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MP&T Director File Reference 1200 – 400 Financial Accounting Standards Board 401 Merritt 7 PO Box 5116 Norwalk Connecticut 06856-5116

Letter of Comment No: 7 -File Reference: 1200-400 Date Received: 4/13/04

12 April 2004

Dear Sir,

USA

Comment Letter – Retrospective Error Correction File Ref. 1200 – 400, Accounting Changes and Error Corrections

1. Executive summary

I have written a serious objection to retrospective error correction, presenting my comment letter with the following sub-headings:

- 2. Background including that I have already written to the IASB on this issue
- 3. Summary of my opinion explored in more detail under sub-heading 6
- 4. The argument about improved comparability and its shortcomings
- 5. Reasons why I think retrospective error correction has become popular
 - a) Convergence of standards internationally
 - b) The business analyst community have requested retrospective error correction
 - c) The Security and Exchange Commission's increased monitoring
 - d) "To report an error is the death of a CFO" hence internal controls are not weakened
 - e) Legal view current CFO should not be held responsible for his predecessor's mistakes (generic masculine used for simplicity)
- 6. Further discussion of the reasons for my opinion
- 7. Changes in accounting principles
- 8. Some proposals for the treatment of errors
- 9. Conclusions

2. Background

I am a UK qualified Chartered Accountant with 10 years' post qualification experience. I have been producing financial statements for large international companies under IAS/IFRS for the last three years, and I am currently working on an IFRS implementation project for an international UK listed company. I have an appreciation of US GAAP through studying various differences in accounting treatment and reconciliations to US GAAP, and it is quite likely that I will be involved in US GAAP reporting in the future.

I am a great supporter of convergence of accounting standards across the world, and of the work the IASB (though I have a different opinion on error correction).

I wrote to the IASB before the recent revision to IAS 8 in respect of error correction expressing my opinions, and also to staff at my accounting institute. I had a letter published about this in my professional body's magazine, and I have also had the opportunity to discuss my views with two IASB Board members, as well as other staff there.

3. Summary of my opinion

I understand that the treatment for error correction in your Exposure Draft (ED) has not changed from ABP Opinion No. 20, but I nevertheless want to express my opinion. My concerns are primarily about paragraphs 25 to 27 of the ED.

My opinion is that retrospective error correction, as proposed in your ED

- a) blurs the historic year-end position as previously presented;
- b) introduces scope for extra creativity in producing accounts;
- c) creates a certain acceptability for accounting errors;
- allows (even forces) errors to be corrected in the past, outside headline performance;
- e) treats errors (bad things) so much like changes in accounting principles (usually good things) that it blurs the difference between them;
- f) loses a (free!) internal control over management behaviour;
- g) reduces management accountability;
- h) creates costly complicated adjustments and extra record keeping; and
- i) confuses some users.

4. Improved comparability through retrospective error correction – and its shortcomings

I can see that comparability is improved by retrospective error correction. This does help users assess an entity's performance and prospects. This is clearly good. The proposals are clearly strengthened by the requirement for specific disclosures on the corrections.

However I do not think that what has been gained is as valuable as what has been lost.

Furthermore, I do not think prescriptive statutory presentations can take the place of the non-statutory explanations which management give for their entities' performance. In every year there are many different factors at work affecting an entity's performance and future prospects, such as the development of new factories and products, and changes in both internal strategy and external conditions. Management explain their results in light of these changes, and present non-statutory disclosures for this purpose. Whilst segmental reporting and disclosure of acquisitions and discontinued businesses goes a long way to improving statutory accounts, there are always further analyses that management can legitimately and should make to explain their entities' performance. I do not think that accounting standards can cater down to this level, though this is the level at which management present to serious investors and business analysts.

If there are past errors which have been corrected in their current year income statements, it has always been open to management to explain these. Furthermore, if there is a downside past error in the results, and the cause of the error has been dealt with, it should be in management's interest to disclose this, in order to give a truer picture of past performance and future potential. I can see how there might not be the same incentive to explain upside past errors like this; but if there is benefit which was not

recorded earlier, then it is due to the entity anyway and I have less issues with non-disclosure.

