'Stealth' Restatements: An Issue Requiring Attention: Certified Public Accountant
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The CPA Journal; Apr 2010; 80, 4; ProQuest Central
pg. 26

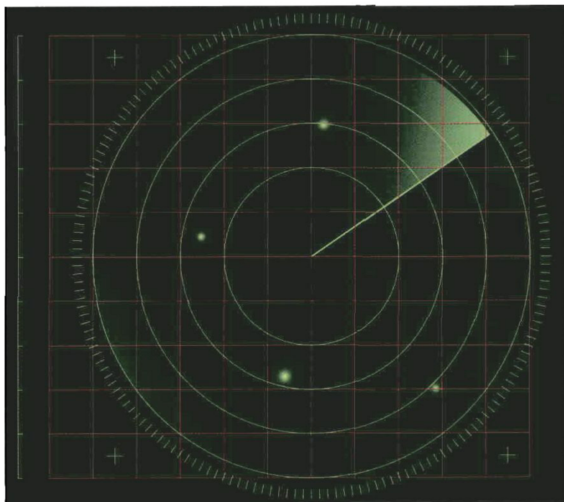
'Stealth' Restatements: An Issue Requiring Attention

By Kevin Hee and Leon Chan

With the current instability in capital markets, both investors and regulators have emphasized the need for increased disclosure and transparency by corporations. Market participants use past and current financial statement information to predict future financial performance, and these predictions are then incorporated into their investment decisions. Therefore, the more timely and transparent a company is in disclosing events that affect the reliability of financial information from past and current years, the more efficiently financial statement users can update their expectations and make decisions with the new information.

This article calls attention to a subset of accounting restatements that may be flying under the radars of financial statement users due to the obscure manner in which they are disclosed to the market. Under current regulatory guidelines for disclosing restatements, a firm can disclose a restatement in multiple ways: 1) press release, 2) Form 8-K, 3) amended periodic reports (10-K/A or 10-Q/A), and 4) periodic financial reports (10-K or 10-Q). For example, a company that restates prior years' financial information could issue a press release disclosing the restatement; file a Form 8-K with the details of the restatement in Item 4.02; and, in conjunction with the 8-K, file any relevant amended periodic returns that cover the restatement period. In the majority of restatements, some combination of these procedures is followed, the preferred practice because of the transparency provided to the capital markets. Because of the negative connotation associated with a restating company and the drop in stock price that usually accompanies a restatement announcement, management has incentives to obscure the manner in which restatements are disclosed. These incentives lead to the issue of "stealth" restatements.

Stealth restatements deal with financial reporting issues that are just as important as the issues in nonstealth restatements. Furthermore, there are certain corporate governance characteristics that, when taken in conjunction with a stealth restatement, can be seen as indicators of future financial reporting weakness for the companies involved. As stealth restatements become more widespread and discussions regarding financial transparency continue to dominate the accounting headlines, both investors and standards setters, such as the SEC, should pay more attention to this phenomenon.



Although the SEC does have rules for restatement disclosures (Item 4.02, "Non-Reliance on Previously Issued Financial Statements or a Related Audit Report or Completed Interim Review"), filers have been able to avoid disclosing restatements in a separate 8-K because of semantic loopholes. Gaining a better understanding of these stealth restatements is important to regulators, auditors, and investors because of the explosion of restatements since the Sarbanes-Oxley Act of 2002 (SOX), as well as the fact that the percentage of restatements classified as stealth restatements has increased each year since 2005. These types of restatements affect regulators because of the public's demand for increased disclosure of financial reporting weaknesses since the major accounting scandals of the early 2000s. Auditors are affected because their reputation may suffer due to their relationship with a stealth restating com-

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pany if that company has future financial reporting quality issues. As for investors, the average investor is most likely to suffer, because more sophisticated investors, such as hedge funds and insurance companies, tend to have access to a wider range of information.

