Accounting Misstatements: Prior Period Financial Statement Errors

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Accounting Misstatements: Prior Period Financial Statement Errors

Honors Thesis

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University of Redlands
Bachelors of Science in Accounting

Spring 2015

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Chapter 1: Thesis & Background

Executive Summary

The current Securities and Exchange Commission authoritative guidance on proper accounting treatment of prior period immaterial errors is accused of allowing certain financial statement abuses. Current SEC regulations and guidelines that allow for financial restatements are designed to provide more accurate financial statements, transparency when misstatements or errors are corrected, and therefore to increase the information content of earnings, but this goal is not always accomplished. Investors and users of the financial information have expressed concerns that the guidance is being misused for earnings management.

The findings of this study rely predominantly on data, trends, and activity spanning the periods of 2003-2014. This time period includes key events which occurred in the past decade such as the implementation of the Sarbanes Oxley Act (SOX) of 2002, the SEC’s 2004 introduction of non-reliance reporting on Form 8-K Item 4.02, the SEC’s 1999 issuance of Staff Accounting Bulletin (SAB) 99 on determining materiality, and SAB 108 on quantifying discovered prior errors, issued in 2006.

This paper examines and clarifies the current guidance on correcting immaterial errors, as well as provides the reader with information to conclude whether the status quo is viable. There are several policy changes that regulatory bodies could implement to increase the effectiveness of the current authoritative literature, as well as improve the level of clarity when dealing with the somewhat complex process of correcting misstatements. Proposed policy changes include changes to financial statement labeling,
the content included in the footnotes, in press releases, certain performance metrics, as well as stricter enforcement of the requirements. With added disclosure, users will be made aware that the correction has occurred, and be in a better position to evaluate its impact on an ongoing basis.

**Earnings Quality-Information Content of Earnings**

Users of financial information often discuss the importance of high earnings quality. In order for financial statements to meet the criteria of high quality, the information must be relevant and reliable. Relevant information must be timely and offer predictive power. Reliable information must be free from error, accurate in its account of transactions, and be verifiable.

Users of financial information need financial statements of high earnings quality in order to make informed decisions regarding investing and lending based on expected future earnings. The purpose of financial restatements/revisions is to provide more transparent and accurate financial statements. For this reason, it is important to scrutinize the impact(s) of financial statement restatements on earnings quality. This paper addresses concerns as to the possibly damaging effects certain restatements have on overall transparency and earnings quality.

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2 Ibid
3 Ibid
Defining Materiality & Misstatements

Material information is anything that would affect the decision making process of a prudent user of financial statements. The American Institute of Certified Public Accountants (AICPA) explains that “the concept of materiality recognizes that some matters, either individually or in the aggregate, are important for fair presentation of financial statements in conformity with generally accepted accounting principles, while other matters are not important.”

When conducting an audit, the auditors are responsible to obtain reasonable assurance that the financial statements are free from material misstatement. There is no universal threshold for defining materiality. An auditor will plan, perform audit test work, research, and gather evidence in a manner that is unique to each audit. The development of an audit strategy (which is typically performed by the audit partner and manager prior to the audit) involves establishing a monetary value for evaluating the materiality threshold level of certain accounts, and takes place in the planning stage of the audit and is subject to revision throughout the audit. Due to all of these variables, the ability of auditors to obtain reasonable assurance “but not absolute assurance that material misstatements are

4 Ibid


6 Ibid

detected”\(^8\) requires a high level of professional judgment throughout the audit process, which includes establishing materiality.

Previous uncorrected misstatements are errors that have been identified by management or the auditors in previously issued financial statements that have not been corrected either by restatement or revision in the issuance of the next financial statements.\(^9\) A financial statement misstatement event occurs when there is an inconsistency between the “amount, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be presented fairly in accordance with the applicable financial reporting framework.”\(^10\) While a misstatement identified by management, or during the process of an audit may be immaterial by itself, if uncorrected, this error can accumulate over time to become material. Additionally, the accumulation of immaterial misstatements, in the aggregate, can have a material effect on the financial statements overall. The auditor along with management is required to accumulate all of those little errors and make a judgment about their materiality and relevant impact to the financial statements.

Once a misstatement has been identified, the AICPA suggests the auditors should evaluate the effectiveness of the audit strategy. They should then decide if the audit plan needs revision if the type of misstatement discovered indicates the possibility of further errors that would become material as they accumulate in the aggregate.\(^11\) Similarly,

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\(^8\) Ibid (AICPA: AU Section 312: Audit Risk and Materiality in Conducting an Audit)


\(^10\) Ibid

\(^11\) Ibid
management and the auditors will most likely examine the effectiveness of internal controls to prevent an error of similar nature from making its way into any future financial statements.

There is distinctly different handling of discovered prior errors and discovered errors that have not made their way onto issued financial statements. When errors arise in the current period, management still has the ability to correct the error before issuance. If the discovered errors arise from prior periods, SAB 108 guidance (which is discussed in depth further on) instructs auditors and management how to evaluate and handle the discovered errors.

After a misstatement is determined to have a material impact on the financial statements, the auditors and management will communicate. The financial statements are the responsibility of management; as such they will assess the materiality of an error. The auditors will then either agree or disagree with management’s materiality determination of the error and the method chosen to handle the error.

If management and the auditors agree the misstatement should be corrected and correction occurs, the auditors should perform test work to conclude if the misstatement still exists. In the case of management’s refusal to correct the misstatements at the request of the auditors, the auditors should understand the accounting methodology applied by the client, and their reasons for disagreement. After a thorough understanding of the client’s argument, if the auditors’ professional judgment determines the current period financial statements are not free from material misstatement they should issue the appropriate departure from an unqualified audit opinion. 12 This could be more detrimental to the

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12 Ibid (AICPA: AU Section 312: Audit Risk and Materiality in Conducting an Audit)
company’s reputation, financing, and market value than the restatement itself. However, in most scenarios where the auditors urge their client to correct their financials due to material error, management will comply with the auditors.

It should be pointed out that management often recognizes accounting errors independent of the audit or related audit work. The handling and correction of these discovered errors involves open communication with the auditors as well.

The Public Company Accounting Oversight Board (PCAOB) provides specific guidance for auditors with respect to communicating discovered errors with the audit committee. AU Section 380 *Communication With Audit Committees* paragraphs 9 and 10 instruct auditors to inform the committee of all uncorrected misstatements aggregated by the auditor during the current engagement and the immediate previous period that were deemed immaterial to the financial statements as a whole either individually or in the aggregate.

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Chapter 2: Authoritative Literature- Restatements

In order to approach the topic of prior period immaterial restatements or revisions, it is crucial to understand the concept of materiality and the differences among material events and immaterial revisions. When an error is discovered in a prior period, the required response is dependent upon whether current and past financial statements are materially misstated a “Big R” restatement is required. If the prior period statements are not materially misstated, the mistake can be corrected through a less burdensome process known as a “little r” revision. While restatement and revision are used interchangeably by some, hereinafter in this paper, the two events will be referred to as “Big R restatement” or simply restatement; and “little r revision”, or simply revision.

“Big R”\textsuperscript{14} – Material restatement event

- Declaring previously filed financial statements unreliable
- Amending/Restating previously misstated annual or quarterly reports (10K/A & 10Q/A)

“little r”\textsuperscript{15} – Immaterial revision

- Revising previous period figures in the comparative section of the current financial statements or as an out of period adjustment.

“Out-of-Period Adjustments”\textsuperscript{16} – This refers to a method of correcting little r errors


\textsuperscript{15} Ibid

\textsuperscript{16} Ibid
• These are adjustments made in the current financial statements to the current period for errors accumulated or arising in previous periods.

• This way of handling little revisions has strict guidance which is explained later.

SAB 108 provides specific guidance on evaluating the effects of prior year misstatements when quantifying the materiality of misstatements in current year financial statements, and SAB 99 provides guidance on determining materiality. These two SAB’s are used in tandem to quantify and evaluate the materiality of the error in question.