5. Reasons why retrospective error correction has become popular

I have heard the following reasons given supporting retrospective error correction:

a) Convergence of standards internationally "As the IASB has now accepted retrospective error correction in IAS 8 (revised), it is only sensible to retain this in the US"

I fully support convergence, but I think that it is more important to strive for the best principles rather than accept a worse principle in pursuit of convergence. I appreciate that this might be a process.

The fact that APB Opinion No. 20 was already in place may have been a factor in the revision of IAS 8 to include retrospective error correction.

Now that IAS 8 (revised) is in place, it will be harder for this ever to change. However, I still think-that excellence is a greater long-term goal than convergence, and I would like to think that the FASB and IASB agree, even if this might take some time.

b) "The business analyst community have requested retrospective error correction"

At one level there is a strong argument here: the analysts are some of the most important users of financial statements, and accounts are produced primarily for the users. As main customers, they should dictate how accounts are prepared.

My concern with this argument is that the voice and concern of accountants who prepare the accounts may not have been considered. My own findings are that a majority of accountants are horrified by retrospective error correction, particularly if they have ever been put under pressure by management (directly or indirectly) to reach published targets.

Accountants are producing the accounts and they know better than anyone the value of closing off a year and drawing a black line under the results. This is the best that they have been able to produce at a certain point in time, even if it is not perfect. Management then publish the results, and the investor community acts on this. It is a very significant change to historic accounting practice (particularly in Europe) to require later corrections for items which are not fundamental to the accounts as presented.

Whilst I respect and must work with business analysts, I do not think they understand the process of preparation as well as accountants do. I am not convinced that they understand the losses to internal control and management accountability (for what management have previously published) which retrospective error correction will almost certainly lead to. Nor do I think that they understand the cost of extra record-keeping that adjusting complex financial consolidation systems entails, and further confusion which may result – both inside and outside an entity.

I have already mentioned that I agree that it is good to improve comparability, but

I think that management provide this comparability anyway, and that this cannot be prescribed by financial standards because true comparability depends on many factors at a sub-entity level. I cannot see why serious business analysts cannot do their own further analysis to adjust for reported errors (alongside the other analyses they must already be doing) – so achieving first class comparability without at the same time sacrificing accounting processes and controls. The trade-off is thus between extra relevance through greater comparability (which I argue cannot be fully prescribed by accounting standards) and better intrinsic internal controls.

c) The Security and Exchange Commission's (SEC) increased monitoring "The SEC has increased its monitoring and inspection of published financial statements, and it has required entities to correct their accounts when it has found errors."

I heard that over three hundred US entities had had their 2002 accounts checked, that errors were detected, and that they were required to make corrections as a result.

At one level I applaud these findings and the resulting corrections, as I am passionate about good financial reporting. It follows very naturally that other entities should correct past errors in their accounts, whether they have been inspected or not, and whether the corrections have been specifically requested or not.

However although better reporting has been achieved in these cases, there is a marked difference between restatements of accounts which have been requested through an official monitoring process and voluntary changes. Also judgement is required to distinguish between errors that really affect the views of users and errors which are more incidental.

Clearly all errors are intrinsically bad, but in any set of financial statements (especially for a large international group), there are always errors of some degree or other. It is a matter of judgement as to what is material and what is immaterial. At the end of every audit there is always a list of unadjusted differences, and it is a matter for discussion between auditors and management as to which items have to be adjusted. Often there are compensating errors, so it is agreed that not all identified adjustments need to be made. Furthermore, there is a timing / benefit balance which has to be judged, and there comes a point where the extra time required to correct or look for an error is outweighed by the loss from untimely reporting; in any case, there are external deadlines.

The SEC has requested error correction for items which would previously (in Europe at least) not have been corrected by restatement. Under UK GAAP, corrections were only made by restatement if they were of such significance as to **destroy** the true and fair view and hence the validity of prior-period accounts. These accounts would only have been issued in exceptional circumstances, and, had such errors been detected earlier, the accounts would have been withdrawn. Although IAS 8 did allow alternative treatment for fundamental errors, the benchmark treatment had been essentially the same as UK GAAP.