Data Source

The authors used Audit Analytics to obtain all restatement announcements for U.S. companies from 2005 through 2008. Any restatement initially disclosed in a 10-K, 10-Q, 10KSB, or 10QSB was classified as a stealth restatement. Therefore, restatements that were disclosed in a press release, 8-K, or amended periodic reports are treated as nonstealth restatements. Duplicate restatements that deal with the same restatement period and the same underlying accounting reason were excluded from the test sample.

Increasing Trend in Stealth Restatements

Exhibit 1 clearly shows the increasing trend in stealth restatements since 2005. Stealth restatements as a percentage of total restatements have increased from 11% to 23%—a 109% increase. Regardless of the underlying reasons, this is a disturbing trend because any time that a company decides to restate prior financial statements and attempts to limit disclosure transparency, it can have serious repercussions for investors.

One possible explanation for the increasing trend in stealth restatements is the lack of an equity penalty for more obscure restatements. Academic research has shown that the market reacts differently to different restatement disclosure methods: A more negative market reaction is associated with restatements disclosed in an 8-K than with those not disclosed in an 8-K. This shows that management has an incentive to hide restatement disclosures because it reduces the "cost" of the restatement. Another explanation lies in the SEC guidelines for Item 4.02 in Form 8-K. The title of this item uses the term "nonreliance" instead of "restatement," and there has been speculation that the idea behind this guideline was to reduce the number of restatements that were deemed unnecessary because they were simply corrections of prior years' financial information that would not affect a reasonable investor's decision making with regard to the restating company. As a result, companies can argue that they do not have to file an 8-K to separately disclose a restatement because it would cause an investor to be unable to rely on previously issued financial statements. This can be a slippery slope due to the subjectivity involved in determining what "materially accurate" means (i.e., Is management's definition of "material" equivalent to that of a reasonable investor?).

Reasons for Restatement

Some studies suggest that investors are more concerned about certain restatements than others. For example, academic research has shown that restatements related to core accounting issues that are essential for forecasting future earnings and cash flows—such as revenue recognition and cost of sales—are associated with a more negative market reaction to the restatement announcement. These findings provide evidence that management can benefit by disclosing restatements related to core accounts in a stealth manner. Thus, it is of interest whether stealth restatements are more likely to be related to the core accounts for valuation. Most restatements are related to multiple accounting issues across different financial statement elements (e.g., one restatement could deal with revenue recognition and cost of goods sold).

From 2005 through 2008, there were 2,227 accounting issues identified by Audit Analytics in the 938 stealth restatements and 10,546 issues in the 4,231 nonstealth restatements. The authors classified

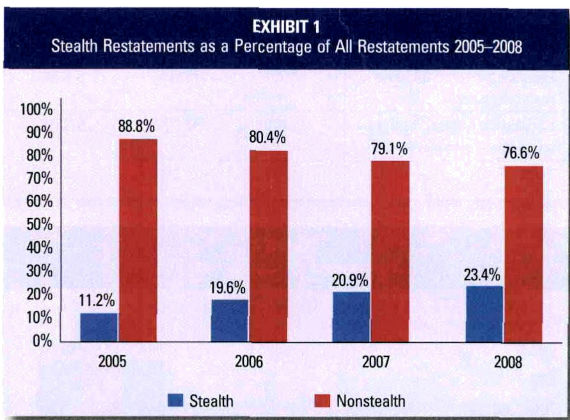

EXHIBIT 1
Stealth Restatements as a Percentage of All Restatements 2005–2008

EXHIBIT 2
Stealth (Nonstealth) Restatements by Accounting Issues Category

Category	Stealth (Nonstealth)%			
	2005	2006	2007	2008
Revenue recognition	5% (5%)	4% (5%)	4% (8%)	4% (6%)
Core expenses	35% (40%)	32% (33%)	36% (31%)	33% (28%)
Noncore expenses	43% (41%)	49% (46%)	44% (42%)	46% (45%)
Reclassification and disclosure	17% (14%)	15% (16%)	16% (19%)	17% (21%)

