607 - Surviving a Restatement

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Faculty Biographies

Douglas Chia

Douglas K. Chia is senior counsel and assistant corporate secretary at Johnson & Johnson, the world's most broadly based health care company, headquartered in New Brunswick, New Jersey. His responsibilities include providing legal counsel to the corporation on matters of corporate governance, securities regulation, public company disclosure, and Sarbanes-Oxley Act compliance.

Prior to joining Johnson & Johnson, Mr. Chia was assistant general counsel, corporate at Tyco International. In private practice, Mr. Chia was an associate at the law firms of Simpson Thacher & Bartlett and Clifford Chance, practicing in the New York and Hong Kong offices of each firm. While in private practice, Mr. Chia provided legal counsel to issuers and underwriters on securities offerings and cross-border transactions.

Mr. Chia is a member of the ACC's Corporate and Securities Law Committee, ACC's New Jersey Chapter, and the board of directors of the Society of Corporate Secretaries & Governance Professionals.

Mr. Chia received his A.B. from Dartmouth College and his J.D. from the Georgetown University Law Center.

Rowland Geddie III

Rowland H. Geddie, III is the vice president, general counsel and secretary of O'Sullivan Industries Holdings, Inc. in Lamar, Missouri. As such, he addresses all of the legal issues facing the company, including SEC reporting, contracts, commercial law, risk management, litigation, employment law, benefits, real estate, and intellectual property.

Prior to joining O'Sullivan, Mr. Geddie addressed corporate and securities law issues as contract attorney for Tandy Corporation, as senior counsel to Houston Industries Incorporated/Houston Lighting & Power Company, and as associate general counsel for the Lower Colorado River Authority. His first position after graduating from law school was as an associate at Baker & Botts in Houston, where he worked on corporate, securities, mergers, acquisitions, and dispositions and municipal finance.

Mr. Geddie has been an active member of ACC's Corporate and Securities Law Committee. He is a member and past president of the board of directors of the Barton County Chamber of Commerce, a member of the board of directors of Stone's Throw Dinner Theatre, and a member and past president of the Lamar Rotary Club. He also served as president of the Tri-State Swim Conference.

Mr. Geddie received his B.A. and J.D. from the University of Mississippi.

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Pamela Parizek

Pamela Parizek is a director in the Washington, DC office of KPMG LLP specializing in financial reporting and securities investigations and regulatory compliance and monitoring. She has experience investigating financial crimes, securities fraud, and accounting irregularities.

Ms. Parizek has worked as an attorney in the private sector representing the interests of equity security holders, a regulator in the enforcement division of the U.S. Securities and Exchange Commission, and an associate managing director and counsel to a business intelligence and investigations firm. Ms. Parizek has conducted a wide variety of forensic accounting investigations in connection with SEC enforcement proceedings and criminal indictments alleging overstatement of revenue, improper deferral of expenses, misappropriation of assets, manipulation of reserves, improper accounting for bonus accruals, performance rebates and accounts receivable reserves, irregularities involving the securitization of credit card receivables, premature recognition of software revenue, and improper capitalization of current period expenses. Many of these investigations have resulted in the restatement of reported financial results. Ms. Parizek has also directed internal investigations involving alleged FCPA and export control violations, traced assets through domestic and foreign bank and securities accounts, and developed FCPA training programs, compliance audits and due diligence procedures around the world. In addition, she provides forensic assistance to the firm's audit engagement teams on fraud risk, accounting irregularities and alleged illegal acts.

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U.S. Securities and Exchange Commission

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September 19, 2006

Dear Sirs:

Several companies have recently issued press releases announcing the restatement of their financial statements due to errors in their accounting for grants of stock options to employees, members of the board of directors, and other service providers. Many other companies have announced that they are currently looking into their past practices related to the granting of stock options. The Office of the Chief Accountant has prepared this letter to discuss certain of the existing accounting guidance related to grants of stock options. As with all staff guidance, this letter has not been approved by the Commission.

The accounting guidance applicable to the grants in question was, in most cases, Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" (Opinion 25). The accounting under Opinion 25 relies heavily on the determination of the *measurement date*, which is defined as "the first date on which are known both (1) the number of shares that an individual employee is entitled to receive and (2) the option or purchase price, if any." Under Opinion 25, the final amount of compensation cost of an option is measured as the difference between the exercise price and the market price of the underlying stock at the measurement date. As such, for the purpose of determining compensation cost pursuant to Opinion 25, it is important to determine whether a company's stock option granting practices resulted in the award of stock options with an exercise price that was lower than the market price of the underlying stock at the date on which the terms and recipients of those stock options were determined with finality. The topics addressed in this letter largely relate to questions about whether a company's determination of the measurement date of past stock option awards was appropriate.

This letter expresses only the views of the Office of the Chief Accountant on accounting issues related to Opinion 25, and its limited application should not be extended by analogy or relied upon in any other circumstances.

Certain option granting practices might raise legal or regulatory issues. It should be noted that the views presented herein are limited to the ramifications of these questions to the financial statements (including the footnotes thereto), and that this letter does not address how these questions might affect disclosures outside of the financial statements or the circumstances under which any of these practices could violate laws or regulations. Of course, any analysis will be heavily dependent on the particular facts and circumstances of each company, and evidence of fraudulent or manipulative conduct would require different or additional analysis.

As can be seen from the views expressed in this letter, the staff believes that many of the issues that have been raised in public disclosures or uncovered in reviews of option granting practices resulted in the grant of in-the-money options and accordingly do have an accounting consequence under Opinion 25. On the other hand, there may also be situations where an at-the-money grant was actually decided with finality, but there were unimportant delays in the completion of administrative procedures to document the grant that did not involve misrepresentation of the option granting actions. In those situations, if compensation cost would not have otherwise been recorded pursuant to Opinion 25, short delays in completing the administrative procedures to finalize the grant would not result in an accounting consequence.

The staff's views are presented in several sections. In the discussion regarding each issue, we briefly describe the issue and the application of the applicable accounting guidance. For ease of discussion, each section of the letter addresses a particular question or issue on its own, and implicitly assumes no other issues exist. That is, we have not attempted to provide specific discussion on all possible combinations of issues that might arise. Therefore, companies may need to consider the views expressed in multiple sections of the letter. As always, we encourage companies that have questions about the application of the accounting literature to consult with us. Instructions for doing so may be found at http://www.sec.gov/about/offices/oca/ocaaccount.htm.

A. Dating an Option Award to Predate the Actual Award Date

As noted previously, pursuant to paragraph 10(b) of Opinion 25, the measurement date for determining the compensation cost of a stock option is the first date on which both of the following are known: (1) the number of options that an individual employee is entitled to receive and (2) the option or purchase price. Thus, even if documents related to an award of options are dated as of an earlier date, the measurement date cannot occur until the date the terms of the award and its recipient are actually determined. As such, dating the underlying stock option grant documents as of a date prior to the date on which the terms of the award and its recipient are determined does not affect the appropriate measurement date under Opinion 25.

B. Option Grants with Administrative Delays

In most instances, the determination of the measurement date of a stock option involves little or no uncertainty. Typically, a company's corporate governance provisions, stock option plans, and applicable laws specify the actions required in order to effect the grant of a stock option (collectively referred to as "required granting actions"). Absent provisions of the option or company practices that indicate the terms of the award could change at a later date, the date when these actions are completed in full has generally been regarded as the measurement date.

However, we understand that some companies have accounted for their option grants using a measurement date that is other than the date at which all required granting actions have been completed. Two such examples that we have become aware of are as follows.

a) Companies may have been awarding stock options by obtaining oral authorization from the board of directors (or compensation committee thereof) and subsequently completing the documents evidencing the award at a later date, or

b) Companies may have delegated the authority to award options to a member or committee of management. That member or committee of management determined option awards to be made to subordinates within specific parameters previously communicated by the board of directors (or compensation committee thereof) and obtained any appropriate approvals at a later date.

The delay in completion of all required granting actions suggests that options terms may not have been final until the completion of those actions. Nonetheless, some companies that utilized the practices described above have asserted that the measurement date occurred before the required granting actions were completed because all option terms and recipients were final and known at an earlier date, and the completion of required granting actions represented only an administrative delay, rather than a period during which any of the terms of the award remained under consideration or subject to change.

The staff believes that a conclusion that a measurement date occurred before the completion of required granting actions must be considered carefully, as the fact that the applicable corporate governance provisions, terms of the stock option plans, or applicable laws require certain procedures to be completed in order to effect a stock option grant suggests that option terms may not have been final (or "known") until those procedures were completed. Question 18 of FASB Interpretation No. 44, "Accounting for Certain Transactions Involving Stock Compensation" (Interpretation 44) addresses a similar circumstance, noting that a measurement date for an option cannot occur before shareholder approval except in the very limited circumstance that management and the board of directors control sufficient shareholder votes to approve the plan. That guidance illustrates the underlying principle that the terms of a stock option cannot be considered known and no longer subject to change until the persons empowered to make grants have determined, *with finality*, the terms and recipients of those awards.

