

October 2006

# FINANCIAL AUDIT

## Restated Financial Statements: Agencies' Management and Auditor Disclosures of Causes and Effects and Timely Communication to Users





Highlights of [GAO-07-91](#), a report to the Director of the Office of Management and Budget

## Why GAO Did This Study

GAO continues to have concerns about restatements to federal agencies' previously issued financial statements. During fiscal year 2005, at least 7 of the 24 Chief Financial Officers (CFO) Act agencies restated certain of their fiscal year 2004 financial statements to correct misstatements. To study this trend, GAO reviewed the nature and causes of the restatements made by certain CFO Act agencies in fiscal year 2004 to their fiscal year 2003 financial statements. Eleven CFO Act agencies had restatements for fiscal year 2003. Nine of those 11 received unqualified opinions on their originally issued fiscal year 2003 financial statements. GAO's view is that users of federal agencies' financial statements and the related audit reports need to be provided at least a basic understanding of why a restatement was necessary and its effect on the agencies' previously issued financial statements and related audit reports. This report communicates GAO's observations on the transparency and timeliness of the 9 federal agencies' and their auditors' restatement disclosures.

## What GAO Recommends

GAO is making 11 recommendations to the Office of Management and Budget (OMB) to further improve the restatement guidance available to agencies' management and the agencies' respective auditors. OMB stated that it would take GAO's recommendations under advisement. GAO reiterates its concern that it is critical for OMB to timely provide additional restatement guidance.

[www.gao.gov/cgi-bin/getrpt?GAO-07-91](http://www.gao.gov/cgi-bin/getrpt?GAO-07-91).

To view the full product, including the scope and methodology, click on the link above. For more information, contact Gary T. Engel at (202) 512-3406 or [engelg@gao.gov](mailto:engelg@gao.gov).

## FINANCIAL AUDIT

# Restated Financial Statements: Agencies' Management and Auditor Disclosures of Causes and Effects and Timely Communication to Users

## What GAO Found

The nine agencies GAO reviewed did not consistently communicate financial statement restatements. GAO found that all nine agencies could have greatly enhanced the adequacy, effectiveness, and timeliness of their restatement disclosures to users. Similar transparency issues existed with the associated audit reports regarding disclosure of all the essential information that would clearly explain the restatements. GAO highlighted the following issues as among the more prevalent issues to be addressed:

- columns of the agencies' restated financial statements were not labeled as "Restated,"
- agencies' restatement footnote disclosures lacked clarity or sufficient detail regarding the nature of the restatements and the effect on balances reported in previously issued financial statements,
- restatement information was not sufficiently disclosed in the agencies' Management Discussion and Analysis,
- audit reports did not disclose that the respective agencies had restated certain of their fiscal year 2003 financial statements,
- audit reports did not provide a statement that the previously issued audit report was withdrawn and replaced by the opinion on the restated financial statements, and
- material misstatements and potential material misstatements were not timely communicated by agencies to either their auditors or to the users of the financial statements.

The primary contributing factor for the restatement disclosure issues that GAO identified was insufficient guidance available at the time to both the agencies' management and their respective auditors for disclosure of the restatements and the timeliness of such disclosures. GAO believes that information regarding restatements should be disclosed in a transparent and timely manner consistent with the qualitative characteristics of information in financial reports described in Statement of Federal Financial Accounting Concepts (SFFAC) No. 1. In GAO's view, more detailed accounting and auditing guidance on how to satisfy the financial reporting characteristics as outlined in SFFAC No. 1 as it relates to the disclosure of restatements would have been helpful. OMB revised Circular No. A-136, *Financial Reporting Requirements*, which provides additional guidance to federal agencies' management regarding disclosure of restatements to previously issued financial statements. Revisions made to OMB Circular No. A-136 address many of GAO's concerns regarding the agencies' disclosure of restatements. In addition, the proposed 2006 revision of generally accepted government auditing standards now includes a section on reporting on restatement of previously issued financial statements. In addition, on August 23, 2006, OMB issued Bulletin No. 06-03, which also provides some information regarding reporting on restatements. However, GAO believes that OMB needs to timely provide additional, though complementary, restatement guidance to both the agencies' management and their respective auditors.

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United States Government Accountability Office  
Washington, DC 20548

October 5, 2006

The Honorable Rob Portman  
Director  
Office of Management and Budget

Dear Mr. Portman:

We continue to have concerns about restatements to federal agencies' previously issued financial statements. During fiscal year 2005, at least 7 of the 24 Chief Financial Officers (CFO) Act agencies restated certain of their fiscal year 2004 financial statements to correct misstatements. To study this trend, we reviewed the nature and causes of the restatements made by certain CFO Act agencies in fiscal year 2004 to their fiscal year 2003 financial statements.<sup>1</sup> Our audit of the consolidated financial statements of the U.S. government (CFS) for fiscal years 2004 and 2003 showed that 11 CFO Act agencies had restated one or more of their fiscal year 2003 financial statements to correct misstatements.<sup>2</sup> Nine of the 11 agencies had received an unqualified audit opinion on their originally issued financial statements. Because of the significant increase in the number of restatements identified during our fiscal year 2004 audit, we initiated a review of the nature and causes of these 9 federal agencies' restatements.

Accounting principles attribute errors in recognition, measurement, presentation, or disclosure in previously issued financial statements to (1) mathematical mistakes, (2) mistakes in the application of generally accepted accounting principles (GAAP), or (3) oversight or misuse of facts when the financial statements were prepared. Restatements occur when an entity, either voluntarily or prompted by its auditors or regulators,

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<sup>1</sup>This report focuses only on those corrections of errors that resulted in restatements to agencies' fiscal year 2003 financial statements. Changes to prior period financial statements may also occur as a result of changes in accounting principles, where specifically required by Federal Accounting Standards Advisory Board (FASAB) standards, and changes in reporting entity.

<sup>2</sup>According to American Institute of Certified Public Accountants, Codification of Auditing Standards, AU section 110, *Responsibilities and Functions of the Independent Auditor* (1972), misstatements can be caused by error (unintentional) or fraud (intentional). The meaning of the term "error," as used in accounting principles, is consistent with the meaning of the term "misstatement."

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revises previously issued financial statements. Accounting standards state that financial statements should only be restated for the correction of errors that would have caused any statements to be materially misstated. Therefore, restatements should not occur if misstatements in previously issued financial statements are not material. Such standards further state that the restated financial statements should disclose the nature of the misstatement and effect of its correction on relevant balances. The Office of Management and Budget (OMB) has issued guidance to federal agencies' management regarding disclosure of restatements to previously issued financial statements. Generally accepted government auditing standards (GAGAS)<sup>3</sup> discuss the auditors' responsibilities when they become aware of information affecting previously issued financial statements, including corrections of material misstatements. GAGAS stress the importance of timely communication of restatements to users relying or likely to rely on the previously issued financial statements. The proposed 2006 revision of GAGAS includes an additional section on reporting on restatement of previously issued financial statements. In addition, on August 23, 2006, OMB issued Bulletin No. 06-03,<sup>4</sup> which also provides some information regarding reporting on restatements.

We believe that federal agencies' financial statements and the related audit reports should provide users with at least a basic understanding of why a restatement was necessary and the effect of the restatement on the agencies' previously issued financial statements and related audit reports. In keeping with full transparency,<sup>5</sup> when restatements occur, restated financial statements should clearly communicate that the financial statements previously issued by management and the opinion thereon should no longer be relied on and instead the restated financial statements and the related auditor's opinion should be used. In addition, timely

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<sup>3</sup>GAGAS, promulgated by the Comptroller General of the United States, are to be followed by federal auditors and audit organizations and by other auditors auditing federal organizations, programs, or activities when required by law, contract, or policy. These standards pertain to auditors' professional qualifications, the quality of audit effort, and the characteristics of professional and meaningful audit reports. GAGAS incorporate American Institute of Certified Public Accountants' field work and reporting standards and the related Statements on Auditing Standards for financial audits unless the Comptroller General of the United States excludes them by formal announcement.

<sup>4</sup>OMB Bulletin No. 06-03, *Audit Requirements for Federal Financial Statements*, August 23, 2006, supersedes OMB Bulletin No. 01-02, *Audit Requirements for Federal Financial Statements*, October 16, 2000.

<sup>5</sup>Transparency is the full, accurate, and timely disclosure of information.

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communication of restatements is critical to prevent users of federal agencies' financial statements and the related audit reports from inadvertently relying on inaccurate information.

