Accounting changes and error corrections

Handbook

US GAAP

October 2025

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Contents

Principles, methods, estimates – and errors

Sometimes mandated and sometimes self-selected, an entity's accounting principles, methods and estimates set the scene for the accounting that follows – directing how assets, liabilities, revenues, expenses, gains and losses are recognized and measured. Applied consistently, they provide structure to the financial statements and give financial statement users confidence in interpreting the information.

Topic 250, Accounting Changes and Error Corrections, doesn't prescribe specific accounting principles or methods or estimates, but it does provide guidance on when and how they are changed. And if an entity stumbles in applying its accounting principles and methods, or in forming estimates, Topic 250 provides guidance on how that error is corrected.

As such, Topic 250 is the companion standard to all others.

We hope you find this Handbook useful in understanding when and how accounting changes are made, and how errors in the financial statements are corrected.

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Acknowledgments

This Handbook has been produced by the Department of Professional Practice (DPP) of KPMG LLP in the United States.

We would like to acknowledge the efforts of the main contributors to this edition:

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We would also like to acknowledge the current and former members of DPP who contributed significantly to this Handbook: Jennifer Austin, Kimber Bascom, Tim Brown, Nick Burgmeier, Halie Creps, Regina Croucher, Brian Fields, Rivka Grund-Sender, Spiros Karagiannidis, Erin McCloskey, Joan Rood, Ellen Russo, Michele Russomanno, Julie Santoro, Angie Storm, Rob Werling, Edna Wong.

About this publication

The purpose of this Handbook is to assist you in understanding the standard on accounting changes and error corrections, Topic 250, and related SEC guidance.

Organization of the text

Each chapter of this Handbook includes excerpts from the FASB's Accounting Standards Codification® and SEC staff guidance, and overviews of the relevant requirements. Our in-depth analysis is explained through Q&As that reflect the questions we are encountering in practice.

Our commentary is referenced to the Codification, and to other literature, where applicable. The following are examples:

- 250-10-50-1 is paragraph 50-1 of ASC Subtopic 250-10
- ASU 2021-03 is FASB Accounting Standards Update 2021-03
- CON 8.BC3.18 is paragraph BC3.18 of FASB Concepts Statement No. 8
- S-K Item 601(a) is Item 601(a) of SEC Regulation S-K
- FRM 4230.2 is paragraph 4230.2 of the Financial Reporting Manual of the SEC's Division of Corporation Finance
- SAB Topic 1M is SEC Staff Accounting Bulletin Topic 1M
- AS 2801 is PCAOB Auditing Standard 2801
- AU-C 708 is Section 708 of the clarified auditing standards issued by the AICPA
- TQA 9030.10 is section 9030.10 of the AICPA's Technical Questions and Answers
- IRDI 10/1/03 is an outline of the International Reporting and Disclosure Issues in the Division of Corporation Finance of the SEC dated October 1, 2003
- Dear CFO 01/2007 is SEC staff guidance published in January 2007 in the form of a sample letter to a fictitious CFO
- Regs Comm 06/2009 is a meeting of the SEC Regulations Committee in June 2009

Scope and terminology

Topic 250 requires retrospective application for most accounting changes and restatement for material error corrections. This Handbook does not discuss how these requirements are applied to per-share information. Chapter 7 of KPMG Handbook, Earnings per share, discusses retrospective adjustments to EPS.

For purposes of applying Topic 250, accounting and reporting for a change in the method of applying an accounting principle is the same as for a change in

an accounting principle. Therefore, in this Handbook they are generally referred to collectively as changes in accounting principle.

In general, this Handbook uses 'immaterial' to describe all items that do not result in an adjustment to, or restatement of, the financial statements. This ranges from items that are clearly trivial, to those that are not trivial but still not material.

The guidance referring to SEC registrants uses terminology applicable to domestic registrants, unless otherwise noted.

October 2025 edition

This edition of our Handbook includes new and updated guidance based on our continued practical experience with entities applying Topic 250 as well as discussions with the FASB and SEC staff. New questions and examples are identified with **** and items that have been significantly updated or revised are identified with **#**.

The Index of changes lists all of the significant additions and changes made in this edition to assist you in locating recently added or updated content.

Pending content

In October 2023, the FASB issued ASU 2023-06, Disclosure Improvements – Codification Amendments in Response to the SEC's Disclosure Update and Simplification Initiative, which incorporates into the Codification several disclosures and presentation requirements currently residing in SEC Regulations S-X and S-K. Relevant to this Handbook, the ASU modifies the disclosure requirements for a change in reporting entity to require that annual disclosures also be presented in interim financial statements. Further, the ASU requires the following disclosures, which currently are required for a change in accounting principle, to also be presented for a change in reporting entity.

Type	Disclosures (impact on)
Cumulative effect as of beginning of earliest period	• Retained earnings • Other components of equity or net assets

The effective dates for ASU 2023-06 are as follows.

	Entities subject to the SEC's existing disclosure requirements[1]	Other entities
Each amendment will be effective:	As of the effective date to remove the related disclosure requirement from Reg S-X or S-K.	Two years later
	If by June 30, 2027, the SEC has not removed the existing disclosure requirement from Reg S-X or S-K, the corresponding pending requirement will be removed from the Codification and will not become effective for any entity.	
Early adoption:	Not permitted	

Note:

1. Entities subject to the SEC's existing disclosure requirements and entities required to file or furnish financial statements with or to the SEC in preparation for the sale of or for purposes of issuing securities that are not subject to contractual restrictions on transfer.

Because this ASU is not effective yet, and might never become effective, the guidance in this Handbook has not been updated for ASU 2023-06. However, the Codification excerpts in this Handbook show the ASU's amendments as pending content.

Abbreviations

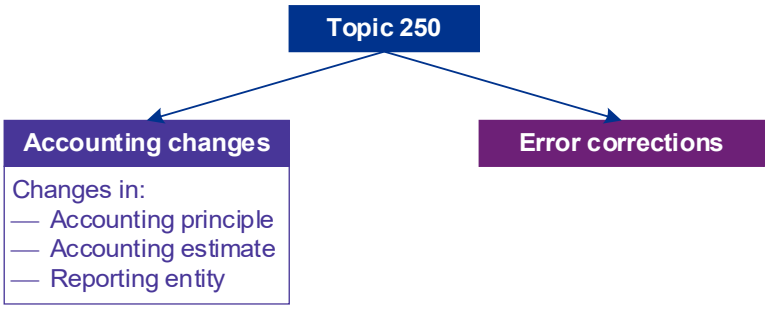
We use the following abbreviations in this Handbook:

ASU	Accounting Standards Update
AOCI	Accumulated other comprehensive income
EBITDA	Earnings before interest, taxes, depreciation and amortization
EPS	Earnings per share
FPI	Foreign Private Issuer
NFP	Not-for-profit entity
OCI	Other comprehensive income
IPO	Initial public offering
CON	FASB Concepts Statement
FIFO	First-in, first-out
SAB	SEC Staff accounting bulletin
SG&A	Sales, general and administrative expenses

1. Executive summary

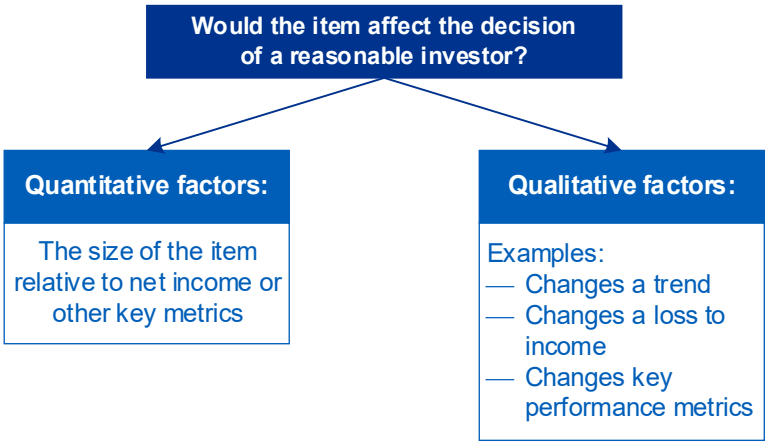
Scope and materiality

The following diagram summarizes the scope of Topic 250.



The concept of materiality is integral to the application of Topic 250, and in particular to evaluating a misstatement. Specifically in relation to error corrections, we believe all entities should consider the SEC staff's interpretive guidance on materiality, which is based on the Supreme Court's position that a fact is material if there is a substantial likelihood that it would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available.

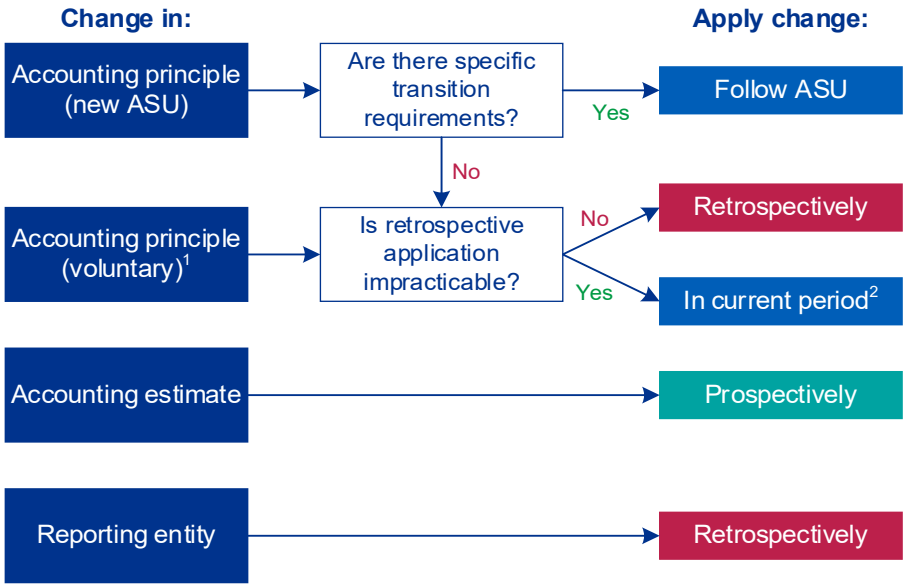
As shown in the diagram, an item can be material by its size (quantitatively material) or its nature (qualitatively material). There is no one-size-fits-all rule of thumb that can be applied by all entities to evaluate materiality.



Read more: Chapter 2

Accounting changes

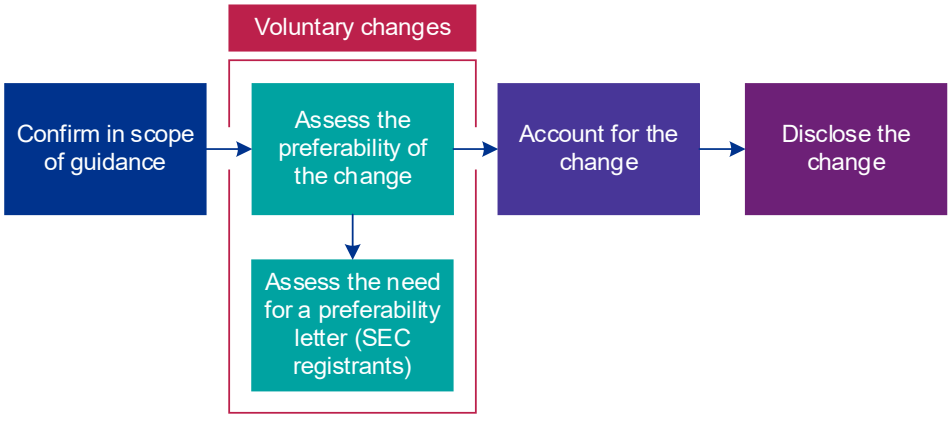
Topic 250 discusses three types of accounting changes that do not arise from an error, and the different accounting approaches are summarized in the following diagram.



Notes:

1. For all entities, the change must be 'preferable'; in addition, SEC registrants require a preferability letter in some cases. For purposes of applying Topic 250, a change in accounting principle includes a change in accounting method.
2. A cumulative catch-up adjustment is recognized. If an entity is able to apply a change partly (but not fully) retrospectively, it applies the change retrospectively to the extent it is able.

The following diagram highlights the steps followed in accounting for a change in accounting principle (method).



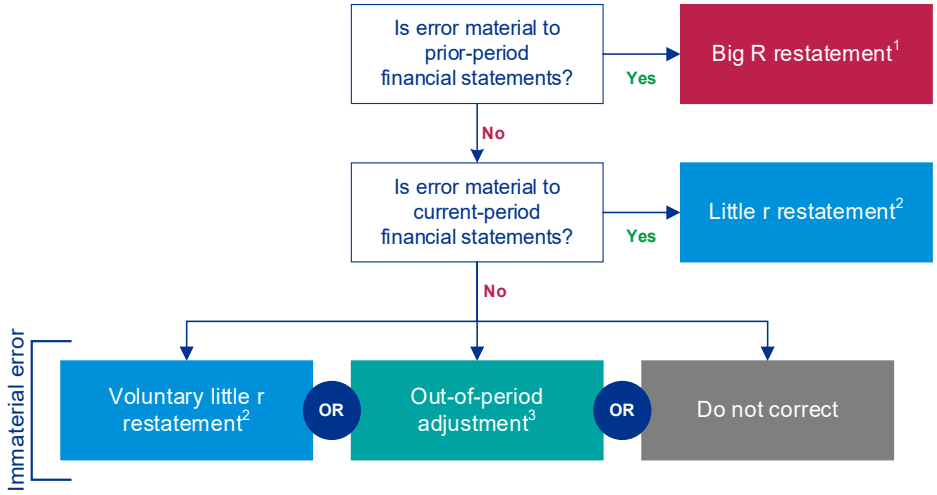
Read more: Chapter 3

Error corrections

An error (or misstatement) in the application of US GAAP might be a monetary misstatement, an incorrect classification, or an omitted or incomplete/ inaccurate disclosure. This Handbook uses the terms 'error' and 'misstatement' interchangeably.

An error can be material by its size (quantitatively material) and/or its nature (qualitatively material). Qualitative factors could cause misstatements of quantitatively small amounts to be material. Errors are assessed individually and in the aggregate – in relation to specific financial statement captions and disclosures, and the financial statements as a whole.

In considering how errors should be corrected in the financial statements, the starting point is to determine whether the prior-period financial statements are materially misstated. The following diagram summarizes the accounting.



Notes:

1. Restate and reissue prior-period financial statements.
2. Restate and revise prior-period financial statements the next time those financial statements are presented.
3. Correct in current-period financial statements.

Read more: Chapter 4

Interim periods

The guidance on interim financial statements includes accounting changes and errors corrections – i.e. the same items that are discussed in the context of annual reporting – with the benefit of additional guidance for interim periods.

However, unlike for annual reporting, Topic 250 includes a defined set of additional items that result in retrospective adjustment to prior interim periods if certain criteria are met.

The following diagram highlights the areas of guidance for interim reporting.

Accounting changes	Error corrections	Other adjustments
Concept consistent with annual reporting	**Concept consistent with annual reporting**	**Specific to interim reporting**
Retrospective adjustment if material: • Accounting principle (method) • Reporting entity Prospective recognition: • Estimate	• Reissuance restatement, if material • Supplemental materiality guidelines for interim reporting	Retrospective adjustment if certain criteria met: • Settlement of litigation or similar claims • Certain income taxes • Renegotiation proceedings • Utility revenue under rate-making processes

Read more: Chapter 5

SEC registrants

Preferability letters

A preferability letter is a letter from an SEC registrant's independent accountant indicating whether the registrant's accounting change is, in the judgment of the independent accountant, preferable under the circumstances. There are numerous types of accounting changes, but only a voluntary change in accounting principle (method) requires a preferability letter.

Recently issued ASUs

When a new accounting standard has been issued, but has not yet been adopted, a registrant discloses the items highlighted below. This enables financial statement users to not only be aware of the impending change, but also to understand the expected significance of the change. We believe these disclosures are best practice for all entities.

Area	Disclosure
Background	Brief description of ASU
Timing	Required adoption date and the registrant's expected adoption date (if earlier)
Method of adoption	Allowable methods of adoption and method the registrant expects to use (if determined)
Effect of the ASU	• Effect that adoption is expected to have on the registrant's financial statements, if known or reasonably estimable

Area	Disclosure
	• If not known or reasonably estimable, further qualitative disclosures
Other consequential effects	Other significant matters the registrant believes might result from adoption – e.g. technical violations of debt covenant agreements and planned or intended changes in business practices.

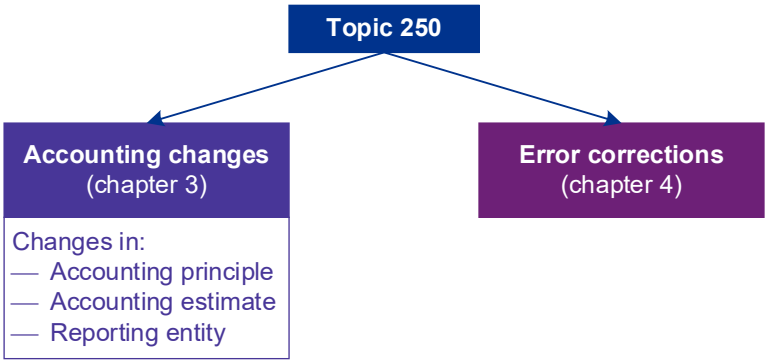
Read more: Chapter 6

2. Scope and materiality

Detailed contents

2.1 How the standard works

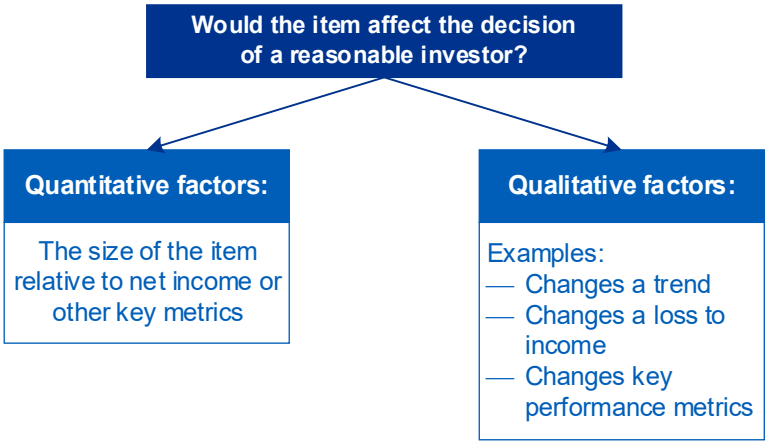
The following diagram summarizes the scope of Topic 250.



Although not explicitly in the scope of Topic 250, we believe that changes in classification and presentation should be accounted for in the same way as other accounting changes.

The concept of materiality is integral to the application of Topic 250, and in particular to evaluating a misstatement. We believe all entities should consider the SEC staff's interpretive guidance on materiality in SAB Topic 1M (codified from SAB No. 99), which is based on the Supreme Court's position that a fact is material if there is a substantial likelihood that it would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available.

As shown in the diagram, an item can be material by its size (quantitatively material) or its nature (qualitatively material). Materiality is the key driver of the accounting for error corrections, and is discussed in more depth in section 4.3. There is no one-size-fits-all rule of thumb that can be applied by all entities to evaluate materiality.



2.2 Scope of Topic 250

Excerpt from ASC 250-10

05-1 This Subtopic provides guidance on the accounting for and reporting of accounting changes and error corrections. An **accounting change** can be a change in an accounting principle, an accounting estimate, or the reporting entity. Guidance for each of these types of changes is presented in separate headings within each Section. Guidance for error corrections is also presented under a separate heading within each Section.

> Entities

15-2 The guidance in this Subtopic applies to all entities.

> Other Considerations

15-3 The guidance in this Subtopic applies to each of the following items for business entities and not-for-profit entities (NFPs):

a. Financial statements
b. Historical summaries of information based on primary financial statements that include an accounting period in which an accounting change or error correction is reflected.

15-4 This Topic does not change the transition provisions of any existing guidance.

Topic 250 provides guidance on accounting for and reporting of: [250-10-05-1]

- accounting changes, which can be a change in:
  - accounting principle;
  - accounting estimate; or
  - reporting entity; and
- error corrections.

Question 2.2.10 Which entities are in the scope of Topic 250?

Interpretive response: Topic 250 applies to *all* entities that prepare financial information. This includes both business entities, whether public or private, and NFPs. [250-10-15-2]

Question 2.2.20 What types of financial information are in the scope of Topic 250?

Interpretive response: Topic 250 applies to: [250-10-15-3]

- financial statements; and
- historical summaries of information that are based on the primary financial statements.

'Historical summaries of information' is not a defined term, but is generally understood to mean information based on the financial statements that is included in a different document, which may or may not also contain the financial statements. Selected financial data (e.g. five-year table) voluntarily included in Form 10-K and financial information in a private entity's annual report are examples of historical summaries of information.

Question 2.2.30 Does Topic 250 apply to both annual and interim periods?

Interpretive response: Yes, Topic 250 applies to both annual and interim periods. However, in some cases the requirements for interim periods are different from those for annual periods (see chapter 5). [250-10-15-2]

Question 2.2.40 Does Topic 250 apply when an accounting principle is being applied for the first time?

Interpretive response: It depends. Topic 250 does not apply when an accounting principle is applied for the first time because it was previously not applicable or was immaterial (see Question 3.3.20). Further, if an entity adopts a new ASU that includes specific transition guidance, it applies the requirements of that ASU in the first instance (see Question 3.3.10).

Conversely, Topic 250 does apply when an accounting principle is applied for the first time because the previous policy was material and did not comply with GAAP (see Question 3.2.90) or when an ASU does not include specific transition guidance. [250-10-05-2, 45-1, 45-3]

Question 2.2.50 Does Topic 250 apply to changes in classification and presentation?

Interpretive response: It depends. While Topic 250 does not provide specific guidance on changes in classification and presentation, such a change might constitute:

- a change in accounting principle, in which case the guidance in chapter 3 applies; or
- the correction of an error, in which case the guidance in chapter 4 applies.

However, changes in classification or presentation are often neither the correction of an error nor considered a change in accounting principle (see Question 3.2.40). In this case, Topic 250 does not apply but the general principles of Topic 205 (financial statement presentation) do. See section 3.5.

2.3 The concept of materiality

Excerpt from Concepts Statement No. 8

QC11. Relevance and materiality are defined by what influences or makes a difference to an investor or other decision maker; however, the two concepts can be distinguished from each other. Relevance is a general notion about what type of information is useful to investors. Materiality is entity specific. The omission or misstatement of an item in a financial report is material if, in light of surrounding circumstances, the magnitude of the item is such that it is probable that the judgment of a reasonable person relying upon the report would have been changed or influenced by the inclusion or correction of the item.

QC11A. A decision not to disclose certain information or recognize an economic phenomenon may be made, for example, because the amounts involved are too small to make a difference to an investor or other decision maker (they are immaterial). However, magnitude by itself, without regard to the nature of the item and the circumstances in which the judgment has to be made, generally is not a sufficient basis for a materiality judgment.

QC11B. No general standards of materiality could be formulated to take into account all the considerations that enter into judgments made by an experienced, reasonable provider of financial information. That is because materiality judgments can properly be made only by those that understand the reporting entity's pertinent facts and circumstances. Whenever an authoritative body imposes materiality rules or standards, it is substituting generalized collective judgments for specific individual judgments, and there is no reason to suppose that the collective judgments always are superior.

The provisions of the Codification are not required to be applied to immaterial items. This refers to any provision from the Codification (whether existing guidance or a new ASU) and, in particular, the requirements in Topic 250 related to accounting changes and error corrections. [105-10-05-6]

This section discusses the general concept of materiality that is applied in US GAAP and that is integral to the application of Topic 250. The evaluation of whether an error is material is discussed in section 4.3.

Question 2.3.10 What guidance on materiality applies?

Interpretive response: The concept of materiality is not discussed in either Topic 105 (generally accepted accounting principles) or Topic 250, but some guidance on materiality is included in FASB Concepts Statement No. 8 (CON 8).

CON 8 was amended in 2018 to reflect an up-to-date understanding of the reporting environment, and to clearly distinguish between relevance (related to the broader financial reporting environment) and materiality (specific to an entity). [CON 8.BC3.18–BC3.18A]

The purpose of the FASB Concepts Statements is to establish concepts that the FASB itself uses in developing guidance; as such, it is not authoritative for entities in preparing their financial statements. However, it provides a framework that is consistent with the precedent on 'materiality' established by the Supreme Court, and with the SEC staff's interpretive guidance that is derived from the Supreme Court precedent. For this reason, we believe all entities should consider the SEC staff's interpretive guidance on materiality (see Appendix). [CON 8.QC11 – QC11B, SAB Topic 1M]

As reported in SAB Topic 1M (codified from SAB No. 99), "The Supreme Court has held that a fact is material if there is — a substantial likelihood that the...fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."

Question 2.3.20 Who is a 'reasonable investor'?

Interpretive response: The concept of a 'reasonable investor' (or 'reasonable person') is used as the basis for determining what is material. There is no definition, but the term derives from the Supreme Court precedent on materiality discussed in Question 2.3.10. The reasonable person is a user of the financial statements who relies on their accuracy to make economic decisions.

The reasonable person test does not consider every financial statement user individually, but instead as a group. An entity should assume that financial statement users: [AU-C 320.04]

- have a reasonable knowledge of business and economic activities and accounting, and a willingness to study the information in the financial statements with reasonable diligence;
- understand that financial statements are prepared, presented and audited to levels of materiality;
- recognize the uncertainties inherent in the measurement of amounts based on the use of estimates, judgment and the consideration of future events; and
- make reasonable economic decisions based on all information in the financial statements.

The term 'reasonable person' may also include regulators, lenders and other users of the financial statements.

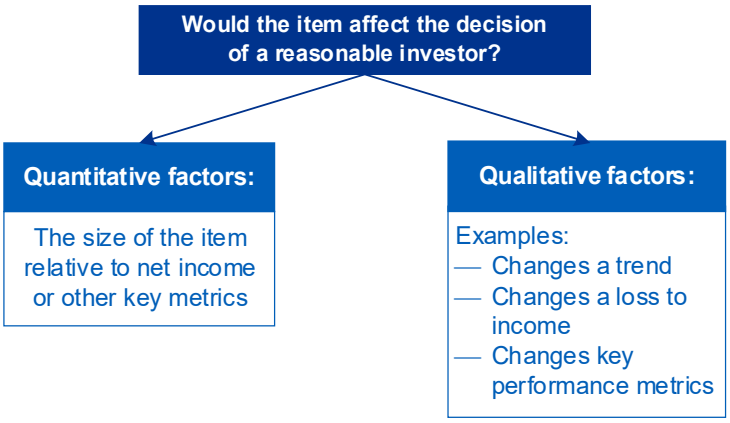
Question 2.3.30 Does an entity assess materiality differently for different groups of financial statement users?

Interpretive response: No. There is no requirement to consider every financial statement user (or possible user) individually, because users' needs may vary widely. While the nature of the users of the financial statements is a key consideration in determining materiality, entities do not determine different materialities for different users. Instead, an entity considers the financial statement users as one group that relies on the accuracy of the financial statements and considers the common financial information to make decisions. This group could be influenced by several of the factors relevant to a materiality assessment (see Question 2.3.40).

Question 2.3.40 What are the components of a materiality assessment?

Interpretive response: There is no one-size-fits-all rule of thumb that can be applied by all entities to evaluate materiality. Materiality is often erroneously measured only in quantitative terms, thought of as a number, which may be based on a percentage of a particular metric. Historically, rules of thumb such as 5% of net income or profit before tax from continuing operations have been used as a guide. [SAB Topic 1M]

However, as shown in the diagram, a materiality assessment is more complex and has two components.



An item can be material by its size (quantitatively material) or its nature (qualitatively material). Qualitative factors could cause quantitatively small amounts to be material. Items are assessed individually and in the aggregate in relation to specific financial statement captions and disclosures, and to the financial statements as a whole.

Materiality is the key driver of the accounting for error corrections, and is discussed in more depth in section 4.3.

Question 2.3.50 Does the concept of materiality relate only to financial statement amounts, or also to disclosures?

Interpretive response: The concept of materiality applies to both recording information in the entity's books and records, and disclosing information in the financial statements. [CON 8.QC11A]

3. Accounting changes

Detailed contents

New item added in this edition: **
Item significantly updated in this edition: #

Questions

Question 3.3.10 Does the transition method in Topic 250 apply when an entity adopts a new ASU?

Question 3.3.20 Does Topic 250 apply when an entity applies an accounting principle that was previously not relevant or was immaterial?

Question 3.3.25 Does Topic 250 apply when aligning accounting principles between a parent and its subsidiaries?

Question 3.3.30 Does a change to a method that the Codification presents as preferable require a preferability assessment?

Question 3.3.35 Does a change to start or stop applying a practical expedient in US GAAP require a preferability assessment?**

Question 3.3.40 Does a change to an alternative when a method is no longer acceptable require a preferability assessment?

Question 3.3.45 Does a change in accounting principle resulting from an entity becoming a public entity require a preferability assessment?**

Question 3.3.50 Does a change in estimate effected by a change in accounting principle require a preferability assessment?

Question 3.3.60 Does a change resulting from new events or transactions require a preferability assessment?

Question 3.3.70 Can preferability be justified for a change to a method that differs from a new, but not yet effective, ASU?

Question 3.3.80 Can preferability be justified for a change to a method in a proposed ASU?

Question 3.3.90 Can preferability be justified by general economic trends, consumer demand or marketing methods?

Question 3.3.100 Is a preferability justification invalidated if an entity must later abandon its business plans or judgment because of economic or other factors?

Question 3.3.110 Can preferability be justified by changes in technology?

Question 3.3.120 Can preferability be justified by standard industry practice?

Question 3.3.130 Is an entity's preferability assessment constrained by support for a different accounting principle expressed by its independent accountant?

Question 3.3.140 Can preferability be justified by an income tax benefit arising from the change?

Question 3.3.150 If an entity changes to a preferable accounting principle, can it later revert back to the original accounting principle?

Examples

3.4 Change in accounting estimate

Questions

Question 3.4.10 How does an entity account for a change in accounting estimate that is inseparable from a change in accounting principle?

Question 3.4.20 How does an entity distinguish between a change in estimate and an error correction?

Question 3.4.30 Does a change in estimate require a preferability assessment?

Question 3.4.40 Does a predetermined change in depreciation method require a preferability assessment?

Question 3.4.50 What are the general disclosure requirements for changes in estimates?

Question 3.4.60 Are the disclosures required if the effect is immaterial in the period of change?

Example

Example 3.4.10 Change in depreciation estimates and method

3.5 Change in classification or presentation

Questions

Question 3.5.10 Does a change in presentation require retrospective application?

Question 3.5.20 Does a change in presentation require specific disclosures?#

3.6 Change in reporting entity

Questions

Question 3.6.10 What changes in reporting entity are in the scope of Topic 250?

Question 3.6.20 Does a reverse acquisition give rise to a change in reporting entity?

Question 3.6.30 Does a sale or partial sale of an interest in a subsidiary give rise to a change in reporting entity?

Question 3.6.40 Does the spinoff of a subsidiary give rise to a change in reporting entity?

Question 3.6.50 Does a combination of entities under common control give rise to a change in reporting entity?

Question 3.6.60 Is a change in reporting entity presented in the same way as a change in accounting principle?

Question 3.6.70 How is a change in reporting entity related to a combination of entities under common control presented when the control relationship did not exist for all periods presented?

Question 3.6.80 How is a change in reporting entity presented when it occurs after the reporting date?

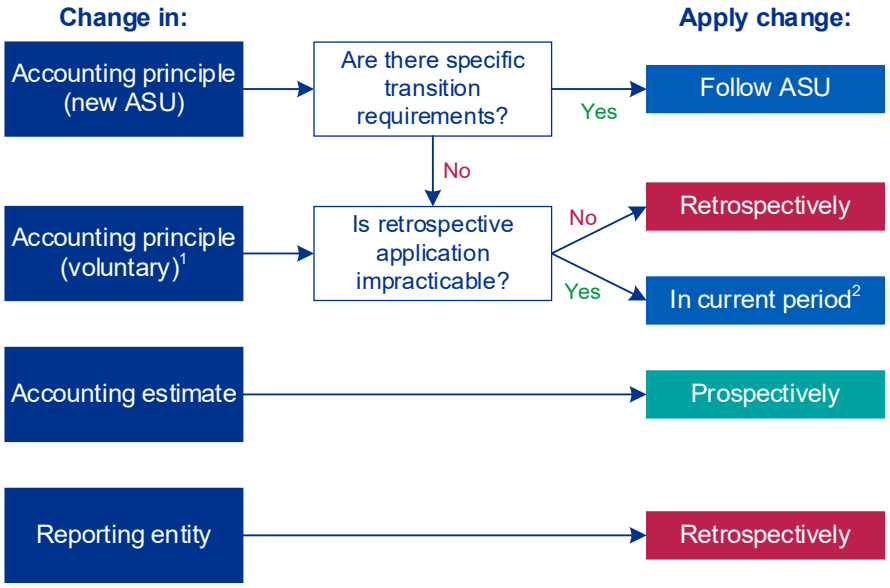
Question 3.6.90 What are the disclosure requirements for a change in reporting entity?

Question 3.6.100 Are the disclosures required every time the financial statements for the period of change are presented (i.e. as comparative information)?

Question 3.6.110 Are the disclosures required if the effect is immaterial in the period of change?

3.1 How the standard works

Topic 250 discusses three types of accounting changes that do not arise from an error, and the different accounting approaches are summarized in the following diagram.



Notes:

1. For all entities, the change must be 'preferable'; in addition, SEC registrants require a preferability letter in some cases. For purposes of applying Topic 250, a change in accounting principle includes a change in accounting method.
2. A cumulative catch-up adjustment is recognized. If an entity is able to apply a change partly (but not fully) retrospectively, it applies the change retrospectively to the extent it is able.

Topic 250 does not provide specific guidance on changes in classification and presentation that do not rise to the level of a change in accounting principle and are not errors. However, similar to a change in accounting principle, we believe an entity should apply the change retrospectively.

3.2 Distinguishing between accounting changes

Excerpt from ASC 250-10

20 Glossary

Accounting Change

A change in an accounting principle, an accounting estimate, or the reporting entity. The correction of an error in previously issued financial statements is not an accounting change.

Change in Accounting Estimate

A change that has the effect of adjusting the carrying amount of an existing asset or liability or altering the subsequent accounting for existing or future assets or liabilities. A change in accounting estimate is a necessary consequence of the assessment, in conjunction with the periodic presentation of financial statements, of the present status and expected future benefits and obligations associated with assets and liabilities. Changes in accounting estimates result from new information. Examples of items for which estimates are necessary are uncollectible receivables, inventory obsolescence, service lives and salvage values of depreciable assets, and warranty obligations.

Change in Accounting Estimate Effected by a Change in Accounting Principle

A change in accounting estimate that is inseparable from the effect of a related change in accounting principle. An example of a change in estimate effected by a change in principle is a change in the method of depreciation, amortization, or depletion for long-lived, nonfinancial assets.

Change in Accounting Principle

A change from one generally accepted accounting principle to another generally accepted accounting principle when there are two or more generally accepted accounting principles that apply or when the accounting principle formerly used is no longer generally accepted. A change in the method of applying an accounting principle also is considered a change in accounting principle.

Distinguishing between a change in accounting principle and a change in accounting estimate is key to accounting for them, because these two types of changes are accounted for differently.

Question 3.2.10 What is the difference between a principle, a method, an estimate and a technique?

Interpretive response: For purposes of applying Topic 250, an accounting change is either a change in accounting principle or a change in accounting estimate. However, while Topic 250 addresses the accounting for these changes, it does not explicitly define the underlying terms.

Principles and methods

A principle specifies how to account for a class of transactions, events or elements (e.g. assets) in the financial statements. A method is the mechanism for executing that principle, which may be specified by the relevant standard or at the discretion of the entity to achieve the principle.

The following are examples.

Principle	Method
Inventory is measured at the lower of cost and either market or net realizable value (depending on the inventory valuation method chosen). [330-10-35]	An entity chooses to measure cost using FIFO as its inventory valuation method.
For graded-vesting stock options awarded to employees, an entity recognizes compensation cost over the employees' requisite service periods. [718-10-35-5, 35-8]	For service-only awards, an entity chooses to recognize compensation cost over the requisite service period for each separately vesting portion (or tranche) of the award.

For purposes of applying Topic 250, accounting and reporting for a change in the method of applying an accounting principle is the same as for a change in an accounting principle. Therefore, in this Handbook generally they are referred to collectively as changes in accounting principle.

Estimates

Faced with uncertainty, an estimate is the outcome of applying an accounting principle (method) using the best information available at the measurement date. Estimates are pervasive to the application of US GAAP and change as new information becomes available – e.g. estimates of fair value under Topic 820, and the estimated rate of forfeitures in accounting for share-based payment awards.

Question 3.2.20 discusses changes in estimates that cannot be distinguished from changes in accounting principle.

Techniques

An accounting 'technique' might refer to a method or an estimate depending on the context, and in some cases might be an estimate that is inseparable from an accounting principle. Therefore, it is necessary to understand how the term is being used to determine the type of accounting change it represents.

Within the Codification itself, the most common usage is related to a valuation technique in measuring fair value under Topic 820. In that context, a technique refers to an estimate (see Question 3.2.60).

Question 3.2.20 When is a change in estimate inseparable from a change in accounting principle?#

Excerpt from ASC 250-10

• > Change in Accounting Estimate

45-18 Distinguishing between a change in an accounting principle and a change in an accounting estimate is sometimes difficult. In some cases, a change in accounting estimate is effected by a change in accounting principle. One example of this type of change is a change in method of depreciation, amortization, or depletion for long-lived, nonfinancial assets (hereinafter referred to as depreciation method). The new depreciation method is adopted in partial or complete recognition of a change in the estimated future benefits inherent in the asset, the pattern of consumption of those benefits, or the information available to the entity about those benefits. The effect of the change in accounting principle, or the method of applying it, may be inseparable from the effect of the change in accounting estimate. Changes of that type often are related to the continuing process of obtaining additional information and revising estimates and, therefore, shall be considered changes in estimates for purposes of applying this Subtopic.

