**Restatements of previously published financial statements**

Probably the best indicator of accounting and auditing failures is when a corporation restates its previously issued financial statements. Restatements are required by law when material misstatements are found to have occurred in previously issued financial statements. These restatements are sometimes claimed to have been necessary due to acquisitions (which is legitimate, but infrequent) or errors or misinterpretation of GAAP (also infrequent).

Excuses of this kind should be viewed with skepticism. In the case of public companies, the materially misstated financial statements had been produced by the professional accountants inside corporations, and had been audited by the outside independent auditors. It seems very unlikely that material misstatements would not be detected by the inside professional accountants nor by the outside independent auditors. A suspicion is that the material misstatements were not accidental, but rather deliberate. In other words, one suspects fraud.

It is an acute embarrasment to a corporation, and to its outside auditors, when the financial statements that had received approval have to be restated. Corporations and their auditors have every incentive to avoid this embarrasment by getting the financial statements right the first time around. Naturally everything of a material nature would be very carefully checked to ensure that it is correct and in compliance with GAAP. One would think that restatements would very seldom be required if audits were thorough. One would also think that restatements could be a sign that the auditors had failed.

So restatements are a red flag, and raise a suspicion of fraud. That is why restatements are considered an  indicator of accounting and auditing failures. And that is why there are studies published every year about financial statement restatements. In past years, restatements were rare. In recent years, they have become more frequent. In 2006, 1,300 U.S. public companies restated their financial statements.

The Wall Street Journal (p. B3, issue of December 23, 2006) reported a study of companies that restated their 1998 and 1999 financial statements. The study found that 47% of the CEO's of these restating companies were gone within 2 years of the restatements. This was twice the turnover of CEO's of similar companies in the same industries that had no restatements. Clearly restatements are an embarrassing symptom of lax financial controls and/or fraud.