Speech by SEC Staff:
Remarks Regarding Restatements Before the Financial Executives International Meeting

by

Scott A. Taub

Acting Chief Accountant
U.S. Securities and Exchange Commission

New York, New York
November 17, 2006

As you know, part of the mission of the Office of the Chief Accountant at the SEC is to seek and find ways to improve financial reporting. While much of that work involves looking to the future and thinking about things like XBRL and improved accounting standards, we can also learn some things from looking back at financial reporting failures, just like businesses learn from product or service failures. In financial reporting, failures often result, eventually, in restatements.

It is well known that the number of accounting restatements has increased dramatically over the years. Glass Lewis & Company reported that the number of restatements by U.S. public companies rose from 116 in 1997 to 1,195 in 2005. And we seem to be headed for an ever larger number in 2006. Of course, the raw numbers mean different things to different people. Some suggest the large number of restatements shows that an overly conservative attitude pervades, resulting in restatements for errors that simply are not material. Others believe that the large number of restatements shows that the reforms of recent years are working, causing companies to look harder at financial reporting and correct errors that arose in earlier years. Others argue that the rise in restatements can be traced to the increased complexity of accounting standards and reporting rules.

To gain further insight into the causes of errors and restatements, I asked a few staff in OCA to review information about some of the restatements disclosed in filings from 2003 to 2005. I wanted to look at public disclosures about restatements to get a sense of what companies said about the underlying errors, and to see how often various factors appear to have contributed to the errors. It is important to note that we did this informal review for our own information purposes and not due to any planned rulemaking or investigatory actions. Of necessity, the analysis is based on OCA staff members' interpretations of the public information, and is thus somewhat subjective. The public filings containing restatements are available on the Commission's website and any person reading those filings may form their own views. Given these caveats, let me tell you a bit more about what we found.

For each restatement, we considered whether the disclosures suggested that factors of the financial reporting environment in the US contributed significantly to the error, or whether the error instead appeared to be caused by a deliberate misstatement, a books and records deficiency such as the company capturing information incorrectly or incompletely, or a simple misapplication of an accounting standard. Discussion at the SEC, in the media, and in other places often focuses on either fraud or errors caused in part by factors like transaction structuring, complexity of accounting standards, etc. However, disclosures we reviewed that accompanied restatements over the past three years suggest that well over half of the errors that resulted in restatements were caused by ordinary books and records deficiencies or by simple misapplications of the accounting standards.

The disclosures did suggest that approximately one-third of the errors related to situations in which there were one or more contributing factors from outside the company. In around 15% of the restatements we reviewed, the use of judgment in applying the accounting standard was cited as a contributing factor to the error. These restatements related most often to inventory, reserves and allowances, and taxes as well as to impairments of long-lived assets and intangible assets. Of course, some people will interpret the high number of restatements related to use of judgment as suggesting that accountants and auditors need to spend more time thinking about such judgments, while others will suggest that the judgment-related restatements indicate that regulators are second-guessing companies too often. As a move towards more principles-based standards will of necessity result in a greater reliance on the judgments of accountants, this seems to be an issue that deserves further consideration.

Another 15% of the time, one or more attributes of the accounting literature seem to have been an underlying factor that contributed to the error. Errors that had such contributing factors most often involved financing transactions such as the issuance of convertible securities with beneficial conversion features and the issuance of equity instruments to third parties. In some cases the troubling attribute seems to be a lack of clarity in standards, while in others, it was difficulty in identifying all of the relevant accounting literature, and in others, it was the complexity of the literature that contributed to the error.

We also considered which areas of accounting the errors occurred in, and which standards in particular seemed to have been misapplied. In part, this will help us consider the FASB's agenda — not that a lot of errors in a particular area is necessarily an indication that the literature is poor, but it certainly bears consideration. The areas of the literature most often identified were leases, income taxes, revenue recognition, derivatives and hedging, and convertible securities, including issues related to APB 14, EITF 00-19, EITF 98-5, and EITF 00-27. All of these groups of errors had a high-instance of identified contributing factors associated with them — judgment in SFAS 109, proliferation of literature in revenue recognition, industry practice in SFAS 13, exceptions and bright lines in derivative accounting (notably related to the short-cut method) and complexity related to convertible securities. As it happens, the FASB currently has agenda projects that would address the accounting in all these areas.

In addition to analyzing what caused the error, we were also interested in how the error was found so that it could be corrected. Unfortunately, about half of the restatement disclosures did not report any information on this point. As it strikes me that market participants would likely be interested in this information, I wonder whether something should be done to encourage its disclosure. Even when information was provided, about half the time the disclosures indicate that the company identified the error with little further discussion of how that occurred. When disclosures discussed how the error was identified, about 15% of the time, the external audit was cited, while SEC staff reviews were cited about 10% of the time. In 2005, around 5% of the restatements were identified by a SOX 404 internal control review.

Again, this was just an informal analysis by the OCA staff based on the staff's interpretation of the company disclosures on the underlying causes of the restatements. While the SEC staff does not discuss in public or disclose our evaluation of individual company filings, I have shared some of the aggregate data from our informal review to provide food for thought.