In many cases, when options were awarded before (or in the absence of) completion of required granting actions, the terms cannot be considered to have been determined with finality until (and unless) such actions were

completed. Indeed, as evidenced by some of the option granting practices and patterns of conduct that the staff has become aware of, awarding options in a manner that did not comply with the required granting actions does suggest that the terms and recipients of the options may have been subject to change. For example, in the event that the company's stock price declined prior to finalizing the required granting actions, the company may have retracted awards (e.g., failed to follow through with the initially determined awards) or lowered the exercise price of options. This type of practice indicates that, for all awards (including those awards for which the terms were not changed), the terms and recipients were not determined with finality (and therefore were not "known") prior to the completion of all required granting actions. Similarly, any evidence indicating that the preparation of documentation was done in a manner calculated to disguise the true nature of the option granting actions would preclude a company from concluding that a measurement date occurred prior to the completion of all required granting actions. **If a company operated as if the terms of its awards were not final prior to the completion of all required granting actions (such as by retracting awards or changing their terms), the staff believes the company should conclude that the measurement date for all of its awards (including those awards that were not changed) would be delayed until the completion of all required granting actions.**

On the other hand, in certain instances where a company's facts, circumstances, and pattern of conduct evidence that the terms and recipients of a stock option award were determined with finality on an earlier date prior to the completion of all required granting actions, it may be appropriate to conclude that a measurement date under Opinion 25 occurred prior to the completion of these actions. This would only be the case, however, when a company's facts, circumstances, and pattern of conduct make clear that the company considered the terms and recipients of the awards to be *fixed and unchangeable* at the earlier date. The practices described in the preceding paragraph would, of course, preclude a company from concluding that a measurement date occurred prior to the completion of all required granting actions.

In evaluating whether a company's facts and circumstances do support a conclusion that the terms of stock option awards were fixed ("known") prior to the completion of all required granting actions, it is important that all information be considered. As previously noted, the fact that such actions were not yet completed suggests that the terms may not have been final. As such, we believe that the existence of other evidence indicating that option terms or recipients were not yet considered final until all required granting actions were complete would make a conclusion that a measurement date occurred at an earlier time difficult to reach. Reference should be made to Section G of this letter for a discussion of certain factors that should be considered in this analysis, such as the company's pattern of historical stock option grants and the presence or absence of documentation of past stock option granting actions.

Any analysis will be heavily dependent upon the particular facts and circumstances of each company, and evidence of fraudulent or manipulative conduct would affect the analysis. Additionally, as a company's practices may have varied for different groups of employees or categories of awards, the staff recognizes that a company may reach different conclusions with respect to these matters for different employee groups or award categories. Of course, any changes to an award subsequent to the completion of required granting actions must be evaluated to determine whether a modification (such as a repricing) or cancellation has occurred. We encourage companies to discuss unique facts and circumstances with the staff.

C. Validity of Prior Grants

We understand that, in certain circumstances, the validity of past option grants has been called into question, even though both the company and the affected employees have and continue to comply with the terms of such options. For example, an option plan may preclude grants that are in-the-money at the grant date, or may contain a cap on the number of options that may be issued. Notwithstanding these restrictions, options that may not have complied with the terms of the plan were awarded to employees. This could arise due to some of the practices described in this letter.

Questions have arisen as to whether an option can be accounted for as a fixed option with a measurement date on the date that the terms and recipient of the award were determined if uncertainty exists as to the validity of the grant. Specifically, the following questions have arisen:

a) If, for example, a shareholder-approved option plan only permits at-the-money grants, some have questioned whether the compensation committee may have lacked the authority under the entity's corporate governance procedures to authorize an in-the-money grant. If that were the case, under the plan, only the shareholders had the ability to approve such a grant and shareholder approval was not obtained. Pursuant to Question 18 of Interpretation 44, absent such authorization, it is possible that a measurement date did not occur at the date that the terms and recipient of the award were determined.

b) Some have questioned whether the non-compliance of options with the company's option plan may create uncertainty as to whether the company will ultimately have the ability to settle the award in stock or instead may be required to settle the award in cash. Absent an ability to settle the award in stock, it is possible that the option would be accounted for as a cash-settled stock appreciation right pursuant to FASB Interpretation No. 28, "Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans."

We understand that, in many of these cases, (a) the company has, as applicable, been honoring the awards and settling in stock, (b) the company intends to honor outstanding unexercised awards and has a reasonable basis to conclude that the most likely outcome is that the awards will be honored, and (c) the company intends to settle the outstanding unexercised awards in stock and has a reasonable basis to conclude that it will be able to do so (even if such settlement is not entirely within the company's control). In those circumstances, the staff believes that the substantive arrangement that is mutually understood by both the company and its employees represents the underlying economic substance of the past option grants, and should serve as the basis for the company's accounting. Accordingly, assuming all other conditions for the establishment of a measurement date have been satisfied, the staff

believes it would be appropriate to account for the awards as fixed options with a measurement date on the date that the terms and recipients were determined with finality. While legal opinions regarding the validity of the option grant and the company's ability to honor the award would be helpful, the staff does not believe that a company would necessarily be required to obtain a legal opinion in order to reach these accounting conclusions.

When a company either does not intend to or does not have a reasonable basis to conclude that it will be able to honor the award or settle it in stock, further analysis of the facts and circumstances would be necessary to determine the appropriate accounting for the options. The staff understands that significant uncertainty as to a company's ability to honor options arises more often for grants that were made to senior officers of the company (particularly officers who were involved in the option granting process), and less often for grants made to rank-and-file employees. Accordingly, the staff believes that the need for a legal analysis may be greater when questions exist as to the validity of grants made to senior officers who participated in the option granting process.

D. Uncertainty as to Individual Award Recipients

We understand that some companies may have approved option awards before the number of options to be granted to each individual employee was finalized. For example, the compensation committee may have approved an award by authorizing an aggregate number of options to be granted prior to the preparation of a final list of individual employee recipients. In these cases, the allocation of options to individual employees was completed by management after the award approval date, or the unallocated options were reserved for grants to future employees. Pursuant to paragraph 10(b) of Opinion 25, no measurement date can occur until "the number of shares that an individual employee is entitled to receive" is known.

In certain circumstances, the approved award may contain sufficient specificity to determine the number of options to be allocated to individual employees, notwithstanding the absence of a detailed employee list. If management's role was limited to ensuring that an allocation was made in accordance with definitive instructions (e.g., the approved award specified the number of options to be granted based on an individual's level within the organization), the measurement date could appropriately be the date the award was approved. However, if management was provided with discretion in determining the number of options to be allocated to each individual employee, a measurement date could not occur for such options prior to the date on which the allocation to the individual employees was finalized. If the allocation of a portion of the award is specified at the award approval date with the allocation of the remainder left to the discretion of management, the measurement date could appropriately be the date the award was approved only for those options whose allocation was specified.

The staff also has become aware that some companies may have changed the list of recipients or the number of options allocated to each recipient subsequent to the preparation of the initial list at the award approval date. When changes to a list are made subsequent to the preparation of the list that was prepared on the award approval date, based on an evaluation of the facts and circumstances, the staff believes companies should conclude that either (a) the list that was prepared on the award approval date did not constitute a grant, in which case the measurement date for the entire award would be delayed until a final list has been determined or (b) the list that was prepared on the award approval date constituted a grant, in which case any subsequent changes to the list would be evaluated to determine whether a modification (such as a repricing) or cancellation has occurred. When a company determines that a repricing occurred, variable accounting should be applied to the option from the date of modification to the date the award is exercised, is forfeited, or expires unexercised.

E. Exercise Price Set by Reference to a Future Market Price

Some companies have awarded options with provisions designed to protect an employee from immediate declines in the stock price. Typically, these awards do not have a stated exercise price at the award approval date but instead include a formula for establishing the exercise price. For example, an award may establish an exercise price as the lowest market price of the company's stock over a 30-day period beginning with the award approval date. If the market price of the company's stock increases following the award approval date, the exercise price will be equal to the price of the company's stock on the award approval date. If the market price of the company's stock declines following the award approval date, the exercise price will be equal to the lowest price of the company's stock during the 30-day period following the award approval date.

Pursuant to paragraph 10(b) of Opinion 25 and Question 11(a) of Interpretation 44, if the original terms of a stock option award provide for a reduction to the award's exercise price if a specified future event or condition occurs, variable accounting would be required from the award approval date until that uncertainty is resolved. However, a measurement date would occur and variable accounting would cease at the date the contingency is resolved or the contingency provision expires. In the fact pattern described above, the amount of compensation cost related to the option would be the difference between the market price of the underlying stock at the end of the 30-day contingency period and the lowest market price of the stock during the contingency period, which would be the exercise price of the option.

In contrast, if the original terms of an award do not include terms that would cause an adjustment of the exercise price upon the occurrence of a contingent event and the exercise price is nonetheless reduced after the award approval date, the staff believes a repricing of the award has occurred. Variable accounting would therefore be appropriate for the option from the date of modification to the date the award is exercised, is forfeited, or expires unexercised.

It should be noted that the views expressed in this section of the letter do not apply to arrangements that meet the criteria for a noncompensatory plan pursuant to paragraph 7 of Opinion 25.

F. Grants Prior to the Commencement of Employment

Many companies grant options to new employees at the commencement of their employment. We understand that, in some cases, companies have determined the terms and conditions of awards to certain new employees

prior to the commencement of employment. For example, the exercise price for a stock option may have been determined based on the market price of the stock on the date an offer of employment was extended to and accepted by an individual, with employment commencing subsequent to the date of offer. The appropriate accounting in this circumstance will depend upon whether the individual performs services in the capacity of a non-employee prior to commencing employment. If awards were provided to individuals who rendered services to the company prior to the commencement of employment, the provisions of FASB Statement No. 123, "Accounting for Stock-Based Compensation" (Statement 123) and EITF Issue No. 96-18, "Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services" should be applied. Once the individual becomes an employee, the accounting for the change in grantee status should be evaluated pursuant to Interpretation 44.

If the individual provided no services to the company prior to commencing employment, the staff believes that, generally, a measurement date cannot occur prior to the date that the individual begins rendering employee service in exchange for the stock options. Opinion 25 applies only to share-based payment awards issued to *employees*; as clarified by Question 1(b) of Interpretation 44, prior to commencing employment, the individual would not be considered an employee. As such, the staff believes compensation cost for a fixed stock option would be measured based on the difference between the exercise price of the option and the market price of the underlying stock at the commencement of employment.

