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M&A Due Diligence: The Effect of Restatements

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The restatement of a public company's financial statements can result in wide-ranging economic and legal consequences. From capital losses such as increased accounting and legal bills, monetary disgorgement (both individual and corporate), negative market reactions and stock price dips and drops, to loan covenant defaults, shareholder litigation and Securities and Exchange Commission civil action, among others. Restatements not only affect the restating company and its executives, but understanding the nature and scope of a restatement is crucial for any company that is contemplating, or in the process of, merging or acquiring a company that is restating, or has restated, its financial statements. This article provides an overview of the effect of a public company's restatement of its financial statements on an acquiror's due diligence efforts and it provides practical insight for the acquiror with the goal of avoiding—or minimizing—any unexpected surprises resulting from such restatement during the course of or following the acquisition.

1. Overview of Restatements

Financial statements filed with the SEC must be prepared in accordance with accounting principles generally accepted in the United States, otherwise, such financial statements "will be presumed misleading or inaccurate."[1] If financial statements contain a material "error"[2] or an "accounting irregularity,"[3] such financial statements must be restated.[4] The most common errors or irregularities resulting in the restatement of financial statements generally arise from issues associated with (i) the recording of equity or debt accounts, (ii) expense recognition, (iii) accounts/loans receivable, investments and cash, (iv) deferred, stock-based or other executive compensation, (v) liabilities, accounts payable, reserves and accrual estimates, and (vi) revenue recognition.[5]

2. Recent Trends

An acquiror pursuing a merger and/or acquisition transaction should not automatically avoid a target that has restated its financials. It is important to note that, despite the struggles of public companies that restated their financial statements in the initial turbulent days and years surrounding Enron and Worldcom and the adoption of the Sarbanes-Oxley Act of 2002, recent trends suggest that the restatement of financial statements does not always lead to ruin. In fact, both the overall financial impact of restatements on a public company and their respective impact on the stock prices of a public company—determined by looking at stock prices immediately before the announcement of a restatement and stock prices immediately after the announcement of a restatement—has continued to decrease since the early 2000s.[6]

Perhaps this is a reflection of the seismic failures witnessed by the investing public in the early years following the beginning of the 21st century, but it also may be a reflection of a more ho-hum reaction to the increasingly more frequent announcements associated with restatements of financial statements, as well as the seemingly better understanding of the term "material" in the context of whether an error is deemed material such that it would require a restatement. It should not be overlooked, however, that

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[1] 17 C.F.R. §210.4-01(a)(1).

[2] An "error" is defined as an unintentional misstatement or omission of amounts or disclosures in financial statements.

[3] An "accounting irregularity" is an "intentional misstatement or omission of amounts or disclosures in financial statements." Irregularities include fraudulent financial reporting undertaken to render financial statements misleading.

[4] See American Institute of Certified Public Accountants, "The Auditor's Responsibility to Detect and Report Errors and Irregularities," Statement on Auditing Standards No. 53; see also American Institute of Certified Public Accountants, "Consideration of Fraud in a Financial Statement Audit," Statement on Auditing Standards No. 82.

[5] Audit Analytics, *2009 Financial Restatements: A Nine Year Comparison* (February 2010), at 21. Restatements also arise from mistakes in gathering or processing accounting data from which the financial statements are prepared, incorrect accounting estimates arising from misinterpretation or oversight of facts, and mistakes in application of accounting principles relating to amount, classification, manner of presentation or disclosure.

[6] See the U.S. Government Accountability Office Report on Financial Restatements: Update of Public Company Trends, Market Impacts and Regulatory Enforcement Activities at 5 (July 2006; Updated March 2007), available at www.gao.gov/new.items/d03138.pdf. See also Audit Analytics, 2009 Financial Restatements: A Nine Year Comparison (February 2010), at 1.

restatements involving irregularities and financial reporting fraud generally led to greater market losses than restatements for other reasons.[7]

In the initial four years after the adoption of Sarbanes-Oxley, the U.S. Government Accountability Office, acting at the request of Senator Paul Sarbanes, found that while the number of public companies announcing financial restatements from 2002 through September 2005 rose from 3.7% to 6.8%, the total number of restatement announcements identified soared 67% over that period.[8] By 2006, the number of restatements had reached its zenith, both in number of restatements and aggregate negative dollar value.[9] Since that time, however, both the number of restatements and the amount of total dollar loss have decreased dramatically.[10]

Another trend of note that will impact M&A due diligence relates to the finding—not surprisingly—that public companies that engaged in "stealth restatements" were less likely to suffer as dramatic decreases in stock prices in comparison with those public companies that disclosed restatements on Form 8-K.[11] From the perspective of the public company that is restating its financials, it is easy to see that the less visible the restatement, the less likely it is that the market will react negatively to that restatement.