Restatements are not unique to the federal government. Over the past several years, we have seen a number of corporate scandals as well as restatements by public companies.<sup>6</sup> In response, the Congress enacted the Sarbanes-Oxley Act<sup>7</sup> in 2002 to strengthen corporate governance and improve transparency and accountability to help ensure the accuracy and integrity of the financial reporting system in the private sector to protect investors. In addition, in May 2005, the Financial Accounting Standards Board's (FASB) Statement of Financial Accounting Standards (FAS) No. 154, *Accounting Changes and Error Corrections*,<sup>8</sup> was issued. FAS No. 154 requires nongovernmental entities to disclose that their previously issued financial statements have been restated, a description of the nature of the error, the effect of the correction on each financial statement line item, and the cumulative effect of change in the statement of financial position. Further, the Securities and Exchange Commission (SEC) now requires companies to disclose restatements in the Form 8-K.<sup>9</sup> Specifically, under the Form 8-K requirements, if a company is advised by its auditor that disclosure should be made to prevent future reliance on a previously issued audit report or completed interim review related to previously issued financial statements, the company should disclose (1) the date on which it was so advised or notified, (2) the financial statements that should no longer be relied upon, (3) a brief description of the information provided by the auditor, and (4) a statement of whether the audit committee or the board of directors discussed with the auditor the matters disclosed in the filing.

America's taxpayers deserve no less in terms of transparency, accountability, disclosure, and notification from federal agencies. Between September 2005 and January 2006, we issued reports covering five of the

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<sup>6</sup>GAO, *Financial Statement Restatements: Trends, Market Impacts, Regulatory Responses, and Remaining Challenges*, [GAO-03-138](#) (Washington, D.C.: Oct. 4, 2002).

<sup>7</sup>Pub. L. No. 107-204, 116 Stat. 745 (July 30, 2002).

<sup>8</sup>Financial Accounting Standards Board, Statement of Financial Accounting Standards No. 154, *Accounting Changes and Error Corrections*.

<sup>9</sup>Form 8-K is the "current report" companies must file with the SEC to announce major events that shareholders should know about.

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nine CFO Act agencies that had received unqualified audit opinions on, but subsequently restated, their originally issued fiscal year 2003 financial statements.<sup>10</sup> We reported that these restatements generally resulted from (1) lack of effective internal controls over the processing and reporting of certain transactions and (2) failure of the auditors to design and/or perform adequate audit procedures to detect such misstatements. During our fieldwork, December 2004 through October 2005, our review of these nine agencies also focused on the following two key areas: (1) the extent of transparency exhibited in disclosing the nature and cause of the misstatement and its impact on the financial statements and the reissued or updated audit report and (2) the timing of communicating the material misstatement to users of the financial statements. This capping report, which summarizes the results of our review of the nine agencies, provides our overall observations on their transparency and timeliness, and includes governmentwide recommendations based on our work at these agencies.

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## Results in Brief

The nine agencies we reviewed did not consistently communicate financial statement restatements. Further, we believe that all nine agencies could greatly enhance the adequacy, effectiveness, and timeliness of their restatement disclosures to users. Specifically, we found that

- two agencies did not label their financial statements as “Restated”;
- of the six agencies that restated their Statements of Changes in Net Position, two of the agencies’ restatement presentations could be misinterpreted because the agencies’ fiscal year 2004 beginning financial statement balances did not agree with the restated fiscal year 2003 ending balances;

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<sup>10</sup>Our review did not include 2 of the 11 agencies that had restatements for fiscal year 2003 because these agencies did not receive unqualified opinions on their originally issued fiscal year 2003 financial statements. Reports were issued to the Department of Agriculture, Department of State, General Services Administration, National Science Foundation, and Nuclear Regulatory Commission. We did not issue separate reports dealing with the other 4 agencies (Departments of Justice, Transportation, and Health and Human Services, and the Office of Personnel Management) since those agencies’ restatements primarily dealt with material misstatements affecting the Statement of Budgetary Resources, which we have already reported on in our February 2005 and March 2006 testimonies. See our Related GAO Products page for a list of these reports as well as other related GAO products.

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- all nine agencies' restatement footnotes<sup>11</sup> lacked sufficient clarity or sufficient detail regarding the nature of the restatements and the effect on balances reported in previously issued financial statements; and
  - seven of the nine agencies asserted in their fiscal year 2004 Management Discussion and Analysis (MD&A) that they had achieved a consecutive number of unqualified opinions on their respective financial statements. Of these, six did not acknowledge restatements to certain of these financial statements in the intervening years, which we believe is misleading to users.

We also found transparency issues with all nine agencies' audit reports related to the disclosure of all the essential information that would clearly explain the restatement. Specifically, we found that

- seven of the nine audit reports did not provide a statement that the previously issued audit report was withdrawn<sup>12</sup> and replaced by the opinion on the restated financial statements and
- three of the nine audit reports either did not disclose the restatement or refer to the restatement footnote in the financial statements.

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<sup>11</sup>According to Federal Accounting Standards Advisory Board, Statement of Federal Financial Accounting Concepts No. 2, *Entity and Display*, financial information is also conveyed with accompanying footnotes, which are an integral part of the financial statements. Footnotes typically provide additional disclosures that are necessary to make the financial statements more informative and not misleading.

<sup>12</sup>According to American Institute of Certified Public Accountants, Codification of Auditing Standards, AU section 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report* (1972), when the auditor has concluded that subsequently discovered information would have affected the previously issued audit report and believes there are persons relying or likely to rely on the previously issued financial statements, the auditor should take action to prevent future reliance on the previously issued audit report. To appropriately withdraw the previously issued audit report, the auditor may reissue the audit report separately from the audit report on the current-period financial statements or issue an updated report in conjunction with the audit report on the current-period financial statements as discussed in American Institute of Certified Public Accountants, Codification of Auditing Standards, AU section 508, *Reports on Audited Financial Statements* (1989).



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With regard to the timely communication of material misstatements affecting previously issued financial statements and restatement of such financial statements, we found that

- three of the nine agencies identified potential material misstatements prior to the fourth quarter of fiscal year 2004 and did not timely communicate that a potential material misstatement had been identified to either their auditor or to the users of the financial statements,
- six of the nine agencies identified potential material misstatements in their fiscal year 2003 financial statements after the third quarter of fiscal year 2004 but before that year's comparative financial statements were issued and did not timely communicate that a potential material misstatement had been identified to the users of the financial statements, and
- at least one agency's auditor did not advise the agency's management to timely notify users of the financial statements as to the potential material misstatements affecting the agency's previously issued financial statements.

The primary contributing factor for these issues was insufficient guidance available at the time to both the agencies' management and their respective auditors for disclosure of the restatements and the timeliness of such disclosures.

Although the guidance available did not provide explicit details for disclosing restatements, we believe that information regarding restatements should be disclosed in a transparent and timely manner consistent with the qualitative characteristics of information in financial reports described in Statement of Federal Financial Accounting Concepts (SFFAC) No. 1.<sup>13</sup> In our view, more detailed accounting and auditing guidance on how to satisfy the financial reporting characteristics outlined in SFFAC No. 1 as it relates to the disclosure of restatements would have been helpful. Nevertheless, a number of federal agencies included information in their restatement disclosures that improved the transparency of the restatement. For example, during fiscal year 2004,

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<sup>13</sup>According to Federal Accounting Standards Advisory Board, Statement of Federal Financial Accounting Concepts No. 1, *Objectives of Federal Financial Reporting*, financial reports must be understandable, reliable, relevant, timely, consistent, and comparable.

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seven of the nine agencies labeled their restated financial statements as “Restated,” although not expressly required by accounting standards at that time. In addition, during fiscal year 2005, we found that one agency, the Department of State (State), went far beyond guidance available for agency management and timely notified its users not to rely on its fiscal year 2004 comparative financial statements and the related audit report because of a potential material misstatement in the financial statements. State’s action serves as a model for what we believe is appropriate for fully and timely notifying users of potential material misstatements.

During our review, OMB revised Circular No. A-136, *Financial Reporting Requirements*,<sup>14</sup> which provides additional guidance to federal agencies’ management regarding disclosure of restatements to previously issued financial statements. The revised OMB Circular No. A-136, issued August 23, 2005,<sup>15</sup> addresses many of our concerns regarding the agencies’ disclosure of restatements. In addition, OMB issued OMB Bulletin No. 06-03, dated August 23, 2006, which provided additional guidance concerning (1) audit report language when the financial statements are restated, (2) actions the auditor should take when previously issued audit reports are not reliable due to material misstatements, and (3) the timing of the restated financial statements and audit reports. However, we believe that additional restatement guidance is needed for both the agencies’ management and their respective auditors. As such, this report contains 11 recommendations to assist OMB in updating OMB Circular No. A-136 as well as OMB Bulletin No. 06-03 to further improve guidance to agencies’ management and the agencies’ respective auditors regarding the timely disclosure of material misstatements in previously issued financial statements and the presentation and disclosure of restatements.

In oral comments on a draft of this report, OMB stated that it would take our recommendations under advisement, but that there were no current plans to update guidance that has been recently issued.<sup>16</sup> OMB also noted that any future plans to update guidance would carefully consider issues already currently being addressed by the American Institute of Certified

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<sup>14</sup>Office of Management and Budget, Circular No. A-136 Revised, *Financial Reporting Requirements*, August 23, 2005.