G. Documentation of Option Granting Activities is Incomplete or Cannot be Located

We understand that, in the course of reviewing their option-granting activities several years after the fact, some registrants have not been able to locate definitive and complete documentation evidencing certain of their past option granting activities. For example, (a) the legal documents evidencing past grants may not exist in the company's records, (b) contemporaneous documentation of the date on which a telephonic or in-person meeting of the compensation committee was held may not have been prepared, (c) written documentation includes only "as of" dates, and not the dates the documentation was actually prepared and approved, or (d) the company may have reason to believe that the documentation that is contained in the company's records is not accurate.

The appropriate accounting in circumstances where records cannot be located or may be inaccurate will depend on the particular facts and circumstances. We understand that, in some cases, the lack of documentation or existence of contradictory documentation may lead a company to conclude either that the terms of options cannot reasonably be considered fixed, resulting in the application of variable accounting, or that awards do not substantively exist until the board of directors affirms which awards will be honored. However, the staff does not believe that the lack of complete documentation being available several years after the activities occurred should necessarily result in a "default" to variable accounting or to treating the awards as if they had never been granted. Rather, a company must use *all available relevant information* to form a reasonable conclusion as to the most likely option granting actions that occurred and the dates on which such actions occurred in determining what to account for. The existence of a pattern of past option grants with an exercise price equal to or near the lowest price of the entity's stock during the time period surrounding those grants could indicate that the terms of those grants were determined with hindsight. Further, in some cases, the absence of documentation, in combination with other relevant factors, may provide evidence of fraudulent conduct. The staff expresses no view in this letter as to the manner in which various facts and forms of evidence should be evaluated under Opinion 25 to determine whether a company's historical accounting records are accurate. We encourage companies to discuss unique facts and circumstances with the staff.

H. Timing of Option Grants

Some companies appear to have engaged in techniques to select their award dates in coordination with the disclosure of information to the public. For example, a company may have granted stock options while it knew of material non-public information that was likely to result in an increase to the stock price. Alternatively, a company may have delayed the grant of options until after material information that was expected to result in a decrease to the stock price was issued. To the extent such practices were used, questions have been raised as to whether an adjustment would be necessary to the market price of the stock at the measurement date for the purpose of measuring compensation cost. Pursuant to paragraph 10(a) of Opinion 25, the staff believes that compensation cost must be computed on the measurement date by reference to the unadjusted market price of a share of stock of the same class that trades freely in an established market.

I. Changes to Option Grants Due to the Release of New Information

The staff is aware that some companies may have changed the terms of previously granted awards due to the release of new information to the public. For example, a company may have granted options to employees at one date, subsequently released information to the public that caused the stock price to decline, and lowered the exercise price of the previously granted options to the market price immediately following the release of the unfavorable news. In that circumstance, the staff believes a repricing of the award has occurred. Variable accounting should therefore be applied to the option from the date of modification to the date the award is exercised, is forfeited, or expires unexercised.

J. Income Tax Benefits Related to Options

We understand that some companies may have documented option exercises as though such exercises occurred as of a date other than the actual date of exercise, which resulted in a reduction of the amount of income taxes due by the employee, with a corresponding reduction in the income tax benefit received by the company. Pursuant to paragraph 17 of Opinion 25, any tax deduction that the company is entitled to receive in excess of the compensation cost recorded for financial reporting purposes is recorded as an addition to paid-in capital. Accordingly, the staff believes that the company should record the excess tax benefit it otherwise would have been entitled to receive on the actual exercise date as an addition to paid-in capital. Any amount of such benefit forgone by the company due to the mischaracterized exercise, and any other tax obligations of the

employee paid by the company, should be recorded as compensation cost to the employee.

We also understand that the discovery of information about option practices, such as the practices discussed in the previous paragraphs, have caused some companies to question the availability or amount of income tax deductions related to options, the period in which those deductions would be available, and the possibility of other obligations including interest, penalties, and additional payroll taxes. Prior to the adoption of FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes," companies should consider the guidance in FASB Statement No. 5, "Accounting for Contingencies" and FASB Statement No. 109, "Accounting for Income Taxes" with respect to these tax contingencies.

The determination of the grant date for income tax purposes may differ from the determination of the measurement date pursuant to Opinion 25. The income tax determination will depend upon the statutes, laws, and regulations of the jurisdictions in which a company operates. The staff expresses no view as to the appropriate grant date of an option for income tax purposes, or on the manner in which the issues addressed in this letter should be evaluated in regard to income tax considerations.

* * * * *

The views noted herein are based upon and in accordance with pre-existing accounting literature. Companies that determine their prior accounting to be in error and that those errors are material should restate their financial statements to reflect the correction of those errors. Evaluation of materiality requires a consideration of all relevant facts and circumstances. Qualitative factors (for example, if the error is intentional) may cause misstatements of quantitatively small amounts to be material. When disclosures of these issues are made, it is important that the registrant discuss not only the accounting restatements, but also the circumstances that gave rise to the errors.

Generally, previously filed reports containing financial statements determined to be materially misstated require amendment. The staff understands that errors related to the issues addressed in this letter may affect several years of filings, and that companies may believe that amending all of the affected filings is unnecessary. Companies that propose to correct material errors without amending all previously filed reports should contact the staff of the Division of Corporation Finance. No amendment of previously filed reports is necessary to correct prior financial statements for immaterial errors. Such corrections, if necessary, may be made the next time the registrant files the prior financial statements.

Registrants that have applied Opinion 25 in historical periods for recognition purposes and provided the footnote disclosures required by Statement 123 may determine that the amount of pro forma compensation cost previously disclosed pursuant to Statement 123 was in error. Although the staff's views expressed herein are discussed in the context of awards accounted for pursuant to Opinion 25, these views may also be useful to registrants in their determination of the grant date and measurement date under Statement 123. While a complete reconsideration of measurements made under Statement 123 to adjust inputs such as volatility and expected term may not be possible, the staff would expect registrants to make appropriate adjustments to the input related to the market price of the underlying stock used in the measurement of fair value under Statement 123. If a registrant determines that material errors existed in the amount of pro forma compensation cost previously disclosed, the staff believes that the registrant should correct the footnote disclosures provided for prior periods. It should be noted that, because of differences in standards, the views expressed herein are not necessarily representative of the staff's views with respect to the determination of the grant date and measurement date pursuant to FASB Statement No. 123R, "Share-Based Payment."

As you know, the staff is continuing to consider these and related matters and may have further discussions on the accounting for stock options with companies and their independent auditors. We encourage companies that wish to discuss the particular facts and circumstances of their stock option grants and the accounting conclusions they have reached to contact the Office of the Chief Accountant.

Further questions about these matters should be directed to Joe Ucuzoglu, Professional Accounting Fellow in the Office of the Chief Accountant (202-551-5301), or Alison Spivey, Associate Chief Accountant in the Office of the Chief Accountant (202-551-5305). Questions on filing requirements should be directed to the staff of the Division of Corporation Finance (202-551-3400).

Sincerely,

Conrad Hewitt
Chief Accountant

cc: Carol Stacey, Chief Accountant, Division of Corporation Finance
Robert Herz, Chairman, Financial Accounting Standards Board
Mark Olson, Chairman, Public Company Accounting Oversight Board

http://www.sec.gov/info/accountants/staffletters/fei_aicpa091906.htm

U.S. Securities and Exchange Commission

SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 211

[Release No. SAB 108]

Staff Accounting Bulletin No. 108

AGENCY: Securities and Exchange Commission.

ACTION: Publication of Staff Accounting Bulletin.

SUMMARY: The interpretations in this Staff Accounting Bulletin express the staff's views regarding the process of quantifying financial statement misstatements. The staff is aware of diversity in practice. For example, certain registrants do not consider the effects of prior year errors on current year financial statements, thereby allowing improper assets or liabilities to remain unadjusted. While these errors may not be material if considered only in relation to the balance sheet, correcting the errors could be material to the current year income statement. Certain registrants have proposed to the staff that allowing these errors to remain on the balance sheet as assets or liabilities in perpetuity is an appropriate application of generally accepted accounting principles. The staff believes that approach is not in the best interest of the users of financial statements. The interpretations in this Staff Accounting Bulletin are being issued to address diversity in practice in quantifying financial statement misstatements and the potential under current practice for the build up of improper amounts on the balance sheet.

DATE: September 13, 2006.

FOR FURTHER INFORMATION CONTACT: Mark S. Mahar, Office of the Chief Accountant (202) 551-5300, Todd E. Hardiman, Division of Corporation Finance (202) 551-3400, or Toai P. Cheng (202) 551-6918, Division of Investment Management, Securities and Exchange Commission, 100 F Street NE, Washington, DC 20549.

SUPPLEMENTARY INFORMATION: The statements in staff accounting bulletins are not rules or interpretations of the Commission, nor are they published as bearing the Commission's official approval. They represent interpretations and practices followed by the Division of Corporation Finance, the Division of Investment Management and the Office of the Chief Accountant in administering the disclosure requirements of the Federal securities laws.

Nancy M. Morris
Secretary

Date: September 13, 2006

Part 211 - [AMEND]

Accordingly, Part 211 of Title 17 of the Code of Federal Regulations is amended by adding Staff Accounting Bulletin No. 108 to the table found in Subpart B.

STAFF ACCOUNTING BULLETIN NO. 108

The staff hereby adds Section N to Topic 1, Financial Statements, of the Staff Accounting Bulletin Series. Section N provides guidance on the consideration of the effects of prior year misstatements in quantifying current year misstatements for the purpose of a materiality assessment.

Note: The text of SAB 108 will not appear in the Code of Federal Regulations.

Topic 1: Financial Statements

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N. Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements

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.[1] 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 registrant's materiality evaluation of an identified unadjusted error should quantify the effects of the identified unadjusted error on each financial statement and related financial statement disclosure.

Topic 1M notes that a materiality evaluation must be based on all relevant quantitative and qualitative factors.[2] 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 misstatement's 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, FASB Concepts Statement No. 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).[3] 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 registrant's 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.[4]

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 registrant's 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 registrant's financial statements would need to be adjusted.

