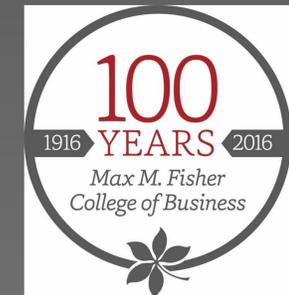


Trends in Reasons for Restatements

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Introduction

Stakeholders, such as investors and creditors, rely upon the financial statements of a company to make important business and financial decisions. When the financial statements of a public company contain a material error, they may mislead these stakeholders.

In order to correct a financial statement error, organizations must file a Form 8-K Item 4.02 disclosure informing investors and creditors that previously issued financial statements cannot be relied upon. The organization must file corrected financial statements through a Form 10-K/A.

In 2014, more than 500 companies found material errors in their financial statements and filed one of these non-reliance disclosures. Each case raises costs to society due to the inaccuracy of public financial information. Each restatement also raises costs to individual companies through auditing fees, restatement costs, and possible lawsuits.

In order for the public sector to diminish the number of restatements, they must understand what is causing so many companies to restate. This study analyses the trends in the reasons that companies restate so that the predominant factors that cause restatements can be purposely diminished. Consequently, by providing information regarding the trends in restatement causes, the number of restatements and the overall costs of restatements can be reduced.

Objectives

- Distinguish the overall trends in restatements from 2004-2014
- Evaluate what common factors cause companies to restate
- Understand how reasons for restatements are changing in comparison to the overall trends in restatements
- Identify which factors cause companies to restate so that accountants can:
 - Mitigate commonplace errors
 - Focus the efforts of internal controls, auditing, and accounting regulation
 - Consequently, decrease the number of restatements
- Examine whether trends in reasons for restatements can be accurately predicted for future years

Methods

Data Characteristics

- Audit Analytics Database from Wharton Research Data Services (WRDS)
- All Item 4.02 Non-Reliance Disclosures from 2004 to 2014
 - Started at 2004 to capture post-Sarbanes-Oxley trends
 - Ended with 2014 so that all years were complete
- Item 4.02 Disclosures contained auditor information, stock price, classification of the type of error, and specific financial accounts effected

Statistical Analysis

- Examined trends in the number of restatements, and trends in the proportion of restatements attributable to each reason
- Linear regression was used to detect the existence and significance of trends

Noteworthy Variable Definitions

Variable Name	Variable Description
Restatement Accounting	Indicates that the error is the result of flawed accounting processes such as accounting principle change, classification errors, or recognition errors
Restatement Clerical	Indicates technical error such as transposition, omission, or duplication
Restatement Fraud	Indicates that the error is the result of fraudulent activity
Restatement Category Title List	Describes with more detail the issue at hand by either explaining the individual balance sheet or income statement accounts affected or the issues that caused the error. For example, this variable may describe that revenue recognition issues were present or that payroll expenses were the source of the error. There were over 800 possible outputs for this variable.

Assumptions

- Any restatements classified as "other" were excluded from analysis as well as from the total number of restatements
- Restatements that were identified as having multiple reasons were considered to be separate restatements for each reason

Results

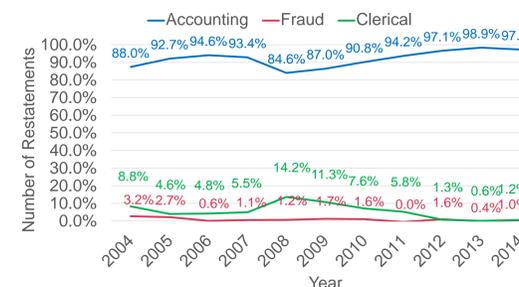
Overall Trend in Restatements

- The total number of restatements rose from 2004 to 2006, fell until 2009, and has increased every year since 2009
- Regression analysis of the years 2009 to 2014 indicates a significant upward trend ($p < .002$)
 - The total number of restatements has been increasing at about 50 restatements per year



Trends in the Proportion of Restatements Attributable to Each Reason

- Examination of the changes in each reason as a proportion of the total restatements indicates:
 - Clerical error has fallen from over 14% in 2008 to about 1% in 2014
 - Fraud has fallen from over 3% in 2004 to about 1% in 2014
 - Accounting error has increased from under 85% in 2008 to about 98% in 2014
- Regression analysis on of these trends indicates:
 - Accounting error has been increasing at a steady trend of 2.5% per year ($p < .001$)
 - Clerical error has been decreasing at about 2.3% per year ($p < .001$)
 - Fraud has only been decreasing at about 0.1% a year ($p < .05$)



Discussion

- The trends in the reasons for restatements could be explained by:
 - Increased regulation, decreasing fraud
 - Increases in technology, decreasing clerical error
- Attention should focus towards diminishing accounting errors

Conclusion

- The total number of restatements is increasing substantially since 2008, increasing costs to investors, creditors, and companies
- The proportion of restatements explained by clerical error has fallen rapidly and the proportion explained by fraud has gradually fallen over time resulting in accounting errors comprising the vast majority of restatements

Further Research

- Build a model that is able to predict future trends in the components that cause restatements
- Analyze the trends in the individual categories; for example, research could look at which line items or accounting processes explain increases in restatements
- Examine trends in restatements by industry, auditor, or company size

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Acknowledgements

I would like to recognize Dean Patricia West for the guidance and feedback she has provided from the inception of this project.

I would also like to recognize Dr. Richard Dietrich for the technical expertise and direction he has offered throughout the research process.