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Restatement VS Revision: A Case Study

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There had been many recent cases of restatements of financial statements by US Corporations. Recently an article in the Wall Street Journal mentioned restatements by Bank of America, Nike and Alphabet among the 663 companies that filed financial revisions or restatements last year. Interestingly the frequency of these errors has more than doubled since 2002, when the Sarbanes-Oxley corporate-governance law was enacted, partly to increase managerial accountability. We will also examine what are the differences between restatements and revisions. We will examine what are the most common mistakes. Over half of last year's corrections involved debt and equity, cash flows or taxes. Many of these issues are also major differences between US GAAP and IFRS, making comparison with international firms even more difficult. We will try to explain why a firm chooses a restatement or revision to announce the correction of errors.

INTRODUCTION

When we discover an error in previous year's financial statements, there are two possibilities, a restatement or a revision. For a restatement, the error must be material. Typically, the restatement is due to a weakness in internal control and disclosures will be required. When the error is discovered, the following procedures must be followed:

- Notify the audit committee
- Determine if an internal investigation should be commenced
- If misconduct, contact counsel
- Consider the ramifications on the system of internal control

If the auditor's opinion was a clean (unqualified) opinion, there could be potential problems for the auditor, especially if it was an integrated audit. This would mean that the auditor failed to discover a material weakness in the internal controls for financial reporting and a material misstatement of the financial statements. This could present potential exposure for the auditor.

The second possibility is a revision. This would be the case if the error is immaterial and overall the financial statements are not materially misstated. When the error is discovered, the following procedures must be followed:

- The error is corrected in the current financial statement
- Prior year statements can still be relied upon

Restatements accounted for just 24% of last year's corrections, down from 68% in 2005. There are many possibilities why there was such a large change. One simple reason might be that since Sarbanes-Oxley (SOX), audit committees became a requirement. SOX restricted the composition of such committee. Furthermore, integrated audits were required. It forced the auditor to perform additional procedures. This reduced the number of material weaknesses, one of the criteria for restatement. There was more emphasis on defining materiality. The term materiality is never precisely defined. It is usually defined in general terms.

It is in the best interest of the firm and of the auditor to have a revision instead of a restatement. Here are some of the advantages:

- No specific announcement is required, the change can be done at the same time an earnings announcement is made
- Financials statements from previous years can be relied upon
- No change is needed in the auditor's opinion

We will now look at some recent restatements and revisions.: Valent, First Data, Nike, Alphabet and Bank of America,

VALEANT

Valeant made the following announcement in early 2016.

February 22, 2016

LAVAL, Québec, Feb. 22, 2016 /PRNewswire/ -- Valeant Pharmaceuticals International, Inc. (NYSE: VRX) (TSX: VRX) ("Valeant" or the "Company") today announced that based on the work of the Ad Hoc Committee of the Board of Directors appointed to review the Company's relationship with Philidor and related matters, as well as additional work and analysis by the Company, the Company has preliminarily identified certain sales to Philidor during 2014, prior to Valeant's entry into an option to acquire Philidor, that should have been recognized when product was dispensed to patients rather than on delivery to Philidor.

The Company currently believes that approximately \$58 million of net revenues previously recognized in the second half of 2014 should not have been recognized upon delivery of product to Philidor. Correcting the misstatement is expected to reduce reported 2014 GAAP EPS by approximately \$0.10 and increase 2015 GAAP EPS by approximately \$0.09. Following entry into the option to acquire Philidor in December 2014, the Company began to consolidate Philidor's accounts and began to recognize sales to Philidor only when dispensed to patients, and no similar adjustments would be necessary for sales after that date.

Valeant decided to do a Restatement. The amount of the adjustment was \$58,000,000. In order to determine materiality, let's compare this number with some other metrics. Revenues were, \$8.103,000,000. The error was less than one percent of revenues. Typically, 5% of a predetermined benchmark is a generally accepted method to determine materiality. If we used this measure (5%) of total revenues, an error of \$400,000,000 would be considered material. The error discovered was well below the traditional materiality benchmark.

Materiality can also be expressed qualitatively. An example of this would be an error discovered in the cash account. Cash is such an important account that any error account would be material. The error discovered at Valeant was in not eliminating the profit on a related party transaction. Related party transactions are critical areas of concern for investors.

The option to acquire Phildor was exercised in December 2014. There was a distinct announcement of the restatement and the market reacted. The announcement was made late on Friday 02/19. There was a reaction on Friday afternoon and a stronger reaction when markets reopened on Monday.

Valeant had been the object of many procedures by government agencies in Canada and the USA because of price gauging. The management might have tried to send the message that it was now very cautious and trying to make sure the firm would be perceived as doing the right thing.

Was there an impact on stock price?

**TABLE 1
IMPACT ON VALEANT'S STOCK PRICE**

Date	Close	Event Date
2/25/2016	84.71	3
2/24/2016	83.83	2
2/23/2016	79.27	1
2/22/2016	75.92	0
2/19/2016	84.99	-1
2/18/2-16	94.11	-2
2/17/2016	94.65	-3

This was bad news for the market and there was a decline in price on the day of the announcement. Three days after the announcement, the price stabilized at the same level as the day before the announcement.