SAB 99

The SEC issued SAB 99 in August of 1999 to provide guidance for considering both quantitative and qualitative components when determining materiality. The Bulletin states, “that exclusive reliance on certain quantitative benchmarks to assess materiality in preparing financial statements and performing audits of those financial statements is inappropriate; misstatements are not immaterial simply because they fall beneath a numerical threshold.” SAB 99 lays out a case, for instance, “During the course of preparing or auditing year-end financial statements, financial management or the registrant’s independent auditor becomes aware of misstatements in a registrant’s


financial statements. When combined, the misstatements result in a 4% overstatement of net income and a $.02 (4%) overstatement of earnings per share (EPS). Because no item in the registrant’s consolidated financial statements is misstated by more than 5%, management and the independent auditor conclude that the deviation from generally accepted accounting principles (‘GAAP’) is immaterial and that the accounting is permissible.” 19

The Staff has acknowledged that registrants and auditors can utilize established “quantitative thresholds as ‘rules of thumb’” 20 as a preliminary evaluative tool in conjunction with “a full analysis of all relevant considerations” 21 when preparing financial statements. Auditors have typically used the “rule of thumb” 22 that an error representing less than 5% of the threshold is not material when there are no other extraordinary circumstances. SAB 99 adds, “the staff reminds registrants and the auditors of their financial statements that exclusive reliance on this or any percentage or numerical threshold has no basis in the accounting literature or law.” 23 In other words, one may not rely on a set percentage as an absolute determination of materiality. Consider for example (in the scenario laid out above by the SEC) the restrictions for a loan covenant required earnings per share to never drop below the amount that was misreported, or the interest rates on certain debt financing could increase. In the overall materiality consideration, management and the auditors would consider the misstatement’s impact on the company’s ability to retain its preferred rates on its loan. Since EPS was reported at an overstated

19 Ibid
20 Ibid
21 Ibid
22 Ibid
23 Ibid
amount of $0.02 the company was not faced with higher costs of financing. This qualitative factor would influence the materiality determination in the discovered error, and demonstrates why there cannot be reliance on a strict numerical line or threshold for determining materiality.

Furthermore, The Bulletin also instructs registrants and auditors to determine materiality by evaluating the “facts in the context of the ‘surrounding circumstances,’” which takes into account the context in which the financial statement user would interpret the financial item. For example, a 1% shift in current assets or current liabilities can adjust the working capital ratio to become in compliance with loan covenants and yet not be material to the overall financial statements, based on a quantitative rule of thumb. Most experts might conclude, however, it is material.

The Financial Accounting Standards Board (FASB) has also made clear that materiality cannot be determined by a numerical formula. For instance, “magnitude by itself, without regard to the nature of the item and the circumstances in which the judgment has to be made, will not generally be a sufficient basis for a materiality judgment.” Since all of the relevant information must be considered, there are many circumstances where an error less than the 5% rule of thumb threshold could be material. As a result, auditors must consider the qualitative and quantitative factors surrounding an error or omission before declaring it material or immaterial. A qualitative factor would be the error’s impact on the trend in earnings. Below is one example demonstrating how an

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24 Ibid
25 Ibid
26 Ibid
error could impact the trend in earnings.

(Figure 1)

<table>
<thead>
<tr>
<th></th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>Uncorrected Error</td>
<td>-3 (Understatement)</td>
<td>-1 (Understatement)</td>
<td>+4 (Overstatement)</td>
</tr>
<tr>
<td>Reported Earnings</td>
<td>97</td>
<td>99</td>
<td>104</td>
</tr>
<tr>
<td>Actual Earnings</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
</tbody>
</table>

As one can see when examining each error individually, these misstatements fall below the 5% rule of thumb threshold as means for determining materiality. However, leaving out these misstatements would mislead users of these financial statements because they see an average positive trend in earnings of roughly 4% even though earnings have been stagnant for the three years. This type of situation is an example of why there cannot be strict numerical guidance, and that this process relies on professional judgment.

**SAB 108**

Accountants rely on SAB 108, issued in September 2006, for guidance when performing analysis to quantify the materiality of discovered prior errors. This accounting literature uses two methods to quantify the effects of prior period misstatements when quantifying the errors on the current year or most recent period’s financial statements: the iron curtain approach and the rollover method. These two methods are tests to determine if an error is material, not the method for restating these errors.

The rollover method measures a misstatement based on the amount the income statement is misstated in the period of the error. The rollover method disregards the impacts that any accumulating error from previous periods has on the period in question,
or the current period.27

This method ignores the misstatement’s impact on the current period balance sheet from correcting any prior period error, and will disregard the “carryover effects”28 of prior year misstatements. The overarching limitation of the rollover approach is this disregard of the “carryover effects”.29 The SEC provides a clear example of this weakness, “in which a registrant, relying on the rollover approach, has allowed an erroneous item to accumulate on the balance sheet to the point where eliminating the improper asset or liability would itself result in a material error in the income statement if adjusted in the current year. Such registrants have sometimes concluded that the improper asset or liability should remain on the balance sheet into perpetuity.” 30

On the other hand, the iron curtain approach quantifies prior errors based on their cumulative effect on the income statement in the current period. One of the weaknesses of the iron curtain method is explained by the SEC, “the iron curtain approach assumes that because the prior year financial statements were not materially misstated, correcting any immaterial errors that existed in those statements in the current year is the ‘correct’ accounting, and is therefore not considered an error in the current year. Thus, utilization of the iron curtain approach can result in a misstatement in the current year income

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28 Ibid, pg. 4
29 Ibid, pg. 4-5
30 Ibid, pg. 5
statement not being evaluated as an error at all.”

Using professional judgment, the auditors and management will evaluate both the quantitative and qualitative factors in compliance with SAB 108 to determine materiality. The diagrams below are simple examples to demonstrate how to use the two methods for quantifying errors when solely examining the quantitative factors surrounding an error.

(Figure 2)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Reported Earnings</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td></td>
</tr>
<tr>
<td>Uncorrected Error in Each Period</td>
<td>+2.5 (Overstatement)</td>
<td>+2</td>
<td>+2</td>
<td>0</td>
</tr>
<tr>
<td>Net Accumulating Error</td>
<td>+2.5</td>
<td>+4.5</td>
<td>+6.5</td>
<td></td>
</tr>
<tr>
<td>Actual Earnings</td>
<td>97.5</td>
<td>98</td>
<td>98</td>
<td>100</td>
</tr>
</tbody>
</table>

Under the iron curtain method, management would evaluate a cumulative misstatement of (+6.5). This cumulative error would overstate earnings by 6.5% in 2014, and might well be deemed material as it is over 5% of earnings. Under the rollover method, management would only consider the (+2) misstatement in 2013 in evaluating materiality, as it only considers the impact of an error occurring in one period, and disregards the cumulative effects of the prior period errors. Under the rollover method, the error would likely not be considered material since it is 2% of reported earnings that year.

31 Ibid, pg. 5
32 Ibid, pg. 3 (SEC: Staff Accounting Bulletin: No 108)
The rollover method would only consider the impacts of the misstatement occurring in 2013. It does not take into consideration the cumulative effects of other prior errors. The (+8) misstatement in 2013 would likely be evaluated as a material misstatement under the rollover method, as it is over 5% of reported earnings for that period. The iron curtain method would consider the net cumulative effects of prior period errors of +4, and would most likely deem the cumulative effects immaterial as they represent less than 5% of earnings for the current period. Now look at the following example for further consideration.
(Figure 4)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Reported Earnings</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td></td>
</tr>
<tr>
<td>Uncorrected Error</td>
<td>+0.5 (Overstatement)</td>
<td>+1</td>
<td>+1.5</td>
<td>0</td>
</tr>
<tr>
<td>Net Accumulating Error</td>
<td>+0.5</td>
<td>+1.5</td>
<td>+3</td>
<td></td>
</tr>
<tr>
<td>Actual Earnings</td>
<td>99.5</td>
<td>99</td>
<td>98.5</td>
<td>100</td>
</tr>
</tbody>
</table>

When examining the above chart, under both the rollover and iron curtain methods none of the errors would likely be quantified as material. The accumulating errors total (+3), which would likely be classified as immaterial by the iron curtain approach, and the (+1.5) error in 2013 is likely to be waived immaterial by the rollover approach.

