



BDO Seidman, LLP  
Accountants and Consultants

233 N. Michigan Ave., Suite 2500  
Chicago, Illinois 60601  
Telephone: 312-616-4661  
Fax: 312-856-9019

April 27, 2007

Mr. Lawrence Smith  
Director of Technical Application and  
Implementation Activities  
Financial Accounting Standards Board  
401 Merritt 7  
P.O. Box 5116  
Norwalk, CT 06856-5116



LETTER OF COMMENT NO. 4

Dear Mr. Smith:

BDO Seidman, LLP is pleased to offer comments on the FASB's proposed FASB Staff Position (FSP) FAS 154-a, *Considering the Effects of Prior-Year Misstatements When Quantifying Misstatements in Current-Year Financial Statements*. We support the Board's proposal to (1) require use of both the rollover and iron curtain approaches to assess materiality of misstatements and (2) provide a practical transition method to correct misstatements that an entity previously evaluated as immaterial. Our comments about the proposal are primarily editorial and are focused on two areas:

- Clarification of the application of the iron curtain method and
- Clarification of the transition paragraphs

In addition, we suggest two areas for further interpretive guidance.

#### Clarification of the Application of the Iron Curtain Method

Many accountants are confused by the iron curtain method. In particular, because the iron curtain method begins with the cumulative misstatement on the balance sheet, some accountants believe that the iron curtain method assesses the materiality of a misstatement solely with respect to the balance sheet. They don't understand that the iron curtain method is focused on the materiality of the cumulative misstatement to the current year income statement. Certain language in the proposal could perpetuate this misunderstanding. In the attached marked draft, we suggest changes in paragraphs 7, 9, and 10 to clarify the application of the iron curtain method.

#### Clarification of the Transition Paragraphs

Our understanding is that the cumulative-effect adjustment of retained earnings is recorded as of the beginning of the year of adoption. The proposal does not make this point until the end of paragraph 13, three paragraphs into the transition section. In the attached marked draft, we suggest changes to make this point at the outset of the transition section.



We also suggest changes to remove guidance about restating prior-period documents, which we believe is a regulatory or contractual matter rather than a GAAP issue.

Further Interpretive Guidance

We suggest providing guidance on two additional issues about which the proposal is silent.

*An additional prior-year error discovered after adoption.* If an entity discovers an additional prior-year error after adoption, can it alter the cumulative-effect adjustment to include the newly identified error, or is the cumulative-effect adjustment intended to be a one-time accommodation? In addition, if the cumulative-effect adjustment is intended to be a one-time accommodation, and the newly discovered prior-year error is recorded by restating the prior year, is it necessary to remove other errors pertaining the restated year(s) from the cumulative-effect adjustment and include them in the restatement?

*Materiality of misstatements of interim financial information.* How should an entity evaluate the materiality of misstatements of interim financial information? The SEC did not provide guidance on this issue in SAB No. 108. We believe it would be appropriate for the FASB to address it.

\* \* \* \* \*

We would be pleased to discuss our comments with the Board or the FASB staff. Please direct questions to Ben Neuhausen at 312-616-4661 or Jeff Lenz at 312-616-3944.

Very truly yours,

s/ BDO Seidman, LLP

**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.

#### **FASB Staff Position**

##### **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 both the statement of income and the statement of financial position for 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) and the misstatement in the statement of income for the current year is an overstatement of expense of \$100. If the \$100 misstatement is not material to the financial statements, the entity must then apply the rollover approach described in paragraph (a) above to the \$20 rollover amount. 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 of revenue or accounts receivable 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) and the misstatement in the statement of income for the current year is an overstatement of revenue of \$50. 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 to the \$60 rollover amount. 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 annual or interim financial statements issued for fiscal years ending after June 15, 2007. It shall be applied as of the beginning of the year of adoption. 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 may be affected. 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 may be affected. [Comment - GAAP historically has not addressed when or whether prior period documents should or should not be adjusted.

Deleted: need not be adjusted

Deleted: need not be adjusted

That is a regulatory or contractual matter. GAAP has dealt only with how prior-period errors should be reflected in current and future financial statements.] However, the subsequent year-to-date operating results for the year of adoption and 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.