IRST DATA CORPORATION

First Data Corporation (the company) refinanced its current debt with debt of comparable maturities. The issue is whether the new debt should be accounted for as “debt modification” or as early extinguishment of debt. The company originally accounted for the transaction as debt modification. Subsequently, the company reconsidered its position and then classified it as an early extinguishment of debt. The resulting change was a \$56 million loss in 2013 and a subsequent \$79 million loss in 2014.

Management concluded the financial statements would not have to be restated but instead be revised as the error was not deemed material. In an SEC amendment to Form S-1, the company cited a number of qualitative and quantitative factors. Among the findings were:

- There was no effect on Adjusted EBITDA(Earnings Before Interest Taxes Depreciation and Amortization)
- The change does not distort any trends
- The change would not have converted a loss into income or income into a loss. The company had a loss and after the correction, it still had a loss.
- There was no intent to conceal a transaction that violated the law.
- The error did not affect revenue, operating expenses or operating income
- Balance Sheet accounts resulting change was no greater than 1%.

- The impact on the Statement of Cash Flows was only in classification. There was no change in cash. Based on this information, First Data determined his was not a material adjustment. Therefore, First Data prepared a revision and announced it at the same time they announced their quarterly report. The company became listed only on 07/01/2016, no price impact can be measured.

NIKE

Management determined in the third quarter of 2015 it erred in reflecting unrealized gains and losses from remeasurement of non-functional currency intercompany balances between certain of its foreign wholly owned subsidiaries in its Consolidated Statements of Cash Flows. The resulting unrealized gains and losses should have been recorded as non-cash reconciling items from Net Income to Cash provided from operations. They were instead classified on the Effect of exchange rate changes on cash and equivalents of the Consolidated Statements of Cash Flows. The result was an understatement in Cash provided from operations reported on the Consolidated Statements of Cash Flows for certain prior periods. There was no change in Cash and cash equivalents reported on the Statements of Cash Flows and Balance Sheets. Based on the information, Nike determined this was not a material error and did a revision at the same time the new earnings were released.

In Nike’s 10-Q filing in Footnote 1- Summary of Significant Accounting Policies, management presented a detailed discussion of the revision. They also described what caused the revision and in their opinion the correction of the error was deemed immaterial in accordance with SEC Staff Accounting Bulletin (SAB) No. 99 that was codified in Accounting Standards Codification (ASC 250). This is the same concept found in the FASB’s Concept Statement 2. It defined material as the omission or misstatement that would have changed or influenced an individual’s decision.

Was there an impact on stock price?

**TABLE 2
IMPACT ON NIKE’S STOCK PRICE**

Date	Close	Event Date
6/30/2015	108.02	3
6/29/2015	107.67	2
6/26/2015	109.71	1
6/25/2015	105.22	0
6/24/2015	106.22	-1
6/23/2015	107.20	-2
6/232015	106.79	-3

On June 25, 2015, Nike reported 2015 fourth quarter earnings of \$0.98 per share, along with the revision statement. The reported number far exceeded the forecast of \$0.83 per share (Nasr, 2015). Accordingly, the stock rose over 4.2% on the next trading day. It is possible that the market price was negatively influenced by the revision, but it is impossible to decipher since the revision was included within the blockbuster earnings report.

Nonetheless, even though Nike did not consider the reclassification to be material, on a quantitative basis, it is possible it is material from a qualitative standpoint. Arguably, net cash provided by operating activities is more meaningful to investors than an effect from a change in exchange rates.

ALPHABET

Alphabet Inc., the parent company of Google, also had to revise their earnings due to the discovery of an accounting error. In the second quarter of 2015, Alphabet found that they had improperly accounted for revenues related to transactions between “legal entities.” Consequently, between the first quarter of 2008 and the first quarter of 2015, total income tax expense was recomputed to be \$711 million higher, on a cumulative basis. Thus, the company was forced to make an “out of period adjustment” (Alphabet, 2015 Annual Report, p. 64). Nonetheless, the adjustment was not regarded as material. In Alphabet’s 2015 annual report, it was indicated that the corporation conducted a materiality assessment both on a quantitative and a qualitative basis (Alphabet, 2015 Annual Report, p. 64).

Materiality is regarded as a certain level that makes an event, transaction, or a dollar value significant enough to separately disclose to shareholders. Typically, 5% of a determined benchmark is used. This threshold could be a percentage of net income, sales revenue, total assets, or some other metric. If an outcome exceeds 5% of the benchmark, then a full restatement would be required. In addition, retrospective adjustment would be necessary. However, if the value is less than 5%, then a revision could, theoretically, be implemented instead.

Yet, there is some ambiguity with regard to what is the proper level of materiality. For instance, if a stricter materiality cutoff is used, many revisions would instead be classified as restatements. In Alphabet’s case, if 3% of current year total revenues were used as the benchmark for materiality, the revision still would not have been material. However, if net income were used instead, a different outcome would have resulted. During 2015, Alphabet’s revenues and net income were \$74,989 million and \$16,348 million, respectively. Thus, the cumulative \$711 million revision would have been approximately 0.9% of revenues and 4.3% of net income, respectively (Alphabet, 2015 Annual Report, p. 21).

