July 2006

GAO
Accountability·Integrity·Reliability

Highlights

Highlights of GAO-06-678, a report to the Ranking Minority Member, Committee on Banking, Housing, and Urban Affairs, U.S. Senate

FINANCIAL RESTATEMENTS

Update of Public Company Trends, Market Impacts, and Regulatory Enforcement Activities

Why GAO Did This Study

In 2002, GAO reported that the number of restatement announcements due to financial reporting fraud and/or accounting errors grew significantly between January 1997 and June 2002, negatively impacting the restating companies' market capitalization by billions of dollars. GAO was asked to update key aspects of its 2002 report (GAO-03-138). This report discusses (1) the number of, reasons for, and other trends in restatements; (2) the impact of restatement announcements on the restating companies' stock prices and what is known about investors' confidence in U.S. capital markets; and (3) regulatory enforcement actions involving accounting- and audit-related issues. To address these issues, GAO collected restatement announcements meeting GAO's criteria, calculated and analyzed the impact on company stock prices, obtained input from researchers, and analyzed selected regulatory enforcement actions.

What GAO Recommends

GAO recommends that SEC investigate potential noncompliance with current Form 8-K filing requirements and make consistent the guidance to registrants concerning required disclosures regarding certain restatements. SEC stated that it would examine the instances of potential non-compliance and carefully consider harmonizing guidance concerning Form 8-Ks.

www.gao.gov/cgi-bin/getrpt?GAO-06-678.

To view the full product, including the scope and methodology, click on the link above. For more information, contact Orice M. Williams at (202) 512-5837 or williamso@gao.gov.

What GAO Found

While the number of public companies announcing financial restatements from 2002 through September 2005 rose from 3.7 percent to 6.8 percent, restatement announcements identified grew about 67 percent over this period. Industry observers noted that increased restatements were an expected byproduct of the greater focus on the quality of financial reporting by company management, audit committees, external auditors, and regulators. GAO also observed the following trends: (1) cost- or expense-related reasons accounted for 35 percent of the restatements, including lease accounting issues, followed in frequency by revenue recognition issues; and (2) most restatements (58 percent) were prompted by an internal party such as management or internal auditors. In the wake of increased restatements, SEC standardized disclosure requirements by requiring companies to file a specific item on the Form 8-K when a company's previously reported financials should no longer be relied upon. However, between August 2004-September 2005, about 17 percent of the companies GAO identified as restating did not appear to file the proper disclosure when they announced their intention to restate. These companies continued to announce intentions to restate previous financial statements results in a variety of other formats.

Although representing about 0.4 percent of the market capitalization of the major exchanges, which was $17 trillion in 2005, the market capitalization of companies announcing restatements between July 2002 and September 2005 decreased $63 billion when adjusted for market movements ($43 billion unadjusted) in the days around the initial restatement announcement. Researchers generally agree that restatements can negatively affect overall investor confidence, but it is unclear what effects restatements had on confidence in 2002–2005. Some researchers noted that investors might have grown less sensitive to the announcements. Others postulated that investors had more difficulty discerning whether restatements represented a response to aggressive or abusive accounting practices, complex accounting standards, remediation of past accounting deficiencies, or technical adjustments. Although researchers generally agree that restatements can have a negative effect on investor confidence, the surveys, indexes, and other proxies for investor confidence that GAO reviewed did not indicate definitively whether investor confidence increased or decrease since 2002.

As was the case in the 2002 report, a significant portion of SEC's enforcement activities involved accounting- and auditing-related issues. Enforcement cases involving financial fraud- and issuer-reporting issues ranged from about 23 percent of total actions taken to almost 30 percent in 2005. Of the actions resolved between March 1, 2002, and September 30, 2005, about 90 percent were brought against public companies or their directors, officers, and employees, or related parties; the other 10 percent involved accounting firms and individuals involved in the external audits of these companies.