

PROPOSED FASB STAFF POSITION

No. FAS 154-a

Title: Considering the Effects of Prior-Year Misstatements When Quantifying Misstatements in Current-Year Financial Statements

Comment Deadline: April 30, 2007

Introduction and Background

1. FASB Statement No. 154, *Accounting Changes and Error Corrections*, provides guidance for reporting the correction of an error in previously issued financial statements. An error can result from mathematical mistakes, mistakes in the application of generally accepted accounting principles (GAAP), or oversight or misuse of facts that existed at the time the financial statements were prepared, and includes a change from an accounting principle that is not generally accepted to one that is generally accepted. Statement 154 requires that an entity report the correction of an error in previously issued financial statements by restating those financial statements. Entities restate previously issued financial statements as required by Statement 154 if the resulting misstatement is material. However, Statement 154 does not specify the appropriate method to quantify the misstatement as a basis for evaluating materiality.

2. In September 2006, the SEC staff issued SEC Staff Accounting Bulletin No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements*. SAB 108 clarifies the methods that SEC registrants should use to quantify a misstatement as a basis for evaluating the materiality of the misstatement in current-year financial statements, eliminating inconsistencies in the reporting of error corrections by SEC registrants. This FASB Staff Position (FSP) extends the guidance for SEC registrants in SAB 108 to all other nongovernmental entities that are not subject to the requirements of SAB 108, conforming the reporting of error corrections between SEC registrants and other entities. In effect, this FSP in conjunction with SAB 108 establishes a single approach for quantifying misstatements that could be material to users of financial statements.

3. This FSP describes the consideration of the effects of prior-year uncorrected misstatements when quantifying misstatements in current-year financial statements. It does not address whether misstatements are material, which is a matter of professional judgment. FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information*, refers to materiality as the magnitude of an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement (paragraph 132). In that context, SEC Staff Accounting Bulletin No. 99, *Materiality*, emphasizes the SEC staff's view that registrants and auditors should not exclusively rely on any percentage or numerical threshold to determine whether amounts and items are material to financial statements. Because of the interaction of quantitative and qualitative considerations, misstatements of a relatively small amount could have a material effect on the financial statements. Also, registrants and auditors must consider how materiality decisions relating to the current-year financial statements might affect future periods. Accordingly, SAB 99 requires that a change that does not have a material effect in the period of change but is reasonably certain to have a material effect in later periods be considered along with other quantitative and qualitative factors when determining whether a misstatement is material.

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Scope

4. **This FSP applies to nongovernmental entities that are not subject to the requirements of SAB 108.**

5. Entities subject to the requirements of this FSP include privately held entities and not-for-profit organizations. Accordingly, all references in this FSP to financial statements apply broadly to financial statements issued by those entities.

Quantifying Financial Statement Misstatements

6. **For purposes of evaluating the materiality of a misstatement, an entity shall quantify the effect of the misstatement in its current-year statement of financial**

position and statement of income using both the rollover approach and the iron curtain approach.

7. The rollover approach quantifies a misstatement based on the amount of the error originating in the current-year statement of income. The iron curtain approach quantifies a misstatement based on the effects of correcting the misstatement existing in the statement of financial position at the end of the current year, irrespective of the misstatement's year(s) of origination. Using both approaches requires that an entity quantify the effect of the misstatement on each financial statement, including the effect of prior-year misstatements, as a basis for evaluating the materiality of the misstatement. The materiality assessment should be based on all relevant quantitative and qualitative factors and consider the effect of the misstatement on future periods.

8. If a misstatement using either the rollover approach or the iron curtain approach is material to the current-year financial statements, an entity shall correct its current-year financial statements. If a misstatement relating to prior-year misstatements exists after the current-year financial statements are corrected and is material to the current-year financial statements, an entity shall correct the previously issued financial statements. That correction is required even if the prior-year misstatements were and continue to be immaterial to the previously issued financial statements.

9. To illustrate the application of the rollover and iron curtain approaches, assume that in preparing its annual financial statements an entity evaluates the materiality of an improperly accrued expense of \$100 (an error), which has built up over 5 years at \$20 per year (overstated liability). The entity previously evaluated the misstatement as being immaterial to each of the previously issued financial statements (years 1–4).

The entity quantifies misstatements using both the rollover approach and the iron curtain approach. If either approach results in a misstatement that is material to the current-year financial statements, the error must be corrected. The following illustrates the thought process for the quantification of misstatements using the rollover and iron curtain approaches:

- a. If the entity starts with the rollover approach, the misstatement in the current-year statement of income is \$20 (overstatement of expenses). If the \$20 misstatement is not material to the current-year financial statements, the entity must then apply the iron curtain approach described in paragraph (b) below. If the \$20 misstatement is material to the current-year financial statements, the entity would decrease current year expenses by \$20 with a corresponding decrease in liabilities. The effect of correcting the \$20 misstatement would be to reduce the overstatement of liabilities in the statement of financial position at the end of the current-year to \$80. If that remaining misstatement is material to the current-year financial statements, the entity would correct the previously issued financial statements even though the prior-year misstatements were and continue to be immaterial to those financial statements.
- b. If the entity starts with the iron curtain approach, the misstatement in the statement of financial position at the end of the current year is \$100 (overstatement of liabilities). If the \$100 misstatement is not material to the financial statements, the entity must then apply the rollover approach described in paragraph (a) above. If the \$100 misstatement is material to the current-year financial statements, the entity would decrease liabilities by \$100 with a corresponding decrease in current-year expenses. The effect of correcting the \$100 misstatement would be to understate expenses in the current-year statement of income by \$80 (the prior-year misstatements). If that \$80 resulting misstatement is material to the current-year financial statements, the entity would correct the previously issued financial statements even though the prior-year misstatements were and continue to be immaterial to those financial statements.