Also, it is important to assess whether the announcement of the revision had an influence on Alphabet’s stock price. For example, on July 16, 2015, Alphabet reported its 2015 second quarter earnings along with the revision announcement. Ironically, the next day, Alphabet’s (then Google’s) stock price soared, adding a record \$65.1 billion to its market capitalization (Rosenberg, 2015). The massive rally was due to the company handily beating earnings estimates by reporting earnings per share of \$6.99 versus the \$6.70 that was estimated (King, 2015). Thus, since the revision was completely buried within the blockbuster earnings release, it is very difficult to determine if there was any negative impact on the stock price.

TABLE 3
IMPACT ON ALPHABET’S STOCK PRICE

Date	Close	Event Date
7/21/2015	662.30	3
7/20/2015	663.02	2
7/17/2015	672.93	1
7/16/2015	579.85	0
7/15/2015	560.22	-1
7/14/2015	561.10	-2
7/13/2015	546.55	-3

BANK OF AMERICA

Bank of America also had a revision. During 2014, and the first and second quarters of 2015, respectively, the company announced they had improperly accounted for specific cash flows related to the “sales of loans and receipt of debts.” The errors were comprised of “investing cash flows” of \$3.4 billion, \$4.8 billion, and \$9.3 billion, during 2014, the first quarter of 2015, and the second quarter of 2015, respectively. However, these transactions should have been recorded as a non-cash adjustment to reconcile net income to net cash provided by operating activities. Once the errors were detected, Bank of America revised the financial statements. Thus, cash from operating activities was increased and cash from investing activities was reduced by the aforementioned amounts.

Although Bank of America’s cash flow errors do appear to be rather large, the net effect on the cash flow statement, when taken in the aggregate, was zero. Also, the company indicated that the mistakes were not regarded as material with regard to the “consolidated financial statements taken as a whole” (Bank of America, 2015 Annual Report, p. 137). Nonetheless, it is not apparent what criterion Bank of America used. For instance, during 2014, net income attributable to common shareholders was \$4.83 billion (Bank of America, 2015 Annual Report, p. 130). If net income were used to evaluate materiality, the \$3.4 billion revision would have amounted to nearly 70.8%! If 2014 total revenues of \$84.2 billion were used to measure materiality, the revision would have only amounted to approximately 4.0%. Alternatively, if a stricter materiality threshold were used, such as 3% of revenues or net income, the revision would have been regarded as material.

In addition, similar to Nike, Bank of America’s reclassification *could* be regarded as material when considered on a qualitative basis. A major increase in operating cash flows significantly enhances a company’s overall liquidity position.

Nevertheless, once again, it is challenging to evaluate if the revision had any influence on the stock price, as the announcement was incorporated into Bank of America’s 2015 third quarter earnings release. On October 14, 2015, the company reported earnings per share of \$0.37, which beat Wall Street expectations of \$0.33 (Singh, 2015). Accordingly, the stock price climbed over 3.5% on the ensuing day. If there was an impact from the revision, it is not noticeable when considering the upward movement in the stock price.

TABLE 4
IMPACT ON BANK OF AMERICAS STOCK PRICE

Date	Close	Event Date
10/19/2015	16.14	3
10/16/2015	16.12	2
10/15/2015	16.19	1
10/14/2015	15.64	0
10/13/2015	15.52	-1
10/12/2015	15.62	-2
10/09/2015	15.58	-3

CONCLUSION

In conclusion, it appears that revisions are much more common than restatements. Revisions are much less burdensome for a public company since they only need to make a modification in the current year's financial report. On the other hand, a restatement would require that all of the financial statements, in the affected years, be reissued. Not only does a restatement raise "red flags" regarding the effectiveness of the company's internal controls, but it also places the external auditor in a difficult position. The auditor may be criticized, by the investing public, for not finding the misstatement in the first place. Obviously, the auditor would favor a revision over a restatement to avoid this critique.

Based on the examples presented, it is difficult to determine if a revision truly had an effect on the respective company's stock price, as nearly all of the revisions were included with the release of earnings. Ironically, with the exception of First Data (since the firm was not public at the time), an *increase* in stock price occurred after the announcement of a revision. Intuitively, that does not make much sense. However, since that news was attached to earnings, it is virtually impossible to analyze the impact of the revision on the market value of the particular firm's equity.

Yet, in the event of a restatement, the reaction in the stock price can be more clearly determined since restatement announcements typically occur separate from earnings releases. That was the case for Valeant. In the day that followed the restatement announcement, Valeant's stock price plunged over 10.6%. Although there is always concern if a corporation needs to restate to earnings, the dollar amount of the restatement should not have been regarded as material, based on any quantitative metric. Does the drop in Valeant's stock price indicate that a restatement, regardless of materiality, will cause a stock's price to drop dramatically?

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