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Iron Curtain or Rollover? The SEC Staff Requires Both.

SEC Issues Staff Accounting Bulletin No. 108 on Quantifying Misstatements

by Lisa Delfini and Sara Glen, Deloitte & Touche LLP

Background

In recent years, the staff of the Securities and Exchange Commission (SEC) has voiced concerns[1] over registrants' exclusive reliance on either the "iron curtain" or "rollover" approaches (explained below) in quantifying financial statement misstatements. To address these concerns, the SEC has issued Staff Accounting Bulletin (SAB) No. 108.[2] In summary, SAB 108:

- States that registrants should use **both** a balance sheet (iron curtain) approach and an income statement (rollover) approach when quantifying and evaluating the materiality of a misstatement.[3]
- Contains guidance on correcting errors under the dual approach.
- **Provides transition guidance for correcting errors** existing in prior years. If prior-year errors that had been previously considered immaterial (based on the appropriate use of the registrant's prior approach) now are considered material based on the approach in the SAB, the registrant need not amend prior period financial statements.
- Is effective for annual financial statements covering the first fiscal year ending after November 15, 2006, with earlier application encouraged for any interim period of the first fiscal year ending after November 15, 2006, and filed after September 13, 2006.

The provisions of SAB 108 are covered in more detail below.

[1] For example, see the remarks made by Russell P. Hodge at the 2004 AICPA National Conference on Current SEC and PCAOB Developments.

[2] SEC Staff Accounting Bulletin No. 108, codified as SAB Topic 1.N, "Considering the Effects of Prior Year Misstatements When Quantifying Misstatements in Current Year Financial Statements."

[3] SEC Staff Accounting Bulletin Topic 1.M, "Materiality," is unchanged by SAB 108. SAB Topic 1.M indicates that quantifying and aggregating errors is only the beginning of an analysis of materiality and that both quantitative and qualitative factors must be considered in determining whether individual errors are material.

Iron Curtain Versus Rollover Approach

Two error evaluation techniques are commonly used in practice: the iron curtain and rollover approaches. Under the iron curtain approach, the registrant focuses on correcting the misstatements existing in the balance sheet at the end of the current year, regardless of the year(s) in which the misstatement originated. This approach does not consider the income statement effects of the reversal of the carryover of a misstatement to be evaluated as an error. The iron curtain approach treats prior period misstatements as immaterial to the prior period financial statements, so correcting the misstatements must be "correct" and, therefore, not an error.

In contrast, the rollover approach quantifies a misstatement based on the amount of error originating in the current-year income statement. Therefore, this approach could allow balance sheet items to grow each year by immaterial amounts, until the cumulative error becomes material.

The SEC staff believes that if either approach is used exclusively, the financial statements may not reflect appropriate balances at period end. The following example illustrates differences between the rollover and iron curtain methods, and describes the SAB 108 approach.

Example

Assume that in 20X2, Registrant A began over-accruing a liability each year by $20. Therefore, at the end of 20X6, liabilities are overstated by $100. The $20 annual over-accrual was not considered material to any of the individual prior period financial statements. In 20X6, should the registrant evaluate the error in the current year as a $100 overstatement of liabilities (iron curtain approach), or as a $20 overstatement of expenses (rollover approach)?

The following chart shows the adjustments that would have been made under each method to correct the 20X6 financial statements:

	20X6 Iron Curtain [A]	20X6 Rollover [B]
Overstatement of Expenses	$ 20	$ 20
Entry to Adjust	(100)	(20)
Understatement of Expenses (as adjusted)	$ (80)	$ —
Overstatement of Liabilities	$ 100	$ 100
Entry to Adjust	(100)	(20)
Overstatement of Liabilities (as adjusted)	$ —	$ 80

[A] Under the iron curtain approach, after the adjustment, liabilities will be correct but **expenses** will be **understated** by $80.

[B] Under the rollover approach, after the adjustment, expenses will be correct but **liabilities** will be **overstated** by $80.

