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## Dealing with Restatements One Company's Story

By Mark Perkins  
and Pam Lagano

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# Dealing with Restatements

## One Company's Story

By Mark Perkins and Pam Lagano

**AUTHORS' NOTE:** *The corporate governance reform movement demands that organizations implement and enforce strict internal controls. The recent escalation of revenue restatements shows that companies, especially smaller ones, are struggling with misapplications of accounting rules, proper documentation, control weaknesses and other issues that can potentially lead to the filing of restatements.*

*One in 10 publicly traded companies in the United States was forced to reissue financial statements because of accounting irregularities in the past five years alone. Based on the Government Accountability Office projections, the restatement rate will have reached 2.9 percent per year by the end of 2004. While the number of restating companies continues to make up a small percentage of all publicly listed companies annually, the number of restatements due to accounting irregularities grew significantly — about 145 percent from January 1997 through June 2002. On average, the stock prices of restating companies fell about 10 percent.*

*The percentage of large companies restating is growing. The Securities and Exchange Commission states that for the fiscal year ending Sept. 30, 2004, it had filed 598 enforcement actions, a 24 percent jump from the year before. SEC actions involving misrepresentation of financial restatements and other disclosures zoomed upward 46 percent.*

*Revenue recognition was the primary reason for restatement, which leads to greater market losses than other causes of restatements.*

*Because of the harmful impact that restatements can have on a company's stock price and investor confidence, it is critical that best practices be followed when dealing with this type of corporate event. The following is a case of one company's experience with restatement and the lessons learned.*



**A**erosonic Corporation, a supplier of precision flight products for commercial, business and military aircraft for over half a century, recently found itself in the unenviable position of having to restate earnings. In a situation like this, as in all crisis situations, there is no specific experience to draw upon. Successful resolution is a combination of ethics and values, career experience and choosing the right counsel.

In March 2003, Aerosonic announced it had discovered accounting discrepancies in revenue and inventory levels for previously audited financial statements. The company took immediate steps to quantify the extent of any incorrect financial reporting, discover the cause and correct any problems to prevent future misstatements.

After this discovery, Aerosonic quickly notified the SEC, the company's auditor, the American Stock

Exchange (where its stock was listed) and the public of the existence of apparent misstatements. In the company's annual report on Form 10-K for the fiscal year ended Jan. 31, 2002, it acknowledged that revenue was overstated by approximately \$800,000 and inventory by approximately \$2.2 million. Aerosonic also identified approximately \$3.2 million of additional charges that had to be made to its previous financial statements.

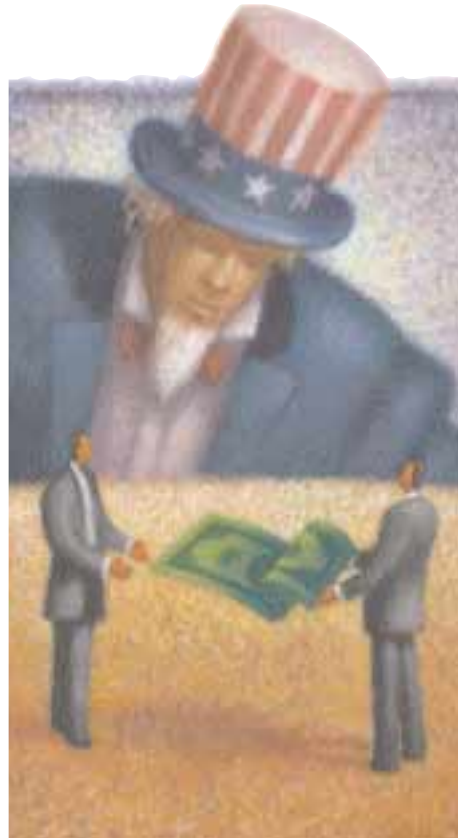
Based on this, it was clear that the company would have to restate earnings going back to audited financial statements for the years ended Jan. 31, 1999, 2000, 2001 and 2002, and the previously reported, unaudited financial statement for the year ended Jan. 31, 2003.

As part of the plan for the restatement process, the company immediately sought additional legal counsel that was experienced in SEC matters and a seasoned investor relations counsel with experience in crisis communication.

The existing general counsel and the newly retained SEC counsel would have the difficult responsibility of ensuring that the company was complying with all governance laws, rules and regulations, and working with the regulatory bodies in the evolving maze of an ongoing investigation.

Investor relations counsel was charged with developing a crisis communication strategy and dealing with it immediately by keeping the lines of communication open with key audiences. Disclosure-related challenges included:

- \* How and when to divulge new material information.
- \* Whether to wait until all information is gathered before issuing releases.
- \* How to diminish shareholder anxiety.



