply put, SAB 99 aligns accounting determinations with existing case law requiring analysis under the "reasonable investor" test. SAB 99 asserts that the formulation endorsed in accounting literature is "in

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substance identical to the formulation used by the courts in interpreting the federal securities law."[9] The relevant inquiry is whether there is a substantial likelihood that a reasonable investor would [10] consider the fact, in this case, the error, as having significantly altered the total mix of information. [11] SAB 99 provides that in assessing materiality, a logical starting point is application of a quantitative test, but SAB 99 also provides a list of qualitative considerations that might render quantitatively small misstatements material, including the following:

- Whether the misstatement masks a change in earnings or other trends;
- Whether the misstatement hides a failure to meet analysts' consensus expectations re the enterprise;
- Whether the misstatement changed the loss to a gain, or vice versa;
- Whether the misstatement affects registrant's compliance with regulatory requirements, loan covenants or other contractual requirements;
- Whether the misstatement has the effect of increasing management's compensation, such as satisfying thresholds for a bonus; and
- Whether the misstatement involves concealment of an unlawful transaction.

SAB 99 is silent on whether and when a quantitatively large error might not be material; however, commentators and the SEC Staff have discussed such situations. [12] Nevertheless, when an error is quantitatively large, there will likely be a tendency to presume that it is material. Moreover, unlike quantitatively small errors, SAB 99 does not provide qualitative factors probative of whether a large error may or may not be immaterial.

A critical step in the process of assessing materiality is management's preparation of a "SAB 99 memo," which documents the company's quantitative and qualitative analysis using SAB 99 and other relevant factors—especially when the item is determined to be immaterial. [13] SAB 99 should be used as a "guide" rather than a "checklist," and not all SAB 99 factors are relevant in every situation. Once the SAB 99 Memo has been completed and management's preliminary determination regarding materiality has been made, management typically will meet with the audit committee, outside auditors, and securities counsel to achieve consensus on both the analysis and the resulting conclusion. Keep in mind that it is possible the SEC and other outsiders may want to walk through that determination and confirm its reasonableness from their perspective. The SAB 99 memo is extremely useful in responding to such external inquiries.

The national office of your outside accounting firm should be involved early, especially if the restatement involves the making of any judgment calls regarding complex aspects of GAAP. In certain situations, it may be appropriate to consult the Staff of the SEC's Office of the Chief Accountant and/or the Office of Chief Accountant of the SEC's Division of Corporation Finance, particularly where difficult or controversial accounting issues are involved. [14]

Disclosure Considerations

The timing of public disclosure will vary depending upon a variety of factors, some of which may not be in the company's control. For example, in the unfortunate circumstance where the error is discovered days prior to a required SEC filing, the company may find itself in a situation where it must disclose aspects of what was uncovered and file a notice of its inability to timely file the required report on Form 12b-25. In other situations, the company may have more time to determine the impact of the error. To the extent possible, employ the Goldilocks Rule of Disclosure: not too early, not too late—time your disclosure just right. This means it is important to go through an analysis before putting out the first press release concerning the restatement. Time is of the essence, so do not delay disclosure unless necessary. Bad news ages poorly, and delayed disclosure of negative information increases the risk of a securities lawsuit and enforcement interest. Do not announce an intent to restate unless a decision has been made to do so. [15] On the other hand, try to get your arms around "the why" as well as "the what" before issuing a release.

When you do issue a press release, make sure it contains complete and accurate disclosure. [16] Since the market reacts negatively to uncertainty, try to anticipate questions and answer them. While people will press

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for an indication of what the restated numbers will be, do not disclose the numbers or ranges of numbers on a restated basis unless the company (and its outside auditors) have a high degree of confidence that the numbers represent the best current estimate of what the restatement will look like. When in doubt, leave that information out. Do not promise anything in the press release about the restatement, especially a completion date. Think about the effect of a restatement on guidance. Do not provide or reaffirm guidance in a press release unless you are confident it can be met. Regardless of the numbers and estimates the press release recites, to receive the benefit of Section 27A of the Securities Act of 1933 and Section 21E of the Exchange Act, the safe harbor language for forward-looking statements contained in the press release should use customized, meaningful, and cautionary language.

If the company is going to host a conference call, make sure to anticipate the questions that will be asked and which of those to defer due to the preliminary stage of the restatement process. Consider how best to answer tough questions that may have unfavorable answers, such as: "Is there fraud?""Is anyone being terminated?""Is there a disagreement with your auditor?""Is the SEC conducting an investigation?" and, "Have you called the SEC?"