<sup>15</sup>OMB revised Circular No. A-136 again on July 24, 2006; however, there were minimal changes to guidance related to restatements.

<sup>16</sup>As noted previously, OMB issued guidance to agency management and agency auditors on July 24, 2006 and August 23, 2006, respectively.

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Public Accountants' (AICPA) Codification of Auditing Standards. In addition, OMB provided some technical comments, which we have incorporated as appropriate.

As noted in this report, we found inconsistent communications and insufficient disclosures of financial statement restatements by agency management and their auditors. As such, we reiterate our concern that it is critical for OMB to timely offer separate, though complementary, guidance to agency management and to agency auditors that provides more explicit and detailed guidance concerning their respective roles and responsibilities when an actual or potential material misstatement is identified in previously issued financial statements. Separate guidance is important because agency management and agency auditors have different roles and responsibilities. For example, management is responsible for preparing the financial statements and adjusting them to correct any material misstatements. The auditor is responsible for expressing or disclaiming an opinion on the financial statements prepared by management. The auditor has certain additional responsibilities should management not properly respond to actual or potential material misstatements.

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## Background

Federal agencies' management responsibilities for their financial statements include, among other things, preparing the financial statements in conformity with GAAP and establishing and maintaining internal controls over financial reporting. Auditors of these financial statements are required to plan and perform their audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. While restatements to previously issued financial statements can happen and may not be surprising given weaknesses in the financial reporting environment at many federal agencies, inherently, restatements raise questions about the reliability of other information in previously issued financial statements. In addition, frequent restatements to correct misstatements can undermine public trust and confidence in both the entity and all responsible parties. Adequate transparency and timely notification of restatements are essential to help preclude users of agencies' financial statements and the related audit reports from inadvertently relying on inaccurate information and allow them to make more informed and relevant decisions.

According to SFFAC No. 1, the primary intended users of federal agencies' financial reports are citizens, the Congress, federal executives, and federal program managers. Each of these groups may use federal agencies'

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financial statements to satisfy their specific needs. Citizens are interested in many aspects of the federal government, especially those federal programs that affect their well-being. The Congress uses the agencies' financial statements to monitor and evaluate the efficiency and effectiveness of federal programs. Federal executives, such as central agency officials at OMB and the Department of the Treasury (Treasury), use the federal agencies' financial statements to oversee government spending. Specifically, OMB assists the President in overseeing the preparation of the federal budget by formulating the President's spending plans, evaluating the effectiveness of agency programs, assessing competing funding demands among agencies, and setting funding priorities. Treasury assists the President in managing the finances of the federal government and prepares the CFS, which is based on audited financial statements prepared by federal agencies. GAO uses the agencies' financial statements and the work of their respective auditors during its annual audit of the CFS. Federal program managers also use agencies' financial statements as a tool for managing their respective agencies' operations within the limits of the spending authority granted by the Congress.

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## Objectives, Scope, and Methodology

The objectives of our review were to determine the transparency and timeliness of the restatement disclosures by the nine CFO Act agencies' management and their respective auditors. For the nine agencies we reviewed, we interviewed the preparers and auditors of the agencies' fiscal year 2003 financial statements, including staff from the agencies' Offices of Inspector General (OIG), and we obtained and reviewed relevant audit documentation. Because the OIGs typically contracted with various independent public accountants (IPA) to audit the agencies' financial statements, we expanded our contacts to include such IPAs. Our work was not designed to and we did not test the accuracy or appropriateness of the restatements. In addition, our review did not include restatements<sup>17</sup> reported in fiscal year 2005 financial statements since such financial statements were issued during November 2005, one month after the

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<sup>17</sup>At least 7 of the 24 CFO Act agencies restated certain of their fiscal year 2004 financial statements to correct misstatements. Three of these agencies had received an unqualified opinion on their originally issued fiscal year 2004 financial statements while the remaining 4 had received a disclaimer of opinion on their financial statements. The auditor for one of the agencies withdrew the unqualified opinion that had been previously rendered on the agency's fiscal year 2004 financial statements and issued a qualified opinion on the restated financial statements.

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completion of our fieldwork. With respect to the two key areas, we reviewed the nine agencies' fiscal years 2004 and 2003 comparative financial statements and the related audit reports to determine, among other things, whether the

- appropriate columns of the agencies' restated financial statements were labeled "Restated";
- fiscal year 2003 ending balance agreed with the fiscal year 2004 beginning balance on the agencies' Statement of Changes in Net Position, if restated;
- agencies' restatement footnotes were properly labeled;
- agencies asserted in their MD&A that they had received a consecutive number of clean audit opinions, and if so, whether they disclosed that certain of their previously issued financial statements were subsequently restated to correct for a material misstatement;
- audit reports referred the reader to the agencies' restatement footnote;
- agencies timely notified their auditors and users of their financial statements of the material misstatement and plans for correcting the misstatement in the financial statements; and
- auditors were aware of a material misstatement to previously issued financial statements prior to the beginning of the fourth quarter of the following fiscal year and whether the amount and effect were known, and if so, did the auditors advise the agencies' management to reissue the financial statements.

For this capping report, which is based on our review of the nine federal agencies that reported restatements in fiscal year 2004 financial statements, we considered certain accounting and auditing standards that were applicable to fiscal year 2004 federal financial reporting as well as accounting standards that were issued subsequent to fiscal year 2004. These standards consist of the Federal Accounting Standards Advisory Board's (FASAB) Statement of Federal Financial Accounting Standards (SFFAS) No. 15, *Management's Discussions and Analysis*; SFFAS No. 21, *Reporting Corrections of Errors and Changes in Accounting Principles*; FAS No. 16, *Prior Period Adjustments*; FAS No. 154, *Accounting Changes and Error Corrections*; and the AICPA's Codification of Auditing Standards, AU section 110, *Responsibilities and Functions of the*

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*Independent Auditor*, AU section 420, *Consistency of Application of Generally Accepted Accounting Principles*, AU section 508, *Reports on Audited Financial Statements*, and AU section 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*. We also considered the following OMB guidance: OMB Bulletins No. 06-03 and No. 01-02, *Audit Requirements for Federal Financial Statements*; OMB Bulletin No. 01-09, *Form and Content of Agency Financial Statements*; and OMB Circular No. A-136, *Financial Reporting Requirements*.<sup>18</sup>

We performed our detailed review and analysis of the fiscal year 2003 restatements reported in agencies' fiscal year 2004 financial statements from December 2004 to October 2005. Between September 2005 and January 2006, we issued reports to five of the nine CFO Act agencies that had received unqualified audit opinions on, but subsequently restated in fiscal year 2004, their originally issued fiscal year 2003 financial statements. In conjunction with our fiscal year 2005 CFS audit, we identified continued restatements of previously issued agency financial statements and the need for additional guidance to agencies and their auditors governmentwide. Our work was performed in accordance with GAGAS.

We requested comments on a draft of this report from the Director of OMB or his designee. OMB provided oral comments, which are discussed in the Agency Comments and Our Evaluation section of this report.

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## Insufficient and Inconsistent Disclosure of Financial Statement Restatements by Certain Federal Agencies and Their Auditors

During our review of the nine CFO Act agencies' restatements reported in fiscal year 2004, we identified issues with the disclosures made by those agencies and their respective auditors regarding the restatements. The primary contributing factor for these disclosure issues was insufficient guidance available at the time to both the agencies' management and their auditors for disclosing the restatements.

Although the available guidance did not provide explicit details for disclosing restatements, we believe that information regarding restatements should be disclosed in a transparent and timely manner consistent with the qualitative characteristics of information in financial reports described in SFFAC No. 1. In our view, more detailed accounting

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<sup>18</sup>OMB Circular No. A-136 was revised during fiscal years 2005 and 2006 and supersedes OMB Bulletin No. 01-09.

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and auditing guidance on how to satisfy the financial reporting characteristics in SFFAC No. 1 as it relates to the disclosure of restatements would have been helpful. Regardless, as discussed later in the report, several agencies included information in their restatement disclosures that improved the transparency of the restatement.

Given the issues we identified in our review of restatements reported in fiscal year 2004 financial statements, we believe it would be appropriate to offer more explicit or detailed guidance for how agency management and their respective auditors should disclose restatements. Specifically, although SFFAS No. 21 required that the nature of an error in previously issued financial statements and the effect of its correction on relevant balances be disclosed, the standard did not provide a detailed explanation of the type of information that should be disclosed or what the nature of an error means. OMB Bulletin No. 01-09, which specifies the form and content for federal financial statements, also did not provide specific guidance on how an agency's management should disclose restatement information in its financial statements. As for the auditor's disclosure of the agency's restatements in its audit report, AU section 561 only stated that the audit report usually should refer to the note to the financial statements that describes the restatement. Thus, if for no other reason than avoiding interpretation issues as to how much disclosure and in what form is appropriate, we believe that guidance to agency auditors should be enhanced to attain some added level of uniform treatment regarding the disclosure of restatements.

