

Q&A Series: When Your Public Company Must Restate Its Financial Statements

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Q: In the course of doing this year's audit, our independent auditor found a problem with our previously issued financial statements. What do we do now?

A: You need to know more. You do not have to restate your financial statements unless they are materially wrong, although bear in mind that the Securities and Exchange Commission (SEC) has said that materiality can be “qualitative” as well as “quantitative.” See Staff Accounting Bulletin No. 99.

Work through the potential issues and determine what, if anything, needs to be restated. Be sure that your independent auditor considers possible accounting alternatives to a restatement, like a cumulative catch-up. Also, you need to understand why the problems occurred; evidence of fraud, for example, will surely call for additional action. Once you have reason to believe that there is a material error, you should shut down trading in the company's securities by insiders. You may also have to suspend outstanding shelf registration statements, if there are any.

Q: Okay, after reviewing everything, the Audit Committee has indeed concluded that some of our previously issued financial statements should no longer be relied on. And, it looks like we are going to be delayed in filing our Annual Report on Form 10-K. What do we do?

A: Once the Audit Committee concludes that previously issued financial statements should no longer be relied on, you must file a Current Report on Form 8-K under Item 4.02 within four business days of the Audit Committee's conclusion. Be careful and complete with this disclosure and don't try to say too much, too soon. Restatements often lead down unforeseen paths and, while it's understandable, it's often unwise for companies to suggest that they fully comprehend their issues or that they have a date certain by which they are sure to be finished with the process. Item 4.02 calls for facts, not guesses.

Having to restate your financials is highly likely to result in a late filing of at least one SEC periodic report, like Form 10-K or 10-Q. However, if you fully comply with Rule 12b-25 of the Exchange Act, then the delayed report will be treated as if it was filed on time. To comply with the rule:

- You must file Form 12b-25 (Notification of Late Filing) within one business day after the due date of the late report.
- You must represent in the Form 12b-25 that the reasons causing the inability to file timely could not be eliminated without unreasonable effort or expense. This necessarily includes providing the reasons for your inability to file timely.
- For an Annual Report on Form 10-K, you must file the subject report no later than the 15th calendar day following the due date, and for a Quarterly Report on Form 10-Q you must file no later than the 5th calendar day.

Form 12b-25 can be tricky because it is not just a “notice” filing. It requires disclosure of the reasons why the company is unable to file timely; therefore, the company will need to think about what information should be disclosed here, especially if it is still early in the restatement process.

Q: What if we cannot file our periodic reports within the Rule 12b-25 grace period?

A: Regrettably, very few restatements can be concluded in time to meet the short extension deadlines provided under Rule 12b-25. Early in the restatement process, you should consider issuing a press release about the situation. In your press release, resist the temptation to

state with too much precision what the problem is, because having to correct yourself later on will hurt the company's credibility in the market. However, make sure the press release has full, fair and complete disclosure that also anticipates questions from the market. Company officials who receive calls should stick strictly to the disclosure in the release.

As for timing, although some companies provide an estimate about when the restatement will be finished, take into consideration that the problem may grow as you work through the issues. Factors to consider in terms of timing include the type and number of accounting issues, the number of fiscal periods involved, and whether the restatement implicates internal control and procedures. If internal control is at issue, the restatement process may take an extended period of time and you may not be able to estimate a completion date with any accuracy.

If you publish a target date and miss it, you will need to file another press release to that effect and provide a new estimated date for completion and filing of restated financials.

Q: What happens when my periodic reports are late?

A: If the company's shares are traded on an exchange like New York or Nasdaq and you fail to file a timely periodic report after filing Form 12b-25, you will soon receive notice from the exchange that your shares are now subject to delisting. This will prompt another Current Report on Form 8-K pursuant to Item 3.01, under which you must advise the public, within four business days of its receipt, that the stock exchange proposes to delist your shares.

The key here is to press for a hearing date with your exchange as far out as possible to increase your chances of showing up to the hearing with the issue resolved or, at the very least, to have a good sense of when it will be resolved.

Q: What else do I need to be thinking about during this process?

A: There are collateral consequences that should be on your radar. Among them:

- The Sarbanes-Oxley Act requires CFOs and CEOs to reimburse their companies for incentive compensation and stock sales profits if the financial statements for that year are restated and the restatement is due to "misconduct." Your company's incentive plans may have their own separate clawback provisions. At a minimum, your compensation committee may have a problem on its hands.
- Incorrect financial statements may result in a breach of a covenant or a default in your bank credit agreement or indenture. If this is the case, address it with your lenders as soon as possible. Also, if your company has recently engaged in a so-called "PIPE" transaction, the delay caused by the restatement may make it impossible for the company to comply with its registration rights agreements, which may result in monetary penalties.
- Some Director & Officer insurance policies may be affected by the fact that your previously issued financial statements were materially inaccurate. Again, this may be something to address with your insurer at an early stage.
- If the independent auditors discover a "material weakness" or a "significant deficiency" in your internal control over financial processes, you are likely to be required to make substantial disclosures in your periodic reports, once they are filed, about those problems. These disclosures typically receive a good deal of scrutiny from the SEC and the stock markets.
- The company will not be eligible to use any registration statement form under the Securities Act the use of which is dependent upon timely filed periodic reports, until such time as it has timely filed those reports for the requisite time period. In addition, Securities Act Rule 144 (an important rule for insiders and owners of restricted stock) will not be available while the company is not current in its filings.

The restatement process can be slow, and it is likely to be expensive, in large part because neither you nor your independent auditors will want the restated financials to be anything but "squeaky clean." There may be litigation by stockholders who will claim to have been misled by prior financials, though in our experience litigation is not a given, and many companies restate financials without being sued. It's a stressful process, but you can get through it with care and patience.

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