The SEC rejects the results for determining materiality when using either the rollover method or the cumulative method (only one method) on its own. The exclusive reliance on either method does not “appropriately quantify all misstatements that could be material to users of financial statements.” 33 If the analysis after quantifying the errors by performing both tests stipulates a material error under either one of the approaches, the filer must make the appropriate adjustments to their financial statements. 34

**When to Restate or Revise, Per SAB 108**

If the misstatements are deemed material under the rollover method, the previously issued financial statements must be corrected promptly by amending prior filings with the

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33 Ibid, pg. 5 (SEC: *Staff Accounting Bulletin: No 108*)
34 Ibid, pg. 6
SEC, this is a Big R restatement. If accumulating errors deemed material under the iron
curtain method were corrected as an out of period adjustment, they must not materially
“misstate the year in which it would be corrected or the trend in earnings”\(^\text{35}\). Otherwise,
the prior period immaterial errors must be revised in the comparative section of the next
financial statement issuance, a little r revision. If however the accumulating error were
corrected as an out of period adjustment and was either material or not to the current
“interim period in which it would be corrected,”\(^\text{36}\) the error may be corrected as an out of
period adjustment with a transparent disclosure, or the comparative financial statements
may be revised the next time of filing. Management has the choice of electing to treat these
accumulating errors in the interim period as either out of period adjustments, or revising
comparative financial statements.\(^\text{37}\) In the case that correcting the accumulating errors is
not material to the interim period, management may also choose to simply leave the errors
on the passed adjustments sheet. The passed adjustments sheet or SUM sheet is a list of all
identified but uncorrected errors maintained by the auditors and shared with management
and the audit committee. During the course of each audit, the auditors are required to
review and re-evaluate the errors remaining on the SUM sheet from the previous periods.
Registrants are required to disclose each error being corrected, detailing the amount of the
error, cumulative adjustments, the nature of the error discovery, and past and current
materiality assessment of the adjustment.\(^\text{38}\)

The author developed the figure below, by amending and expanding on an existing

\(^{35}\) Ibid (\textit{May et el: Dateline: A look at Current Financial Reporting Issues})
\(^{36}\) Ibid
\(^{37}\) Ibid
\(^{38}\) Ibid
flowchart found in an article by PwC. It summarizes in chart-form the decisions described in the paragraphs above.
Process/Actions for Discovery and Treatment of Prior Period Errors Per SAB 108 Guidance (For Public Companies)

Start

Discovery of accounting error

Run SAB 108 materiality tests (Iron Curtain & Rollover Method)

If the income statement materially misstated in the most recent year (or year in question), disregarding the impacts any accumulating errors from the previous periods has on the period under scrutiny?

Yes

"Big R" Restatement

The financial statements are materially misstated and must be amended ASAP with forms 10-K/A or 10-Q/A.

No

Iron Curtain Method

Are the cumulative effects of immaterial prior period errors material to the "YEAR in which the error would be corrected or the trend in earnings?"

Yes

"little r revision"

The previously issued financial statements must be revised the next time they are filed.

No

No

Are the cumulative effects of immaterial prior period errors material to the Interim Period in which the error would be corrected?

Yes

"little r revision"

The error may be corrected as an out of period adjustment with a transparent disclosure, or the comparative financial statements may be revised the next time of filing.

No

"little r revision"

The error may be corrected as an out of period adjustment with a transparent disclosure, or the comparative financial statements may be revised the next time of filing.

Refer to figure above for further understanding of how to handle an error deemed material by the iron curtain method: Under the iron curtain method, an accumulating overstatement of 6.5 would be evaluated. If the error were corrected as an out of period adjustment to the current year-end financials, it would materially misstate the current year’s earnings by 6.5%, as well as the trend in earnings, and reported earnings would be 93 instead of 100. This would materially interrupt the trend of earnings for the years (97.5, 97.5, 98, 93.5). In this situation, each overstatement must be corrected and adjusted to the year in which the error occurred at the next financial statement issuance in the comparative section, with full disclosure.

If however the out of period adjustment were “material to the interim period in which it would be corrected”\textsuperscript{39} (as would likely be the case in the example below with an accumulating overstatement of 7.5), the error could either be corrected as an out of period adjustment to the current year-end financials or be corrected as an out of period adjustment to the interim period in which it was corrected or both. One must also consider the materiality of the error to the interim period where if it were deemed material, the error could either be corrected as an out of period adjustment to the current year-end financials or be corrected as an out of period adjustment to the interim period in which it was corrected or both.

\textsuperscript{39} Ibid
adjustment, or through revision to the comparative section of the next financial statement filing.

(Figure 6)

<table>
<thead>
<tr>
<th></th>
<th>Q1</th>
<th>Q2</th>
<th>Q3</th>
<th>(Current Period) Q4 Unfiled Interim Financial Statements</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reported Earnings</td>
<td>99</td>
<td>100</td>
<td>101</td>
<td></td>
</tr>
<tr>
<td>Uncorrected Error</td>
<td>+2.5</td>
<td>+2</td>
<td>+3</td>
<td>0</td>
</tr>
<tr>
<td>(Overstatement)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net Accumulating Error</td>
<td>+2.5</td>
<td>+4.5</td>
<td>+7.5</td>
<td></td>
</tr>
<tr>
<td>Actual Earnings</td>
<td>96.5</td>
<td>98</td>
<td>98</td>
<td>100</td>
</tr>
</tbody>
</table>

However, if the out of period adjustment were not “material to the interim period in which it would be corrected”40 (as would likely be the case in the example below with an accumulating overstatement of 4), management could choose to correct the error as an out of period adjustment, through revision to the comparative section of the next financial statement filing, or added to the SUM.

40 Ibid


(Figure 7)

<table>
<thead>
<tr>
<th></th>
<th>Q1</th>
<th>Q2</th>
<th>Q3</th>
<th>Q4</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Reported Earnings</strong></td>
<td>99</td>
<td>100</td>
<td>101</td>
<td></td>
</tr>
<tr>
<td><strong>Uncorrected Error</strong></td>
<td>+0.5 (Overstatement)</td>
<td>+2</td>
<td>+1.5</td>
<td>0</td>
</tr>
<tr>
<td><strong>Net Accumulating Error</strong></td>
<td>+0.5</td>
<td>+2.5</td>
<td>+4</td>
<td></td>
</tr>
<tr>
<td><strong>Actual Earnings</strong></td>
<td>98.5</td>
<td>98</td>
<td>99.5</td>
<td>100</td>
</tr>
</tbody>
</table>

It is important to mention that auditors do not perform audits of interim periods. Although auditors typically perform reviews of the interim financial information, it is the responsibility of management to identify errors at this time. If auditors find any errors at the year-end, they will need to assess whether it affects any previous quarters.

**Methods Prior to SAB 108 Adoption**

Prior to the adoption of Staff Accounting Bulletin (SAB) 108, companies were able to use one of the two materiality assessment methods, either the rollover or the iron curtain method. According to an article in *The CPA Journal*, “when used individually, these methods can lead to false negative assessments of no material errors” and allowed earnings manipulation. In response to these shortfalls, implementation of SAB 108 required the dual approach, applying materiality assessment under both methods. SAB 108 also

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provided the formal framework for companies to revise their financial statements of immaterial errors. Prior to the current guidance, companies could correct materially accumulating errors as out-of-period adjustments.
Chapter 3: Analysis of Prior Research

Purpose of (Prior) Research Review

This selected research was gathered and compiled to introduce some of the studies being conducted by academics and other organizations to contribute to the larger discussion revolving around financial statement restatements. In brief, these articles identified differentiating factors among restating companies and the nature of the restatements; qualitative and quantitative variables that impact the degree of market response; incongruities among restatements and their disclosures; as well as some factors with high and low correlations to the likelihood of restatements. The information below should be used to provide background information on the research conducted thus far, and should aid in the reader’s analysis and conclusion of the overall thesis statement.

History of Restatements

Professor Susan Scholz of the University of Kansas collected data on restating companies spanning the decade from 2003-2012. During the time span of 2006-2012 the Audit Analytics database recorded 3,269 Big R restatements, and 3,788 little r revisions. That’s a total of 7,057 financial statement restatements and revisions from fiscal years 2006 through December 31, 2012.\(^{42}\)

(Figure 8)

\(^{42}\) Ibid, pg. 3 (Scholz: Financial Restatement- Trends in the United States)
Restating Companies/Industries

The study written by Scholz and commissioned by the Center for Audit Quality found the average size of Big R companies in terms of assets was $6.8 billion, compared with that of $7.5 billion\textsuperscript{43} for little r, a statistically significant difference. When looking at the chart above, it is clear that the proportion of revisions to restatements changes over time from less than half being revisions to roughly two-thirds of each annual population of misstatements being corrected by revisions. Although the total number of both restatements and revisions has been decreasing, this shift to a higher proportionate use of revisions suggests the increasing importance of revisions in accounting. Scholz’ study also found that 18% of the restatements came from the computer and software industry, 16% from the financial, banking, and insurance industries, and 14% represented the energy,

\textsuperscript{43} Ibid, pg. 21
mining, and chemicals industries.\textsuperscript{44} The following is a sector breakdown of the S&P Composite 1500 from the S&P Dow Jones Indices that represents roughly 90\% of the market capitalization of public companies in the United States.\textsuperscript{45} It is important to note that the sectors are weighted by their market capitalization in comparison to the entire index, and not by the number of companies in each industry relative to the entire index.