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## Issues Regarding Agencies' Restatement Disclosures

We identified the following four issues related to the agencies' reporting of the restatements.

### Labeling of Restated Financial Statements

While guidance available during fiscal year 2004 did not expressly require agencies to label the columns of restated financial statements as "Restated," seven of the nine agencies labeled their financial statements as such. Such labeling is a common practice in reporting restated financial statements. Two of the nine agencies did not label their financial statements as "Restated," and as a result, users of such statements may be unaware that a restatement occurred.

OMB Circular No. A-136 was revised during fiscal year 2005 to provide additional guidance for disclosing restatements; however, it does not require agencies to label their financial statements as "Restated." In our view, revising OMB Circular No. A-136 to require agencies to label the columns of the restated financial statements as "Restated" would make the

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Restatements to Certain Agencies' Statement of Changes in Net Position

existence of restated financial statements more evident to the readers of the financial statements.

We also found issues regarding certain agencies' restated Statement of Changes in Net Position. Of the six agencies that restated their originally issued fiscal year 2003 Statements of Changes in Net Position to correct for material misstatements, two of the restatement presentations could be misinterpreted because the fiscal year 2004 beginning balances did not agree with the restated fiscal year 2003 ending balances. Instead of carrying forward the restated fiscal year 2003 ending balance to the fiscal year 2004 beginning balance, these two agencies made prior period adjustments to the fiscal year 2004 beginning balances to reflect the restated fiscal year 2003 ending balances. We believe that a clearer presentation on the agencies' fiscal years 2004 and 2003 comparative Statement of Changes in Net Position would have been to carry forward the restated fiscal year 2003 ending balances and present them as the fiscal year 2004 beginning balances instead of presenting prior period adjustments in the fiscal year 2004 column.

Although authoritative guidance available during fiscal year 2004 did not expressly prohibit agencies from reflecting prior year restatements as adjustments to the current year's beginning balances on the Statement of Changes in Net Position, we found that the other four agencies' restated fiscal year 2003 ending balances agreed with the fiscal year 2004 beginning balances on their Statement of Changes in Net Position. The current version of OMB Circular No. A-136 includes guidance from SFFAS No. 21, which states that the adjustment should be made to the beginning balance of cumulative results of operations, in the Statement of Changes in Net Position for the earliest period presented. In our view, OMB Circular No. A-136 would be enhanced if it explicitly stated that the current year unadjusted beginning balances on the Statement of Changes in Net Position are to agree with the restated ending balances on the prior year's statement (i.e., that adjustments are to be made only to the prior year and carried forward as restated).

Agencies' Restatement Footnotes

In our view, all nine of the agencies' restatement footnotes lacked sufficient clarity or sufficient detail regarding the restatements in at least one of the following two areas: (1) the title of the footnote or (2) the content of the footnote.

For five agencies, the title of the restatement footnote did not reflect the existence of a restatement. Specifically, three agencies titled their restatement footnotes as either "Prior Period Adjustments" or "Prior



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Period Reclassification,” which could be misinterpreted since the changes to the financial statements represented restatements because of material misstatements rather than prior period adjustments<sup>19</sup> or prior period reclassifications.<sup>20</sup> The other two agencies did not include separate footnotes disclosing the restatement information. Instead, one agency provided the restatement information under its “Significant Accounting Policies” and the other included it under its “Statement of Changes in Net Position” and its “Statement of Budgetary Resources” notes. The remaining four agencies appropriately titled their restatement disclosures by entitling their footnote “Restatement.”

With respect to restatement footnote content, five clearly explained the misstatement and reason for the restatement while the other four agencies did not. Accordingly, it was not clear if these four agencies’ misstatements were attributed to errors in recognition, measurement, presentation, or disclosure in financial statements resulting from mathematical mistakes, mistakes in the application of GAAP, or oversight or misuse of facts that existed at the time the financial statements were prepared. In addition, one of the nine agencies did not disclose the specific year(s) being restated, while two other agencies did not disclose all of the financial statements impacted by the restatements.

Further, we also believe some additional language should be included in related footnotes. Specifically, in our view, a sufficient restatement footnote would also include (1) the specific amount(s) of the material misstatement(s) and the related effect(s) on the previously issued financial statement(s) (e.g., year(s) being restated and the specific financial statement(s) affected and line items restated); (2) the overall impact the restatement has on the current year financial statements (e.g., the change in overall net position, change in the audit opinion); and (3) a discussion of the corrective actions taken by the agency’s management.

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<sup>19</sup>According to Federal Accounting Standards Advisory Board, Statement of Federal Financial Accounting Standards No. 21, *Reporting Corrections of Errors and Changes in Accounting Principles*, a prior period adjustment is defined as a correction for an error that occurred in and whose cumulative effect is attributable to periods not presented in the current financial statements.

<sup>20</sup>According to American Institute of Certified Public Accountants, Codification of Auditing Standards, AU section 420, *Consistency of Application of Generally Accepted Accounting Principles* (1972), classifications in the current financial statements may be different from classifications in the prior year’s financial statements. Although changes in classification are usually not of sufficient importance to necessitate disclosure, material changes in classification should be indicated and explained in the financial statements or notes.

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Although six agencies appropriately disclosed the amounts being restated, the remaining three did not disclose the specific line items restated and the related amounts. In addition, five agencies did not disclose the effect of the restatement on the financial statements as a whole. Further, none of the nine agencies' restatement footnotes discussed the actions taken by the agency's management after discovering the misstatement, such as measures taken to better prevent similar misstatements from occurring in the future (e.g., improvements in internal controls).

Authoritative guidance available during fiscal year 2004 did not provide explicit guidance to the agencies as to what information should be included in the agencies' footnotes or how the restatement note should be titled. Revisions made to OMB Circular No. A-136 address a number of these areas. Specifically, OMB Circular No. A-136 now requires agencies to provide restatement information in a separate note entitled "Restatements." In addition, regarding content of the note, the revised circular calls for the following information to be included in the note: the nature of the error and the reason for the restatement, the year(s) being restated, which financial statements are impacted, the amounts being restated, and the effect of the restatement on the financial statements as a whole (i.e., change in overall net position, change in audit opinion, etc.). Further, per the revised OMB Circular No. A-136, agencies should discuss the actions management took after discovering the error.

The additional requirements in OMB Circular No. A-136 address many of our concerns with the transparency of the restatement footnote. We did, though, identify three areas where OMB Circular No. A-136 could further enhance transparency. The first is to clarify that when agencies disclose the amounts being restated, it is important that they also disclose the specific line items restated and the related amounts. In our view, this additional information will allow the readers of the restated financial statements to more clearly see how the restatement affected such statements. The second is to define the meaning of the "nature" of an error. The third is to explicitly state what type of information should be provided when discussing the actions management took after discovering the error.

## Disclosure of Restatements in Agencies' Management's Discussion and Analysis

We also found that certain agencies' presentation of restatements in their MD&A could be misleading. Seven of the nine agencies we reviewed stated in their fiscal year 2004 MD&A that they had achieved a consecutive number of unqualified opinions on their respective financial statements. However, six did not acknowledge that one or more of these financial statements had been restated in the intervening years to correct for

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material misstatements. We believe stating that there have been consecutive years of unqualified audit opinions without the appropriate context could be misleading to the reader of the financial statements. It erroneously conveys an impression of consistent, accurate financial reporting over a period of time, when in fact this was not the case because subsequently, the financial statements and the opinion were found to be incorrect.

According to SFFAS No. 15, *Management's Discussions and Analysis*, management should have great discretion regarding what to say in its MD&A. At the same time, the standard also states that the pervasive requirement is that the MD&A not be misleading. In our view, it is misleading for an agency to state in its MD&A that it has received a consecutive number of unqualified opinions on its financial statements when one or more of its financial statements within that time frame were subsequently restated. In our view, agencies having restated their financial statements should either refrain from such claims or clearly disclose in their MD&A which of the agency's prior year financial statements, as originally issued, were materially misstated and subsequently restated. Although standards do not specifically state that agencies shall disclose restatement information in their MD&A, we found that one of the seven agencies did state that it had received a clean audit opinion for 7 consecutive years but appropriately disclosed that its fiscal year 2003 financial statements were restated to correct misstatements.

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## Issues Regarding Auditors' Restatement Disclosures

During our review, we found issues regarding how agency auditors disclosed the agencies' restatements in their audit reports. According to AU section 561, the restatement footnote in the agency's financial statements "usually should" be referred to in the audit report, but given the latitude, such disclosure is not an across-the-board requirement. In any report on financial statements, the auditor has the discretion to add a separate paragraph to the audit report to emphasize a matter regarding the financial statements. In our view, such matters include the effect of the material misstatements on previously audited financial statements and the accompanying audit report. Also, we believe that if the agency's restatement footnote does not provide a clear and adequate description of the restatement, then the auditor should go beyond merely referencing the restatement footnote and add a separate paragraph to the audit report that provides additional details regarding the effects of the restatement and should consider whether it is necessary to modify the audit opinion.

