Deloitte.

Accounting restatements and remediations: Insights from recent IPOs and SPAC mergers

Leading practices for responding to and potentially preventing restatements and related remediations

The initial public offering (IPO) surge of 2020 and 2021 resulted in record numbers of US companies—more than 800—going public either through a traditional IPO or a SPAC merger.[1] Public company restatements rose commensurately in 2021, from less than 400 to 1,470, an increase of 289%.[2] The parallel rise in IPOs and restatements is no coincidence; of the companies that went public, more than three-quarters had a restatement.[3]

A 2022 Deloitte survey, moreover, found that 59.1% of public companies revised or remediated one or more financial processes in the past 12 months, and 51.6% said they expected to do so in the next 12 months.[4] A deeper dive into newly public companies that had a restatement, based on Deloitte's discussions with company CFOs, helps us understand what leads to these events.

People, processes, and technology not keeping up with new requirements

While internal control issues can affect any company, newly public companies tend to be more susceptible to internal control weaknesses. These organizations are often still refining their internal controls, putting additional controls in place, establishing accounting policies, assembling their teams, and considering or implementing technology solutions—works in progress that can put a company at increased risk of controls deficiencies, restatements, and the need for related remediations.

Common areas for restatements

Based on Securities and Exchange Commission (SEC) filings of newly public organizations since 2020, accounting restatements were typically related to five specific areas, each of which generally requires technical accounting and reporting expertise: revenue recognition, deferred tax assets and liabilities, leases, equity instruments, and earnings per share (EPS).

- **Revenue recognition (ASC 606):** ASC 606, *Revenue from Contracts with Customers,* is a complex standard that has led to numerous restatements. It requires the application of a principles-based framework to recognize revenue, which often involves the application of significant judgment and may result in changes to the timing or amount of revenue recognized compared to legacy GAAP. Not surprisingly, revenue recognition is a topic on which entities commonly seek SEC guidance in prefiling submissions, and these topics are frequently discussed in SEC staff speeches (e.g., at the annual AICPA & CIMA Conference on Current SEC and PCAOB Developments). For example, the identification of performance obligations is an area of significant judgment that has been commonly challenged by the SEC staff and has led to certain restatements.

- **Deferred tax assets and liabilities (ASC 740):** ASC 740, *Accounting for Income Taxes*, further increases the risk of restatements for newly public companies. This standard governs recognition, measurement, presentation, and disclosure of income tax assets and liabilities and requires a thorough understanding of accounting and reporting matters. To comply with ASC 740, companies often need a set of tax basis books and records as well as a balance sheet. The risk of restatement can occur when a company underestimates or overestimates the amount of income tax expense, deferred liability, or assets in its financial statements. For newly public companies, organizational/structural changes increase these risks. Private companies, for example, are often passthrough entities (partnerships, LLC, etc.). Upon going public, they become corporations with a new set of accounting rules.

- **Leases (ASC 842):** ASC 842, *Leases*, another relatively new accounting standard, has far-reaching impacts on leases. The lease standard brought many leases onto lessee balance sheets, which can significantly impact the financial statements and could cause errors associated with lease accounting to be more material as compared to legacy GAAP. To accommodate this standard, entities have to change not only their accounting for and financial reporting of leases but also their related systems and processes.

- **Warrant liabilities and redeemable shares:** Warrant liabilities had an outsized effect on SPACs and companies that went public via SPAC merger, generating hundreds of restatements involving these entities. Most of these companies classified these warrants within equity; however, the SEC issued a statement highlighting commonly observed features in SPAC warrants that prevent the warrants from being indexed to the company's stock or could result in the cash settlement of the warrants. Warrants that are not indexed to a company's own stock or that could require cash settlement should generally be recorded as a derivative liability with fair value adjustments recorded on a quarterly basis through the income statement.