A "stealth restatement" is made when the company restates its financial statements in a regularly scheduled filing (i) without filing an amended quarterly or annual report for the affected quarter or year, (ii) without first announcing the restatement in a press release filed on Form 8-K, Item 4.02 or (iii) if the regularly scheduled filing is filed late, without citing the restatement as the reason for a late quarterly or annual report in a Form 12b-25 (Notification of Late Filing).[12] Due to the various issues a company must consider in disclosing a restatement of its financial statements to the public, many companies opt to engage in filing "stealth restatements" even in light of the filing requirements for Form 8-K.[13] This includes situations where financials are intentionally misstated in order to make a company seem a more attractive target. Accordingly, an acquiror conducting M&A diligence must be persistent in ensuring that a potential duty to restate was never ignored, so that it is not walking into the potential liability that would be attached.

3. How to Identify a Restatement

A key element of conducting M&A diligence is determining whether the target has restated its financial statements. An acquiror may make that determination by reviewing (i) Item 4.02 of a target's Form 8-Ks, (ii) searching for stealth restatements, (iii) reviewing audit reports made pursuant to Section 10A of the Securities Exchange Act of 1934, and (iv) analyzing stock price patterns in the target's public stock for significant drops in stock price or reviewing credit ratings drops as a means to probe market reactions to the target's financial performance. Of course, no M&A due diligence checklist would be complete without including a few well-worded inquiries regarding the target's financial statements and whether any restatements of those financial statements have occurred or are expected to occur.[14]

Form 8-Ks

Aside from specific inquiries of the target regarding restatements of its financial statements, the foremost method of identifying a restatement is to review the target's Form 8-K filings, in particular Item 4.02. Item 4.02 of Form 8-K ("Non-Reliance on Previously Issued Financial Statements or Related Audit Report or Completed Interim Review") requires that a company file a Current Report on Form 8-K within four

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[7] Id.

[8] See the U.S. Government Accountability Office Report on Financial Restatements: Update of Public Company Trends, Market Impacts and Regulatory Enforcement Activities at 5 (July 2006; Updated March 2007), available at www.gao.gov/new.items/d03138.pdf.

[9] Audit Analytics, *2009 Financial Restatements: A Nine Year Comparison* (February 2010), at 11, 14.

[10] There are a number of reasons for this decrease, including regulatory changes. For more information, see Gourley and Lavender, *Restatements of Financial Statements*, Corporate Governance Advisor (July/August 2010).

[11] Myers, et al., *Restating Under the Radar? Determinants of Restatement Disclosure Choices and the Related Market Reactions*, at 6 (April 2010), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1309786.

[12] Id.; Myers, Linda A. et al., *Restating Under the Radar? Determinants of Restatement Disclosure Choices and the Related Market Reactions* (April 2010).

[13] Id.

[14] See section entitled "*—Due Diligence Request Checklist*" below.

days of one of the following two occurrences: (i) when its board of directors concludes that any of the company's previously issued financial statements "no longer should be relied upon because of an error in such financial statements;" and (ii) when its independent accountant advises the company that "disclosure should be made or actions should be taken to prevent future reliance on a previously issued audit report or completed interim review related to previously issued financial statements."[15]

The prevailing opinion in legal circles is that a company must issue a public statement on Form 8-K disclosing the determination that investors cannot rely on previously issued financial statements if the restatement of the financial statements is due to a material error.[16] However, shortly after the issuance of the new Form 8-K requirements, the SEC Regulations Committee of the American Institute of CPAs asked the SEC if all restatements needed to be reported on Form 8-K. The SEC responded by stating that a Form 8-K filing pursuant to Item 4.02 is not required for every restatement and that the discretion of the filing companies should be used in determining the necessity of the filing.[17] Therefore, although a review of the company's Form 8-K is important, it alone may not be sufficient in identifying a restatement.