My opinion is that for the lesser gain of some non-fundamental corrections, a

number of extremely valuable accounting procedures and internal controls have been seriously weakened through the SEC's insistence on error correction for items which were not critical to an understanding of the business. I think that it would have been better to require disclosure of these errors, without restatement, together with the production of pro-forma corrections to give the comparability gains.

When the SEC first decided to request restatement of accounts for material errors discovered through their investigations, I doubt if all the implications and effects of this practice (some of which I have mentioned above) were apparent and considered.

d) "To report an error is the death of a CFO" – hence internal controls are not weakened

I have been told that, because the market reacts so negatively to the reporting of an error nowadays (after the huge accounting scandals of the last few years), a CFO is unlikely to survive reporting an error. For this reason CFOs will strive to ensure that current period errors are not carried forward (to become past errors), but are corrected in the current period. There is thus still a strong incentive for good internal controls. I have also heard it said that a CFO might be allowed to report one error without being forced to resign, if he has good reasons, but it is unlikely that the international markets will allow him more than one such error.

I appreciate this argument. Certainly publicly reporting errors has led to the resignation or removal of senior staff in international companies even in 2004.

However this may not be the case, especially if there is a change of personnel: an incoming CFO may be able to blame errors on his predecessor, or possibly explain them away as different judgements taken by outgoing auditors. An entity's management may make a CFO, other personnel or advisors scapegoats, and so survive error reporting.

Also retrospective error correction is an accounting procedure which is affecting not just large listed international companies, but also smaller ones with lower profiles, where controls are already weak, and where management may be less likely to be subject to external market controls.

Legal view – current CFO should not be held responsible for his predecessor's mistakes

I have heard it said that retrospective error correction is good because it separates the responsibilities of an incoming CFO from the responsibilities of an outgoing CFO.

I understand that an incoming CFO should not have responsibility for past mistakes, and indeed should have this set out clearly in writing before accepting a post, so that he is legally covered. However, it is certainly possible to separate out the effect of prior year errors from current performance without having to have a retrospective restatement.

Furthermore, I am firmly of the opinion that an incoming CFO has responsibility for the internal control environment which he establishes when he joins an entity. This will include regular analytical review and reasonableness checks to scan for

errors, and decisions on the way in which any errors found are handled. Whilst he is not responsible for past errors, he is responsible for reporting going forward, and he must decide whether or not to correct or report errors which have been found internally.

Thus I do not think that retrospective error correction is necessary for an incoming CFO to protect his legal position.

6. Further discussion of the reasons for my opinion

I think that retrospective error correction will lead to all the results which I mentioned in my summary under sub-heading 3, and I discuss each in turn.

a) Blurring the historic year-end position as previously presented

If results are changed because of errors, this means that the historic position, as previously presented, is altered. Instead of the closing position being fixed (except if completely untrustworthy), it can now be altered for relatively small (even if judged "material") error correction.

Whilst I applaud the alms of these corrections, I am concerned that the black line which we used to have has become a grey one. There is so much which is judgemental in financial accounting that it is a great loss for the reported historic position to be left so open to subsequent alteration.

There have been many changes to accounting standards over the last few years, and more are expected in the near future, so there are going to be a considerable number of restatements. It is a great pity that this simple control over fixing the previous year's results as regards errors will not be retained.

b) Introducing scope for extra creativity in producing accounts

As stated above, whereas the published accounts used to be fixed (at least in respect of errors), under retrospective error correction they are not. An extra dimension for change has been introduced. Despite acknowledgement of market pressures on error reporting, it is still conceivable that retrospective error correction will be abused, as discussed in point 4(d).

In the worst cases, if there is a change of senior management, the incoming management can blame the error on other staff who have left; if there are new audit staff, the decisions taken on what is or is not material in the prior year summary of unadjusted differences can be changed. At each change of staff, an error could be explained in this way, and the lines legitimately redrawn.

