



AUDIT COMMITTEE INSTITUTE

Managing a Financial Restatement

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A financial statement restatement can have significant consequences for a company, its management, directors and investors. What are the implications for the audit committee?

In recent years there has been a dramatic increase in the number of financial statement restatements, generating significant discussions as to their causes and consequences. This has been particularly evident in the United States where, in 2005, companies with US-listed securities filed 1,295 restatements, nearly double the previous year's mark¹. A similar phenomenon is occurring in Canada. Such restatements can have significant consequences for a company, its management and directors, investors and others.

In the United States a press release announcing a restatement often brings out shareholder lawsuits and causes a serious blow to the company's stock price. Such lawsuits might become more commonplace in Canada as a result of the recent enactment of Bill 198. This legislation establishes a secondary market civil liability regime which will significantly change the legal liability of reporting issuers, their directors and officers, and experts for any misrepresentation in continuous disclosure documents, such as financial statements.

One of the audit committee's principal responsibilities is to oversee the financial reporting process. So what should happen when a company discovers there may be a problem with previously reported financial statements? A restatement creates a crisis situation which must be skillfully managed.

How restatements are identified and why they arise

Restatements can result from accounting irregularities, a fraud or other malfeasance, negligence or a failure to understand an interpretation of a complex accounting standard. These can be caused for various reasons including poor documentation of transactions, the wrong choice of an accounting treatment, a lack of transparency in reporting and/or weak internal controls. Restatements affecting multiple items generally point to flawed accounting policies or practices and they are generally more problematic than those involving the correction of one-time errors.

Restatements can be identified in many different ways. Poor internal controls increase the risk that there may be financial reporting errors. The increased focus on assessing and evaluating disclosure controls and procedures and internal control over financial reporting have brought many recent restatements to light. On occasion, a restatement can occur after a change in auditors, when the new auditors find fault with past accounting treatments. A restatement can also be triggered due to issues being raised by internal audit or whistle-blower complaints or by securities regulatory or media investigations either with respect to an industry group or a particular accounting practice.

There is much speculation about the reasons why restatements are on the rise. Restatements often involve accounting issues such as revenue recognition, financial instruments, stock compensation, and leases – areas involving complex accounting standards and in some cases, requiring significant amounts of judgment in their application. However, restatements may also be caused by an effort on the part of management to manage earnings. The audit committee should be alert to certain red flags which may indicate the company is engaging in earnings management. The article *Confronting Earning Management*, in the Spring 2006 edition of *Canadian Audit Committee Update*, explores this topic in greater deal.

The audit committee has an important role to play in the prevention of earnings management. However, we do not live in a perfect world and the need to restate previously issued financial statements may arise. When a situation occurs that requires a restatement, the audit committee has a pivotal role to play. A strong audit committee will recognize the need to quickly implement a robust action plan to prevent or limit the restatement process from becoming a major corporate crisis.

Restatements often involve complex accounting issues involving a significant amount of judgment.

The restatement action plan

When a problem arises the company is responsible for finding out why errors occurred, correcting the financial statements and then communicating the restatement to all stakeholders. The audit committee's role is to oversee this process.

Ideally a restatement action plan allows the company to retain control of a difficult situation and manage it.

A restatement action plan involves a delicate balance act – balancing between getting to the root cause of the problem while avoiding embarking on a plan that is overly time consuming and excessively costly. For a company in the throes of an accounting restatement, the stakes can be high. There is a need for action. Every day and every week count. Having a detailed action plan which assesses the problem, determines realistic project milestones and establishes a comprehensive communication plan is essential – it allows the company an opportunity to retain control of a difficult situation and manage it. All constituents, the board and audit committee, management, auditors, legal counsel and external advisers should strive for a process which resolves issues, in a way that serves the best interests of all stakeholders.

Following are some of the key activities that should form part of an action plan. They are not meant to be exhaustive and the activities must be tailored to the company-specific circumstances.