Stealth Restatements

The impact of stealth restatements should not be underestimated. If a company chooses to pursue a stealth restatement strategy, the financial restatement may be accomplished without filing an amended quarterly or annual report for the affected quarter or year, or without first announcing the restatement on Form 8-K under Item 4.02. In conducting M&A diligence, an acquiror must be aware of this type of restatement strategy and should actively search for occurrences of "stealth restatements" by the target. For example, a target may have:

- Restated its financial statements in a regularly scheduled 10-K or 10-Q without amending the affected 10-K or 10-Q;
- Restated its financial statements in a regularly scheduled 10-K or 10-Q without otherwise disclosing the restatement in a Form 8-K, Item 4.02 filing; or
- Filed a regularly scheduled 10-K or 10-Q late without citing the restatement as a reason for the delay and then restating its financial statements in a later 10-K or 10-Q filing.

An acquiror should note that although studies show that the number of companies restating their financial statements has decreased since 2006, the number of stealth restatements remains a large percentage of the restatements filed.[18] In particular, a recent study shows that the number of stealth restatements filed in 2008 and 2009 were 435 and 310, respectively, which represent approximately 52% and 49%, respectively, of the total restatements filed in each of those years.[19] Thus, even though the total number of restatements and stealth restatements has dropped over the past few years, the rate of stealth restatements out of the total number of restatements filed has remained steady (*i.e.,* roughly 50%).

Audit Report Pursuant to Section 10A of the Securities Exchange Act of 1934

Another indicator of a financial restatement is to review the audit reports of a target. Section 10A of the Securities Exchange Act of 1934 imposes a duty on auditors to report uncorrected illegal acts to a company's board of directors and, if certain actions are not taken by the company, ultimately to the SEC. If, during an audit, the independent accountant detects or becomes aware of information that an illegal act has or may have occurred, the accountant must (i) determine whether it is likely that an illegal act has occurred and (ii) if so, determine and consider the possible effect of the illegal act on the company's financial statements. The accountant must inform the appropriate level of management as soon as practi-

[15] *See* Securities and Exchange Commission, Final Rule: Additional Form 8-K Disclosure Requirements and Acceleration of Filing Date, available at http://www.sec.gov/rules/final/33-8400.htm.

[16] *See* Division of Corporation Finance, Current Report on Form 8-K, Frequently Asked Questions, November 23, 2004, available at http://www.sec.gov/divisions/corpfin/form8kfaq.htm.

[17] Turner, Lynn E. and Thomas R. Weirich, *A Closer Look at Financial Restatements: Analyzing the Reasons Behind the Trend* (December 2006), available at http://www.nysscpa.org/cpajournal/2006/1206/infocus/p12.htm.

[18] Whitehouse, Tammy, *Financial Statements Drop Again in 2009; Will It Last?*, Compliance Week (March 16, 2010), available at http://www.complianceweek.com/article/5847?printable=1.

[19] Id.

cable and ensure that the audit committee is adequately informed, unless the illegal act is inconsequential. Consequently, if M&A diligence leads to the discovery of an audit report indicating that an illegal act has occurred, the acquiror should be prepared to find a financial restatement as well.

Significant Drops in Stock Price or Credit Rating

A final method that should be used in conducting M&A diligence is to analyze the potential effects that a restatement may cause. The most immediate result of a restatement is the negative market reaction, such as a significant drop in the company's stock price, which, in some instances, can average ten percent during the three days surrounding the restatement.[20] To the acquiror, a drop in stock price may be evidence of several factors, including that a financial restatement has taken place, that the company is not properly conducting its business or that its management does not have adequate control over internal procedures. In any case, the financial statements of a target that has experienced a significant drop in stock price should be reviewed for the period(s) relating to such drop and an assessment should be made as to whether a stealth restatement, or other type of restatement, has occurred.

Additionally, a restatement of financial statements may be the cause of a default under representations and warranties or covenants in debt instruments or indentures, or a negative impact on the company's credit rating. The failure to provide financials in a timely fashion, such as when there is a delay in filing due to a restatement, could itself constitute a default or acceleration of payments under existing debt instruments. The restatement may also cause the decreased ability of the company to negotiate financial covenants or pursue certain transactions. All of these types of results can signal that a restatement has occurred and those conducting M&A diligence on behalf of an acquiror should be aware of these warning signs.