**A corporate reputation takes years to build, but a mishandled crisis can destroy it in seconds. But, if handled well, a crisis can generate valuable trust and respect.**

problem affected a larger time period than first believed, analyzing accounting issues and securing the auditor's approval. Also, in restatement situations, legal and auditing counsel play a more active role in a company's disclosures, resulting in less positive language explaining the restatement.

A corporate reputation takes years to build, but a mishandled crisis can destroy it in seconds. But, if handled well, a crisis can generate valuable trust and respect.

### More Challenges

The year continued to get even more challenging with the unfolding of events including a lengthy audit

- \* How to work with all parties concerned regarding expectations and timing of restatements.

The importance of responding to these challenges in an effective manner is critical. The extent of the information being released corresponds to the severity of the company's stock price being impacted. Management at Aerosonic worked closely with communication counsel, maximizing all efforts. A few of the initiatives surrounding the restatement included:

- \* Redesign and restructure of the corporate Web site, including the addition of a more comprehensive investor relations section.
- \* Drafting of corporate governance-related documents.
- \* Incorporation of intangible information in corporate collateral.
- \* Outreach (on a variety of levels) to the investment community when approved by legal counsel.
- \* Media outreach when approved by legal counsel.

Aerosonic's first priority was to maintain control while confronting a variety of challenges, including finding out that the financial prob-

## TIMELINE

### 2003

Jan. 21	Management strengthened with new CFO
Feb. 12	Retained external consultant for strategic communication
March 17	Accounting issues addressed
March 28	New independent director announced
May 22	Accounting issues substantially reviewed
June 3	Notice of SEC Formal Order announced
Aug. 1	New independent director announced
Sept. 25	Trading halt announced
Oct. 15	AMEX compliance plan accepted
Nov. 24	Trading resumed
Dec. 18	New independent accountants announced
Dec. 29	New board announced

### 2004

Nov. 1	SEC concludes investigation
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sequence, a Formal Order of Investigation issued by the SEC, a halt in trading of the stock and, after filing required financials, a resumption of trading.

As is typical in crisis situations, there are numerous opinions and strategies offered. How a corporation deals with the ethical dimensions of a crisis is critical to a successful outcome. What simplified the decision process for Aerosonic was that no matter how embarrassing the situation or how much it hurt to completely bare the company's soul, the only real consideration was whether an action was the right thing to do for the shareholders.

#### Heal Thyself

Management never doubted Aerosonic was a good company and through the dark times focused on the positive. One board member compared the situation to doing whatever is necessary to make a patient healthy again.

These healing steps included:

1. Bringing the situation to the attention of the governing bodies (the American Stock Exchange and the SEC) and having frequent contact with them until the resolution of a restatement.
2. Implementing accounting controls, including retaining a new auditor.
3. Keeping shareholders abreast of every discovery made and every action taken to resolve the restatement issue.
4. Adopting a business code of conduct and ethics.
5. Creating and adopting a corporate disclosure policy.
6. Developing a new Web site with a focus on transparency and disclosure that includes a corporate governance section listing board committees,

board bios, corporate governance documents and insider transactions.

7. Adding an industry-related news section to the Web site.

8. Addition of independent members to the board of directors.



Mark Perkins

### Crisis Team

A senior management leadership team was mobilized to address the restatement issue and all that it encompassed. But management was lean — the people who worked on the restatement were the same people responsible for the day-to-day activities of the company. For months, busy days turned into long nights as the restatement process and audit sequence continued. Even though it was a true juggling act, during this time revenues increased 21 percent, exceeding \$31 million for the first time in the company's 50-year history.



Pam Lagano

But the company also had to be prepared to respond to shareholder questions about the accounting irregularities. Working with management and legal counsel, we included responses to the following questions in our written communication:

- How was the problem discovered?
- What was done when the problem was discovered?
- How quickly was the problem addressed?
- How is the problem being investigated?
- Is the company certain that the full extent of the problem has been identified?
- What steps have been taken to ensure that this problem does not occur again?

By answering these questions, Aerosonic was able to mitigate negative consequences, creating an accurate record of its activity and demonstrating the ability to skillfully manage a crisis.

External communication counsel also had a dedicated Aerosonic hotline to ensure all calls were handled promptly. An intimate knowledge of all public information was essential to be able to respond to calls quickly

and efficiently. The inside corporate contact was also accessible to shareholders at all times.

Unquestionably, it was an extremely challenging time for Aerosonic. The unexpected restatement of earnings and the eventual trading halt of the stock tested the capabilities of the organization. But Aerosonic demonstrated that focused determination — and a commitment to do what is right — can yield desired results. Aerosonic went from a company with little organized communication to one that is committed to transparency and disclosure.

On Nov. 1, 2004, Aerosonic announced that the SEC had concluded its investigation and that no enforcement action was recommended. [IRU](#)

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