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In our view, none of the nine agencies' audit reports we reviewed sufficiently disclosed all the essential information that would clearly explain the restatement. Specifically, we found that

- seven of the nine audit reports did not provide a statement that the previously issued audit report was withdrawn and replaced by the opinion on the restated financial statements,
- three of the nine audit reports either did not disclose the restatement or include a reference to the agency restatement footnote in the financial statements,<sup>21</sup> and
- none of the nine agencies provided a sufficient description of the restatement (i.e., the nature and cause of the misstatement, year(s) being restated, financial statements and line items impacted, specific amount(s) of the material misstatement(s) and the related effects on the previously issued financial statements, and actions management took after discovering the misstatement) in the notes to their financial statements and none of these agencies' auditors compensated for this by providing such information in their audit reports.

In our view, the auditor plays an important role in ensuring proper disclosure of restatements. Accordingly, if any of the prior year financial statements are restated and management did not already provide a sufficient description of the restatement in the note(s) to the financial statements, the audit report should include such information. In addition, although none of the nine agencies' auditors disclosed misstatements of unknown amounts, we believe that if at the time of issuance of the audit report, a material misstatement or potential material misstatement has been identified in any of the prior years' financial statements but the specific amount of the misstatement and the related effects of such are not yet known, it is important for the auditor to disclose the situation in its audit report and modify its opinion or disclaim an opinion on the prior year financial statements as appropriate.

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<sup>21</sup>Specifically, two audit reports neither disclosed the restatement nor referred to the restatement footnote and another audit report disclosed the restatement, but did not refer to the restatement footnote.

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## Timely Communication of Material Misstatements to Users of Previously Issued Financial Statements

We also identified issues with the timeliness of management and auditor communication regarding material misstatements affecting certain agencies' previously issued financial statements. We attributed these issues to a combination of the lack of specific guidance at that time for both agencies management and their respective auditors and the lack of compliance with the related accounting and auditing standards that were in effect during fiscal year 2004.

During fiscal year 2004, neither OMB Bulletin No. 01-09 nor SFFAS No. 21, which apply primarily to agency management, provided specific guidance on the timely investigation and reporting of a material misstatement or potential material misstatement in a previously issued financial statement following its discovery. The guidance available to auditors at that time was AU section 561 and OMB Bulletin No. 01-02, which provided guidance to the agencies' auditors regarding the timely communication of restatements for corrections of misstatements. While this audit guidance conveyed the intent of timely communication, it did not provide much guidance for how the agencies' management or their respective auditors should timely communicate such restatements.

OMB Bulletin No. 01-02 stated that there shall be open and timely communication throughout the audit process between the agencies' management and their auditors, which includes potential audit findings, materially misstated or unsupported amounts in the financial statements, and material weaknesses in internal control. The bulletin did not provide guidance for what the auditor should communicate to management for when and how an actual or potential restatement should be disclosed to the users of the agency's financial statements. With respect to the auditor's responsibilities for timely communication, AU section 561 states that consideration should be given to, among other things, the "time elapsed" since the erroneous financial statements were issued. According to AU section 561, when the auditor has concluded that action should be taken to prevent future reliance on the audit report, the auditor should advise the auditee to make appropriate disclosure of the newly discovered facts and their impact on the financial statements to persons who are known to be currently relying or who are likely to rely on the financial statements and the related auditor's report. AU section 561 also states that if an auditor determines that issuance of financial statements accompanied by the audit report for a subsequent period is "imminent," appropriate disclosures can be made in such statements rather than by separately issuing the restated

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financial statements. However, guidance available during fiscal year 2004, AU section 561 and OMB Bulletin No. 01-02,<sup>22</sup> did not define “time elapsed” or “imminent.” In addition, existing standards and guidance do not provide sufficient explicit or detailed guidance to management and auditors regarding ensuring the timely disclosure of material misstatements affecting previously issued financial statements.

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### Issues Regarding Timeliness of Management’s Communication of Misstatements to Auditors and Users

In our view, none of the agencies timely communicated that a potential material misstatement had been identified to either their auditor or to the users of the financial statements. Agency management is responsible for reporting key information in a timely manner, including timely notification of known material or potential material misstatements in previously issued financial statements.

During fiscal year 2004, OMB Bulletin No. 01-02 called for communication between the agencies’ management and their auditors, but it did not provide details for disclosing restatements to users of agency financial statements. In addition, as noted above, neither OMB Bulletin No. 01-09 nor SFFAS No. 21 provided specific guidance on the timely investigation and reporting of a material misstatement or potential material misstatement in a previously issued financial statement following its discovery. Our review of the nine CFO Act agencies that restated certain of their fiscal year 2003 financial statements found that three of these agencies identified potential material misstatements prior to the beginning of the fourth quarter of fiscal year 2004, and in our view, did not timely communicate that a potential misstatement had been identified either to their auditors or to the users of their financial statements. The remaining six agencies identified potential material misstatements after the third quarter of fiscal year 2004 but before that year’s comparative financial statements were issued. These six agencies, in our view, also did not timely communicate the potential material misstatements to the users of their financial statements since they did not notify the users of the potential material misstatement prior to the issuance of the restated fiscal year 2003 financial statements during fiscal year 2004.

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<sup>22</sup>Subsequent to our initial review, OMB issued OMB Bulletin No. 06-03, *Audit Requirements for Federal Financial Statements* on August 23, 2006, which now supersedes OMB Bulletin No. 01-02. OMB Bulletin No. 06-03 provides a definition for what is considered “imminent.” Specifically, OMB defines imminent as being “within 90 calendar days of the subsequent period financial statements planned issue date.”

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We believe that the current version of OMB Circular No. A-136, if properly implemented, should address many of our concerns regarding agencies' timely communication of restatements. For example, according to this version of OMB Circular No. A-136, "management shall assume responsibility for any false or misleading information in the financial statements, or omissions that render information made in the financial statements misleading. As such, as soon as possible after errors are detected, management shall notify their auditors and inform their primary users of their financial statements of the error and plans for correcting it in the financial statements ... it is imperative that management work with their auditor as soon as the error is detected to assist the auditor in any actions that need to be taken."

These are important advances. We do, though, have some remaining concerns regarding the adequacy of guidance to agencies relating to the timely communication of material misstatements in previously issued financial statements. Specifically, we believe it is important for subsequently discovered material misstatements and potential material misstatements be disclosed to OMB in the agencies' quarterly financial statements for the reporting period in which the misstatements were discovered. In our view, agencies need to report on the misstatement within a reasonable time period following the discovery of the misstatement. In particular, if the specific amount of a material misstatement and the related effect of such on the previously issued financial statements are known and the issuance of the subsequent period audited financial statements is not imminent, then we believe it is important that the agencies promptly (1) reissue the most recently issued fiscal year financial statements before issuing the current year's financial statements and (2) communicate the reissuance (a) in writing to the Congress, OMB, Treasury, and GAO; and (b) to the public on the Internet pages where the agencies' audited financial statements that were affected by the material misstatements were published. If a material misstatement is identified when issuance of the subsequent period audited financial statements is imminent, we believe it is important that the agencies (1) issue restated financial statements as part of the current year's comparative financial statements and (2) communicate the restatement (a) in writing to the Congress, OMB, Treasury, and GAO; and (b) to the public on the same Internet page where the agencies' audited financial statements that were affected by the material misstatements were published.

Further, in our view, if at any time an agency identifies a material misstatement or potential material misstatement and the effects of it on

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the financial statements are not known or cannot be determined without a prolonged investigation, the agencies should timely notify persons that are known to be relying or who are likely to rely on the previously issued financial statements and the related audit report that the (1) previously issued financial statements will or may be restated and therefore, (2) the related audit report is no longer reliable. It is important that the agencies include the Congress, OMB, Treasury, and GAO in any such notification and notify the public by posting such notification on the same Internet pages where the agencies' previously issued financial statements that were affected by the material or potential material misstatement were published.