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

- If only the $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 Statement 154.[5]

Facts: When preparing its financial statements for years ending on or before November 15, 2006, a registrant quantified errors by using either the iron curtain approach or the rollover approach, but not both. Based on consideration of the guidance in this Staff Accounting Bulletin, the registrant concludes that errors existing in previously issued financial statements are material.

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[6] 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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[1] 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 FASB Statement 154, *Accounting Changes and Error Corrections*, paragraph 2, for the distinction between an error and a change in accounting estimate.

[2] Topic 1N addresses certain of these quantitative issues, but does not alter the analysis required by Topic 1M.

[3] Concepts Statement 2, paragraph 132. See also Concepts Statement 2, Glossary of Terms - Materiality.

[4] Statement 154, paragraph 2h.

[5] Statement 154, paragraph 25.

[6] 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 Statement 154, paragraph 25. 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.

http://www.sec.gov/interp/account/sab108.htm

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Sample Letter Sent in Response to Inquiries Related to Filing Restated Financial Statements for Errors in Accounting for Stock Option Grants

In December 2006, the Division of Corporation Finance responded to inquiries from several public companies requesting filing guidance as they prepare to restate previously issued financial statements for errors in accounting for stock option grants. The following illustrative letter provides information for registrants to consider as they prepare reports to be filed with the Commission to correct errors in accounting for stock option grants.

January 2007

Name
Chief Financial Officer
XYZ Corporation
Address

Dear Chief Financial Officer:

We understand that you plan to restate previously issued financial statements for errors in your accounting for grants of stock options to employees, members of the board of directors, and other service providers and that you have determined that your periodic filings for multiple periods contain materially inaccurate financial statements and related disclosures. In this letter, we are providing you with guidance as you consider how you will address these deficiencies in your periodic filings. You should not interpret this guidance to mean that we will not review your filings if you follow it. Furthermore, as with all staff guidance, the Commission has not approved this letter or the guidance we provide in it.

The Securities Exchange Act of 1934 requires you and your company to file reports with the Commission and to determine the accuracy and adequacy of the information you provide in them. Generally, previously filed reports containing financial statements determined to be materially misstated require amendment. However, since the restatement for errors in accounting for grants of stock options will affect a significant number of years, you have indicated that your company would be unduly burdened by amending all previously filed reports and that the filing of those numerous amendments could adversely impact the ability of a reader of your financial statements to easily and fully understand the impact of the restatement.

The staff of the Division of Corporation Finance will not raise further comment regarding your company's need to amend prior Exchange Act filings to restate financial statements and related MD&A if your company amends its most recent Form 10-K and includes in that amendment the comprehensive disclosure outlined below. If your next Form 10-K is due to be filed within two weeks of the Form 10-K amendment that you would file in response to this guidance, we will not comment on your company's need to amend or file prior Exchange Act

filings to restate financial statements and related MD&A if your company includes the comprehensive disclosure outlined below in that next Form 10-K, rather than including the comprehensive disclosure in an amendment to your most recent Form 10-K.

In taking this position, we understand that you will include the following disclosure in your Form 10-K amendment (or your next Form 10-K, as appropriate):

- An explanatory note at the beginning of the Form 10-K amendment that discusses the reason for the amendment.
- Selected Financial Data for the most recent five years as required by Item 301 of Regulation S-K, restated as necessary and with columns labeled "restated".
- Management's Discussion and Analysis as required by Item 303 of Regulation S-K, based on the restated annual and quarterly financial information, explaining the company's operating results, trends, and liquidity during each interim and annual period presented. Discussions relative to interim periods may be incorporated into the annual-period discussions or presented separately.
- Audited annual financial statements for the most recent three years, restated as necessary and with columns labeled "restated".
- If interim period information for the most recent two fiscal years as required by Item 302 of Regulation S-K is required to be restated, the information presented for the balance sheets and statements of income should be in a level of detail consistent with Regulation S-X Article 10-01 (a)(2) and (3), and appropriate portions of 10-01(b) and with columns labeled "restated". Note that there is no need to present cash flow information as it is not required by Item 302.
- Footnote disclosure reconciling previously filed annual and quarterly financial information to the restated financial information, on a line-by-line basis and for each material type of error separately, within and for the periods presented in the financial statements (audited), in selected financial data, and in the interim period information (see paragraph 26 of FASB Statement No. 154).
- The disclosure referred to in the Chief Accountant's September 19, 2006 letter that applies to your restatement (the letter can be found at http://www.sec.gov/info/accountants/staffletters/fei_aicpa091906.htm).
- Audited financial statement footnote disclosure of the nature and amount of each material type of error separately that is included in the cumulative adjustment to opening retained earnings.
- Audited financial statement footnote disclosure of the restated stock compensation cost in the following manner:
  - For the most recent three years: restated net income and compensation cost and pro forma disclosures, required by paragraph 45.c. of FASB Statement No. 123, *Accounting for Stock-Based Compensation*, as clarified and amended by FASB Statement No. 148, for each annual period presented in the financial statements for which the intrinsic value method of accounting in APB Opinion 25 was used, with columns labeled "restated" as appropriate.

- For each annual period preceding the most recent three years: disclosure of the information required by paragraph 45.c.2. of FASB Statement No. 123, the restated stock compensation cost that should have been reported for each fiscal year. The total of the restated stock-based compensation cost should be reconciled to the disclosure of the cumulative adjustment to opening retained earnings. While the disclosure required by paragraph 45.c.2. is net of tax, material tax adjustments related to the accounting for stock-based compensation should also be disclosed by year. Registrants may also elect to voluntarily provide the full restated information previously disclosed pursuant to paragraph 45.c. of FASB Statement No. 123, for each period prior to the most recent three years, either in the audited financial statement footnotes or elsewhere in the filing.
- For companies that adopted (1) FASB Statement No. 123 using the retroactive restatement method specified in FASB Statement No. 148 and/or (2) FASB Statement No. 123R, *Accounting for Share-Based Payment*, using the modified retrospective application method for all prior years for which FASB Statement No. 123 was effective: the disclosure outlined in the preceding two paragraphs should include the restated stock-based compensation pursuant to FASB Statement No. 123 and also the restated stock-based compensation cost that should have been reported under the accounting principle originally used for each period, presumably Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees*.

- Appropriate revisions, if necessary, to previous disclosure under Items 9A and 9B:
  - As we discussed in "Staff Statement on Management's Report on Internal Control Over Financial Reporting" (May 16, 2005) (available at http://www.sec.gov/spotlight/soxcomp.htm), in disclosing any material weaknesses that were identified as a result of the restatement and/or investigation, you should consider including in your disclosures: the nature of the material weaknesses, the impact on the financial reporting and the control environment, and management's current plans, if any, for remediating the weakness. While there is no requirement for management to reassess or revise its original conclusion of the effectiveness of internal control over financial reporting, management should consider whether its original disclosures are still appropriate and should supplement its original disclosure to include any other material information that is necessary for such disclosures not to be misleading.
  - In light of the restatement and new facts discovered by management, including identification of any material weaknesses, disclose the certifying officers' conclusion regarding the effectiveness of the company's disclosure controls and procedures as of the end of the period covered by the amended filing. If the certifying officers' conclusion remains the same, that disclosure controls and procedures are effective, you should consider discussing the basis for that conclusion.

In advising you that the staff of the Division of Corporation Finance will not raise further comment regarding your company's need to amend prior Exchange Act filings to restate financial statements and related MD&A, it is important that we

advise you that this guidance does not:

- mean the Division of Corporation Finance will not comment on or require changes in your Form 10-K amendment or Form 10-K that includes the comprehensive disclosure we outlined above;
- mean the Division of Corporation Finance has concluded that you or your company have complied with all applicable financial statement requirements;
- mean the Division of Corporation Finance has concluded that the company has satisfied all rule and form eligibility standards under the Securities Act and the Exchange Act;
- mean that the Division of Corporation Finance has concluded that the company is current in filing its Exchange Act reports;
- mean that the Division of Corporation Finance has concluded that the company has complied with the reporting requirements of the Exchange Act;
- foreclose any action recommended by the Division of Enforcement with respect to your disclosure, filings or failures to file under the Exchange Act; or
- foreclose any action recommended by the Division of Enforcement under Section 304 of the Sarbanes-Oxley Act, *Forfeiture of Certain Bonuses and Profits*, with respect to the periods that the company's financial statements require restatement, irrespective of whether the company amended the filings to include the restated financial statements.

As you know, the staff of the Office of the Chief Accountant is continuing to consider matters related to the accounting for stock options (we refer you again to Conrad Hewitt's September 19th letter at http://www.sec.gov/info/accountants/staffletters/fei_aicpa091906.htm). If you would like to discuss the particular facts and circumstances of your stock option grants and the accounting conclusions you have reached, we encourage you to contact Joe Ucuzoglu, Professional Accounting Fellow in the Office of the Chief Accountant at 202-551-5301 or Mark Barrysmith, Professional Accounting Fellow in the Office of the Chief Accountant 202-551-5304.

We have provided this guidance to you based on our understanding of your circumstances surrounding your decision to restate your financial statements to correct errors related to your accounting for stock options. Materially different circumstances, including filing delinquencies and restatements for other reasons, could result in our reaching a different conclusion.

Please direct any questions about the guidance we have provided to you in this letter to the staff of the Chief Accountant's Office in the Division of Corporation Finance (202-551-3400).

Sincerely,

Carol A. Stacey
Chief Accountant
Division of Corporation Finance

NO. 268-A | MAY 2005

Financial Accounting Series

Statement of Financial Accounting Standards No. 154

Accounting Changes and Error Corrections

a replacement of APB Opinion No. 20
and FASB Statement No. 3

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Summary

This Statement replaces APB Opinion No. 20, *Accounting Changes,* and FASB Statement No. 3, *Reporting Accounting Changes in Interim Financial Statements,* and changes the requirements for the accounting for and reporting of a change in accounting principle. This Statement applies to all voluntary changes in accounting principle. It also applies to changes required by an accounting pronouncement in the unusual instance that the pronouncement does not include specific transition provisions. When a pronouncement includes specific transition provisions, those provisions should be followed.