Expect the Staff to promptly review your Item 4.02 Form 8-K and the SROs to request disclosure of the date when the company will issue restated numbers. Try not to provide such information until the company is highly confident as to the completion date.

In making public disclosure, remember your audience. It is important to balance the interests of investors, customers, suppliers, employees, joint venture partners, and regulators ranging from the SEC through the SROs with the requirements of Regulation FD, Rule 10b-5, Regulation G and Item 10 of Regulation S-K, non-GAAP financial measures, SAB 99, and the duty to update. If Q&As will be circulated to employees, in order to avoid inadvertent Regulation FD violations, make sure those Q&As do not contain material facts absent from the press release.

As noted earlier, one of the many potential unfortunate ramifications of the discovery of an error is the inability to file periodic reports until the nature, amount and effect of the error is understood. If the press release also relates to the late filing of a periodic report, coordinate your disclosure with Forms 8-K and 12b-25.

In the past, if a restatement took a protracted period to complete, a company would "go dark,"*i.e.*, not file periodic reports or make any ongoing disclosure between the initial disclosure and the filing of restated financial statements. This practice changed with the restatements for options backdating in the mid-2000s, which often involved 10-year restatements and took a prolonged period to complete. Form 12b-25 became the disclosure form of choice. [17] Instead of serving as a bare-bones form providing a minimum of required information, Form 12b-25 became the core for the initial press release as well as the vehicle for companies to provide current business information, other than financial statements, during the restatement process.

The Mode of Correction—To Restate or Correct?

Materiality is the principal driver in the determination of whether to restate or correct errors within the financial statements. If the errors are determined to be material and the Item 4.02 Form 8-K stated that previous periods' financial statements should not be relied on, a full restatement with amended filings may be required. If the errors are not material to previously reported financial statements, then the previously issued financial statements are not considered to be materially misstated.

When a determination has been made that the previously issued financial statements are not materially misstated, errors should be corrected prospectively. [18] This prospective correction can be accomplished using one of two methods. An "out of period" adjustment is appropriate if the correction would not result in a material misstatement of the estimated income/loss for the year in which the adjustments are made or to the trend in earnings. [19] However, if the errors cannot be corrected as an out-of-period adjustment, then they must be corrected through a revision of the previously issued financial statements the next time they are filed (such as for comparative purposes in a Form 10-Q). The revised financial statement also should include clear disclosure regarding the nature and amount of the errors being corrected and how they affect relevant periods, including, if applicable, subsequent filings.

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We do not recommend leaving even immaterial errors uncorrected, as correcting the error eliminates the risk that it will later become material due to a change in circumstances. It also reduces potential liability should plaintiffs' lawyers or regulators disagree with the materiality conclusion.

What if the error is material and requires restatement of more than one prior annual period? Historically, a restatement rippled through every periodic report containing financial statements requiring revision. Thus, restating five years of financial statements resulted in amending five Form 10-Ks and 15 Form 10-Qs. Starting in the early 2000s, companies reflected multiple periodic restatements in a Jumbo Form 10-K, which contained all restated fiscal years and the eight most recent fiscal quarters in accordance with Item 10 of Regulation S-X and a robust MD&A. Jumbo 10-Ks became standard operating procedure when options backdating resulted in some restatements spanning 10 years. A Jumbo Form 10-K is preferable to filing multiple amended periodic reports. Today, the practice preferred by the Staff of the Office of Chief Accountant of the Division of Corporation Finance is to submit a waiver request to be able to file a Jumbo Form 10-K. [20] A waiver letter can avoid Staff comment on the amendment process after the restatement.

Additional Business and Legal Considerations

The inability to deliver financial statements in a timely manner can result in a number of unintended consequences.

Third-party contracts. Third-party contracts often contain requirements regarding the timely delivery of financial statements and/or payment obligations that are based upon financial statements included in SEC filings. For example, license and royalty payments that base compensation on audited financial statements could be viewed as in arrears, resulting in breach of contract claims. Consideration should be given to the affected contracts, and a strategy designed for mitigating the associated risk.

Rating agencies. An announced restatement resulting in lower revenue and earnings could produce a downgrade in a credit rating, resulting in a higher cost of capital as investors demand higher interest rates, which in turn could impact the company's expenses and costs of doing business. Consider the impact of a possible restatement on the company's credit ratings.