Interpretive response: It is not always easy to separate a change in accounting estimate from a change in accounting principle (method); this is because the change in principle is driven by or otherwise intertwined with the change in estimate. The example provided in Topic 250 is a change in the method of depreciation, amortization or depletion for long-lived, nonfinancial assets. Such cases are referred to as a 'change in accounting estimate effected by a change in accounting principle' and often require significant judgment. They are accounted for as changes in estimates (i.e. accounted for prospectively) but preferability assessments are required to support the changes (see Question 3.4.10). [250-10 Glossary, 250-10-45-18]

Another example is an investment company that changes its methodology for calculating return of capital distributions from the prior period under Topic 946 (investment companies). Assuming there was no error in previously measuring return of capital distributions, we believe this is a change in accounting estimate effected by a change in accounting principle.

In contrast, we believe that changing from an accounting principle that did not involve an estimate to an accounting principle that does involve an estimate is a change in accounting principle rather than a change in estimate effected by a change in accounting principle. For example, we believe an investment company is making a change in accounting principle when it changes its cost relief methodology under Topic 946 to account for partial redemptions of investments in limited partnerships from the cost recovery method (no estimation required) to the average cost method (estimation required). As a change in accounting principle, both retrospective application and a preferability assessment to support the change are required (see sections 3.3.20 and 3.3.30).

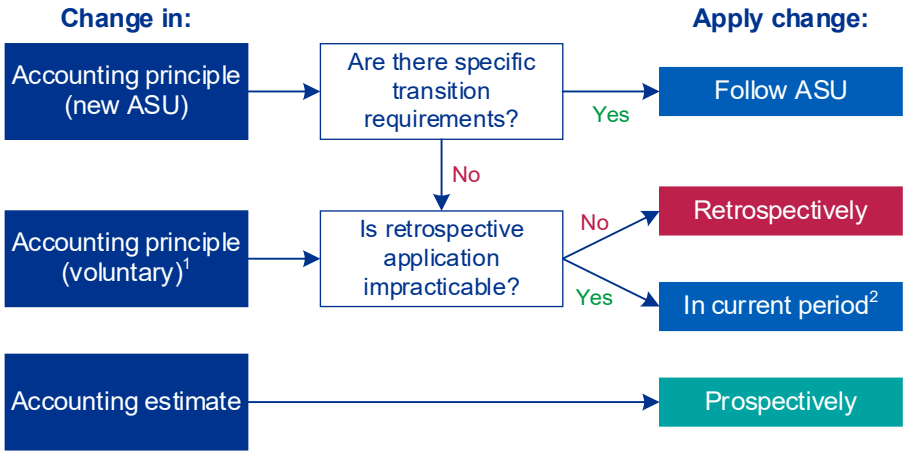
The following table summarizes the accounting implications of the three scenarios discussed above.

Methods' estimation requirements	Type of change	Accounting treatment	Preferability assessment required?
Change in depreciation method			
Both pre-change and post-change methods require estimation	Change in estimate effected by change in accounting principle	Prospective	Yes
Change in return of capital calculation method (investment companies)			
Both pre-change and post-change methods require estimation	Change in estimate effected by change in accounting principle	Prospective	Yes
Change from cost recovery method to average cost method for partial redemptions of investments in limited partnerships (investment companies)			
Pre-change method requires no estimation Post-change method requires estimation	Change in accounting principle	Retrospective	Yes

Question 3.2.30 How does the accounting for a change in accounting principle differ from a change in estimate?

Interpretive response: A voluntary change in accounting principle (method) – i.e. not one that is required by an ASU – is permitted only if the change is preferable to the existing principle, which is assessed based on individual facts and circumstances (see section 3.3.20). A preferability assessment is generally not required for a change in accounting estimate (see Question 3.4.30).

A change in accounting principle is applied retrospectively to the extent that such application is not impracticable (see section 3.3.30). In contrast, a change in accounting estimate is applied prospectively (see Question 3.4.10). This difference is highlighted in the following diagram.



Notes:

1. The change must be 'preferable'.
2. A cumulative catch-up adjustment is recognized. If an entity is able to apply a change partly (but not fully) retrospectively, it does that.

Question 3.2.40 What type of accounting change is a change in classification or presentation?

Interpretive response: Topic 250 does not provide specific guidance on changes in classification and presentation, and we believe such changes do not always rise to the level of a change in accounting principle.

For example, we do not believe the following changes in presentation are a change in accounting principle because the changes do not materially affect the level of information provided to the users of the financial statements.

- An entity that previously showed SG&A expenses together on the face of the income statement decides to separate selling from general and administrative expenses.
- An entity changes from presenting a single statement of comprehensive income to two consecutive statements (income statement followed by a statement of comprehensive income) – or vice versa.

However, we believe the following are changes in accounting principle, and therefore the guidance in section 3.3 applies.

- An entity changes the presentation of its balance sheet – from a classified to an unclassified balance sheet or vice versa.
- An entity changes the presentation of its statement of cash flows from the indirect to the direct method of presenting operating cash flows. Question 3.3.20 in KPMG Handbook, Statement of cash flows, discusses how to address preferability in that case.

In some cases, a change in classification or presentation represents the correction of an error. For example, a retailer discovers that certain selling expenses for one of its regional locations were classified as cost of goods sold instead of SG&A expenses in the income statement for the last three years.

The change in classification required is the correction of an error (see chapter 4).

For discussion of the appropriate presentation and disclosure for a change in classification or presentation that is *not* a change in accounting principle or the correction of an error, see section 3.5.

Question 3.2.50 What type of accounting change is a change in valuation technique or model under Topic 718?

Excerpt from SAB Topic 14C

Valuation Methods

Question 3: In subsequent periods, may a company change the valuation technique or model chosen to value instruments with similar characteristics?[26]

Interpretive Response: As long as the new technique or model meets the fair value measurement objective as described in Question 2 above, the staff would not object to a company changing its valuation technique or model.[27] A change in the valuation technique or model used to meet the fair value measurement objective would not be considered a change in accounting principle. As such, a company would not be required to file a preferability letter from its independent accountants as described in Rule 10-01(b)(6) of Regulation S-X when it changes valuation techniques or models.[28] However, the staff would not expect that a company would frequently switch between valuation techniques or models, particularly in circumstances where there was no significant variation in the form of share-based payments being valued. Disclosure in the footnotes of the basis for any change in technique or model would be appropriate.

[26] FASB ASC paragraph 718-10-55-17 indicates that an entity may use different valuation techniques or models for instruments with different characteristics.

[27] The staff believes that a company should take into account the reason for the change in technique or model in determining whether the new technique or model meets the fair value measurement objective. For example, changing a technique or model from period to period for the sole purpose of lowering the fair value estimate of a share option would not meet the fair value measurement objective of the Topic.

[28] FASB ASC paragraph 718-10-55-27.

Background: In applying Topic 718 (stock compensation), the measurement objective is to estimate, at the grant date, the fair value of the award to which grantees become entitled when they have delivered the goods or rendered services and satisfied other conditions necessary to earn the right to benefit from the award. The estimate of fair value is based on share price and other factors as of the grant date (the measurement date). Therefore, this fair value measure is referred to as grant-date fair value. [718-10-30-6]

Interpretive response: A change in valuation technique or model in applying Topic 718 is a change in estimate (see section 3.4). [SAB Topic 14C (Q3)]

However, the SEC staff cautions entities to carefully consider the appropriateness of any change in valuation technique or model. Factors to consider include whether there is any difference in the form of the share-based payments that justifies a change, and the reason for the change in the context of meeting the fair value measurement objective.

We believe this guidance should be applied by all entities.

Question 3.2.60 What type of accounting change is a change in valuation technique or premise under Topic 820?

Background: In applying Topic 820, generally the valuation technique used to measure the fair value of a particular item is consistently applied. However, a change in valuation technique (or its application) is required if the change results in a value that is more representative of fair value, or may be made if the change results in a value that is equally representative of fair value. This might occur if, for example, new markets develop, new information becomes available or is no longer available, or valuation techniques improve. [820-10-35-25]

Interpretive response: A change in valuation technique or premise is a change in estimate. This is consistent with the SEC staff's approach to a change in valuation method or model related to share-based payments (see Question 3.2.50). [820-10-35-26]

The following are examples.

- The basis of measuring the fair value of certain securities may change from dealer markets to an exchange market because a new market develops that meets the criteria in Topic 820. See Question F10 in KPMG Handbook, Fair value measurement.
- A combination of valuation techniques (under the market and income approaches) may be used to measure fair value, and judgment is then used to apply a weighting that results in a measurement most representative of fair value; in theory, each measure of fair value should converge as the calculations in each are further refined. The judgment about the appropriate weighting to apply may change over time. See Question F20 in KPMG Handbook, Fair value measurement.
- One of an entity's reporting units for goodwill impairment testing purposes is a stand-alone legal entity that has originated debt without any guarantees or recourse to a parent entity; as a result, in measuring fair value the entity changes the valuation premise of the reporting entity from an equity premise to an enterprise premise. See section 8.3.20 in KPMG Handbook, Impairment of nonfinancial assets.

For a discussion of the appropriate accounting for a change in estimate, see section 3.4. However, for changes in estimates related to the measurement of

fair value, the relevant disclosures are in Topic 820 and the requirements in Topic 250 do not apply. [250-10-50-5, 820-10-50-7]

Question 3.2.70 What type of accounting change is a change in the date of performing the annual goodwill impairment test?

Interpretive response: A change in the date of performing the annual goodwill impairment test is a change in the method of applying an accounting principle. Regardless of materiality, the change is generally accounted for prospectively. This is because retrospective application under Topic 250 is deemed impracticable if: [250-10-45-2, 45-9]

- it would require assumptions about management's intent in a prior period that cannot be independently substantiated; or
- it requires significant estimates of amounts and it is impossible to objectively distinguish information about those estimates that provides evidence of circumstances that existed on the date at which those amounts would be measured (i.e. indistinguishable from the use of hindsight).

See section 4.2 of KPMG Handbook, Impairment of nonfinancial assets.

However, even though the change must be preferable (see section 3.3.20), a preferability letter is not required if certain criteria are met (see Question 6.2.30).

Question 3.2.80 What type of accounting change is a change in the functional currency of a foreign operation?

Excerpt from ASC 830-10

• > Changes in the Functional Currency

45-7 Once the functional currency for a foreign entity is determined, that determination shall be used consistently unless significant changes in economic facts and circumstances indicate clearly that the **functional currency** has changed. Previously issued financial statements shall not be restated for any change in the functional currency.

Interpretive response: A change in the functional currency of a foreign entity is not a change in accounting principle. Therefore, the cumulative translation adjustments of prior periods are not removed from equity, and the exchange rate on the date of the change becomes the historical rate for subsequent remeasurement of nonmonetary assets and liabilities into the new functional currency. [830-10-45-7]

For further discussion about accounting for changes in functional currency, see KPMG Handbook, Foreign currency, beginning at paragraph 4.023.

Question 3.2.90 Is a change from a non-GAAP accounting principle to one that is acceptable an accounting change?

Interpretive response: No, this is not an accounting change. A material change from an accounting principle that is not generally accepted to one that is generally accepted is the correction of an error (see chapter 4).

See also Question 2.2.40 (applying an accounting principle for the first time), Question 4.2.20 (small departures from GAAP) and Example 3.3.10.

Question 3.2.100 Is a change in accounting basis considered an accounting change under Topic 250?**

Interpretive response: No. Topic 250 only addresses accounting changes within the same accounting basis. There is no broad US GAAP addressing changes in accounting basis, but specific types of basis changes are addressed. [TQA 9030.10]

For example, adopting the liquidation basis of accounting is a change in accounting basis that is specifically addressed in the Codification. When liquidation is imminent as defined under Subtopic 205-30 (liquidation basis of accounting), an entity needs to cease preparing financial statements under the going concern basis of accounting and adopt the liquidation basis of accounting. Subtopic 205-30, rather than Topic 250, provides the specific measurement, recognition, presentation and disclosure requirements that apply to this change. [205-30-25-2, 205-40-05-1]

Another example is when an entity is acquired by a new parent and elects pushdown accounting in its separate financial statements, as permitted under Subtopic 805-50. Electing pushdown accounting upon the change-in-control event establishes a new basis of accounting from the acquisition date forward – i.e. prior periods are not restated. Conversely, electing pushdown accounting at a later date (i.e. not when the change-in-control event occurred) is a change in accounting principle and pushdown accounting is applied as of the most recent change-in-control event (see section 27 of KPMG Handbook, Business combinations). [805-50-25-7]

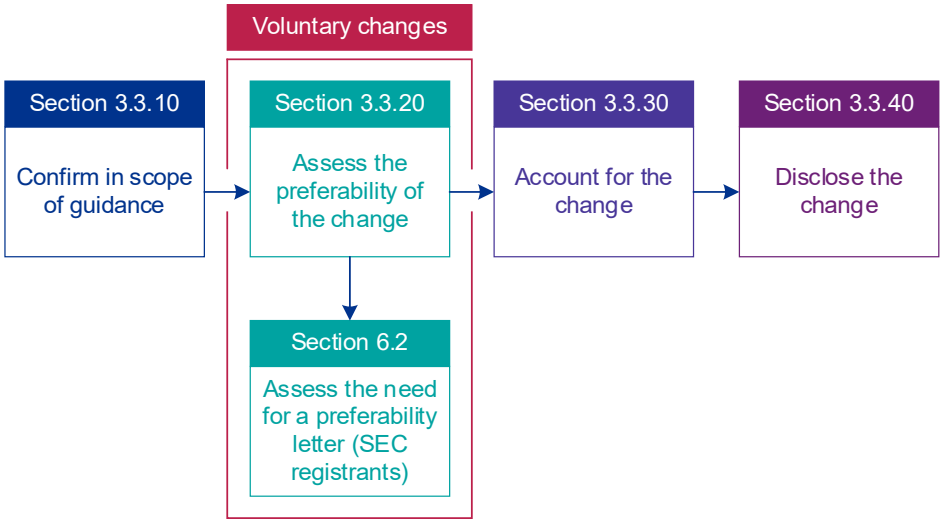
When no specific guidance applies to a change in accounting basis (e.g. transition from the accrual basis of accounting to the cash basis of accounting), we believe the change should be accounted for by retrospectively restating all periods presented as if the new basis of accounting had always been applied. [TQA 9030.10]

Question 3.2.110 Is adopting US GAAP as a new financial reporting framework considered an accounting change under Topic 250?**

Interpretive response: No. Transitioning from home-country GAAP (e.g. IFRS® Accounting Standards) to US GAAP is the adoption of a new financial reporting framework rather than a change in accounting principle under Topic 250. While the Codification does not address this change, the SEC staff has stated that US GAAP should be applied on a fully retrospective basis. This means the financial statements and selected financial data for all periods presented must be restated to reflect the application of US GAAP as if US GAAP had always been applied. We believe this guidance should be applied by all entities. [IRDI 10/1/03]

3.3 Change in accounting principle

This section goes through the stages that are part of accounting for a change in accounting principle (method). Specific to voluntary changes in accounting principle, this includes justifying that the change is preferable and determining the need for a preferability letter (SEC registrants).



3.3.10 Confirm in scope of the guidance

Excerpt from ASC 250-10

• > Change in Accounting Principle

45-1 A presumption exists that an accounting principle once adopted shall not be changed in accounting for events and transactions of a similar type. Consistent use of the same accounting principle from one accounting period to

another enhances the utility of financial statements for users by facilitating analysis and understanding of comparative accounting data…

45-2 A reporting entity shall change an accounting principle only if either of the following apply:

a. The change is required by a newly issued Codification update.
b. The entity can justify the use of an allowable alternative accounting principle on the basis that it is preferable

As discussed in Question 3.2.10, an accounting principle specifies how to account for a class of transactions, events or elements (e.g. assets) in the financial statements. A method is the mechanism for executing that principle, which may be specified by the relevant standard or at the discretion of the entity to achieve the principle. For purposes of applying Topic 250, a method of applying an accounting principle is the same as an accounting principle.

Question 3.3.10 Does the transition method in Topic 250 apply when an entity adopts a new ASU?

Excerpt from ASC 250-10

> Accounting Changes

05-2 This Subtopic establishes, unless impracticable, **retrospective application** as the required method for reporting a **change in accounting principle** in the absence of explicit transition requirements specific to a newly adopted accounting principle.

Interpretive response: It depends. Usually a new ASU includes specific transition guidance, in which case an entity applies those transition requirements. An entity applies the transition method in Topic 250 only if the ASU is silent. [250-10-05-2]

Question 3.3.290 discusses relevance of Topic 250 disclosures when adopting a new ASU.

Question 3.3.20 Does Topic 250 apply when an entity applies an accounting principle that was previously not relevant or was immaterial?

Excerpt from ASC 250-10

• > Change in Accounting Principle

45-1 Neither of the following is considered to be a change in accounting principle:

a. Initial adoption of an accounting principle in recognition of events or transactions occurring for the first time or that previously were immaterial in their effect
b. Adoption or modification of an accounting principle necessitated by transactions or events that are clearly different in substance from those previously occurring.

Interpretive response: No. An entity might apply an accounting principle for the first time because it was previously not applicable or was immaterial. [250-10-45-1]

For example, an entity that enters into its first business combination will apply Topic 805 for the first time. This is not considered an accounting change in the scope of Topic 250. However, Topic 250 does apply if an accounting principle should have been applied previously, but in error it was not (see chapter 4).

Whether an accounting principle, or a change therein, is material requires judgment. We believe that if an accounting principle is disclosed in the financial statements, it is generally material.

Example 3.3.10 Change in policy to capitalize inventory supplies

ABC Corp. has been operating for a few years and plans to start capitalizing supplies inventory used in the production of machine parts. ABC's previous policy was to expense supplies inventory when purchased.

Inventory includes items of tangible personal property that will be consumed in the production of goods or services that will be available for sale in the ordinary course of business. ABC's supplies meet that definition and therefore the aggregate costs of the supplies are capitalized as inventory (if material). [330-10 Glossary]

Scenario 1: Unrecorded supplies are immaterial

Because the amounts of unrecorded supplies inventory in prior periods were immaterial, ABC need not report the capitalization of supplies inventory in the current year as a change in accounting principle.

Scenario 2: Unrecorded supplies are material

Even though ABC is changing the way it recognizes the supplies, this change is due to an error and therefore is not treated as a change in accounting principle. Because the amounts of unrecorded supplies inventory in the prior periods were material and should have been recorded as inventory, ABC follows the specific guidance for the correction of an error (see chapter 4).

Question 3.3.25 Does Topic 250 apply when aligning accounting principles between a parent and its subsidiaries?

Interpretive response: It depends. In most scenarios, we expect the accounting principles to be aligned between a parent and its subsidiaries. However, alignment is not always required or possible and may require accounting changes to be subject to a preferability analysis. As further explained below, this question is assessed differently in the consolidated financial statements of the parent and the separate (standalone) financial statements of the subsidiary.

In the consolidated financial statements of the parent

Although US GAAP does not specifically address this issue, we believe accounting principles should be conformed in the consolidated financial statements of the parent unless: [250-10-45-1, 810-10-25-15]

- dissimilar operations provide a basis for different accounting principles; or
- the subsidiary is applying industry-specific guidance.

Therefore, when acquiring a subsidiary, the parent generally has the following options:

- Conform the subsidiary's principles to those of the parent. This is not considered an accounting change by the parent because it is presenting the consolidated information according to its existing accounting principles. [250-10-45-1]
- Conform the parent's principles to those of the subsidiary. This change is considered an accounting change and only permitted if the subsidiary's accounting principle is preferable to that of the parent. [250-10-45-2(b)]
- If the parent did not have an applicable established principle due to immateriality, it can adopt an accounting principle acceptable under US GAAP for the first time. [250-10-45-1]

For further guidance, see Questions 7.4.20 and 7.4.30 in KPMG Handbook, Consolidation, and paragraph 12.030 in KPMG Handbook, Business combinations.

In the separate financial statements of an acquired subsidiary

The accounting principles that an acquired entity (subsidiary) applies in its separate financial statements sometimes do not align with those of the acquirer (new controlling parent) at the date of acquisition. Post-acquisition, the subsidiary is not required, but may nevertheless seek, to conform its accounting principles to those of its new parent for practical reasons – e.g. to simplify consolidation procedures.

To conform some or all its accounting principles to those of its parent, we believe the subsidiary has the following options post-acquisition:

Apply pushdown accounting	Reflect a change in accounting principle	Justify that the new principle is preferable
Yes	No	No
No	Yes	Yes

As explained in section 27 of KPMG Handbook, Business combinations, an acquired entity is allowed, but not required, to apply pushdown accounting upon acquisition by a new controlling parent. In pushdown accounting, a new basis of accounting is established (see Question 3.2.100). Therefore, we believe a subsidiary can adopt new accounting principles in its separate financial statements when it elects pushdown accounting, without having to justify that the change is preferable – i.e. the change is not considered an accounting change. [250-10-45-1 – 45-2]

In the first-time issuance of separate financial statements by a subsidiary

There may be situations where a subsidiary needs to prepare separate financial statements for the first time – e.g. to issue to a lender or to future investors in preparation for the subsidiary to be sold or spun off or in conjunction with a public offering.

In our experience, a subsidiary generally prepares its first separate financial statements by selecting accounting principles consistent with those of its parent. This may be for practical reasons or because it is required to do so.

We believe a subsidiary should generally select accounting principles consistent with those of its parent, except in the following circumstances:

- Materiality – items that were immaterial to the parent's financial statements may be material to the subsidiary and new accounting principles need to be selected accordingly (see also Question 3.3.20);
- Adoption of accounting standards – the effective date of a new ASU for the parent and the subsidiary may be different based on the type and size of entity, and they may use a different transition method for adoption;
- Private company alternatives – if only the parent or subsidiary qualifies for private company alternatives; and
- Termination of one basis of accounting and application of a new basis – understanding when a subsidiary can change its basis of accounting requires consideration of all relevant facts and circumstances. For example:
  - A newly acquired subsidiary can change its basis of accounting by electing pushdown accounting after being acquired (see Question 3.2.100).
  - A subsidiary to be sold cannot change its basis of accounting until a change in control has occurred, at which point it can elect pushdown accounting.
  - In a pro rata spin-off, we believe the spun-off subsidiary cannot change its basis of accounting. This view is consistent with the fact that the parent distributes the holdings of the subsidiary on a pro rata basis to the parent's stockholders; therefore, there is in substance no change in

ownership and no justification for a new basis of accounting (e.g. fair value). [845-10-30-10]

Other than in the above circumstances, we believe a subsidiary adopting an accounting principle different from that of its parent is considered an accounting change for the subsidiary and only permitted if the subsidiary's new accounting principle is preferable to that of the parent's.

If any of the exceptions explained above exist and, as a result, accounting principles have been applied in the subsidiary's separate financial statements that are different from those of its parent, then the subsidiary's accounting principles generally need to be conformed to those of the parent in the consolidated financial statements.

3.3.20 Assess preferability of the change

Excerpt from ASC 250-10

• • > Justification for a Change in Accounting Principle

45-11 In the preparation of financial statements, once an accounting principle is adopted, it shall be used consistently in accounting for similar events and transactions.

45-12 An entity may change an accounting principle only if it justifies the use of an allowable alternative accounting principle on the basis that it is preferable. However, a method of accounting that was previously adopted for a type of transaction or event that is being terminated or that was a single, nonrecurring event in the past shall not be changed. For example, the method of accounting shall not be changed for a tax or tax credit that is being discontinued. Additionally, the method of transition elected at the time of adoption of a Codification update shall not be subsequently changed. However, a change in the estimated period to be benefited by an asset, if justified by the facts, shall be recognized as a **change in accounting estimate.**

45-13 The issuance of a Codification update that requires use of a new accounting principle, interprets an existing principle, expresses a preference for an accounting principle, or rejects a specific principle may require an entity to change an accounting principle. The issuance of such an update constitutes sufficient support for making such a change.

55-1 … In applying the guidance in this Subtopic, preferability among accounting principles shall be determined on the basis of whether the new principle constitutes an improvement in financial reporting and not on the basis of the income tax effect alone.

Excerpt from SAB Topic 6G.2

Accounting Series Releases 177 and 286—Relating to Amendments to Form 10-Q, Regulation S-K, and Regulations S-X Regarding Interim Financial Reporting

b. Reporting requirements for accounting changes

1. Preferability

Facts: Rule 10-01(b)(6) of Regulation S-X requires that a registrant who makes a material change in its method of accounting shall indicate the date of and the reason for the change. The registrant also must include as an exhibit in the first Form 10-Q filed subsequent to the date of an accounting change, a letter from the registrant's independent accountants indicating whether or not the change is to an alternative principle which in his judgment is preferable under the circumstances. A letter from the independent accountant is not required when the change is made in response to a standard adopted by the Financial Accounting Standards Board which requires such a change.

Question 1: For some alternative accounting principles, authoritative bodies have specified when one alternative is preferable to another. However, for other alternative accounting principles, no authoritative body has specified criteria for determining the preferability of one alternative over another. In such situations, how should preferability be determined?

Interpretive Response: In such cases, where objective criteria for determining the preferability among alternative accounting principles have not been established by authoritative bodies, the determination of preferability should be based on the particular circumstances described by and discussed with the registrant. In addition, the independent accountant should consider other significant information of which he is aware.[5]

[5] Registrants also are reminded that FASB ASC paragraph 250-10-50-1 (Accounting Changes and Error Corrections Topic) requires that companies disclose the nature of and justification for the change as well as the effects of the change on net income for the period in which the change is made. Furthermore, the justification for the change should explain clearly why the newly adopted principle is preferable to the previously-applied principle.

Question 2: Management may offer, as justification for a change in accounting principle, circumstances such as: their expectation as to the effect of general economic trends on their business (e. g., the impact of inflation), their expectation regarding expanding consumer demand for the company's products, or plans for change in marketing methods. Are these circumstances which enter into the determination of preferability?

Interpretive Response: Yes. Those circumstances are examples of business judgment and planning and should be evaluated in determining preferability. In the case of changes for which objective criteria for determining preferability have not been established by authoritative bodies, business judgment and business planning often are major considerations in determining that the change is to a preferable method because the change results in improved financial reporting.

Question 4: If a registrant, who has changed to an accounting method which was preferable under the circumstances, later finds that it must abandon its business plans or change its business judgment because of economic or other factors, is the registrant's justification nullified?

Interpretive Response: No. A registrant must in good faith justify a change in its method of accounting under the circumstances which exist at the time of the change. The existence of different circumstances at a later time does not nullify the previous justification for the change.

Question 5: If a registrant justified a change in accounting method as preferable under the circumstances, and the circumstances change, may the registrant revert to the method of accounting used before the change?

Interpretive Response: Any time a registrant makes a change in accounting method, the change must be justified as preferable under the circumstances. Thus, a registrant may not change back to a principle previously used unless it can justify that the previously used principle is preferable in the circumstances as they currently exist.

Question 6: If one client of an independent accounting firm changes its method of accounting and the accountant submits the required letter stating his view of the preferability of the principle in the circumstances, does this mean that all clients of that firm are constrained from making the converse change in accounting (e. g., if one client changes from FIFO to LIFO, can no other client change from LIFO to FIFO)?

Interpretive Response: No. Each registrant must justify a change in accounting method on the basis that the method is preferable under the circumstances of that registrant. In addition, a registrant must furnish a letter from its independent accountant stating that in the judgment of the independent accountant the change in method is preferable under the circumstances of that registrant. If registrants in apparently similar circumstances make changes in opposite directions, the staff has a responsibility to inquire as to the factors which were considered in arriving at the determination by each registrant and its independent accountant that the change was preferable under the circumstances because it resulted in improved financial reporting. The staff recognizes the importance, in many circumstances, of the judgments and plans of management and recognizes that such management judgments may, in good faith, differ. As indicated above, the concern relates to registrants in apparently similar circumstances, no matter who their independent accountants may be.

To make a voluntary change in an accounting principle, an entity must demonstrate that the new accounting principle is preferable to the existing principle. When there is no preference expressly stated in the Codification, preferability is assessed based on individual facts and circumstances. For purposes of applying Topic 250, a method of applying an accounting principle is the same as an accounting principle (see Question 3.2.10). [250-10-45-11– 45-12, SAB Topic 6G.2.b]

Question 3.3.30 Does a change to a method that the Codification presents as preferable require a preferability assessment?

Interpretive response: No. When the FASB has expressed a preference for a specific accounting method, a change to adopt that method does not require the entity to justify its preferability. [250-10-45-13, SAB Topic 6G.2.b (Q7)]

The following are examples.

- If a nonpublic entity has issued liability-classified share-based payment awards, the liability is remeasured at each financial statement date until the award is settled. Topic 718 explicitly states that measuring the liability based on fair value is preferable to the intrinsic value method. Therefore, a change in accounting principle to adopt the fair value-based method does not need to be justified as preferable. [718-30-35-4]
- An SEC registrant wishing to change its accounting for exploratory oil and gas activities from full cost to the successful efforts method does not need to justify the change as preferable. This is because the successful efforts method is preferable under Topic 932. [SAB Topic 12C.1]

Question 3.3.35 Does a change to start or stop applying a practical expedient in US GAAP require a preferability assessment?**

Background: Practical expedients exist in certain Topics to provide relief to entities from having to apply complex accounting guidance without significantly affecting financial reporting. The election to apply a practical expedient is generally a one-time decision made when an entity first applies the relevant guidance.

Interpretive response: Yes. A change to start or stop applying a practical expedient in US GAAP is a change in accounting principle under Topic 250.

Stopping

While we believe a practical expedient is presumed to be less preferable, a preferability assessment is still required when an entity elects to discontinue application of a practical expedient in US GAAP.

Starting

Unless the Board has explicitly expressed a preference for the general guidance over the practical expedient, we believe each is equally acceptable. For this reason, although we expect this to be rare, we also believe that changing to a practical expedient in US GAAP might be acceptable if the entity can demonstrate that applying the practical expedient is preferable.

Question 3.3.40 Does a change to an alternative when a method is no longer acceptable require a preferability assessment?

Interpretive response: No. If several methods are available, and the previous method used is no longer acceptable, a change to one of the other approved methods does not require the entity to justify the preferability of that method.

However, if the entity has been using one of the approved methods, and wishes to change to an alternative approved method, then the entity must justify the change as being preferable. [SAB Topic 6G.2.b (Q7)]

Question 3.3.45 Does a change in accounting principle resulting from an entity becoming a public entity require a preferability assessment?**

Interpretive response: No. An entity is required to change accounting principles upon becoming a public entity when the existing accounting principle only applies to private companies. For example, when filing a registration statement for an IPO, an entity can no longer apply Private Company Council accounting alternatives (e.g. goodwill amortization) and is required to adopt the accounting principles applicable to a public entity. In this situation, neither a preferability assessment nor the related disclosure are required. The remaining Topic 250 disclosures (see section 3.3.40) are required. [350-20-15-4]

However, if an entity anticipates that it will go public in the future and voluntarily changes to accounting principles that align with those applicable to public entities in advance of filing a registration statement, the entity has made a voluntary change in accounting principle that requires a preferability assessment.

Question 3.3.50 Does a change in estimate effected by a change in accounting principle require a preferability assessment?

Interpretive response: Yes. Because a change in estimate effected by a change in accounting principle (see Question 3.2.20) is still a change in accounting principle, a preferability assessment is required. This is notwithstanding that the change is accounted for as a change in estimate. [250-10-45-19]

Question 3.3.60 Does a change resulting from new events or transactions require a preferability assessment?

Interpretive response: It depends. As discussed in Question 3.3.20, Topic 250 does not apply when an entity applies an accounting principle for the first time because it was previously not applicable or was immaterial. [250-10-45-1]

However, care is required in asserting that a transaction or event is 'new' and therefore that the entity's existing accounting principles do not apply to the transaction or event. The SEC staff has cautioned that a transaction or event needs to be clearly different in substance from previous transactions or events to conclude that the entity is applying an accounting principle for the first time – and that analysis should be documented. Otherwise, the entity is changing an accounting principle and a preferability assessment is required. [2016 AICPA Conf]

For example, Subtopic 805-50 provides guidance on the accounting for asset acquisitions, but in some areas the accounting is not specified and an entity is able to develop appropriate accounting policies, such as allocating cost to a reacquired right (see KPMG Handbook, Asset acquisitions). An entity acquires a group of manufacturing assets in an asset acquisition in Year 3, and a group of real estate assets in an asset acquisition in Year 5. In determining the appropriate accounting in Year 5, the entity should have regard to the accounting policies it applied in Year 3. The fact that the assets acquired in Year 5 are in a different industry does not, in itself, indicate a difference in substance from the Year 3 acquisition.

We believe the SEC staff comments are relevant for all entities.

Question 3.3.70 Can preferability be justified for a change to a method that differs from a new, but not yet effective, ASU?

Interpretive response: The SEC staff has objected to a registrant changing an accounting principle to adopt a method of accounting that will not be allowed under a newly issued ASU that is not yet effective – even if the method is otherwise preferable. If the registrant were to change its method of accounting, it would need to change it again on adoption of the ASU.

While this interpretive response applies only to SEC registrants, we believe that other entities changing an accounting principle in this circumstance have a high threshold in demonstrating that the proposed method is preferable.

Question 3.3.80 Can preferability be justified for a change to a method in a proposed ASU?

Interpretive response: No. A proposed ASU is still subject to change before being issued. Therefore, preferability cannot be justified on the basis of a *proposed* accounting principle. [250-10-45-13]

Question 3.3.90 Can preferability be justified by general economic trends, consumer demand or marketing methods?

Interpretive response: Yes. In determining preferability, an entity may consider factors such as management's expectations about the effect of general economic trends and consumer demand, and planned changes in marketing methods. These are examples of business judgment and planning.

The SEC staff guidance notes that when objective criteria for determining preferability have not been established by authoritative bodies, business judgment and planning are often major considerations in determining that the change is to a preferable method. This is because the change results in improved financial reporting. [SAB Topic 6G.2.b (Q2)]

We believe this guidance should be followed by all entities.

Question 3.3.100 Is a preferability justification invalidated if an entity must later abandon its business plans or judgment because of economic or other factors?

Interpretive response: No. An entity must in good faith justify a change in an accounting principle under the circumstances that exist at the time of the change. Following SEC staff guidance, if circumstances change at a later time, this does not invalidate the previous justification for the change. [SAB Topic 6G.2.b (Q4)]

We believe this guidance should be applied by all entities.

Question 3.3.110 Can preferability be justified by changes in technology?

Interpretive response: Yes. Sometimes a change in circumstances or advancing technology may enable the application of an accounting method that previously could not be applied.

For example, a growing retailer upgrades its inventory systems to support detailed, real-time tracking and valuation. The enhanced system enables the retailer to move from the retail inventory method, which was adopted when system limitations restricted data granularity, to the weighted average cost method.

Question 3.3.120 Can preferability be justified by standard industry practice?

Interpretive response: Not as the sole justification. The SEC believes that solely conforming to industry practice may not justify a change if the industry

practice is not the preferable method. Therefore, just because a practice is commonly accepted does not make it preferable. We believe this guidance should be applied by all entities. [FRM 4230.2]

However, if there is no clear indication in the Codification that a particular method is preferable, we believe industry practice may be used as a factor (but not the sole justification) in evaluating whether the method is preferable to the entity under the circumstances. This only applies if there is a clear preference in the industry; if there is diverse industry practice then there is no industry practice.

Question 3.3.130 Is an entity's preferability assessment constrained by support for a different accounting principle expressed by its independent accountant?

Interpretive response: No. The SEC staff has confirmed that each registrant must justify a change in accounting method on the basis that the method is preferable under the circumstances of that registrant. The staff recognizes the importance, in many circumstances, of the judgments and plans of management and recognizes that such management judgments may, in good faith, differ. Therefore, if a registrant's independent accountant has supported a change to a different accounting principle in a preferability letter for another entity (see section 6.2), this does not constrain the registrant's preferability assessment. [SAB Topic 6G.2.b (Q6)]

However, if registrants in apparently similar circumstances make changes in opposite directions, the SEC staff may inquire as to the factors that were considered in concluding that the change was preferable under the circumstances because it resulted in improved financial reporting.

Question 3.3.140 Can preferability be justified by an income tax benefit arising from the change?

Interpretive response: No. Preferability is determined based on the merits of the accounting principle – i.e. whether the new principle constitutes an improvement in financial reporting. Preferability cannot be justified on the basis of the income tax effect alone. [250-10-55-1]

Question 3.3.150 If an entity changes to a preferable accounting principle, can it later revert back to the original accounting principle?

Interpretive response: It depends. Because a change in accounting principle must be justified as preferable, an entity cannot change back to a principle previously used unless it can justify that the previously used principle is now preferable in the circumstances as they currently exist. [SAB Topic 6G.2.b (Q5)]

Further, we do not believe it is appropriate for an entity to change an accounting principle multiple times without carefully considering the criteria to qualify for a voluntary change in accounting principle. Frequent changes may indicate the entity is attempting to mask performance metrics, for example.

3.3.30 Account for the change

Excerpt from ASC 250-10

> Accounting Changes

05-2 This Subtopic establishes, unless impracticable, **retrospective application** as the required method for reporting a **change in accounting principle** in the absence of explicit transition requirements specific to a newly adopted accounting principle.

05-3 This Subtopic provides guidance for determining whether retrospective application of a change in accounting principle is impracticable and for reporting a change when retrospective application is impracticable.

