#### **Accountants and Business Advisors**

April 30, 2007



LETTER OF COMMENT NO.

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Technical Director
Financial Accounting Standards Board
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Proposed FASB Staff Position FAS 154-a, "Considering the Effects of Prior-Year Misstatements When Quantifying Misstatements in Current-Year Financial Statements"

We appreciate the opportunity to comment on 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 issuance of a final FSP for nongovernmental entities that are not subject to the requirements of SEC Staff Accounting Bulletin (SAB) 108, Considering the Effects of Prior-Year Misstatements When Quantifying Misstatements in Current-Year Financial Statements. Additionally, we support (1) requiring application of both the rollover and iron curtain approach for quantifying misstatements when evaluating materiality and (2) permitting entities to record a one-time cumulative-effect adjustment upon initial application of the FSP's guidance. However, we believe the proposed guidance could be clarified and, toward that end, offer the following suggestions.

## **Background**

## Paragraph 3

In our view, the purpose of the reference to SEC Staff Accounting Bulleting (SAB) 99, *Materiality*, in the proposed FSP is unclear. SAB 99 does not apply to any entity within the scope of the proposed FSP and is not incorporated into the proposed guidance. It appears that the Board decided to adopt the guidance in SAB 108 without adopting the provisions of SAB 99. We believe that financial statement preparers of entities covered by the proposed FSP might be confused about whether full knowledge and application of SAB 99 is necessary to apply the proposed guidance on quantifying prior-year misstatements. To eliminate any ambiguity, we therefore recommend that the Board consider either deleting the reference to SAB 99 and its related guidance in the FSP or clarifying that the Board is not adopting a framework for evaluating materiality that is similar to the one found in SAB 99.

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### Scope

### Paragraph 5

We recommend the inclusion of cooperatives and mutual organizations in the list of entities that would be subject to the proposed FSP in the first sentence of paragraph 5.

Additionally, we recommend that the Board consider clarifying the second sentence of paragraph 5 to include specific references to financial statements issued by not-for-profit organizations, as follows:

All references in this FSP to financial statements apply broadly to financial statements issued by those entities. For example, Statement 117, Financial Statements of Not-for-Profit Organizations, provides for the issuance of a statement of activities rather than a statement of income.

## Quantifying financial statement misstatements

## Paragraph 6

Paragraph 6 requires quantifying misstatements in both the statement of financial position and the statement of income. In contrast, SAB 108 provides a broader, more principle-based statement on quantifying misstatements, as follows: "The staff believes a registrant's materiality evaluation of an identified unadjusted error should quantify the effects of the identified unadjusted error on each financial statement and related financial statement disclosure."

We suggest the Board consider revising paragraph 6 as follows:

For purposes of evaluating the materiality of a misstatement, an entity shall quantify the effects of the misstatement on each financial statement and in the related financial statement disclosure. Accordingly, an entity shall quantify the effect of the misstatement in its current-year statement of financial position and statement of income (or the statement of activities of a not-for-profit organization) using both the rollover and the iron curtain approach. The materiality assessment should be based on all relevant quantitative and qualitative factors and should consider the effect of the misstatement on future periods.

We recommend using a bold typeface to emphasize the preceding paragraph for the following reasons:

- The first sentence is the principle and refers broadly to financial statements and disclosures.
- The second sentence establishes a requirement to use specific techniques to quantify misstatements. We suggest including a reference to the statement of activities of a not-for-profit organization because this statement is defined in Statement 117, Financial Statements of Not-for-Profit Organizations.

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> The third sentence provides the context for considering the misstatements quantified and establishes the requirement to consider the effects of the misstatement on future periods.

### Paragraph 8

The second sentence in paragraph 8 refers to a misstatement that "exists after the current year financial statements are corrected." However, if current-year financial statements continue to be misstated, they have been adjusted but not fully corrected. Accordingly, we recommend clarifying the first two sentences of paragraph 8 as follows:

If the misstatement quantified using either the rollover approach or the iron curtain approach is material to the current-year financial statements, an entity shall <u>adjust</u> eorrect-its current-year financial statements. If a misstatement related to prior-year misstatements exists after the current-year financial statements are eorrected <u>adjusted</u> and that misstatement is material to the current year financial statements, then the prior-year financial statements should be corrected.