Indenture default. Indentures may contain provisions that mandate the delivery of SEC reports. At least one state court has interpreted an indenture provision that required a company to provide copies of reports filed with the SEC within 15 days after it actually filed them with the SEC as creating an obligation to provide the indenture trustee with timely annual and quarterly reports. [21] While the case has not been followed, a restatement can cause issues to arise under the terms of an indenture.

Bank credit agreement, line of credit, and other lending arrangements. Lending arrangements, such as lines of credit, typically require the prompt delivery of financial statements as well as maintaining certain financial ratios and other financially oriented covenants. Consider the impact of a restatement on outstanding credit arrangements including the impact on liquidity from both a disclosure standpoint, such as in the MD&A, and from a business planning perspective.

Loss of WKSI status. The company's status as a well known seasoned issuer (WKSI) depends upon the timely filing of periodic reports. WKSIs receive a number of other accommodations under the federal securities laws, such as streamlined incorporation by reference and automatic effectiveness of certain registration statements that should be considered.

Rule 144 sales. Rule 144(c) requires a company to be current in its reporting requirements as a condition to shareholders selling certain restricted or control securities in reliance on the rule. As a result, financial statements that are delayed may preclude Rule 144 sales until the company regains current filer status.

Disclosure and internal controls. Companies are required to make a number of disclosures regarding both the adequacy of internal controls and disclosure controls. In the event an error is discovered, the company needs to assess, with its outside auditors, whether a particular error reveals any internal control deficiencies or disclosure control changes. For example, material errors might be perceived as material weaknesses or significant deficiencies requiring disclosure and correction. Further, such errors could impact an issuer's ability to state in its periodic reports that it has adequate disclosure controls. [22] On the other hand, a change in GAAP requiring restatement of prior periods may not affect internal controls.

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Section 211 of the Delaware General Corporation Law (DGCL). The DGCL requires a company to hold an annual meeting independent of whether it is able to distribute an annual report to shareholders pursuant to Rule 14a-3 of the Exchange Act. Shareholders could bring an action in Delaware Chancery Court to compel the company to hold a meeting. [23] Thus, Section 211 can collide with Rule 14a-3 because the company cannot distribute an annual report with current audited financial statements to solicit proxies for management's slate of directors under the SEC's proxy rules. Hedge funds and activist investors could take advantage of this weakness by commencing a proxy contest at a time the company is unable to adequately respond.

Use of registration statements. The use of registration statements that incorporate information by reference, such as a Form S-8 and Form S-3, may need to be discontinued during the pendency of an investigation for fear that such registration statements now contain material errors resulting in liability under Section 11 of the Securities Act and Rule 10b-5 under the Exchange Act for the company and potentially its officers and directors.

Employee morale. In companies where equity or equity equivalents constitute a significant percentage of compensation, employee moral may be impacted by the inability to provide equity compensation while the restatement process is being completed.

Listing requirements. The listing requirements of both Nasdaq and the New York Stock Exchange (NYSE) require companies to timely file SEC reports. Both exchanges have developed processes to deal with late filings. Staff of the exchange should be kept informed regarding the company's progress and steps being taken to resume compliance. Counsel should closely monitor timetables dealing with the delisting process, required notifications, and potential disclosure implications. Although there are differences in the manner and processes by which Nasdaq and the NYSE react to and handle companies undergoing restatements, both exchanges view restatements and the subject companies in a broader context than merely as late filers of SEC periodic reports. The exchanges will often seek additional information from the company to see that: management, the board of directors, and the audit committee are appropriately reacting; a reasonable response and process was implemented, in some cases including an independent investigation by an independent board committee that is advised by experienced professionals; and there is sufficient public information available to merit continued trading.

Shareholder litigation. The announcement of a restatement is often followed by the filing of shareholder litigation, especially where there has been a drop in the trading price of the stock or an investigation has found intentional wrongdoing by senior management. In addition, a shareholder derivative suit alleging that senior management and the board members breached their fiduciary duties may be filed.

SEC enforcement. The announcement of a restatement can result in an investigation by the SEC's Division of Enforcement. At various points during the restatement process, it is common for company counsel, the audit committee, or management to meet with the Staff to explain key facts that led to a restatement or findings made during the restatement process. Some of these investigations never move beyond the "informal" stage—especially where the restatement appears to be the product of innocent mistakes. However, the Staff of the Division of Enforcement is now empowered to issue formal orders which grant subpoena power to the Staff. After conducting an investigation, whether informal or formal, the Division of Enforcement may recommend enforcement action to the Commission.