There may be specific targets which need to be met. It is certainly conceivable that this year's 'past' error was last year's deception by management – for something which should have been solved in the previous year. A bank covenant or stock market target for last year may be met; an error could be corrected retrospectively, and then a similar target could be met for the current year – when either target might not have been met if the error had been included. As the problem has now been resolved, why should the analysts and bankers be so concerned – after all, they are looking largely to future potential, are they not? Management may end up not being held as accountable for poor performance last year as they should have been if the error had been corrected

then (and in comparison with a prior year restated downwards, the current year will probably look better as well!).

Also if an error is reported alongside a change in accounting principle, then the impact of the error can be explained away less obtrusively, potentially reducing its impact to users.

Allowing retrospective error correction does give more scope for manipulation of results.

c) Creating a certain acceptability for accounting errors

The ED prescribes restatement for error correction, which makes error correction less unusual. All material errors would be required to be corrected – certainly many more than have been under the previous European rules.

And yet errors, especially if resulting from deliberate misstatement, are a very serious matter. Indeed, IAS 8.41 states that, "Financial statements do not comply with IFRSs if they contain either material errors or immaterial errors made intentionally to achieve a particular presentation of an entity's financial position, financial performance or cash flows."

My issue here is that by making error correction a more routine process, the disclosure and correction of an error would be seen as more common-place and not the cause for concern that it should be. CFOs who are adept at communicating to the markets would be more likely to survive several restatements with impunity.

d) Allowing (even forcing) errors to be corrected in the past, outside headline performance

Retrospective correction, by its nature, puts errors into past results. Clearly it is the current results which are the main focus of attention when accounts are published. By prescribing correction in the past, the focus is taken off the errors, and their effects on reserves might not be so clearly noticed. If prospects for the business are good going forward, management may not be held as responsible as they should be.

e) Treating errors (bad things) so much like changes in accounting principles (usually good things) blurs the difference between them

I think that it is dangerous to give such similar treatment to errors and changes in accounting principles. Changes in accounting principles are generally good things, improving financial reporting so that the most appropriate principles for the business are used. Errors, however, are bad things. At the very least, errors indicate internal control weaknesses somewhere, because errors cannot remain undetected if all internal controls are strong.

To some users, the full force of errors and their correction may be lost, if errors and changes in accounting principle are recorded at the same time.

f) Losing a (free!) internal control over management behaviour

One of the most difficult areas to control independently in an entity is the influence and internal workings of top management. This is particularly the case in badly run companies or small enterprises, where other controls are also weak.

One effect of the previous rules, whereby error correction had to be recorded in the income statement of the current year, was that downside errors appearing in future results were very undesirable. To knowingly allow an error to carry forward was like

Sec. 1

storing up a problem; of course this could be done, but at some point the debit had to hit future results, which would be necessary if it was found out and forced to be corrected by auditors or through other circumstances (for example, due diligence prior to a sale or purchase of an entity might bring extra scrutiny and flush out errors).

One of main muscles in International Accounting Standards and UK GAAP has always been that, if a downside error was not corrected when first detected, it would have to be corrected in the future – perhaps at a time when it would be more unavoidable or inconvenient to management.

If there is now a chance that errors can be corrected retrospectively and management are sufficiently convincing to escape losing their positions as a result, this internal control is severely weakened, if not entirely lost.

Given that the Sarbanes-Oxley Act has forced the introduction of costly rules and procedures to strengthen internal controls, it seems strange that retrospective error correction should be kept in place under US GAAP when it reduces internal controls over management. It seems to me that this is going against the principles behind the Sarbanes-Oxley Act.

g) Reducing management accountability

Linked to the internal control mentioned in point 6(f) above is management accountability for the results which they or their predecessors have published. Again, this management accountability is an area which the Sarbanes-Oxley Act seeks to strengthen.

However if management are required to record errors in the past, the full impact of errors is less visible. No longer do management have to concern themselves so much with the accuracy of the results, as they know that, provided that there are good reasons, the results can be changed.