Opinion 20 previously required that most voluntary changes in accounting principle be recognized by including in net income of the period of the change the cumulative effect of changing to the new accounting principle. This Statement requires retrospective application to prior periods' financial statements of changes in accounting principle, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. When it is impracticable to determine the period-specific effects of an accounting change on one or more individual prior periods presented, this Statement requires that the new accounting principle be applied to the balances of assets and liabilities as of the beginning of the earliest period for which retrospective application is practicable and that a corresponding adjustment 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 rather than being reported in an income statement. When it is impracticable to determine the cumulative effect of applying a change in accounting principle to all prior periods, this Statement requires that the new accounting principle be applied as if it were adopted prospectively from the earliest date practicable.

This Statement defines *retrospective application* as the application of a different accounting principle to prior accounting periods as if that principle had always been used or as the adjustment of previously issued financial statements to reflect a change in the reporting entity. This Statement also redefines *restatement* as the revising of previously issued financial statements to reflect the correction of an error.

* Not disc op ?

This Statement requires that retrospective application of a change in accounting principle be limited to the direct effects of the change. Indirect effects of a change in accounting principle, such as a change in nondiscretionary profit-sharing payments resulting from an accounting change, should be recognized in the period of the accounting change.

This Statement also requires that a change in depreciation, amortization, or depletion method for long-lived, nonfinancial assets be accounted for as a change in accounting estimate effected by a change in accounting principle.

This Statement carries forward without change the guidance contained in Opinion 20 for reporting the correction of an error in previously issued financial statements and a change in accounting estimate. This Statement also carries forward the guidance in Opinion 20 requiring justification of a change in accounting principle on the basis of preferability.

Need for preferability letter

Reasons for Issuing This Statement

This Statement is the result of a broader effort by the FASB to improve the comparability of cross-border financial reporting by working with the International Accounting Standards Board (IASB) toward development of a single set of high-quality accounting standards. As part of that effort, the FASB and the IASB identified opportunities to improve financial reporting by eliminating certain narrow differences between their existing accounting standards. Reporting of accounting changes was identified as an area in which financial reporting in the United States could be improved by eliminating differences between Opinion 20 and IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors.*

How the Changes in This Statement Improve Financial Reporting

Under the provisions of Opinion 20, most accounting changes were recognized by including in net income of the period of the change the cumulative effect of changing to the newly adopted accounting principle. This Statement improves financial reporting because its requirement to report voluntary changes in accounting principles via retrospective application, unless impracticable, enhances the consistency of financial information between periods. That improved consistency enhances the usefulness of the financial information, especially by facilitating analysis and understanding of comparative accounting data.

Also, in instances in which full retrospective application is impracticable, this Statement improves consistency of financial information between periods by requiring that a new accounting principle be applied as of the earliest date practicable.

This Statement requires that a change in depreciation, amortization, or depletion method for long-lived, nonfinancial assets be accounted for as a change in accounting estimate that is effected by a change in accounting principle. The provisions of this Statement better reflect the fact that an entity should change its depreciation, amortization, or depletion method only in recognition of changes in estimated future benefits of an asset, in the pattern of consumption of those benefits, or in the information available to the entity about those benefits.

A change in accounting principle required by the issuance of an accounting pronouncement was not within the scope of Opinion 20. Including all changes in accounting principle within the scope of this Statement establishes, unless impracticable, retrospective application as the transition method for new accounting standards, but only in the unusual instance that the new accounting pronouncement does not include explicit transition provisions.

Statement of Financial Accounting Standards No. 154

Accounting Changes and Error Corrections

a replacement of APB Opinion No. 20
and FASB Statement No. 3

May 2005

Financial Accounting Standards Board
of the Financial Accounting Foundation
401 MERRITT 7, PO BOX 5116, NORWALK, CONNECTICUT 06856-5116

Statement of Financial Accounting Standards No. 154

Accounting Changes and Error Corrections

a replacement of APB Opinion No. 20 and FASB Statement No. 3

May 2005

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Statement of Financial Accounting Standards No. 154

Accounting Changes and Error Corrections

a replacement of APB Opinion No. 20 and FASB Statement No. 3

May 2005

INTRODUCTION

1. This Statement provides guidance on the accounting for and reporting of accounting changes and error corrections. It 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 the newly adopted accounting principle. This Statement also 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. 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 Statement.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Definitions

2. The following terms are defined as used in this Statement:

a. **Accounting change**—a change in (1) an accounting principle, (2) an accounting estimate, or (3) the reporting entity. The correction of an error in previously issued financial statements is not an accounting change.
b. **Accounting pronouncement**—a source of generally accepted accounting principles (GAAP) in the United States, including FASB Statements of Financial Accounting Standards, FASB Interpretations, FASB Staff Positions, FASB Statement 133 Implementation Issues, Emerging Issues Task Force Consensuses, other pronouncements of the FASB or other designated bodies, or other forms of GAAP as described in categories (a)–(c) of AICPA Statement on Auditing Standards (SAS) No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted

Accounting Principles, as codified in the AICPA Codification of Statements on Auditing Standards, AU Section 411, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles.[1] AICPA accounting interpretations and implementation guides ("Q & A's") issued by the FASB staff, as described in category (d) of SAS 69, also are considered accounting pronouncements for the purpose of applying this Statement.

c. **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.

d. **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.

e. **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.

f. **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 (1) presenting consolidated or combined financial statements in place of financial statements of individual entities, (2) changing specific subsidiaries that make up the group of entities for which consolidated financial statements are presented, and (3) changing the entities included in combined financial statements. Neither a business combination accounted for by the purchase method nor the consolidation of a variable interest entity pursuant to FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities*, is a change in reporting entity.

g. **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 lower-of-cost-or-market test to the adjusted inventory balance, also are examples of direct effects of a change in accounting principle.

h. **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 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.

i. **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.

j. **Restatement**—the process of revising previously issued financial statements to reflect the correction of an error in those financial statements.

k. **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.

Scope

3. This Statement applies to financial statements of business enterprises and not-for-profit organizations, both of which are referred to herein as entities. This Statement also applies to historical summaries of information based on primary financial statements that include an accounting period in which an accounting change or error correction is reflected. The guidance in this Statement also may be appropriate in presenting financial information in other forms or for special purposes.

[1]The Board's technical agenda includes a project that could result in the issuance of a Statement of Financial Accounting Standards that identifies the sources of accounting principles and the framework for selecting the principles used in the preparation of financial statements of nongovernmental enterprises that are presented in conformity with GAAP. The Board issued an Exposure Draft of that proposed Statement in April 2005.

Accounting Changes

Change in Accounting Principle

4. 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.

5. Neither (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 nor (b) adoption or modification of an accounting principle necessitated by transactions or events that are clearly different in substance from those previously occurring is a change in accounting principle. A reporting entity shall change an accounting principle only if (a) the change is required by a newly issued accounting pronouncement or (b) the entity can justify the use of an allowable alternative accounting principle on the basis that it is preferable.

6. It is expected that accounting pronouncements normally will provide specific transition requirements. However, in the unusual instance that there are no transition requirements specific to a particular accounting pronouncement, a change in accounting principle effected to adopt the requirements of that accounting pronouncement shall be reported in accordance with paragraphs 7–10 of this Statement.[2] Early adoption of an accounting pronouncement, when permitted, shall be effected in a manner consistent with the transition requirements of that pronouncement.

7. 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 the following:

B/S adjustment only

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.

8. 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.

9. 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. APB Opinion No. 20, *Accounting Changes*, illustrated that type of change with a change from the first-in, first-out (FIFO) method of inventory valuation to the last-in, first-out (LIFO) method. This Statement carries forward that example (as Illustration 2 in Appendix A) for illustrative purposes without implying that such a change would be considered preferable as required by paragraph 13 of this Statement.

10. 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.

Impracticability

11. 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.

[2]This requirement is not limited to newly issued accounting pronouncements. For example, if an existing pronouncement permits a choice between two or more alternative accounting principles, and provides requirements for changing from one to another, those requirements shall be followed.

c. Retrospective application requires significant estimates of amounts, and it is impossible to distinguish objectively information about those estimates that:
   (1) Provides evidence of circumstances that existed on the date(s) at which those amounts would be recognized, measured, or disclosed under retrospective application, and
   (2) Would have been available when the financial statements for that prior period were issued.[3]

Justification for a Change in Accounting Principle

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

13. 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 an accounting pronouncement 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.

14. The issuance of an accounting pronouncement 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 a pronouncement constitutes sufficient support for making such a change provided that the hierarchy established for GAAP is followed. The burden of justifying other changes in accounting principle rests with the entity making the change.

Reporting a Change in Accounting Principle Made in an Interim Period

15. A change in accounting principle made in an interim period shall be reported by retrospective application in accordance with paragraphs 7–10 of this Statement.

[3] This Statement 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.

However, the impracticability exception in paragraph 11 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.

16. If a public company 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 30 of APB Opinion No. 28, *Interim Financial Reporting* (as amended), 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 17 of this Statement, in a note to the annual financial statements for the fiscal year in which the change is made.

Disclosures

17. An entity shall disclose 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, and:
   (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 (paragraph 7) is impracticable, disclosure of the reasons therefor, and a description of the alternative method used to report the change (paragraphs 8 and 9).
c. If indirect effects of a change in accounting principle are recognized:
   (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,[4] 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.

Financial statements of subsequent periods[5] 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 paragraph 17(a) shall be provided whenever the financial statements of the period of change are presented.

18. 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.