• > Change in Accounting Principle

45-1 A presumption exists that an accounting principle once adopted shall not be changed in accounting for events and transactions of a similar type. Consistent use of the same accounting principle from one accounting period to another enhances the utility of financial statements for users by facilitating analysis and understanding of comparative accounting data…

45-3 It is expected that Codification updates normally will provide specific transition requirements. However, in the unusual instance that there are no transition requirements specific to a particular Codification update, a change in accounting principle effected to adopt the requirements of that Codification update shall be reported in accordance with paragraphs 250-10-45-5 through 45-8. Early adoption of a Codification update, when permitted, shall be effected in a manner consistent with the transition requirements of that update.

45-4 This requirement is not limited to newly issued Codification updates. For example, if existing Codification guidance permits a choice between two or more alternative accounting principles, and provides requirements for changing from one to another, those requirements shall be followed.

45-5 An entity shall report a change in accounting principle through **retrospective application** of the new accounting principle to all prior periods, unless it is impracticable to do so. Retrospective application requires all of the following:

a. The cumulative effect of the change to the new accounting principle on periods prior to those presented shall be reflected in the carrying amounts of assets and liabilities as of the beginning of the first period presented.
b. An offsetting adjustment, if any, shall be made to the opening balance of retained earnings (or other appropriate components of equity or net assets in the statement of financial position) for that period.

c. Financial statements for each individual prior period presented shall be adjusted to reflect the period-specific effects of applying the new accounting principle.

45-8 Retrospective application shall include only the **direct effects of a change in accounting principle**, including any related income tax effects. Indirect effects that would have been recognized if the newly adopted accounting principle had been followed in prior periods shall not be included in the retrospective application. If indirect effects are actually incurred and recognized, they shall be reported in the period in which the **accounting change** is made.

Topic 250 requires that a change in accounting principle be applied retrospectively unless impracticable. [250-10-45-5]

Example 1 in Topic 250 (reproduced in section 3.3.50) illustrates retrospective application of a change in accounting principle with applicable disclosures.

Question 3.3.160 What is retrospective application?

Excerpt from ASC 250-10

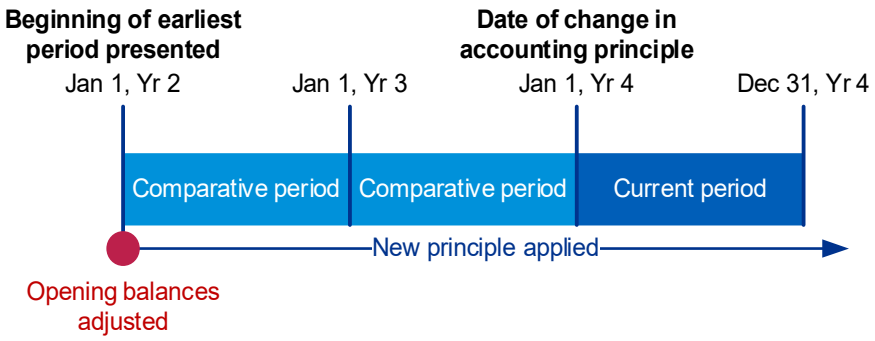
20 Glossary

Retrospective Application

The application of a different accounting principle to one or more previously issued financial statements, or to the statement of financial position at the beginning of the current period, as if that principle had always been used, or a change to financial statements of prior accounting periods to present the financial statements of a new reporting entity as if it had existed in those prior years.

Interpretive response: Retrospective application means applying the accounting principle to all periods presented in the financial statements. This approach is intended to enhance the usefulness of the financial statements by consistently applying the same accounting principle from one accounting period to another. [250-10-45-1]

For example, an SEC registrant with a calendar year-end changes an accounting principle in Year 4. Applying the change retrospectively means the change is effected as of January 1, Year 2 by adjusting opening balances, and the new principle is applied from that point onward. The adjustment to opening balances is referred to as the cumulative-effect adjustment – i.e. the cumulative effect of applying the new accounting principle up until January 1, Year 2.



Retrospective application therefore involves the following process, which applies only to the direct effects of a change in accounting principle (see Question 3.3.170).

Adjust opening balances	Opening balances are adjusted in the financial statements of the earliest period presented. The offsetting entry is to the opening balance of retained earnings (or comparable account) for that period. [250-10-45-5]
Reflect change in each period presented	The financial statements for each period presented reflect the application of the new accounting principle. [250-10-45-5]

See section 3.3.50 for an illustration of the retrospective accounting for a change in accounting principle.

As an exception, a change in accounting principle is not applied retrospectively if it is impracticable (see Questions 3.3.250 and 3.3.260).

Question 3.3.170 How are the direct vs indirect effects of a change in accounting principle recognized?

Excerpt from ASC 250-10

20 Glossary

Direct Effects of a Change in Accounting Principle

Those recognized changes in assets or liabilities necessary to effect a change in accounting principle. An example of a direct effect is an adjustment to an inventory balance to effect a change in inventory valuation method. Related changes, such as an effect on deferred income tax assets or liabilities or an impairment adjustment resulting from applying the subsequent measurement guidance in Subtopic 330-10 to the adjusted inventory balance, also are examples of direct effects of a change in accounting principle.

Indirect Effects of a Change in Accounting Principle

Any changes to current or future cash flows of an entity that result from making a change in accounting principle that is applied retrospectively. An example of an indirect effect is a change in a nondiscretionary profit sharing or

royalty payment that is based on a reported amount such as revenue or net income.

Interpretive response: The direct effects of a change in accounting principle are recognized retrospectively as explained in Question 3.3.160; this includes the related income tax effects (see Question 3.3.180). Direct effects are those adjustments that must be recognized as part of applying the new principle itself.

In contrast, the indirect effects of a new accounting principle are accounted for in the period in which the accounting change takes place. Indirect effects result from changes to reported amounts that use or rely on the amounts directly affected by the change in accounting principle. [250-10-45-8]

Example 3.3.20 illustrates the indirect effects of a change in accounting principle.

Example 3.3.20 Indirect effects of retrospective application

ABC Corp. sponsors a profit-sharing plan for certain employees. The agreement requires ABC to contribute a percentage of pretax profits to the plan.

For the year ended December 31, Year 3, ABC incurred a net loss. As a result, ABC was not required to make a contribution to the profit-sharing plan and no profit-sharing expense was recorded in its Year 3 results of operations.

In Year 4, ABC adopted a voluntary change in accounting principle that would have resulted in ABC earning a small profit in Year 3. The plan requires ABC to pay the incremental amount that would have been paid had the new accounting principle been applied during Year 3.

In calculating the effect of the change in accounting principle for Year 4, ABC accrues the profit-sharing expense in Year 4 net income. Because this expense is an indirect effect of a change in accounting principle (i.e. it stems from how the accounting change altered reported profit or loss amounts), ABC does not report it as an adjustment to its Year 3 financial statements that are retrospectively adjusted for the accounting change.

Question 3.3.180 How are the income tax effects of a change in accounting principle recognized?

Interpretive response: The income tax effects of a change in accounting principle follow the principles of retrospective application. To the extent that the change is presented as an adjustment to opening retained earnings, the income tax effect is likewise included in the cumulative-effect adjustment to retained earnings. Further, the balance sheet income tax effects (e.g. deferred taxes) are recognized as if the new accounting principle had been followed in prior periods.

For further discussion about the income tax effects of changes in accounting principle, see KPMG Handbook, Income taxes, beginning at paragraph 9.037.

Question 3.3.190 How does a change in accounting principle affect OCI?

Interpretive response: A cumulative-effect adjustment presents the historical effects of a change in accounting principle without affecting the financial results in the period in which the change is first reflected. Therefore, we do not believe it is appropriate to include the cumulative effect of the accounting change as a component of OCI in the period of the change. Instead, the adjustment should be made to opening retained earnings at the beginning of the earliest period presented.

However, the AOCI balance at the beginning of the earliest period presented and the OCI for that period might still need to be adjusted if the cumulative-effect adjustment affects items of OCI.

Question 3.3.200 Is the adjustment to retained earnings allocated between continuing and discontinued operations?

Interpretive response: No. The adjustment to opening retained earnings at the beginning of the earliest period presented as a result of a retrospective change in accounting principle is not allocated between continuing and discontinued operations. The adjustment is presented as a single line item, net of related income tax effects.

For example, an entity with a calendar year-end changes an accounting principle in Year 4. The entity has a discontinued operation in Year 4 and the Year 3 comparatives will be adjusted to reflect the effect of operations discontinued in the current period. The income statement presentation of discontinued operations is discussed in section 6.3 of KPMG Handbook, Discontinued operations and held-for-sale disposal groups.

In this example, the change in accounting principle affects both continuing and discontinued operations. The Year 3 comparatives are adjusted to reflect the effect of the change on continuing versus discontinued operations. However, no such distinction is made for the adjustment to opening balances as of January 1, Year 3 because this is a balance sheet adjustment.

Question 3.3.210 What is the difference between retrospective application and restatement?

Interpretive response: Retrospective application and restatement both involve adjusting prior-period financial information, but they are two different concepts and are not interchangeable terms.

- As discussed in this section, retrospective application involves reflecting the effects of a change in accounting principle retroactively to prior periods presented to enhance comparability and usefulness.
- Restatement is a correction of the prior-period financial statements that contained an error (see chapter 4).

Question 3.3.220 How does an investor report an equity method investee's retrospective accounting changes?

Interpretive response: If an equity method investee reports a retrospective change in accounting principle, the recognition requirements of Topic 250 apply in the usual way – there is no exception. This means the investor generally reflects the direct effects of its share through retrospective adjustment of its equity in earnings of the investee. Further, we believe the disclosures required by Topic 250 apply (see Question 3.3.280).

See also Question 7.3.10 in KPMG Handbook, Equity method of accounting.

Question 3.3.230 When is retrospective application not required?

Excerpt from ASC 250-10

• > Change in Accounting Principle

45-6 If the cumulative effect of applying a change in accounting principle to all prior periods can be determined, but it is impracticable to determine the period-specific effects of that change on all prior periods presented, the cumulative effect of the change to the new accounting principle shall be applied to the carrying amounts of assets and liabilities as of the beginning of the earliest period to which the new accounting principle can be applied. An offsetting adjustment, if any, shall be made to the opening balance of retained earnings (or other appropriate components of equity or net assets in the statement of financial position) for that period.

45-7 If it is impracticable to determine the cumulative effect of applying a change in accounting principle to any prior period, the new accounting principle shall be applied as if the change was made prospectively as of the earliest date practicable. See Example 1 (paragraphs 250-10-55-3 through 55-11) for an illustration of a change from the first-in, first-out (FIFO) method of inventory valuation to the last-in, first-out (LIFO) method. That Example does not imply that such a change would be considered preferable as required by paragraph 250-10-45-12.

Interpretive response: Retrospective application is not required:

- if the effect is immaterial (see Question 3.3.240); or [105-10-05-6]
- to the extent that retrospective application is impracticable (see Question 3.3.250). [250-10-45-5]

When determining if the effect of an accounting change is material, materiality is evaluated both qualitatively and quantitatively (see section 2.3).

Question 3.3.240 How is a change in accounting principle recognized when the effect is immaterial?

Excerpt from SAB Topic 5F

Accounting Changes Not Retroactively Applied Due to Immateriality

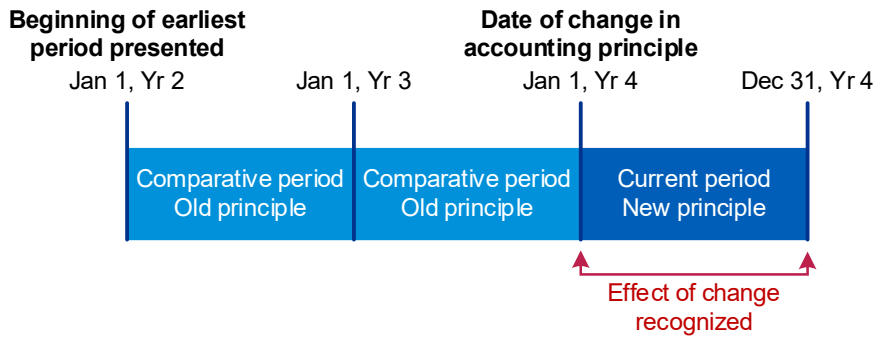
Facts: A registrant is required to adopt an accounting principle by means of retrospective adjustment of prior periods' financial statements. However, the registrant determines that the accounting change does not have a material effect on prior periods' financial statements and, accordingly, decides not to retrospectively adjust such financial statements.

Question: In these circumstances, is it acceptable to adjust the beginning balance of retained earnings of the period in which the change is made for the cumulative effect of the change on the financial statements of prior periods?

Interpretive Response: No. If prior periods are not retrospectively adjusted, the cumulative effect of the change should be included in the statement of income for the period in which the change is made. Even in cases where the total cumulative effect is not significant, the staff believes that the amount should be reflected in the results of operations for the period in which the change is made. However, if the cumulative effect is material to current operations or to the trend of the reported results of operations, then the individual income statements of the earlier years should be retrospectively adjusted.

Interpretive response: If a change in accounting principle is not recognized retrospectively because the effect on prior periods is immaterial, the SEC staff generally requires the effect of the change to be recognized in the current period. [SAB Topic 5F]

For example, an SEC registrant with a calendar year-end changes an accounting principle in Year 4. The effect of the change is immaterial to prior years. In this example, the registrant recognizes the effect of the change in Year 4 – i.e. no adjustment is made to the opening balances at January 1, Year 4.



As an exception, the SEC staff requires the financial statements of prior periods to be adjusted retrospectively if the cumulative effect of the change is material to: [SAB Topic 5F]

- current operations; or
- the trend of the reported results of operations.

We believe this guidance should be applied by all entities.

Question 3.3.250 When is retrospective application impracticable?

Excerpt from ASC 250-10

• • > Impracticability

45-9 It shall be deemed impracticable to apply the effects of a change in accounting principle retrospectively only if any of the following conditions exist:

a. After making every reasonable effort to do so, the entity is unable to apply the requirement.
b. Retrospective application requires assumptions about management's intent in a prior period that cannot be independently substantiated.
c. Retrospective application requires significant estimates of amounts, and it is impossible to distinguish objectively information about those estimates that both:
    1. Provides evidence of circumstances that existed on the date(s) at which those amounts would be recognized, measured, or disclosed under retrospective application
    2. Would have been available when the financial statements for that prior period were issued.

45-10 This Subtopic requires a determination of whether information currently available to develop significant estimates would have been available when the affected transactions or events would have been recognized in the financial statements. However, it is not necessary to maintain documentation from the time that an affected transaction or event would have been recognized to determine whether information to develop the estimates would have been available at that time.

Interpretive response: Retrospective application is impracticable if: [250-10-45-9]

- the entity is unable to do so after making every reasonable effort;
- it requires assumptions about management's intent in prior period(s) and these assumptions cannot be independently verified after the fact; or
- it requires significant estimates of amounts, and it is impossible to objectively distinguish information about those estimates that provides evidence of circumstances that existed on the date at which those amounts would be measured (i.e. indistinguishable from the use of hindsight).

Determining impracticability can be a difficult judgment. Further, Topic 250 states that an entity must make 'every reasonable effort' to apply a change retrospectively before concluding that retrospective application is impracticable. [250-10-45-9]

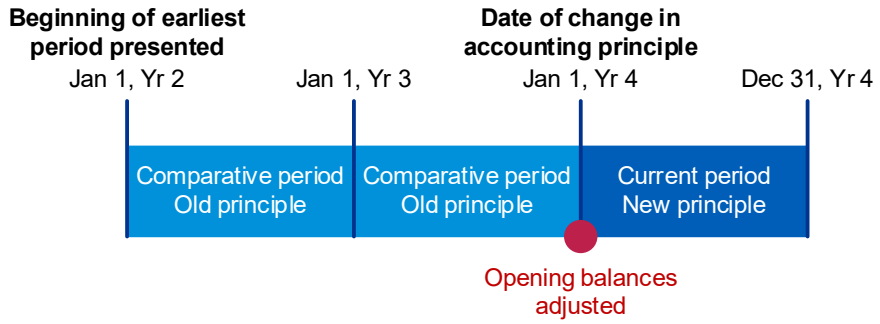
We understand the SEC staff believes that impracticability is a very high hurdle, which means more than just being very difficult. We believe retrospective application will usually be possible, so support for the use of the impracticability exception should be well documented. If a registrant does apply the exception, we encourage the entity to consider consultation with the SEC staff.

For example, an entity no longer qualifies as a private company and will change certain of its accounting principles so that it no longer applies the accounting alternatives (e.g. amortizing goodwill and not separating certain identifiable intangible assets in a business combination). In this circumstance, the SEC staff may not accept an assertion that adjusting historical financial statements would be impracticable, even though doing so may be difficult. See paragraph 26.002 of KPMG Handbook, Business combinations.

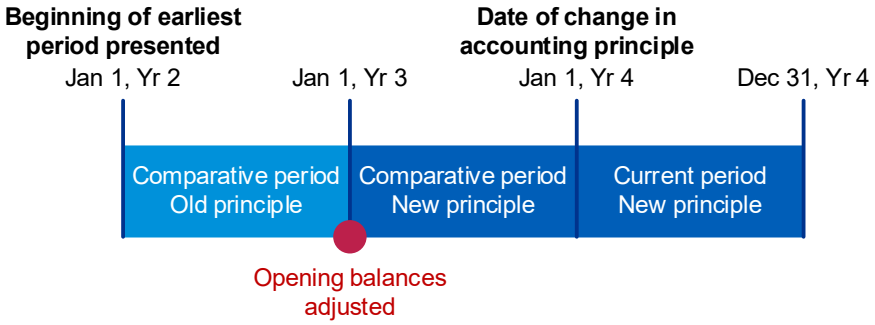
Question 3.3.260 How is a change in accounting principle recognized when retrospective application is impracticable?

Interpretive response: If it is impracticable to apply a change in accounting principle retrospectively, it is applied as of the earliest period practicable. In many cases, this means the effect of the change will be recognized in the current period. [250-10-45-6]

For example, a company with a calendar year-end presents two years of comparative information, and changes an accounting principle in Year 4. Retrospective application of the new principle is impracticable and the change can be applied only from the beginning of Year 4. Therefore, the company recognizes the cumulative effect of the change as of January 1, Year 4.



Changing the example, if the company is able to apply the new principle from the beginning of Year 3, it recognizes the cumulative effect of the change as of January 1, Year 3.



If the company is unable to apply the change retrospectively or determine the cumulative effect of the change as of any period, it applies the change prospectively. [250-10-45-7]

Example 2 in Topic 250 further illustrates reporting on an accounting change when it is impracticable to determine the cumulative effect for all prior years retrospectively.

Excerpt from ASC 250-10

• > Example 2: Reporting an Accounting Change when Determining Cumulative Effect for All Prior Years is Not Practicable

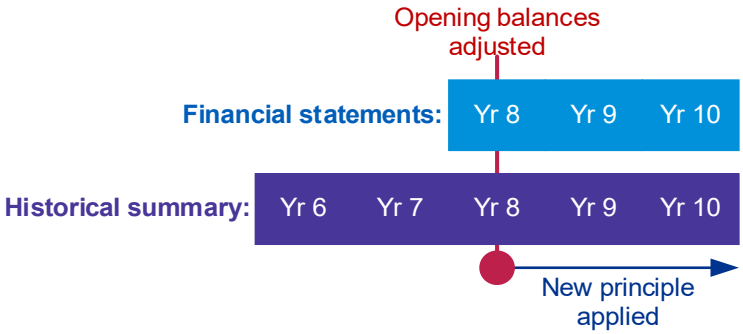
55-12 This Example illustrates the guidance in paragraphs 250-10-45-9 through 45-10. Assume Entity A changed its accounting principle for inventory measurement from FIFO to LIFO effective January 1, 20X4. Entity A reports its financial statements on a calendar year-end basis and had used the FIFO method since its inception. Entity A determined that it is impracticable to determine the cumulative effect of applying this change retrospectively because records of inventory purchases and sales are no longer available for all prior years. However, Entity A has all of the information necessary to apply the LIFO method on a prospective basis beginning in 20X1. Therefore, Entity A should present prior periods as if it had carried forward the 20X0 ending balance in inventory (measured on a FIFO basis) and begun applying the LIFO method to its inventory beginning January 1, 20X1. (The example assumes that Entity A established that the LIFO method was preferable for Entity A's inventory. No particular inventory measurement method is necessarily preferable in all instances.)

Question 3.3.270 Must historical summaries be adjusted for all years to reflect the retrospective application of a change in accounting principle?

Interpretive response: No. The guidance in Topic 250 related to historical summaries (see Question 2.2.20) applies only to the periods in those historical summaries in which a change in accounting principle is *reflected*. [250-10-15-3(b)]

For example, a company (not an SEC registrant) with a calendar year-end changes an accounting principle in Year 10. The company presents two years of comparatives and applies the change retrospectively with an adjustment to opening balances as of January 1, Year 8. The company also discloses a five-year historical summary and adjusts Years 8, 9 and 10 to align with the periods in which the change is reflected in its financial statements.

The following diagram shows the company's approach in its financial statements and historical summary in its Year 10 financial statements. In addition, the company discloses sufficient information to explain how the change has affected comparability of the data in the historical summary.



The SEC staff approach to registrants is discussed in Question 6.4.10.

3.3.40 Disclose the change

Excerpt from ASC 250-10

• > Change in Accounting Principle

50-1 An entity shall disclose all of the following in the fiscal period in which a change in accounting principle is made:

a. The nature of and reason for the change in accounting principle, including an explanation of why the newly adopted accounting principle is preferable.
b. The method of applying the change, including all of the following:
    1. A description of the prior-period information that has been retrospectively adjusted, if any.
    2. The effect of the change on income from continuing operations, net income (or other appropriate captions of changes in the applicable net assets or performance indicator), any other affected financial statement line item, and any affected per-share amounts for the current period and any prior periods retrospectively adjusted. Presentation of the effect on financial statement subtotals and totals other than income from continuing operations and net income (or other appropriate captions of changes in the applicable net assets or performance indicator) is not required.

3. The cumulative effect of the change on retained earnings or other components of equity or net assets in the statement of financial position as of the beginning of the earliest period presented.
4. If retrospective application to all prior periods is impracticable, disclosure of the reasons therefore, and a description of the alternative method used to report the change (see paragraphs 250-10-45-5 through 45-7).

c. If indirect effects of a change in accounting principle are recognized both of the following shall be disclosed:
1. A description of the indirect effects of a change in accounting principle, including the amounts that have been recognized in the current period, and the related per-share amounts, if applicable
2. Unless impracticable, the amount of the total recognized indirect effects of the accounting change and the related per-share amounts, if applicable, that are attributable to each prior period presented. Compliance with this disclosure requirement is practicable unless an entity cannot comply with it after making every reasonable effort to do so.

Financial statements of subsequent periods need not repeat the disclosures required by this paragraph. If a change in accounting principle has no material effect in the period of change but is reasonably certain to have a material effect in later periods, the disclosures required by (a) shall be provided whenever the financial statements of the period of change are presented.

Excerpt from SAB Topic 6I.3

3. Net of tax presentation

Question: What disclosure is required when an item is reported on a net of tax basis (e.g., extraordinary items, discontinued operations, or cumulative adjustment related to accounting change)?

Interpretive Response: When an item is reported on a net of tax basis, additional disclosure of the nature of the tax component should be provided by reconciling the tax component associated with the item to the applicable statutory Federal income tax rate or rates.

Question 3.3.280 What are the general disclosure requirements for changes in accounting principle?

Interpretive response: The following disclosures are required for all changes in accounting principle and are illustrated in section 3.3.50. [250-10-50-1, S-X Rule 3-04]

Type	Disclosures (impact on)
Descriptive	• What the change was • Reason for the change • Why the newly adopted accounting principle is preferable • Which information has been recast

Type	Disclosures (impact on)
Current period and any prior periods adjusted	• Income statement effect:[1,2] — income from continuing operations — net income — any affected per-share amounts • Other affected financial statement line items
Cumulative effect as of beginning of earliest period	• Retained earnings • Other components of equity or net assets
Notes: 1. Presentation of the effect on other financial statement *subtotals* and *totals* is not required. [250-10-50-1(b)(2)] 2. For an NFP, the disclosures relate to appropriate captions of changes in the applicable net assets or performance indicator.	

The following disclosures are also required, if relevant.

Type	Disclosures
Retrospective application impracticable [250-10-50-1(b)(4)]	• Why retrospective application was impracticable • How change was accounted for
Indirect effects [250-10-50-1(c)]	• Description, including: — amounts recognized in current period — related per-share amounts (if applicable) • Effects attributable to each prior period presented, unless impracticable.[1]
Items recorded net of tax (SEC registrants) [SAB Topic 6I.3]	• Nature of the tax component • Reconciliation to the applicable statutory income tax rate(s)
Note: 1. Compliance is impracticable if an entity cannot comply after making every reasonable effort to do so (see Question 3.3.250).	

Question 3.3.290 Are the Topic 250 disclosures required when an entity adopts a new ASU?

Background: As discussed in Question 3.3.10, if a new ASU includes specific transition guidance, an entity applies those transition requirements. An entity applies the transition method in Topic 250 only if the ASU is silent.

Interpretive response: It depends. We believe the disclosure requirements in Topic 250 apply only when the ASU does not include disclosure requirements, or otherwise references the requirements of Topic 250.

The following are contrasting examples, highlighting the need to understand the specific requirements of the ASU.

- ASU 2016-02 (leases, Topic 842) explicitly scopes out certain (but not all) Topic 250 disclosures that would otherwise be required in the year of adopting the standard. Therefore, it is clear that the remaining Topic 250 disclosures apply. [842-10-65-1(i)]
- ASU 2019-12 (simplifying income taxes) includes a definitive statement that a specific paragraph in the ASU "represents the transition and effective date information related to Accounting Standards Update No. 2019-12…" The requirements of that paragraph include required disclosures in the first fiscal year (including any interim periods during that year) following adoption. Therefore, it is clear that the transition is self-contained in the ASU and the Topic 250 disclosures do not apply. [740-10-65-8(e)]

Question 3.3.300 Are the disclosures required every time the financial statements for the period of change are presented?

Interpretive response: Generally, no. Topic 250 disclosures are not usually repeated in subsequent periods. For example, a calendar year-end entity presents one year of comparative information and changes an accounting principle in Year 4. Its Year 4 financial statements include the Topic 250 disclosures, but the disclosures are not required to be repeated (as part of the comparative information) in its Year 5 financial statements. [250-10-50-1]

However, if an accounting change is not applied retrospectively because of impracticability (see Question 3.3.250), we believe the Topic 250 disclosures should continue to be provided until all periods reflect the new accounting principle.

See also Question 3.3.310, which discusses an exception if a change in accounting principle has no material effect in the period of change.

Question 3.3.310 Are the disclosures required if the effect is immaterial in the period of change?

Interpretive response: Yes, for certain disclosures. If a change in accounting principle has no material effect in the period of change but is reasonably certain to have a material effect in later periods, the following disclosures are required: the nature of and reason for the change, including an explanation of why the new accounting principle is preferable. [250-10-50-1]

Further, these disclosures must be repeated every time the financial statements for the period of change are presented. Continuing the example in Question 3.3.300, these disclosures would be required in the entity's Year 5 financial statements. [250-10-50-1]

Question 3.3.320 Is the labeling of the financial statements changed to acknowledge the retrospective application of a new accounting principle?

Interpretive response: There is no specific requirement to change the presentation of the financial statements to acknowledge the retrospective application of a new accounting principle. However, we believe it is best practice to identify the adjustment in the column header with, 'As Adjusted'. This is consistent with Example 1 in Topic 250 (reproduced in section 3.3.50). [250-10-55-10]

Question 3.3.330 How does an investor disclose an investee's retrospective accounting changes?

Background: If an equity method investee reports a retrospective change in accounting principle, the recognition requirements of Topic 250 apply in the usual way – there is no exception. See Question 3.3.220.

Interpretive response: If an equity method investee reports a retrospective change in accounting principle, we believe the investor should provide the relevant disclosures required by Topic 250. See also Question 7.3.10 in KPMG Handbook, Equity method of accounting.

Question 3.3.340 Do all entities disclose the future effects that recently issued, but not yet adopted, ASUs will have on their financial statements?

Interpretive response: We believe all entities should disclose the future effects that recently issued, but not yet adopted, ASUs will have on their financial statements. While this is a requirement for SEC registrants, we believe providing such disclosure is a best practice for all entities.

For a discussion about what such disclosures might entail, based on the requirements for SEC registrants, see section 6.3.

3.3.50 Topic 250 Example 1

Excerpt from ASC 250-10

• > Example 1: Retrospective Application of a Change in Accounting Principle

55-3 This Example illustrates the guidance in paragraphs 250-10-45-5 through 45-8. Entity A decides at the beginning of 20X7 to adopt the first-in, first-out (FIFO) method of inventory valuation. Entity A had used the last-in, first-out (LIFO) method for financial and tax reporting since its inception on January 1, 20X5, and had maintained records that are adequate to apply the FIFO method

retrospectively. Entity A concluded that the FIFO method is the preferable inventory valuation method for its inventory. The **change in accounting principle** is reported through **retrospective application** as described in paragraph 250-10-45-5.

55-4 The effects of the change in accounting principle on inventory and cost of sales are presented in the following table.

	Inventory Determined by		Cost of Sales Determined by	
Date	LIFO Method	FIFO Method	LIFO Method	FIFO Method
1/1/20X5	$ -	$ -	$ -	$ -
12/31/20X5	100	80	800	820
12/31/20X6	200	240	1,000	940
12/31/20X7	320	390	1,130	1,100

55-5 This Example is based on the following assumptions:

a. For each year presented, sales are $3,000 and selling, general, and administrative costs are $1,000. Entity A's effective income tax rate for all years is 40 percent, and there are no permanent or temporary differences under Subtopic 740-10 prior to the change.
b. Entity A has a nondiscretionary profit-sharing agreement in place for all years. Under that agreement, Entity A is required to contribute 10 percent of its reported income before tax and profit sharing to a profit-sharing pool to be distributed to employees. For simplicity, it is assumed that the profit-sharing contribution is not an inventoriable cost.
c. Entity A determined that its profit-sharing expense would have decreased by $2 in 20X5 and increased by $6 in 20X6 if it had used the FIFO method to compute its inventory cost since inception. The terms of the profit-sharing agreement do not address whether Entity A is required to adjust its profit-sharing accrual for the incremental amounts. At the time of the accounting change, Entity A decides to contribute the additional $6 attributable to 20X6 profit and to make no adjustment related to 20X5 profit. The $6 payment is made in 20X7.
d. Profit sharing and income taxes accrued at each year-end under the LIFO method are paid in cash at the beginning of each following year.
e. Entity A's annual report to shareholders provides two years of financial results, and Entity A is not subject to the requirements of Subtopic 260-10.

55-6 In accordance with paragraph 250-10-45-8, recognized **indirect effects of a change in accounting principle** are recorded in the period of change. That provision applies even if recognition of the indirect effect is explicitly required by the terms of the profit-sharing contract.

55-7 Entity A's income statements as originally reported under the LIFO method are presented below.

55-8 Income Statement

	20X6	20X5
Sales	$ 3,000	$ 3,000
Cost of goods sold	1,000	800

Selling, general, and administrative expenses	1,000	1,000
Income before profit sharing and income taxes	1,000	1,200
Profit sharing	100	120
Income before income taxes	900	1,080
Income taxes	360	432
Net income	$ 540	$ 648

55-9 Entity A's income statements reflecting the retrospective application of the accounting change from the LIFO method to the FIFO method are presented below.

55-10 Income Statement

	20X7	20X6
		As Adjusted (Note A)
Sales	$ 3,000	$ 3,000
Cost of goods sold	1,100	940
Selling, general, and administrative expenses	1,000	1,000
Income before profit sharing and income taxes	900	1,060
Profit sharing	96	100
Income before income taxes	804	960
Income taxes	322	384
Net income	$ 482	$ 576

55-11 Entity A's disclosure related to the accounting change is presented below.

NOTE A:

Change in Method of Accounting for Inventory Valuation

On January 1, 20X7, Entity A elected to change its method of valuing its inventory to the FIFO method, whereas in all prior years inventory was valued using the LIFO method. The new method of accounting for inventory was adopted [state justification for change in accounting principle] and comparative financial statements of prior years have been adjusted to apply the new method retrospectively. The following financial statement line items for fiscal years 20X7 and 20X6 were affected by the change in accounting principle.

Income Statement

20X7

	As Computed Under LIFO	As Reported Under FIFO	Effect of Change
Sales	$ 3,000	$ 3,000	-
Cost of goods sold	1,130	1,100	(30)
Selling, general, and administrative expenses	1,000	1,000	-
Income before profit sharing and income taxes	870	900	30
Profit sharing	87	96 (a)	9
Income before income taxes	783	804	21
Income taxes	313	322	9
Net income	$ 470	$ 482	$ 12

(a) This amount includes a $90 profit-sharing payment attributable to 20X7 profits and $6 profit-sharing payment attributable to 20X6 profits, which is an indirect effect of the change in accounting principle. The incremental payment attributable to 20X6 would have been recognized in 20X6 if Entity A's inventory had originally been accounted for using the FIFO method.

20X6

	As Originally Reported	As Adjusted	Effect of Change
Sales	$ 3,000	$ 3,000	-
Cost of goods sold	1,000	940	(60)
Selling, general, and administrative expenses	1,000	1,000	-
Income before profit sharing and income taxes	1,000	1,060	60
Profit sharing	100	100	9
Income before income taxes	900	960	60
Income taxes	360	384	24
Net income	$ 540	$ 576	$ 36

Balance Sheet

12/31/X7

	As Computed Under LIFO	As Reported Under FIFO	Effect of Change
Cash	$ 2,738	$ 2,732	$ (6)
Inventory	320	390	70
Total assets	$ 3,058	$ 3,122	$ 64
Accrued profit sharing	$ 87	$ 90	$ 3
Income tax liability	313	338	25
Total liabilities	400	428	28
Paid-in capital	1,000	1,000	-
Retained earnings	1,658	1,694	36
Total stockholders' equity	2,658	2,694	36
Total liabilities and stockholders' equity	$ 3,058	$ 3,122	$ 64

12/31/X6

	As Originally Reported	As Adjusted	Effect of Change
Cash	$ 2,448	$ 2,448	$ -
Inventory	200	240	40
Total assets	$ 2,648	$ 2,688	$ 40
Accrued profit sharing	$ 100	$ 100	$ -
Income tax liability	360	376	16
Total liabilities	460	476	16
Paid-in capital	1,000	1,000	-
Retained earnings	1,188	1,212	24
Total stockholders' equity	2,188	2,212	24
Total liabilities and stockholders' equity	$ 2,648	$ 2,688	$ 40

As a result of the accounting change, retained earnings as of January 1, 20X6, decreased from $648, as originally reported using the LIFO method, to $636 using the FIFO method.

Statement of Cash Flows

20X7

	As Computed Under LIFO	As Reported Under FIFO	Effect of Change
Net income	$ 470	$ 482	12
Adjustments to reconcile net income to net Cash provided by operating activities			
Increase in inventory	(120)	(150)	(30)
Decrease in accrued profit sharing	(13)	(10)	3
Decrease in income tax liability	(47)	(38)	9
Net cash provided by operating activities	290	284	(6)
Net increase in cash	290	284	(6)
Cash, January 1, 20X7	2,448	2,448	-
Cash, December 31, 20X7	$ 2,738	$ 2,732	$ (6)

20X6

	As Originally Reported	As Adjusted	Effect of Change
Net income	$ 540	$ 576	36
Adjustments to reconcile net income to net Cash provided by operating activities			
Increase in inventory	(100)	(160)	(60)
Decrease in accrued profit sharing	(20)	(20)	-
Decrease in income tax liability	(72)	(48)	24
Net cash provided by operating activities	348	348	-
Net increase in cash	348	348	-
Cash, January 1, 20X6	2,100	2,100	-
Cash, December 31, 20X6	$ 2,448	$ 2,448	$ -

3.4 Change in accounting estimate

3.4.10 Account for the change

Excerpt from ASC 250-10

• > Change in Accounting Estimate

45-17 A change in accounting estimate shall be accounted for in the period of change if the change affects that period only or in the period of change and future periods if the change affects both. A change in accounting estimate shall not be accounted for by restating or retrospectively adjusting amounts reported in financial statements of prior periods or by reporting pro forma amounts for prior periods.

45-18 Distinguishing between a change in an accounting principle and a change in an accounting estimate is sometimes difficult. In some cases, a change in accounting estimate is effected by a change in accounting principle. One example of this type of change is a change in method of depreciation, amortization, or depletion for long-lived, nonfinancial assets (hereinafter referred to as depreciation method). The new depreciation method is adopted in partial or complete recognition of a change in the estimated future benefits

inherent in the asset, the pattern of consumption of those benefits, or the information available to the entity about those benefits. The effect of the change in accounting principle, or the method of applying it, may be inseparable from the effect of the change in accounting estimate. Changes of that type often are related to the continuing process of obtaining additional information and revising estimates and, therefore, shall be considered changes in estimates for purposes of applying this Subtopic.

45-19 Like other changes in accounting principle, a change in accounting estimate that is effected by a change in accounting principle may be made only if the new accounting principle is justifiable on the basis that it is preferable. For example, an entity that concludes that the pattern of consumption of the expected benefits of an asset has changed, and determines that a new depreciation method better reflects that pattern, may be justified in making a change in accounting estimate effected by a change in accounting principle. (See paragraph 250-10-45-12.)

45-20 However, a change to the straight-line method at a specific point in the service life of an asset may be planned at the time some depreciation methods, such as the modified accelerated cost recovery system, are adopted to fully depreciate the cost over the estimated life of the asset. Consistent application of such a policy does not constitute a change in accounting principle for purposes of applying this Subtopic.

Estimates are inherently uncertain, and are subject to change from period to period, as information that relates to the estimate is obtained. Therefore, a change in estimate is accounted for prospectively – i.e. in the period of change, and in future periods (if relevant). Unlike a change in accounting principle, a change in estimate is *not* retrospectively applied. [250-10-45-17 – 45-18]

Question 3.4.10 How does an entity account for a change in accounting estimate that is inseparable from a change in accounting principle?