(Figure 9)

\begin{figure}[h]
\centering
\includegraphics[width=\textwidth]{figure9}
\caption{Restatements by Industry (Big R & little r)}
\end{figure}

(Figure 10)

\begin{figure}[h]
\centering
\includegraphics[width=\textwidth]{figure10}
\caption{Restatements by Industry (Big R & little r)}
\end{figure}

\textsuperscript{44} Ibid, pg. viii
\textsuperscript{46} Ibid, pg. 17 (Scholz: \textit{Financial Restatement- Trends in the United States})
S&P 1500 Industry (Relative Market Share)

- Information Technology: 19%
- Financials: 17%
- Energy & Materials: 12%
- Industrials: 11%
- Consumer Discretionary: 12%
- Health Care: 14%
- Other: 15%

(Figure 11)

% of Restatements by Industry vs. Industry Market Share

- IT
- Financial
- Energy & Materials (In S&P)

- Scholz Study
- S&P 1500

47 Ibid (S&P Dow Jones Indices: S&P Composite 1500)
Figure 11 indicates that the top three-restatement/revision producing industries in Scholz’ study are also three of the largest represented industries in the public U.S. market. For comparative purposes Energy and Materials were combined from Figure 10 to be comparable to the sector energy, mining, and chemicals in Figure 9. This is important because it indicates that no industry is disproportionately responsible for restatements/revisions in relation to that industry’s market share of the economy. If it were the case that one industry was disproportionately representative of restatements, this would raise questions as to the unfair or potentially misleading and corrosive effects of SAB 108 and earnings quality.

**Account Impacts**

Ernst & Young (EY) performed a study of Big R and little r companies audited by the “Big 4” accounting firms for fiscal years 2010 and 2011, and found that of the restatements and revisions examined, income taxes and revenue recognition were the two leading causes for the public companies examined for both years. EY discussed the complexities associated with Accounting Standards Codification (ASC) 740 and other difficulties accompanying the accounting for income taxes as reasons for these related restatements. They found the specific causes for recent restatements related to tax accounting issues as follows:

- “Inappropriate evaluation of the reliability of deferred tax assets
- Incorrect identification or calculation of the tax basis, resulting in inappropriate measurement of deferred tax assets and liabilities
• *Income tax accounting errors associated with intercompany transactions*” \(^{48}\)

EY further added, “The accounting for income taxes presents unique challenges because it requires detailed knowledge of both technical tax matters and financial accounting skills that a single employee or department may not possess. Companies should consider building a team approach to tax process to leverage the expertise of their technical tax and financial accounting professionals and clearly delineating responsibilities.” \(^{49}\) The Ernst and Young researchers have laid out a deeper understanding of some causes related to income tax related misstatements. While accountants and other professionals can make mistakes, it is hard to imagine that companies with an average of $7.5 billion in assets (from Scholz’ study) lack the expertise or resources to work with professionals who are competent in the complexities of large corporate taxation.

Additionally, EY discusses some of the factors that influence the higher proportion of revenue recognition related restatements. “Revenue recognition guidance is accumulated from more than 200 individual pieces of literature. In some cases, the guidance is general, and in other cases it is prescriptive. Much of the guidance is specific to certain transactions or industries. These factors and other complexities cause inappropriate revenue recognition to be one of the more frequent topics of restatements.” \(^{50}\) They list a few reasons the revenue-related restatements vary:

• Calculation errors


\(^{49}\) Ibid, pg. 4

\(^{50}\) Ibid, pg. 6
• Misappropriation of accounting literature
• Misunderstanding of contractual terms
• Lack of oversight in revenue-related accounting estimates

With this information in mind, Scholz’ research discovered that by 2012, restatements were trending toward involving fewer accounting issues than in earlier years.\(^{51}\) This trend also indicated there were fewer issues arising from errors such as revenue related restatements, and those related to on-going business expenses. Both revenue and on-going expenses are viewed as critical accounts by investors, according to Scholz’ study.\(^ {52}\)

**Nature of Restatement Companies & Restatements**

(Tan and Young) published *An Analysis of “Little r”* in January 2014. Their research focused on the use of little r revisions for earnings management, the occurrence and nature of these restatements, the firms which restate using SAB 108 guidance, as well as the firms’ behavior surrounding such disclosures. This report gathered its data in a similar fashion to the previous report. By using Extensible Business Reporting Language (XBRL), these researchers extracted information on more than 300 little r restatement companies and over 1000 Big R restatement companies from the SEC’s website. In their comparison of Big R firms to little r firms, Tan and Young (2014) have found little r companies to possess

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\(^{51}\) Ibid, pg. viii (Scholz: *Financial Restatement- Trends in the United States*)

\(^{52}\) Ibid, pg. viii (Scholz: *Financial Restatement- Trends in the United States*)
higher profitability, market-to-book, and free cash flow levels as well as lower leverage.\textsuperscript{53} These variables suggest that little r companies “exhibit better performance...and may not be as financially distressed as Big R firms.”\textsuperscript{54} Their sample identified a high frequency of restating companies within the banking, insurance, and real estate industries.\textsuperscript{55}

Immaterial restatements corrected as out-of-period adjustments, according to Tan and Young (2014) are more likely to decrease current/prospective income which would indicate that auditors previously “allowed income-increasing reporting choices”\textsuperscript{56} in prior periods. In order to further break down the findings of the little r firms, Tan and Young categorized the restatements in their sample as “good” or “bad” by evaluating the direction of the revision. Restatements are considered bad if assets, revenues, or income are revised downward or; expenses or liabilities revised upwards.\textsuperscript{57} Also included were any adjustments, which “caused the firm to show higher performance in the as-first-reported year.”\textsuperscript{58} Their sample of revisions from 2009-2011 produced results showing that 55% of these revisions were “bad.”\textsuperscript{59} (“Bad” from the perspective of the investor because they were previously relying on financial statements that overstated earnings.) This information indicates that slightly more than half of the companies in their sample had previously overstated income or painted a better financial picture than was accurate.

\textsuperscript{54} Ibid, pg. 3
\textsuperscript{55} Ibid, pg. 7
\textsuperscript{56} Ibid, pg. 7
\textsuperscript{57} Ibid, pg. 3
\textsuperscript{58} Ibid, pg. 16
\textsuperscript{59} Ibid, pg. 16
Some might argue this information is indicative of earnings management because more than half of restatements directly mislead the past decisions of users of financial information to assess earnings and performance as better than reality. However, this fact also means that nearly half of the restatements studied did just the opposite. For example, if 80% of restatements had previously reported better earnings than reality, there would be little room to argue that management was using the revision to prop up earnings or maintain a trend in earnings in time of mediocre performance. There is no smoking gun here.

Within the last year, the American Accounting Association (AAA) produced *Accounting Restatements: A Review of the Literature* which primarily emphasizes research conducted from 2000 to 2013 and provides an impressive summary account of the research conducted thus far on the issue of restatements. This study provided data that when calculated as a percentage indicates 24% of restatements were caused by accounting irregularities, where 76% were due to errors. 60

The report by the AAA found higher rates of “C-suite” (chief level executives of a firm) turnover during the two-year period following a restatement event.61 (The following rates include executives from companies of both little r and Big R restatements, but do not differentiate between the turnover rates for specifically Big R and little r.) Within three years of a negative restatement event director turnover is almost half, compared to roughly

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61 Ibid, pg. 28
a third for companies without a restatement event in the last three years.\textsuperscript{62} The directors involved in these companies no longer hold positions on 25\% of other boards they previously served.\textsuperscript{63} As a result, they postulate that the labor market and potential employers penalize executives and directors associated with restatement events.\textsuperscript{64}

**Market Reaction Indicators**

Scholz’ study found the “average stock price reaction to restatements was -1.5\%, measured as the percent change in the stock price at the time of the announcement, adjusted for the overall market return.”\textsuperscript{65} This same study showed the average market reaction to Big R restatements was -2.3\%, whereas little r revisions had an average market response of -0.6\%. Big R restatements are responsible for market reaction that is almost four times greater than the market response to little r revisions.

The review published by the American Association of Accountants found that the degree of market reaction was mixed depending on the nature and reason of the restatements. It reports an average cumulative abnormal return (CAR) of negative 6\% for restatements and revisions related to errors, whereas fraud-related revisions command a negative 20\% return.\textsuperscript{66} This demonstrates there is a perceived difference in the eyes of an investor as to the implications of restated financial information due to a fraud, mistake, or a change in an accounting standard.