Change in Accounting Estimate

19. A change in accounting estimate shall be accounted for in (a) the period of change if the change affects that period only or (b) 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.

20. 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

[4]Compliance with this disclosure requirement is practicable unless an entity cannot comply with it after making every reasonable effort to do so.

[5]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.

to the continuing process of obtaining additional information and revising estimates and, therefore, are considered changes in estimates for purposes of applying this Statement.

21. 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.[6] (Refer to paragraph 13.)

Disclosures

22. 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.[7] When an entity effects a change in estimate by changing an accounting principle, the disclosures required by paragraphs 17 and 18 of this Statement 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.

[6]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 Statement.

[7]The requirement to disclose the effects if a change in estimate is material is carried forward from Opinion 20. The Board did not reconsider the need for that requirement in the project that led to issuance of this Statement. Numerous Statements have been issued by the Board subsequent to Opinion 20 that address required changes in estimates. Those Statements also include various disclosure requirements. This Statement is not intended to impose new disclosure requirements or change the existing disclosures that GAAP requires for specific changes in estimate.

Change in the Reporting Entity

23. 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 FASB Statement No. 58, *Capitalization of Interest Cost in Financial Statements That Include Investments Accounted for by the Equity Method*, shall not be changed when retrospectively applying the accounting change to the financial statements of prior periods.

Disclosures

24. 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 before extraordinary items, 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. (Paragraphs 51–58 of FASB Statement No. 141, *Business Combinations*, describe the manner of reporting and the disclosures required for a business combination.)

Correction of an Error in Previously Issued Financial Statements

25. Any error in the financial statements of a prior period discovered subsequent to their issuance shall be reported as a prior-period adjustment by restating the prior-period financial statements. Restatement requires that:

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.

Disclosures

26. 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 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.

In addition, the entity shall make the disclosures of prior-period adjustments and restatements required by paragraph 26 of APB Opinion No. 9, *Reporting the Results of Operations*. Financial statements of subsequent periods[8] need not repeat the disclosures required by this paragraph.

Effective Date and Transition

27. This Statement shall be effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. Early adoption is permitted for accounting changes and corrections of errors made in fiscal years beginning after the date this Statement is issued. This Statement does not change the transition provisions of any existing accounting pronouncements, including those that are in a transition phase as of the effective date of this Statement.

The provisions of this Statement need not be applied to immaterial items.

[8]Refer to footnote 5.

This Statement was adopted by the unanimous vote of the seven members of the Financial Accounting Standards Board:

Appendix A

ILLUSTRATIONS

A1. This appendix presents generalized examples intended to illustrate how to apply certain provisions of this Statement. The examples do not address all possible situations or applications of this Statement, nor do they establish additional requirements.

Illustration 1—Retrospective Application of a Change in Accounting Principle

A2. ABC Company decides at the beginning of 20X7 to adopt the FIFO method of inventory valuation. ABC Company had used the 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. ABC Company 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 7 of this Statement.

A3. 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	$ 0	$ 0	$ 0	$ 0
12/31/20X5	100	80	800	820
12/31/20X6	200	240	1,000	940
12/31/20X7	320	390	1,130	1,100

A4. This illustration is based on the following assumptions:

a. For each year presented, sales are $3,000 and selling, general, and administrative costs are $1,000. ABC Company's effective income tax rate for all years is 40 percent, and there are no permanent or temporary differences under FASB Statement No. 109, *Accounting for Income Taxes*, prior to the change.
b. ABC Company has a nondiscretionary profit-sharing agreement in place for all years. Under that agreement, ABC Company 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. ABC Company 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 ABC Company is required to adjust its profit-sharing accrual for the incremental amounts.[9] At the time of the accounting change, ABC Company 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. ABC Company's annual report to shareholders provides two years of financial results, and ABC Company is not subject to the requirements of FASB Statement No. 128, *Earnings per Share.*

A5. ABC Company's income statements as originally reported under the LIFO method are presented below.

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

[9] In accordance with paragraph 10 of this Statement, 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.

A6. ABC Company's income statements reflecting the retrospective application of the accounting change from the LIFO method to the FIFO method are presented below.

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

A7. ABC Company's disclosure related to the accounting change is presented below.

NOTE A:

Change in Method of Accounting for Inventory Valuation

On January 1, 20X7, ABC Company 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	$ 0
Cost of goods sold	1,130	1,100	(30)
Selling, general, and administrative expenses	1,000	1,000	0
Income before profit sharing and income taxes	870	900	30
Profit sharing	87	96*	9
Income before income taxes	783	804	21
Income taxes	313	322	9
Net income	$ 470	$ 482	$ 12

*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 ABC Company'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	$ 0
Cost of goods sold	1,000	940	(60)
Selling, general, and administrative expenses	1,000	1,000	0
Income before profit sharing and income taxes	1,000	1,060	60
Profit sharing	100	100	0
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	0
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	$ 0
Inventory	200	240	40
Total assets	$2,648	$2,688	$40
Accrued profit sharing	100	100	0
Income tax liability	360	376	16
Total liabilities	460	476	16
Paid-in capital	1,000	1,000	0
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	0
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)	0
Decrease in income tax liability	(72)	(48)	24
Net cash provided by operating activities	348	348	0
Net increase in cash	348	348	0
Cash, January 1, 20X6	2,100	2,100	0
Cash, December 31, 20X6	$2,448	$2,448	$ 0

Illustration 2—Reporting an Accounting Change When Determining Cumulative Effect for All Prior Years Is Not Practicable

A8. Assume ABC Company changed its accounting principle for inventory measurement from FIFO to LIFO effective January 1, 20X4. ABC Company reports its financial statements on a calendar year-end basis and had used the FIFO method since its inception. ABC Company 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, ABC Company has all of the information necessary to apply the LIFO method on a prospective basis beginning in 20X1. Therefore, ABC Company should present prior periods as if it had (a) carried forward the 20X0 ending balance in inventory (measured on a FIFO basis) and (b) begun applying the LIFO method to its inventory beginning January 1, 20X1. (The example assumes that ABC Company established that the LIFO method was preferable for ABC Company's inventory. No particular inventory measurement method is necessarily preferable in all instances.)

Appendix B

BACKGROUND INFORMATION AND BASIS FOR CONCLUSIONS

CONTENTS

Appendix B

BACKGROUND INFORMATION AND BASIS FOR CONCLUSIONS

Introduction

B1. This appendix summarizes considerations that Board members deemed significant in reaching the conclusions in this Statement. It includes reasons for accepting certain approaches and rejecting others. Individual Board members gave greater weight to some factors than to others.

B2. In September 2002, the FASB and the International Accounting Standards Board (IASB) (collectively, the Boards) committed to a broad effort to improve international comparability of financial reporting by working toward development of a single set of high-quality accounting standards. As part of that effort, the Boards jointly undertook a project to eliminate certain narrow differences between the accounting pronouncements issued by the IASB and the accounting pronouncements issued by the FASB and its predecessors. Both Boards agreed to limit the scope of the short-term project to issues for which (a) the Boards' respective accounting pronouncements were different; (b) convergence to a high-quality solution would appear to be achievable in the short term, usually by selecting between the existing standards of either the FASB or the IASB; and (c) the issue was not within the scope of other projects on the current agenda of either Board. The reporting of accounting changes is one such difference that the FASB decided should be addressed in the short-term convergence project.

B3. In May 2002, the IASB issued its Exposure Draft, *Improvements to International Accounting Standards* (Improvements Exposure Draft), which, among other things, proposed changing the accounting for certain changes in accounting principles to require that those changes be reported through retrospective application to prior periods. The Improvements Exposure Draft also proposed classifying a change in depreciation method for a previously recorded asset as a change in estimate and accounting for it prospectively. The IASB affirmed those changes during its redeliberations of the proposed standard. In December 2003, the IASB issued IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors (Revised 2003).*

B4. In December 2003, the Board issued an Exposure Draft, *Accounting Changes and Error Corrections,* for a 120-day comment period. That Exposure Draft proposed retrospective application for voluntary changes in accounting principle and for changes in accounting principle required by a new accounting pronouncement that does not provide specific transition provisions. The Board received 66 comment letters on the

Exposure Draft. In late 2004 and early 2005, the Board redeliberated the issues identified in the Exposure Draft and concluded that on the basis of existing information, it could reach an informed decision on the matters addressed in this Statement without a public hearing or roundtable meeting.

Scope

B5. The Board decided to incorporate the guidance for all accounting changes and error corrections, including changes made in interim periods, into this Statement to facilitate its objective of codification and simplification of U.S. GAAP. Thus, this Statement supersedes FASB Statement No. 3, *Reporting Accounting Changes in Interim Financial Statements*, as well as Opinion 20. The Board noted that FASB Statement No. 117, *Financial Statements of Not-for-Profit Organizations*, requires that not-for-profit organizations apply the disclosure and display provisions required by GAAP for accounting changes; therefore, the Board decided to include not-for-profit financial statements within the scope of this Statement.

B6. Under International Financial Reporting Standards (IFRS), entities are required to apply the general guidance for a change in accounting principle when applying a new standard, unless that standard has other specific transition guidance. The Board concluded that including transition for new accounting pronouncements in the scope of this Statement would establish retrospective application as the presumed transition method for new accounting pronouncements. However, the Board noted that this Statement does not preclude the Board or other standard setters from establishing specific transition provisions in future pronouncements that may differ from the provisions of this Statement. The Board expects to establish transition guidance on a standard-by-standard basis by selecting the transition requirements appropriate for those specific circumstances.