If management are responsible for the accounts which they or their predecessors have reported, then they have a massive incentive to ensure that a healthy internal control environment is established and maintained, and that errors are quickly picked up before they can ever become 'past errors'. As with the previous point, the last thing they want is for downside errors to reduce their results next year. Given that the international markets are unforgiving towards companies which do not meet their targets, this is an especially powerful incentive for management to ensure that their companies are well run. This intrinsic internal control does not cost extra money or involve extra bureaucracy to implement, as it exists by nature of management accountability – in contrast to compliance costs for Sarbanes-Oxley. The natural control is arguably more powerful than the statutory control.

It is also worth stating that management are judged on the figures which they report, and share prices move as investors respond to these results. However, share prices in the past cannot be changed in the future, even through retrospective error correction will alter the accounts on which those share prices were established, in response to investor decisions. It might be argued that in a perfect market, investors will correct the share prices fully when new information is available – including about restatements for errors. However, it is unlikely to be always the same shareholders who will gain or lose from this. In this respect, the link between historic results and share prices is distorted by retrospective error correction.

The accountability which management should bear is entirely appropriate, as investors make their investment decisions based on the published accounts. The principle of retrospective error correction weakens the confidence investors can have that management are truly accountable for the results they publish.

h) Creating costly complicated adjustments and extra record keeping
Retrospective error correction requires accounting and consolidation systems to be altered, if the internal records are to be kept up to date. If this means reconsolidating the results of a complex group, this can be difficult to do, and if this is not done, then the adjustments have to held offline 'in a spreadsheet somewhere'. In either case this is an extra cost, the extent of which depends on how complicated the changes are.

I appreciate that there might well be retrospective corrections from changes in accounting principles, but that is not an argument for extra work if it is not necessary.

Unless the error correction would have been likely to make a significant difference to investment decisions or the actions of other stakeholders, then I consider that the extra cost and effort is an unnecessary nuisance (NB: this is not to play down the importance of the link between share prices and reporting in point 6(g) above). Under the old European terminology and practice, there would only have been a correction if the errors were fundamental.

i) Confusing some users

When past figures are altered, it is highly likely that some users will not appreciate all the causes and implications of the changes. This may be because errors are explained together with changes in accounting principle, and figures are shown in notes which some users will not find. Some other users may not even notice that prior year figures have been changed, unless they compare them with the previously published results. In complicated cases, even preparers can get confused!

Accounting standards are evolving and converging at a rapid rate at present. As changes in accounting principles require retrospective corrections and many accounts will have restatements over the next few years to record all the changes, it is even more likely that errors will not be noticed and appreciated for what they are by some users.

7. Changes in accounting principles

I only want to make a short comment about this.

Generally I am in agreement with your proposals to require retrospective application of changes in accounting principles (as if the new accounting principle had always been used). This is partly because I am used to this treatment in Europe, but also because I recognise that a change in accounting principle usually leads to an improvement in reporting. The fact that previously published figures have changed in this case does not concern me in the same way as for error correction, as the reason for and the background to the change are normally good.

However, I think it is good that the transitional provisions in individual standards should be able to overrule retrospective correction (as stated in the ED, paragraphs 3 and 10), as this might be deemed appropriate in some cases.

Page 9 of 12

Changes in the use of accounting principles can have a significant effect on an entity's results, and, where there is genuine flexibility on introduction, it is only sensible for management to make changes at the most beneficial time for the entity. However, the timing of changes in accounting principle can be abused, and changes can also be made inappropriately. It is hard to limit these abuses, except by good auditing and other external monitoring.

Despite being wary of abuse, I am in agreement with the ED's proposed changes in this area.

8. Some proposals for the treatment of errors

I have proposed three possible treatments for past errors:

(a) Errors found internally, not through inspection

My proposal is that errors should be recorded through the income statement in the period in which they were discovered, prospectively, with no restatement. Only if the errors were fundamental would there be a requirement for restatement.

There should be no rules about disclosure, to prevent abuse of this (I think of too many entities reporting smaller errors too freely, though this might not be an issue). However, an entity would be free to disclose an error either in the notes to the financial statements or elsewhere.

Essentially these are the benchmark rules under IAS 8 (before the recent revision). The basic controls of management accountability and responsibility for the previous year's balance sheet, together with improved controls following from the Sarbanes-Oxley Act, audit and other external reviews should limit most errors in financial statements.

