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Technical Line

Financial reporting development

Lessons learned from our review of restatements

In this issue:

What you need to know

- Understanding the topics that gave rise to restatements of financial statements can help companies as they perform internal risk reassessments and evaluate their control environments.
- Identified errors should be corrected as soon as practicable to mitigate the risk of restatement due to an accumulation of individually immaterial errors.
- Management and audit committee members should consider asking about accounting topics that are more frequent sources of restatements as they discharge their responsibilities.
- Errors in accounting for income taxes, revenue recognition and the preparation of the statement of cash flows were the leading causes of annual restatements in 2011.

Overview

While only a small percentage of companies experience restatements, we believe that companies can benefit from understanding the accounting topics that gave rise to restatements, particularly as they perform internal risk assessments and evaluate their control environment. Asking questions about the more frequent restatement topics also could assist management and audit committee members as they discharge their responsibilities.

In this publication, we look at recent restatement trends and analyze the accounting topics that gave rise to restatements. In the Appendix, we also provide a list of questions for management or audit committee members to consider about some of the more frequent restatement topics.

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Background

When an error is material[1] to the prior-period(s) financial statements, a company is required to revise previously issued financial statements and correct the error (e.g., in an amendment to the Form 10-K it previously filed with the Securities and Exchange Commission [SEC]). The audit opinion is also revised to disclose the restatement. This type of material error correction is referred to in this publication as a "Big R" restatement.

When an error is immaterial to the prior-period(s) financial statements, but correcting it in the current period would materially misstate the current-period income statement or statement of comprehensive income, the error is corrected in the current-period financial statements by adjusting the prior-period information. The company does not need to amend the previously filed financial statements and the audit opinion is not revised. This type of restatement, which we refer to as a "Little r" restatement, often occurs when an immaterial error remains uncorrected for several periods and aggregates to a material number.

When an error is immaterial to the prior-period(s) financial statements and correcting it in the current period is not material to the current-period financial statements, the error is simply corrected in the current period. Financial statements for the prior period(s) are not restated.

Asking some questions now could reduce the risk of restatements later.

How we see it

Individually immaterial errors can accumulate over several years and become material to a financial reporting period, resulting in the need to restate financial statements. One way to reduce the risk of restatement is to correct all known errors in the period in which the errors are discovered.

Summary of results

To identify the accounting topics that were the subject of restatements, we looked at restatements of annual financial statements of US public companies that are audited by the four largest accounting firms. While we recognize that our review covers only a portion of US publicly traded companies, we believe this subset of the population provides us with relevant information to examine and share with others.

The following table provides restatement statistics for the past three years:[2]

2009–2011 restatement statistics[3]	2011	2010	2009
Big R — audit opinion revised	39	42	49
Big R rate	1.0%	1.1%	1.3%
Little r — audit opinion not revised	24	23	21
Little r rate	0.6%	0.6%	0.6%

It is important to keep in mind that only a small percentage of the companies in the population we reviewed had restatements and that percentage has remained fairly consistent over the last few years.

The following table provides a breakout of the accounting topics that gave rise to restatements in the population we reviewed for 2011 and 2010:

Causes of restatements by accounting topic					
2011			2010		
Topic	#	%	Topic	#	%
Income taxes	18	20	Revenue recognition	21	17
Revenue recognition	9	10	Income taxes	15	12
Statement of cash flows	5	6	Derivatives	9	7
Financial statement presentation	4	5	Accrued liabilities	9	7
Lease accounting	4	5	Depreciable assets	7	5
Accounts receivable allowance	4	5	Financial statement presentation	6	5
Derivatives	3	3	Postretirement benefits	6	5
Business combinations	3	3	Foreign currency translations	6	5
Other	38	43	Other	47	37
Total 2011*	**88**	**100**	**Total 2010***	**126**	**100**

* The totals are greater than the number of companies that restated (Big R and Little r) because some companies correct multiple errors in a single restatement.

Accounting topics

The following is a summary description of the accounting topics that gave rise to restatements in 2011.