An example of how to appropriately convey this type of information is State's communication and disclosure of a potential material misstatement in its fiscal year 2004 financial statements. Specifically, State identified a potential material misstatement during the fourth quarter of fiscal year 2005 and, in our view, went beyond the then existing guidance and appropriately disclosed the problem. Guidance available to agency management at that time, SFFAS No. 21 and OMB Bulletin No. 01-09, did not provide explicit guidance for timely communication of a restatement to users of financial statements. State also complied with the revised OMB Circular No. A-136, issued August 23, 2005, even though it was not effective until the end of fiscal year 2005. Specifically, during September 2005, State's CFO timely notified external parties, including GAO, to which State's fiscal year 2004 comparative financial statements were directly distributed, not to rely on its fiscal year 2004 comparative financial statements and the related audit report. The notification also stated that State was committed to resolving this issue as quickly as possible. State also notified the public of this issue in the form of a cautionary note on the same Internet pages where the agency's audited financial statements that were affected by the material misstatement were published. State's cautionary note included a statement that such actions were necessary because State recently became aware of a potential material misstatement affecting the previously issued financial statements and the related audit report. State noted that due to the need for a complete and thorough analysis, the complexity of the matters involved, and the accelerated financial reporting requirements, State was unable to satisfy the independent auditors by November 15 as to the amount of the potential material misstatement. As a result, the independent auditors issued a qualified opinion on the fiscal year 2005 and 2004 financial statements. State's CFO also sent a subsequent letter to GAO on December 23, 2005, to inform us that the independent auditors had satisfied themselves about the amounts presented and the auditor updated its opinion on the fiscal year



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2005 and 2004 financial statements from a qualified to an unqualified opinion. State was fully transparent in its reports of the restatement in all respects and showed how disclosing the restatement should be done. As such, in our view, State's actions serve as a model for full and timely notification of a potential material misstatement found in a previously issued financial statement when identified after the third quarter of the current fiscal year and before the current year's comparative financial statements are issued.

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### Issues Regarding Timeliness of Certain Auditors' Restatement Disclosures

Auditors play a critical role in helping to ensure that users of financial statements are timely notified of material misstatements affecting previously issued financial statements and restatement of such financial statements.

AU section 561, guidance available during fiscal year 2004, requires that auditors consider the "time elapsed" since the financial statements were issued when a material misstatement is discovered. According to AU section 561, if an auditor determines that issuance of financial statements accompanied by the audit report for a subsequent period is "imminent," appropriate disclosures can be made in such statements rather than in reissued statements. However, neither "time elapsed" nor "imminent" is defined in AU section 561. We found that at least one of the auditors of the three agencies that had discovered misstatements prior to the fourth quarter of the current fiscal year did not advise its respective agency to make such a disclosure because (1) in May 2004 the auditor did not think that there were any users who would still be relying on the fiscal year 2003 financial statements and the related audit report and (2) the auditor considered issuance of the fiscal years 2004 and 2003 comparative financial statements to be imminent.<sup>23</sup> We have concerns that, without notification, anyone who may have been relying on the fiscal year 2003 financial statements would not have known for more than 5 months that the agency's originally issued financial statements, which received an unqualified opinion, were materially misstated and should not be relied on.

In our view, existing auditing standards and guidance, including OMB Bulletin No. 06-03, while conveying the need for appropriate notifications,

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<sup>23</sup>The auditor did not provide us with documentation of the basis for its conclusion that users were not likely to still be relying on fiscal year 2003 financial statements and would not attach importance to the correction of the material error.

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do not provide sufficient explicit or detailed guidance to auditors regarding ensuring the timely disclosure of material misstatements affecting previously issued financial statements. Our position is that when a material misstatement or potential material misstatement affecting previously issued financial statements and the related audit report is identified, the auditor has a responsibility to advise the agency's management to timely notify users such as the Congress, OMB, Treasury, and GAO in writing as well as the public and clearly disclose the situation to them. If the agency's management does not timely provide adequate disclosure to the relevant users, the auditor has the responsibility to do so.

We believe that it is also important that the auditor advise the agency's management of its responsibility to determine the specific amount of the material misstatement or potential material misstatement and the related effects of such on the previously issued financial statements as soon as reasonably possible. In those cases where the specific amount of the material misstatement and the related effects of such on a previously issued financial statement are known and issuance of the subsequent period audited financial statements is not imminent, we believe that the auditor would need to also advise the agency's management to promptly reissue the most recently issued fiscal year financial statements before issuing the current fiscal year financial statements and to communicate the reissuance to relevant users in writing as well as the public to clearly disclose the situation to them. If the agency's management does not reissue the financial statements or communicate the reissuance as required, our position is that the auditor has the responsibility to notify the Congress, OMB, Treasury, and GAO in writing as well as any other users known to be relying on the previously issued financial statements. If the specific amount of the material misstatement and the related effects of such on a previously issued financial statement are known and issuance of the subsequent period audited financial statements is imminent, it is important that the auditor advise the agency's management to issue restated financial statements as part of the current year comparative financial statements and disclose restatements in the audit report. If the specific amount of the misstatement and the related effect of such on a previously issued financial statement remain unknown when the current year financial statements are issued, it is necessary that the auditor disclose such information when issuing the audit report and modify or disclaim the opinion on the previously issued financial statements as appropriate.

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## Conclusions

The issues we identified regarding the transparency and timeliness of restatement disclosures primarily resulted from insufficient guidance available during fiscal year 2004 to both the agencies' management and their respective auditors for disclosure of the restatements and the timeliness of such disclosures. It will be important that those agencies needing, in the future, to restate their prior year financial statements ensure the adequacy of the disclosure and presentation of such restatements as well as timely notifying users known to be relying on the previously issued financial statements. It will also be important that the agencies' financial statements and the related audit reports provide sufficient detail so that the reader will be able to gain at least a basic understanding of why the agencies needed to restate their previously issued financial statements and the effects of such on the agencies' previously issued financial statements. The revision of OMB Circular No. A-136 during fiscal year 2005 addressed many of our concerns regarding the agencies' disclosure of restatements; however, additional guidance is still needed. In this regard, we are making recommendations for further revisions to OMB Circular No. A-136 as well as OMB Bulletin No. 06-03. We have provided our views, as outlined in appendix I, on how OMB guidance could be further enhanced to ensure that future restatement disclosures are uniform and more transparent.

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## Recommendations for Executive Action

We recommend that the Director of OMB direct the Controller of OMB's Office of Federal Financial Management to incorporate the restatement guidance and requirements, as detailed in appendix I, into Circular No. A-136 to assist OMB in addressing the issues we found with the agencies' restatement disclosures and the timeliness of such disclosures. Appendix I incorporates seven recommendations as specific changes to Circular No. A-136 that focus on the

- timely disclosure by agency management of material misstatement(s) or potential material misstatement(s) and the related effect(s) of such in the previously issued financial statements and
- presentation and disclosure of restatements in the agencies' MD&A and financial statements and related footnotes.

We also recommend that the Director of OMB direct the Controller of OMB's Office of Federal Financial Management to incorporate the restatement guidance and requirements, as detailed in appendix I, into Bulletin No. 06-03 to assist OMB in addressing the issues we found with auditors' restatement disclosures and the timeliness of such disclosures.

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Appendix I incorporates four recommendations as specific changes to Bulletin No. 06-03 that focus on the

- auditor's timely disclosure of material misstatement(s) or potential material misstatement(s) and the related effect(s) of such in the previously issued financial statements and
- presentation and disclosure of restatements in the audit report.

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## Agency Comments and Our Evaluation

In oral comments on a draft of this report, OMB stated that it would take our recommendations under advisement, but that there were no current plans to update guidance that has been recently issued.<sup>24</sup> OMB also noted that any future plans to update guidance would carefully consider issues already currently being addressed by the AICPA's Codification of Auditing Standards. In addition, OMB provided some technical comments, which we have incorporated as appropriate.

As noted in this report, we found inconsistent communications and insufficient disclosures of financial statement restatements by agency management and their auditors. As such, we reiterate our concern that it is critical for OMB to timely offer separate, though complementary, guidance to agency management and to agency auditors that provides more explicit and detailed guidance concerning their respective roles and responsibilities when an actual or potential material misstatement is identified in previously issued financial statements. Separate guidance is important because agency management and agency auditors have different roles and responsibilities. For example, management is responsible for preparing the financial statements and adjusting them to correct any material misstatements. The auditor is responsible for expressing or disclaiming an opinion on the financial statements prepared by management. The auditor has certain additional responsibilities should management not properly respond to actual or potential material misstatements.

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This report contains recommendations to the Director of OMB. The head of a federal agency is required by 31 U.S.C. § 720 to submit a written

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<sup>24</sup>As noted previously, OMB issued guidance to agency management and agency auditors on July 24, 2006 and August 23, 2006, respectively.

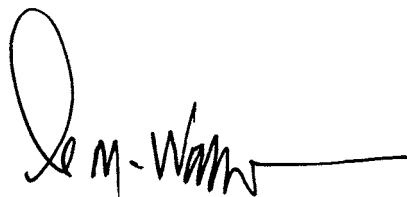
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statement on actions taken on these recommendations. You should submit your statement to the Senate Committee on Homeland Security and Governmental Affairs and the House Committee on Government Reform within 60 days of the date of this report. A written statement also must be sent to the House and Senate Committees on Appropriations with the agency's first request for appropriations made more than 60 days after the date of the report.

We are sending copies of this report to the Chairmen and Ranking Minority Members of the Senate Committee on Homeland Security and Governmental Affairs; the Subcommittee on Federal Financial Management, Government Information, and International Security, Senate Committee on Homeland Security and Governmental Affairs; the House Committee on Government Reform; and the Subcommittee on Government Management, Finance, and Accountability, House Committee on Government Reform. In addition, we are sending copies to the Secretary of the Treasury and the Fiscal Assistant Secretary of the Treasury. Copies will be made available to others upon request. This report is also available at no charge on GAO's Web site at <http://www.gao.gov>.