Reaction is negative to little r revisions partly because it’s indicative of management and auditor’s failure to identify an error prior to making its way onto the financial

\textsuperscript{62} Ibid, pg. 28  
\textsuperscript{63} Ibid, pg. 28  
\textsuperscript{64} Ibid, pg. 28  
\textsuperscript{65} Ibid, pg. IX (Scholz: *Financial Restatement- Trends in the United States*)  
\textsuperscript{66} Ibid, pg. 8 (AAA: *Accounting Restatements: A Review of the Literature*)
statements. Investors respond more negatively to Big R restatements, and even more so adversely to misstatements as a result of fraud. It also argues there is a higher perceived degree of information risk because there is less market reaction to earnings announcements for several periods following a restatement event.\(^\text{67}\) The information can suggest that investors view a restating company with a high degree of uncertainty and risk.\(^\text{68}\) A high level of information content of earnings is the relationship between financial data having high earnings quality (high reliability/accuracy) and investors responding to this information with a high degree of confidence in the information presented to them.

Regardless of investors’ claims of potentially misleading and inaccurate information, they respond to prior period adjustments rationally, and in a manner proportional to the information reported. This indicates that although the current guidance may not be perfect, and there is certainly room for improvement, SAB 108 works.

In February 2011, Omer et al published *Investors’ response to revelations of prior uncorrected misstatements*, which investigates the market reaction to prior period misstatement corrections as well as the impact of audit quality and related auditor independence to such restatement events. They conducted their research of market return testing on a sample of 272 companies by using the Morningstar Document Research and SEC’s EDGAR databases. They also examined the effects of the timing of a SAB 108 announcement.

The market reaction to a restatement announcement occurs around the time of announcement of the restatement, whether by press release or amended filing. Omer controlled for investors’ prior expectations of the restatement announcement on the

\(^{67}\) Ibid, pg. 8

\(^{68}\) Ibid, pg. 8
overall financial statements if there was a press release or announcement before the updated financial statements were issued. The study found that when the restatement event was announced without the total financial statement impact quantified, market reaction was more negative than when the issue was quantified and included in the initial public announcement.\(^{69}\) Conversely, they also examined the impact of a prior period revision when nothing was disclosed to the public prior to updated financial statement issuance. Also, the same study found the “negative market reaction effects may be reduced based upon the disclosure strategy, i.e., employing a stealth disclosure.”\(^{70}\)

Market reaction to restatements can be classified by the direction certain line items are impacted and even the specific accounts that are affected. Omer et al found that analysts consider the direction in which restatement events increase, decrease, or have no impact on net income. Market reaction is negative to overstatements of previously reported income, but the market commands close to zero reaction from income understatements of prior periods. This would suggest that regardless of the quality of past/future earnings, the market reacts slightly negatively to overstatements of previously reported income, and it responds with almost zero price change to understatements of prior periods.

This information is consistent with the thinking that the market reaction is comprised of a negative response to the disclosure of a misstatement, and is either pushed more negative if earnings were previously overstated, or counteracts the implications of an


\(^{70}\) Ibid, pg. 8 (AAA: Accounting Restatements: A Review of the Literature)
error by increasing the value of the stock when prior earnings were understated. All of this information can suggest the market response to a prior period error revision/restatement considers both the effects of a prior period error on the perceived level of earnings quality and trust in management along with the actual information presented in the restatement.

Also, investor’s perception of the company’s reporting system, management competence, and the pervasiveness of misstatements is more negative if there has been a previous restatement or if the misstatement affects multiple periods. Furthermore, regulatory reaction to a restatement event such as litigation, auditor turnover/resignation, or SEC enforcement can impact the degree of market response as well.

Other variables that can impact the degree of investor reaction to restatement events are the perceived degree of auditor independence and the perception of audit quality. Omer et al also considered the implications that auditor’s economic and social incentives to maintain clients have on the overall audit and the quality of earnings. The decisions surrounding a misstatement revision are not observed by the public, and financial statement users are generally unaware of the discussions held amongst management, audit committee members, and the auditors before the materiality decision is made. The researchers concluded firms should disclose the information gathered, discussions, and decision process amongst the auditors, management, and audit committee when the evaluation and quantification of a prior period immaterial error takes place. In their view, this would ideally improve financial statement quality and provide more transparency.

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71 Ibid, pg. 23 (Omer et al: Investors’ Response to Revelations of Prior Uncorrected Misstatements)
72 Ibid, pg. 24
73 Ibid, pg. 2
Investors have indicated the overall level of audit quality and auditor independence impacts their perception of the information content of earnings, both of which are brought into question as possibly being compromised whenever misstatements are waived as immaterial under SAB 108. They state “disclosure of previously waived misstatements suggest that auditors detected misstatements but, in the resulting negotiation with management, ultimately waived correction of the misstatements.”\cite{Ibid, pg. 4} This could exhibit a possible lack of independence or the auditor’s ability to be influenced and manipulated. Disclosing the process and information relevant to a restatement decision would help the public evaluate the auditor’s willingness to yield to client pressure, providing more transparency.

The study examines some economic incentives auditors are faced with which might also compromise their independence. The costs of establishing a new audit are much higher than a recurring audit. This advantages incumbent auditors because it costs less to the firm to perform an audit than it would with a new audit firm. As incumbent auditors develop longer relationships with their clients, and as client importance increases, the researchers found that auditors might be economically motivated not to report certain identified misstatements.

The study conducted by Omer et al found a “negative association between these measures...” (Factors regarded as possibly damaging auditor independence and thus audit quality) “And investors’ response to SAB No. 108 disclosures.”\cite{Ibid, pg. 2} Similarly, there are social and economic incentives such as developed personal relationships and client familiarity that is perceived as compromising auditor independence as well. Some investors perceive

\cite{Ibid, pg. 4}
\cite{Ibid, pg. 2}
longer auditor-client relationships as possibly compromising their independence, and therefore respond more negatively to restatements from companies with lengthy audit tenure. The research concludes there is “little evidence suggesting that longer auditor tenure compromises auditor independence.” Regardless of the accuracy of this assertion, auditor tenure is important to evaluate because investors may perceive it as damaging to audit quality and auditor independence. This perception demonstrates the impact little r restatements have on the perception of the information content of earnings, as well as the influence little r's have on market reaction.

**Disclosure**

Other researchers have focused on the actual method of disclosure of these restatements by the companies. Currently, there is limited authoritative guidance instructing firms on how to specifically disclose and announce restatements. Restating/revising firms are instructed, (as) per SAB 108, to provide full disclosure of the nature and amount of the errors being corrected in a cumulative adjustment, as well as when and how the errors were caused.\(^7^7\) This is important as the method and message communicated by management to investors affects the degree of market reaction.

Interestingly, Tan and Young found no consistency of disclosure among the companies restating, “Some firms report a detailed schedule of changes, while others simply discuss the numbers within a sentence.”\(^7^8\) Further research into the consideration of the linguistic context of restatements was performed in the AAA study. They found the

\(^{76}\) Ibid, pg. 9  
\(^{77}\) Ibid, pg. 10 (SEC: *Staff Accounting Bulletin: No 108*)  
\(^{78}\) Ibid, pg. 19 (Tan & Young: *An Analysis of “Little R” Restatements. Social Science Research Network*)
medium used for a restatement announcement such as video or text affects investors’ trust in the company after restatement events. Their research concluded that very few of the restatement disclosures provided an in-depth explanation for the changes to amounts reported in the financial statements. Tan and Young describe the method for disclosure used by some management as “quiet”\textsuperscript{79}. Their paper cited an article in Forbes magazine that claims “managers are increasingly using earnings revisions, or ‘little r’ restatements, rather than formal, or Big R restatements, in order to handle errors quietly and therefore avoid claw backs in executive pay and shareholder lawsuits.”\textsuperscript{80} This information can be utilized in the discussion of restatements, as management’s language and methods for disclosure can be used as a tool for earnings management.

**The Need for Restatements is Unyielding**

Another area of study explained in a review of prior literature by the AAA is the existence of a base restatement rate regardless of effective Internal Controls over Financial Reporting (ICFR) or high audit quality. According to the Center for Audit Quality, “Internal control includes all of the processes and procedures that management puts in place to help make sure that its assets are protected and that company activities are conducted in accordance with the organization’s policies and procedures.”\textsuperscript{81}

The study evaluates variables inherent in the current market that make it impossible to eliminate the need for restatements/revisions entirely. According to the

\textsuperscript{79} Ibid, pg. 3-4
\textsuperscript{80} Ibid, pg. 1
study, “this observation is based on: the current complex business and regulatory environment; the desire for cost effective audits i.e., standards focused on achieving reasonable, not absolute, assurance; and the state of existing audit practices, technologies and techniques. Added to this base rate are variations due to differences in industry, management, governance, internal controls, audit practices, people and CPA firms.”