Income taxes

Accounting for income taxes is one of the leading causes of restatements. We believe this is due, in part, to the detailed recordkeeping needed to appropriately account for income taxes. Accounting for income taxes requires the preparer to maintain detailed records of the tax bases of all assets and liabilities (i.e., a tax basis balance sheet). In essence, this results in an entity keeping a second set of books on a tax basis. Tracking the tax basis requires an understanding of the tax law, often for multiple taxing jurisdictions. Further complicating matters, the accounting model under ASC 740[4] is complex.

While the specific causes of recent income tax accounting restatements vary, a significant portion fall into the following categories:

- Inappropriate evaluation of the realizability 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

How we see it

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 into the tax process to leverage the expertise of their technical tax and financial accounting professionals and clearly delineating responsibilities.

In the sections that follow, we discuss ways to mitigate these three areas of frequent income tax accounting restatements.

Realizability analysis: consider all four sources of taxable income

A valuation allowance for a deferred tax asset is required if, based on the weight of available evidence, there is more than a 50% likelihood that some portion, or all, of the deferred tax asset will not be realized. The realizability of deferred tax assets depends on the existence of sufficient taxable income of the appropriate character in either the carryback or carryforward period under the tax law. The realizability analysis is required even if the company has a net deferred tax liability as of the reporting date.

Restatements related to valuation allowances generally occurred due to errors in assessing the four sources of taxable income. Examples include:

- Inappropriately considering a projection of future income to be a tax planning strategy
- Evaluating deferred tax assets for realizability on a net versus gross basis
- Inappropriate consideration of taxable temporary differences (e.g., taxable temporary differences related to indefinite-lived intangibles) as a source of taxable income

Four sources of taxable income (from least to most subjective: carrybacks, future reversal of existing temporary differences, tax planning strategies and future taxable income) are considered in determining whether sufficient income exists to support the realizability of deferred tax assets. A company cannot choose to ignore one or more of its available sources of income.

To be a source of future taxable income to support realizability of a deferred tax asset, a taxable temporary difference must reverse in a period such that it would result in the realization of the deferred tax asset (e.g., in the US, within the 20-year loss carryforward period). Taxable temporary differences related to indefinite-lived intangible assets and tax deductible goodwill are problematic because, by their nature, they are not predicted to reverse. These are commonly called naked credits. These temporary differences would reverse on impairment or the sale of the related assets, but those events are not anticipated for purposes of predicting the reversal of the related taxable temporary difference. That is, predicting the reversal of a temporary difference related to an indefinite-lived intangible asset and tax deductible goodwill for tax accounting purposes is inconsistent with the financial reporting assertion that the intangible asset is indefinite-lived.

As a result, the reversal of taxable temporary differences related to indefinite-lived intangible assets and goodwill generally should not be considered a source of future taxable income. However, some exceptions do exist, including situations in which indefinite-lived intangible assets and goodwill are classified as held for sale.

How we see it

Companies should carefully evaluate the realizability of the gross deferred tax asset (not net of deferred tax liabilities) and consider the four sources of taxable income from least to most subjective.

Tax basis

The tax basis may be relatively simple to determine for temporary differences that also have a financial reporting basis (e.g., warranty accruals). However, some temporary differences are based on provisions in the tax law and not on the expected recovery or settlement of a financial reporting asset or liability (e.g., costs that are capitalized for tax but not for financial reporting purposes). For other temporary differences, the tax basis can be different from the financial reporting basis both at acquisition and in subsequent periods. Examples could include inventory capitalization and depreciation of fixed assets.

Accounting for income taxes requires knowledge of both technical tax matters and financial accounting — skills that a single individual or department often do not possess.

Maintaining a detailed and accurate record of the tax basis of all assets and liabilities, including those without a book basis, is an essential starting point in accounting for income taxes. This detailed recordkeeping is often maintained in the form of a tax basis balance sheet. Restatements have been caused by not properly identifying a tax basis or attribute or not appropriately recording and tracking the tax basis or attribute in subsequent periods.

How we see it

Companies should consider maintaining a comprehensive list of tax attributes and their values (by jurisdiction) in a central location. Analyzing a tax basis balance sheet (e.g., looking for changes from the prior year or expectations) also may help companies identify errors in the determination of a tax basis or attribute that would otherwise result in inappropriate financial reporting.