Interpretive response: Question 3.2.20 discusses when a change in estimate is inseparable from a change in accounting principle. A change in estimate that cannot be separated from the effect of a change in accounting principle is accounted for as a change in estimate – i.e. prospectively. [250-10-45-18]

However, because the change in estimate is effected by a change in principle, a preferability assessment is required to support the change (see section 3.3.20). [250-10-45-19]

Question 3.4.20 How does an entity distinguish between a change in estimate and an error correction?

Interpretive response: A change in estimate may indicate an error in the estimate made in prior periods. Careful consideration is needed to determine if the change is due to new facts and circumstances that arose in the current period, or to facts and circumstances that existed in the prior periods (and were

known or could have been known) but were not previously taken into account when developing the estimate. We believe these considerations should be carefully evaluated and well documented.

For example, in applying Topic 718 (stock compensation), an entity may use a peer group to determine stock-price volatility because it does not have a sufficient history of its own. A change in peer group companies may be justified (as a change in estimate) if circumstances have changed and the prior peer group is no longer representative of the entity. However, if the change arises because the prior peer group was not appropriate in the first place then there was an error in the previous financial statements.

Chapter 4 discusses accounting errors.

Question 3.4.30 Does a change in estimate require a preferability assessment?

Interpretive response: Generally, no. However, if the change in estimate is effected by a change in accounting principle, then a preferability assessment is required (see Question 3.4.10).

Although there is no requirement to establish preferability, frequent changes in estimation techniques may indicate the entity is attempting to mask performance metrics. For example, a change in valuation technique in measuring fair value is a change in estimate (see Question 3.2.60). While a change in valuation technique may sometimes be warranted, an entity should carefully consider whether a change is appropriate.

Example 3.4.10 Change in depreciation estimates and method

Manufacturer is considering changing its depreciation method for certain machinery and equipment in its auto parts business.

Manufacturer currently depreciates these assets using the double-declining balance method, and is considering a change to the straight-line method. It also reevaluates the useful lives of these assets and expects to extend their useful lives for depreciation purposes. Manufacturer accounts for the changes as a change in accounting estimate – i.e. prospectively.

The change in useful lives, on its own, does not require a preferability assessment. However, the change in the method of depreciation does require a preferability assessment even though it is accounted for as a change in estimate.

Question 3.4.40 Does a predetermined change in depreciation method require a preferability assessment?

Background: A change in depreciation method is a change in estimate that is inseparable from a change in accounting principle, and a preferability assessment is required (see Question 3.4.10).

Interpretive response: No. If a change in depreciation method is predetermined when a long-lived asset is first recognized, the accounting principle is to apply dual methods over the useful life of the asset. Therefore, if the change occurs as scheduled, there is no change in accounting principle. [250-10-45-20]

Topic 250 provides the example of an entity that plans to start depreciating a long-lived asset using the modified accelerated cost recovery system and then, at a specific point in the service life of the asset, change to the straight-line method. This is not a change in accounting principle. [250-10-45-20]

3.4.20 Disclose the change

Excerpt from ASC 250-10

• > Change in Accounting Estimate

50-4 The effect on income from continuing operations, net income (or other appropriate captions of changes in the applicable net assets or performance indicator), and any related per-share amounts of the current period shall be disclosed for a change in estimate that affects several future periods, such as a change in service lives of depreciable assets. Disclosure of those effects is not necessary for estimates made each period in the ordinary course of accounting for items such as uncollectible accounts or inventory obsolescence; however, disclosure is required if the effect of a change in the estimate is material. When an entity effects a change in estimate by changing an accounting principle, the disclosures required by paragraphs 250-10-50-1 through 50-3 also are required. If a change in estimate does not have a material effect in the period of change but is reasonably certain to have a material effect in later periods, a description of that change in estimate shall be disclosed whenever the financial statements of the period of change are presented.

• • > Change in Estimate Used in Valuation Technique

50-5 The disclosure provisions of this Subtopic for a change in accounting estimate are not required for revisions resulting from a change in a valuation technique used to measure fair value or its application when the resulting measurement is fair value in accordance with Topic 820.

Question 3.4.50 What are the general disclosure requirements for changes in estimates?

Interpretive response: In addition to any specific disclosures required by other standards depending on the nature of the estimate (e.g. a contingency under Topic 450), Topic 250 requires the disclosures in the following table for all changes in accounting estimate. [250-10-50-4 – 50-5]

As an exception to the disclosures in the table, for changes in estimates related to the measurement of fair value (see Question 3.2.60), the relevant disclosures are in Topic 820 and the following requirements do not apply. [820-10-50-5]

Type of change in estimate	Disclose
• Change in estimate affects future periods (e.g. useful life of depreciable asset) • Estimate made in ordinary course of accounting for item (e.g. inventory obsolescence) is material	For the *current* period, effect of change on:[1] • income from continuing operations • net income • any related per-share amounts
Change in estimate inseparable from a change in accounting principle (e.g. depreciation method)	• The above items • Additional disclosures required for a change in accounting principle (see Question 3.3.280)
Estimate made in ordinary course of accounting for item is immaterial	No Topic 250 disclosures required
Note: 1. For an NFP, the disclosures relate to appropriate captions of changes in the applicable net assets or performance indicator.	

Question 3.4.60 Are the disclosures required if the effect is immaterial in the period of change?

Interpretive response: Yes, for certain disclosures. If a change in estimate has no material effect in the period of change but is reasonably certain to have a material effect in later periods, an entity discloses a description of the change. Further, that disclosure must be repeated every time the financial statements for the period of change are presented. [250-10-50-4]

3.5 Change in classification or presentation

Excerpt from ASC 205-10

> Comparative Financial Statements

45-3 Prior-year figures shown for comparative purposes shall in fact be comparable with those shown for the most recent period. Any exceptions to comparability shall be clearly brought out as described in Topic 250.

> Changes Affecting Comparability

50-1 If, because of reclassifications or for other reasons, changes have occurred in the manner of or basis for presenting corresponding items for two or more periods, information shall be furnished that will explain the change. This procedure is in conformity with the well recognized principle that any change in practice that affects comparability of financial statements shall be disclosed.

Topic 250 does not provide specific guidance on changes in classification and presentation that do not rise to the level of a change in accounting principle (see Question 3.2.40) and are not errors (see section 4.2). Instead, the general principles of Topic 205 (financial statement presentation) apply.

Question 3.5.10 Does a change in presentation require retrospective application?

Interpretive response: As discussed in Question 3.2.40, a change in presentation is not always considered an accounting change subject to Topic 250.

However, consistent with the general requirements of Topic 205, we believe an entity should nonetheless recast prior-period information to conform to the presentation in the current period. For example, if the entity decides to present selling expenses separately from general and administrative expenses when these were previously combined into an SG&A caption on the face of the income statement, the comparative period(s) should be similarly presented. [205-10-45-3]

Question 3.5.20 Does a change in presentation require specific disclosures?#

Interpretive response: Although no specific disclosures are required under Topic 250, consistent with the general requirements of Topic 205, we believe an entity should consider providing the following disclosures in the period of the change: [205-10-45-3, 50-1]

- the nature of and reason for the change in presentation; and
- the fact that comparative information has been recast.

3.6 Change in reporting entity

3.6.10 Identify the change

Excerpt from ASC 250-10

20 Glossary

Change in the Reporting Entity

A change that results in financial statements that, in effect, are those of a different reporting entity. A change in the reporting entity is limited mainly to the following:

a. Presenting consolidated or combined financial statements in place of financial statements of individual entities
b. Changing specific subsidiaries that make up the group of entities for which consolidated financial statements are presented
c. Changing the entities included in combined financial statements.

Neither a business combination accounted for by the acquisition method nor the consolidation of a variable interest entity (VIE) pursuant to Topic 810 is a change in reporting entity.

A change in reporting entity arises in certain circumstances that result in financial statements of a different reporting entity than previously presented.

Question 3.6.10 What changes in reporting entity are in the scope of Topic 250?

Interpretive response: Topic 250 only applies to a change in the reporting entity that is in effect a new reporting entity. It does not apply every time the composition of the consolidated group has changed – e.g. through a business combination. The following are examples of each type of change in reporting entity.

Type of change in reporting entity	Example
Presenting consolidated or combined statements in place of statements of individual companies.	ABC Corp. starts preparing combined financial statements for all of its real estate investees that are under common management. [810-10 Glossary, 55-1B]
Changing the companies included in combined financial statements.	ABC Corp. changes the composition of its combined financial statements following two new real estate investees coming under common management.
Changing specific subsidiaries that are included in the group of companies for which the reporting entity presents consolidated financial statements.	An intermediate parent company acquires a subsidiary from a sister company in a common control transaction. See Question 3.6.50.

Question 3.6.20 Does a reverse acquisition give rise to a change in reporting entity?

Interpretive response: No. A reverse acquisition is just a type of business combination in which the legal acquiree is the accounting acquirer. Acquisition accounting applies, subject to specific requirements in Topic 805, and there is no change in reporting entity under Topic 250. [250-10 Glossary]

Reverse acquisitions are discussed in KPMG Handbook, Business combinations, beginning at paragraph 9.012.

Question 3.6.30 Does a sale or partial sale of an interest in a subsidiary give rise to a change in reporting entity?

Interpretive response: No. A sale or partial sale of an interest in a subsidiary, whereby the parent loses its controlling interest, is not a change in reporting entity under Topic 250. This conclusion was specifically addressed by the SEC staff in the context of a change from consolidation to equity method accounting. [2007 AICPA Conf]

Question 3.6.40 Does the spinoff of a subsidiary give rise to a change in reporting entity?

Background: A spinoff is, "The transfer of assets that constitute a business by an entity (the spinnor) into a new legal spun-off entity (the spinnee), followed by a distribution of the shares of the spinnee to its shareholders, without the surrender by the shareholders of any stock of the spinnor." [505-60 Glossary]

Interpretive response: Generally, no. However, in limited circumstances the SEC staff allows an entity (spinnor) to conclude that a change in reporting entity has occurred in connection with an IPO if the spinoff occurs before effectiveness of the registration statement. This exception is intended to benefit entities whose financial statements that include the spun-off subsidiary have not been widely distributed. [SAB Topic 5Z.7]

To qualify, the entity (spinnor) and subsidiary (spinnee): [SAB Topic 5Z.7]

- are in dissimilar businesses; the evaluation of whether the businesses are dissimilar requires differences 'substantially greater' than those that typically distinguish reportable segments in Topic 280 (see section 4.4 of KPMG Handbook, Segment reporting);
- have been managed and financed historically as if they were autonomous;
- have no more than incidental common facilities and costs;
- will be operated and financed autonomously after the spinoff; and
- will not have material financial commitments, guarantees or contingent liabilities to each other after the spinoff.

We believe all of these factors must be met for an entity to conclude that a change in reporting entity has occurred.

For further discussion on the accounting for spinoffs, see section 5.9 of KPMG Handbook, Debt and equity financing.

Question 3.6.50 Does a combination of entities under common control give rise to a change in reporting entity?

Background: A transaction qualifies as a combination of entities under common control only if all combining entities in the transaction are controlled by the common parent or a controlling ownership group that has agreed to vote in concert both before and after the combination.

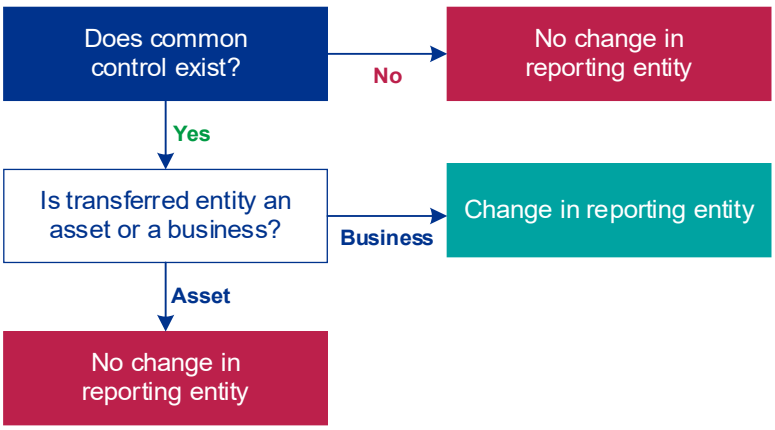
Control has the same meaning as used in Topic 810 (consolidation). As a general rule, ownership by one entity, directly or indirectly, of over 50% of the outstanding voting shares of another entity represents control. However, control could also be achieved by means other than majority ownership of outstanding voting shares (e.g. by contract).

Combinations of entities under common control are discussed in chapter 28 of KPMG Handbook, Business combinations. The discussion that follows is summarized.

Interpretive response:

Receiving entity

As illustrated in the following diagram, a change of reporting entity has occurred from the perspective of the receiving entity if the entity being transferred (transferee) and receiving entity are under common control and a 'business' (as defined in Topic 805) is transferred.



Transferring entity

From the perspective of the transferor (transferring entity), generally a transfer of entities in a common control transaction does not give rise to a change in reporting entity.

As an exception, there are limited circumstances in which we believe the SEC staff guidance on spinoffs (see Question 3.6.40) may be applied by analogy. To qualify, the transferee and transferor:

- are in dissimilar businesses;
- have been managed and financed historically as if they were autonomous;
- have no more than incidental common facilities and costs;
- will be operated and financed autonomously after the transaction; and
- will not have material financial commitments, guarantees or contingent liabilities to each other after the transaction.

If the criteria are met, it may be acceptable for the transferring entity to conclude that there has been a change in reporting entity. However, we believe careful consideration should be applied in determining whether a change in reporting entity has truly occurred for the transferring entity, and the SEC staff may challenge an entity's assertions in that regard. If any of the criteria are not met, the presumption is retrospective adjustment of the prior-period financial statements is generally not appropriate.

3.6.20 Account for the change

Excerpt from ASC 250-10

• > Change in Reporting Entity

45-21 When an accounting change results in financial statements that are, in effect, the statements of a different reporting entity, the change shall be retrospectively applied to the financial statements of all prior periods presented to show financial information for the new reporting entity for those periods. Previously issued interim financial information shall be presented on a retrospective basis. However, the amount of interest cost previously capitalized through application of Subtopic 835-20 shall not be changed when retrospectively applying the accounting change to the financial statements of prior periods.

A change in reporting entity is applied retrospectively in the same way as a change in accounting principle (see section 3.3.30) with the exception discussed in Question 3.6.60. This means that the comparative financial information presented is that of the new reporting entity. [250-10-45-21]

Question 3.6.60 Is a change in reporting entity presented in the same way as a change in accounting principle?

Interpretive response: In principle, yes. However, interest cost that was capitalized under Subtopic 835-20 before the change in reporting entity is not recalculated – i.e. the amount capitalized stays the same even if the expenditures related to the qualifying asset change. [250-10-45-21]

Subject to this exception, the guidance in section 3.3.30 applies to a change in reporting entity.

Note: For a 'qualifying' asset that requires a period of time to reach the condition and location necessary for its intended use, attributable interest cost incurred during that period is capitalized following the guidance in Subtopic 835-20.

Question 3.6.70 How is a change in reporting entity related to a combination of entities under common control presented when the control relationship did not exist for all periods presented?

Interpretive response: In some cases, entities combined in a common control transaction may not have been under common control for all periods presented in the receiving entity's financial statements. Therefore, applying the change to all periods presented in the financial statements would not be appropriate. In that case, the financial statements are presented for all periods as if the combination occurred at the inception of common control. See Example 2.8.4 in KPMG Handbook, Business combinations. [805-50-45-5]

Question 3.6.80 How is a change in reporting entity presented when it occurs after the reporting date?

Interpretive response: A change in reporting entity that occurs after the reporting date but before the financial statements are issued is a nonrecognized subsequent event under SEC staff guidance. [FRM 13410.2]

Therefore, those financial statements are not retrospectively adjusted, and disclosures about the change are made under Topic 855. Retrospective adjustment is first applied in the financial statements issued for the period in which the change occurs.

We believe this guidance should be applied by all entities.

3.6.30 Disclose the change

Excerpt from ASC 250-10

• > Change in Reporting Entity

50-6 When there has been a **change in the reporting entity**, the financial statements of the period of the change shall describe the nature of the change and the reason for it. In addition, the effect of the change on income from continuing operations, net income (or other appropriate captions of changes in the applicable net assets or performance indicator), other comprehensive income, and any related per-share amounts shall be disclosed for all periods

presented. Financial statements of subsequent periods need not repeat the disclosures required by this paragraph. If a change in reporting entity does not have a material effect in the period of change but is reasonably certain to have a material effect in later periods, the nature of and reason for the change shall be disclosed whenever the financial statements of the period of change are presented. (Sections 805-10-50, 805-20-50, 805-30-50, and 805-740-50 describe the manner of reporting and the disclosures required for a business combination.)

Pending content

Transition Date: (P) June 30, 2027; (N) June 30, 2027 Transition Guidance:105-10-65-7

50-6 When there has been a **change in the reporting entity**, the financial statements of both the interim period of the change and the annual period of the change shall describe the nature of the change and the reason for it. In addition, the effect of the change on income from continuing operations, net income (or other appropriate captions of changes in the applicable net assets or performance indicator), other comprehensive income, and any related per-share amounts shall be disclosed for all periods presented. The cumulative effect of the change on retained earnings or other appropriate components of equity or net assets in the statement of financial position as of the beginning of the earliest period presented also shall be disclosed. Financial statements of subsequent periods need not repeat the disclosures required by this paragraph. If a change in reporting entity does not have a material effect in the period of change but is reasonably certain to have a material effect in later periods, the nature of and reason for the change shall be disclosed whenever the financial statements of the period of change are presented. See paragraph 270-10-45-12 for additional guidance related to accounting changes in interim periods. (Sections 805-10-50, 805-20-50, 805-30-50, and 805-740-50 describe the manner of reporting and the disclosures required for a business combination.)

Question 3.6.90 What are the disclosure requirements for a change in reporting entity?

Interpretive response: The following disclosures are required for a change in reporting entity. [250-10-50-6]

Type	Disclosures (impact on)
Descriptive	• What the change was • Reason for the change
Effect of the change for all periods presented[1]	• Income from continuing operations • Net income • OCI • Any affected per-share amounts • Shareholder's equity accounts, for SEC registrants [S-X Rule 3-04]

Note:
1. For an NFP, the disclosures relate to appropriate captions of changes in the applicable net assets or performance indicator.

Question 3.6.100 Are the disclosures required every time the financial statements for the period of change are presented (i.e. as comparative information)?

Interpretive response: Generally, no. Topic 250 disclosures are not usually repeated in subsequent periods. However, see Question 3.6.110 for disclosures regarding immaterial changes that could have a material effect in later periods. [250-10-50-6]

Question 3.6.110 Are the disclosures required if the effect is immaterial in the period of change?

Interpretive response: Yes, for certain disclosures. If a change in reporting entity has no material effect in the period of change but is reasonably certain to have a material effect in later periods, an entity discloses the nature of and reason for the change. Further, that disclosure must be repeated every time the financial statements for the period of change are presented. [250-10-50-6]

4. Error corrections

Detailed contents

Item significantly updated in this edition: #

Question 4.4.60 What are the disclosure requirements for corrections of material errors?

Question 4.4.70 Are the disclosures required every time financial statements that include the restated and reissued information are presented?

Question 4.4.80 What are the steps to restating prior-period financial statements in a little r restatement?

Question 4.4.90 What is the timing of a little r restatement of prior-period financial statements?

Question 4.4.100 Is the labeling of the prior-period financial statements changed to acknowledge a little r restatement?

Question 4.4.110 Are historical summaries adjusted for little r restatements?

Question 4.4.120 How are errors that are immaterial to prior periods and the current period treated?

Examples

Example 4.4.10 Big R restatement of prior-period financial statements#

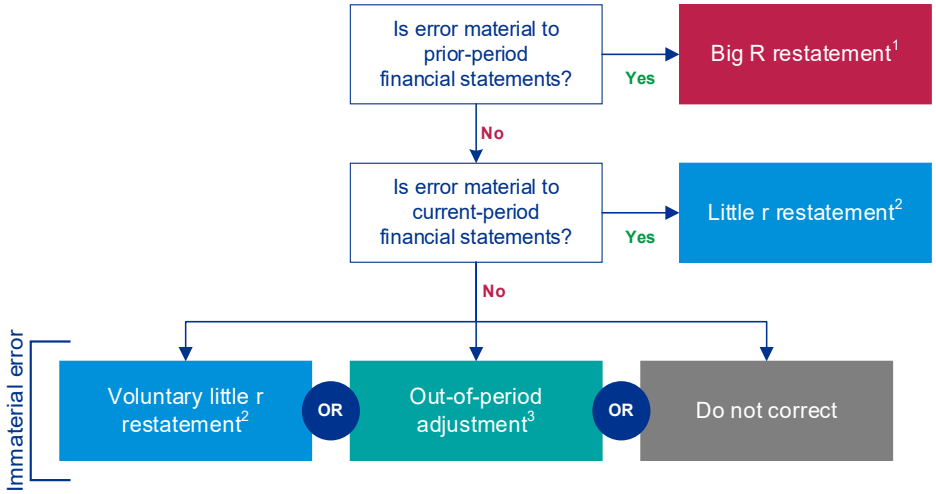
Example 4.4.20 Little r restatement of prior-period financial statements#

4.1 How the standard works

An error (or misstatement) in the application of US GAAP might be a monetary misstatement, an incorrect presentation, or omitted or incomplete/inaccurate disclosures. This chapter uses the terms 'error' and 'misstatement' interchangeably.

An error can be material by virtue of its size (quantitatively material) and/or its nature (qualitatively material). Qualitative factors could cause misstatements of quantitatively small amounts to be material. Errors are assessed individually and in the aggregate – in relation to specific financial statement captions and disclosures, and the financial statements as a whole.

In considering how errors should be corrected in the financial statements, the starting point is to determine whether the prior-period financial statements are materially misstated. The following diagram summarizes the steps in the determination.



Notes:

1. Restate and reissue prior-period financial statements.
2. Restate and revise prior-period financial statements the next time those financial statements are presented.
3. Correct in current-period financial statements.

If and when an error is corrected is based on the following framework:

- If the error is material to the prior-period financial statements, it is corrected as soon as practicable by restating and reissuing the financial statements (a 'Big R restatement' or 'reissuance restatement').
- If the error is not material to the prior period but correcting the error in the current period or leaving the error uncorrected in the current period would cause the current-period financial statements to be materially misstated, the prior-period financial statements are restated by revising them the next time they are presented – e.g. as comparatives (a 'little r restatement' or 'revision restatement').

- If the error is not material to the prior-periods or current-period financial statements, the error can either be corrected through an 'out-of-period adjustment' in the current-period financial statements or through a voluntary little r restatement of the prior-period financial statements or left uncorrected.

4.2 The nature of an error

Excerpt from ASC 250-10

20 Glossary

Error in Previously Issued Financial Statements

An error in recognition, measurement, presentation, or disclosure in financial statements resulting 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. A change from an accounting principle that is not generally accepted to one that is generally accepted is a correction of an error.

Restatement

The process of revising previously issued financial statements to reflect the correction of an error in those financial statements.

> Error Corrections

05-4 The correction of an error in previously issued financial statements is not an accounting change. However, the reporting of an error correction involves adjustments to previously issued financial statements similar to those generally applicable to reporting an accounting change retrospectively. Therefore, the reporting of a correction of an error by restating previously issued financial statements is also addressed by this Subtopic.

05-5 This Subtopic also:

a. Specifies the method of treating error corrections in comparative statements for two or more periods
b. Specifies the disclosures required when previously issued statements of income are restated
c. Recommends methods of presentation of historical, statistical-type financial summaries that are affected by error corrections.

> Correction of an Error in Previously Issued Financial Statements

45-22 As indicated in paragraph 220-10-45-7A, net income for the period shall include all items of profit and loss recognized during the period, including accruals of estimated losses from loss contingencies, but shall not include corrections of errors from prior periods. As used in this Subtopic, the term *period* refers to both annual and interim reporting periods.

45-23 Any error in the financial statements of a prior period discovered after the financial statements are issued or are available to be issued (as discussed in Section 855-10-25) shall be reported as an error correction, by restating the prior-period financial statements…

An accounting error, or misstatement, occurs when the financial statements do not appropriately reflect GAAP. An error, if material individually or in combination with other errors, causes the financial statements not to be presented fairly in conformity with GAAP. [AS 2810.A1]

Question 4.2.10 What types of departures from GAAP constitute accounting errors?

Interpretive response: An error may relate to a difference between the amount, classification, presentation or disclosure of a reported financial statement item and the amount, classification, presentation or disclosure that should be reported in conformity with GAAP. [AS 2810.A2, AU-C 450.04]

Therefore, a misstatement may occur in:

- amount – i.e. a monetary misstatement;
- presentation – i.e. the presentation of an item is incorrect;
- classification – i.e. an item is incorrectly classified; or
- disclosure – i.e. omitted or incomplete/inaccurate disclosures.

Question 4.2.20 Can small departures from GAAP be ignored?#

Interpretive response: No. Even when a misstatement is relatively small, departures from GAAP may not be ignored, particularly if they are intentional or qualitatively material.

Although the Codification does not apply to immaterial items, intentional errors – even if small – must be evaluated to take into consideration the nature and reason for the errors when determining if they are qualitatively material (see Question 4.3.30). For example, capitalizing a small expense to convert a loss into profit could be deemed material because of its intent and effect. [105-10-05-6]

In addition, an entity should consider the effect of small departures from GAAP on *future* periods – because a small departure may accumulate to become a material error and require restatement in the future (see Question 4.3.130 and section 4.4.40).

4.3 Determine materiality of the error

Section 2.3 discusses the general concept of materiality, which is integral to the application of Topic 250. This section explores materiality in the context of error corrections, and how that analysis drives how the error is corrected.

The SEC staff guidance that underpins the materiality discussion in this section is reproduced in the Appendix.

Question 4.3.10 Why is it important to evaluate the materiality of an error?

Interpretive response: The materiality of an error will indicate whether an error must be corrected and if corrected, what options are available to correct the

error in the financial statements. The starting point is to determine whether the prior-period financial statements are materially misstated.

Depending on the outcome of that assessment, if the error is material to the prior period, the prior-period financial statements are restated by being reissued as soon as practicable. However, even if not material to the prior period, the prior period financial statements may still need to be revised the next time they are presented (e.g. as comparatives). If the error is not material to either current or prior periods, the error can be corrected through an 'out-of-period adjustment' in the current-period financial statements or through a voluntary little r restatement of the prior-period financial statements, or it can be left uncorrected. See section 4.1 and Question 4.4.10.

The materiality of an error can also have other implications, including potentially triggering the clawback of executive compensation.

Question 4.3.20 Should non-SEC registrants follow the SEC guidance on materiality?

Interpretive response: Generally, yes. Specifically in relation to error corrections, we believe all entities should consider the SEC staff's interpretive guidance on materiality in SAB Topic 1.M (see Appendix), which is based on Supreme Court precedent and consistent with CON 8 (see Question 2.3.10).

As discussed in section 2.3, that guidance provides a practical framework that is consistent with the overall direction in CON 8 that materiality is based on the judgment of a 'reasonable person' and is not simply a question of magnitude. It is also consistent with the principles of materiality discussed in the auditing standards. [AS 2105, AU-C 320]

4.3.10 Overview

Question 4.3.30 What is the process for assessing whether an error is material?

Excerpts from SEC staff speeches

If you have to evaluate whether a large error is material, don't color your analysis by trying to guess what an accountant in the Division may or may not find important. A better proxy would seem to be the folks that are making investment decisions. And as company management, you talk to them on a regular basis. So ask yourself: Why doesn't the size of the error matter to the reasonable investor? What is it about your individual facts and circumstances that supports your conclusion? Or in accounting parlance, what qualitative factors exist that make the size of the error unimportant to the reasonable

investor? A high hurdle to climb? Perhaps, but with the right facts and circumstances, a surmountable one.

Todd E. Hardiman, Remarks before the 2007 AICPA National Conference on Current SEC and PCAOB Developments

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Further, if an error is identified in the financial statements, management must determine whether the error is material, which is based on what is important to the user. If that analysis indicates that previously issued financial statements are materially misstated, those financial statements would need to be restated and reissued. By comparison, if the error is not material to previously issued financial statements, but correcting the error in the current period would be material to the current period, an entity is not precluded from correcting the error in the current period comparative financial statements by restating the prior period information and disclosing the error, which is commonly referred to as a "little r" restatement. While the total number of restatements by U.S.-based public companies has declined each year for the past six years, we note that "little r" restatements as a percentage of total restatements rose to nearly 76% last year, up from about 35% in 2005. [footnote omitted] In this regard, we note that under existing accounting guidance assessing whether an error is material to prior periods is not a mechanical exercise, nor is it based solely on a quantitative analysis. Rather, management must judiciously evaluate the total mix of information, taking into consideration both quantitative and qualitative factors to determine whether an error is material to investors and other users. [footnote omitted]

We also emphasize the importance of identifying and communicating material weaknesses in ICFR before they become evident in the form of a restatement and reissuance. We encourage ongoing attention, including audit committee participation, regarding the adequacy of and basis for a company's effectiveness assessment, particularly where there are "close calls" in the assessment of whether a deficiency is a significant deficiency (and reported to the audit committee) or a material weakness (and also reported to investors).

Paul Munter, Statement on OCA's Continued Focus on High Quality Financial Reporting in a Complex Environment (December 6, 2021)

Concept of Materiality and the Correction of Material Errors

Central to the process a registrant must follow when an error is identified in its historical financial statements is determining whether the error is material to those historical financial statements. The Supreme Court has held that a fact is material if there is:

"a substantial likelihood that the ... fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." [footnote omitted]

…

Objective Assessment of Materiality

Since the concept of materiality is focused on the total mix of information from the perspective of a reasonable investor, those who assess the materiality of errors, including registrants, auditors, audit committees, and others, should do

so through the lens of the reasonable investor. To be consistent with the concept of materiality, this assessment must be objective. A materiality analysis is not a mechanical exercise, nor should it be based solely on a quantitative analysis. Rather, registrants, auditors, and audit committees need to thoroughly and objectively evaluate the total mix of information. Such an evaluation should take into consideration all relevant facts and circumstances surrounding the error, including both quantitative and qualitative factors, to determine whether an error is material to investors.

An objective analysis should put aside any potential bias of the registrant, auditor, or audit committee that would be inconsistent with the perspective of a reasonable investor. For example, a restatement of previously-issued financial statements may result in the clawback of executive compensation, reputational harm, a decrease in the registrant's share price, increased scrutiny by investors or regulators, litigation, or other impacts. An assessment where a registrant's, auditor's, or audit committee's biases based on such impacts influenced a determination that an error is not material to previously-issued financial statements so as to avoid a Big R restatement would not be objective and would be inconsistent with the concept of materiality.

One area where the staff in OCA have observed an increased need for objectivity is in the assessment of qualitative factors. The interpretive guidance on materiality in SAB No. 99 speaks to circumstances where a quantitatively small error could, nevertheless, be material because of qualitative factors. However, we are often involved in discussions where the reverse is argued—that is, a quantitatively significant error is nevertheless immaterial because of qualitative considerations. We believe, however, that as the quantitative magnitude of the error increases, it becomes increasingly difficult for qualitative factors to overcome the quantitative significance of the error.

We also note that the qualitative factors that may be relevant in the assessment of materiality of a quantitatively significant error would not necessarily be the same qualitative factors noted in SAB No. 99 when considering whether a quantitatively small error is material. So it might be inappropriate for a registrant to simply assess those qualitative factors in reverse when evaluating the materiality of a quantitatively significant error. Such a scenario highlights the importance of a holistic and objective assessment from a reasonable investor's perspective.

Paul Munter, Statement on Assessing Materiality: Focusing on the Reasonable Investor When Evaluating Errors (March 9, 2022) – See Appendix.

Interpretive response: To determine whether an error is material, an entity performs both a quantitative assessment and a qualitative assessment – i.e. the assessment is not an either/or determination. [SAB Topic 1M]

Because of the interaction of quantitative and qualitative considerations in materiality judgments, by evaluating these factors together an entity may determine that an error is:

- material even if it is not quantitatively large; or
- immaterial even if it is quantitatively large.

An entity evaluates errors individually and in the aggregate – in relation to specific financial statement captions and disclosures, and the financial

statements as a whole. The entity considers not just the current period, but also the effect on prior periods and future periods, and whether correcting the error or leaving the error uncorrected would cause the financial statements in each of those periods to be materially misstated.

When performing the quantitative and qualitative assessments, an entity considers all relevant circumstances, including the factual context in which the user of financial statements would view the financial item (see Question 2.3.20).

Error is material *even if it is not quantitatively large*

The following are examples of an error being material even if it is not quantitatively large.

- A relatively small error could be material if it relates to or results from an illegal payment.
- A relatively small error could be material if it was made intentionally (e.g. fraud).
- A misclassification between balance sheet financial statement captions that is small in relation to the size of the related balance sheet captions may be material if the error affects compliance with loan covenants.
- A relatively small error may be considered material if it affects a disclosure that has a history of causing volatility in the price of an entity's securities.
- Multiple errors in the same account offset in the aggregate but may be considered material individually.
- An error in revenue that is not quantitatively material may be material if it changes the trend in revenues (from decreasing to increasing) and that trend is important to the financial statement users.
- A relatively small error could be material if it increases management's incentive-based compensation.

Error is immaterial *even if it is quantitatively large*

Practically, in many cases it is clear that an error that is quantitatively large is material, and the entity can then proceed with correcting the error (see section 4.4). However, this will not always be the case. For example, a large classification error might not be material if it (1) is small in relation to the size of the individual line items or subtotals in the financial statements, (2) does not affect key ratios, (3) does not affect debt covenants calculations, and (4) does not affect management's incentive-based compensation.

The SEC staff has provided useful comments in making this assessment (see excerpts above), which tie back to the concept of thinking about what would be important to a 'reasonable investor' (see Question 2.3.20). In particular, we understand the SEC staff has a view that if an error is quantitatively large, registrants should be cautious in concluding that qualitative factors could overcome the magnitude of the error and that the restatement to correct the error is a 'little r' restatement (see section 4.4.30). Magnitude often cannot be overcome by qualitative factors. [2021 AICPA Conf]

Question 4.3.40 Can errors be netted in assessing their materiality?

Interpretive response: Generally no. If by itself an error causes the financial statements as a whole to be materially misstated, its effect cannot be eliminated by other errors whose effects may be to diminish or offset the impact of the misstatement. The following are examples where netting errors to assess their materiality is not appropriate.

- An error in revenue is offset by an error in cost of sales, and the net effect on gross margin is immaterial. However, the error in revenue may nonetheless be material, because revenue is generally important to investors.
- An error in SG&A expenses is offset by an error in interest expense, and the net effect on pretax income and net income is immaterial. However, the error in interest expense may nonetheless be material because it affects the calculation of times interest coverage, and masks that the entity is close to defaulting on certain loan covenants. Additionally, SG&A expense and SG&A expense as a percentage of revenue are often key metrics, so even if the error's effect on net income is immaterial, it could still be significant to users of the financial statements.
- An error related to the income tax provision for a new foreign subsidiary is offset by an error related to uncertain tax positions in another tax jurisdiction. These two errors cannot be netted for purposes of evaluating their materiality, even though they both impact income tax expense, because their nature is different.

In limited circumstances, where the errors reside in the same line item, it may be appropriate to net errors in assessing their materiality. However, the nature of the individual errors should be considered.

Further, if one error can be measured precisely but the other is an estimate, netting the two errors may not be appropriate. This is because the lack of precision inherent in an estimated error will in effect be expanded through netting it against an error whose amount is known. An entity should exercise particular care when considering whether to offset such errors. [SAB Topic 1M]

Question 4.3.50 Why are errors evaluated both individually and in the aggregate?

Interpretive response: If an entity evaluates the materiality of errors only in aggregate, it might not notice that an error by itself is material to the financial statements as a whole when, for example, it is offset by other errors (see Question 4.3.40). Conversely, if an entity evaluates errors only individually, it might not notice that a number of errors in aggregate cause the financial statements as a whole to be materially misstated. [SAB Topic 1M]

Question 4.3.60 How does an entity evaluate errors in the aggregate and in relation to totals and subtotals?

Interpretive response: Evaluating errors in the aggregate does not simply mean looking at the sum total. Instead, errors should be combined in different ways based on the entity's specific circumstances.

The following are examples of how errors can be combined to enable a comparison of specific metrics in the financial statements. The appropriate metrics will vary by entity.

Combining factor	Examples
Totals in the financial statements	• Total assets • Total liabilities • Total net income (loss)
Subtotals in the financial statements	
• Balance sheet	• Current assets • Noncurrent assets • Current liabilities • Noncurrent liabilities
• Income statement	• Gross margin • Income from continuing operations • SG&A expenses
• Statement of cash flows	• Operating activities • Investing activities • Financing activities
• Statement of changes in equity	• OCI • Additional paid-in capital
• Disclosures	• Totals or subtotals within the note disclosures
A common qualitative characteristic	• Misstatements that affect debt covenant calculations • Misstatements that affect management's incentive-based compensation
The same matter	A number of misstatements related to an acquisition, considered collectively, may affect an understanding of the business combination

Example 4.3.20 Assessing errors against totals and subtotals

During ABC Corp.'s financial statement close process, the CFO identifies the following errors.

Account affected	Amount dr/(cr)
Revenue	25,000
Administrative expenses	(15,000)
Revenue	7,500
Revenue	20,000
Marketing expenses	(18,000)
Cost of goods sold	(19,000)
Effect on pretax income	500

ABC assesses each error individually and also evaluates the total effect of the errors on pretax income (among other totals/subtotals). In both cases, ABC concludes that the errors are not quantitatively material to these specific line items.