Even though there are factors, which will continue to increase the likelihood of restatements, there are some variables that are correlated with fewer restatements. For example, companies with more experienced CFOs who are also CPA licensed have a smaller chance of association with a restatement. This information could suggest that CPAs are less likely than non-CPA licensed executives to make errors due to CPA training or perhaps, less likely to be unethical. When examining factors that could lessen the chance of restatements, the study also found that “stronger audit committee independence and competence but not diligence relate to lower incidence and severity of restatements.”

This suggests an independent and experienced board lessens the risk of restatement.

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82 Ibid, pg. 5 (AAA: Accounting Restatements: A Review of the Literature)
83 Ibid, pg. 24
Chapter 4: Original Work

The initial plan for this research paper was to incorporate original work that was comprised of findings from a matched pairs analysis. The design for the matched pairs analysis would have compared several companies with little r revisions to similar companies without any history of little r revisions or Big R restatements. While conducting research for companies that met suitable criteria, with the resources available to the author, it was extremely difficult and time consuming to find and identify enough companies with recent prior period revisions. Resources available to the researcher were tools such as Google.com, WallStreetJournal.com, as well as a research database made available through the author's university library website. In addition to the difficult nature of finding companies for a sample, the small size of the sample of a matched pairs analysis would result in statistically insignificant inferences or findings, and would thus be irresponsible to include in the discussion on the topic of prior errors.

Due to the decision that performing a matched pairs analysis would not add significant value to the discussion, and the difficulty in finding relevant information, the original work consists of: First hand interviews with accounting professionals, interpretation of the current situation, and proposals that could improve the current situation.

Phone Interviews

Michelle Wroan, a KPMG Los Angeles audit partner, has dealt with immaterial revisions first hand with some of her own clients and as a consultant to her colleagues. She previously spent time working within the national office’s Department of Professional Practice. At KPMG, when there is a discussion to restate or revise the financial statements
of a public company, the auditor-in-charge (AIC) partner must consult the Department of Professional Practice. This requirement increases assurance of proper handling of the revision by means of consulting an objective professional that is independent of the client and the audit. Wroan said that in most cases, all parties involved were in agreement as to the handling of the situation in question. This process is beneficial because the national office provides feedback to the AIC with a fresh set of eyes. Additionally, smaller offices serving clients in less diverse markets with professionals who might be less experienced in restatements or revisions in specific industries can seek guidance and feedback from the national office.

M. Christian Mitchell is a former Deloitte partner with the Los Angeles audit practice, currently serving on the audit committees of six corporate boards, two of which are publicly traded companies. Mitchell left Deloitte prior to the issuance of SAB 108 and provides the audit committee’s perspective of this process. Stuart McMullen is a current KPMG LA audit partner. Bryan Banta is a former KPMG LA manager in the assurance practice, currently running his own accounting and consulting practice. All interviewees have had some previous experience with little r revisions.

Mitchell believes the existence of SAB 108 improves financial reporting because it provides more guidance and a method for testing materiality with more than a simple binary test, and allows for disclosure and correction without the “mess” of a Big R restatement. In Mitchell’s experience, the guidance gives enough information to come to a reasonable conclusion. He feels financial reporting is better now than before the issuance

of SAB 108, as current earnings more accurately reflect current operations. Also, he believes that because the way books and records are kept today with advanced software and IT systems in compliance with SEC expectations, the auditors are able to sign off on more accurate financials.\textsuperscript{85}

McMullen, Banta, and Wroan also agree that SAB 108 is beneficial for everyone involved, including the users of the financials. The new guidance provides more clarity to the auditors by adding a framework to determine materiality through examination of the qualitative and quantitative factors.\textsuperscript{86,87,88} This is beneficial to users of the financial information because although each materiality determination is subject to unique circumstances, the framework and guidance for determining materiality is the same for all reporting firms.

McMullen is skeptical of pronouncements or guidance that lessens audit partner’s use of judgment, but believes SAB 108 improves clarity and does not specifically lessen auditor’s judgment.\textsuperscript{89}

When asked what changes might improve the guidance, Banta and Wroan mentioned that although every situation is unique, drawing more strict numerical lines for determining the quantitative thresholds could further improve the current situation.\textsuperscript{90,91}

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\textsuperscript{86} McMullen, Stuart "SAB 108 Interview: KPMG Audit Partner." Telephone interview. 17 Dec. 2014.
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\textsuperscript{88} Ibid (Wroan: SAB 108 Interview: KPMG Audit Partner)
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\textsuperscript{89} Ibid (McMullen: SAB 108 Interview: KPMG Audit Partner)
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\textsuperscript{90} Ibid (Wroan: SAB 108 Interview: KPMG Audit Partner)
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\textsuperscript{91} Ibid (Banta: SAB 108 Interview)
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that any misstatement over 5% of any account, for example is material. However, they believe more guidance related to the quantitative factors could provide a more standardized method. In a follow-up interview with Wroan, she mentioned that the SEC would most likely never provide guidance in terms of a specific percentage for an error’s impact in certain statements in the financial statements, but more guidance could be useful.\textsuperscript{92} This would leave more reliance on the professional judgment of the auditors for evaluation of the qualitative factors.

McMullen is skeptical of a changing audit environment that lessens the use of his professional judgment. Conversely, Banta and Wroan would like a little less reliance on judgment of the quantitative thresholds, and more flexibility with the qualitative factors. This could be seen as a discrepancy in materiality assessment methodology.

I would argue that while having more defining “hard lines” for the quantitative thresholds would possibly standardize the process and help guide auditors in determining materiality, it is not appropriate because each company and misstatement situation is unique. Using a strict number across the board for materiality determinations (\textbf{None} of the interviewees are calling for this) wouldn’t be suitable. Materiality levels would be different for companies of different industries and companies operating in different geographic areas. Also, the first audit of a company looking to file for its initial public offering (IPO) would be subject to different materiality thresholds and degree of audit risk than the audit of a company that has been operating as a publicly traded entity for over three decades. Companies preparing for an IPO are often placed under a microscope and faced with more

\textsuperscript{92} Wroan, Michelle. "SAB 108 Interview: KPMG Audit Partner- Follow-up." Telephone interview. 20 Jan. 2015.
scrutiny by investors and auditors reviewing their financial information than an established public entity with a record of clean audit opinions.

According to the first hand accounts of the interviewees, their experiences indicated the auditors identified the discovery of the accounting error just as often as management made the discovery.\textsuperscript{93} Often, management and the auditors discover errors together when they are working to understand or resolve some other issue.

The interviewees did not express explicit concerns that little r’s were being used for any kind of earnings management. As an individual tasked with this accounting research topic from a point of view that is skeptical of SAB 108’s potential use for earnings management, the author of this paper expected the auditors would approach all revisions with more skepticism. When asked, Mitchell could not create a scenario in his mind to use SAB 108 for earnings manipulation. He explained that if it became standard practice for management to use recurring accumulating errors as a method for manipulation, it would be indicative of an internal controls problem that would be discovered during an audit. Furthermore, he explained that analysts and people who intensely study the company and its trends would acknowledge if management attempted to recognize an early transaction for example, that could impact reported information directly related to the core operations of the business.

Another topic of discussion with the interviewees was how management/auditors decide which immaterial items on the passed adjustments sheet get revised. There are typically several immaterial errors either identified in the current period or identified in previous periods that remain on the passed adjustments sheet: for re-evaluation, to keep

\textsuperscript{93} Ibid (Mitchell: SAB 108 Interview: Audit Committee)
track of the accumulating effects, until the item is no longer relevant (corrects itself), or until the item is revised.\textsuperscript{94} Even though management has the formal ability to revise their financial statements (of) for any and all immaterial errors, they often only revise when management and the auditors feel the information is relevant or impactful enough to the decision making process of users of the financial information to revise.

Mitchell explained that immaterial items that are one-time events, not part of the ongoing operations or the core business operations are likely to be ignored. On the other hand, these types of items would be more likely to be revised if they were recurring before their accumulating impacts became material, if they were recurring. Additionally, to report the correct information, immaterial items that are part of the ongoing and regular business that could impact trends or margins should be revised.\textsuperscript{95}

When asked the same question, McMullen explained there are lots of factors and considerations that go into the decision to revise or leave an immaterial error on the passed adjustments sheet. He identified timing as one of the most important factors. For example, if he as an auditor or as a client found an immaterial audit difference the day before the press release when the earnings call transcript, press release, earnings release and books had been closed and wrapped up, it would not make sense to open things back up. If however the error was discovered a week before the press release for example, he would be more likely to open the books back up and discuss the wisdom of revising as opposed to leaving the immaterial item on the SUM sheet. McMullen added that in the decision to revise, an error that has black and white accounting implications is likely to

\textsuperscript{94} McMullen, Stuart "SAB 108 Interview: KPMG Audit Partner- Follow-up." Telephone interview. 26 Jan. 2015. \\
\textsuperscript{95} Mitchell, Chris. "SAB 108 Interview: Audit Committee - Follow-up." Telephone interview. 23 Jan. 2015.
receive much less push back from management than an error involving more judgment. Furthermore, the discussion can get more difficult if the immaterial error causes expected earnings to be met or upset, or if a bonus metric for executives would be met or missed.  