Conduct an initial assessment – time is of the essence

Any allegations or concerns about the misstatement of financial results should be treated seriously and must involve the audit committee. This could not be truer than in today's environment of heightened expectations by investors, regulators and the public at large. Management needs to gather and thoroughly review all available information concerning the potential restatement. This will involve interviews of financial personnel, external auditors, and others in management positions. The extent of this initial assessment will require significant judgment, which will be guided by the complexity of the issues and the nature of the errors. The initial assessment of errors can be a time consuming process – it needs to be done expeditiously, but without undue pressure. The process must identify the full extent of the problems such that conclusions can be drawn about the severity of the issues and whether a restatement is actually necessary.

Restatements can be caused by a variety of factors including inadvertent errors, misapplication of accounting standards or fraudulent behaviour.

Through this process, a determination also needs to be made as to the cause of the restatement – was it a result of an inadvertent error, a misapplication of an accounting standard, a weakness in internal controls or is there a possibility of fraudulent behaviour? Understanding the root cause of the problem will assist the company and its audit committee in determining the need for corrective action as well as the need for further investigation and actions on the part of the board. While not all restatements require an independent investigation by forensic specialists and the formation of a special committee of the company's directors, once the need for a restatement arises, the audit committee must take the necessary steps to determine whether such an investigation is warranted. When there are indicators of possible fraudulent activity on the part of senior management, an independent investigation is usually conducted and significant remedial action is frequently necessary.

Create a task force – a team effort is needed

Once a company embarks on a restatement of its results, the number one priority should be to maintain control of the restatement process. The establishment of a team dedicated to the restatement effort, including the CEO, CFO, senior finance managers, internal legal counsel, investor relations and possibly outside securities counsel, accounting experts, forensic accountants and other advisers, helps bring balance to the process.

A multi-disciplinary team should be established at the outset to work with management, the auditors, legal counsel and outside advisers.

The task force will be responsible for the coordination of all activities which will be key to completion of the restatement. In this time of crisis there needs to be a strong working relationship between management, external auditors, legal counsel and outside advisers. Teamwork is very important and when the restatement issues are complex, reaching consensus on the issues and alternative approaches is imperative. The task force should regularly report to the audit committee regarding the process being followed in the restatement, the progress being made and what remains to be done.

The task force should be involved in all matters related to the restatement, including potential investigations by securities and other regulators, the preservation of original and restated data, the impact of the restatement and related delays on continuous disclosure filings, on debt covenant violations or on future financings, and the management of relationships with key customers and suppliers.

It is all too easy to underestimate the time it will take to complete a restatement.

Establish timelines – realistic not optimistic

Scheduling the tasks to be completed and project milestones is central to establishing realistic timelines for completion of the restatement and monitoring ongoing progress. Timelines should include the remediation of deficient internal controls and processes, so that the company can clearly demonstrate that action has been taken to help ensure the problem will not occur again. The project plan needs not only to reflect the time necessary to gather the information and determine the necessary adjustments, but also to build in time for review by others not on the task force, such as the external auditors.

Early in the project, consideration should be given to other potential restatement items, since once the books are reopened, other items may be discovered or should be considered for restatement. For example, proposed audit adjustments which had been waived in prior years should be re-evaluated. While such audit differences and errors may have been judged immaterial in the past, they may now become significant to the individual period's restated results or on a cumulative basis. Consideration should be given to correcting all these items at the same time. The audit committee should be reluctant to let any known error remain uncorrected after a restatement. The restatement process is an ideal opportunity to clear up such items.

Multiple revisions to restatement timelines can wreak havoc with the company's credibility.

It is easy to understate the time required to complete the restatement, especially the time to prepare the company's public disclosures. Auditors and securities counsel will also play a more active role in the finalization of the company's disclosures in a restatement due to the likelihood of enhanced regulatory scrutiny and the need for transparency in restatement disclosures. Gathering the necessary information to reconstruct the financial statement results can be a real challenge – especially with decentralized multinational operations and for restatements spanning a number of years and quarters. While there may be general agreement there has been a departure from generally accepted accounting principles and there is a need for a restatement, often the particular accounting errors are not obvious – frequently they involve complex accounting standards and require difficult accounting judgments and estimates. Setting realistic deadlines upfront will help to avoid multiple announcements of revisions to the timelines for the restatement. Such revisions can wreak havoc with the company's credibility as well as its share price.