  SPACs commonly issued to investors who participated in their IPOs redeemable shares, which were historically classified as permanent equity to maintain a minimum net tangible assets requirement. In light of comment letters issued by the SEC, most of these companies had a restatement based on their re-evaluation of their application of ASC 480-10-S99-3A to its accounting classification of the redeemable shares. It was deemed that certain provisions require the classification of these shares as temporary equity regardless of the net tangible assets requirement. Equity securities that are classified as temporary equity are subject to the recognition, measurement, and EPS guidance in ASC 480-10-S99-3A, which is often complex to apply. SEC registrants are required to apply the SEC's guidance on redeemable equity securities. An entity that has filed a registration statement with the SEC is considered an SEC registrant. Other entities, such as companies that anticipate an IPO in the future, may elect to apply this guidance.

- **EPS:** EPS is a widely used calculation to assess a company's financial performance. On the surface, EPS may seem like a straightforward calculation; however, the nuances of applying EPS guidance, which is not applicable to non-public companies, can be highly challenging. The process often involves information from disparate reports and schedules and may result in manual calculations, all of which increase the likelihood of miscalculations and restatements.

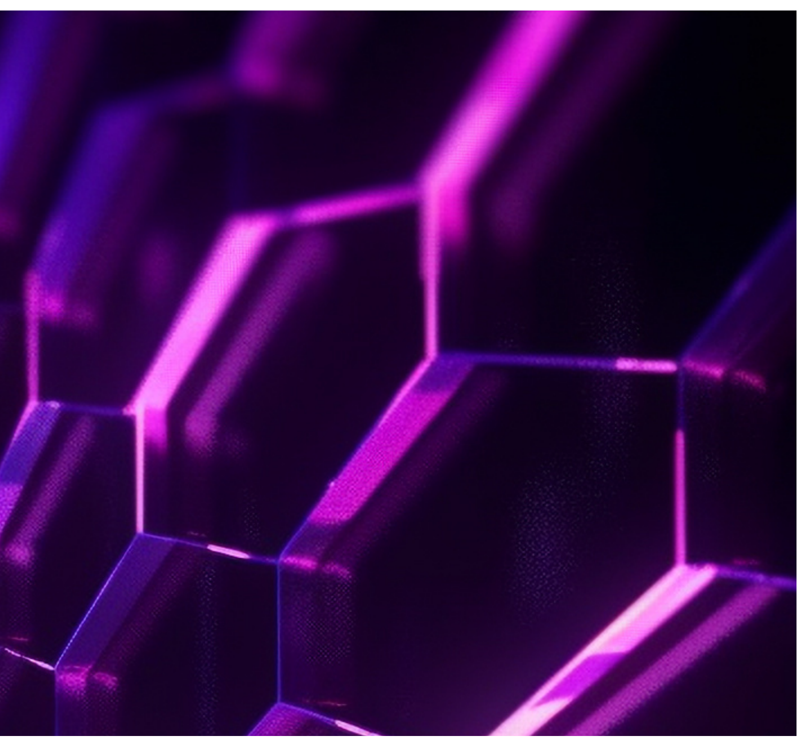
Lessons learned from new public companies

Drilling down into the most common reasons for restatements, there are three recurring themes across the five areas that surfaced in conversations with finance leaders in newly public companies:

- The relevant accounting standards were particularly complex and/or required the use of more judgment and making more estimates.
- Navigating the complexities also involved manual processes or multiple schedules and spreadsheets that were not properly controlled, increasing the likelihood of errors.
- Existing accounting staff did not have the required knowledge, experience, and specialized skill sets, which is not unusual for a newly public company trying to comply with unfamiliar standards.

According to the CFOs Deloitte surveyed, having a finance team with the appropriate skill sets, as well as a finance infrastructure to meet the objectives and demands of a publicly traded company, are among the most critical keys to a successful IPO and beyond.[5] Not only is the team crucial, but having the proper processes, technologies, and control environment in place is also extremely important.

The CFOs indicated that a scarcity of finance and accounting talent impacted and continues to impact implementation of systems, preparation of technical accounting analyses, implementation of a robust control environment, and the preparation and filing of SEC- and GAAP-compliant financial statements.[6] Resource plans should consider alternative sources of required accounting and reporting skills and knowledge.