Due Diligence Request Checklist

In addition to conducting its own independent diligence about a target's financial statements, an acquiror should also be certain to include in its diligence checklist a request relating to restatements. For example, the acquiror's checklist should include a request substantially similar to the following: "*Provide a description of any revisions or restatements of financial statements, any accounting irregularities or any of the target's accounting principles that do not comply with accounting principles generally accepted in the United States*." The acquiror may also want to include a request for a qualitative description of the restatement or irregularity and the reasons therefor.

Upon receipt of an affirmative response to a restatement diligence request, an acquiror should not only have its counsel review the materials, but should also have its accountants' review the materials. When reviewing the materials, the accountants should ensure that the target's accounting practices comply with GAAP and that they are consistent with the acquiror's own accounting policies. To the extent the target's accounting practices differ from the acquiror's practices, the acquiror's accountants will need to identify the differences and provide a roadmap for the future assimilation of their respective accounting practices. It will also be instructive for the acquiror's accountants to identify how differences in accounting principles can impact the target's financial statements and affect the purchase price discussions.

4. The Effect of an SEC Investigation of a Target

It is often the case that once a target has discovered a material error in its financial statements, it will conduct an internal investigation to assess the depth of the problem and then it will disclose the issue both to the public and to the SEC (as well as to the stock exchange on which it is listed, if applicable). If the target discloses certain remedial measures and effectively implements such measures, it is possible that a substantial SEC investigation may be avoided.

However, if the SEC decides to investigate the matter, it may request access to the documents related to the target's internal investigation and may require that the target waive its attorney-client privilege in connection with the internal investigation. The most important consequence of the waiver, for both the target and acquiror, is that any information provided to the SEC could be discoverable in the future by shareholder plaintiffs in an action against the target. To avoid this dangerous possibility, it is common

[20] Bischoff, Jane et al, *Financial Statement Restatements: Causes and Effects, Tennessee CPA Journal* (April 2008), available at www.tscpa.com/Journal/articles/fin_statmt_restatmt.pdf.

practice that a target should request to substitute the documents for an oral report to the SEC, detailing the results of the internal investigation, and thus preserving the privacy of such documents.

An acquiror must also be aware of the SEC's recent decision to strengthen its investigative efforts.[21] In March 2010, the SEC and the U.S. Department of Justice announced new incentives to encourage companies and individuals to aid in the investigation of financial fraud. In addition to offering deferred prosecution agreements and non-prosecution agreements, the SEC and DOJ may allow cooperating individuals or companies to receive credit for assisting in investigations, as long as the assistance is substantial and truthful.[22] Because of these incentives, whistleblowers may defeat a target or acquiror's efforts to conduct a stealth restatement and may create media attention that could lead to a significant drop in stock price and/or an expensive settlement agreement.[23]

Other sections of this article support the proposition that an acquiror should not automatically terminate deal discussions simply because the target has restated its financial statements (or has reason to restate its financials statements in the future). However, this section underscores the need to pursue a cautionary approach if the acquiror discovers a target is under investigation by the SEC or DOJ.

5. Evaluating Controls and Procedures Versus the Personnel of a Target

When conducting diligence on a target that has been through a restatement, it is worth looking at the impetus for the restatement because it can be an indicator of the future success of the target following the acquisition. When looking at the causes of restatements, generally, a couple of interesting trends stand out.

First, the most common reasons for restatements have not been consistent. In the GAO's initial report on restatements issued in 2002, revenue recognition issues were the leading causes of restatements, generating nearly 38% of all restatements.[24] However, in its report issued in 2006, the leading causes of restatements were for expense recognition reasons—especially lease-accounting expenses, which spawned over 35% of all restatements—and deferred compensation-related issues, which accounted for over 14% of all restatements.[25] By 2009, the leading causes of restatements were the improper recording of equity or debt accounts—nearly 18% of all restatements—and expense recognition errors—over 14% of all restatements.[26]

Second, the changing nature of the most common causes of restatements suggests that the trend will continue with a healthy dose of influence by regulatory proclamations and rulings invariably leading to a new batch of types of restatements.[27] By focusing on the cause of a restatement, three things become easier to understand: (i) why a target was subject to a restatement, (ii) whether the restatement can be attributed to the actions of certain personnel—personnel that the acquiror may not want to retain following the closing of the acquisition, and (iii) whether the restatement that occurred was necessary for more benign reasons, such as the impact of regulatory changes and rulings (*e.g.*, the proliferation of restatements owing to lease-accounting expense recognition).