Other regulatory consequences. A restatement can result in action on the part of other federal or state agencies that regulate the company's business. For example, depending on the facts and circumstances, these actions might include loss of licenses, debarment and penalties.

Final Thoughts

Although the steps required to analyze whether to restate will be similar regardless of the circumstances, every restatement is different. [24] Expect the restatement process to cost more and to take longer than anyone thought it would and prepare core constituencies accordingly. Factors to consider in terms of timing include: the type and number of accounting issues; the number of periods involved; and how the restatement implicates disclosure controls, internal control over financial reporting, and prior certifications under Sections 302 and 906 of SOX.

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Even if internal control over financial reporting is not an issue at the beginning of the restatement process, it can become an issue before the process is completed. The finding of control deficiencies often accompanies restatements. If internal control over financial reporting becomes an issue during the restatement process, for example in a situation where systems are incapable of providing reliable data, or where personnel are no longer available to assist in preparing restated financial statements—the restatement process may take an extended period of time and the company may not be able to estimate a completion date with accuracy.

Keep in mind that finalizing the restatement does not mean the job is finished. Among other things, it is still necessary to analyze internal control over financial reporting, draft and file amendments to periodic reports, and resolve litigation and regulatory proceedings.

Restatements are expensive. Devoting the time, effort and expense before an issue arises to making sure top management sets the right tone; fully staffing and training the accounting and auditing departments; and establishing effective disclosure controls and internal control over financial reporting can minimize the likelihood of a restatement.

Finally, remember that the biggest issue in restatements is often not a legal, accounting, auditing or even a business issue—it is psychological. It is not unusual for company personnel to experience stages of denial, blaming of others, self doubt and depression. How quickly a company passes through these stages and returns to a "can do" culture is critical to completing the restatement process. Thus, the right attitude and the proper corporate culture can go a long way toward bringing closure and avoiding having to make a restatement of a restatement. [25]

Footnotes

1 In 2010 there were 735 restatements by 635 unique filers compared to 613 restatements by 577 unique filers in 2001, the year before enactment of the Sarbanes-Oxley Act of 2002 (SOX). Since SOX became law, the number of restatements has remained higher than in 2001, reaching 1,795 restatements for 1,566 unique filers in 2006 and representing more than 10 percent of the public companies subject to the filing requirements of the Securities Exchange Act of 1934 (the Exchange Act). Audit Analytics, 2010 Financial Restatements, A Ten Year Comparison, (May, 2011) *info@auditanalytics.com* (Audit Analytics).

2 *Free Enter. Fund and Beckstead and Watts, LLP v. Pub. Co. Accounting Oversight Bd. et. al.*, 130 S. Ct. 3138, (2010).

3 In the Obama Administration's budget proposal for fiscal year 2013, DOJ was allocated $700 million for investigating and prosecuting financial crimes, an increase of $55 million from fiscal year 2012. The SEC was budgeted $1.566 billion. In the early 1980s, the entire SEC had an annual budget of $700 to $800 million.

4 The notification at this point is likely to convey only that an error has been identified, the extent to which the scope and nature of the error are known, what steps are being taken, and what steps are anticipated. It should not offer a view of materiality or the exact mode of correction. Ideally, the company's disclosure controls and procedures will address appropriate lines of communication in this situation.

5 Clawbacks under SOX and Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) have exacerbated an issue that has always complicated the restatement process: potentially divergent interests among participants. Responsibilities that might spur divergence among participants include: audit committee members' special responsibilities; certifications by the CEO and the CFO under Sections 302 and 906 of SOX; outside auditor responsibilities such as Section 10A of the Exchange Act ; the outside auditor's aversion to risk; and Part 205 for attorneys. These interests run the gamut from macro-issues, such as duties under SOX and under the Delaware General Corporation Law (DGCL) as well as self-regulatory organization (SRO) listing, to micro-issues, such as the disclosure in a Form 12b-25 and whether to file a Form 8-K pursuant to Item 4.02(a), 4.02(b), or 8.01. The more aggressive clawback provisions mandated under Dodd-Frank, when promulgated, will require forfeiture of executive officers' performance-based compensation for the prior three years, regardless of fault or misconduct, whenever that compensation was paid as a result of the error. This

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development raises the stakes even further for management teams in discussions with auditors, the audit committee, and regulators regarding whether an error is or is not material and thus requires a restatement.