(b) Errors found by a monitoring-body inspection

In order to prevent the negative aspects of retrospective error correction which I have mentioned above in this comment letter, I would propose that for material errors uncovered by a monitoring-body inspection there should be full disclosure, but no restatement. [For 'fundamental' errors there should be restatement.]

As I have reviewed published financial statements, I have found that the clearest and fullest disclosure of changes to prior-period figures are the most helpful.

Thus on introduction of FRS 17, the recently introduced Retirement Benefits standard under UK GAAP, I found it extremely helpful when entities presented the change showing the balance sheet layout with three columns: the published prior year balance sheet, the effect of the change by balance sheet line and the restated balance sheet in the final column.

I have limited literature to hand on US GAAP. I have a comprehensive UK/US GAAP comparison book, the ED to which I am responding and I have read a number of the comment letters. I do not currently have access to the text of APB Opinion No. 20 or APB Opinion No. 9, but I hope that I have picked up the most relevant main points from what I have read.

I do not think that the proposed disclosure in the ED (paragraph 27 - albeit with restatement for errors, which I do not think is a good idea) allows a user to understand the effect of an error correction as quickly and as easily as fuller disclosure would allow.

I would be interested to examine APB Opinions No. 9 and No. 20 to be sure, but I nevertheless offer my own proposal for your consideration.

I would propose that for material errors, pro-forma statements are prepared at the back of the financial statements with the errors corrected. These should be after the full financial statements, as an extra note to the accounts; the full financial statements would be prepared without any retrospective error correction. The note on the errors would include each of the main statements (income statement, balance sheet, cash flow and statement of changes in equity) with a three column approach as suggested above in the FRS 17 implementation example, any other notes affected, and any further notes which the company chooses to prepare. For the statement of changes in equity, it might be easier to prepare this information as a reconciliation to retained earnings rather than a full statement. It is certainly not as onerous to revise figures on a pro-forma statement as it is to change the underlying accounting systems.

I think that a company which has disclosed a prior-period error should also be permitted to publish restated historical information in subsequent years (at the back of the notes to the financial statements) but only if it also publishes the historic (uncorrected information) in the main body of the notes to the financial statements, and it has published accounts in an earlier year showing the detailed effect of the error against previously published figures as above.

This fuller disclosure, with all the main statements, could also be used for accounting principle changes if these are material.

(c) Alternative to (a) for errors found internally, not through inspection
If it was deemed unacceptable not to require disclosure of errors found internally, then I would propose the full disclosure which I have suggested under (b) (for errors found by a monitoring-body inspection).

It is not intended that the disclosure of the restated figures for errors found internally should be too onerous, and I stress that I have in mind pro-forma accounts rather than full accounts. In cases where it might be impractical to restate exactly, the disclosures should show the effect of errors, perhaps using a best estimate approach, provided that this was stated.

The accounting treatment would be as in (a): namely errors should be recorded through the income statement in the period in which they were discovered, prospectively, with no restatement (except if the errors were 'fundamental').

9. Conclusions

I have given serious reasons why I think that retrospective correction should not be used for reporting past errors, after noting the main objections which I have heard over the last few months. I understand that the ED did not seek to change these proposals from those already in APB Opinion No. 20, but I still felt that it would be valuable for you to consider my views, which are representative of a large number of accountants I have spoken with.

I have proposed three possible treatments for past errors, none of which would allow restatement except for fundamental errors:

(a) for errors found internally, not through inspection, there would be no rules on disclosure, and no restatement;

- (b) for errors found by a monitoring-body inspection, there would be prescribed and full disclosure without restatement; and
- (c) as an alternative to (a) for errors found internally, there could be a requirement for full disclosure of past errors without restatement.

I am also an advocate of fuller disclosure (based on the main financial statements before and after restatement in a columnar format) in any case, including for retrospective application of changes in accounting principles where the effect is material.

I am generally in agreement with your proposals for changes in accounting principles.

I hope that my opinions may help you in your work to improve the quality of US financial reporting, and also to influence global standards as they evolve.

Yours faithfully,

Nicholas Dunhill ACA

Page 12 of 12