## **Examples**

## Paragraphs 9 and 10

We think the statements in both paragraphs 9 and 10, which indicate that an entity (1) quantifies misstatements using both the iron curtain and rollover approaches and (2) must correct the error if either approach results in a material misstatement are appropriate. However, we believe the examples provided in paragraphs 9 and 10 do not properly illustrate how to consider the misstatements quantified by applying the iron curtain and rollover approaches, as described below.

## Paragraph 9

The examples provided in the proposed FSP describe the process of considering misstatements quantified under the iron curtain and rollover approaches as a two-step sequence, requiring the evaluation of materiality and adjustment of misstatements quantified under only one approach before considering the amount quantified under the other approach. Paragraphs 9(a) and 9(b) indicate that the amount of the adjustment recorded using that process could differ, depending on which approach, iron curtain or rollover, is considered first in the sequence. Paragraph 9(a) indicates that after correcting a \$20 misstatement under the rollover approach, it is possible that an entity might conclude the remaining \$80 would not be material. However, in paragraph 9(b), if the entity considers the iron curtain approach first and concludes that the \$100 misstatement is material, it would adjust the financial statement for the full \$100.

Furthermore, we think that the proposed wording in paragraphs 9(a) and 9(b)—as well as in paragraphs 10(a) and 10(b)—could create an impression that applying both the iron curtain and rollover approaches may not be required in all cases. For example, paragraph 9(a) states, "If the \$20 misstatement [under the rollover approach] is not material to the current-year financial statements, the entity must apply the iron curtain approach described in paragraph 9[(b)] below." We believe that an entity must consider the misstatement quantified using the iron curtain approach regardless of whether it determines the rollover misstatement is material.

We think that an entity should evaluate materiality considering both the \$20 misstatement under the rollover approach and the \$100 misstatement under the iron curtain approach. The amount of any

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required adjustment should be based on consideration of all relevant qualitative and quantitative information and should not depend on the sequence of consideration as described in paragraph 9. Accordingly, we recommend that the Board consider providing examples that are more consistent with those provided in SAB 108. More specifically, we recommend replacing paragraphs 9(a) and (b) with the following:

The entity should quantify the current-year misstatement in this example using both the iron curtain approach (i.e., \$100) and the rollover approach (i.e., \$20). Therefore, if the \$100 misstatement is considered material to the financial statements after all relevant quantitative and qualitative factors are considered, the entity's financial statements must be adjusted. Consideration of the effect of the misstatement on future periods could indicate that an error should be corrected, even if the error would not otherwise be considered material to the current-year financial statements.

It is possible that adjusting an error in the current year could materially misstate the current year's income statement. For example, adjusting the \$100 misstatement in the current year would:

- Correct the \$20 error originating in the current year;
- Correct the \$80 balance sheet carryover error that originated in years 1 through 4; but also
- Misstate the current-year income statement by \$80.

If the \$80 understatement of current-year expense is material to the current year after considering all relevant quantitative and qualitative factors, the prior-year financial statements should be corrected, even though such revision previously was, and continues to be, immaterial to the prior-year financial statements.

## Paragraph 10

As previously noted, we think that the proposed wording in paragraphs 9(a), 9(b), 10(a), and 10(b) could create the impression that considering both the iron curtain and rollover approaches may not be required in all cases. Furthermore, our concerns about the appropriateness of the sequential consideration process, as illustrated in paragraphs 9(a) and 9(b), also apply to the example in paragraphs 10 (a) and 10(b).

In addition, paragraph 10(a) indicates that the effect of adjusting the current-year income statement for the \$60 error quantified under the rollover approach would be to increase the overstatement of accounts receivable to \$110 in the current year-end balance sheet. We do not think it is clear why the example in paragraph 10(a) assumes that adjusting the \$60 misstatement in the current-year income statement, as quantified under the rollover approach, would also increase current year-end accounts receivable.

Therefore, we recommend that paragraphs 10(a) and 10(b) be replaced with the following:

The entity should quantify the current-year misstatement in this example using both the iron curtain approach (i.e., \$50) and the rollover approach (i.e., \$60). Therefore, assuming a \$60

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misstatement is considered material to the financial statements after considering all relevant quantitative and qualitative factors, as well as the effect of the misstatement on future periods, the entity's financial statements would need to be adjusted.