As ABC performs its analysis, it observes that there are three errors that result in a $52,500 effect on revenue ($25,000 + $7,500 + $20,000), which represents a significant effect to the revenue line item. Notwithstanding that these three errors are offset by other errors affecting other income statement accounts, ABC concludes that these errors in the aggregate represent a material error.

Question 4.3.70 When evaluating the materiality of an error, does an entity consider the effect of the error on non-GAAP measures?

Interpretive response: Yes. The assessment of materiality includes the effect of the error on relevant non-GAAP financial measures – e.g. EBITDA. This may be particularly relevant if the non-GAAP measure affects the calculation of management's incentive-based compensation. As discussed in Question 4.3.30, the key consideration is whether the information would be important to a financial statement user. However, the SEC staff has emphasized that it is generally not appropriate to conclude on the materiality of an error based solely on its effect on a non-GAAP measure – e.g. to conclude that an error is not material solely based on the fact that it does not affect EBIDTA.

Question 4.3.75 How is an error in the classification of a cash flow item evaluated?

Excerpt from SEC staff speech

[…]

Key Reminders of Professional Responsibilities around the Statement of Cash Flows

Materiality

The statement of cash flows has consistently been a leading area of restatements,[6] and we have observed that a significant majority of these restatements represent prior period errors corrected in the current period comparative financial statements, or what are referred to colloquially as "little r" restatements.[7] This indicates that issuers are routinely making a determination that errors in the statement of cash flows do not constitute a material error in prior periods. We remind issuers, auditors, and others of the importance of performing an objective analysis from the perspective of a reasonable investor when evaluating the materiality[8] of both the financial statement and ICFR impacts[9] of an error in the statement of cash flows, including the significance of the statement of cash flows to the investor's complete understanding of the financial condition of the company.

In certain instances, the staff in OCA have been presented with analyses that conclude an error in the statement of cash flows is not material because it is an error in classification only. We have not found such analyses and their corresponding arguments persuasive since classification itself is the foundation of the statement of cash flows. Accurately classifying cash flows as operating, investing, or financing activities is paramount to investors understanding the nature of the issuer's activities that generated and used cash during the reporting period. Therefore, issuers and auditors must consider all relevant facts and circumstances to thoroughly and objectively evaluate the total mix of information and determine if such classification errors are material to a reasonable investor.

[…]

[3] See Audit Analytics, Financial Restatements, A 20-Year Review: 2003 – 2022, at 5 and 10 (noting that cash flows have been the fourth most common accounting issue cited in restatements from 2003 through 2022, including the most frequently cited issue among large accelerated filers) (November 2023).

[6] See supra note 3.

[7] See Paul Munter, Assessing Materiality: Focusing on the Reasonable Investor When Evaluating Errors (Mar. 9, 2022).

[8] The Supreme Court has held that a fact is material if there is "a substantial likelihood that the [...] fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." TSC Industries v. Northway, Inc., 426 U.S. 438, 449 (1976); see also Basic, Inc. v. Levinson, 485 U.S. 224 (1988) (as the Supreme Court has noted, determinations of materiality require "delicate assessments of the inferences a

'reasonable shareholder' would draw from a given set of facts and the significance of those inferences to him...." TSC Industries, 426 U.S. at 450). See also FASB, Statement of Financial Accounting Concepts No. 8—Conceptual Framework for Financial Reporting—Chapter 3, Qualitative Characteristics of Useful Financial Information (As Amended) (Aug. 2018); Staff Accounting Bulletin ("SAB") No. 99, Materiality (Aug. 12, 1999); SAB No. 108, Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements (Sept. 13, 2006).

[9] Management's ICFR effectiveness assessment must consider the magnitude of the potential misstatement that could result from a control deficiency, and we note that an actual error is only the starting point for determining the potential impact and severity of a deficiency.

Paul Munter, SEC Chief Accountant, The Statement of Cash Flows: Improving the Quality of Cash Flow Information Provided to Investors (December 4, 2023)

Interpretive response: An entity should evaluate errors in classification in the statement of cash flows in the same manner as errors in any other financial statement, as noted in an SEC speech (see Appendix for full remarks). Because the statement of cash flows is centered on classification, an argument that an error is not material because it only affects classification is not persuasive. As with other errors, the evaluation should consider the total mix of information available to the user. [2023 AICPA Conf]

See KPMG Handbook, Statement of cash flows, for further information.

4.3.20 Step 1: Assess the quantitative materiality of the error

Question 4.3.80 What does evaluating materiality of errors using quantitative factors entail?

Interpretive response: When evaluating the materiality of errors using quantitative factors, the focus is on whether the amount/size of the errors, individually or in the aggregate, are of such a magnitude that they are material to the financial statements.

As highlighted in the following table, considering quantitative factors entails comparing the amount of the misstatement with: [SAB Topic 1M]

- materiality level(s);
- the specific financial statement captions and disclosures involved; and
- the financial statements as a whole.

Compare to:	Commentary
Materiality level(s)	Materiality for the financial statements as a whole serves as an initial measure for determining when errors are quantitatively material.

Compare to:	Commentary
	However, an entity may determine a lower materiality for a particular financial statement caption or disclosure – e.g. if it is expected that financial statement users scrutinize or place more weight on those items. The entity then considers that lower materiality level when evaluating errors that affect that particular caption or disclosure.
Specific financial statement captions and disclosures	An error of an amount less than materiality may still be material in relation to a specific financial statement caption or disclosure.
Financial statements as a whole	An error is evaluated in relation to totals and/or subtotals in *all* the primary financial statements – e.g. balance sheet, income statement, statement of cash flows and statement of changes in equity.

Question 4.3.90 What are the methods for quantifying the materiality of errors?#

Interpretive response: In general, there are three methods used to quantify and evaluate the effect of uncorrected prior-period errors on the current period income statement. [SAB Topic 1N]

Iron curtain method	Rollover method
This method quantifies an error to the income statement based on the effects of correcting the error that exists in the balance sheet at the end of the current period, irrespective of the error's period(s) of origin.	This method quantifies an error to the income statement based on the effect of correcting the error that exists in the current period's income statement. It does not consider the cumulative effect of the error in prior periods.

Dual method – required for SEC registrants
Combines both iron curtain and rollover methods.

The SEC staff requires the dual method because of shortcomings in both the iron curtain and rollover methods as summarized below. [SAB 108]

Method	Shortcomings
Iron curtain	This method focuses on correcting the balance sheet, including errors from the current period, while ignoring the effect on the income statement from correcting prior period errors in the current period (i.e. out-of-period corrections).
Rollover	Because this method focuses on the error in the current period income statement, it could allow misstatements in the balance sheet to increase by immaterial amounts each period without regard to the cumulative error.

When an error is evaluated under the dual method, the error is quantified using both the rollover and iron curtain methods.

The evaluation of errors in the prior periods needs to take place regardless of whether the errors are material to the current period. The SEC staff permits registrants to evaluate the previous periods using the rollover method, meaning the errors in the prior periods are only evaluated based on the errors in each period. [2008 AICPA Conf]

It is important to remember that the above methods assess materiality based only on how the error affects the current-period income statement. As a result, it is essential to consider the error's effect on the financial statements as a whole, including the other statements and disclosures.

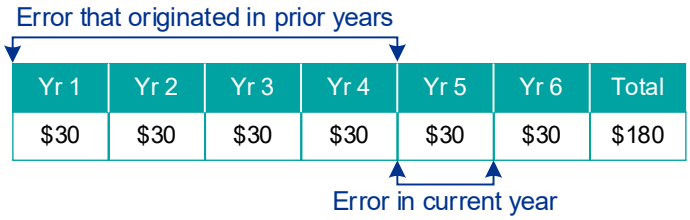
Regardless of the method used, the entity evaluates whether an error is material, individually or in combination with other misstatements, considering both quantitative and qualitative factors.

Example 4.3.30 Methods for quantifying error materiality#

In Year 1, ABC Corp. begins receiving a regular service for which it will pay $180 at the end of the six-year contract. Management decided not to record the liability because it was not considered material in the prior years. Therefore, at the end of Year 5, the financial statements contain an understated liability of $150 that has built up over five years ($30 per year). This example assumes that no other errors are identified.

The following diagram highlights the focus of the analysis in Year 5.

- $30 is the error that originated in the current period (Year 5).
- $120 is the amount of the error that originated in the prior periods that remains uncorrected (Years 1 to 4).



To evaluate the effect of the error at the end of the current period (Year 5), ABC quantifies the error using the dual method (both the iron curtain method and the rollover method).

Iron curtain method

As described in Question 4.3.90, this method quantifies the materiality of an error based on the effects to the income statement of correcting the cumulative error existing at the end of the current period. At the end of Year 5, an adjustment of $150 to the income statement would be necessary to correctly state the balance sheet accounts.

Rollover method

As described in Question 4.3.90, this method quantifies the materiality of an error based on the effects to the income statement of correcting the error existing in the relevant period. At the end of Year 5, an adjustment of $30 to increase expenses would be necessary to correctly state the current-period income statement.

Next steps

Once ABC has quantified the effect of the error in the current period under both the iron curtain method and the rollover method, it evaluates the error individually and in combination with other errors, considering both quantitative and qualitative factors.

In this evaluation, ABC considers the errors in relation to:

- the materiality level for the financial statements as a whole and any lower materiality level for particular accounts or disclosures;
- the specific financial statement captions and disclosures involved; and
- the financial statements as a whole – i.e. subtotals and totals in all primary financial statements. With respect to the statement of cash flows, ABC evaluates the errors in relation to operating, investing and financing activities.

Depending on the outcome of this evaluation, ABC then determines how to correct its financial statements (see section 4.4).

Question 4.3.100 How is the dual method applied in an IPO?

Background: A nonpublic entity may apply the iron curtain, rollover or dual method to evaluate errors. When an entity prepares for an IPO, the financial statements included in the registration statement are required to comply with SEC rules, regulations and guidance. However, these financial statements may include periods in which errors were not evaluated using the dual method as prescribed by SEC staff guidance (see Question 4.3.90). Had the dual method been used, the financial statements may have been different.

Interpretive response: An SEC registrant is required to apply the dual method in financial statements included in an initial registration statement, which may require reevaluating the materiality of errors and prior-period financial statements to be restated, depending on the entity's previous approach.

Question 4.3.110 Can a nonpublic entity change its method of evaluating the quantitative materiality of an error?

Interpretive response: A nonpublic entity may evaluate the quantitative materiality of an error based on any of the three methods outlined in Question 4.3.90: the iron curtain method, the rollover method or the dual method.

However, we believe that a nonpublic entity should not change from the dual method to either the iron curtain or rollover method. This is because of the drawbacks of those latter methods (with their different focus points) identified in Question 4.3.90. As a result of those drawbacks, we do not believe that such a change could be justified as preferable (see section 3.3.20).

Question 4.3.115 Is the dual method required for a nonregistrant whose financial statements are included in an SEC filing?

Interpretive response: Financial statements for nonregistrants included in a filing with the SEC (such as pursuant to Rules 3-05 or 3-09 of Regulation S-X) are generally expected to be compliant with Regulation S-X, including the application of SEC Staff Accounting Bulletins. This includes evaluating errors under the dual method. [FRM 2935.1, 2400.5]

4.3.30 Step 2: Assess the qualitative materiality of the error

Qualitative factors relate to the nature of errors and the circumstances of their occurrence.

Question 4.3.120 What are some qualitative factors to consider in evaluating materiality of an error?

Interpretive response: In assessing qualitative factors, the focus is how the error(s) could affect how a 'reasonable person' (see Question 2.3.20) views the financial information.

Similar to evaluating quantitative factors (see section 4.3.20), qualitative factors are evaluated in relation to: [SAB Topic 1M]

- the specific financial statement captions and disclosures involved; and
- the financial statements as a whole.

The following are examples of how an entity's high-level characteristics can affect the types of qualitative factors that may be relevant.

- For a profit-seeking entity, its profitability and prospects for future net cash inflows.

- For a highly leveraged entity, its ability to comply with any debt service, including the ability to satisfy obligations and continue as a going concern.
- In an industry where margins can fluctuate significantly, an entity's sales base that drives future profitability and cash flows.
- For an entity primarily generating profit from lending activities, its asset base that drives lending activities.
- For an entity with management incentive-based compensation, its compensation formula and clawback policy, if any.

The following are more detailed examples (not exhaustive) of qualitative considerations that may be relevant in specific circumstances. A number of these factors are included in the SEC staff guidance (SAB 1M, see Appendix).

Factor	Examples
What is the character of the error – factual or judgmental?	Estimating a loss contingency after a warehouse fire with hundreds of affected employees may be difficult soon after the loss event; therefore, a higher degree of variability in the estimate may be expected with less likelihood of an error.
Does the error reveal management's motivations?	An error reveals a possible pattern of bias by management when developing and accumulating accounting estimates, or is triggered by management's continued unwillingness to correct weaknesses in its financial reporting process.
Does the error mask a change in earnings or other trends?	An error changes the trend in revenues (from a decrease to an increase) and that trend is important to financial statement users.
Does the error hide a failure to meet analysts' consensus expectations?	An error in operating income results in an entity meeting analysts' earnings expectations.
Does the error change a loss into income or vice versa?	An error in SG&A expenses results in an entity reporting income from continuing operations instead of a loss.
Does the error relate to a segment or other portion of the business that has been identified as playing a significant role in the entity's operations or profitability?	An error related to a recently acquired business shows a significant segment as having higher net income.
How significant is the financial statement caption affected by the error?	A classification error increases income from continuing operations (and decreases income from discontinued operations) such that the entity meets its target EPS from continuing operations.
Does the error affect items disclosed separately in the financial statements?	A classification error reduces environmental remediation obligations (a disclosure scrutinized by an entity's

Factor	Examples
	financial statement users) and increases 'other liabilities'.
Does the error affect compliance with regulatory requirements?	An entity operates under license, and reversing the error results in the entity not complying with the terms of the license.
Does the error conceal an unlawful transaction (e.g. fraud, contract violations)?	A classification error conceals an illegal payment that could lead to a material criminal action against the entity, a contingent liability and/or a material loss of revenue.
Does the error affect the entity's compliance with loan covenants or other contractual requirements?	A classification error inflates the calculation of an entity's interest coverage, which is a key ratio that it must maintain to comply with loan covenants.
Does the error increase management's compensation?	An error inflates earnings enough for an entity's earnings to meet the target level set by the compensation committee for executive bonuses.
What is the significance of the error or disclosure relative to known financial statement user needs?	An error in the acquisition accounting for a key strategic business combination understates the premium (goodwill) that the entity paid for the acquiree.
Does the error relate to items involving particular parties?	An entity fails to disclose information about supply contracts awarded to related parties.

An entity may assert that an error is not qualitatively material because it occurred in previous periods, and the investor may be less focused on prior periods. During the 2021 AICPA Conference on Current SEC & PCAOB Developments, the SEC staff commented that it generally does not view the 'passage of time' argument alone as a persuasive qualitative factor because investors are not solely focused on the most recent financial statements. Further, errors in prior-period financial statements may be indicative of errors in the current-period financial statements.

The SEC staff has also stated that the qualitative factors that may be relevant in the assessment of materiality of a quantitatively large error would not necessarily be the same qualitative factors when considering whether a quantitatively small error is material. So it might be inappropriate for an entity to simply assess those qualitative factors in reverse when evaluating the materiality of a quantitatively large error. [SEC Statement Mar 9, 2022]

Example 4.3.40 Assessing qualitative factors

ABC Corp. is a calendar year-end SEC registrant. In Q1 of Year 10, ABC identifies an error resulting from miscalculating the loss on sale of a business in Year 8, which was reported in discontinued operations. In evaluating whether the error is material to Year 8, ABC considers the following factors.

Quantitative factors	Qualitative factors
• Net income in Year 8 was misstated by 20% • The loss on discontinued operations in Year 8 was misstated by 50%	• The error was isolated to the discontinued operations portion of the income statement • The sale transaction to which the error related was completed in Year 8.

ABC determines that the qualitative factors considered related to the isolation of the error and the passage of time (see Question 4.3.120) are not sufficient to overcome the magnitude of the quantitative error to net income and to discontinued operations.

Based on this assessment, ABC determines that its previous financial statements may no longer be relied upon. Accordingly, ABC restates and reissues those financial statements (Big R restatement – see section 4.4.20) and provides the required disclosures (see Questions 4.4.60 and 4.4.70). In addition, ABC amends previous SEC filings that contained those financial statements (see section 6.4).

Question 4.3.130 Is it relevant to consider the effect of uncorrected errors in future periods?

Interpretive response: Yes. An error that is immaterial in prior periods does not require reissuance of the financial statements. Further, if the error is also immaterial in the current period, there would be no need to correct the error. However, if errors are left uncorrected, they may accumulate to become material.

In our experience, to avoid issues in the future, entities often correct these errors even though they were and still are immaterial. See section 4.4.40.

Question 4.3.140 How is the anticipated effect on the entity's share price considered in evaluating materiality of an error?

Interpretive response: If the entity anticipates that disclosing a particular misstatement will have a significant effect (whether positive or negative) on its share price, this would be an indication that the misstatement may be material. However, the absence of a significant market reaction does not mean that the misstatement is immaterial. As discussed in Question 4.3.30, the key consideration is whether the information would be important to a financial statement user, noting that users of the financial statements are not limited to equity investors.

Question 4.3.150 How are misstatements (or omissions) in narrative disclosures evaluated?

Interpretive response: Qualitative factors can be particularly relevant when evaluating misstatements within narrative disclosures. A misstatement in a narrative disclosure could represent information that is misstated or omitted from a disclosure – e.g. management's failure to disclose a reasonably possible loss contingency.

Although a disclosure error or omission might be immaterial in relation to the financial statements taken as a whole, a full analysis often depends on the specific circumstances of the entity. The following are examples that might be material in the circumstances.

- An entity with mining operations is facing a significant long-term decline in the demand for a metal or commodity; the entity records an impairment of long-lived assets, but fails to disclose information about the facts and circumstances that led to the impairment loss. [360-10-50-2(a)]
- Just before year-end, an entity had a significant pollution accident at one of its plants. The entity was unable to reasonably estimate the amount of loss before issuing its financial statements, but it failed to disclose information about the accident or that an estimate could not be made. [450-20-50-3 – 50-4]

4.4 Correct the error

4.4.10 Overview

Question 4.4.10 What is the framework for evaluating how a prior-period error is corrected?

Excerpt from SEC staff speech

When an error is determined to be material to previously-issued financial statements, the error must be corrected by restating the prior-period financial statements. [footnote omitted] This type of restatement is sometimes referred to colloquially as a reissuance restatement or a "Big R" restatement.

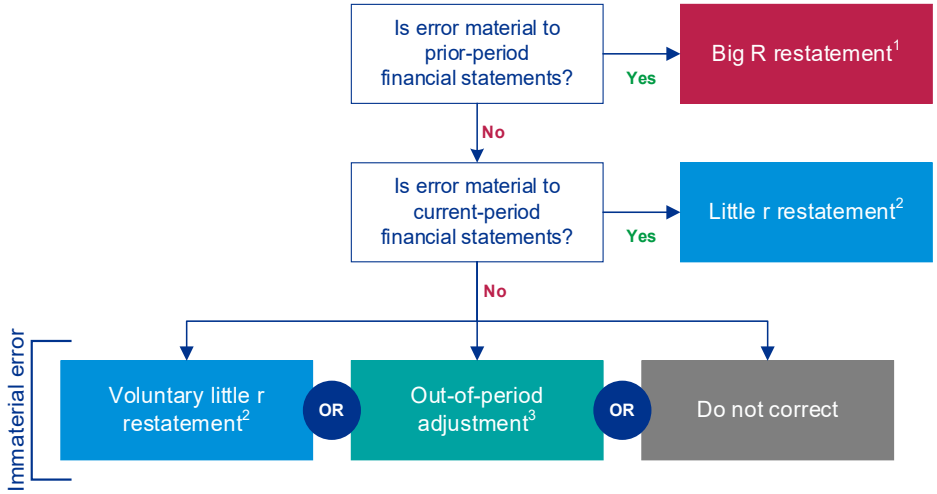
If the error is not material to previously-issued financial statements, but either correcting the error or leaving the error uncorrected would be material to the current period financial statements, a registrant must still correct the error, but is not precluded from doing so in the current period comparative financial statements by restating the prior period information and disclosing the error. This type of restatement is sometimes referred to colloquially as a revision restatement or a "little r" restatement.

It is important to note that both of these methods—reissuance and revision, or "Big R" and "little r"—constitute restatements to correct errors in previously-issued financial statements as those terms are defined in U.S. GAAP. [footnote

omitted] In either case, such errors should be transparently disclosed to investors.

Paul Munter, SEC Acting Chief Accountant Statement on Assessing Materiality: Focusing on the Reasonable Investor When Evaluating Error (March 9, 2022) – See Appendix.

Interpretive response: As shown in the following diagram, how a prior-period error is corrected depends on the results of the materiality assessment (see section 4.3).



Notes:

1. Restate and reissue prior-period financial statements.
2. Restate and revise prior-period financial statements the next time those financial statements are presented.
3. Correct in current-period financial statements.

If it is determined that the financial statements of one or more prior periods were materially misstated, those financial statements are restated and reissued. This process, referred to in this Handbook as a 'Big R restatement' or 'reissuance restatement', is explained in section 4.4.20.

If the entity concludes that prior-period financial statements were not materially misstated, an entity next determines whether (a) the correction of the error is material to the current period or (b) leaving the error uncorrected in the current period is material to the current period. If either of these two conditions exists, the financial statements are revised the next time they are presented (i.e. as comparative information). This process, referred to in this Handbook as a 'little r restatement' or 'revision restatement', is explained in section 4.4.30. This is not a restatement that requires notification of non-reliance (see Question 4.4.30) and reissuance of financial statements.

In contrast, if neither of the above two conditions exists, then the error may be corrected in the current period (without revision to comparative information). This is referred to as an 'out-of-period adjustment' (which introduces an error to the current period). The error may also be corrected as a 'voluntary little r restatement' or be left uncorrected. See section 4.4.40.

Further, an error is usually an indication of a deficiency in internal controls. While the existence of a material accounting error is an indicator of a material weakness, a material weakness may also be present even if the error is not material. [2022 SEC staff speech]

An entity also considers the indirect accounting effects of the error or restatement, e.g. from debt covenants and clawback policies.

Question 4.4.15 How is an error in a subsidiary's separate financial statements corrected?

Background: An error is identified in a subsidiary's separate (stand-alone) financial statements for the prior year. The error is material to those financial statements. However, the error is immaterial to the parent's consolidated financial statements.

Interpretive response: The subsidiary corrects the error in its separate financial statements according to its level of materiality (Big R or little r restatement, see sections 4.4.20 and 4.4.30, respectively). The parent's consolidated financial statements may have been issued with amounts related to the subsidiary that differ from those after the error correction. In this case, the subsidiary may consider if specific disclosures in its separate financial statements are necessary to help financial statement users understand the difference in the reported amounts between the corrected separate financial statements and consolidated financial statements.

If the error identified is material to the parent's consolidated financial statements, the parent's financial statements need to be corrected (see sections 4.4.20 and 4.4.30).

4.4.20 Error is material to prior-period financial statements: Big R restatement

Excerpt from ASC 250-10

> Correction of an Error in Previously Issued Financial Statements

45-22 As indicated in paragraph 220-10-45-7A, net income for the period shall include all items of profit and loss recognized during the period, including accruals of estimated losses from loss contingencies, but shall not include corrections of errors from prior periods. As used in this Subtopic, the term period refers to both annual and interim reporting periods.

45-23 Any error in the financial statements of a prior period discovered after the financial statements are issued or are available to be issued (as discussed in Section 855-10-25) shall be reported as an error correction, by restating the prior-period financial statements. Restatement requires all of the following:

a. The cumulative effect of the error on periods prior to those presented shall be reflected in the carrying amounts of assets and liabilities as of the beginning of the first period presented.
b. An offsetting adjustment, if any, shall be made to the opening balance of retained earnings (or other appropriate components of equity or net assets in the statement of financial position) for that period.
c. Financial statements for each individual prior period presented shall be adjusted to reflect correction of the period-specific effects of the error.

45-24 Those items that are reported as error corrections shall, in single period statements, be reflected as adjustments of the opening balance of retained earnings. When comparative statements are presented, corresponding adjustments should be made of the amounts of net income (and the components thereof) and retained earnings balances (as well as of other affected balances) for all of the periods reported therein, to reflect the retroactive application of the error corrections.

If it is determined that the financial statements of one or more prior periods were materially misstated, those financial statements cannot be relied upon and users must be notified. The prior-period financial statements are then restated and reissued as soon as is practicable. This process is referred to as a 'Big R restatement' or 'reissuance restatement'.

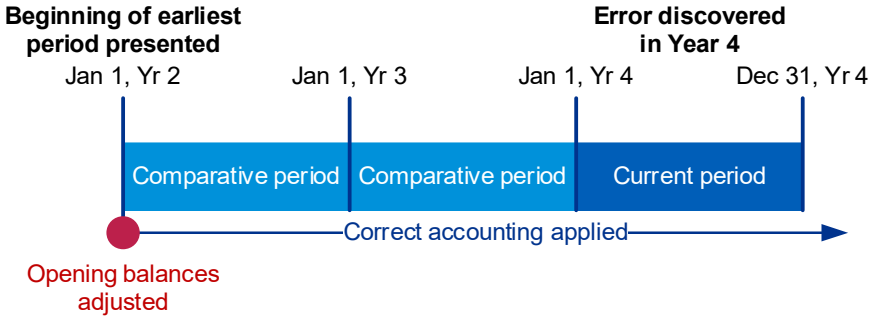
Question 4.4.20 What are the steps to restating prior-period financial statements in a Big R restatement?

Interpretive response: The following are the steps required to correct the prior-period financial statements. [250-10-45-23]

Step 1: Adjust opening balances of earliest period presented	Adjust the opening balances of the earliest period presented in the financial statements for the cumulative effect of the error on period(s) prior to the periods presented in the financial statements. This includes: • adjusting the opening balance of the assets and liabilities for the earliest period presented in the financial statements; and • recording a corresponding adjustment to the opening balance of retained earnings (or other appropriate components of equity or net assets) for that period.
Step 2: Adjust incorrect prior-period amounts and disclosures	Adjust the financial statements of prior period(s) so that they reflect the correct amounts and disclosures for that period.
Step 3: Disclose in financial statements and notes	Label each affected column on the face of the financial statements as restated (see Question 4.4.40), disclose in the notes and label each affected note as restated (see Questions 4.4.60 and 4.4.70).

For example, an SEC registrant with a calendar year-end discovers in Year 4 an error in the application of an accounting principle that has affected its financial

statements for a number of years. The registrant determines that the error is material to prior periods (see section 4.3). Therefore, the registrant notifies the users not to rely on its prior-period financial statements (see Question 4.4.30) and restates and reissues these financial statements as soon as practicable. In its Year 4 financial statements, the registrant adjusts opening balances as of January 1, Year 2 and applies the correct accounting from that point onward.



Question 4.4.30 What additional steps are required in a Big R restatement?

Interpretive response: In a Big R restatement, prior-period financial statements cannot be relied upon. Therefore, it is important for the statements to be restated and reissued as soon as practicable. An entity cannot simply wait to update the comparative information the next time it issues financial statements.

The steps taken to ensure that anyone in receipt of the previously issued financial statements is informed of the situation, including that the financial statements are not to be relied on, depend on the circumstances. They may include the following.

- Notifying anyone who is known to be relying, or who is likely to rely, on the financial statements and the auditors' report(s) that they are not to be relied on and that restated financial statements, together with a new auditors' report(s) including an explanatory paragraph, will be issued. This is always required for SEC registrants and may be necessary for other entities when the issuance of restated financial statements and a new auditors' report(s) is not imminent.
- Issuing, as soon as practicable, restated financial statements with appropriate disclosure of the matter, and for registrants, amending related SEC filings (see section 6.4).
- Issuing the subsequent period's financial statements with appropriate disclosure of the matter. This may be appropriate when issuance of the subsequent period's audited financial statements is imminent. [AS 2905.06 (b)]

Example 4.4.10 Big R restatement of prior-period financial statements#

ABC Corp. is a calendar year-end SEC registrant. In the first quarter of Year 3, ABC identifies an error where a goodwill impairment has not been recognized. Specifically, ABC failed to recognize a required goodwill impairment in Year 2. Proper accounting for the impairment would have resulted in an additional $130 of impairment expense in Year 2.

The effects of the error to the income statement and balance sheet are summarized as follows.

Yr	Reported income	Income statement error	Balance sheet error
1	500	N/A	N/A
2	300	130	130
3	Projected 300	N/A	130

As discussed in Question 4.3.90, ABC starts its evaluation using the rollover method to determine whether the Year 2 (i.e. prior-period) financial statements are materially misstated. To do this, ABC evaluates the income statement error in Year 2 by reference to the affected income statement line item(s) as well as the financial statements as a whole, including disclosures.

As a result of this evaluation, ABC determines that the financial statements of Year 2 were materially misstated – i.e. a Big R restatement is required. Accordingly, ABC notifies the users of its financial statements not to rely on those for Year 2 through the issuance of Item 4.02 of Form 8-K (see Question 6.4.80). ABC restates and reissues the Year 2 financial statements, provides the disclosures required by Topic 250 (see Questions 4.4.60 and 4.4.70) and amends previous SEC filings that contained those financial statements (see section 6.4).

Question 4.4.40 Is the labeling of the financial statements changed to acknowledge a Big R restatement?

Interpretive response: Yes. The SEC staff has stated that when there is a correction of a material error in a prior period's financial statements, the column headings in the financial statements should include 'As Restated'. [Dear CFO 01/2007]

We believe this guidance should be applied by all entities.

Question 4.4.50 Should historical summaries be restated and reissued when an error is corrected in the underlying information?

Excerpt from ASC 250-10

> Historical Summaries of Financial Data

45-28 It has become customary for business entities to present historical, statistical-type summaries of financial data for a number of periods—commonly 5 or 10 years. Whenever error corrections have been recorded during any of the periods included therein, the reported amounts of net income (and the components thereof), as well as other affected items, shall be appropriately restated, with disclosure in the first summary published after the adjustments...

> Correction of an Error in Previously Issued Financial Statements

50-7A An entity that restates historical, statistical-type summaries of financial data for error corrections shall disclose that information in accordance with paragraph 250-10-45-28.

Interpretive response: Yes. If prior-period financial statements have been restated and reissued for the correction of an error, any corresponding information in historical summaries (see Question 2.2.20) should also be restated and reissued. Disclosure about the Big R restatement is required in the first historical summary published after the reissuance restatement. [250-10-45-28, 50-7A]

Question 4.4.60 What are the disclosure requirements for corrections of material errors?

Excerpt from ASC 250-10

> Correction of an Error in Previously Issued Financial Statements

50-7 When financial statements are restated to correct an error, the entity shall disclose that its previously issued financial statements have been restated, along with a description of the nature of the error. The entity also shall disclose both of the following:

a. The effect of the correction on each financial statement line item and any per-share amounts affected for each prior period presented
b. The cumulative effect of the change on retained earnings or other appropriate components of equity or net assets in the statement of financial position, as of the beginning of the earliest period presented.

50-8 When prior period adjustments are recorded, the resulting effects (both gross and net of applicable income tax) on the net income of prior periods shall be disclosed in the annual report for the year in which the adjustments are

made and in interim reports issued during that year after the date of recording the adjustments.

50-9 When financial statements for a single period only are presented, this disclosure shall indicate the effects of such **restatement** on the balance of retained earnings at the beginning of the period and on the net income of the immediately preceding period. When financial statements for more than one period are presented, which is ordinarily the preferable procedure, the disclosure shall include the effects for each of the periods included in the statements. (See Section 205-10-45 and paragraph 205-10-50-1.) Such disclosures shall include the amounts of income tax applicable to the prior period adjustments. Disclosure of restatements in annual reports issued after the first such post-revision disclosure would ordinarily not be required.

50-10 Financial statements of subsequent periods shall not repeat the disclosures required by paragraphs 250-10-50-7 through 50-9. See paragraph 250-10-50-2.

Interpretive response: An entity that restates and reissues its financial statements to correct an error includes the following disclosures in the financial statements that include restated information. [250-10-50-7 – 50-9]

Type	Disclosures (impact on)
Descriptive	• Statement that the previously issued financial statements have been restated • What the error was
Each prior period presented	• Net income, including the related income tax effect • Each affected financial statement line item • Any affected per-share amounts
Cumulative effect as of beginning of earliest period	• Retained earnings • Other components of equity or net assets

Notes:

- The SEC staff has commented that the disclosures should facilitate as much transparency as possible, and changes and corrections should be easy for financial statement users to understand. We believe this is best practice for all entities.
- If an entity does not present comparative financial information, it discloses the effect on the opening balance of retained earnings and net income (including the related income tax effect) for the immediately preceding period.

See Question 6.4.80 for additional guidance for SEC registrants.

Question 4.4.70 Are the disclosures required every time financial statements that include the restated and reissued information are presented?

Excerpt from ASC 250-10

> Accounting Changes

• > Change in Accounting Principle

50-2 An entity that issues interim financial statements shall provide the required disclosures in the financial statements of both the interim period of the change and the annual period of the change.

> Correction of an Error in Previously Issued Financial Statements

50-10 Financial statements of subsequent periods shall not repeat the disclosures required by paragraphs 250-10-50-7 through 50-9. See paragraph 250-10-50-2.

Interpretive response: We believe this depends on whether the financial statements are for a period that is in, or subsequent to, the year in which the error was corrected.

- **In the year of correction.** Similar to the requirement in paragraph 250-10-50-2 for accounting changes, we believe an entity includes the disclosures in each filing until the annual financial statements are filed. This means that an entity that issues interim financial statements should provide the required disclosures in the financial statements of both the interim period in which the correction was made, as well as future interim periods and the annual period of the correction. See also section 5.3.
- **Subsequent to the year of correction**. The required restatement disclosures do not need to be repeated in either interim or annual financial statements for years subsequent to the year of correction. [250-10-50-10]

4.4.30 Error correction is material to current-period financial statements but not to prior-period financial statements: little r restatement

The guidance in this section applies to 'little r restatements' (also known as 'revision restatements') – i.e. when the following conditions are met (see Question 4.4.10):

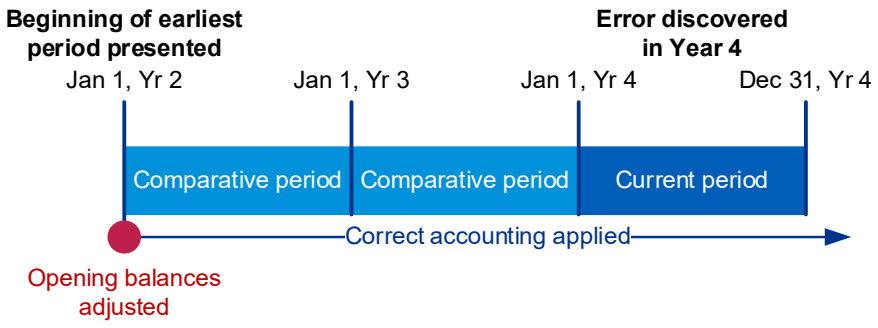
- the error is immaterial to prior-period financial statements; but
- the correction of the error in the current period would result in a material misstatement of the current-period financial statements.

Question 4.4.80 What are the steps to restating prior-period financial statements in a little r restatement?

Interpretive response: In a little r restatement, the immaterial error to the prior-period financial statements is corrected by revising prior-period financial statements the next time they are presented (e.g. as comparatives). The process is as follows.

Step 1: Adjust opening balances of earliest period presented	Adjust the opening balances of the earliest period presented in the financial statements for the cumulative effect of the error on period(s) prior to the periods presented in the financial statements. This includes: • adjusting the opening balance of the assets and liabilities for the earliest period presented in the financial statements; and • recording a corresponding adjustment to the opening balance of retained earnings (or other appropriate components of equity or net assets) for that period.
Step 2: Adjust incorrect prior-period amounts and disclosures	Adjust the financial statements of all affected prior period(s) presented so that they reflect the correct amounts and disclosures for that period.
Step 3: Disclose in the notes	We believe the entity should disclose that prior-year financial statements have been corrected for immaterial errors to provide the appropriate context for the adjustments. However, this disclosure is less detailed than what would be disclosed for a material restatement.

For example, an SEC registrant with a calendar year-end discovers in Year 4 an error in the application of an accounting principle that has affected its financial statements for a number of years. The registrant determines that the error is immaterial to prior periods (see section 4.3) but would be material to Year 4 if it was reversed in the current period. Therefore, the registrant restates its prior financial statements to correct the error by revising the comparative information presented.



An entity also evaluates the effect of the error on its internal controls and, if the entity has a clawback policy, whether recovery of compensation has been

triggered under the policy. See Question 4.4.10 and KPMG Handbook, Internal control over financial reporting.

Question 4.4.90 What is the timing of a little r restatement of prior-period financial statements?

Interpretive response: Because the error is immaterial to prior-period financial statements, those statements can continue to be relied upon and are not reissued. The entity restates the comparative information by revising it the next time it is presented in financial statements. [SAB Topic 1N (Q1)]

Example 4.4.20 Little r restatement of prior-period financial statements#

ABC Corp. is a calendar year-end SEC registrant. In the first quarter of Year 6, ABC identifies an error where the accrual for a long-term incentive-based compensation program has not been recognized. Proper accounting for the compensation program would have resulted in an additional $30 of compensation expense in each of the years in the previous five-year period (Years 1 to 5).

The effects of the error on the income statement and balance sheet are summarized as follows:

Yr	Reported income	Income statement error	Balance sheet error
1	1,000	30	30
2	800	30	60
3	700	30	90
4	700	30	120
5	750	30	150
6	Projected 300	N/A	150

Is the error material to prior-period financial statements?

Using the rollover method, ABC performs a separate analysis for the financial statements of each prior period affected (Years 1 to 5) to determine if any period is materially misstated.

