



**BDO Seidman, LLP**  
Accountants and Consultants



# Financial Reporting

## For Further Information

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Material discussed in this *Financial Reporting* letter is meant to provide general information and should not be acted upon without first obtaining professional advice appropriately tailored to your individual circumstances.

## SEC Issues SAB No. 108 on Quantifying Misstatements in Financial Statements

### Summary

On September 13, 2006, the SEC staff outlined the approach it believes registrants should use to quantify the misstatement of current year financial statements that results from misstatements of prior year financial statements. The staff communicated its views in the long-anticipated Staff Accounting Bulletin (SAB) No. 108 (SAB Topic 1N). **Implementing the approach outlined in SAB 108 may require a registrant to make significant adjustments in its 2006 annual financial statements.** A registrant may also need to disclose the expected effect of applying SAB 108 in the interim financial statements it files before it implements the SAB 108 approach.

As discussed further below, the SAB will change practice by requiring registrants to use a combination of the two approaches for quantifying misstatements that are currently used. The SAB requires registrants to adjust their financial statements if the new approach results in a conclusion that an error is material. The staff recognizes that this combined approach represents a change in practice for many registrants. Consequently, the staff will not require registrants that followed an acceptable approach in the past to restate prior years' historical financial statements. Instead, these registrants can report the cumulative effect of adopting the new approach as an adjustment to the current year's beginning balance of retained earnings. If the new approach is adopted in a quarter other than the first quarter, financial statements for prior interim periods within the year of adoption may need to be restated. SAB 108 is effective for fiscal years ending after November 15, 2006. Thus calendar year registrants are required to adopt the new approach in the year ending December 31, 2006.

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### The “Dual” Approach

To evaluate whether financial statements are materially misstated, registrants and auditors typically follow a two-step process. They (1) identify and quantify misstatements that have not been corrected and (2) evaluate whether the effects of those misstatements are material. SAB 99 (Topic 1M) provides guidance for performing the second step in the process. SAB 108 addresses the first step.

The SAB discusses the two approaches for quantifying errors most commonly used in practice:

- The “rollover” approach – Focuses on the income statement and quantifies an error as the amount by which the current year income statement is misstated. Because the rollover approach focuses on the income statement, consistent use of it may result in the accumulation of significant misstatements in the balance sheet; and
- The “iron curtain” approach – Focuses on the magnitude of the misstatement to the current balance sheet. If a prior year misstatement is corrected in the current year (e.g., the current period effect of a prior period cutoff error), this approach does not consider the current year financial statements to be misstated, because the current balance sheet is correct. Thus, this approach may not prevent significant misstatements in the income statement.

The staff believes that registrants should quantify the effects of all errors, including the effects of correcting prior misstatements, on each

of the financial statements and related disclosures. To accomplish this objective, the staff advises registrants to quantify and evaluate errors using a “dual” approach that includes both an income statement *and* a balance sheet assessment of any misstatement. This means that a registrant that historically used the rollover approach must also consider whether correcting misstatements of the balance sheet that may have built up over many years are material to the income statement. It also means that if a registrant corrects an error in the current year that was immaterial in prior years and the effect of the correction is material to the current year, the registrant should restate its prior year financial statements. The staff notes in the SAB that since the error was immaterial in prior years, the registrant can restate prior year financial statements without amending previously filed reports (i.e., they can restate prior years in their current filing). This approach is consistent with the staff’s position on reporting accounting changes not retroactively applied due to immateriality (see SAB Topic 5F).

The staff views quantifying errors and assessing materiality as an accounting issue for which a registrant has primary responsibility. After the registrant has prepared materially correct financial statements, then the auditor must also quantify and evaluate errors identified in the process of the audit.

### Effective Date and Transition

**Existing registrants** – SAB 108 is effective for fiscal years ending after November 15, 2006. Although restating prior years’ financial statements

is permitted, it is not required *if* management:

- Properly applied its previous assessment approach (iron curtain or rollover); and
- Considered all relevant *qualitative* factors in its assessment of previous errors.

These registrants can report the cumulative effect of adopting the SAB 108 approach as an adjustment to the opening balance of assets and liabilities, with an offsetting adjustment to the opening balance of retained earnings in the fiscal year of adoption. (For calendar year companies, the adjustment would be reported as of January 1, 2006.) Also, registrants are required to disclose:

- The nature and amount of each *individual* error being corrected in the cumulative effect adjustment;
- When and how each error being corrected arose; and
- The fact that the errors had previously been considered immaterial.

If a registrant adopts SAB 108 in an interim period other than the first quarter, it is not required to amend its previously filed interim reports. For example, if a calendar year registrant adopts the dual assessment approach in its third quarter 2006 financial statements, it is not required to amend its first and second quarter Form 10-Qs. Although the SAB does not specifically address disclosure in the quarter of adoption, FASB Statement 154, *Accounting Changes and Error Corrections*, requires disclosure of the effect on the current period and any prior periods that are adjusted. In the selected quarterly information presented in the first Form 10-K reflect-

ing the adjustment, a registrant should reconcile its pre and post adjustment quarterly results for the year of the adjustment, as required by Regulation S-K, Item 302(a)(2).

If, as permitted, a registrant wants to implement SAB 108 at its fiscal year end, it should consider the disclosure requirements of SAB 74 (Topic 11M) in interim financial statements it files prior to that time. SAB 74 requires a registrant to notify readers if its accounting will change in the future to assist them in assessing the significance of the change. SAB 74 is written in the context of new accounting standards and requires registrants to disclose the following:

- 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.