Paying close attention to intercompany transactions

One of the few exceptions to the general income tax accounting provisions in ASC 740 is the accounting for certain intercompany transactions.[5] Assets (e.g., inventory) are sometimes sold at a profit between affiliated companies that are consolidated for financial statement purposes but file separate income tax returns (either unconsolidated returns in the same tax jurisdiction or tax returns in different jurisdictions). The seller's separate books generally reflect the profit or loss on the sale and the related income tax effect of that profit or loss. The buyer's separate books generally reflect the assets at the intercompany transfer price (including the seller's profit or loss), and the buyer's tax basis equals the transfer price. In consolidation, the seller's pretax profit (intercompany profit) is eliminated, and the assets are carried at historical cost (that is, the seller's cost). No tax effect associated with the intercompany profit and change in tax basis should be recognized in consolidated earnings. Instead, the consolidation entries that eliminate intercompany profit also will eliminate the related tax expense (benefit), and any income taxes paid by the seller will be recorded as a prepaid tax. The prepaid tax is not a temporary difference.

How we see it

Companies need to track intercompany activity and the related income tax effects to avoid misstatement of current and deferred income taxes in the consolidated financial statements. Care should be taken to ensure that the change in tax basis in the buying jurisdictions is appropriately eliminated in consolidation and any prepaid tax is appropriately deferred until the asset leaves the consolidated group (e.g., by sale to a third party, depreciation or amortization, or asset impairment or abandonment).

Revenue recognition

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.

The reasons for revenue-related restatements vary. They include calculation errors, failure to understand contractual terms and misapplication of accounting literature. One recent trend is ineffective monitoring of accounting estimates related to revenue.

Understanding the contractual terms and selecting an appropriate accounting policy is critical to reducing the risk of revenue restatements.

Revenue recognition requires the use of accounting estimates and ongoing monitoring such as comparing estimates and assumptions to actual results. Required estimates include determining:

- Returns
- The standalone selling price for separate units of accounting for new contracts
- The pattern of performance of a contracted service (i.e., determining the extent to which the earnings process has been completed, including using the proportional performance method)
- The progress toward completion for contracts applying the percentage-of-completion method

These estimates should be reassessed continually to determine whether the underlying assumptions continue to be appropriate. If the actual results do not support the assumptions used to develop the accounting estimate, a company should evaluate whether any required change reflects a change in estimate or an error. Examples of an error include:

- Inappropriately applying assumptions that are not consistent with the best available information (e.g., historical results)
- Not changing the underlying assumptions timely when facts and circumstances change

How we see it

Companies need to ensure that material estimation processes and related controls appropriately confirm whether the underlying assumptions are consistent with actual results and circumstances.

Statement of cash flows

Statement of cash flows restatements were due to the inappropriate classification of cash inflows and outflows between operating, investing and financing activities (e.g., inappropriate classification of changes in restricted cash and derivative-related activity).

Accounting guidance[6] on the appropriate classification of cash flows is explicit with respect to the proper classification of certain items; other items require the use of judgment. For example, when the classification is not explicitly addressed, it will often be based on the nature of the activity and the predominant source of the related cash flow.

How we see it

Because the primary purpose of the statement of cash flows is to provide relevant information about the cash receipts and cash payments of a company during a period, companies should pay particular attention to the presentation of items that require judgment as well as new or unusual transactions.

Other accounting topics

Such topics as the accounting for derivative instruments and financial statement presentation are also significant contributors to restatements. Other topics fluctuate in frequency due to various factors, including new accounting pronouncements, changes in the nature or volume of transactions, and the focus of regulators.

Some examples from 2011 restatements include:

- Accounting guidance issued over the past several years regarding business combinations and derivative transactions — For transactions involving business combinations, some companies inappropriately accounted for contingent consideration or failed to identify intangible assets.[7] In restatements involving derivative transactions, certain warrant instruments were inappropriately treated as a component of equity instead of a derivative liability.[8]

- Financial statement presentation — Companies made errors in the classification of items on the balance sheet and income statement. More frequent errors included inappropriate classification of income statement activity (i.e., between operating expenses, selling, general and administrative expenses and other expenses) and incorrect balance sheet presentation of current and long-term assets and liabilities.