Wroan reaffirmed that the items left to accumulate over time on the SUM sheet are in fact monitored and re-evaluated by the auditors. She mentioned in certain circumstances management will just decide to book the item in question and revise the financial statements as a little r so they no longer have to think about or worry about the error and its potential accumulating impacts. Like McMullen, Wroan agreed that timing plays a big role into the decision to restate certain items. Wroan further explained at the end of the audit management must sign a management representation letter that is signed by the CEO, CFO, and corporate controller. A piece of the signed document indicates that management has reviewed and agreed that the uncorrected adjustments on the SUM sheet are immaterial. The letter is shared with the audit committee so that everyone involved has knowledge of which items are being passed as immaterial and the items not booked for revision.

The overall consensus of the interviewees was that SAB 108 is effective in providing more accurate financial statements, and that it has not presented them with reason to believe the situations they’ve handled were tainted with earnings manipulation.

**Hypotheses**

The consensus of four experienced accounting professionals interviewed is that SAB 108 is effective, and that no concerns of misuse for earnings manipulation existed.

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96 Ibid, (McMullen: SAB 108 Interview: KPMG Audit Partner- Follow-up)
97 Ibid (Wroan: SAB 108 Interview: KPMG Audit Partner- Follow-up)
98 Ibid
However, investors remain concerned about revisions.99 Tan and Young’s study alludes to a Forbes article when discussing the existing apprehension amongst investors that management is using little r revisions as opposed to Big R restatements in order to discreetly handle errors without affecting executive compensation metrics and the negative market reaction from a Big R event.100 In fact, in July 2013 the SEC established the Financial Reporting and Audit Task Force designed to detect and identify “areas susceptible to fraudulent financial reporting, including on-going review of financial statement restatements and revisions.”101 This indicates there is a clear discrepancy in the perceptions of the two parties most involved in financial reporting: those responsible for creating and auditing the financial information, and the actual users of the information, with respect to their trust in the current system to function properly.

The following questions when viewed together can assist the accounting profession and regulators in determining whether any changes should be proposed to the current guidance on little r revisions. The purpose of each hypothesis is designed to demonstrate how Big R and little r differ in order to argue why different treatment for these two methods of handling discovered prior misstatements is necessary.

**Hypothesis 1: The nature of the economic events that give rise to Big R and little r differ.**

No, the nature of the items that necessitate these two activities is the same. As explained previously on pages 6-8, only the discovery of financial misstatements creates

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99 Ibid, pg. 2 (Tan & Young: *An Analysis of "Little R" Restatements. Social Science Research*)
100 Ibid, pg. 2-3
the need for Big R's and little r's. The only substantive difference in the nature of the two events is the level of materiality of the misstatement that causes the correction as being subject to either Big R or little r treatment. It is important to distinguish the initial cause of revisions and restatements because it helps demonstrate why the handling of these distinct events must be tailored to each respective situation's circumstances.

**Hypothesis 2: There is no important difference between Big R and little r.**

No, they are different. As explained in pages 13-17, the level of materiality establishes whether a Big R or little r should be applied. According to SAB 108, an error's materiality or immateriality as determined by both the iron curtain and rollover methods leads to distinctly separate handling of the discovered prior errors. By definition, Big R and little r are separate items.

**Hypothesis 3: The treatment for both is the same.**

No, treatment for the two is different. After running both the iron curtain and rollover method tests of materiality, as explained in pages 17-20: The treatment for Big R results in formally amending prior financials, while a little r enables management to revise the cumulative effects either as out-of-period adjustments or to the comparative section at next financial issuance. This hypothesis establishes that the current guidance already recognizes that treatment for each of these items is distinct, and thus helps in the argument that treatment should remain separate.

**Hypothesis 4: The transparency of little r revisions and Big R restatements is the same.**

No, the level of transparency of these two events is different. The review of regulations completed on pages 9-10 describes that Big R events require an item 4.02 8-K
SEC filing and either a 10K/A or 10Q/A (amended annual and quarterly report, respectively) to be filed as soon as possible. The 8-K specifically alerts investors to the material restatement and to no longer rely on the previously issued financial statements. The little r revision only requires disclosure of the nature and amount of the errors being corrected, in addition to the timing and cause of the error. The level of awareness of these two events is different simply due to their distinct disclosure and announcement requirements. The treatment for Big R events produces much louder and visible awareness than the footnote required of little r events.

**Hypothesis 5: Management never has the choice between either Big R or little r.**

No, in some cases it is clear that management must either formally restate prior financials, or should revise. However, as discussed in pages 10-12, there is no bright line defining material or immaterial items. Both the data and the literature suggest there are some issues that require more judgment of the qualitative factors than others, and consequently allow the companies more flexibility. For instance, an item that is 4.5% of net income might require more judgment in the materiality determination than an item that is 9% of net income. As such, depending on the interpretation of the qualitative factors surrounding the quantitative impacts of an error, some items might be considered material to one professional and immaterial to another. On pages 46-48 the interviewees provided examples of situations that did not clearly dictate management to act in either direction. In these situations, the qualitative circumstances surrounding the nature of the errors greatly impacted the determination of materiality. In consideration of the qualitative factors (as is required in all materiality determination) the auditors waived materiality, indicating management/auditors are occasionally presented the choice to revise immediately or
correct the error in the next period. This hypothesis proves that the decision to arrive at a little r event or a Big R event is based on circumstances of different severities.

**Hypothesis 6: Investor reaction is the same to these two events.**

No, the information presented in pages 34 finds that the market response to Big R events is -2.3% and -0.6% for little r events. Big R disclosures produce market response that is almost four times greater than the market reaction to immaterial revisions. The research presented in those pages also indicates that the degree of market response also varies relative to the direction financial statement items are revised, as well as the monetary amounts they are restated. This hypothesis shows that even investors view these two items as conveying different information.

**Hypothesis 7: It is easy for a financial statement user to identify and analyze a little r revision.**

No. During the research of this paper, a time-consuming search of wsj.com and google.com only presented several revisions, even though there have been thousands according to the studies evidenced throughout this paper. Additionally, a similar query on the proquest.com database ABI/Inform Complete, available through the author’s university library website only produced several financial statement revisions. There seems to be a couple ways to find this data in a more fruitful manner. A search on the SEC’s Edgar Online Database did not adequately produce financial statements that match the search for keywords such as SAB 108, prior period, revision, or error. The typical investor is unable to identify firms that have undergone a little r revision without special software, training, or investment in expensive databases. Therefore, the lack of transparency is difficult to pierce for a typical investor. Analysts can pay for and subscribe to other databases such as S&P
Capital IQ, the SEC Edgar Online Database could be utilized, or complex software that uses XBRL data to run a comparison of the prior year’s financial data with comparative numbers in more recent filings could be used. Analysts who maintain spreadsheets of company’s financial performance may notice revisions when they perform company analysis because the new information will change prior year information. It is important to understand the ease in which researcher or investors identify Big R restatements and the difficulty they have in finding little r revisions because it identifies another difference between the two items, and points to an area for improvement.

**Hypothesis 8: Little r’s are immaterial; therefore there is no significant negative impact if a financial statement user is unaware that a little r occurred.**

No, transparency of little r revisions is just as important as Big R restatements. Just because a revision is waived as immaterial does not mean it should be harder to identify than a material restatement. For example, analysts still rely on accurate past financial information to detect trends, create forecasting models, and to make accurate projections. The information conveyed in these revisions could alter the projections and decisions of analysts at large financial institutions that wield significant market moving power. Furthermore, the existence of little r revisions, especially if they occur frequently, can be important information for the financial statement user about the quality of the firm's internal controls and reporting processes, and thus can affect the user's perception of information risk. This final hypothesis points to another difference in these two items, as well as an area where the current guidance can be improved.
Proposals

Proposal 1: Eliminate the current guidance or require companies to file a form 8-K with the SEC for little r disclosures, similar to the requirement for Big R.

This option is not ideal because it would have the effect of revoking the current regulation, and in essence would treat all restatements and revisions the same. The SEC form 8-K is a current report for disclosing material corporate events “that shareholders should know about.” These material restatements disclosed in an 8-K disclosure typically result in significant negative market reaction, response in excess of that of immaterial revisions.