The communications plan – an information balancing act

Restatements bring about a number of unique disclosure challenges. Competing interests will need to be carefully balanced. New material information needs to be disclosed quickly, yet at times it may be more appropriate to defer such disclosures until more fulsome information is available. For example, it may not be possible to quantify the impact of a restatement and the periods effected by it on the day of the announcement of the need for a restatement. However, this lack of information should not delay the announcement of the need for a restatement.

Be cautious when making an announcement about the likely outcome or completion date of the restatement. Frequently unforeseen complications arise which extend the time required to complete the restatement.

Management often want to believe they are further along in the process than they actually are. External parties such as investors and securities regulators do not like these types of surprises. A restatement usually takes longer to complete than was originally planned. There is a need to balance the requirement to provide timely information with the risk of rushing the process so much that it eventually leads to either multiple announcements into the market or, worse yet, multiple restatements because the financial information was incorrect. The most important thing is to get it right the first time!

During a restatement, there will be a number of questions that the company will need to be in a position to respond to – from analysts, investors, the media and others. Anticipating these questions should be part of the company's communications plan. Communications should deal with the nature and cause of the errors that necessitated the restatement and the company's planned corrective action. While it is important to include relevant positive information in the communications – the company's credibility can be lost quickly if the scope of restatement or time frame for completion is greater than initially communicated. Being overly optimistic can also lead to other actions by regulators. If done correctly, a communications plan will help to reduce anxiety in the investment community. A poorly executed communications plan will cause the investment community to start thinking something more serious is wrong – even if it is not.

In addition to the needs of shareholders, analysts and the media, the communications plan should also consider rating agencies, the stock exchanges (as exchange delisting procedures may be commenced as a result of the company's delay in filing its annual and interim financial statements), as well as securities regulators. Regulatory agencies may initiate enforcement actions as a result of false and misleading securities

The number one priority should be to get the restatement right – the first time!

Anticipating the answers to questions from analysts, investors, the media and regulatory agencies should be part of the communications plan.

filings and may launch their own investigation. Candid discussions with securities regulators, together with evidence of a thorough review (and possibly an independent investigation) by the company and its audit committee, may help the company avoid the often painful process of a formal investigation by the regulators, or at least minimize the impact if such an investigation becomes a reality.

Revise filings – the need for transparency

Investors and regulators demand transparency in financial reporting and are increasingly intolerant of accounting errors. Clear and comprehensive disclosures setting out the nature and the impact of the restatement need to be made. As part of its financial reporting oversight role, the audit committee needs to be satisfied that adequate disclosure has been made of the impact of the restatement on the company's historic trends, its business outlook and liquidity. The company and its legal counsel will also have to consider whether it needs to refile other disclosure documents such as management's discussion and analysis and the CEO and CFO certifications.

Companies may also need to refile MD&A and the CEO and CFO certifications.

The key is to manage the process

Changes over the past few years to the role of audit committees have improved their focus towards the oversight of financial statements. Audit committees are more attuned to earnings management, a strong indicator of a potential risk for financial statement restatement. Audit committee members play an important oversight role in helping to prevent financial reporting errors and thus minimizing the chance of a company facing an accounting restatement. However, with the number of restatements growing at record breaking rates, the odds are increasing that an audit committee may, at some time, be faced with a financial statement restatement. If this occurs, the audit committee needs to be ready to take swift and decisive action. Having a robust action plan will assist in mitigating the negative consequences of a restatement. Intensive investigations by regulators may also be minimized by having a timely, proactive approach to assessing and rectifying the problems. A comprehensive and realistic plan will not only help the company survive the restatement process but it may be able to do so in a way that maintains its corporate image.

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