To do this, ABC evaluates the income statement errors by reference to the affected income statement line item(s). In assessing the materiality of the errors to Years 1 to 5, ABC is not required to consider whether the cumulative effect on the balance sheet (the balance sheet error) is material to any of the prior years' income statements – i.e., it is not necessary to use the iron curtain method and compare the balance sheet error to the income statement metrics in those prior years. However, the error on the balance sheet (e.g. 120 in Year 4) needs to be evaluated in relation to the balance sheet and financial

statements as a whole to determine if the prior period financial statements are materially misstated.

Based on this evaluation, ABC concludes that the errors are immaterial to the prior-period financial statements for Years 1 to 5.

Is the error material to the current-period financial statements?

Because correcting the cumulative (or balance sheet) error would be material to the current period income statement (Year 6) under the iron curtain method, ABC concludes it is required to correct the error through a little r restatement.

Based on this conclusion, ABC's financial statements for prior periods may continue to be relied upon and the correction can be made by revising comparative information the next time ABC issues financial statements. In those financial statements, ABC discloses (a) that its prior-year financial statements have been corrected for immaterial errors and (b) the nature of the errors to provide appropriate context for the adjustments.

Further, ABC assesses if its policy to claw back erroneously awarded incentive-based compensation to certain executives has been triggered.

Question 4.4.100 Is the labeling of the prior-period financial statements changed to acknowledge a little r restatement?

Interpretive response: No. The error was immaterial to the prior period and therefore we believe a little r restatement does not need to be highlighted by adjusting column headings in the financial statements. (see Question 4.4.80).

Question 4.4.110 Are historical summaries adjusted for little r restatements?

Interpretive response: Yes. If corrections have been made to prior-period financial statements, even if those corrections were for an immaterial error, we believe the corresponding information in the historical summaries (see Question 2.2.20) should be adjusted.

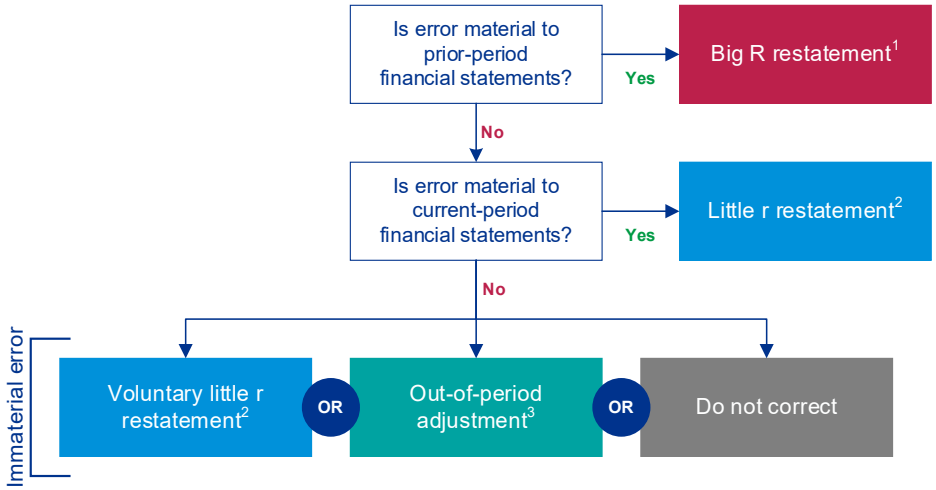
4.4.40 Error is immaterial to all periods: voluntary little r restatement and other options

The guidance in this section applies when the following conditions are met (see Question 4.4.10):

- the error is immaterial to prior-period financial statements; and
- the correction or reversal of the error in the current period is immaterial to the current-period financial statements.

Question 4.4.120 How are errors that are immaterial to prior periods and the current period treated?

Interpretive response: The following diagram shows the alternatives available when an immaterial error is found.



Notes:

1. Restate and reissue prior-period financial statements.
2. Restate and revise prior-period financial statements the next time those financial statements are presented.
3. Correct in current-period financial statements.

When an error that relates to prior periods is discovered and concluded to be immaterial to the prior periods and the current period (see section 4.3), it may be recorded in the period in which it was discovered. This is known as an 'out-of-period adjustment'. If an entity decides to restate the prior-period financial statements (i.e. a 'voluntary little r' restatement), it follows the same process and provides similar disclosures as an error correction that is material to current-period financial statements (see section 4.4.30). The error may also be left uncorrected. [SAB Topic 1N (Q1)]

However, sometimes an error that is immaterial in the current period can accumulate and become material in future periods if left uncorrected. When this is a concern, entities often correct the immaterial error in the current period (see Question 4.3.130).

5. Interim periods

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5.3 Error corrections

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5.4 Other adjustments

Questions

Question 5.4.10 Under what circumstances is a 'specified adjustment' made to a prior interim period?

Question 5.4.20 How are the 'specified adjustments' in an interim period accounted for?

Question 5.4.30 What disclosures are required for the 'specified adjustments' in an interim period?

5.1 How the standard works

The guidance on interim reporting includes accounting changes and errors corrections – i.e. the same items that are discussed in the context of annual reporting – with the benefit of additional guidance for interim periods.

However, unlike for annual reporting, Topic 250 includes a defined set of additional items that result in retrospective adjustment to prior interim periods if certain criteria are met.

The following diagram highlights the areas of guidance for interim reporting.

Accounting changes	Error corrections	Other adjustments
Concept consistent with annual reporting	**Concept consistent with annual reporting**	**Specific to interim reporting**
Retrospective adjustment if material: • Accounting principle (method) • Reporting entity Prospective recognition: • Estimate	• Reissuance restatement if material • Supplemental materiality guidelines for interim reporting	Retrospective adjustment if certain criteria met: • Settlement of litigation or similar claims • Certain income taxes • Renegotiation proceedings • Utility revenue under rate-making processes

5.2 Accounting changes

Chapter 3 discusses changes in the following in annual periods:

- accounting principles (methods) – section 3.3;
- accounting estimates – section 3.4;
- classification or presentation – section 3.5; and
- reporting entity – section 3.6.

This section discusses the same changes from the perspective of an interim period.

5.2.10 Change in accounting principle

Excerpt from ASC 250-10

• • > Reporting a Change in Accounting Principle Made in an Interim Period

45-14 A change in accounting principle made in an interim period shall be reported by retrospective application in accordance with paragraphs 250-10-45-5 through 45-8. However, the impracticability exception in paragraph 250-10-45-9 may not be applied to prechange interim periods of the fiscal year in which the change is made. When retrospective application to prechange interim periods is impracticable, the desired change may only be made as of the beginning of a subsequent fiscal year.

45-15 If a public entity that regularly reports interim information makes an accounting change during the fourth quarter of its fiscal year and does not report the data specified by paragraph 270-10-50-1 in a separate fourth-quarter report or in its annual report, that entity shall include disclosure of the effects of the accounting change on interim-period results, as required by paragraph 250-10-50-1, in a note to the annual financial statements for the fiscal year in which the change is made.

45-16 As indicated in paragraph 270-10-45-15, whenever possible, entities should adopt any accounting changes during the first interim period of a fiscal year. Changes in accounting principles and practices adopted after the first interim period in a fiscal year tend to obscure operating results and complicate disclosure of interim financial information.

• > Change in Accounting Principle

50-2 An entity that issues interim financial statements shall provide the required disclosures in the financial statements of both the interim period of the change and the annual period of the change.

50-3 In the fiscal year in which a new accounting principle is adopted, financial information reported for interim periods after the date of adoption shall disclose the effect of the change on income from continuing operations, net income (or other appropriate captions of changes in the applicable net assets or performance indicator), and related per-share amounts, if applicable, for those post-change interim periods.

Excerpt from ASC 270-10

> Accounting Changes in Interim Periods

45-12 Each report of interim financial information shall indicate any change in accounting principles or practices from those applied in any of the following:

a. The comparable interim period of the prior annual period
b. The preceding interim periods in the current annual period
c. The prior annual report.

45-13 Changes in an interim or annual accounting practice or policy made in an interim period shall be reported in the period in which the change is made, in accordance with the provisions of Topic 250.

45-15 Whenever possible, entities should adopt any accounting changes during the first interim period of a fiscal year. Changes in accounting principles and practices adopted after the first interim period in a fiscal year tend to obscure operating results and complicate disclosure of interim financial information.

Whenever possible, an entity effects a change in accounting principle (method) in the first interim period of a fiscal year. [250-10-45-14, 45-16, 270-10-45-15]

Question 5.2.05 How are prior interim periods in a fiscal year affected if a change in accounting principle (method) occurs in an interim period other than the first interim period?

Interpretive response: When a change in accounting principle occurs in an interim period other than the first interim period, we believe that the notes to interim period financial statements should disclose the effects of the new principle on previously reported interim periods (assuming the change applies retrospectively). For registrants, previously filed interim financial statements that were correct when filed need not be amended for retroactive effects of these changes.

Question 5.2.10 Does the interim period guidance apply when an entity adopts a new ASU?

Interpretive response: It depends. As discussed in Question 3.3.10, usually a new ASU includes specific transition guidance, in which case an entity applies those transition requirements.

For example, for a nonpublic entity with a calendar year-end, Topic 842 (leases) was effective in 2022 for annual reporting, but in 2023 for interim reporting. In this case, the specific transition in Topic 842 took precedence over the general requirement in Topics 250 and 270 that an accounting change is generally made in the first interim period of the fiscal year in which the change is recognized.

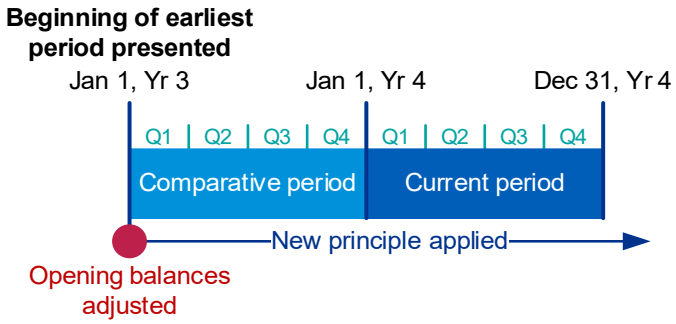
Question 5.2.20 How is the materiality of a change in accounting principle assessed in interim periods?

Interpretive response: Question 3.3.240 discusses how a change in accounting principle is recognized when the effect is immaterial. When evaluating the materiality of a change in an interim period, we believe the guidance related to error corrections should be considered. That guidance is explained in Question 5.3.10 and highlights that materiality is assessed both quantitatively and qualitatively.

Question 5.2.30 How is a change in accounting principle in an interim period accounted for?

Interpretive response: A change in accounting principle is applied retrospectively following the guidance in section 3.3 (except as explained in Question 5.2.40).

For example, a public entity (not an SEC registrant) with a calendar year-end changes an accounting principle in Q1 of Year 4. Applying the change retrospectively means that the change is effected as of January 1, Year 3 by adjusting opening balances, and the new principle is applied from that point onward in all interim periods.



Question 5.2.40 Does the impracticability exception apply to prior interim periods in the fiscal year in which an accounting principle is changed?

Background: Retrospective application of a change in accounting principle is not required in annual reporting to the extent the entity can demonstrate that it is impracticable. See Questions 3.3.250 and 3.3.260.

Interpretive response: No. If a change in accounting principle is made in an interim period, the impracticability exception does not apply to previous interim periods in that fiscal year. Therefore, if an entity wishes to change an accounting principle during an interim period, but is unable to apply that change

retrospectively, it must wait to make the change at the beginning of the following fiscal year. [250-10-45-14]

For example, a public entity changes an accounting principle voluntarily in Q3 of Year 4; it was not possible to make the change in Q1 because the underlying software supporting the new accounting principle was not yet fully tested. In this example, the entity can either:

- make the change in Q3 of Year 4 and, as a minimum, retrospectively adjust Q1 and Q2 of Year 4.
- make the change in Q1 of Year 5.

Question 5.2.50 How does an entity report a Q4 change in accounting principle if it does not separately present Q4 results?

Interpretive response: If an entity changes an accounting principle in Q4, but it does not present Q4 results, the effect of the change is disclosed in the notes to the annual financial statements of that year. [250-10-45-15]

Question 5.2.60 What disclosures are required for a change in accounting principle in an interim period?

Interpretive response: Interim financial statements include disclosures that should clearly indicate changes in accounting principles that occurred in the current interim period from those applied in the: [270-10-45-12]

- comparable interim period of the prior annual period;
- preceding interim periods in the current annual period; and
- previous annual report.

Interim period of the change

When an entity issues interim financial statements that include a change in accounting principle, the required Topic 250 disclosures are the same as for annual financial statements (see Question 3.3.280). [250-10-50-2, S-X Rule 10-1](b)(7)]

Subsequent interim periods in that fiscal year

In subsequent interim periods of that fiscal year disclose the impact on: [250-10-50-3]

- Income from continuing operations
- Net income[1]
- Any affected per-share amounts
- Retained earnings, for SEC registrants [S-X Rule 10-1](b)(7)]

Note:

1. For an NFP, the disclosure relates to appropriate captions of changes in the applicable net assets or performance indicator.

5.2.20 Change in accounting estimate

Excerpt from ASC 270-10

> Accounting Changes in Interim Periods

45-14 The effect of a **change in accounting estimate**, including a change in the estimated effective annual tax rate, shall be accounted for in the period in which the change in estimate is made. No **restatement** of previously reported interim information shall be made for changes in estimates, but the effect on earnings of a change in estimate made in a current interim period shall be reported in the current and subsequent interim periods, if material in relation to any period presented and shall continue to be reported in the interim financial information of the subsequent year for as many periods as necessary to avoid misleading comparisons. Such disclosure shall conform with paragraph 250-10-50-4.

Question 5.2.70 How is a change in estimate in an interim period accounted for?

Interpretive response: If an entity makes a change in estimate in an interim period, that change is reflected from the date of the change onward. Therefore, the year-to-date results will reflect the pre-change estimate for the period up to the change date, and the post-change estimate from the change date onward. [250-10-45-17, 270-10-45-14]

For example, an entity that changes its depreciation estimates mid-year will, in its Q3 interim financial statements, reflect depreciation for the first six months using the pre-change rates, and deprecation for the remaining quarter using the post-change rates.

Question 5.2.80 What disclosures are required for a change in estimate in an interim period?

Interpretive response: When an entity issues interim financial statements that include a change in estimate, the required disclosures are the same as for annual financial statements (see Question 3.4.50). [250-10-50-4, 270-10-45-14]

The disclosures are repeated in all interim periods (including in the subsequent year) for as long as necessary to allow a meaningful comparison of the periods. [270-10-45-14]

5.2.30 Change in classification or presentation

As discussed in section 3.5, Topic 250 does not provide specific guidance on changes in classification and presentation that do not rise to the level of a change in accounting principle (see Question 3.2.40) and are not errors (see

section 4.2). Instead, the general principles of Topic 205 (financial statement presentation) apply.

Question 5.2.90 How is a change in classification or presentation in an interim period accounted for?

Interpretive response: We believe an entity should recast prior interim periods to conform to the presentation in the current interim period. This is consistent with the approach taken for annual reporting (see Question 3.5.10) and with the general requirement for consistency of 'practices' in interim financial statements. [270-10-45-2]

A change in presentation that rises to the level of a change in accounting principle (see Question 3.2.40) falls under the guidance discussed in section 5.2.10.

Question 5.2.100 What disclosures are required for a change in classification or presentation in an interim period?

Interpretive response: Consistent with the approach taken for annual reporting (see Question 3.5.20), we believe an entity should provide the following disclosures in the period of the change:

- the nature of and reason for the change in classification or presentation; and
- the fact that comparative information has been recast.

The disclosures should clearly indicate changes in accounting 'practices' that occurred in the current period from those applied in the: [270-10-45-12]

- comparable interim period of the prior annual period;
- preceding interim periods in the current annual period; and
- previous annual report.

5.2.40 Change in reporting entity

Excerpt from ASC 250-10

• > Change in Reporting Entity

45-21 When an accounting change results in financial statements that are, in effect, the statements of a different reporting entity... Previously issued interim financial information shall be presented on a retrospective basis...

A change in reporting entity arises in certain circumstances that result in financial statements of a different reporting entity than previously presented – e.g. as a result of presenting combined financial statements. See section 3.6.

Question 5.2.110 How is a change in reporting entity in an interim period accounted for?

Interpretive response: A change in reporting entity in the scope of Topic 250 (see section 3.6.10) is applied retrospectively following the guidance in section 3.6.20. [250-10-45-21]

Question 5.2.120 What disclosures are required for a change in reporting entity in an interim period?

Interpretive response: Each report of interim financial information includes disclosures that clearly indicate changes in accounting 'practices' from those applied in the: [270-10-45-12]

- comparable interim period of the prior annual period;
- preceding interim periods in the current annual period; and
- previous annual report.

When an entity issues interim financial statements that include a change in reporting entity, we believe the entity should also disclose the same information required by Topic 250 as for annual financial statements (see Question 3.6.90). SEC registrants are required to provide similar disclosures and also to disclose the effect of the change on the balance of retained earnings. [S-X Rule 10-01(b)(7)]

5.3 Error corrections

Excerpt from ASC 250-10

> Materiality Considerations for Correction of an Error

45-27 In considering materiality for the purpose of reporting the correction of an error, amounts shall be related to the estimated income for the full fiscal year and also to the effect on the trend of earnings…

When an error is identified, its materiality is evaluated to determine if and how to correct it.

Question 5.3.10 How is the materiality of an error assessed in interim periods?

Interpretive response: SAB Topic 1M does not specifically address the assessment of materiality of errors in interim periods. However, Topic 250 indicates that considering materiality for purposes of reporting the correction of an error in an interim period should be based on estimated income for the full fiscal year and the effect on the trend of earnings. [250-10-45-27]

We believe this application of paragraph 250-10-45-27 is appropriate when considering the materiality of the correction of a prior-year error in a current-year interim period and the assessment should include consideration of all relevant quantitative and qualitative factors. Changes that are material with respect to an interim period but are not material with respect to the estimated income for the full year or to the trend of earnings should be separately disclosed in the interim period in which such errors are corrected (see Question 5.3.40).

Generally, errors originating in the current year are assessed for materiality against the current-year interim period in which the error originated and the current-year interim period in which the error is corrected and must be immaterial to each current-year interim period and the interim period trend of earnings.

Question 5.3.20 Can the materiality assessment of an error change in future interim periods?

Interpretive response: Yes. Because an error identified in an interim period is evaluated in relation to the estimated income for the full year, an error that is considered immaterial during an interim period may become material if earnings estimates change or actual annual earnings are different from estimated.

For example, an error relating to Year 3 was discovered in Q2 Year 4. The error is material to Q1 (the previously published quarter) as a stand-alone reporting period. However, it is immaterial (quantitatively and qualitatively) in relation to Year 3 income, estimated Year 4 income, and earnings trends (see Question 5.3.10). Therefore, the error is immaterial for purposes of applying Topic 250.

However, in Q3 Year 4 the materiality of the error is reassessed against the updated estimate of Year 4 income, which has declined, and is determined to be material. Therefore, the error is now material for purposes of applying Topic 250.

Question 5.3.30 What disclosures are required for error corrections related to prior interim periods of the current fiscal year?

Excerpt from ASC 250-10

• > Error Corrections Related to Prior Interim Periods of the Current Fiscal Year

50-11 The following disclosures shall be made in interim financial reports about an adjustment related to prior interim periods of the current fiscal year. In financial reports for the interim period in which the adjustment occurs, disclosure shall be made of both of the following:

a. The effect on income from continuing operations, net income, and related per-share amounts for each prior interim period of the current fiscal year

b. Income from continuing operations, net income, and related per-share amounts for each prior interim period restated in accordance with paragraph 250-10-45-26.

Interpretive response:

Big R restatement

An entity that restates and reissues its financial statements for prior interim periods of the current fiscal year to correct an error includes the following disclosures in the interim financial statements that include restated information. [250-10-50-11]

Type	Disclosures (impact on)
Each prior interim period of the current fiscal year	The following amounts as restated, plus the amount of the restatement: • Income from continuing operations • Net income • Any affected per-share amounts

These disclosures are required in all interim financial reports for the fiscal year that include restated amounts. [250-10-50-11]

Further, we believe the interim financial statements should disclose:

- a statement that the previously issued interim financial statements have been restated; and
- what the error was.

Lastly, we believe the column headings in the financial statements should include 'As Restated', which is required for SEC registrants (see Question 4.4.40).

Little r and voluntary little r restatement

We believe an entity that restates and revises its prior-period interim financial statements should disclose that they have been corrected for immaterial errors to provide the appropriate context for the adjustments (see Question 4.4.80).

See Question 6.4.80 for additional guidance for SEC registrants.

Question 5.3.40 What disclosures are required if an error correction is material to an interim period but restatement is not required?

Excerpt from ASC 250-10

> Materiality Considerations for Correction of an Error

50-12 In considering materiality for the purpose of reporting the correction of an error, amounts shall be related to the estimated income for the full fiscal year and also to the effect on the trend of earnings. Changes that are material

with respect to an interim period but not material with respect to the estimated income for the full fiscal year or to the trend of earnings shall be separately disclosed in the interim period...

Interpretive response: If an entity concludes that an error originating in the prior year is material to the current year interim period in which that error reverses, and correction of the error in the prior year is not required based on an annualized assessment (see Question 5.3.10), disclosure of the error is required. [250-10-45-27, 50-12]

Topic 250 does not prescribe specific disclosures, but we believe an entity should generally disclose:

- what the error was; and
- the effect of the error (or its correction) on the relevant interim period.

For example, an error that originated in Year 3 is discovered before release of the Q2 Year 4 financial statements. The error was the recognition of an operating expense and an accrued liability in Year 3 that should never have been recorded. The entity discovers the error several quarters later as part of closing the books for the second quarter of Year 4.

In this example, correcting the error as an adjustment in the Q2 Year 4 financial statements (by reversing the accrual and reducing operating expenses) creates a material error to the Q2 interim reporting period on a stand-alone basis. However, the error is immaterial to both Year 3 and in relation to estimated Year 4 annual income. Further, the error does not impact the quarterly trend in earnings.

Therefore, the entity may correct the error as an adjustment in its Q2 interim financial statements. However in its Q2 interim financial statements, the entity discloses the nature of the error and the effect on the Q2 interim period.

5.4 Other adjustments

Excerpt from ASC 250-10

• > Corrections Related to Prior Interim Periods of the Current Fiscal Year

45-25 For purposes of this Subtopic, an adjustment related to prior interim periods of the current fiscal year is an adjustment or settlement of litigation or similar claims, of income taxes (except for the effects of retroactive tax legislation), of renegotiation proceedings, or of utility revenue under rate-making processes provided that the adjustment or settlement meets all of the following criteria:

a. The effect of the adjustment or settlement is material in relation to income from continuing operations of the current fiscal year or in relation to the trend of income from continuing operations or is material by other appropriate criteria.

b. All or part of the adjustment or settlement can be specifically identified with and is directly related to business activities of specific prior interim periods of the current fiscal year.
c. The amount of the adjustment or settlement could not be reasonably estimated prior to the current interim period but becomes reasonably estimable in the current interim period.

The criterion in (b) is not met solely because of incidental effects such as interest on a settlement. The criterion in (c) would be met by the occurrence of an event with currently measurable effects such as a final decision on a rate order. Treatment as adjustments related to prior interim periods of the current fiscal year shall not be applied to the normal recurring corrections and adjustments that are the result of the use of estimates inherent in the accounting process. Changes in provisions for doubtful accounts shall not be considered to be adjustments related to prior interim periods of the current fiscal year even though the changes result from litigation or similar claims.

45-26 If an item of profit or loss occurs in other than the first interim period of the entity's fiscal year and all or a part of the item of profit or loss is an adjustment related to prior interim periods of the current fiscal year, as defined in the preceding paragraph, the item shall be reported as follows:

a. The portion of the item that is directly related to business activities of the entity during the current interim period, if any, shall be included in the determination of net income for that period.
b. Prior interim periods of the current fiscal year shall be restated to include the portion of the item that is directly related to business activities of the entity during each prior interim period in the determination of net income for that period.
c. The portion of the item that is directly related to business activities of the entity during prior fiscal years, if any, shall be included in the determination of net income of the first interim period of the current fiscal year.

In relation to interim reporting, Topic 250 contemplates one further set of adjustments for a defined set of circumstances that do not fall into the categories of accounting changes (see section 5.2) and are also not error corrections (see section 5.3). These adjustments are referred to as 'specified adjustments' in this section.

Question 5.4.10 Under what circumstances is a 'specified adjustment' made to a prior interim period?

Interpretive response: Topic 250 requires adjustments to prior interim periods of the current fiscal year for the adjustment or settlement of the following specific items. [250-10-45-25]

- litigation or similar claims;
- income taxes (except for the effects of retroactive tax legislation);
- renegotiation proceedings; and
- utility revenue under rate-making processes.

The reference to 'similar claims' does not encompass items that are normal and recurring – e.g. an allowance for credit losses. [250-10-45-25]

The adjustment or settlement is recognized as an adjustment to prior interim periods of the current fiscal year if *all* of the following criteria are met. [250-10-45-25]

Criterion	Explanation	Considerations
Materiality	The effect of the adjustment or settlement is material in relation to: • income from continuing operations of the current fiscal year; • the trend of income from continuing operations; or • other appropriate criteria.	In assessing materiality, we believe the guidance for error corrections in Question 5.3.10 should be considered.
Specifically identifiable and directly related	All or part of the adjustment or settlement can be specifically identified with and is directly related to business activities of specific prior interim periods.	Incidental effects of the adjustment or settlement (e.g. interest, fees) are not sufficient on their own to meet this criterion.
Reasonably estimable	The amount becomes reasonably estimable in the current interim period. A reasonable estimate could not be made before.	For example, a final decision on a rate order for utilities, or a final arbitration ruling that settles a dispute.

Question 5.4.20 How are the 'specified adjustments' in an interim period accounted for?

Interpretive response: The following diagram shows how the adjustments specified in Question 5.4.10 (e.g. major litigation settled) are accounted for. [250-10-45-26]

Portion of adjustment that relates to activity in:	Record adjustment in:
Current interim period	Current-period income
Prior interim period(s) of the current fiscal year	Respective prior interim period(s)
Prior fiscal years	Q1 of the current fiscal year

The adjustments are recorded in the same way as a change in accounting principle (see Question 5.2.30).

Question 5.4.30 What disclosures are required for the 'specified adjustments' in an interim period?

Interpretive response: We believe the disclosures for an error correction in an interim period apply to adjustments specified in Question 5.4.10 (see Question 5.3.40). This view is based on the following:

- although the heading to those disclosures refers to 'error corrections', the underlying disclosures are written more broadly in the context of adjustments; and
- there are no other disclosures in Topics 250 or 270 that would apply.

6. SEC registrants

Detailed contents

Examples

6.1 How the standard works

Preferability letters

A preferability letter is a letter from an SEC registrant's independent accountant indicating whether the registrant's accounting change is, in the judgment of the independent accountant, preferable under the circumstances. There are numerous types of accounting changes, but only a voluntary change in accounting principle (method) requires a preferability letter.

Recently issued ASUs

When a new accounting standard has been issued, but has not yet been adopted, a registrant discloses the following. This enables financial statement users to not only be aware of the impending change, but also to understand the expected significance of the change. We believe these disclosures are best practice for all entities.

Area	Disclosure
Background	Brief description of ASU
Timing	Required adoption date and registrant's expected adoption date (if earlier)
Method of adoption	Allowable methods of adoption and alternative registrant expects to use (if determined)
Effect of the ASU	• Effect that adoption is expected to have on registrant's financial statements, if known or reasonably estimable • If not known or reasonably estimable, further qualitative disclosures
Other consequential effects	Other significant matters registrant believes might result from adoption – e.g. technical violations of debt covenant agreements and planned or intended changes in business practices.

6.2 Preferability letters

Excerpt from SAB Topic 6G.2

Accounting Series Releases 177 and 286—Relating to Amendments to Form 10-Q, Regulation S-K, and Regulations S-X Regarding Interim Financial Reporting

b. Reporting requirements for accounting changes

1. Preferability

Facts: Rule 10-01(b)(6) of Regulation S-X requires that a registrant who makes a material change in its method of accounting shall indicate the date of and the reason for the change. The registrant also must include as an exhibit in the first Form 10-Q filed subsequent to the date of an accounting change, a letter from the registrant's independent accountants indicating whether or not the change is to an alternative principle which in his judgment is preferable under the circumstances. A letter from the independent accountant is not required when the change is made in response to a standard adopted by the Financial Accounting Standards Board which requires such a change. …

Question 3: What responsibility does the independent accountant have for evaluating the business judgment and business planning of the registrant?

Interpretive Response: Business judgment and business planning are within the province of the registrant. Thus, the independent accountant may accept the registrant's business judgment and business planning and express reliance thereon in his letter. However, if either the plans or judgment appear to be unreasonable to the independent accountant, he should not accept them as justification. For example, an independent accountant should not accept a registrant's plans for a major expansion if he believes the registrant does not have the means of obtaining the funds necessary for the expansion program.

Question 7: If a registrant changes its accounting to one of two methods specifically approved by the FASB in the Accounting Standards Codification, need the independent accountant express his view as to the preferability of the method selected?

Interpretive Response: If a registrant was formerly using a method of accounting no longer deemed acceptable, a change to either method approved by the FASB may be presumed to be a change to a preferable method and no letter will be required from the independent accountant. If, however, the registrant was formerly using one of the methods approved by the FASB for current use and wishes to change to an alternative approved method, then the registrant must justify its change as being one to a preferable method in the circumstances and the independent accountant must submit a letter stating that in his view the change is to a principle that is preferable in the circumstances.

2. Filing of a letter from the accountants

Facts: The registrant makes an accounting change in the fourth quarter of its fiscal year. Rule 10-01(b)(6) of Regulation S-X requires that the registrant file a letter from its independent accountants stating whether or not the change is

preferable in the circumstances in the next Form 10-Q. Item 601(b)(18) of Regulation S-K provides that the independent accountant's preferability letter be filed as an exhibit to reports on Forms 10-K or 10-Q.

Question: When the independent accountant's letter is filed with the Form 10-K, must another letter also be filed with the first quarter's Form 10-Q in the following year?

Interpretive Response: No. A letter is not required to be filed with Form 10-Q if it has been previously filed as an exhibit to the Form 10-K.

Excerpt from Regulation S-X Rule 10-01

Interim financial statements.

(b) *Other instructions as to content.* The following additional instructions shall be applicable for purposes of preparing interim financial statements:…

(6) For filings on Form 10-Q (§ 249.308(a) of this chapter), a letter from the registrant's independent accountant shall be filed as an exhibit (in accordance with the provisions of 17 CFR 229.601 (Item 601 of Regulation S-K)) in the first Form 10-Q after the date of an accounting change indicating whether or not the change is to an alternative principle which, in the accountant's judgment, is preferable under the circumstances; except that no letter from the accountant need be filed when the change is made in response to a standard adopted by the Financial Accounting Standards Board that requires such change.

A preferability letter is a letter from an SEC registrant's independent accountant indicating whether the registrant's accounting change is, in the judgment of the independent accountant, preferable under the circumstances. [S-X Rule 10-01(b)(6), FRM 4230.2, SAB Topic 6G.2]

Question 6.2.10 What types of filings require a preferability letter?

Interpretive response: Preferability letters are required only in 1934 Act filings on Form 10-Q or Form 10-K. The letter is included as Exhibit 18 in the first applicable filing following the accounting change, and need only be filed once. [S-K Item 601(a), 601(b)(18)]

If the accounting change is effected in Q1, Q2 or Q3, the letter is included with the Form 10-Q filing. If the change is effected in Q4, the letter is included with the Form 10-K filing. [SAB Topic 6G.2(b)(2)]

Preferability letters are not required in 1933 Securities Act filings (e.g. registration statements on Forms S-1, S-2, S-3).

Question 6.2.20 What types of accounting changes require a preferability letter?

Interpretive response: Chapter 3 discusses the following types of accounting changes, but only a voluntary change in accounting principle (method) requires a preferability letter.

Accounting change	Letter required?
Mandatory change in accounting principle – e.g. adoption of an ASU	✘
Voluntary change in accounting principle[1,2] (section 3.3)	✓
Change in accounting estimate (section 3.4)	✘
Change in accounting estimate effected by a change in accounting principle (Question 3.4.10)	✘
Change in classification or presentation that does not rise to the level of a change in accounting principle[2] (section 3.5)	✘
Change in reporting entity (section 3.6)	✘

Notes:

1. Some voluntary changes in accounting principle (method) do not require a preferability letter (see Question 6.2.30).
2. Sometimes a change in presentation rises to the level of a change in accounting principle, in which case a preferability letter is required (see Question 3.2.40).

Question 6.2.30 Do all voluntary changes in accounting principle require a preferability letter?

Interpretive response: No. The following voluntary changes in accounting principle (method) do not require a preferability letter.

Circumstances	Commentary
Preferability assessment not required	If a preferability assessment under Topic 250 is not required then a preferability letter is also not required. This applies in the following cases. • A change to a method that the Codification presents as preferable (see Question 3.3.30). • A change to an alternative when a method is no longer acceptable (see Question 3.3.40). • A change resulting from new events or transactions (see Question 3.3.60).
Date of annual goodwill impairment test[1]	If a registrant changes an annual goodwill impairment testing date, a preferability letter is not required if: [2014 AICPA Conf] • the entity determines that the change does not result in a material change in the method of applying the accounting

Circumstances	Commentary
	principle; this requirement may be met even if goodwill is material to the financial statements; and • the change in testing date is prominently disclosed.
Note: 1. A preferability assessment is still required under Topic 250 (see section 3.3.20).	

Question 6.2.40 Is a preferability letter required for an accounting change that is immaterial?

Interpretive response: No. A preferability letter is required if the change is material in the period of change or is 'reasonably certain' to affect future financial statements. Conversely, a preferability letter is not required if the accounting principle is immaterial in the current year and not reasonably expected to have a material effect on the financial statements in future years. [S-K Item 601(b)(18)]

However, we understand the SEC staff has a view that an accounting principle is presumed to be material if it is described in a document filed with the SEC, even if the change does not materially affect the comparability of the financial statements. The registrant's reference to and description of a change in accounting principle creates a presumption that the information is material and therefore a preferability letter is required.

Question 6.2.50 Is a preferability letter required for an FPI not applying US GAAP?

Interpretive response: It depends. Preferability letters are only required for Form 10-K and Form 10-Q. There is no SEC requirement for a preferability letter in connection with an FPI changing an accounting principle, presuming the FPI has not elected to use these domestic registrant forms. [S-K Item 601(a)]

However, if there is a regulatory requirement for the FPI to file a preferability letter in its home jurisdiction, the FPI is required to attach that letter to Form 6-K as required by Instruction B of Form 6-K, which requires the FPI to furnish material information the foreign registrant discloses or is required to disclose in the foreign jurisdiction. [Form 6-K Instr. B]

6.3 Disclosures about recently issued ASUs ('SAB 74' disclosures)

Excerpt from SAB Topic 11.M (codified from SAB No. 74)

Disclosure of the Impact that Recently Issued Accounting Standards Will Have on the Financial Statements of the Registrant when Adopted in a Future Period

Facts: An accounting standard has been issued[5] that does not require adoption until some future date. A registrant is required to include financial statements in filings with the Commission after the issuance of the standard but before it is adopted by the registrant.

Question 1: Does the staff believe that these filings should include disclosure of the impact that the recently issued accounting standard will have on the financial position and results of operations of the registrant when such standard is adopted in a future period?

Interpretive Response: Yes. The Commission addressed a similar issue and concluded that registrants should discuss the potential effects of adoption of recently issued accounting standards in registration statements and reports filed with the Commission.[6] The staff believes that this disclosure guidance applies to all accounting standards which have been issued but not yet adopted by the registrant unless the impact on its financial position and results of operations is not expected to be material.[7] MD&A[8] requires registrants to provide information with respect to liquidity, capital resources and results of operations and such other information that the registrant believes to be necessary to understand its financial condition and results of operations. In addition, MD&A requires disclosure of presently known material changes, trends and uncertainties that have had or that the registrant reasonably expects will have a material impact on future sales, revenues or income from continuing operations. The staff believes that disclosure of impending accounting changes is necessary to inform the reader about expected impacts on financial information to be reported in the future and, therefore, should be disclosed in accordance with the existing MD&A requirements. With respect to financial statement disclosure, GAAS[9] specifically address the need for the auditor to consider the adequacy of the disclosure of impending changes in accounting principles if (a) the financial statements have been prepared on the basis of accounting principles that were acceptable at the financial statement date but that will not be acceptable in the future and (b) the financial statements will be retrospectively adjusted in the future as a result of the change. The staff believes that recently issued accounting standards may constitute material matters and, therefore, disclosure in the financial statements should also be considered in situations where the change to the new accounting standard will be accounted for in financial statements of future periods, prospectively or with a cumulative catch-up adjustment.

Question 2: Does the staff have a view on the types of disclosure that would be meaningful and appropriate when a new accounting standard has been issued but not yet adopted by the registrant?

Interpretive Response: The staff believes that the registrant should evaluate each new accounting standard to determine the appropriate disclosure and recognizes that the level of information available to the registrant will differ with respect to various standards and from one registrant to another. The objectives of the disclosure should be to (1) notify the reader of the disclosure documents that a standard has been issued which the registrant will be required to adopt in the future and (2) assist the reader in assessing the significance of the impact that the standard will have on the financial statements of the registrant when adopted. The staff understands that the registrant will only be able to disclose information that is known.

The following disclosures should generally be considered by the registrant:

- A brief description of the new standard, the date that adoption is required and the date that the registrant plans to adopt, if earlier.
- A discussion of the methods of adoption allowed by the standard and the method expected to be utilized by the registrant, if determined.
- A discussion of the impact that adoption of the standard is expected to have on the financial statements of the registrant, unless not known or reasonably estimable. In that case, a statement to that effect may be made.
- Disclosure of the potential impact of other significant matters that the registrant believes might result from the adoption of the standard (such as technical violations of debt covenant agreements, planned or intended changes in business practices, etc.) is encouraged.