What to do once you have a restatement and a related remediation need

Accounting restatements often correlate to the maturity of an organization's internal controls. But even the most proactive companies can find themselves in a situation requiring restatement and remediation. When that happens, responding quickly and methodically is important:

- **Create a plan.** Set up a project management office (PMO) process, tools, and protocols for status tracking and reporting. Then assign resources, including a PMO manager, while making sure to allow enough time for each workstream. Strong and frequent communication should be part of the plan.
- **Assess your resources.** Involve resources with sufficient knowledge, whether from internal or external sources or a combination of the two. Resources with deep technical knowledge are often the key to correcting a mistake.
- **Evaluate the misstatement.** Investigate the nature and cause while considering risks in adjacent areas. Determine the amount and extent of the restatement, including the impact on account balances and other areas within financial statements; finally, make the adjustments.
- **Determine why internal controls failed.** Identify the control deficiencies, focusing on the root cause, and prepare a control deficiency assessment with an eye to developing a remediation plan. Keep in mind that the root cause may affect other controls and processes, including some that do not directly relate to the area being remediated. Restatements are often indicators of a material weakness in a company's internal control framework.
- **Communicate.** Execute the communication plan. Bring the company's auditors and board of directors along on the journey with frequent updates. Meanwhile, proactively manage communications to other stakeholders, such as investors, regulators (including the SEC), and banks.
- **Complete the reporting.** A public company is required to make financial filings in a timely manner. These filings include financial restatements when errors are discovered. Once the errors have been identified, prepare the restated financials, including disclosures within the restated financial statements regarding the reason for the misstatement, the impact to the financial statements, and the changes to internal controls.

- **Repair and improve.** Determine the key learnings from the event, along with opportunities for improvement. This may mean obtaining additional resources with deep technical expertise internally or externally. Identify other areas of similar risk, and then update internal controls and the company's response framework. Beyond that, consider steps for continuous improvement for an enhanced and modernized internal control framework. Benefits of modernizing a company's internal control framework include enhanced quality, increased efficiency, deeper insights, and reduced total cost of compliance.

Why bring in an adviser?

If this sounds like a lot to do under intense pressure, it certainly can be. An accounting and reporting adviser can assist with the complex analyses often needed to assess the technical topics that cause challenges. For many companies that have recently become public, not having staff with specialized knowledge of new accounting standards can be a contributing factor to the restatement and will also be an obstacle in resolving it. An outside advisory firm that is up to speed in ever-evolving accounting standards and has the required controls, governance, remediation, and PMO experience can often be part of the solution to putting a restatement and internal control material weaknesses behind you.

Preventing future restatements

After responding to a restatement and remediating the related deficiency, how can you build a more resilient accounting organization to avoid a similar situation down the road? Doing so invariably will mean building an agile and capable team, a strong controls and governance framework, and a playbook for proactive remediation.

Staying on top of controls

Companies must continuously assess the sufficiency of their internal controls. Shifts in technology, regulation, and other business conditions require a new risk assessment and—potentially—new or changed controls to address those risks. Failure to keep pace can result in additional remediation.

Keeping pace with regulatory changes

Monitoring the business environment for shifts that potentially affect your accounting and financial reporting can go a long way toward preventing restatements. This process includes anticipating changes in the regulatory landscape by keeping your ear to the ground for up-to-date information on rule changes. Here's a partial list of Deloitte sources to have on your radar:

- **Financial Reporting Alerts.** Deloitte provides a summary of recent accounting, regulatory, and other developments that may necessitate immediate action or affect financial reporting and disclosure.
- **Road map series.** Deloitte roadmaps are comprehensive, easy-to-understand guides on applying FASB and SEC accounting and financial reporting requirements. They include Deloitte's publication "a roadmap to sec comment letter considerations, including industry insights," an annual publication that includes SEC topics of frequent comment plus analysis of other comment letter statistics.
- **Heads Up.** This newsletter presents an overview of important accounting and regulatory developments, such as new or proposed guidance from the FASB or SEC, to help readers understand and prepare for these changes.
- **Deloitte Accounting Research Tool (DART)*.** This comprehensive resource provides information on FASB, IFRS, and SEC accounting and financial reporting requirements—including:
  - Deloitte's US GAAP accounting and disclosure checklist tool.
  - Certain FASB literature and materials from meetings of the Emerging Issues Task Force.
  - SEC rules and regulations (Title 17 — Commodity and Securities Exchanges), the SEC Financial Reporting Manual, and SEC staff bulletins.
  - PCAOB staff guidance.

