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Can An Event During The Year-End Closing Process Impair A Company's Financial Reporting Quality?

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Over the last month, many companies have filed their year-end audited financial statements with the Securities and Exchange Commission. A study recently published in [The Accounting Review](#) finds that corporate events occurring immediately after year-end, such as mergers and acquisitions or debt and equity issuances, constrain management and auditor resources and result in lower financial reporting quality.

In a study titled “Do Type II Subsequent Events Impair Financial Reporting Quality?” researchers analyzed 39,119 year-end financial statement filings with the SEC from 2000 to 2013. The study is authored by Keith Czerney from the University of Missouri-Columbia, Jaime Schmidt of the University of Texas at Austin, and Anne Thompson and Wei Zhu from the University of Illinois at Urbana-Champaign.

The study reports that 36% of their sample included a “subsequent event” or a material corporate event that occurred after the date of the year-end financial statements, but before the financial statements were filed with the SEC.

Further, the researchers find that the frequency of subsequent events has risen from 30% in the early 2000s, to 40% in 2013. “The upward trend in subsequent events was somewhat surprising because the SEC shortened 10-K filing deadlines during this time period. Normally, one would expect that shorter deadlines leave less time for subsequent events to occur,” notes Thompson.

The study focuses on Type II subsequent events that are independent of the year-end financial statements, such as a post-year-end debt or stock offerings, mergers and acquisitions, as well as new contracts. “We were surprised by how few of these subsequent events were truly a ‘surprise’ to management,” says Czerney. “Managers likely have some control over the timing of many of these events.”

The researchers first demonstrate that the presence of a subsequent event is associated with lower year-end financial reporting quality. Specifically, the study finds that companies with subsequent events experience a significantly higher rate of restatements for financial reports that are being prepared and audited at the same time as the subsequent event. The likelihood of a restatement is higher when the subsequent event requires more effort to address, occurs earlier in the year-end closing process, and if the company experiences more than one subsequent event. The study importantly describes how the events occurring should not have any bearing on the quality of the year-end accounts.

Next, the study attempts to explain why financial reporting quality declines with subsequent events. With respect to constraints on corporate management, the study finds stronger results for companies that have an abundance of job postings for accounting positions and rate lower on a measure of managerial ability. Schmidt notes that, “Auditors have limited ability to foresee material events that could occur in the future. However, during the risk assessment phase of the audit, the auditor should consider whether management has the resources to produce high quality financial statements and attend to a material event at the same time.”

From an audit perspective, the study finds the subsequent event and restatement relationship to be stronger when the auditor of the financial statements is constrained as well. For example, the results are more pronounced for audits of financial statements with December year-ends that are performed during the auditor’s “busy season.” “It’s important to note that our results suggest that auditors can alleviate this risk, as long as the auditor is not also resource constrained,” says Zhu.

Schmidt concludes that, “Given we live in a world where globalization keeps increasing, with that comes more mergers, acquisitions, and debt and equity issuances. Those events are time-consuming and can be costly to the quality of a company’s financial reports. If such events can be moved to the second quarter, after the financial closing process is complete, it can save you from having to deal with the cost of a subsequent restatement.”



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