[5] Some registrants may want to disclose the potential effects of proposed accounting standards not yet issued, (e. g., exposure drafts). Such disclosures, which generally are not required because the final standard may differ from the exposure draft, are not addressed by this SAB. See also FRR 26.

[6] FRR 6, Section 2.

[7] In those instances where a recently issued standard will impact the preparation of, but not materially affect, the financial statements, the registrant is encouraged to disclose that a standard has been issued and that its adoption will not have a material effect on its financial position or results of operations.

[8] Item 303 of Regulation S-K.

[9] See AU 9410.13-18.

Excerpt from ASC 250-10

• > SEC Staff Announcement at Emerging Issues Task Force (EITF) Meetings

• • > SEC Staff Announcement: Disclosure of the Impact That Recently Issued Accounting Standards Will Have on the Financial Statements of a Registrant When Such Standards Are Adopted in a Future Period (in accordance with Staff Accounting Bulletin [SAB] Topic 11.M)

S99-6 The following is the text of SEC Staff Announcement: Disclosure of the Impact That Recently Issued Accounting Standards Will Have on the Financial Statements of a Registrant When Such Standards Are Adopted in a Future Period (in accordance with Staff Accounting Bulletin [SAB] Topic 11.M).

This announcement applies to Accounting Standards Update (ASU) No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*; ASU No. 2016-02, *Leases (Topic 842)*; and ASU No. 2016-13, *Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*.[FN1]

SAB Topic 11.M provides the SEC staff view that a registrant should evaluate ASUs that have not yet been adopted to determine the appropriate financial statement disclosures [FN2] about the potential material effects of those ASUs on the financial statements when adopted. Consistent with Topic 11.M, if a registrant does not know or cannot reasonably estimate the impact that adoption of the ASUs referenced in this announcement is expected to have on the financial statements, then in addition to making a statement to that effect, that registrant should consider additional qualitative financial statement disclosures to assist the reader in assessing the significance of the impact that the standard will have on the financial statements of the registrant when adopted. In this regard, the SEC staff expects the additional qualitative disclosures to include a description of the effect of the accounting policies that the registrant expects to apply, if determined, and a comparison to the registrant's current accounting policies. Also, a registrant should describe the status of its process to implement the new standards and the significant implementation matters yet to be addressed.

FN 1 This announcement also applies to any subsequent amendments to guidance in the ASUs that are issued prior to a registrant's adoption of the aforementioned ASUs.

FN 2 Topic 11.M provides SEC staff views on disclosures that registrants should consider in both Management's Discussion & Analysis (MD&A) and the notes to the financial statements. MD&A may contain cross references to these disclosures that appear within the notes to the financial statements.

When a new accounting standard has been issued, but has not yet been adopted, a registrant discloses the expected effect of adopting the new standard on its future financial statements in its pre-adoption SEC filings. This enables financial statement users not only to be aware of the impending change, but also to understand the expected significance of the change. [SAB Topic 1M]

As noted in Question 3.3.340, we believe these disclosures are best practice for all entities.

Question 6.3.10 Must a registrant disclose the effect of all ASUs not yet adopted?

Interpretive response: No. It is not necessary to provide disclosure for accounting standards that will not apply to a registrant's financial statements. For example, a registrant that is not in the insurance industry does not have to disclose the effect of ASU 2022-05 (transition for sold contracts). [FRM 9270.1]

Question 6.3.20 What does a registrant disclose about the effect of an ASU not yet adopted?

Interpretive response: The SEC staff states that the registrant should consider disclosing the following: [SAB Topic 1M (Q2)]

Area	Disclosure
Background	Brief description of ASU
Timing	Required adoption date and registrant's expected adoption date (if earlier)
Method of adoption	Allowable methods of adoption and alternative registrant expects to use (if determined)
Effect of the ASU	• Effect that adoption is expected to have on registrant's financial statements, if known or reasonably estimable • If not known or reasonably estimable, further qualitative disclosures
Other consequential effects	Other significant matters registrant believes might result from adoption – e.g. technical violations of debt covenant agreements and planned or intended changes in business practices.

On several occasions in recent years, often following the issuance of significant accounting standards, the SEC staff has announced that public companies are expected to provide additional qualitative disclosures when they cannot reasonably estimate the effect of adopting the new standards. [250-10-S99-6]

Most recently, the staff reminded companies about their obligations under SAB 74 at the 2023 AICPA & CIMA Conference on Current SEC and PCAOB Developments. These additional disclosures include:

- a description of the effect of the accounting policies the entity expects to apply, if determined, and a comparison with the current accounting policies; and
- the entity's progress in implementing the new standard and the significant implementation matters it still needs to address.

The SEC staff also has stated that it expects these disclosures to become increasingly more informative as the effective date of a new standard approaches. [SEC speech]

This means that companies are expected to disclose additional and more precise quantitative and qualitative information as the effective date gets closer. The disclosures should be transparent about where the entity is in its implementation process, enabling financial statement users to evaluate what progress has been made toward implementation.

Further, the SEC staff has encouraged public companies to disclose known or reasonably estimable quantitative information about adopting a new standard, even if that information may differ from the ultimate effect of adoption, and even if it is for only a portion of the entity's arrangements. [2016 AICPA Conf]

Therefore, if the quantitative impact of the adoption of a new accounting standard is known or reasonably estimable, that information should be disclosed, even if the impact of adoption on the financial statements as a whole is not yet reasonably estimable.

When assessing whether the effect of a new or updated standard is material, companies must consider the full scope of the standard, including recognition, measurement, presentation and disclosure requirements.

Question 6.3.30 What does a registrant disclose if it does not know or cannot reasonably estimate the effect of adopting an ASU?

Interpretive response: If a registrant does not know or cannot reasonably estimate the effect that adopting a new standard will have on its financial statements, it makes a statement to this effect. [SAB Topic 1M (Q2)]

In addition, the SEC staff expects additional qualitative disclosures, such as: [250-10-S99-6]

- a description of the effect of the accounting policies that the registrant expects to apply, if determined, and a comparison to current accounting policies; and
- the status of the registrant's process to implement the new standards and the significant implementation matters yet to be addressed.

Further, a registrant does not need to complete and finalize information before concluding that it can provide disclosures about the effect of adopting the standard. The SEC staff has encouraged registrants to disclose known or reasonably estimable quantitative information about adopting a new standard, even if that information may differ from the ultimate effect of adoption and even if it is for only a portion of the registrant's arrangements. [2016 AICPA Conf]

Question 6.3.40 If a registrant discloses the effects of future accounting changes in its financial statements, must it repeat these disclosures in MD&A?

Interpretive response: No. It is generally not necessary to provide duplicative disclosure in MD&A and financial statements. Therefore, if the disclosure is appropriately provided in the financial statements, it does not need to be provided in MD&A. [FRM 9270.1]

Question 6.3.50 Do SAB 74 disclosures apply to a disclosure-only standard?

Background: While many ASUs impact primarily the recognition, measurement and presentation of transactions, certain ASUs only address disclosures in the financial statements (e.g. ASU 2023-07, Segment reporting, and ASU 2023-09, Improvements to income tax disclosures).

Interpretive response: Yes. We believe SAB 74 applies to all ASUs, including disclosure-only standards, because SAB 74 requires disclosures for standards that will have a material effect on an entity's financial statements, including the accompanying notes.

While SAB 74 refers to 'financial statements', the SEC staff has frequently remarked that this term includes the accompanying notes to the financial statements as required by Reg S-X Rule 1-01(b). We interpret this to mean that the effect of disclosure-only standards needs to be evaluated under SAB 74.

While judgment is required regarding the extent of disclosure, we do not interpret SAB 74 to mean that early adoption of an accounting standard (including a disclosure-only standard) is required. Therefore, we do not believe that SAB 74 requires an entity to provide a complete disclosure that would be required under a fully effective standard (which would effectively result in early adoption of the standard). However, we believe an entity should make comprehensive qualitative disclosures consistent with SAB 74 about expected changes as a result of the upcoming adoption of a disclosure-only standard.

6.4 Filing matters

This section discusses a number of filing matters related to the application of Topic 250. These are based on the questions that we encounter most frequently and are not intended to be exhaustive. Companies should consult with their legal counsel and auditors regarding SEC filing requirements relevant to their specific facts and circumstances.

6.4.10 Change in accounting principle

Question 6.4.10 Is selected financial data adjusted for all years to reflect the retrospective application of a change in accounting principle?

Interpretive response: As noted in Question 3.3.270, the guidance in Topic 250 related to historical summaries applies only to the periods in those historical summaries in which a change in accounting principle is *reflected*. [250-10-15-3(b)]

SEC registrants that voluntarily include selected financial data (e.g. five-year table) in Form 10-K, are generally expected to present this information on a consistent basis. However, a registrant may be able to demonstrate that additional explanatory disclosures are sufficient to explain factors that materially affect the comparability of the information reflected in the selected financial data. [Regs Comm 09/2019]

Question 6.4.30 Must the significance of an equity method investee be remeasured when a change in accounting principle is retrospectively applied?

Background: Rule 3-09 of Regulation S-X requires that separate financial statements of significant equity method investees be included as an exhibit in a registrant's annual filings (e.g. Form 10-K). Rule 4-08(g) requires summarized financial information of significant equity method investments to be disclosed in the notes to the registrant's quarterly and annual financial statements. Rule 1-02(w) of Regulation S-X prescribes how to determine whether an equity method investment is significant to a registrant.

Interpretive response: No. The registrant need not recalculate significance using the financial statements that give retrospective effect to the change in accounting principle and are included or incorporated into the registration or proxy statement. In addition, the SEC staff will not object if a registrant, when filing a subsequent Form 10-K, does not recalculate significance for periods earlier than the one during which a retrospectively applied change in accounting principle occurred. [FRM 2410.8]

Question 6.4.40 Should pro forma information include the effect of a future change in accounting principle?

Interpretive response: No. The SEC staff believes that pro forma information prepared under Article 11 of Regulation S-X should include a pro forma adjustment to reflect a change in accounting principle only if GAAP requires the pro forma disclosure of the change. Because Topic 250 does not require pro forma disclosure of an accounting change, this information should not be included within pro forma information presented for other purposes. This is the

case even if the pro forma information covers a period that will be retrospectively adjusted upon adoption of the future accounting change. [Regs Comm 10/2001, 06/2006]

Question 6.4.43 When does a registrant first report on a change in accounting principle?

Interpretive response: When a registrant makes a change in accounting principle, a Form 8-K is typically not required to be filed. The registrant generally first includes the effects of the change in the first periodic filing (i.e. Form 10-K or Form 10-Q) that contains financial statements for the period in which the change is adopted. Further, in this filing and each successive periodic filing, any prior-year information that ordinarily would appear in that filing is revised for the retrospective effects of the change in accounting principle, if material (see Question 3.3.240). For example, when making a change in accounting principle as of the beginning of the current year, a calendar-year registrant includes the effects of the change in its 10-Q filing for Q1 of the current year and retrospectively recasts prior-year information accordingly. [FRM 13110.3, 13110.4]

The above requirement applies equally to voluntary and mandatory changes in accounting principles, unless a mandatory change provides specific transition relief for interim periods in the year of adoption. Question 6.4.45 provides further timing considerations for registrants making a voluntary change in accounting principle.

Generally, annual information does not need to be retrospectively revised until the information is included in the next Form 10-K. However, prior information may need to be revised in between periodic filings, or prior to filing the next Form 10-K, for purposes of registration statements and shelf offerings, as further explained in Questions 6.4.50 and 6.4.60. Additionally, a registrant may elect to file recast annual (audited) information prior to filing its next Form 10-K as long as at least one Form 10-Q has been filed that reports on the period when the change was adopted. These recast financial statements are typically filed on Form 8-K. [FRM 13110.5, Form 8-K]

See also Question 6.4.62.

Question 6.4.45 What factors are important in determining when to make a voluntary change in accounting principle?

Interpretive response: In determining when to make a voluntary change in accounting principle, a registrant should be mindful of the potential reporting implications. As discussed in section 5.2.10, whenever possible, an entity adopts a change in accounting principle in the first interim period of a fiscal year. However, there are other variables for a registrant to consider when evaluating when to make a change in accounting principle. These include:

- when its next periodic filing is due (see Question 6.4.43);
- whether any new registration statements (e.g. Form S-3) are expected to be filed (see Question 6.4.50);
- if take-downs on previously filed shelf registration statements (e.g. Form S-3) are expected, whether the proposed change in accounting principle constitutes a fundamental change to the financial information included in the Form 10-K currently on file. A fundamental change would require the previously filed shelf registration statement to be updated (see Question 6.4.60); and
- the time expected to complete the analysis required to prepare recast financial statements for all of the periods required.

A registrant should allow sufficient time to prepare the required reporting.

Question 6.4.50 How does a change in accounting principle affect the financial statements in a new registration statement?

Interpretive response: It depends on the timing of the filing.

Registration statement filed* before *filing first (interim) financial statements reflecting the accounting change

When a registrant makes a change in accounting principle requiring retrospective application, and files a new registration statement before filing its first (interim) financial statements reflecting the accounting change, it is sufficient for the registrant to disclose the impending change (e.g. provide SAB 74 disclosures) in the registration statement – i.e. pre-change financial statements do not need to be revised. [Regs Comm 10/2007]

Registration statement filed* after *filing first (interim) financial statements reflecting the accounting change

When the change is made *after* the registrant files its first (interim) financial statements reflecting the change, the registrant provides (i.e. includes or incorporates by reference) audited revised financial statements reflecting the change for all periods required in the registration statement. However, short-form registration statements on Form S-8 do not necessarily require this. [FRM 13110.1, 13110.2, Regs Comm 10/2007]

Question 6.4.60 How does a change in accounting principle affect the financial statements in a currently effective shelf registration statement?

Background: A shelf registration statement is one that permits registering securities that may then be offered and sold on a delayed or continuous basis in the future without the need for an additional registration statement. The shelf

registration, generally filed on Form S-3, incorporates by reference financial statements from current and future Exchange Act reports. Further, a 'take-down from the shelf' means an actual offering of securities from an already effective shelf registration statement.

Interpretive response: Regulation S-K requires the registrant to undertake: "To reflect in the prospectus any facts or events arising after the effective date of the registration statement (or the most recent post-effective amendment thereof) which, individually or in the aggregate, represent a fundamental change in the information set forth in the registration statement." [S-K Item 512(a)(1)(ii)V]

If a registrant retrospectively adopts an accounting principle and has a previously effective shelf registration statement, it is not required to revise its previously issued financial statements before a take-down from the shelf, unless it deems the accounting change a 'fundamental change'. However, in certain circumstances, pro forma financial statements under Article 11 of Regulation S-X may be required. [FRM 13110.2]

It is management's responsibility to determine what constitutes a fundamental change or a material retroactive restatement. The judgment related to this determination is a legal matter that should be addressed in consultation with a registrant's SEC counsel. [FRM 13110.2, C&DI 126.40]

Further, restated financial statements prepared in accordance with Regulation S-X are required if there has been a change in accounting principle that requires a material retroactive restatement of financial statements. [Form S-3 Item 11(b)(ii)]

Question 6.4.62 Are the retrospective effects of a change in accounting principle required to be reflected when previously filed financial statements are amended for a Big R restatement?

Interpretive response: It depends. A change in accounting principle generally requires retrospective application without amending previously filed financial statements (see Question 6.4.43). Nevertheless, the SEC staff will not object to a registrant reflecting the retrospective effects of a change in accounting principle in a Form 10-K/A filing to correct a material error if that accounting change is already reflected in SEC filings (e.g. Form 10-Q) subsequent to the original Form 10-K. However, doing so cannot delay the filing of the Form 10-K/A to correct the material error.

In contrast, if the Form 10-K/A is being incorporated by reference into a registration statement, then the accounting change would be *required* to be presented in the Form 10-K/A (see Question 6.4.60).

The financial statement disclosures in the Form 10-K/A should clearly distinguish the effects of the material error from those of any subsequent accounting change. [FRM 13110.6]

6.4.20 Change in reporting entity

Question 6.4.65 May a registrant voluntarily reflect in its Form 10-K for the current period a change in reporting entity after the reporting date?

Interpretive response: As discussed in Question 3.6.80, if a registrant undergoes a change in reporting entity after the reporting date but before the Form 10-K is filed, the financial statements in the report are not retrospectively adjusted to reflect the change in reporting entity. However, the registrant may voluntarily provide supplemental audited combined financial statements of the entities to be reorganized. [FRM 13410.2]

Question 6.4.70 How does a change in reporting entity that will occur upon an IPO affect the financial statements in a registration statement?

Background: A change in reporting entity is applied retrospectively so that the comparative financial information presented is that of the new reporting entity (see section 3.6). In some IPOs, a change in reporting entity will occur at or shortly after the effectiveness of the registration statement, but no later than the closing of the IPO.

Interpretive response: The SEC staff may allow a registrant to present financial statements of a consolidated or combined entity (i.e. reflecting the change) in lieu of separate financial statements of the registrant and the entities to be reorganized. This accommodation would be based on the facts and circumstances and be subject to preclearance by the SEC staff. [FRM 13410.3]

6.4.30 Error corrections

Question 6.4.80 How is a Big R restatement disclosed in SEC filings?

Background: When financial statements are restated and reissued to correct a material error (see section 4.4.20), the registrant is required to timely file a Form 8-K, in addition to meeting other applicable requirements under Regulation S-K. [Form 8-K Item 4.02(b)]

Interpretive response: The SEC staff has confirmed that the correction of a material error in prior-period financial statements should be reported via an amendment to the previously filed Form 10-K (i.e. a Form 10-K/A) or Form 10-Q rather than only announced on a Form 8-K. [Regs Comm 06/2009]

In addition to the financial statement disclosures discussed in Questions 4.4.60 and 4.4.70 (annual periods) and Question 5.3.40 (interim periods), the SEC staff

encourages registrants to disclose information about how the error was found. [2006 SEC staff speech]

In 2022, the SEC adopted final rules that require listed companies to establish policies to assess the need to recover incentive compensation when there is an accounting restatement (both Big R and little r as defined in those rules). These rules also require specific disclosures when there is such a restatement. See also KPMG Hot Topic, SEC approves clawback listing standards. [2022 SEC press release]

Question 6.4.90 How does a Big R restatement affect the financial statements in an initial registration statement?

Background: When an entity discovers a material error in prior-period financial statements, it restates and reissues these financial statements, and includes the restatement disclosures required by Topic 250 (see Question 4.4.60) and labeling (see Question 4.4.40). The disclosures and labeling generally can be removed in the next year's financial statements (see Question 4.4.70). [250-10-50-9 – 50-10]

Interpretive response: The SEC staff has indicated that when a material error is identified prior to the effectiveness of a registration statement, the registrant should file a pre-effective amendment to the initial registration statement to include the restated financial statements with applicable restatement disclosures. Registrants may remove the restatement disclosures and labeling only when the pre-effective amendment includes updated (i.e. the following year's) annual financial statements, and the restatement disclosures have already been included for more than a very short period of time.[1] This view also applies when an entity's initial registration statement is submitted confidentially to the SEC. [2011 AICPA Conf]

Note:

1. This minimum time requirement is more restrictive than the general Topic 250 guidance that the restatement disclosures not be repeated in subsequent years' financial statements. However, the minimum time requirement may be subject to interpretation and the SEC staff encourages consultation with the Office of the Chief Accountant.

Example 6.4.10 Material error identified before filing an initial registration statement

ABC Corp. discovers a material error in the financial statements prior to their inclusion in an IPO registration statement. Before the error was discovered, the financial statements had been distributed only to ABC's lender and private investors (limited distribution).

First, ABC restates and reissues the financial statements with the restatement disclosures required by Topic 250 (Big R restatement - see Question 4.4.60) and labeling (see Question 4.4.40) for distribution to those limited users. Then, ABC

removes these restatement disclosures from the financial statements included in its initial registration statement.

Example 6.4.20 Material error identified after filing an initial registration statement

ABC Corp. filed an initial registration statement with the most recent annual financial statements for Year 10. Subsequently, management discovers a material error in the Year 10 financial statements. ABC amends its initial registration statement and includes restated and reissued Year 10 financial statements with the restatement disclosures required by Topic 250 (Big R restatement - see Question 4.4.60) and labeling (see Question 4.4.40). ABC continues to present the restatement disclosures and labeling until the annual financial statements are updated from Year 10 to Year 11.

Scenario A: ABC plans to request effectiveness in Year 11, or in Year 12* before *the Year 10 financial statements are 'stale'

Because ABC plans to request effectiveness before being required to update its annual financial statements to include Year 11, the initial registration statement will include the restatement disclosures and labeling as of the effective date of the IPO.

Scenario B: ABC plans to request effectiveness in Year 12,* after *the Year 10 financial statements are 'stale'

Because ABC plans to request effectiveness during Year 12, and the Year 10 financial statements are stale, ABC will be required to file a pre-effective amendment to update its annual financial statements to the three years ended Year 11. Assuming this is done more than a very short period of time (see Question 6.4.90) after amending its initial registration statement for the error, ABC may remove the Year 10 restatement disclosures and labeling in the Year 11 financial statements included in this pre-effective amendment. Therefore, the initial registration statement will not include the restatement disclosures as of the effective date of the IPO.

Question 6.4.100 Does a Big R restatement require a currently effective shelf registration statement to be amended?

Interpretive response: No. Instructions to Form S-3 (shelf registration statement) require that restated financial statements be filed if there has been an error correction requiring a material retroactive restatement of financial statements (i.e. Big R restatement). A Big R restatement is made by filing an amended Form 10-K (Form 10-K/A) or Form 10-Q/A (as relevant). This form is incorporated by reference into a shelf registration statement; therefore, the shelf registration statement itself does not need to be amended. [Form S-3 Item 11(b)(ii)]

Appendix – SEC staff guidance: Materiality and error correction

SAB Topic 1M (codified from SAB No. 99)

M. Materiality

1. Assessing materiality

Facts: During the course of preparing or auditing year-end financial statements, financial management or the registrant's independent auditor becomes aware of misstatements in a registrant's financial statements. When combined, the misstatements result in a 4% overstatement of net income and a $.02 (4%) overstatement of earnings per share. Because no item in the registrant's consolidated financial statements is misstated by more than 5%, management and the independent auditor conclude that the deviation from GAAP is immaterial and that the accounting is permissible.[24]

Question: FASB ASC paragraph 105-10-05-6 (Generally Accepted Accounting Principles Topic) states, "The provisions of the Codification need not be applied to immaterial items." In the staff's view, may a registrant or the auditor of its financial statements assume the immateriality of items that fall below a percentage threshold set by management or the auditor to determine whether amounts and items are material to the financial statements?

Interpretive Response: No. The staff is aware that certain registrants, over time, have developed quantitative thresholds as "rules of thumb" to assist in the preparation of their financial statements, and that auditors also have used these thresholds in their evaluation of whether items might be considered material to users of a registrant's financial statements. One rule of thumb in particular suggests that the misstatement or omission[25] of an item that falls under a 5% threshold is not material in the absence of particularly egregious circumstances, such as self-dealing or misappropriation by senior management. The staff reminds registrants and the auditors of their financial statements that exclusive reliance on this or any percentage or numerical threshold has no basis in the accounting literature or the law.

The use of a percentage as a numerical threshold, such as 5%, may provide the basis for a preliminary assumption that — without considering all relevant circumstances — a deviation of less than the specified percentage with respect to a particular item on the registrant's financial statements is unlikely to be material. The staff has no objection to such a "rule of thumb" as an initial step in assessing materiality. But quantifying, in percentage terms, the magnitude of a misstatement is only the beginning of an analysis of materiality; it cannot appropriately be used as a substitute for a full analysis of all relevant considerations. Materiality concerns the significance of an item to users of a registrant's financial statements. A matter is "material" if there is a substantial likelihood that a reasonable person would consider it important. In its Concepts

Statement 2, Qualitative Characteristics of Accounting Information, the FASB stated the essence of the concept of materiality as follows:

> The omission or misstatement of an item in a financial report is material if, in the light of surrounding circumstances, the magnitude of the item is such that it is probable that the judgment of a reasonable person relying upon the report would have been changed or influenced by the inclusion or correction of the item.[26]

This formulation in the accounting literature is in substance identical to the formulation used by the courts in interpreting the federal securities laws. The Supreme Court has held that a fact is material if there is —

> a substantial likelihood that the...fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available.[27]

Under the governing principles, an assessment of materiality requires that one views the facts in the context of the "surrounding circumstances," as the accounting literature puts it, or the "total mix" of information, in the words of the Supreme Court. In the context of a misstatement of a financial statement item, while the "total mix" includes the size in numerical or percentage terms of the misstatement, it also includes the factual context in which the user of financial statements would view the financial statement item. The shorthand in the accounting and auditing literature for this analysis is that financial management and the auditor must consider both "quantitative" and "qualitative" factors in assessing an item's materiality.[28] Court decisions, Commission rules and enforcement actions, and accounting and auditing literature[29] have all considered "qualitative" factors in various contexts.

The FASB has long emphasized that materiality cannot be reduced to a numerical formula. In its Concepts Statement 2, the FASB noted that some had urged it to promulgate quantitative materiality guides for use in a variety of situations. The FASB rejected such an approach as representing only a "minority view, stating —

> The predominant view is that materiality judgments can properly be made only by those who have all the facts. The Board's present position is that no general standards of materiality could be formulated to take into account all the considerations that enter into an experienced human judgment.[30]

The FASB noted that, in certain limited circumstances, the Commission and other authoritative bodies had issued quantitative materiality guidance, citing as examples guidelines ranging from one to ten percent with respect to a variety of disclosures.[31] And it took account of contradictory studies, one showing a lack of uniformity among auditors on materiality judgments, and another suggesting widespread use of a "rule of thumb" of five to ten percent of net income.[32] The FASB also considered whether an evaluation of materiality could be based solely on anticipating the market's reaction to accounting information.[33]

The FASB rejected a formulaic approach to discharging "the onerous duty of making materiality decisions"[34] in favor of an approach that takes into account all the relevant considerations. In so doing, it made clear that —

> [M]agnitude by itself, without regard to the nature of the item and the circumstances in which the judgment has to be made, will not generally be a sufficient basis for a materiality judgment.[35]

Evaluation of materiality requires a registrant and its auditor to consider all the relevant circumstances, and the staff believes that there are numerous circumstances in which misstatements below 5% could well be material. Qualitative factors may cause misstatements of quantitatively small amounts to be material; as stated in the auditing literature:

> As a result of the interaction of quantitative and qualitative considerations in materiality judgments, misstatements of relatively small amounts that come to the auditor's attention could have a material effect on the financial statements.[36]

Among the considerations that may well render material a quantitatively small misstatement of a financial statement item are —

- Whether the misstatement arises from an item capable of precise measurement or whether it arises from an estimate and, if so, the degree of imprecision inherent in the estimate.[37]
- Whether the misstatement masks a change in earnings or other trends.
- Whether the misstatement hides a failure to meet analysts' consensus expectations for the enterprise.
- Whether the misstatement changes a loss into income or vice versa.
- Whether the misstatement concerns a segment or other portion of the registrant's business that has been identified as playing a significant role in the registrant's operations or profitability.
- Whether the misstatement affects the registrant's compliance with regulatory requirements.
- Whether the misstatement affects the registrant's compliance with loan covenants or other contractual requirements.
- Whether the misstatement has the effect of increasing management's compensation — for example, by satisfying requirements for the award of bonuses or other forms of incentive compensation.
- Whether the misstatement involves concealment of an unlawful transaction.

This is not an exhaustive list of the circumstances that may affect the materiality of a quantitatively small misstatement.[38] Among other factors, the demonstrated volatility of the price of a registrant's securities in response to certain types of disclosures may provide guidance as to whether investors regard quantitatively small misstatements as material. Consideration of potential market reaction to disclosure of a misstatement is by itself "too blunt an instrument to be depended on" in considering whether a fact is material.[39] When, however, management or the independent auditor expects (based, for example, on a pattern of market performance) that a known misstatement may result in a significant positive or negative market reaction, that expected

reaction should be taken into account when considering whether a misstatement is material.[40]

For the reasons noted above, the staff believes that a registrant and the auditors of its financial statements should not assume that even small intentional misstatements in financial statements, for example those pursuant to actions to "manage" earnings, are immaterial.[41] While the intent of management does not render a misstatement material, it may provide significant evidence of materiality. The evidence may be particularly compelling where management has intentionally misstated items in the financial statements to "manage" reported earnings. In that instance, it presumably has done so believing that the resulting amounts and trends would be significant to users of the registrant's financial statements.[42] The staff believes that investors generally would regard as significant a management practice to over- or under-state earnings up to an amount just short of a percentage threshold in order to "manage" earnings. Investors presumably also would regard as significant an accounting practice that, in essence, rendered all earnings figures subject to a management-directed margin of misstatement.

The materiality of a misstatement may turn on where it appears in the financial statements. For example, a misstatement may involve a segment of the registrant's operations. In that instance, in assessing materiality of a misstatement to the financial statements taken as a whole, registrants and their auditors should consider not only the size of the misstatement but also the significance of the segment information to the financial statements taken as a whole.[43] "A misstatement of the revenue and operating profit of a relatively small segment that is represented by management to be important to the future profitability of the entity"[44] is more likely to be material to investors than a misstatement in a segment that management has not identified as especially important. In assessing the materiality of misstatements in segment information — as with materiality generally —

> situations may arise in practice where the auditor will conclude that a matter relating to segment information is qualitatively material even though, in his or her judgment, it is quantitatively immaterial to the financial statements taken as a whole.[45]

Aggregating and Netting Misstatements

In determining whether multiple misstatements cause the financial statements to be materially misstated, registrants and the auditors of their financial statements should consider each misstatement separately and the aggregate effect of all misstatements.[46] A registrant and its auditor should evaluate misstatements in light of quantitative and qualitative factors and "consider whether, in relation to individual amounts, subtotals, or totals in the financial statements, they materially misstate the financial statements taken as a whole."[47] This requires consideration of —

> the significance of an item to a particular entity (for example, inventories to a manufacturing company), the pervasiveness of the misstatement (such as whether it affects the presentation of numerous financial statement items), and the effect of the misstatement on the financial statements taken as a whole….[48]

Registrants and their auditors first should consider whether each misstatement is material, irrespective of its effect when combined with other misstatements. The literature notes that the analysis should consider whether the misstatement of "individual amounts" causes a material misstatement of the financial statements taken as a whole. As with materiality generally, this analysis requires consideration of both quantitative and qualitative factors.

If the misstatement of an individual amount causes the financial statements as a whole to be materially misstated, that effect cannot be eliminated by other misstatements whose effect may be to diminish the impact of the misstatement on other financial statement items. To take an obvious example, if a registrant's revenues are a material financial statement item and if they are materially overstated, the financial statements taken as a whole will be materially misleading even if the effect on earnings is completely offset by an equivalent overstatement of expenses.

Even though a misstatement of an individual amount may not cause the financial statements taken as a whole to be materially misstated, it may nonetheless, when aggregated with other misstatements, render the financial statements taken as a whole to be materially misleading. Registrants and the auditors of their financial statements accordingly should consider the effect of the misstatement on subtotals or totals. The auditor should aggregate all misstatements that affect each subtotal or total and consider whether the misstatements in the aggregate affect the subtotal or total in a way that causes the registrant's financial statements taken as a whole to be materially misleading.[49]

The staff believes that, in considering the aggregate effect of multiple misstatements on a subtotal or total, registrants and the auditors of their financial statements should exercise particular care when considering whether to offset (or the appropriateness of offsetting) a misstatement of an estimated amount with a misstatement of an item capable of precise measurement. As noted above, assessments of materiality should never be purely mechanical; given the imprecision inherent in estimates, there is by definition a corresponding imprecision in the aggregation of misstatements involving estimates with those that do not involve an estimate.

Registrants and auditors also should consider the effect of misstatements from prior periods on the current financial statements. For example, the auditing literature states,

> Matters underlying adjustments proposed by the auditor but not recorded by the entity could potentially cause future financial statements to be materially misstated, even though the auditor has concluded that the adjustments are not material to the current financial statements.[50]

This may be particularly the case where immaterial misstatements recur in several years and the cumulative effect becomes material in the current year.

2. Immaterial Misstatements that are Intentional

Facts: A registrant's management intentionally has made adjustments to various financial statement items in a manner inconsistent with GAAP. In each accounting period in which such actions were taken, none of the individual adjustments is by itself material, nor is the aggregate effect on the financial statements taken as a whole material for the period. The registrant's earnings

"management" has been effected at the direction or acquiescence of management in the belief that any deviations from GAAP have been immaterial and that accordingly the accounting is permissible.

Question: In the staff's view, may a registrant make intentional immaterial misstatements in its financial statements?

Interpretive Response: No. In certain circumstances, intentional immaterial misstatements are unlawful.

Considerations of the books and records provisions under the Exchange Act

Even if misstatements are immaterial,[51] registrants must comply with Sections 13(b)(2) (7) of the Securities Exchange Act of 1934 (the "Exchange Act").[52] Under these provisions, each registrant with securities registered pursuant to Section 12 of the Exchange Act,[53] or required to file reports pursuant to Section 15(d),[54] must make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of assets of the registrant and must maintain internal accounting controls that are sufficient to provide reasonable assurances that, among other things, transactions are recorded as necessary to permit the preparation of financial statements in conformity with GAAP.[55] In this context, determinations of what constitutes "reasonable assurance" and "reasonable detail" are based not on a "materiality" analysis but on the level of detail and degree of assurance that would satisfy prudent officials in the conduct of their own affairs.[56] Accordingly, failure to record accurately immaterial items, in some instances, may result in violations of the securities laws.

The staff recognizes that there is limited authoritative guidance[57] regarding the "reasonableness" standard in Section 13(b)(2) of the Exchange Act. A principal statement of the Commission's policy in this area is set forth in an address given in 1981 by then Chairman Harold M. Williams.[58] In his address, Chairman Williams noted that, like materiality, "reasonableness" is not an "absolute standard of exactitude for corporate records."[59] Unlike materiality, however, "reasonableness" is not solely a measure of the significance of a financial statement item to investors. "Reasonableness," in this context, reflects a judgment as to whether an issuer's failure to correct a known misstatement implicates the purposes underlying the accounting provisions of Sections 13(b)(2) - (7) of the Exchange Act.[60]

In assessing whether a misstatement results in a violation of a registrant's obligation to keep books and records that are accurate "in reasonable detail," registrants and their auditors should consider, in addition to the factors discussed above concerning an evaluation of a misstatement's potential materiality, the factors set forth below.

- **The significance of the misstatement.** Though the staff does not believe that registrants need to make finely calibrated determinations of significance with respect to immaterial items, plainly it is "reasonable" to treat misstatements whose effects are clearly inconsequential differently than more significant ones.
- **How the misstatement arose.** It is unlikely that it is ever "reasonable" for registrants to record misstatements or not to correct known

misstatements — even immaterial ones — as part of an ongoing effort directed by or known to senior management for the purposes of "managing" earnings. On the other hand, insignificant misstatements that arise from the operation of systems or recurring processes in the normal course of business generally will not cause a registrant's books to be inaccurate "in reasonable detail."[61]

- **The cost of correcting the misstatement.** The books and records provisions of the Exchange Act do not require registrants to make major expenditures to correct small misstatements.[62] Conversely, where there is little cost or delay involved in correcting a misstatement, failing to do so is unlikely to be "reasonable."
- **The clarity of authoritative accounting guidance with respect to the misstatement.** Where reasonable minds may differ about the appropriate accounting treatment of a financial statement item, a failure to correct it may not render the registrant's financial statements inaccurate "in reasonable detail." Where, however, there is little ground for reasonable disagreement, the case for leaving a misstatement uncorrected is correspondingly weaker.

There may be other indicators of "reasonableness" that registrants and their auditors may ordinarily consider. Because the judgment is not mechanical, the staff will be inclined to continue to defer to judgments that "allow a business, acting in good faith, to comply with the Act's accounting provisions in an innovative and cost-effective way."[63]

The Auditor's Response to Intentional Misstatements

Section 10A(b) of the Exchange Act requires auditors to take certain actions upon discovery of an "illegal act."[64] The statute specifies that these obligations are triggered "whether or not [the illegal acts are] perceived to have a material effect on the financial statements of the issuer...." Among other things, Section 10A(b)(1) requires the auditor to inform the appropriate level of management of an illegal act (unless clearly inconsequential) and assure that the registrant's audit committee is "adequately informed" with respect to the illegal act.

As noted, an intentional misstatement of immaterial items in a registrant's financial statements may violate Section 13(b)(2) of the Exchange Act and thus be an illegal act. When such a violation occurs, an auditor must take steps to see that the registrant's audit committee is "adequately informed" about the illegal act. Because Section 10A(b)(1) is triggered regardless of whether an illegal act has a material effect on the registrant's financial statements, where the illegal act consists of a misstatement in the registrant's financial statements, the auditor will be required to report that illegal act to the audit committee irrespective of any "netting" of the misstatements with other financial statement items.