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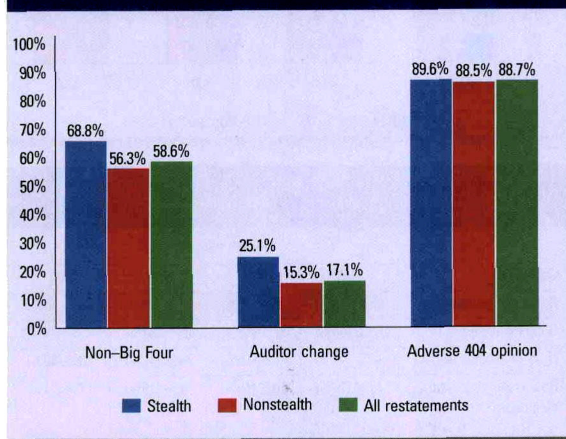
each accounting issue into one of four groups: 1) revenue recognition, 2) core expenses, 3) noncore expenses, and 4) reclassification and disclosure. *Exhibits 2* and *3* provide analyses of the different accounting issues involved with both types of restatements. Exhibit 2 shows a year-by-year analysis of the percentages of stealth and nonstealth restatements within each of the four groups listed above. Comparing stealth and nonstealth restatements by the percentage of accounting issues grouped in the categories for the study period, the average frequency distribution is fairly similar. Nevertheless, the relative percentage of stealth restatements that dealt with core expenses actually increased after 2006. While the stealth restatement percentage for core expenses is fairly constant over the 2005–2008 period, the nonstealth percentage dropped from 40% in 2005 to 28% in 2008. Overall, this exhibit shows that stealth restatements are not just restatements dealing with relatively unimportant accounting issues such as reclassifications. Rather, the accounting issues in stealth restatements are at least as important as the issues in nonstealth restatements. The argument that companies are not separately disclosing stealth restatements because they deal with minor accounting issues is not valid.

Because expenses are the most often-cited accounting issue in both types of restatements, the authors took a closer look at the different types of accounting issues within the core expenses category. They found the most frequently cited restatement reasons within the core expense category and compared the occurrence rates for stealth and nonstealth restatements. Exhibit 3 shows that the three most common reasons within core expense restatements actually make up a higher proportion of the stealth restatements (21%) than nonstealth restatements (17%).

EXHIBIT 3
Stealth and Nonstealth Restatements, by Most Frequent Accounting Issues

Accounting Issues (2005–2008) Most Common Core Expenses	Frequency	Stealth Restatements (Percentage)	Nonstealth Restatements (Percentage)
Deferred, stock-based, and executive compensation issues	760	135 (6%)	625 (6%)
Expense (payroll, SGA, other) recording issues	751	173 (8%)	578 (6%)
Liabilities, payables, reserves, and accrual estimate failures	670	147 (7%)	523 (5%)
Total		21%	17%

EXHIBIT 4
Comparative Analysis of Restatements, 2005–2008



Corporate Governance Issues

Given that stealth restatements deal with accounting issues of at least equal importance as nonstealth restatements, the authors next looked at the corporate governance of both stealth and nonstealth restatement companies to see whether stealth restatements are an indicator of financial reporting quality in future periods. Operating under the assumption that stronger corporate governance reduces the likelihood of a restatement, evidence of weaker corporate governance with the stealth restatements would lend additional support to the authors' belief that stealth restatements are a serious issue to be addressed. *Exhibit 4* displays a comparative analysis of a few corporate governance indicators to determine if there are any systemic differences in auditor type, auditor turnover, and the issuance of an adverse SOX section 404 opinion between the two types of restatements and the entire restatements sample.

The authors initially examined whether or not the external auditor during the restatement was a Big Four firm. Academic accounting research often uses having a Big Four accounting firm (Ernst & Young, PricewaterhouseCoopers, KPMG, and Deloitte & Touche) as external auditor as a proxy for the quality of a firm's corporate governance system (i.e., a Big Four auditor is believed to correlate with higher quality financial statements).

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Because stealth restatements can be construed as the restating firm wanting to hide or obscure the restatement from financial statement users, this type of action may be easier to do with a smaller, lower profile auditor (non–Big Four) with more limited resources.

