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Mitigating the risk of a remediation and restatement: A proactive approach to potential issues

During the second quarter of 2021, something unusual happened in the financial markets. More companies issued restatements than the previous year—or any year since 2013.[1] One of the contributing reasons? New guidance from the Securities and Exchange Commission (SEC), which affected an area of accounting applicable to an increasingly popular investment vehicle.

It was just one example among many of a change or event that demonstrates risk in financial reporting. Few companies expect to find themselves in the situation of needing to remediate their accounting and financial reporting, much less restate their financial results. After all, mitigating the risk of a restatement is what some internal control procedures are designed to do. But as recent activity shows, surprises do occur, and they're more common than anyone would probably like to believe.

There might not be much you can do to influence certain events in the external environment (although we encourage stakeholders to provide feedback when the SEC or accounting standards-setters ask for input). But you ***can*** control how you deal with them. In this twopart series, we examine how companies can get ahead of potential issues and be prepared to respond in case a remediation situation happens. Let's begin with a look at some of the drivers behind the rise in remediation activities.

Dialing up the risk

Companies must account for—and report on—a growing volume of conditions that affect business performance. Examples include:

Changing economic environment. The recent pandemic has upended numerous assumptions about business operations, from consumer behavior to workforce norms and the global supply chain. This has challenged planning and forecasting efforts, along with the ability to develop accounting judgments and estimates.

Digital transformation. Organizations are accelerating their use of technology to improve the customer experience, make operations more efficient, streamline administrative functions, and more. At the same time, system updates or implementations can expose shortcomings with data organization and integrity.

New standards and regulations. The Financial Accounting Standards Board is continuing to update accounting standards in the interest of providing decision-useful information at home and harmonization with standard-setters abroad. Similarly, regulators such as the SEC are issuing new rules and adjusting areas of focus as companies and markets evolve. Each change demands time and attention as companies work through the nuances of compliance.

Nonrecurring transactions. Unique transactions are surging as companies pursue faster routes to growth (traditional mergers and acquisitions), seek a vehicle to enter the public markets (initial public offerings and special-purpose acquisition companies), or combine forces to gain scale (stock-for-stock mergers). Each brings new revenue streams and other transactions under the CFO's purview. Even complementary businesses can introduce processes that the acquiring company's systems and controls aren't designed to handle.

Employee turnover. Companies are enhancing compensation and career paths in a bid to acquire new talent and retain the employees they have. But an elevated resignation rate can mean greater misalignment of skills and loss of institutional knowledge.

Any of these conditions can have a destabilizing effect on the company and raise the risk of a remediation event in the future.

Finding where the wind blows

An important step is to regularly monitor the business environment for shifts that potentially affect your accounting and financial reporting. Here's a partial list of targets to put on your radar:

SEC comment letters. When the SEC reviews filings made by issuers, including those filing initial registration statements, and has questions or observations, the staff will send a letter of comment, which may involve pointing out errors or inconsistencies the company should address. Comment letters issued by SEC staff related to periodic filings become public 20 days after the SEC completes its review.

Public company executives can monitor which topics the SEC homes in on based on how frequently they come up in letters of comment. *A Roadmap to SEC Comment Letter Considerations, Including Industry Insights* is an annual publication that includes topics of frequent comment plus analysis of other comment letter statistics. The publication also includes an update on some of the SEC's strategic priorities. Use of data like that found in this publication allows companies to remain abreast of trends and focus areas. That gives management the opportunity to preemptively evaluate how their financial statements and internal controls may be impacted.

The Division of Corporation Finance. This division of the SEC produces several sources of guidance that are publicly available. One is the Financial Reporting Manual, a periodically updated compilation of informal guidance. Another is the division's Compliance & Disclosure Interpretations, or C&DIs, which offer interpretations of certain rules and regulations, such as the use of non-GAAP financial measures. These resources provide useful information in terms of interpretive guidance that companies may use to further understand the respective rules and regulations and tailor their financial statements accordingly. This content is also helpful for companies responding to comment letters from the SEC staff.

Trends at the SEC. In addition to the above, keep tabs on SEC speeches and work discussions. Together, they can reveal areas of focus that you may want to apply internally. For instance, revenue recognition and leases held the headlines for years. More recently, as we've seen, the SEC has been scrutinizing accounting for warrants in SPAC transactions. Going forward, expect more movement on environmental, social, and governance (ESG) disclosures.

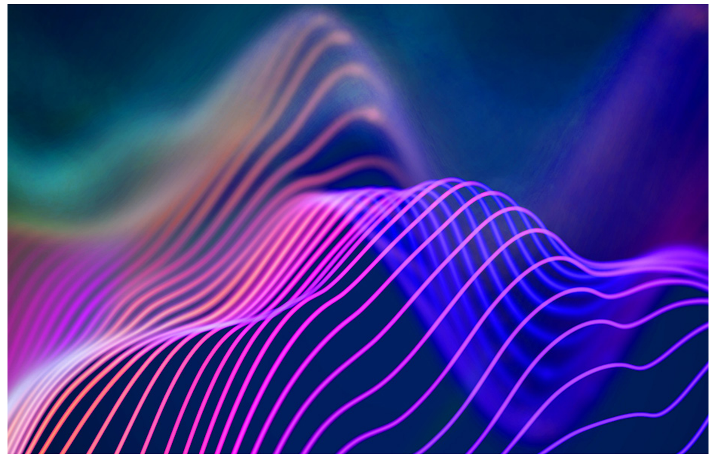
A framework to foster resilience

So how can companies build an accounting organization that's more resilient to change? Start with a framework for mitigating restatement risk—one that's based on people, processes, and technology.

People should be agile, empowered, and ready to respond to issues that arise. Cross-training is essential to interpret—and challenge assumptions about—internal and external conditions that raise the risk of remediation and restatement. Look into engaging outside help to enhance in-house efforts.

Processes should center around monitoring to provide early warning of potential issues. Internally, look for changes in the business and how they affect financial information. Externally, watch for themes that point to SEC sentiment on key topics, including comment letters, publications, and other communications (see sidebar). Remember to report on any findings.

Technology refers to the way your organization applies its digital capabilities. A proactive organization has an effective data management policy and a way to monitor the integrity of its data. It also affords enough time to implement new systems, which helps ward off surprises that may require remediation. (As an example, consider the mismatch that can occur between existing processes and the processes enabled by a new enterprise resource planning system, muddying the data required for financial reporting.)



The next step is to create a toolkit for responding to challenges as they occur. This includes:

- A repository of tools and preassembled knowledge;
- A plan for status tracking and reporting;
- Project, training, and stakeholder engagement plans that are continually updated based on experience;
- An effective system of governance and controls that focuses on the right risks in the right areas; and
- A playbook for proactive remediation, even if it's just a checklist of high-level action items.

The aim is to give the organization the resources it needs to scale quickly, all while keeping an eye on the horizon.

Public companies must navigate a sea of complexity. Whether it's implementing a new system, entering a new line of business, or any other potentially destabilizing factor, an accounting organization that's resilient to change means less room for errors that can trigger the need for remediation. And if the company does find itself having to remediate its financial processes, the foundation is in place to emerge successfully—a scenario we'll explore in greater detail in the second part of this series.

Endnotes

1. Jean Eaglesham, "A Wave of Earnings Restatements Slams a Hot Market," *Wall Street Journal*, July 2, 2021.

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