10. To further illustrate the application of the rollover and iron curtain approaches, assume that in preparing its annual financial statements an entity evaluates the materiality of a sales cut-off error. As a result of the sales cut-off error, \$50 of revenue from the following year was included in the current-year financial statements and \$110 of revenue from the current year was included in the prior-year financial statements. The prior-year financial statements were not corrected because the effect of the sales cut-off error was not material to those financial statements. In the current-year financial statements,

revenues are understated by \$60 (\$110 understatement less \$50 overstatement) and accounts receivable is overstated by \$50.

The entity quantifies misstatements using both the rollover approach and the iron curtain approach. If either approach results in a misstatement that is material to the current-year financial statements, the error must be corrected. The following illustrates the thought process for the quantification of misstatements using the rollover and iron curtain approaches:

- a. If the entity starts with the rollover approach, the misstatement in the current-year statement of income is \$60 (understatement of revenues). If the \$60 misstatement is not material to the current-year financial statements, the entity must then apply the iron curtain approach described in paragraph (b) below. If the \$60 misstatement is material to the current-year financial statements, the entity would increase current-year revenue by \$60 with a corresponding increase in accounts receivable. The effect of the \$60 adjustment would be to increase the overstatement of accounts receivable in the statement of financial position at the end of the current-year to \$110. If that resulting misstatement is material to the current-year financial statements, the entity would correct the previously issued financial statements even though the prior-year misstatement was and continues to be immaterial to those financial statements.
- b. If the entity starts with the iron curtain approach, the misstatement in the statement of financial position at the end of the current year is \$50 (overstatement of accounts receivable). If the \$50 misstatement is not material to the current-year financial statements, the entity must apply the rollover approach described in paragraph (a) above. If the misstatement is material to the current-year financial statements, the entity would decrease accounts receivable by \$50 with a corresponding decrease in current-year revenue. The effect of the \$50 adjustment would be to increase the understatement of revenue in the current-year statement of income to \$110. If that resulting misstatement is material to the current-year financial statements, the entity would correct the previously issued financial statements even though the prior-year misstatement was and continues to be immaterial to those financial statements.

Effective Date and Transition

11. This FSP shall be effective for financial statements issued for fiscal years ending after June 15, 2007. Earlier application is permitted. For example, if an entity has not

yet issued its financial statements for its year ended December 31, 2006, the entity may apply the provisions of this FSP to those financial statements. For an error in previously issued financial statements that results in a misstatement that is material to the current-year financial statements under this FSP, the transition approach differs depending on how the entity evaluated the materiality of the misstatement to the previously issued financial statements.

One-Time Cumulative-Effect Adjustment upon Initial Application

12. If an entity appropriately evaluated the materiality of the misstatement to the previously issued financial statements based on all relevant qualitative factors using either the rollover approach or the iron curtain approach (but not both), the entity need not correct the error by restating previously issued financial statements. Instead, the entity may elect to recognize the cumulative effect of initially applying this FSP as an adjustment to the opening balance of retained earnings if that election is made during the fiscal year in which this FSP becomes effective. If such an election is not made during the fiscal year in which this FSP becomes effective, the entity shall report the correction of an error in previously issued financial statements by restating those financial statements in accordance with Statement 154.

13. The cumulative-effect adjustment is the difference between the amounts recognized in the statement of financial position before the initial application of this FSP and the amounts recognized in the statement of financial position at initial application of this FSP. In a circumstance in which a private company has issued financial statements for a period prior to the issuance of this FSP, for example, quarterly statements to a bank, and as a result the cumulative-effect adjustment is first applied to an interim period other than the first interim period in the year of adoption, the previously issued interim financial statements need not be adjusted. To illustrate, if the provisions of this FSP are first applied in the quarter ending June 30, 2007, and financial statements were issued for the quarter ending March 31, 2007, prior to the issuance of this FSP, the financial statements issued for the March quarter need not be adjusted. However, comparative information presented in reports for interim periods of the first year subsequent to initial application

should be adjusted to reflect the cumulative-effect adjustment as of the beginning of the year of initial application.

14. An entity that elects to recognize a cumulative-effect adjustment shall disclose the following, separately for each error that is corrected through the cumulative-effect adjustment:

- a. The amount of the error
- b. A description of the error, including the nature of the error, when the error initially arose, and how the error arose
- c. The fact that the error had previously been considered immaterial.

15. In periods subsequent to initial application of this FSP, an entity shall report the correction of an error in previously issued financial statements by restating those financial statements in accordance with Statement 154.

Restatement of Previously Issued Financial Statements

16. If an entity evaluated the materiality of the misstatement in previously issued financial statements using an approach other than the rollover approach or the iron curtain approach, or if an entity did not otherwise consider all relevant quantitative and qualitative factors, the entity shall correct the error by restating previously issued financial statements. The disclosures required by paragraph 26 of Statement 154 apply.