6 *See* Steven E. Bochner and Samir Bukhari, *The Duty to Update and Disclosure Reform: The Impact of Regulation FD and Current Disclosure Initiatives*, 7 Stan. J.L. Bus. & Fin. 225, 227–231 (2002).

7 From a procedural standpoint, restatements fall into two categories: those that require a review or investigation—possibly conducted by independent counsel with oversight by the audit committee; and those that do not, such as a restatement resulting from discontinued operations. In determining which type of restatement a company faces, it is not enough to consider only the error's cause. Follow the red flags wherever they lead. Where warranted, be prepared to initiate an investigation or expand the scope of an investigation already underway. The company's goal is to produce accurate results that the outside auditor will accept and that will avoid the need to restate a restatement. Having to restate a restatement or redo an internal review can: have a negative effect on litigation and regulatory proceedings; cause the market to doubt the company and its management; and heighten concerns of vendors, lenders, and banks.

8 Restatements are disclosed in Item 4.02 Form 8-Ks, but are also often disclosed under Item 8.01 of Form 8-K. For restatements reported under Item 4.02, the company or the audit committee states that the financial statements can no longer be relied upon. Restatements disclosed by means of an Item 8.01 Form 8-K typically state that financial statements are being restated or revised, but do not caution against further reliance on them. Known as Little R Restatements, Stealth Restatements, or Revision Restatements, these restatements were once considered noncompliant because an Item 4.02 Form 8-K had not been filed. However, Little R Restatements have now become accepted practice. Of the 735 restatements in 2010, 362 or 49.25 percent were Revision Restatements, according to Audit Analytics. In addition, restatements are sometimes first reported when the financial statements are included in a filing—whether in an amendment to a previously filed periodic or current report, or in a new filing. Certain restatements may be required under GAAP but may not be material from a practical perspective because they do not affect stock price, current business, or future prospects. Examples of such restatements include: amortization of leasehold improvements; classification errors in cash flow statements; and goodwill impairments.

9 Codification of Accounting Standards and Procedures No. 250-10-S99-1. *See also TSC Indus. Inc. v. Northway, Inc.,*426 U.S. 438 (1976), *Basic Inc. v. Levinson,*485 U.S. 224 (1988), and *Fait v. Regions Fin. Corp.,*655 F.3d 105 (2d Cir. 2011).

10 The Supreme Court has articulated a "would" test, not a "could,""should" or "might" test. Prior to TSC, Rule 405 under the Securities Act of 1933 (Securities Act) and Rule 12b-2 under the Exchange Act used a "might" test that was consistent with the case law at that time. *See*, *e.g., Mills v. Electric Auto-Lite Co.,*396 U.S. 375, 384 (1970).

11 The total mix of information includes examining all the facts and circumstances. In *Matrixx Initiatives, Inc. v. Siracusano*, 131 S. Ct. 1309 (2011), a unanimous Supreme Court rejected using statistical significance as a bright-line test to determine materiality under Rule 10b-5 of the Exchange Act. "[A]ny approach that designates a single fact or occurrence as always determinative of an inherently fact-specific finding such as materiality must necessarily be over-inclusive or under-inclusive." 131 S. Ct. at 1318 (quoting *Basic*485 U.S. at 236).

12 Todd E. Hardiman, Assoc. Chief Accountant, Div. of Corp. Fin. U.S. Sec. and Exch. Comm'n., Speech by SEC Staff: Remarks Before the 2007 AICPA Nat'l Conference on Current SEC and PCAOB Developments, Can a Large Error be Immaterial? (Dec. 11, 2007) (transcript available at *www.sec.gov/news/speech/2007/spch121107teh.htm); see also* Scott Taub, *Avoiding Unnecessary Restatements*, Compliance Week, May 8, 2007; *see also Litwin v. The Blackstone Group, L.P.*, 634 F.3d 706, 716–18 (2d Cir. 2011) (finding investments falling below 5 percent material after considering the relevant circumstances).