Exhibit 4 shows that approximately 69% of stealth restatements involved a non–Big Four auditor in the 2005–2008 period, compared to only 56% of nonstealth restatements. If the non–Big Four auditor percentage were in line with all restatements, it could be disregarded. However, when the total sample is analyzed, only 58.6% of total restatements involved a non–Big Four auditor. In addition, a 2003 Government Accountability Office (GAO) report detailed that only 22% of U.S. public companies used a non–Big Four firm as its independent auditor. In short, the percentage of stealth restatements involving smaller audit firms is relatively high, even among all restatements and all U.S. public companies. Showing that the percentage of stealth restatements involving a non–Big Four auditor is significantly higher than that of nonstealth restatements and higher than the percentage for all restatements lends support to the theory that companies involved in stealth restatements do have lower quality accounting controls, and it also underlines the importance of taking a closer look at less transparent restatements.

Another proxy for corporate governance used in academic research is auditor turnover. A change in auditor can indicate a disagreement between management and auditors regarding management's discretion in its financial reporting choices. This can result in a situation where there is the potential for management to exert increased influence over reporting practices. Although auditor turnover by itself is not necessarily an indication of weak corporate governance or poor internal controls, when an auditor change follows a stealth restatement, it suggests a deficiency in internal controls or corporate governance. Exhibit 4 shows that 25% of stealth restatements from 2005 through 2008 involved a case where the auditor during the restatement period was different from the auditor at the restatement disclosure date, while only 15% of nonstealth restatements had a similar auditor change. The stealth restatement proportion was also larger than the 17% of all restatements in the same time period that involved a change in auditor.

The final corporate governance characteristic is the issuance of an adverse opinion on the restating firm's internal controls. Section 404 of SOX requires management and the external auditor to assess and report on the adequacy of the firm's internal control over financial reporting (ICFR). The percentage of stealth restatements that contained an "adverse" section 404 opinion (90%) was slightly higher than for nonstealth restatements (88%). This, again, shows that stealth restatements do not just involve minor financial reporting issues that investors should dismiss. Rather, these restatements are dealing with financial reporting issues severe enough for auditors to issue adverse opinions on internal controls. That being said, the data is not sufficient to conclude that stealth restatements are significantly more likely to contain adverse SOX section 404 opinions than nonstealth restatements. Furthermore, the data is insufficient to conclude that an ICFR weakness is severe based solely on the existence of an adverse section 404 opinion. To make any such conclusions would require more rigorous statistical modeling with additional control variables. That analysis is beyond the scope of this article but would make for interesting future research. Once again, by itself, this analysis cannot establish a causal relationship between adverse section 404 opinions and stealth restatements, but, in combination with other findings, the authors believe that stealth restatements are an issue that deserves more attention from regulators and investors.

The authors believe that all restatements should, at the very least, be disclosed in an amended periodic filing.

Stricter Guidelines for Disclosure

This article highlights the following: 1) companies are increasingly hiding restatements in their periodic reports, instead of separately disclosing them; 2) the accounting issues involved with stealth restatements are just as serious—in some cases, such as core expenses, more so—as the accounting issues in nonstealth restatements; and 3) indicators of weaker corporate governance are more evident in stealth restatements than they are in nonstealth restatements and all restatements. When this evidence of weaker corporate governance is combined with regulatory guidelines that allow stealth restatements, it culminates in a situation where companies have both the incentive and opportunity to use stealth restatements. This not only affects past financial statements, but also has implications for future financial reporting quality and the timeliness with which financial information reaches investors. As a result, the authors believe that stealth restatements are a serious issue that merits more attention from the SEC and auditors. The authors believe that stricter guidelines that would require disclosure of all material restatements in a Form 8-K would be extremely beneficial to users of financial statements. What the SEC considers a "material restatement" is a wholly different matter that will always be a topic of substantial debate due to its subjective nature, and, thus, it is beyond the scope of this article. Nevertheless, the authors believe that all restatements should, at the very least, be disclosed in an amended periodic filing. This should provide some additional notice to financial statements users and make it easier for them to update their expectations with the restated financial numbers. ❑

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