Change in Accounting Principle

B7. During the deliberations that led to the Exposure Draft, the Board concluded that use of the retrospective application approach described in IAS 8 would enhance the interperiod comparability of financial information. Accordingly, the Board proposed converging with the requirements of IAS 8 for reporting a change in an accounting principle. The Board noted that, in addition to the benefit of convergence, retrospective application as if a newly adopted accounting principle had always been used results in greater consistency across periods. The FASB's conceptual framework describes comparability (including consistency) as one of the qualitative characteristics of accounting information. The Board concluded that retrospective application improves financial reporting because it enhances the consistency of financial information

between periods. That improved consistency enhances the usefulness of the financial statements, especially by facilitating analysis and understanding of comparative accounting data.

B8. During initial deliberations, the Board noted that in some cases the IASB and the FASB use different terms to describe the same principle. For example, the term *retrospective application* as used by the IASB is synonymous with the term *retroactive restatement* as used in Opinion 20. The Boards believe that whenever possible, it is preferable to use the same terms to reduce the potential for inconsistent application of accounting pronouncements. Thus, the Board proposed using the term *retrospective application* to describe the manner of reporting a change in accounting principle or a change in reporting entity and to use the term *restatement* only to refer to the correction of an error. That change reflects the Board's conclusion that a terminology change would better distinguish changes in amounts reported for prior periods related to a change in accounting principle or a change in the reporting entity from those related to the correction of an error. Most respondents to the Exposure Draft agreed with the Board's decision and it was affirmed in redeliberations.

B9. Many respondents to the Exposure Draft, including many users of financial statements, supported the Board's proposal for requiring retrospective application for voluntary changes and mandated changes in accounting principle in instances where specific transition provisions are not provided in accounting pronouncements. Others disagreed with the Board's proposal generally for the reasons that were cited in Opinion 20, such as a disincentive to change to a preferable accounting principle or the dilution of public confidence in financial reporting. During redeliberations, the Board again considered those reasons and affirmed the retrospective approach because that approach improves consistency of information across fiscal periods and converges with the requirements of IAS 8.

B10. Some respondents to the Exposure Draft expressed concern that the proposed requirements did not adequately differentiate between the terms *retrospective application*, for changes in accounting principle and changes in the reporting entity, and *restatement*, for corrections of errors. Those respondents were concerned that numerous reissuances of financial statements to reflect retrospective application might dilute investor confidence in those financial statements. The Board believes that this Statement adequately differentiates between the two terms and the requirements for each. In addition, the Board will consider transition requirements in new accounting standards on a standard-by-standard basis. The Board believes this should mitigate the concerns raised by respondents. Thus, during redeliberations, the Board decided to retain the terminology as originally proposed.

Exceptions from the General Principle of Retrospective Application

B11. The Board believes that under certain circumstances it would be impracticable for an entity to determine (a) the period-specific effects of an accounting change on all prior periods presented or (b) the cumulative effect of applying a change in accounting principle to all prior periods. In those instances, the Board decided to require a limited form of retrospective application to provide financial statement users with the most consistent financial information practicable. The Board decided that if it is impracticable for an entity to determine the period-specific effects of a change in accounting principle for all prior periods, the cumulative effect of the change to the new accounting principle should be applied to the carrying amounts of assets and liabilities as of the beginning of the earliest period to which the new principle is applied, and an offsetting adjustment should 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. The Board believes that method maximizes consistency across accounting periods for which the necessary information is available, and it also provides better information than a cumulative-effect adjustment in the period of change.

B12. This Statement requires that the cumulative effect of the change in accounting principle be recorded directly in the opening retained earnings balance (or other appropriate components of equity or net assets in the statement of financial position) when it is impracticable to determine the period-specific effects of a change in accounting principle. The Board also considered requiring the cumulative effect of the change to be included in the net income (or other appropriate captions of changes in the applicable net assets or performance indicator) of the period in which the change was made, as was required by Opinion 20. However, the Board rejected that alternative on the basis that the cumulative effect of the change in accounting principle does not relate to the period in which the change was made. Therefore, it would be inappropriate to record the cumulative effects on prior periods in net income of the period of change, since none of the effects relate to that period. The Board believes that the requirements of this Statement recast prior-period financial statements to the extent practicable and therefore affirmed that decision in its redeliberations.

B13. For circumstances for which it is impracticable to determine the cumulative effect of applying a change in accounting principle to all prior periods, this Statement requires that the entity apply the new accounting principle as if it was made prospectively as of the earliest date practicable. The Board decided that adjustment of one or more prior periods provides more consistency across periods than the prospective approach required by Opinion 20 for that type of change.

B14. To enhance consistency of application, the Board decided to provide guidance limiting the use of the impracticability exception. The Exposure Draft contained an exception to retrospective application for circumstances in which the effects of retrospective application are not determinable. Many respondents to the Exposure Draft noted that it might be possible to determine the effects of retrospective application but only at unreasonable cost and effort. Those respondents requested that the Board adopt an exception for cases in which retrospective application would involve "undue cost or effort." Other respondents noted that an impracticability exception similar to "undue cost or effort" appears in certain other FASB Statements. During redeliberations, the Board considered those comments and revised its proposed guidance to indicate that retrospective application is impracticable if an entity cannot apply it after making every reasonable effort to do so. The Board also noted that such language was consistent with a similar exception in IAS 8.

B15. The Board noted that retrospective application also would be impracticable if it would require assumptions about management's intent in a prior period that cannot be independently substantiated. The Board was concerned that retrospective application in that case might require an inappropriate use of hindsight and decided to provide an exception from the general principle of retrospective application in those circumstances.

B16. The Board also discussed whether retrospective application involving significant estimates made as of a prior period would be impracticable. The Board notes that it is frequently necessary to make estimates in order to apply an accounting principle. Estimation is inherently subjective, and estimates are frequently developed for the purpose of preparing financial statements after the close of a fiscal period. The use of estimates in retrospective application of an accounting principle is potentially more difficult because a longer period of time may have passed since a transaction or event occurred. However, in the context of retrospective application, the objective of estimates related to prior periods is the same as the objective of estimates related to current periods. That objective is to make an estimate that reflects the conditions that existed at the date the transaction or event would have been recognized in the financial statements had the newly adopted accounting principle been applied as of that earlier date. Achieving that objective requires differentiating between information that provides additional evidence about conditions that existed when an event or transaction occurred and information about conditions that arose subsequently. For some types of estimates (for example, an estimate of fair value based on inputs that are not derived from observable market sources), it may not be practicable to distinguish the information that would have been available about conditions that previously existed from all other types of information. Therefore, the Board decided, and affirmed its decision during redeliberations, that prospective application from the date of change should be required when retrospective application would involve making a significant estimate for which it is not possible to objectively distinguish information that provides additional evidence about conditions that previously existed from other types of information.

B17. A number of respondents to the Exposure Draft stated that the proposed provisions were unclear as to whether contemporaneous documentation was required to objectively determine whether information used to develop significant estimates would have been available at the time the affected transactions or events would have been recognized in the financial statements. The Board does not believe that contemporaneous documentation is necessary. Therefore, the Board added a footnote to paragraph 11 of this Statement to clarify that point.

B18. The Board agrees with the Accounting Principles Board's conclusion that an entity should not change an accounting principle unless the entity can justify the newly adopted accounting principle on the basis that it is preferable. Thus, the Board decided to retain the requirement of Opinion 20 that the nature and justification for a change in accounting principle be disclosed. Similarly, the Board decided that a change in estimate effected by a change in accounting principle must be justified on the basis that the new method is preferable.

Indirect Effects

B19. Some respondents asked that the Board clarify how to report the indirect effects of a change in accounting principle that is accounted for by retrospective application. The Board considered requiring that the indirect effects of an accounting change be included in the retrospective application. Some Board members draw no distinction between indirect effects and other consequential effects of an accounting change and, therefore, believe that indirect effects should be included as part of the retrospective application of the change that gives rise to them. In addition, they believe that including indirect effects in retrospective application may, in some cases, provide better information to users by showing more consistent trend information related to the items indirectly affected by an accounting change. Other Board members believe that an effect on the cash flows of the entity that is caused by the adoption of an accounting change should be recognized in the period in which that adoption occurs. They believe the accounting change is the necessary "past event" in the definition of an asset or a liability that gives rise to accounting recognition of the indirect effect. They also believe that certain practical issues are more easily resolved by recognizing all such effects in the period the accounting change is adopted. The Board considered the various views and ultimately decided to adopt the latter view. The Board also decided to require

disclosure of any indirect effects of an accounting change that have been recognized, and the amount of those effects attributable to each prior period presented unless impracticable.

B20. Some Board members expressed concern about circumstances in which the indirect effects of an accounting change are explicitly governed by a contractual agreement. For example, a royalty agreement may require that the amount due to the counterparty be subsequently adjusted, or "trued up," if the reported reference amount (for example, revenues) is subsequently adjusted to reflect an accounting change. However, the Board believes that such cases are rare and that in those cases, the accounting change is still the necessary past event that gives rise to the indirect effect. Therefore, the Board decided that even when the indirect effect is explicitly required to be recognized, it should be recognized in the period of the accounting change.

Disclosures

B21. The Board noted that it is important to provide financial statement users with information that allows them to distinguish between the effect of a change in accounting principle and other income statement changes. Therefore, the Board proposed continuing to require disclosure of the effects of a change in accounting principle. Generally, those disclosure requirements are consistent with those required by Opinion 20.

B22. Some respondents to the Exposure Draft suggested eliminating certain proposed disclosures, such as the requirement to disclose the impact of retrospective application on each line of the financial statements. Other respondents suggested expanding the disclosures to include, for example, a requirement for those entities that use the impracticability exception to specify the information that is missing and which therefore makes retrospective application impracticable. The Board considered those suggestions in its redeliberations and modified or clarified some of the required disclosures. For example, the Board clarified that the requirement to disclose the effect on each financial statement line item applies only to line items actually affected by the change and that presentation of the effect on financial statement subtotals, other than income from continuing operations and net income, is not required. The Board also decided to add an illustration of the application of this Statement as an appendix to the Statement.