- Accounts receivable allowances — Companies increasingly made errors related to the allowance for doubtful accounts, including errors resulting from the use of an inappropriate reserve methodology (e.g., inappropriately aggregating receivables that are dissimilar in nature) or the use of flawed or incomplete facts. A thorough analysis of all factors including historical results should be considered when making this judgment.

- Leases — Companies misapplied the leasing guidance. Examples include incorrectly classifying leases (i.e., operating versus capital leases for lessees) and inappropriately accounting for sale and leaseback transactions and build-to-suit lease transactions. The wide variety of leases coupled with the complexity of the accounting model makes lease accounting a recurring cause of restatements.

Endnotes:

[1] See ASC 250, *Accounting Changes and Error Corrections*, SEC Staff Accounting Bulletin Topic 1-M, *Materiality*, and SEC Staff Accounting Bulletin Topic 1-N, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements*, for further guidance.

[2] Statistics include restatements disclosed in annual reports filed during the calendar year listed in the table.

[3] Percentages were derived using the most recently published number of public companies audited by the largest four accounting firms (3,730 companies). United States Government Accountability Office, *Audits of Public Companies*, GAO-08-163, January 2008. We assumed a consistent number of companies through 2011.

[4] ASC 740, *Income Taxes*.

[5] ASC 810-10-45-8. See our Financial Reporting Developments: *Income taxes* (SCORE No. BB1150) for further information.

[6] ASC 230, *Statement of Cash Flows*. See our Financial Reporting Developments: *Statement of cash flows — Accounting standards codification 230* (SCORE No. 42856) for further information.

[7] ASC 805, *Business Combinations* (formerly FAS 141(R)). See our Financial Reporting Developments: *Business combinations* (SCORE No. BB1616) for additional information.

[8] ASC 815-40 (formerly EITF 07-5 *Determining whether an instrument (or embedded feature) is indexed to an entity's own stock*). See our Financial Reporting Developments: *Derivative instruments and hedging activities* (SCORE No. BB0977) for additional information.

Appendix: Questions for management and the audit committee

Management and audit committee members should consider asking the following questions to assess whether topics that have been a frequent source of restatements present risks for their companies.

- Are there any known errors not recorded? Why weren't they recorded? How was materiality assessed by the company? When will these known errors be recorded? What steps did the company take to consider any control implications for these errors?
- Were any new accounting standards adopted during the year? What was the effect on the financial statements? Does the new standard require any new significant judgments or estimates?
- If the business environment has changed (e.g., new competition, a change in regulation), how did this change affect judgments and estimates, revenue recognition, recoverability of assets (e.g., fixed assets) and financial statement classification (e.g., classification of debt)?
- What did the company do to validate that the underlying assumptions of material estimates are consistent with actual results and circumstances? Were there any significant changes in estimates during the period?
- How do the tax department and financial accounting department coordinate to prepare the income tax provision?
- Are the deferred tax accounts reconciled to supporting records? Is a tax basis balance sheet or similar schedule maintained? What analysis was performed to confirm the appropriateness of the tax attributes and their values?
- Have significant deferred tax assets been recognized for which no valuation allowance has been recorded? What is the rationale for concluding deferred tax assets are realizable? If realizability is based on the projection of future taxable income, are the company's expectations about future taxable income reasonable and consistent with other forecasts provided to analysts and in Management's Discussion and Analysis (especially when the company has recognized recurring losses or experienced a significant loss in the current year)?
- What was the nature of intercompany transactions during the year? What are the process and related controls to ensure that all intercompany activity, including income taxes, are appropriately eliminated and accounted for in subsequent periods?
- Was the classification of transactions in the balance sheet, income statement and statement of cash flows a focus? Were there any infrequently occurring transactions or transactions that involved the use of judgment for which classification was not clear?
- How was the allowance for doubtful accounts determined? Has there been a change in the methodology or assumptions used in determining the allowance for doubtful accounts? If so (or if not), why? How was its adequacy evaluated? Has the allowance changed from last year in proportion to changes in receivables? If not, why not?
- Was there a structured transaction during the year (e.g., sale-leaseback) and if so, what was the business purpose of the transaction? What were the accounting implications of the transaction?