The SAB requires the registrant to evaluate the error using both approaches and to adjust the financial statements if **either** approach results in quantifying a misstatement that is material. Assume that the $100 error under the iron curtain approach is material to 20X6 and that the 20X6 financial statements need to be adjusted. This, in turn, causes the 20X6 income statement to be misstated by understating expenses by $80. The $80

understatement should be evaluated for materiality to the 20X6 financial statements, and **if considered material, the prior period financial statements should be corrected regardless of materiality to those financial statements**. In this example, the $20 accrual each year should be reversed as follows:

	20X6*	20X5	20X4	20X3	20X2
Overstatement of Expenses (as reported)	$ —	$ 20	$ 20	$ 20	$ 20
Adjustment	—	(20)	(20)	(20)	(20)
Overstatement of Expenses (as adjusted)	$ —	$ —	$ —	$ —	$ —
Overstatement of Liabilities (as reported)	$ —	$ 80	$ 60	$ 40	$ 20
Accumulated Adjustment	—	(80)	(60)	(40)	(20)
Overstatement of Liabilities (as adjusted)	$ —	$ —	$ —	$ —	$ —

* No additional adjustment would be necessary in 20X6 since the error was adjusted prior to filing the financial statements as shown above.

The adjustment to increase net income for each year results in an increase in retained earnings. Previously filed reports would not be amended. Rather, under SAB 108, the correction would be made the next time the registrant files prior year financial statements.[4]

Editor's Note:

- The SAB is silent on whether the corrected financial statement columns should be labeled as "restated" in accordance with FASB Statement No. 154, *Accounting Changes and Error Corrections*, or handled in some other way. Registrants should discuss with their audit committee and independent auditors whether they should include such labeling in their corrected financial statements.
- If the correction of the error in the current year results in an **immaterial** misstatement of the financial statements for the prior periods and the current period, the adjusting entry can be recorded to the current year, without adjusting prior period statements.
- If a correction of prior period amounts is required on the face of the financial statements, the correction will also be required in the amounts included throughout the filing, including in footnotes to the financial statements, Management's Discussion and Analysis, and selected financial data.

The SAB does not change the requirements for the correction of an error. If in the current year an error is discovered that indicates that prior year financial statements were materially misstated, the registrant should restate the financial statements of the prior year(s) in accordance with Statement 154.

Effective Date and Transition

The SAB is effective for financial statements for fiscal years ending after November 15, 2006, with earlier application encouraged in any report for an interim period of the first fiscal year ending after November 15, 2006, and filed after September 13, 2006 (the publication date of SAB 108). If a registrant early adopts, previous interim

[4] Upon initial application of SAB 108, this adjustment would qualify for the special transistion rules if the other requirements of the special transition rules are met. See discussion below.

reports need not be amended. However, any comparative interim information presented in reports for interim periods of the first year subsequent to initial application should be adjusted to reflect the cumulative effect adjustment (see below) as of the beginning of the year of initial application. Also, the disclosures of selected quarterly information required by Item 302 of SEC Regulation S-K, "Supplementary Financial Information," should reflect the adjusted results.

Special Transition Rules for Certain Prior Year Errors

The staff will not object if a registrant records a one-time transitional cumulative effect adjustment to correct for misstatements in fiscal years ending on or before November 15, 2006, for errors that were not deemed material under the registrant's prior approach but are material under the SAB 108 approach. That is, the registrant would not have to restate prior period financial statements at initial application so long as management properly applied its previous approach and all relevant qualitative factors were considered. The effects of the initial application should be reflected in the carrying amounts of assets and liabilities as of the beginning of that fiscal year with the offsetting adjustment to the opening balance of retained earnings. Also, registrants should disclose the nature and amount of each error being corrected, when and how it arose, and that the errors had previously been considered immaterial.

Editor's Note: Private companies are advised that although SAB 108 only applies to SEC registrants, the AICPA's Auditing Standards Board has indicated that it will likely revisit Statement on Auditing Standards No. 107, *Audit Risk and Materiality in Conducting an Audit*, now that the SEC has issued its guidance. Private companies that are considering becoming a registrant should note that special transition (cumulative effect adjustment) is not available to registrants that have initial registration statements that are not effective on or before November 15, 2006.

In the Next Issue

The FASB issued Statement No. 157, *Fair Value Measurements*, on September 15, 2006. The Statement provides guidance on how to measure assets and liabilities using fair value. Look for additional information in Deloitte & Touche's upcoming *Heads Up* on the new Statement.

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