Further, in this example, recording an adjustment in the current year could alter the amount of the error affecting the current-year financial statements. For instance:

- If only the \$50 overstatement of accounts receivable was adjusted in the current year, then the understatement of current-year revenues would increase to \$110.
- If the \$60 understatement of revenues was adjusted in the current year, then the sales cut-off errors originating in the prior and current years would be corrected.

If the misstatement that exists after recording the adjustment in the current-year financial statements is material after considering all relevant quantitative and qualitative factors, the prior-year financial statements should be corrected, even though such revision previously was, and continues to be, immaterial to the prior-year financial statements.

#### Effective date and transition

### Paragraph 11

We are concerned that entities may not have sufficient time to effectively apply the FSP by the proposed effective date. The earliest the final FSP could be issued following FASB due process is the middle of May 2007, leaving little time for the staff of entities with years ending at June 30, 2007 to become familiar with and then implement the final FSP requirements. Therefore, we recommend that the final FSP be effective for *annual* financial statements for fiscal years ending after December 15, 2007. For reasons discussed below, we recommend that the initial application of the final FSP not be required for financial statements issued for interim periods within the fiscal year an entity adopts the FSP. However, if the final FSP requires application to interim financial statements within the year the entity adopts the FSP, then we recommend that the FSP be effective for financial statements issued for annual periods *beginning* after June 15, 2007 and for interim periods in the year of adoption.

We recommend that the Board clarify the proposed effective date and transition provisions in paragraphs 11 and 13 for interim period financial statements. Paragraph 11 states that the FSP would be "effective for financial statements issued for fiscal years ending after June 15, 2007. Earlier application is permitted." However, paragraph 13 indicates that an entity would first apply the FSP in an interim period after the FSP is issued in its final form. It is unclear whether all entities or only those electing early application would be required to apply the FSP to interim financial statements during the year of adoption.

We recommend that the initial application of the final FSP not be required for financial statements issued for interim periods within the fiscal year an entity adopts the FSP, because reliable information necessary to apply the FSP may not be readily available for those interim periods within the adoption year. We believe that non-SEC registrants are more likely to have documentation of the quantification and assessment of misstatements for annual financial statements that are subject to audit rather than for interim period financial statements, which may not be audited or reviewed. We

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also believe it may be difficult to evaluate the effect of prior-year misstatements on future periods if the proposed FSP is applied in an interim period.

Paragraph 12

We think that the Board should clarify how a not-for-profit organization should report the cumulative-effect adjustment described in paragraph 12 of the proposed FSP. Paragraph 12 provides that an entity may elect to recognize the cumulative-effect of initially applying the FSP as an adjustment to the opening balance of retained earnings. For a not-for-profit organization, a direct adjustment to the opening balance of the appropriate classification of net assets (equity) would be similar to the adjustment of a for-profit entity's retained earnings balance. On the other hand, reporting the cumulative-effect adjustment as a separate line item in the statement of activities might be more consistent with the requirement in paragraph 18 of Statement 117, Financial Statements of Not-for-Profit Organizations, which states that a change in net assets reported in the statement of activities should articulate to the net assets or equity reported in the statement of financial position. Because different interpretations are possible under the proposed guidance, we think that the FSP should address the presentation of the cumulative effect in the financial statements of a not-for-profit organization.

Additionally, paragraph 12 of the proposed FSP indicates that an entity may apply a one-time cumulative-effect adjustment if it "appropriately evaluated the materiality of the misstatement to the previously issued financial statements based on all relevant qualitative factors using the rollover or iron curtain approach (but not both). ... "We believe that an entity's previous materiality evaluation should have properly considered quantitative factors before permitting the entity to apply the one-time cumulative-effect adjustment upon initial adoption.

#### Paragraph 13

We recommend replacing the term "private company" in paragraph 13 with "entity" to be consistent with the rest of the proposed FSP.

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We would be pleased to discuss our comment with Board members or staff. Please direct your questions or comments to Joseph Graziano at (732) 516-5560.

Sincerely,

/s/ Grant Thornton LLP