In their Form 10-Qs for the first year after adoption of SAB 108, the prior

year comparative information should be adjusted to reflect the adoption of SAB 108. For the calendar year registrant in the example above, this means that the 2006 financial statements in the registrant's first and second quarter Form 10-Qs for 2007 would be adjusted to reflect postadoption amounts.

**Initial registrations (e.g., IPOs)** – The approach in SAB 108 must be applied if the registration statement is not effective on or before November 15, 2006. The transition approach is significantly different than the one existing registrants are permitted to use. If the effect of applying the SAB 108 approach is material, the registrant must restate the financial statements for all periods that are materially misstated in accordance with Statement 154, paragraph 25.

**EXAMPLE 1–  
Registrant Used the  
Rollover Approach and  
Adopts the Dual Approach**

Registrant A, a calendar year-end company, is in the process of preparing its annual 2006 financial statements. The registrant evaluates the materiality of an improper expense accrual (i.e., overstated liability) in the amount of \$100 that has built up over 5 years at \$20 per year. Registrant A determines that this is a result of an error, not a change in accounting estimate. The registrant previously evaluated the error under the rollover approach and concluded that the \$20 misstatement of income was immaterial in each of the prior year financial statements (i.e., 2002 – 2005). In 2006, Registrant A evaluates the error using the dual assessment approach:

Rollover approach – Registrant A quantifies the 2006 error as a \$20 overstatement of expenses. Under this approach, the registrant concludes that the error is not material.

Iron curtain approach – Registrant A quantifies the error as a \$100 overstatement of liabilities and expenses. Under this approach, the registrant concludes that the error is material.

Registrant A reviews its prior application of the rollover approach and decides that it has applied this approach properly. The registrant decides to make a cumulative catch up entry to the January 1, 2006 balance sheet to correct the misstatement that had occurred through that date. It makes the following entry to the balance sheet as of January 1, 2006 (this illustration ignores income taxes):

Dr. Liability	\$80
Cr. Retained earnings	\$80

*(Note that under this approach the \$80 of excess expenses will never be reversed to income. Registrant A could avoid this by restating its financial statements.)*

Registrant A would correct the remaining \$20 misstatement that arose in 2006 as an adjustment to 2006 earnings:

Dr. Liability	\$20
Cr. Expense	\$20

Assume Registrant A makes the \$20 correcting entry in its annual financial statements after its third quarter Form 10-Q has been filed. The materiality assessment Registrant A must make to evaluate whether it needs to restate its 2006 quarterly financial statements (vs. reflecting the \$20 adjustment in the fourth quarter) is not affected by SAB 108.

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### EXAMPLE 2 – Registrant Used the Iron Curtain Approach and Adopts the Dual Approach

Registrant B, a calendar year-end company, is in the process of preparing its annual 2006 financial statements. The registrant evaluates the materiality of a sales cut-off error in which \$20 of revenue from 2007 was recorded in the current year, thereby overstating revenues and accounts receivable by \$20 at the end of 2006. Also, a similar sales cut-off error existed at the end of the prior year, in which \$110 of revenue from 2006 was recorded in 2005. In preparing the 2005 financial statements, the registrant evaluated the 2005 error under the iron curtain approach as being immaterial to those financial statements. In 2006, Registrant B evaluates the error using the dual assessment approach (this illustration assumes that there are no costs associated with the revenue):

Iron curtain approach – Registrant B quantifies the error as a \$20 overstatement of accounts receivable and revenues. Under this approach, the registrant concludes that the error is immaterial.

Rollover approach – Registrant B quantifies the error as a \$90 understatement of revenues (\$20

overstatement of revenues at the end of the current year offset by a \$110 understatement of revenues at the beginning of the current year). Under this approach, the registrant concludes that the error is material.

Registrant B reviews its prior application of the iron curtain approach and decides that it has applied this approach properly. The registrant decides to make a cumulative catch up entry to the January 1, 2006 balance sheet to correct the misstatement that had occurred through that date. It makes the following entry to the balance sheet as of January 1, 2006 (this illustration assumes that there are no costs associated with the revenue and ignores income taxes):

Dr. Retained earnings    \$110  
Cr.    Accounts receivable    \$110

*(Note that under this approach the \$110 of revenues will be recorded twice – both in 2005 and 2006. Registrant B could avoid this by restating its 2005 financial statements.)*

If Registrant B determines that the remaining \$20 misstatement that arose in 2006 is material, it reflects the correction of that error as an adjustment to 2006 earnings:

Dr. Revenue                    \$20  
Cr.    Accounts receivable    \$20

Registrant B will need to restate its operating results for the first quarter of 2006 to reflect the \$110 of revenues in that quarter. The registrant reflects the restated first quarter 2006 results in the selected quarterly financial information reported in its 2006 Form 10-K and reconciles those results to the amounts reported in the first quarter 2006 Form 10-Q. The 2006 Form 10-Qs do not need to be amended. In the 2007 Form 10-Qs, Registrant B will reflect restated 2006 results in the prior year comparative financial statements.

### Link to SAB 108

SAB 108 is available on the SEC website at:  
<http://www.sec.gov/interps/account/sab108.pdf>.

The SAB is short, and registrants and auditors are encouraged to read it in its entirety.