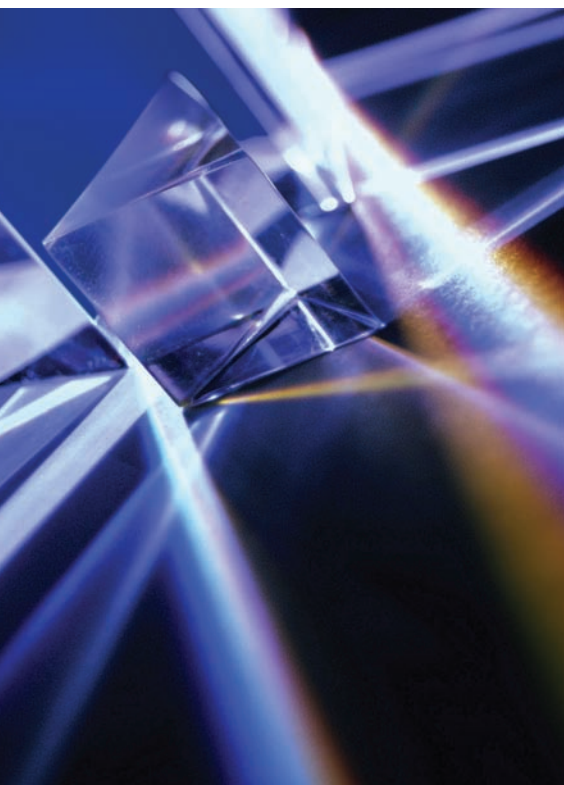


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SEC Staff Guidance on Quantifying Financial Statement Misstatements

A new Staff Accounting Bulletin addresses how the effects of prior-year uncorrected misstatements should be considered when quantifying misstatements in current-year financial statements.¹ The SAB requires registrants to quantify misstatements using both the balance-sheet and income-statement approaches and to evaluate whether either approach results in quantifying an error that is material in light of relevant quantitative and qualitative factors. The SAB does not change the staff's previous guidance in SAB 99 on evaluating the materiality of misstatements.²

When the effect of initial adoption is determined to be **material**, the SAB allows registrants to record that effect as a cumulative-effect adjustment to **beginning-of-year** retained earnings. The requirements are effective for annual financial statements covering the first fiscal year ending after November 15, 2006. See Initial Adoption below.

Quantifying Misstatements

The new guidance applies when uncorrected misstatements in a previous year affect the current year, either because the misstatements carry over or reverse. The SAB provides the example of a liability that is overstated by \$100, because a \$20 misstatement occurred in each year of a five-year period, and discusses two methods currently used to quantify the current-year misstatement. These methods are commonly referred to as the "rollover" and "iron curtain" methods.

Under the rollover method, the current-year effect would be the amount by which the current-year income statement is misstated (i.e., \$20). Under the iron curtain method, the current-year effect would be the amount by which the year-end balance sheet is misstated (i.e., \$100). The SAB points out that the rollover method could cause a misstatement to accumulate until it is too large to be corrected in a single year, resulting in errors remaining in the balance

¹ Staff Accounting Bulletin No. 108 (Topic 1N), Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements, available at www.sec.gov.

² Staff Accounting Bulletin No. 99 (Topic 1M), Materiality, available at www.sec.gov.

sheet. The SAB also points out that the iron curtain method does not consider the correction of prior-year misstatements in the current year. For example, if the \$80 misstatement from the prior years in the example was corrected in the current year, the current-year income statement would be misstated by the \$80 out-of-period correction, but the year-end balance sheet would not be misstated, and no uncorrected misstatement would exist at year-end.

In order to eliminate diversity in practice for quantifying misstatements and to address the shortfalls of each of the two methods, the SAB requires registrants to quantify misstatements using both methods, with adjustment required if either method results in a material error. The materiality of the quantified misstatement would be evaluated using the staff's previously published guidance in SAB 99.

Correcting Errors

The new SAB addresses the mechanics of correcting misstatements that include effects from prior years. The SAB indicates that the current-year correction of a material error that includes prior-year effects may result in the need to correct prior-year financial statements, even if the misstatement in the prior year or years is considered immaterial. For example, if the \$100 error in the above example was determined to be material in the current year, the current-year correction would result in an \$80 misstatement of the current-year income statement (the portion of the \$100 error that originated in prior years). In this case, the prior-year financial

statements would need to be corrected, even though the misstatement had been considered, and continues to be, immaterial to the prior-year's financial statements.