13 *See* John J. Huber, *Rules of the Road in Responding to Staff Accounting Comments*, available at *http://www.fticonsulting.com/global2/media/collateral/united-states/rules-of-the-road-in-responding-to-staff-accounting-comments.pdf.*

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14 Companies also should be aware of the guidance within Staff Accounting Bulletin No. 108. SAB 108 requires companies to assess the impact of the error in the context of its impact in the current year regardless of the misstatement's year of origination (the "iron curtain" approach) and its impact on current period financials without regard to the carryover effects of prior-year misstatements (the "rollover" approach).

15 *See* Taub, *supra* note 12.

16 Beware of the tension between disclosure and a "self-fulfilling prophesy," such as disclosure that can lead the market to believe that a downgrade in credit rating or a delisting is imminent.

17 For a discussion of how important Form 12b-25 can be, *see SEC v. Spiegel, Inc.,* 2003 WL 22176223 at *27–28 (N.D. Ill. Sept. 15, 2003) (containing *Independent Examiner's Report Concerning Spiegel, Inc.* analysis regarding Spiegel's failure to satisfy Form 12b-25 's requirements).

18 *See* SAB 108 for additional guidance on considerations in making a materiality determination for previously issued financial statements. *See* Mark Mahar, Assoc. Chief Accountant, Office of the Chief Accountant, U.S. Sec. and Exch. Comm'n, Speech by SEC Staff: Remarks Before the 2008 AICPA Nat'l Conference on Current SEC and PCAOB Developments (clarifying Staff's view regarding application of SAB 108) (Dec. 8, 2008) (transcript available at *www.sec.gov/news/speech/2008/spch120808mm.htm).*

19 *See* Accounting Standards Codification 250-10-45-27 Accounting Changes and Error Corrections and SAB Topic 5F Accounting Changes not Retroactively Applied Due to Immateriality.

20 *Sample Letter Sent in Response to Inquiries Related to Filing Restated Financial Statements for Errors in Accounting for Stock Option Grants*, U.S. SEC. AND E XCH. C OMM'N, *www.sec.gov/divisions/corpfin/guidance/oilgasltr012007.htm* (last visited March 5, 2012). If multiple prior periodic reports must be amended as a result of the restatement, submit a waiver request to the Office of Chief Accountant of the Division of Corporation Finance at *dcaoletters@sec.gov.*

21 *See Bank of New York v. BearingPoint, Inc.*, 2006 WL 2670143 (N.Y. Sup. Ct. Sept. 18, 2006) (unpublished table decision). While federal courts have largely rejected *BearingPoint*'s approach, *see, e.g.*, *Affiliated Computer Servs., Inc. v. Wilmington Trust Co.*, 565 F.3d 924, 931 (5th Cir. 2009) (joining the Eighth Circuit in rejecting *BearingPoint*'s logic), the case highlights a potential risk that should be considered.

22 *See* Items 307 and 308 of Regulation S-K.

23 *Newcastle Partners, L.P. v. Vesta Ins. Grp.*, 2005 WL 576558 (Del. Ch. Nov. 16, 2005), *aff'd by Vesta Ins. Grp., Inc. v. Newcastle Partners, L.P.,* 2005 WL 3092847 (Del. Nov. 16, 2005) (unpublished table decision).

24 Similarly, the work of forensic accountants will differ with every restatement even though the process follows a familiar pattern:

- Find the records or, if the records do not exist or cannot be found, recreate the records. If the records cannot be recreated, strategize with other participants in the process, especially the outside auditor, to come up with alternative solutions. Compare the records to the general ledger and then to the reported financial statements.
- Identify discrepancies by looking for: instances; patterns; and practices that deviate from expected, normal business practices, GAAP or GAAS.
- Once identified, test against source documents and records to determine whether appropriate support exists.
- Separate the items where appropriate support exists from those with insufficient support and make the necessary adjustments.

25 Coping mechanisms include overcoming the negatives by sharing the positives— for example, by celebrating milestones in the restatement process. "Staffs often become both extremely conservative and shell shocked when a restatement is required. Part of the psychology that must be reinforced is surfacing issues promptly so they can be resolved. Bad news doesn't age well. Also, do not be critical of mistakes or false starts. The issues are typically complex and if management is not 100 percent supportive, guess what? The issue doesn't get promptly raised the next time." Roy Harris, *Say Again? An Explosion in Accounting Errors—in part reflecting the difficulties of today's complex rules*

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—has forced nearly a quarter of U.S. companies to learn the art of the restatement, *CFO.com, http://www.cfo.com/article.cfm/8885662?f=search,* at 4 (April 1, 2007).

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