SAB 108 was designed in part to provide management a means for making their financial statements more accurate without the negative reaction associated with a Big R event or the time and costs associated with the formal restatement. While requiring revising companies to issue an 8-K would increase transparency and awareness of financial revisions, companies might be less willing to revise prior immaterial errors if the immaterial error is announced on a form reserved for material events. Investor response to immaterial revisions announced in 8-K’s would probably be more negative than the current response to little r disclosures simply because the nature of the information typically disclosed on this form implies the information is material.

Furthermore, eliminating SAB 108 entirely would result in financial statements with more accumulated immaterial errors and consequently less accurate financial information.

The current system (while not perfect) enables management to “true-up”\(^{103}\) the financial statements. If governing bodies eliminate the ability or requirement for entities to disclose an immaterial correction to the content or presentation of previously reported information, the overall information content of earnings would decrease over time. Companies would again only revise inaccurate financial information once an accumulating error becomes so material that management must issue a Big R restatement, or when individually material errors are discovered. For example, the crew of a ship would likely prefer to have the ability to repair small damages to the hull of the boat whenever little holes are discovered, rather than waiting for those little holes to amass into one large hole.

Reverting to the previous system (prior to SAB 108) would hurt users of the financial information because a reliance on high earnings quality would be diminished, and the reporters of the financial information would be presenting information that could be potentially misleading to investors.

**Proposal 2: Make no changes.**

When evaluating the effectiveness of the current guidance, there is a disparity in viewpoints between users of the financial information and auditors and their clients. One side feels the current guidance is working properly, while the other party feels it is subject to manipulation and is ineffective at achieving its main goals. Since there is disagreement between the group responsible for creating/auditing information and the group that relies on it, it would not make sense to leave the situation in its current status.

**Proposal 3: Require several specific changes to the current guidance, as laid out below.**

\(^{103}\) Ibid, *(SAB 108 Interview: Audit Committee - Follow-up)*
1. Stricter enforcement of the requirement to disclose immaterial revisions could benefit users of the financial information.

As explained on page 51, full disclosure of the nature and amount of the errors being corrected in a cumulative adjustment, as well as the cause and timing of the error is currently required. A study by Tan and Young (that) compared the value of an account previously reported to the value of the same account and same fiscal year at a later filing. Their study controlled for differences that would arise from issues such as stock splits, change in operations, numerical precision, Big R restatements and other similar variables that could skew the data. The researchers concluded that roughly 12% of all U.S. public reporting companies (little r, Big R, and companies with no change to financial data) in the sample from 2009-2012 had minor revisions. Additionally, they found that only about 14% of the companies with small revisions had footnote disclosures for the revisions.\footnote{Ibid, pg. 4-5 (Tan & Young: An Analysis of "Little R" Restatements. Social Science Research)} Therefore it appears there are deficiencies in either understanding or complying with the current regulations.

2. The footnote disclosure of the revision should include the following:

   a. How many periods the error impacted
   b. When the decision to revise was made by management
   c. Why management decided to do a little r revision (How they came to the conclusion that it was immaterial)
   d. What accounts are directly impacted
   e. Total monetary amount of error
f. Impact to retained earnings, net income, earnings per share, assets, liabilities

g. How the adjustment impacted metrics used in determining executive compensation or loan covenants

The above requirements would provide the user of the financial statements with a better understanding of the event causing the revision, the reasoning and logic for the decision to revise, as well as the (other relevant) impact(s) the adjustment has to areas of concern for a user of the financial statements.

3. **Earnings/press release must include the footnote disclosure of the revision, and the word “revision” must be used in the disclosure.**

This would assist in making the revision more transparent and more publicly acknowledged. Analysts would likely notice the disclosure in the condensed reports for the companies they follow, rather than relying on purchasing data or complex systems to identify little r’s in the lengthy and inclusive annual or quarterly reports. Requiring the word revision would aid simple word searches of the financial statements to identify a little r revision when analysts review these often-extensive reports.

4. **Any revised figures that are reported in the consolidated financial statements must have a footnote or asterisk indicating the number was revised and referring the reader to the footnote disclosure for the error.**

The above suggestion helps investors and other users of the financial information remain aware of recent revisions and their impacts to the comparative financial statements when conducting analysis.
Conclusion

An examination of the current restatement climate, the unique handling of immaterial and material misstatements, and interviews of professionals has provided the data for the following arguments: The current situation is one that requires improvements in order to eliminate some of the points of contention that divide users of the financial statements, (who remain concerned about SAB 108) and the groups responsible for organizing the information (who seem content with the status quo). The third proposal outlined above provides the best course of action that regulators could take to improve the current restatement climate, dampen investor’s concerns about immaterial prior period revisions, and provide a financial statement platform that has inherently higher information content of earnings. Finally, there should be more research to determine what changes could be enacted to improve the current system without eliminating reliance on professional judgment of auditors, while providing more quantitative guidance.

Areas of Further Study

During the course of compiling research for this (honors project), it was established that several topics and aspects which if further studied could add value to understanding the impacts of prior period errors and offer beneficial changes to the current guidance.

Examining the guidance for handling prior period errors under the International Financial Reporting Standards, and evaluating how foreign companies handle prior period errors could be examined. When conducting research on the IFRS’ handling of prior period errors, researchers should also focus attention on any actions amongst the restating entities or authoritative literature that is aimed to increase the information content of earnings. Researchers could benefit from more closely examining the content of the
information communicated, the level of clarity, as well as the means of communicating the restatement and revision events. When examining the implications auditor independence has on the degree of market reaction, researchers could look to see if auditors’ materiality determinations are commonly more or less conservative than their clients’ in order to protect the reputation of the audit firm. Similarly, it could be interesting to see if the accounting firm’s internal guidance with respect to handling prior errors is consistent between the Big 4 firms. Additionally, research should be conducted to see the degree (if any) of change analyst’s recommendations for stocks are subject to after a little r event. Finally, further research should be conducted examining the relationship between internal controls over financial reporting and misstatements.
Works Cited


Appendix

Analysis Matrix

In my ACCT 400 capstone course, the concept of an Analysis Matrix was introduced. This theory “describes three perspectives from which to view accounting, corporate governance and risk management theory: Enterprise, Auditor and User.” The implication this paper has on these three perspectives is examined below.

From the perspective of the Enterprise, the research in this paper impacts companies in a few ways; it provides significance to management’s decisions, and offers possible improvements to their operations. If management is aware of the negative reaction associated with restatement events they might implement more strict internal controls which could help lessen the chance of future restatements and the subsequent negative market reaction and decreased trust by investors that often follows a restatement. If management is considering options to “smooth” or manipulate earnings, they might now be more educated on the consequences for executives associated with these restatement events, and might be less inclined to act in this manner. Furthermore, if management is more versed in this topic, they might be more inclined to ensure their accounting department is highly compliant and forthcoming with the audit team to ensure audit risk is as low possible. With this new perspective of the opportunity cost associated with employees spending time providing information to the audit team, chance of restatement and negative consequences could lessen.

Audit firms might be impacted by this research as it could significantly alter the way in which partners and firms approach audits and restatement events. A better
understanding of the consequences and results of restatement events in the market, user trust, and perceived auditor independence would have implications on audit approach and fees as well. If auditors are aware of the high restatement risk accounts and industries, they could design the audit approach to include more testing or scrutiny of specific accounts or clients that are more prone to mistakes. Also, if auditors were more mindful of the subconscious implications of short audits with lower fees, they would hopefully apply the same professional skepticism associated with larger audits to prevent as many errors as possible.

This research significantly affects the users of financial statements, primarily investors, who rely on the accuracy of financial information. If users are more informed of restatement events, audit risk, restatement history of reporting companies, materiality thresholds, internal control efficiency, and inherent audit risk these users of financial information will be more effective in interpreting financial statements, as well as developing a more balanced understanding of the impacts of these respective restatement events. If there is more specific guidance in the medium, timing, and content requirements for restatement disclosures, there should be more transparency and comparability of restatements and other companies without restatements. Overall, users who understand these events would be able to make decisions based on an expanded understanding and analysis of the reported information.

Finally, it would be beneficial for all parties discussed above to lobby the SEC and other authoritative bodies to make the proposed (above) changes to the current restatement guidance. If the proposed changes are enacted, users, enterprises, and auditors would be positively impacted: Investors would have more confidence in management and
their projections/financial decisions when presented with financials that have a higher information content of earnings. Management and auditors would be able to better serve their clients and the users of the financial statements by providing more accurate, more transparent, and more forthcoming information.