The SAB points out that "correcting prior-year financial statements for immaterial errors would not require previously filed reports to be amended." The "correction may be made the next time the registrant files the prior year financial statements." The correction could therefore be made in subsequent filings by adjusting the prior-year financial statements, as long as the adjustments made to those financial statements are considered immaterial. Although the subject is not specifically addressed in the SAB, the prior-year financial statements reflecting immaterial corrections need not be labeled "restated," and the adjustments would not necessarily require mention in the auditors' report. Registrants should, however, disclose the fact that they have adjusted the prior-year financial statements and provide appropriate context for the adjustments made so that readers can understand why the comparative financial statements presented in the current-year report do not agree with the previously issued financial statements.

Previously Undetected Misstatements

Misstatements originating in years subsequent to the issuance of the SAB that are not detected in the years they arose will be evaluated using the method outlined in the SAB to determine whether the prior-year financial statements were materially misstated. Financial statements that are found to be materially misstated would be restated in accordance with Statement 154.³

In the previous example regarding the overstated liability that grew by \$20 per year over a five-year period, assume that the misstatement was not identified until year five. The registrant would need to use the approach outlined in the SAB to separately evaluate each year affected by the misstatement and determine whether individual prior years were materially misstated. If, for example, the fourth year was found to be materially misstated, the financial statements for year four would have to be restated and labeled as restated. If the misstatements in the first three years were determined to be immaterial, financial statements for those years could be adjusted without labeling them restated.

Initial Adoption

A registrant applying the new guidance for the first time that identifies **material** errors in existence at the beginning of the first fiscal year ending after November 15, 2006, may correct those errors through a one-time cumulative-effect adjustment to **beginning-of-year** retained earnings. The cumulative-effect alternative is available only if the application of the new guidance results in a conclusion that a material error exists as of the beginning of the first fiscal year ending after November 15, 2006, and those misstatements were determined to be immaterial based on a proper application of the registrant's previous method for quantifying misstatements.

Because of the beginning-of-year recognition of the cumulative-effect adjustment, misstatements occurring in the year of adoption cannot be included in that adjustment. The cumulative-effect adjustment may be reflected in a Form 10-K for the year of adoption or, if early

³ FASB Statement No. 154, *Accounting Changes and Error Corrections*, May 2005, available at www.fasb.org.



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adoption is chosen, the adjustment may be reflected in any Form 10-Q filed after issuance of the SAB. For example, a registrant with a June 30 year-end may wait until it issues its Form 10-K for the year ending June 30, 2007, to reflect the cumulative-effect adjustment, or it may reflect the adjustment in its first, second, or third quarter Form 10-Q for the fiscal year ending June 30, 2007. In any event, the cumulative-effect adjustment would be calculated as of July 1, 2006, the first day of the fiscal year of adoption.

The SAB requires the following disclosures if a cumulative-effect adjustment is recorded:

- The nature and amount of each individual error included in the cumulative-effect adjustment,
- When and how each error arose, and
- The fact that the errors had previously been considered immaterial.

The cumulative-effect adjustment is available only for prior-year uncorrected misstatements. The adjustment should not include amounts related to changes in accounting estimates.

Companies that issue reports before the SAB is adopted should make the disclosures required by SAB 74.⁴

Foreign Private Issuers

The SAB's guidance applies to all SEC registrants. A foreign private issuer that presents its primary financial statements on a basis other than U.S. GAAP will need to determine how the adoption of the SAB will affect its primary financial statements and the related U.S. GAAP reconciliation because the cumulative-effect adjustment accommodation provided by the SEC may not be acceptable for preparation of its primary financial statements. We expect this implementation issue to require additional discussion with the SEC staff.

Non-SEC Registrants

The SAB's guidance does not apply to non-SEC registrants. It is currently not clear whether the FASB will consider the cumulative-effect treatment under U.S. GAAP.

Registrants should not consider the descriptive and summary statements above about the Staff Accounting Bulletin, or any other cited requirements, as a substitute for the text of SEC or FASB requirements. Registrants should refer to the texts of the SEC and FASB requirements, consider their particular circumstances, and consult their accounting and legal advisors when considering the implications of the SAB.

⁴ Staff Accounting Bulletin No. 74 (Topic 11M), Disclosure Of The Impact That Recently Issued Accounting Standards Will Have On The Financial Statements Of The Registrant When Adopted In A Future Period, available at www.sec.gov.