We acknowledge and appreciate the cooperation and assistance provided by OMB and the nine CFO Act agencies' management and their respective auditors throughout our work. We look forward to continuing to work with your office to help improve financial management in the federal government. If you or your staff have any questions about the contents of this report, please contact Gary T. Engel, Director, Financial Management and Assurance, at (202) 512-3406 or by e-mail at [engelg@gao.gov](mailto:engelg@gao.gov). Staff acknowledgments are provided in appendix II.

Sincerely yours,

A handwritten signature in black ink, appearing to read "D. M. Walker", with a long horizontal line extending to the right.

David M. Walker  
Comptroller General  
of the United States

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# Appendix I: Recommendations to OMB

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As noted throughout this report, we believe that additional restatement guidance is needed for both the agencies' management and their respective auditors. To facilitate in this process, we are providing the following 11 requirements that, in our view, should be incorporated into Office of Management and Budget (OMB) Circular No. A-136 and OMB Bulletin No. 06-03.

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## Recommendations Regarding OMB Circular No. A-136

GAO recommends that the following requirement be added to sections II.4.3.1, II.4.4.1, II.4.5.1, II.4.6.1, and II.4.7.1 of OMB Circular No. A-136, *Financial Reporting Requirements*:

Agencies shall label restated financial statements as "Restated."

GAO recommends that the "*Management Actions Related to Corrections of Errors*" subsection of section II.4.5.5 of OMB Circular No. A-136, *Financial Reporting Requirements*, be modified to read as follows:

If the agency's management becomes aware of a material misstatement(s) or potential material misstatement(s) affecting a previously issued financial statement(s), then the agency's management, in coordination with their respective auditor, shall do the following:

1. Communicate the following information to those charged with governance, oversight bodies, funding agencies, and others who are relying or are likely to rely on the financial statement(s). This includes communication (1) in writing to the Congress, OMB, Treasury, and GAO; (2) to the public on the Internet pages where the agency's previously issued financial statements that were affected by the material misstatement(s) or potential material misstatement(s) are published; and (3) to OMB in the agency's next quarterly financial statements and in subsequent quarterly financial statements until the specific amount(s) of the material misstatement(s) and the related effect(s) of such on the previously issued financial statement(s) are known and reported:
  - (a) the nature and cause(s) of the known or likely material misstatement(s),
  - (b) the amount(s) of known or likely material misstatement(s) and the related effect(s) on the previously issued financial statement(s) (e.g., disclosure of the specific financial statement(s) and line item(s) affected). If this information is

not known, then the disclosure includes information that is known and a statement that management cannot determine the amount(s) and the related effect(s) on the previously issued financial statement(s) without further investigation, and

(c) a notice that (1) a previously issued financial statement(s) will or may be restated<sup>1</sup> and, therefore, (2) the related auditor's report is no longer reliable.

2. Promptly determine the financial statement effects of the known or potential material misstatement(s) on the previously issued financial statement(s).

(a) If the specific amount(s) of the material misstatement(s) and the related effect(s) of such on a previously issued financial statement(s) are known and issuance of the subsequent period audited financial statements is not imminent,<sup>2</sup> then the agency's management shall promptly:

- i. reissue the most recently issued fiscal year financial statements before issuing the current fiscal year's financial statements;
- ii. communicate the reissuance to those charged with governance, oversight bodies, funding agencies, and others who are relying or are likely to rely on the financial statement(s). This includes communication (a) in writing to the Congress, OMB, Treasury, and GAO and (b) to the public on the Internet pages where the agency's previously issued financial statements that were affected by the material misstatement(s) are published; and
- iii. disclose the following information, at a minimum, in the agency's restatement footnotes:
  1. the nature and cause(s) of the misstatement(s) that led to the need for restatement, and

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<sup>1</sup>Financial statements are restated to correct an error(s) in previously issued financial statement(s).

<sup>2</sup>For purposes of this guidance, imminent means within 90 days of determining the effect of the misstatement(s) on the previously issued financial statements.

2. the specific amount(s) of the material misstatement(s) and the related effect(s) on the previously issued financial statement(s) (e.g., year(s) being restated, specific financial statement(s) affected and line items restated, actions the agency's management took after discovering the misstatement), and the impact on the financial statements as a whole (e.g., change in overall net position, change in the audit opinion).
- (b) If the specific amount(s) of the material misstatement(s) and the related effect(s) of such on a previously issued financial statement(s) are known and issuance of the subsequent period audited financial statements is imminent, then the agency's management shall:
- i. issue restated financial statement(s) as part of the current year's comparative financial statements;
  - ii. communicate the restatement to those charged with governance, oversight bodies, funding agencies, and others who are relying or are likely to rely on the financial statement(s). This includes communication (a) in writing to the Congress, OMB, Treasury, and GAO and (b) to the public on the Internet pages where the agency's previously issued financial statements that were affected by the material misstatement(s) are published; and
  - iii. disclose the following information, at a minimum, in the agency's restatement footnote:
    1. the nature and cause(s) of the misstatement(s) that led to the need for restatement, and
    2. the specific amount(s) of the material misstatement(s) and the related effect(s) on the previously issued financial statement(s) (e.g., year(s) being restated, specific financial statement(s) affected and line items restated, actions the agency's management took after discovering the misstatement), and the impact on the financial statements as a whole (e.g., change in overall net position, change in the audit opinion).
- (c) If the specific amount(s) of the misstatement(s) and the related effect(s) of such on a previously issued financial statement(s) remain unknown when the current year's financial statements



are issued, then the agency's management shall follow section II.4.5.5 (1) above and include the following, at a minimum, in its restatement footnote:

- i. a statement disclosing that a material misstatement(s) or potential material misstatement(s) affects a previously issued financial statement(s), but the specific amount(s) of the misstatement(s) and the related effect(s) of such are not known,
- ii. the nature and cause(s) of the misstatement(s) or potential misstatement(s),
- iii. an estimate of the magnitude of the misstatement(s) or potential misstatement(s) and the related effect(s) of such on a previously issued financial statement(s) (e.g., disclosure of the specific financial statement(s) and line items affected) that are known and a statement that the specific amount(s) and the related effect(s) of such cannot be determined without further investigation, and
- iv. a statement disclosing that a restatement(s) to a previously issued financial statement(s) will or may occur.

GAO also recommends that the following requirement be added to the "Corrections of Errors" subsection of section II.4.5.5 of OMB Circular No. A-136, *Financial Reporting Requirements*:

The Statement of Changes in Net Position's current year's unadjusted beginning balances shall agree with the restated ending balances on the agency's prior year's Statement of Changes in Net Position.

GAO recommends that section II.4.10.43, of OMB Circular No. A-136, *Financial Reporting Requirements*, be revised to:

- clarify the definition of the "nature" of an error,
- include an explanation that the disclosure of the "amounts being restated" specifically refers to the disclosure of the specific line items restated and the related amounts, and
- clarify how an agency should specifically further discuss the actions management took after discovering the error.

GAO recommends that the following requirement be added to section II.2.7 of OMB Circular No. A-136, *Financial Reporting Requirements*, which discusses guidance for information included in the Management Discussion and Analysis (MD&A):

Agency's management shall disclose the existence of restatements in its MD&A if the agency asserts in its MD&A that it received an unqualified opinion on any previously issued financial statement and that respective financial statement was subsequently restated.

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## Recommendations Regarding OMB Bulletin No. 06-03

GAO recommends that section 5.2 of OMB Bulletin No. 06-03, *Audit Requirements for Federal Financial Statements*, be modified to read as follows:

5.2 The nature or amount of known or likely misstatement(s) in previously issued audited financial statement(s) may lead the auditor to believe that the auditor's report would or could reasonably have been affected if the auditor had known of the misstatement(s) when the auditor issued the auditor's report. When this condition exists, the auditor shall advise management to communicate the following information to those charged with governance, oversight bodies, funding agencies, and others who are relying or are likely to rely on the financial statement(s):

- the nature and cause(s) of the known or likely material misstatement(s),
- the amount(s) of known or likely material misstatement(s) and the related effect(s) on the previously issued financial statement(s) (e.g., disclosure of the specific financial statement(s) and line item(s) affected). If this information is not known, then the disclosure includes information that is known and a statement that management cannot determine the amount(s) and the related effect(s) on the previously issued financial statement(s) without further investigation, and
- a notice that (1) a previously issued financial statement(s) will or may be restated and, therefore, (2) the related auditor's report is no longer reliable.

This includes communication (1) in writing to the Congress, OMB, Treasury, and GAO; (2) to the public on the Internet pages where the agency's previously issued financial statements that were affected by the material misstatement(s) or potential material misstatement(s) are

published; and (3) to OMB in the agency's next quarterly financial statements and in subsequent quarterly financial statements until the specific amount(s) of the material misstatement(s) and the related effect(s) of such on the previously issued financial statement(s) are known and reported.