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[21] Darmer, Roman, *SEC and DOJ Announce Changes to Enhance Investigation and Prosecution of Financial Fraud*, The Defender, (Spring 2010) available at http://thedefender.howrey.com/sec-and-doj-announce-changes-to-enhance-investigation-and-prosecution-of-financial-fraud-03-30-2010/.

[22] Id.

[23] For example, after the SEC investigation following its own internal investigation and restatement of its financial statements, AIG agreed to pay more than $1.6 billion in a global settlement agreement related to the SEC's claim of securities fraud. *See* Securities and Exchange Commission, Press Release 2006-19, *AIG to Pay $800 Million to Settle Securities Fraud Charges by SEC*, available at http://www.sec.gov/news/press/2006-19.htm.

[24] *See* the U.S. Government Accountability Office Report on Financial Statement Restatements: Trends, Market Impacts, Regulatory Responses and Remaining Challenges at 5.

[25] Id. at 17. A leading factor in the increase of expense recognition restatements was the SEC's chief accountant's February 7, 2005 letter regarding the treatment of certain lease and leasehold improvements and a leading factor in the increase of equity-related restatements likely was the revisions to Financial Accounting Standards No. 123 in the wake of the option back-dating scandals discovered in 2004 and 2005. *See* http://www.sec.gov/info/accountants/staffletters/cpcaf020705.htm.

[26] Audit Analytics, *2009 Financial Restatements: A Nine Year Comparison* (February 2010), at 22, 23.

[27] There can be no doubt that just as Enron and Sarbanes-Oxley provided ample work for lawyers, their economic impact on the accounting industry (the spawn of the PCAOB and the reduction of competition among the Big 4 accounting firms through the implosion of Arthur Anderson demonstrates their impact) cannot be underestimated.

6. Litigation and Investigations

Another major concern when doing diligence on a company that has announced a financial restatement, especially recently, is the effect that its interaction with the government may have, potentially many years into the future. A public company that has announced a financial statement restatement may well expect both litigation and an investigation by the SEC, usually beginning at the company level, but which, depending on the reasons for the restatement, may ultimately mature into an executive-level investigation and/or litigation. Of course, a company's executives and counsel should anticipate these types of investigations and litigation before a press release is issued, so as to ensure the accuracy of the information contained in the press release and to make sure that the nature of the restatement is conveyed in such a way as to discourage litigation (while still maintaining the truthfulness of the disclosure).

Yet another factor that influences both the likelihood of SEC involvement and the aggression of their enforcement relates to the manner of restatement. Research shows that before Sarbanes-Oxley, a transparent disclosure tended to make a company more likely to face SEC enforcement.[28] However, in the recent years after Sarbanes-Oxley, that trend has reversed and companies that are transparent with their disclosure not only face a reduced likelihood of government enforcement, but also smaller penalties when they are sanctioned.[29] This is likely a result of the SEC's desire to discourage stealth restatements, while also encouraging companies to be candid and thorough when deciding a restatement strategy. Any decision to disclose must be analyzed carefully though because transparency does not come without another risk. While the SEC may be more forgiving in light of increased public disclosure, shareholders are not likely to be similarly inclined. As disclosure becomes more public, the chances that more shareholders will both see it and act on it also increase.

7. Conclusion

One of the acquiror's essential processes when pursuing an M&A transaction is conducting its due diligence on the target, and two of the key components of that diligence are evaluating the financial health of the target and understanding the reliability of its financial statements and practices. To that end, determining if a target has or should have undertaken, or if it will need to undertake, a restatement of its financial statements, is a critical part of the diligence analysis.

The goals of this article have been to provide an understanding of why these parts of the diligence process are necessary and to explore the best methods of discovering and evaluating a financial statement restatement. Absent outright fraud, the discovery of a recent restatement should not cause an acquiror to automatically abandon the M&A transaction. Rather, a restatement will be just another risk that the acquiror should consider when determining when to go forward with the transaction and whether the substantive terms of the transaction (*i.e.,* price, escrow provisions, survival of representations and warranties, and indemnity coverage) should be revised in light of the restatement.

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[28] Files, Rebecca L, *Do More Transparent Corporate Actions Following a Restatement Influence the SEC's Decision to Issue an Enforcement Action?* (February 2009), available at acctwkshop.cox.smu.edu/acctwkshop/Rebecca%20Files%20road%20paper%20Feb%2009.doc.

[29] Id.

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