The requirements of Section 10A echo the auditing literature. See, e.g. Statement on Auditing Standards (SAS) Nos. 54 and 99. Pursuant to paragraph 77 of SAS 99, if the auditor determines there is evidence that fraud may exist, the auditor must discuss the matter with the appropriate level of management that is at least one level above those involved, and with senior management and the audit committee. The auditor must report directly to the audit

committee fraud involving senior management and fraud that causes a material misstatement of the financial statements. Paragraph 6 of SAS 99 states that "misstatements arising from fraudulent financial reporting are intentional misstatements or omissions of amounts or disclosures in financial statements designed to deceive financial statement users..."[65] SAS 99 further states that fraudulent financial reporting may involve falsification or alteration of accounting records; misrepresenting or omitting events, transactions or other information in the financial statements; and the intentional misapplication of accounting principles relating to amounts, classifications, the manner of presentation, or disclosures in the financial statements.[66] The clear implication of SAS 99 is that immaterial misstatements may be fraudulent financial reporting.[67]

Auditors that learn of intentional misstatements may also be required to (1) re-evaluate the degree of audit risk involved in the audit engagement, (2) determine whether to revise the nature, timing, and extent of audit procedures accordingly, and (3) consider whether to resign.[68]

Intentional misstatements also may signal the existence of reportable conditions or material weaknesses in the registrant's system of internal accounting control designed to detect and deter improper accounting and financial reporting.[69] As stated by the National Commission on Fraudulent Financial Reporting, also known as the Treadway Commission, in its 1987 report,

> The tone set by top management — the corporate environment or culture within which financial reporting occurs — is the most important factor contributing to the integrity of the financial reporting process. Notwithstanding an impressive set of written rules and procedures, if the tone set by management is lax, fraudulent financial reporting is more likely to occur.[70]

An auditor is required to report to a registrant's audit committee any reportable conditions or material weaknesses in a registrant's system of internal accounting control that the auditor discovers in the course of the examination of the registrant's financial statements.[71]

GAAP precedence over industry practice

Some have argued to the staff that registrants should be permitted to follow an industry accounting practice even though that practice is inconsistent with authoritative accounting literature. This situation might occur if a practice is developed when there are few transactions and the accounting results are clearly inconsequential, and that practice never changes despite a subsequent growth in the number or materiality of such transactions. The staff disagrees with this argument. Authoritative literature takes precedence over industry practice that is contrary to GAAP.[72]

General comments

This SAB is not intended to change current law or guidance in the accounting or auditing literature.[73] This SAB and the authoritative accounting literature cannot specifically address all of the novel and complex business transactions and events that may occur. Accordingly, registrants may account for, and make disclosures about, these transactions and events based on analogies to similar situations or other factors. The staff may not, however, always be persuaded

that a registrant's determination is the most appropriate under the circumstances. When disagreements occur after a transaction or an event has been reported, the consequences may be severe for registrants, auditors, and, most importantly, the users of financial statements who have a right to expect consistent accounting and reporting for, and disclosure of, similar transactions and events. The staff, therefore, encourages registrants and auditors to discuss on a timely basis with the staff proposed accounting treatments for, or disclosures about, transactions or events that are not specifically covered by the existing accounting literature.

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[25] As used in this SAB, "misstatement" or "omission" refers to a financial statement assertion that would not be in conformity with GAAP.

[26] Concepts Statement 2, paragraph 132. See also Concepts Statement 2, Glossary of Terms — Materiality.

[27] TSC Industries v. Northway, Inc., 426 U.S. 438, 449 (1976). See also Basic, Inc. v. Levinson, 485 U.S. 224 (1988). As the Supreme Court has noted, determinations of materiality require "delicate assessments of the inferences a `reasonable shareholder' would draw from a given set of facts and the significance of those inferences to him...." TSC Industries, 426 U.S. at 450.

[28] See, *e.g.,* Concepts Statement 2, paragraphs 123-124; AU 312A.10 (materiality judgments are made in light of surrounding circumstances and necessarily involve both quantitative and qualitative considerations); AU 312A.34 ("Qualitative considerations also influence the auditor in reaching a conclusion as to whether misstatements are material."). As used in the accounting literature and in this SAB, "qualitative" materiality refers to the surrounding circumstances that inform an investor's evaluation of financial statement entries. Whether events may be material to investors for non-financial reasons is a matter not addressed by this SAB.

[29] See, *e.g.,* Rule 1-02(o) of Regulation S-X, 17 CFR 210.1-02(o), Rule 405 of Regulation C, 17 CFR 230.405, and Rule 12b-2, 17 CFR 240.12b-2; AU 312A.10 -.11, 317.13, 411.04 n. 1, and 508.36; In re Kidder Peabody Securities Litigation, 10 F. Supp. 2d 398 (S.D.N.Y. 1998); Parnes v. Gateway 2000, Inc., 122 F.3d 539 (8th Cir. 1997); In re Westinghouse Securities Litigation, 90 F.3d 696 (3d Cir. 1996); In the Matter of W.R. Grace & Co., Accounting and Auditing Enforcement Release ("AAER") 1140 (June 30, 1999); In the Matter of Eugene Gaughan, AAER 1141 (June 30, 1999); In the Matter of Thomas Scanlon, AAER 1142 (June 30, 1999); and In re Sensormatic Electronics Corporation, Sec. Act Rel. No. 7518 (March 25, 1998).

[36] AU 312.11.

[37] As stated in Concepts Statement 2, paragraph 130:

Another factor in materiality judgments is the degree of precision that is attainable in estimating the judgment item. The amount of deviation that is considered immaterial may increase as the attainable degree of precision decreases. For example, accounts payable usually can be estimated more accurately than can contingent liabilities arising from litigation or threats of it, and a deviation considered to be material in the first case may be quite trivial in the second.

This SAB is not intended to change current law or guidance in the accounting literature regarding accounting estimates. *See, e.g.,* FASB ASC Topic 250, Accounting Changes and Error Corrections.

[38] The staff understands that the Big Five Audit Materiality Task Force ("Task Force") was convened in March of 1998 and has made recommendations to the Auditing Standards Board including suggestions regarding communications with audit committees about unadjusted misstatements. *See generally* Big Five Audit Materiality Task Force. "Materiality in a Financial Statement Audit - Considering Qualitative Factors When Evaluating Audit Findings" (August 1998).

[39] See Concepts Statement 2, paragraph 169.

[40] If management does not expect a significant market reaction, a misstatement still may be material and should be evaluated under the criteria discussed in this SAB.

[41] Intentional management of earnings and intentional misstatements, as used in this SAB, do not include insignificant errors and omissions that may occur in systems and recurring processes in the normal course of business. See notes 37 and 49 *infra*.

[42] Assessments of materiality should occur not only at year-end, but also during the preparation of each quarterly or interim financial statement. *See, e.g.,* In the Matter of Venator Group, Inc., AAER 1049 (June 29, 1998).

[43] *See, e.g.,* In the Matter of W.R. Grace & Co., AAER 1140 (June 30, 1999).

[44] AU 9326.33.

[45] *Id*.

[46] The auditing literature notes that the "concept of materiality recognizes that some matters, either individually or in the aggregate, are important for fair presentation of financial statements in conformity with generally accepted accounting principles." AU 312.03. See also AU 312.04.

[47] AU 312.34. Quantitative materiality assessments often are made by comparing adjustments to revenues, gross profit, pretax and net income, total assets, stockholders' equity, or individual line items in the financial statements. The particular items in the financial statements to be considered as a basis for the materiality determination depend on the proposed adjustment to be made and other factors, such as those identified in this SAB. For example, an adjustment to inventory that is immaterial to pretax income or net income may be material to the financial statements because it may affect a working capital ratio or cause the registrant to be in default of loan covenants.

[48] AU 508.36.

[49] AU 312.34.

[50] AU 380.09.

[51] FASB ASC paragraph 105-10-05-6 states that "[t]he provisions of the Codification need not be applied to immaterial items." This SAB is consistent with that provision of the Codification. In theory, this language is subject to the interpretation that the registrant is free intentionally to set forth immaterial items in financial statements in a manner that plainly would be contrary to

GAAP if the misstatement were material. The staff believes that the FASB did not intend this result.

[52] 15 U.S.C. 78m(b)(2) - (7).

[53] 15 U.S.C. 78l.

[54] 15 U.S.C. 78o(d).

[55] Criminal liability may be imposed if a person knowingly circumvents or knowingly fails to implement a system of internal accounting controls or knowingly falsifies books, records or accounts. 15 U.S.C. 78m(4) and (5). See also Rule 13b2-1 under the Exchange Act, 17 CFR 240.13b2-1, which states, "No person shall, directly or indirectly, falsify or cause to be falsified, any book, record or account subject to Section 13(b)(2)(A) of the Securities Exchange Act."

[56] 15 U.S.C. 78m(b)(7). The books and records provisions of section 13(b) of the Exchange Act originally were passed as part of the Foreign Corrupt Practices Act ("FCPA"). In the conference committee report regarding the 1988 amendments to the FCPA, the committee stated: The conference committee adopted the prudent man qualification in order to clarify that the current standard does not connote an unrealistic degree of exactitude or precision. The concept of reasonableness of necessity contemplates the weighing of a number of relevant factors, including the costs of compliance. Cong. Rec. H2116 (daily ed. April 20, 1988).

[57] So far as the staff is aware, there is only one judicial decision that discusses Section 13(b)(2) of the Exchange Act in any detail, SEC v. World-Wide Coin Investments, Ltd., 567 F. Supp. 724 (N.D. Ga. 1983), and the courts generally have found that no private right of action exists under the accounting and books and records provisions of the Exchange Act. See *e.g.,* Lamb v. Phillip Morris Inc., 915 F.2d 1024 (6th Cir. 1990) and JS Service Center Corporation v. General Electric Technical Services Company, 937 F. Supp. 216 (S.D.N.Y. 1996).

[58] The Commission adopted the address as a formal statement of policy in Securities Exchange Act Release No. 17500 (January 29, 1981), 46 FR 11544 (February 9, 1981), 21 SEC Docket 1466 (February 10, 1981).

[59] Id. at 46 FR 11546.

[60] Id.

[61] For example, the conference report regarding the 1988 amendments to the FCPA stated: The Conferees intend to codify current Securities and Exchange Commission (SEC) enforcement policy that penalties not be imposed for insignificant or technical infractions or inadvertent conduct. The amendment adopted by the Conferees [Section 13(b)(4)] accomplishes this by providing that criminal penalties shall not be imposed for failing to comply with the FCPA's books and records or accounting provisions. This provision [Section 13(b)(5)] is meant to ensure that criminal penalties would be imposed where acts of commission or omission in keeping books or records or administering accounting controls have the purpose of falsifying books, records or accounts, or of circumventing the accounting controls set forth in the Act. This would include the deliberate falsification of books and records and other conduct

calculated to evade the internal accounting controls requirement. Cong. Rec. H2115 (daily ed. April 20, 1988).

[62] As Chairman Williams noted with respect to the internal control provisions of the FCPA, "[t]housands of dollars ordinarily should not be spent conserving hundreds." 46 FR 11546.

[63] Id., at 11547.

[64] Section 10A(f) defines, for purposes of Section 10A, an "illegal act" as "an act or omission that violates any law, or any rule or regulation having the force of law." This is broader than the definition of an "illegal act" in AU 317.02, which states, "Illegal acts by clients do not include personal misconduct by the entity's personnel unrelated to their business activities.".

[65] An unintentional illegal act triggers the same procedures and considerations by the auditor as a fraudulent misstatement if the illegal act has a direct and material effect on the financial statements. See AU 110 n. 1, 317.05 and 317.07. Although distinguishing between intentional and unintentional misstatements is often difficult, the auditor must plan and perform the audit to obtain reasonable assurance that the financial statements are free of material misstatements in either case.

[66] Although the auditor is not required to plan or perform the audit to detect misstatements that are immaterial to the financial statements, SAS 99 requires the auditor to evaluate several fraud "risk factors" that may bring such misstatements to his or her attention. For example, an analysis of fraud risk factors under SAS 99 must include, among other things, consideration of management's interest in maintaining or increasing the registrant's stock price or earnings trend through the use of unusually aggressive accounting practices, whether management has a practice of committing to analysts or others that it will achieve unduly aggressive or clearly unrealistic forecasts, and the existence of assets, liabilities, revenues, or expenses based on significant estimates that involve unusually subjective judgments or uncertainties.

[67] In requiring the auditor to consider whether fraudulent misstatements are material, and in requiring differing responses depending on whether the misstatement is material, SAS 99 makes clear that fraud can involve immaterial misstatements. Indeed, a misstatement can be "inconsequential" and still involve fraud. Under SAS 99, assessing whether misstatements due to fraud are material to the financial statements is a "cumulative process" that should occur both during and at the completion of the audit. SAS 99 further states that this accumulation is primarily a "qualitative matter" based on the auditor's judgment. The staff believes that in making these assessments, management and auditors should refer to the discussion in Part 1 of this SAB.

[68] Auditors should document their determinations in accordance with SAS 96, SAS 99, and other appropriate sections of the audit literature.

[69] See, *e.g.,* SAS 99.

[70] Report of the National Commission on Fraudulent Financial Reporting at 32 (October 1987). See also Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees (February 8, 1999).

[71] AU 325.02. See also AU 380.09, which, in discussing matters to be communicated by the auditor to the audit committee, states: The auditor should inform the audit committee about adjustments arising from the audit that could, in his judgment, either individually or in the aggregate, have a significant effect on the entity's financial reporting process. For purposes of this section, an audit adjustment, whether or not recorded by the entity, is a proposed correction of the financial statements.

[72] See AU 411.05.

[73] The FASB Discussion Memorandum, "Criteria for Determining Materiality," states that the financial accounting and reporting process considers that "a great deal of the time might be spent during the accounting process considering insignificant matters.... If presentations of financial information are to be prepared economically on a timely basis and presented in a concise intelligible form, the concept of materiality is crucial." This SAB is not intended to require that misstatements arising from insignificant errors and omissions (individually and in the aggregate) arising from the normal recurring accounting close processes, such as a clerical error or an adjustment for a missed accounts payable invoice, always be corrected, even if the error is identified in the audit process and known to management. Management and the auditor would need to consider the various factors described elsewhere in this SAB in assessing whether such misstatements are material, need to be corrected to comply with the FCPA, or trigger procedures under Section 10A of the Exchange Act. Because this SAB does not change current law or guidance in the accounting or auditing literature, adherence to the principles described in this SAB should not raise the costs associated with recordkeeping or with audits of financial statements.

Excerpt from SAB Topic 1N (codified from SAB No. 108)

Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements

(Added by SAB 108)

Facts: During the course of preparing annual financial statements, a registrant is evaluating the materiality of an improper expense accrual (*e.g.,* overstated liability) in the amount of $100, which has built up over 5 years, at $20 per year.[74] The registrant previously evaluated the misstatement as being immaterial to each of the prior year financial statements (*i.e.,* years 1-4). For the purpose of evaluating materiality in the current year (*i.e.,* year 5), the registrant quantifies the error as a $20 overstatement of expenses.

Question 1: Has the registrant appropriately quantified the amount of this error for the purpose of evaluating materiality for the current year?

Interpretive Response: No. In this example, the registrant has only quantified the effects of the identified unadjusted error that arose in the current year income statement. The staff believes a registrants 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.

Topic 1M notes that a materiality evaluation must be based on all relevant quantitative and qualitative factors.[75] This analysis generally begins with quantifying potential misstatements to be evaluated. There has been diversity in practice with respect to this initial step of a materiality analysis.

The diversity in approaches for quantifying the amount of misstatements primarily stems from the effects of misstatements that were not corrected at the end of the prior year ("prior year misstatements"). These prior year misstatements should be considered in quantifying misstatements in current year financial statements.

The techniques most commonly used in practice to accumulate and quantify misstatements are generally referred to as the "rollover" and "iron curtain" approaches.

The rollover approach, which is the approach used by the registrant in this example, quantifies a misstatement based on the amount of the error originating in the current year income statement. Thus, this approach ignores the effects of correcting the portion of the current year balance sheet misstatement that originated in prior years (*i.e.,* it ignores the "carryover effects" of prior year misstatements).

The iron curtain approach quantifies a misstatement based on the effects of correcting the misstatement existing in the balance sheet at the end of the current year, irrespective of the misstatements year(s) of origination. Had the registrant in this fact pattern applied the iron curtain approach, the misstatement would have been quantified as a $100 misstatement based on the end of year balance sheet misstatement. Thus, the adjustment needed to correct the financial statements for the end of year error would be to reduce the liability by $100 with a corresponding decrease in current year expense.

As demonstrated in this example, the primary weakness of the rollover approach is that it can result in the accumulation of significant misstatements on the balance sheet that are deemed immaterial in part because the amount that originates in each year is quantitatively small. The staff is aware of situations in which a registrant, relying on the rollover approach, has allowed an erroneous item to accumulate on the balance sheet to the point where eliminating the improper asset or liability would itself result in a material error in the income statement if adjusted in the current year. Such registrants have sometimes concluded that the improper asset or liability should remain on the balance sheet into perpetuity.

In contrast, the primary weakness of the iron curtain approach is that it does not consider the correction of prior year misstatements in the current year (*i.e.,* the reversal of the carryover effects) to be errors. Therefore, in this example, if the misstatement was corrected during the current year such that no error existed in the balance sheet at the end of the current year, the reversal of the $80 prior year misstatement would not be considered an error in the current year financial statements under the iron curtain approach. Implicitly, the iron curtain approach assumes that because the prior year financial statements were not materially misstated, correcting any immaterial errors that existed in those statements in the current year is the "correct" accounting, and is

therefore not considered an error in the current year. Thus, utilization of the iron curtain approach can result in a misstatement in the current year income statement not being evaluated as an error at all.

The staff does not believe the exclusive reliance on either the rollover or iron curtain approach appropriately quantifies all misstatements that could be material to users of financial statements.

In describing the concept of materiality, Concepts Statement 2, Qualitative Characteristics of Accounting Information, indicates that materiality determinations are based on whether it is probable that the judgment of a reasonable person relying upon the report would have been changed or influenced *by the inclusion or correction of the item*" (emphasis added).[76] The staff believes registrants must quantify the impact of correcting all misstatements, including both the carryover and reversing effects of prior year misstatements, on the current year financial statements. The staff believes that this can be accomplished by quantifying an error under both the rollover and iron curtain approaches as described above and by evaluating the error measured under each approach. Thus, a registrants financial statements would require adjustment when either approach results in quantifying a misstatement that is material, after considering all relevant quantitative and qualitative factors.

As a reminder, a change from an accounting principle that is not generally accepted to one that is generally accepted is a correction of an error.[77]

The staff believes that the registrant 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 of the relevant quantitative and qualitative factors are considered, the registrants financial statements would need to be adjusted.

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

- 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 all of the relevant quantitative and qualitative factors are considered, 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. Correcting prior year financial statements for immaterial errors would not require previously filed reports to be amended. Such correction may be made the next time the registrant files the prior year financial statements.

The following example further illustrates the staff's views on quantifying misstatements, including the consideration of the effects of prior year misstatements:

Facts: During the course of preparing annual financial statements, a registrant is evaluating the materiality of a sales cut-off error in which $50 of revenue from the following year was recorded in the current year, thereby overstating accounts receivable by $50 at the end of the current year. In addition, a similar sales cut-off error existed at the end of the prior year in which $110 of revenue from the current year was recorded in the prior year. As a result of the combination of the current year and prior year cut-off errors, revenues in the current year are understated by $60 ($110 understatement of revenues at the beginning of the current year partially offset by a $50 overstatement of revenues at the end of the current year). The prior year error was evaluated in the prior year as being immaterial to those financial statements.

Question 2: How should the registrant quantify the misstatement in the current year financial statements?

Interpretive Response: The staff believes the registrant 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 misstatement is considered material to the financial statements, after all relevant quantitative and qualitative factors are considered, the registrants 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 $60 understatement of revenues were to be corrected in the current year, then the overstatement of current year end accounts receivable would increase to $110; or,
- If only the $50 overstatement of accounts receivable were to be corrected in the current year, then the understatement of current year revenues would increase to $110.

If the misstatement that exists after recording the adjustment in the current year financial statements is material (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. Correcting prior year financial statements for immaterial errors would not require previously filed reports to be amended. Such correction may be made the next time the registrant files the prior year financial statements.

If the cut-off error that existed in the prior year was not discovered until the current year, a separate analysis of the financial statements of the prior year (and any other prior year in which previously undiscovered errors existed) would need to be performed to determine whether such prior year financial statements were materially misstated. If that analysis indicates that the prior year financial statements are materially misstated, they would need to be restated in accordance with FASB ASC Topic 250, Accounting Changes and Error Corrections.[78]

Question 3: Will the staff expect the registrant to restate prior period financial statements when first applying this guidance?

Interpretive Response: The staff will not object if a registrant[79] does not restate financial statements for fiscal years ending on or before November 15, 2006, if management properly applied its previous approach, either iron curtain or rollover, so long as all relevant qualitative factors were considered.

To provide full disclosure, registrants electing not to restate prior periods should reflect the effects of initially applying the guidance in Topic 1N in their annual financial statements covering the first fiscal year ending after November 15, 2006. The cumulative effect of the initial application should be reported in the carrying amounts of assets and liabilities as of the beginning of that fiscal year, and the offsetting adjustment should be made to the opening balance of retained earnings for that year. Registrants should disclose the nature and amount of each individual error being corrected in the cumulative adjustment. The disclosure should also include when and how each error being corrected arose and the fact that the errors had previously been considered immaterial.

Early application of the guidance in Topic 1N is encouraged in any report for an interim period of the first fiscal year ending after November 15, 2006, filed after the publication of this Staff Accounting Bulletin. In the event that the cumulative effect of application of the guidance in Topic 1N is first reported in an interim period other than the first interim period of the first fiscal year ending after November 15, 2006, previously filed interim reports need not be amended. However, 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. In addition, the disclosures of selected quarterly information required by Item 302 of Regulation S-K should reflect the adjusted results.

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[74] For purposes of these facts, assume the registrant properly determined that the overstatement of the liability resulted from an error rather than a change in accounting estimate. See the FASB ASC Master Glossary for the distinction between an error and a change in accounting estimate.

[75] Topic 1N addresses certain of these quantitative issues, but does not alter the analysis required by Topic 1M.

[76] Concepts Statement 2, paragraph 132. See also Concepts Statement 2, Glossary of Terms - Materiality.

[77] See definition of "error in previously issued financial statements" in the FASB ASC Master Glossary.

[78] FASB ASC paragraph 250-10-45-23.

[79] If a registrant's initial registration statement is not effective on or before November 15, 2006, and the registrant's prior year(s) financial statements are materially misstated based on consideration of the guidance in this Staff Accounting Bulletin, the prior year financial statements should be restated in accordance with FASB ASC paragraph 250-10-45-23. If a registrant's initial registration statement is effective on or before November 15, 2006, the guidance in the interpretive response to Question 3 is applicable.

Excerpt from SEC staff speech

Paul Munter, SEC Acting Chief Accountant, Statement on Assessing Materiality: Focusing on the Reasonable Investor When Evaluating Errors (March 9, 2022)

Introduction[1]

Under our federal securities laws, public companies are required to disclose certain financial and other information to investors. The basic premise of this disclosure-based regulatory regime is that if investors have timely, accurate, and complete financial and other information, they can make informed, rational investment decisions.

Accordingly, providing investors with high quality financial information, including financial statements prepared in compliance with generally accepted accounting principles ("GAAP"), should be the focus of all those involved in financial reporting. Management is responsible for providing investors with GAAP-compliant financial statements, so whenever a material error is identified in previously-issued financial statements,[2] investors must be notified promptly and the error must be corrected. The determination of whether an error is material is an objective assessment focused on whether there is a substantial likelihood it is important to the reasonable investor.[3]

Concept of Materiality and the Correction of Material Errors

Central to the process a registrant must follow when an error is identified in its historical financial statements is determining whether the error is material to those historical financial statements. The Supreme Court has held that a fact is material if there is:

"a substantial likelihood that the ... fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."[4]

When an error is determined to be material to previously-issued financial statements, the error must be corrected by restating the prior-period financial statements.[5] This type of restatement is sometimes referred to colloquially as a reissuance restatement or a "Big R" restatement.

If the error is not material to previously-issued financial statements, but either correcting the error or leaving the error uncorrected would be material to the current period financial statements, a registrant must still correct the error, but is not precluded from doing so in the current period comparative financial statements by restating the prior period information and disclosing the error. This type of restatement is sometimes referred to colloquially as a revision restatement or a "little r" restatement.

It is important to note that both of these methods—reissuance and revision, or "Big R" and "little r"—constitute restatements to correct errors in previously-issued financial statements as those terms are defined in U.S. GAAP.[6] In either case, such errors should be transparently disclosed to investors.

Objective Assessment of Materiality

Since the concept of materiality is focused on the total mix of information from the perspective of a reasonable investor, those who assess the materiality of errors, including registrants, auditors, audit committees, and others, should do so through the lens of the reasonable investor. To be consistent with the concept of materiality, this assessment must be objective. A materiality analysis is not a mechanical exercise, nor should it be based solely on a quantitative analysis. Rather, registrants, auditors, and audit committees need to thoroughly and objectively evaluate the total mix of information. Such an evaluation should take into consideration all relevant facts and circumstances surrounding the error, including both quantitative and qualitative factors, to determine whether an error is material to investors.

An objective analysis should put aside any potential bias of the registrant, auditor, or audit committee that would be inconsistent with the perspective of a reasonable investor. For example, a restatement of previously-issued financial statements may result in the clawback of executive compensation, reputational harm, a decrease in the registrant's share price, increased scrutiny by investors or regulators, litigation, or other impacts. An assessment where a registrant's, auditor's, or audit committee's biases based on such impacts influenced a determination that an error is not material to previously-issued financial statements so as to avoid a Big R restatement would not be objective and would be inconsistent with the concept of materiality.

One area where the staff in OCA have observed an increased need for objectivity is in the assessment of qualitative factors. The interpretive guidance on materiality in SAB No. 99 speaks to circumstances where a quantitatively small error could, nevertheless, be material because of qualitative factors. However, we are often involved in discussions where the reverse is argued—that is, a quantitatively significant error is nevertheless immaterial because of qualitative considerations. We believe, however, that as the quantitative magnitude of the error increases, it becomes increasingly difficult for qualitative factors to overcome the quantitative significance of the error.

We also note that the qualitative factors that may be relevant in the assessment of materiality of a quantitatively significant error would not necessarily be the same qualitative factors noted in SAB No. 99 when considering whether a quantitatively small error is material. So it might be inappropriate for a registrant to simply assess those qualitative factors in reverse when evaluating the materiality of a quantitatively significant error. Such a scenario highlights the importance of a holistic and objective assessment from a reasonable investor's perspective.

Observations from Recent Interactions with Registrants and Auditors on Materiality

In considering recent restatement trends, we note that while the total number of restatements by registrants declined each year from 2013 to 2020, "little r" restatements as a percentage of total restatements rose to nearly 76% in 2020, up from approximately 35% in 2005.[7] While some attribute that trend primarily to improvements in the effectiveness of internal control over financial reporting ("ICFR") and audit quality, we continue to monitor this and other

restatement trends to understand the nature and prevalence of accounting errors and how they are corrected.

Accounting Errors and Materiality

Through our monitoring of restatements, and recent discussions with registrants and auditors regarding their assessment of the materiality of accounting errors, we have observed that some materiality analyses appear to be biased toward supporting an outcome that an error is not material to previously-issued financial statements, resulting in "little r" revision restatements.

For example, the staff in OCA have, not infrequently, been presented with arguments that financial statements or specific line items in financial statements are irrelevant to investors' investment decisions. One variation of this argument is that certain elements of financial statements prepared in accordance with U.S. GAAP or International Financial Reporting Standards ("IFRS") do not provide useful information to investors, so an error in those elements cannot be material. A related argument is that historical financial statements, or specific line items in those financial statements, are irrelevant to investors' current investment decisions. We have not found these types of arguments to be persuasive because such views could be used to justify a position that many errors in previously-issued financial statements could never be material regardless of their quantitative significance or other qualitative factors. In this regard, we note that Commission rules generally require audited financial statements to be prepared in accordance with U.S. GAAP or IFRS, and to be included for each period specified in those rules. We also note that comparative financial statements facilitate an investor's trend analysis to identify changes in financial results of a registrant over time and to inform investment decisions. Accordingly, we view financial statements prepared in accordance with U.S. GAAP or IFRS, as required by Commission rules, to be the starting point for any objective materiality analysis.

However, this does not imply that the effects of errors on certain key non-GAAP measures that are important to users of the registrant's financial statements should not also be considered in the registrant's analysis. Rather, analysis of key non-GAAP measures, where applicable, should be performed in addition to, but not as a substitute for, the analysis of materiality to the financial statements.

OCA staff have also observed materiality analyses that argued that an error is not material to previously-issued financial statements because the error was also made by other registrants, and therefore reflects a widely-held view rather than an intention to misstate. This type of argument has been raised by registrants in various industries and with various structures, including special purpose acquisition companies. SAB No. 99 states that while the intent of management does not render a misstatement material, it may provide significant evidence of materiality. We have not found persuasive, however, arguments that attempt to apply that SAB No. 99 premise in reverse—that is, that the lack of intentional misstatement is viewed as providing evidence that the error is not material.

We further note that registrants often argue that an error is not material because its effect is offset by other errors. As noted in SAB No. 99, registrants and their auditors first should consider whether each misstatement is material,

irrespective of its effect when combined with other misstatements. The aggregated effects should then also be considered to determine whether an otherwise immaterial error, when aggregated with other misstatements, renders the financial statements taken as a whole to be materially misleading. However, we do not believe this analysis of the aggregate effects should serve as the basis for a conclusion that individual errors are immaterial.

Accounting Errors and Internal Control over Financial Reporting

We note that the identification of an accounting error also impacts management's assessment of the effectiveness of ICFR, and that the principles mentioned here regarding an objective assessment similarly apply to the ICFR analysis as to the severity of the control deficiency. Management's ICFR effectiveness assessment must consider the magnitude of the potential misstatement that could result from a control deficiency, and we note that the actual error is only the starting point for determining the potential impact and severity of a deficiency. Therefore, while the existence of a material accounting error is an indicator of the existence of a material weakness, a material weakness may also exist without the existence of a material error. Management's assessment of the effectiveness of ICFR should therefore be focused on a holistic, objective analysis of what could happen in the context of current and evolving financial reporting risks.

We continue to emphasize the importance of identifying and communicating material weaknesses to investors promptly. We encourage ongoing attention, including audit committee participation and training, as needed, regarding the adequacy of and basis for a registrant's ICFR effectiveness assessment—particularly where there are close calls in the assessment of whether a deficiency is a significant deficiency (and only required to be reported to the audit committee) or a material weakness (required to be disclosed to investors).

Other Auditor Considerations

A registrant's auditor plays an important role in the assessment of the materiality of accounting errors. In addition to the observations noted above, when auditors evaluate the materiality of uncorrected misstatements, it is important for the audit firm to consider whether its systems of quality control are suitably designed to provide reasonable assurance that its professionals comply with applicable professional standards. For example, the audit firm should have policies and processes in place to ensure that the appropriate individuals are involved in the supervision and review in evaluating the significant judgments made about materiality and the effects of identified accounting errors. This includes the engagement quality reviewer[8] and other consulting parties, as appropriate. In this regard, audit firms need to ensure that their system of quality control includes policies and procedures to provide reasonable assurance that individuals being consulted have the appropriate levels of knowledge, competence, judgment, and authority.[9] We continue to emphasize the importance of effectively designed and implemented systems of quality control by audit firms in support of continued enhancements to audit quality.

Conclusion

In our disclosure-based regime, investors have a right to financial statements prepared in accordance with GAAP. When an error is identified, it is important for registrants, auditors, and audit committees to carefully assess whether the error is material by applying a well-reasoned, holistic, objective approach from a reasonable investor's perspective based on the total mix of information. To be objective, those involved in the process must eliminate from the analysis their own biases, including those related to potential negative impacts of a restatement, that would be inconsistent with a reasonable investor's view. Additionally, the objective analysis should consider all relevant facts and circumstances including both quantitative and qualitative factors.

When investor needs are not adequately considered, investors can lose confidence in financial reporting, threatening a foundational principle upon which our capital markets system is built. It is therefore imperative that registrants—including management, boards of directors, audit committees, and every individual involved in the registrant's financial reporting process—and their auditors each fulfill their respective financial reporting roles and responsibilities with investors' needs in mind.

The staff of OCA remain available for consultation on conclusions regarding the correction of accounting errors, and we encourage stakeholders to contact our office with questions.[10] We value our interactions with registrants and other stakeholders on issues they are facing, and we will continue to be informed by such feedback as we focus on investors' need for high quality financial information, consistent with the SEC's mission.

[1] This statement represents the views of the staff of the Office of the Chief Accountant ("OCA"). It is not a rule, regulation, or statement of the Securities and Exchange Commission ("SEC" or the "Commission"). The Commission has neither approved nor disapproved its content. This statement, like all staff statements, has no legal force or effect: it does not alter or amend applicable law, and it creates no new or additional obligations for any person. "Our" and "we" are used throughout this statement to refer to OCA staff.

[2] *See* Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") Topic 250, *Accounting Changes and Error Corrections*, which defines an "error in previously issued financial statements" as an error in recognition, measurement, presentation, or disclosure in financial statements resulting from mathematical mistakes, mistakes in the application of GAAP, or oversight or misuse of facts that existed at the time the financial statements were prepared.

[3] See Staff Accounting Bulletin ("SAB") No. 99, *Materiality* (Aug. 12, 1999); *see also* SAB No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements* (Sept. 13, 2006).

[4] *TSC Industries v. Northway, Inc.*, 426 U.S. 438, 449 (1976); *see Basic, Inc. v. Levinson*, 485 U.S. 224 (1988) (as the Supreme Court has noted, determinations of materiality require "delicate assessments of the inferences a 'reasonable shareholder' would draw from a given set of facts and the significance of those inferences to him...." *TSC Industries*, 426 U.S. at 450);

see also FASB, *Amendments to Statement of Financial Accounting Concepts No. 8—Conceptual Framework for Financial Reporting—Chapter 3, Qualitative Characteristics of Useful Financial Information* (Aug. 2018), available at https://fasb.org/jsp/FASB/Document_C/DocumentPage?cid=1176171111614; *see also* SAB No. 99.

[5] *See* ASC Topic 250; *see also* Item 4.02(a) of Form 8-K, which requires timely disclosure when the registrant's board of directors, a committee of the board of directors, or the officer or officers of the registrant authorized to take such action if board action is not required, concludes that any previously-issued financial statements, covering one or more years or interim periods for which the registrant is required to provide financial statements under Regulation S-X (17 CFR 210) should no longer be relied upon because of an error, as addressed in ASC Topic 250, in such financial statements.

[6] *See* supra at n. 2; *see also* ASC Topic 250, which defines "restatement" as "the process of revising previously issued financial statements to reflect the correction of an error in those financial statements."

[7] *See* Audit Analytics, *2020 Financial Restatements: A Twenty-Year Review* (November 2021).

[8] *See* Public Company Accounting Oversight Board ("PCAOB") AS 1220, *Engagement Quality Review*, paragraph .10.

[9] *See* PCAOB Quality Control Section 20 ("QC 20"), *System of Quality Control for a CPA Firm's Accounting and Auditing Practice*, available at https://pcaobus.org/oversight/standards/qc-standards/details/QC20. As required by PCAOB QC 20.19, the audit firm's "policies and procedures should also be established to provide reasonable assurance that personnel refer to authoritative literature or other sources and consult, on a timely basis, with individuals within or outside the firm, when appropriate (for example, when dealing with complex, unusual, or unfamiliar issues). Individuals consulted should have appropriate levels of knowledge, competence, judgment, and authority. The nature of the arrangements for consultation depends on a number of factors, including the size of the firm and the levels of knowledge, competence, and judgment possessed by the persons performing the work."

[10] More information about how to initiate a dialogue with OCA, what to expect from the consultation process, and what information should be included in a consultation submission in order for OCA to most quickly address a company's or auditor's question is available on OCA's webpage, available at https://www.sec.gov/page/communicating-oca.

Excerpt from SEC staff speech

Mark Mahar, Associate Chief Accountant, Office of the Chief Accountant, Remarks before the 2008 AICPA National Conference on Current SEC and PCAOB Developments

Materiality and SABs 99 and 108

…Question 1 of SAB 108 addresses a circumstance where, during the course of preparing its financial statements, a registrant discovers an improper $100

expense accrual which has built up at a rate of $20 per year over the course of the previous 5 years, inclusive of the Year 5 financial statements currently being prepared.

Let us assume that the error existing on each balance sheet and income statement is not material, quantitatively or qualitatively, to any of the previous Years 1 through 4. However, correcting the cumulative $100 balance sheet error in Year 5 would introduce an $80 error in the Year 5 income statement which would materially misstate Year 5.

In that circumstance, SAB 108 indicates 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." However, the response also notes that "correcting prior year financial statements for immaterial errors would not require previously filed reports to be amended." Said another way, if a restatement of previously issued financial statements is required, but such restatement would not result in the previous year financial statements changing materially, than the company can restate those financial statements the next time they are presented without amendment to the previous filings or the issuance of an Item 4-02 8-K.

In evaluating whether the Year 2, 3 or 4 financial statements are materially misstated, we understand that some look to the response in Question 2. That response states that a "separate analysis of the financial statements of the prior year (and any other prior year in which previously undiscovered errors existed) would need to be performed to determine whether such prior year financial statements were *materially* misstated" (emphasis added). Despite the guidance, some registrants and auditors have interpreted this to mean that when evaluating Years 2, 3 or 4 separately, if the effect of correcting the error that exists in each balance sheet materially impacts the income statement of each year, then the registrant must amend those previously filed financial statements.

This is not how the staff applies SAB 108. The discovery of a material error generally requires restatement consistent with SFAS No. 154. However, SAB 108 contemplated that in some circumstances restatements could be included in a company's next filing rather than via an amendment to the previous filing or filings when the effect of restating the previously issued financial statements does not result in a material change to those financial statements.

Using my example, recall that the balance sheet and income statement affect of the error is not material to any given period however an out of period correction of the cumulative balance sheet error in any particular year might have been material. If that is true, then the restatements would not materially alter the previous financial statements, as reported, and therefore those financial statements could still be relied upon. Therefore, the registrant could include the restatement with the next filing without amending the previous filings.

…

[footnotes omitted]

Index of changes

This index lists the significant additions and changes made in this edition to assist you in locating recently added or updated content. The following symbols are used throughout this Handbook to indicate the types of revisions made in this edition for sections, Questions, Examples and other items:

** new item
# significant updates or revisions to the item

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