*** Note:** Some content may require subscription to DART.

Let's talk

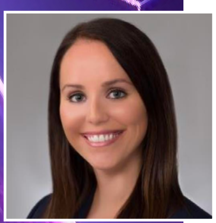
Building an agile and resilient controls environment to help prevent restatements and remediations requires knowledge and experience. With our specialized skills and experience, Deloitte can provide insights that companies considering going public may be lacking. We can assist with building a resilient controls environment with the people, processes, and technology needed to reduce the likelihood of restatements and remediations.

Want to know more?

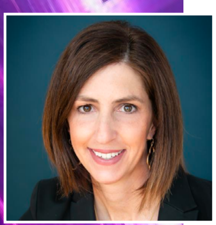
Want more answers to your questions about restatements and remediations and how to prevent them? Contact us to get the conversation started.

Authors

Hogan Miller
Audit & Assurance, Partner
Accounting & Reporting Advisory
Deloitte & Touche LLP
+1 713 982 2586
hmiller@deloitte.com



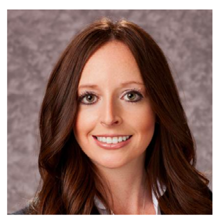
Kori Reeves
Audit & Assurance, Senior Manager
Accounting & Reporting Advisory
Deloitte & Touche LLP
+1 713 982 4291
kreeves@deloitte.com



Mary Schmidlin
Audit & Assurance, Senior Manager
Accounting & Reporting Advisory
Deloitte & Touche LLP
+1 720 264 4879
mschmidlin@deloitte.com

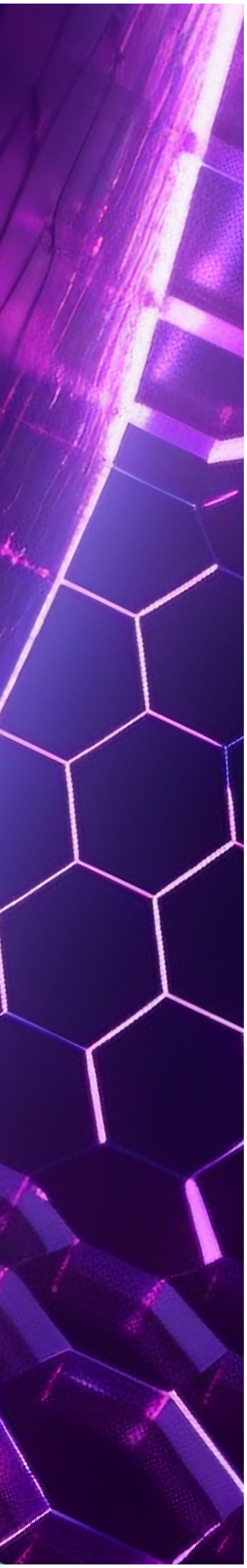
Contributors

Nick Accordino
Audit & Assurance, Partner
National Post-IPO Services Leader
Accounting & Reporting Advisory
Deloitte & Touche LLP
+1 330 329 2306
naccordino@deloitte.com



Lindsay Rosenfeld
Audit & Assurance, Partner
National Governance, Risk and Controls Leader
Accounting & Reporting Advisory
Deloitte & Touche LLP
+1 313 310 0595
linrosenfeld@deloitte.com

Jamie Davis
Audit & Assurance, Partner
National Accounting and Reporting Leader
Accounting & Reporting Advisory
Deloitte & Touche LLP
+1 312 486 0303
jamiedavis@deloitte.com



Endnotes

1. Deloitte, "IPOs: When C-suite hindsight is 20/20," May 2023.
2. Audit Analytics, "2021 financial restatements: A twenty-one year review," May 2022.
3. Ibid.
4. Deloitte, "Perspectives: Financial remediation and restatement," 2022.
5. Deloitte, "IPOs."
6. Ibid.

Accounting and Reporting Services

Remediation and Restatement Services

Sox ICFR Services