

May 18, 2007



LETTER OF COMMENT NO. //

Ms. Suzanne Bielstein, CPA Technical Director Financial Accounting Standards Board 401 Merritt 7 PO Box 5116 Norwalk, CT 06856-5116

Re: March 13, 2007 Proposed FASB FSP FAS 154-a, Considering the Effects of Prior-Year Misstatements When Quantifying Misstatements in Current-Year Financial Statements

Dear Ms. Bielstein:

One of the objectives that the Council of the American Institute of Certified Public Accountants (AICPA) established for the PCPS Executive Committee is to act as an advocate for all local and regional firms and represent those firms' interests on professional issues, primarily through the Technical Issues Committee (TIC). This communication is in accordance with that objective. These comments, however, do not necessarily reflect the positions of the AICPA.

TIC has reviewed the Proposed FASB Staff Position (FSP) and is providing the following comments for your consideration.

GENERAL COMMENTS

TIC agrees with the substance of the Proposed FSP. The one-time cumulative effect adjustment is an appropriate and practical alternative. However, clarifying language is necessary in some sections of the proposal to answer certain questions that may arise in practice. TIC also requests reconsideration of:

- the prohibition on using the one-time cumulative effect adjustment for entities that have always followed the combined rollover/iron curtain methodology for evaluating prior year misstatements and
- the effective date of the proposed FSP.

The final FSP will impact almost every nongovernmental entity. Given this broad





applicability, TIC believes special attention should be given to addressing any remaining implementation issues.

SPECIFIC COMMENTS

TIC presents the identified issues below along with specific proposed revisions for the Board's consideration.

Paragraph 7, last sentence—Consideration of Future Periods in the Assessment of Materiality

After describing the rollover and iron curtain approaches to quantifying misstatements, the last sentence of paragraph 7 states that the materiality of the quantified misstatements be assessed by examining "all relevant quantitative and qualitative factors" and considering "the effect of the misstatement on future periods" [emphasis added]. TIC believes further explanation is needed, along with an example, to clarify why the circumstances underlying immaterial, unrecorded adjustments in the current period could lead to material misstatements in future financial statements. Without this guidance, readers of the standard may not know what to look for.

TIC proposes the following changes (noted in **boldface italics**) to the last sentence of paragraph 7 and a new explanatory paragraph with an illustrative example:

7....The materiality assessment should be based on all relevant quantitative and qualitative factors and consider whether the foreseeable or projected effect of the misstatement could potentially cause future financial statements to be misstated.

That is, misstatements in the current period which are determined to be immaterial and which do not reverse in the subsequent period can lead to the accumulation of errors in the current and future balance sheets that may become material, under the iron curtain approach, in future periods. One such example would be a misstatement in accounting for operating leases with scheduled increases in rent. Generally accepted accounting principles require that rent expense be recognized on a straight line basis over the term of the lease. Failure to do so will generally cause immaterial errors in the income statement when assessed using the rollover approach, but may lead to large errors in the balance sheet that, if corrected in the current period, would be material under the iron curtain approach and require restatement of prior periods.





Paragraph 12—One-Time Cumulative-Effect Adjustment upon Initial Application

The first sentence of paragraph 12 restricts the one-time cumulative-effect adjustment upon initial application to those entities that appropriately applied either the rollover approach or iron curtain approach (but not both) to the unadjusted misstatements in the previously issued financial statements. The majority of TIC members (by a 2:1 margin) believe the phrase "but not both" adds an unnecessary anti-abuse provision which is designed to prevent entities from using the one-time cumulative effect adjustment as a strategy for cleaning up their balance sheets.

The majority view believes the "but not both" phrase should be removed from paragraph 12 in favor of language that would permit the one-time adjustment as a matter of professional judgment. TIC suggests the first sentence of the paragraph be amended as follows:

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 and/or the iron curtain approach, the entity need not correct the error by restating previously issued financial statements.

The minority view disagrees that an entity should be eligible for the one-time cumulative-effect adjustment simply because it used both methods to evaluate prior year's misstatements. If both methods were used appropriately in the prior year, then, in theory, all material misstatements would have been corrected in the prior year with no material impact on the current year.

The majority view took the above argument into consideration but believes the materiality threshold in the current year could be so much lower than in the prior year that the previously immaterial prior period adjustments could be material in the current year. Correcting the misstatement in the current year could misstate current year's earnings and prompt restatement accounting.

The majority view holds that an entity should not be penalized if it used the new preferred methodology (i.e., both methods) to evaluate the materiality of the misstatement to the previously issued financial statements. The proposed revisions to paragraph 12, as described above, would allow relief from restatement and thereby provide a fair alternative to address this potential implementation issue.

Paragraph 12, 2nd Sentence—Applicability to Not-For-Profit Organizations





TIC believes the reference to "an adjustment to the opening balance of retained earnings" should be revised to acknowledge the terminology used by not-for-profit organizations. TIC believes the general statement of applicability in paragraph 5 is not sufficient to remind not-for-profit organizations that they fall under the scope of this proposed FSP. TIC therefore recommends that the above phrase be revised as follows: "an adjustment to the opening balance of retained earnings or other measure of equity."

Paragraph 13—Follow-through on Example from Paragraph 9b

TIC believes the text of the Proposed FSP should refer back to the examples presented to reinforce application principles and thereby enhance the understandability of the standard. TIC therefore recommends that the following sentence should be added after the first sentence in paragraph 13 to carry the example through and attach numbers to the narrative describing the calculation of the one-time cumulative-effect adjustment:

For example, with respect to the error discussed in paragraph 9, if the iron curtain approach led to a decision to correct an error as noted in example b, the cumulative effect adjustment would have been \$80.

Paragraph 16—Subsequent Discovery of Prior-Period Misstatements

Paragraph 16 fails to address an issue that TIC believes will arise frequently in practice. A question that may be asked is whether the one-time cumulative-effect adjustment is available to entities that first discover prior-period misstatements in the current period. TIC recommends that the following paragraph be added to the section on Restatement of Previously Issued Financial Statements to answer this question:

17. If an entity discovers a material error in a subsequent period that previously had not been discovered and assessed for materiality by using the rollover method or the iron curtain method, the entity shall correct the error by restating previously issued financial statements. The disclosures required by paragraph 26 of Statement No. 154 apply.

Paragraph 11—Effective Date

TIC appreciates the early application provisions of this Proposed FSP. However, TIC requests a deferred effective date for those entities with June 30 year-ends, which includes many not-for-profit organizations, to allow adequate time for them to become aware of and apply the standard. TIC therefore suggests the following effective date:





This FSP shall be effective for financial statements issued for fiscal years ending after **December 15, 2007**. Early application is permitted.

TIC appreciates the opportunity to present these comments on behalf of PCPS member firms. We would be pleased to discuss our comments with you at your convenience.

Sincerely,

Edward J. Knauf, Chair

PCPS Technical Issues Committee

Edward J. Mucon

cc: PCPS Executive and Technical Issues Committees