GAO also recommends that the following requirements be added to section 5 of OMB Bulletin No. 06-03, *Audit Requirements for Federal Financial Statements*, as follows:

5.3 The auditor shall review the adequacy of management's communication information about the known or potential material misstatement(s) to report users, including those charged with governance, oversight bodies, and funding agencies. When performing this review, the auditor shall consider whether (1) management acted timely to determine the financial statement effects of the potential material misstatement(s), (2) management acted timely to communicate with appropriate parties, and (3) management disclosed the nature and extent of the known or likely material misstatement(s) on Internet pages where the agency's previously issued financial statements are published.

5.4 The auditor shall notify those charged with governance if the auditor believes that management is unduly delaying its determination of the effect(s) of the misstatement(s) on a previously issued financial statement(s).

5.5 The auditor shall evaluate the timeliness and appropriateness of management's decision whether to issue restated financial statement(s). Management may separately issue the restated financial statement(s) or may present the restated financial statement(s) on a comparative basis with those of a subsequent period. Ordinarily, the auditor would expect management to issue restated financial statement(s) as soon as practicable. However, it may not be necessary for management to separately issue the restated financial statement(s) and the auditor's report when issuance of the subsequent period audited financial statements is imminent.<sup>3</sup>

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<sup>3</sup>For purposes of this guidance, imminent means within 90 days of determining the effect of the misstatement(s) on the previously issued financial statements.

5.6 If the auditor becomes aware of a material misstatement(s) or potential misstatement(s) affecting a previously issued financial statement(s), then the auditor shall advise the agency's management to determine the specific amount(s) of the material misstatement(s) or potential material misstatement(s) and the related effect(s) of such on the previously issued financial statement(s) as soon as reasonably possible.

5.7 If the specific amount(s) of the material misstatement(s) and the related effect(s) of such on a previously issued financial statement(s) are known and the issuance of the subsequent period audited financial statements is not imminent, then the auditor shall advise the agency's management to promptly:

- reissue the most recently issued fiscal year financial statements before issuing the current fiscal year's financial statements;
- communicate the reissuance to those charged with governance, oversight bodies, funding agencies, and others who are relying or are likely to rely on the financial statement(s). This includes communication (1) in writing to the Congress, OMB, Treasury, and GAO and (2) to the public on the Internet pages where the agency's previously issued financial statements that were affected by the material misstatement(s) are published; and
- disclose the following information, at a minimum, in the agency's restatement footnotes: (1) the nature and cause(s) of the misstatement(s) that led to the need for restatement, and (2) the specific amount(s) of the material misstatement(s) and the related effect(s) on the previously issued financial statement(s) (e.g., year(s) being restated, specific financial statement(s) affected and line items restated, actions the agency's management took after discovering the misstatement), and the impact on the financial statements as a whole (e.g., change in overall net position, change in the audit opinion).

5.8 If the specific amount(s) of the material misstatement(s) and the related effect(s) of such on a previously issued financial statement(s) are known and issuance of the subsequent period audited financial statements is imminent, then the auditor shall disclose restatements in the auditor's report as listed in 7.7 and advise agency's management to:

- issue restated financial statement(s) as part of the current year's comparative financial statements;

- communicate the restatement to those charged with governance, oversight bodies, funding agencies, and others who are relying or are likely to rely on the financial statement(s). This includes communication (a) in writing to the Congress, OMB, Treasury, and GAO and (b) to the public on the Internet pages where the agency's previously issued financial statements that were affected by the material misstatement(s) are published; and
- disclose the following information, at a minimum, in the agency's restatement footnote: (1) the nature and cause(s) of the misstatement(s) that led to the need for restatement and (2) the specific amount(s) of the material misstatement(s) and the related effect(s) on the previously issued financial statement(s) (e.g., year(s) being restated, specific financial statement(s) affected and line items restated, actions the agency's management took after discovering the misstatement), and the impact on the financial statements as a whole (e.g., change in overall net position, change in the audit opinion).

5.9 If the specific amount(s) of the misstatement(s) and the related effect(s) of such on a previously issued financial statement(s) remain unknown when the current year's financial statements are issued, then the auditor shall follow 7.8 when issuing the auditor's report and advise the agency's management as required in 5.2.

5.10 The auditor shall notify those charged with governance, oversight bodies, and funding agencies when management (1) does not take the necessary steps to promptly inform report users of the situation or (2) does not restate with appropriate timeliness the financial statements in circumstances when the auditor believes they need to be restated. The auditor shall inform these parties that the auditor will take steps to prevent future reliance on the auditor's report. The steps taken will depend on the facts and circumstances, including legal considerations. This includes communication in writing to the Congress, OMB, Treasury, and GAO as well as any other users known to be relying on the previously issued financial statement(s).

GAO recommends that section 7.7 of OMB Bulletin No. 06-03, *Audit Requirements for Federal Financial Statements*, be modified to read as follows:

7.7 When management restates a previously issued financial statement(s), the auditor shall perform audit procedures sufficient to reissue or update the auditor's report on the restated financial

statement(s). The auditor shall fulfill these responsibilities whether the restated financial statement(s) are separately issued or presented on a comparative basis with those of a subsequent period. The auditor shall include the following information in an explanatory paragraph in the reissued or updated auditor's report on the restated financial statement(s):

- a statement disclosing that a previously issued financial statement(s) has been restated,
- a statement that the previously issued financial statement(s) was materially misstated and that the previously issued auditor's report (including report date) is withdrawn and replaced by the auditor's report on the restated financial statement(s),
- a reference to the note(s) to the restated financial statement(s) that discusses the restatement,
- a description of the following if not already provided in the note(s) to the financial statement(s): (1) the nature and cause(s) of the misstatement(s) that led to the need for restatement and (2) the specific amount(s) of the material misstatement(s) and the related effect(s) on the previously issued financial statement(s) (e.g., year(s) being restated and the specific financial statement(s) affected and line items restated) and the impact on the financial statements as a whole (e.g., change in overall net position, change in the audit opinion), and
- a discussion of any significant internal control deficiency that failed to prevent or detect the misstatement and what action management has taken about the deficiency.

GAO also recommends that the following requirements be added to section 7 of OMB Bulletin No. 06-03, *Audit Requirements for Federal Financial Statements*, as follows:

7.8 If at the time of issuance of the auditor's report a material misstatement(s) or potential material misstatement(s) has been identified in any of the previously issued financial statements and the specific amount(s) of the misstatement(s) and the related effect(s) of such are not known, then the auditor shall update the auditor's report on the previously issued financial statement(s) as appropriate. Furthermore, the auditor's report shall disclose, at a minimum, the following:

- a statement disclosing that a material misstatement(s) or potential material misstatement(s) affects a previously issued financial statement(s) but the specific amount(s) of the misstatement(s) and the related effect(s) of such are not known;
- a reference to note(s) to the financial statements that discusses the restatement or potential restatement;
- a description of the following, if not already provided in the agency's note(s) to the financial statements: (1) the nature and cause(s) of the misstatement(s) or potential misstatement(s), and (2) an estimate of the magnitude of the misstatement(s) or potential misstatement(s) and the related effect(s) of such on a previously issued financial statement(s) (e.g., disclosure of the specific financial statement(s) and line items affected) that are known and a statement that the specific amount(s) and the related effect(s) of such cannot be determined without further investigation; and
- a statement disclosing that a restatement(s) to a previously issued financial statement(s) will or may occur.

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# Appendix II: GAO Contact and Staff Acknowledgments

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## GAO Contact

Gary T. Engel, (202) 512-3406.

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# Related GAO Products

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*Financial Audit: Restatements to the Department of State's Fiscal Year 2003 Financial Statements.* [GAO-05-814R](#). Washington, D.C.: September 20, 2005.

*Financial Audit: Restatements to the Nuclear Regulatory Commission's Fiscal Year 2003 Financial Statements.* [GAO-06-30R](#). Washington, D.C.: October 27, 2005.

*Financial Audit: Restatement to the General Services Administration's Fiscal Year 2003 Financial Statements.* [GAO-06-70R](#). Washington, D.C.: December 6, 2005.

*Financial Audit: Restatements to the National Science Foundation's Fiscal Year 2003 Financial Statements.* [GAO-06-229R](#). Washington, D.C.: December 22, 2005.

*Financial Audit: Restatements to the Department of Agriculture's Fiscal Year 2003 Consolidated Financial Statements.* [GAO-06-254R](#). Washington, D.C.: January 26, 2006.

*Fiscal Year 2005 U.S. Government Financial Statements: Sustained Improvement in Federal Financial Management is Crucial to Addressing Our Nation's Financial Condition and Long-term Fiscal Imbalance.* [GAO-06-406T](#). Washington, D.C.: March 1, 2006.

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