Change in Accounting Estimate

B23. Paragraph 21 of FASB Concepts Statement No. 1, *Objectives of Financial Reporting by Business Enterprises,* states that "estimates resting on expectations of the future are often needed in financial reporting, but their major use, especially of those formally incorporated in financial statements, is to measure financial effects of past transactions or events or the present status of an asset or liability."

B24. The Board carried forward without reconsideration the general provisions in Opinion 20 related to a change in accounting estimate. Those provisions are consistent with the requirements of IFRS, with the exception that IFRS requires a change in the method of depreciation or amortization for a long-lived, nonfinancial asset to be reported as a change in estimate. The Board noted that the information an entity would need to establish a basis for changing the depreciation, amortization, or depletion method for a long-lived, nonfinancial asset (hereinafter described as a change in depreciation method) would be obtained by continued observation of actual use of the expected benefits of the asset as compared to previous estimations of the pattern of consumption that formed the basis for the initial method. Thus, during initial deliberations, the Board concluded that a change in depreciation method is a change in estimate effected by a change in accounting principle. That decision was affirmed in redeliberations.

B25. The Board noted that because it is a change in estimate, a change in depreciation method should not be accounted for by retrospective application to prior periods. However, appropriate disclosures should be required for the change in accounting principle that effected the change in estimate. Thus, the Board decided that a change in estimate effected by a change in accounting principle should be subject to the same requirement to justify the change in principle on the basis that the new principle is preferable. Most respondents to the Exposure Draft agreed with the Board's initial decision. The Board affirmed the disclosure requirements related to a change in estimate during redeliberations.

B26. Several respondents to the Exposure Draft stated that there may be valid reasons unrelated to the available information about the pattern of consumption of future benefits for deciding that a depreciation method other than the one currently used is preferable. Some respondents stated that a change from one method of depreciation to another can be justified as preferable if the new method is more prevalent in the industry in which the reporting entity operates. The Board noted that the objective of depreciation accounting is to allocate the cost of a capital asset over its expected useful life in a manner that best represents the pattern of consumption of the expected benefits. Therefore, in redeliberations, the Board affirmed that better reflecting the pattern of consumption of the asset being depreciated should be the sole basis in determining the preferable depreciation method.

Change in the Reporting Entity

B27. The Board carried forward without reconsideration the guidance in paragraphs 12, 34, and 35 of Opinion 20 on changes in the reporting entity. Editorial changes have been made to the guidance carried forward to make it easier to read within the context of this Statement. In addition, this Statement classifies the recasting of financial statements for a change in the reporting entity as a retrospective application rather than as a restatement.

Accounting Change in Interim-Period Information

B28. During initial deliberations, the Board decided not to permit voluntary accounting changes made in interim periods if it is impracticable to distinguish between the cumulative effects on prior years and the effects on prior interim periods of the year of change. Statement 3 required an entity to report an accounting change made during an interim period as if it had been adopted at the beginning of the fiscal year. Therefore, an entity making an accounting change in other than the first interim period must have been able to distinguish between the effects on the year of change and the effects on prior years to have met the requirements of Statement 3. The Board expects that accounting changes for which it is impracticable to distinguish between the cumulative effects on prior years and the effects on prior interim periods of the year of change will be rare. Also, the benefit of intraperiod consistency of annual reporting outweighs the hardship placed on enterprises that are unable to make that distinction for a given change. Respondents to the Exposure Draft did not disagree with the Board's initial decision. Therefore, that decision was affirmed during redeliberations.

B29. The Board decided to carry forward the disclosure requirements contained in paragraphs 11(e) and 14 of Statement 3 to this Statement.

Correction of an Error

B30. The Board carried forward without substantive change the provisions for correction of an error from paragraphs 13, 36, and 37 of Opinion 20. Editorial changes have been made to the sections carried forward to make those sections easier to read within the context of this Statement. Also, the Board concluded that when an entity restates its financial statements to correct an error, it should disclose that fact so as to distinguish corrections of errors from accounting changes. In response to concerns of the respondents to the Exposure Draft, the Board decided to limit the use of the term *restatement* in this Statement to refer only to the revising of financial statements to correct an error in those previously reported financial statements.

Convergence of U.S. GAAP and International Financial Reporting Standards

B31. This Statement is the result of a broader effort by the FASB to improve the comparability of cross-border financial reporting by working with the IASB toward development of a single set of high-quality accounting standards. Although convergence is an important objective in this Statement, this Statement and IAS 8 differ in some areas. Those areas include the correction of an error, indirect effects of a change in accounting principle, and certain elements of disclosure.

B32. This Statement and IAS 8 both require restatement to correct an error that exists in previously issued financial statements. However, in this Statement that requirement is absolute, while IAS 8 permits an exception to the restatement requirement in instances in which it is not practicable to determine the effect of the error on any or all prior periods. Under IAS 8, if restatement is impracticable, the correction of an error is effected by restating the opening balances of assets, liabilities, and equity or net assets for the earliest period for which retrospective restatement is practicable (which may be the current interim or annual period). The Board considered permitting a similar exception; however, it rejected that proposal because it would be inconsistent for a reporting entity to state that its financial statements for a prior period are prepared in accordance with GAAP if an error had been discovered that affected those financial statements but was not corrected because it was impracticable to do so.

B33. This Statement explicitly requires that the indirect effects of a change in accounting principle be reported in the period in which those effects are actually incurred. This Statement also requires specific disclosures related to the indirect effects of a change in accounting principle. IAS 8 does not specifically address the accounting for or disclosure of indirect effects of a change in accounting principle.

B34. IAS 8 includes some disclosure requirements that differ from the disclosures required by this Statement. The FASB considered each of the disclosure requirements of IAS 8 as well as other potential requirements and concluded that the requirements in this Statement are appropriate and sufficient.

Effective Date and Transition

B35. The Board decided that the provisions of this Statement should be effective for accounting changes made in fiscal years beginning after December 15, 2005. The Board decided to require prospective application of this Statement because it does not believe the benefits of adjusting previously issued financial statements to retrospectively apply accounting changes that were made before this Statement was issued outweigh the costs of doing so.

B36. The Board noted that there may be some accounting pronouncements that are in the transition phase on the effective date of this Statement and that might require transition provisions that are inconsistent with this Statement. The Board decided that changing the transition provisions of existing pronouncements would not be cost-beneficial. Thus, the Board decided to exclude from the provisions of this Statement transition provisions of any existing pronouncements.

Benefits and Costs

B37. The mission of the FASB is to establish and improve standards of financial accounting and reporting for the guidance and education of the public, including preparers, auditors, and users of financial information. In fulfilling that mission, the Board endeavors to determine that a proposed standard will fill a significant need and that the costs imposed to meet that standard, as compared with other alternatives, are justified in relation to the overall benefits of the resulting information. Although the costs to implement a new standard may not be borne evenly, investors and creditors—both present and potential—and other users of financial information benefit from improvements in financial reporting, thereby facilitating the functioning of markets for capital and credit and the efficient allocation of resources in the economy.

B38. The Board acknowledges that there will be costs involved in retrospective application related to accounting changes beyond those previously required to develop pro forma disclosures of the effects of accounting changes on prior periods. However, the Board believes that the benefits to users of more comparable information in comparative financial statements will outweigh the effort that will be required on the part of preparers. Further, the Board notes that this Statement will reduce the number of reconciling items between U.S. GAAP and IFRS, which should reduce the costs borne by an entity that is required to prepare a reconciliation of its balance sheet and statement of financial performance determined under IFRS to U.S. GAAP.

Appendix C

AMENDMENTS TO EXISTING PRONOUNCEMENTS

C1. This Statement supersedes the following pronouncements:

a. APB Opinion No. 20, *Accounting Changes*
b. FASB Statement No. 3, *Reporting Accounting Changes in Interim Financial Statements*
c. FASB Statement No. 73, *Reporting a Change in Accounting for Railroad Track Structures*
d. FASB Interpretation No. 20, *Reporting Accounting Changes under AICPA Statements of Position.*

C2. ARB No. 43, Chapter 2A, "Form of Statements—Comparative Financial Statements," is amended as follows:

a. Paragraph 3, as amended by Opinion 20:

> It is necessary that prior-year figures shown for comparative purposes be in fact comparable with those shown for the most recent period, or that any exceptions to comparability be clearly brought out as described in FASB Statement No. 154, *Accounting Changes and Error Corrections*~~APB Opinion No. 20, *Accounting Changes*~~.

C3. APB Opinion No. 22, *Disclosure of Accounting Policies,* is amended as follows:

a. Paragraph 14:

> Financial statement disclosure of accounting policies should not duplicate details (e.g., composition of inventories or of plant assets) presented elsewhere as part of the financial statements. In some cases, the disclosure of accounting policies should refer to related details presented elsewhere as part of the financial statements; for example, changes in accounting policies during the period should be described with cross-reference to the disclosure required by FASB Statement No. 154, *Accounting Changes and Error Corrections*.~~APB Opinion No. 20, *Accounting Changes*, of the current effect of the change and of the pro forma effect of retroactive application~~.

C4. APB Opinion No. 25, *Accounting for Stock Issued to Employees,* is amended as follows:

a. Paragraph 15:

> Accruing compensation expense may require estimates, and adjustment of those estimates in later periods may be necessary (FASB Statement No. 154, *Accounting Changes and Error Corrections,* paragraphs 19–22)~~APB Opinion No. 20, *Accounting Changes*, paragraphs 31 to~~ 33. For example, if a stock option is not exercised (or awarded stock is returned to the corporation) because an employee fails to fulfill an obligation, the estimate of compensation expense recorded in previous periods should be adjusted by decreasing compensation expense in the period of forfeiture.

C5. APB Opinion No. 28, *Interim Financial Reporting,* is amended as follows:

a. Paragraph 24:

> Changes in an interim or annual accounting ~~practice or policy~~principle made in an interim period should be reported in the period in which the change is made, in accordance with the provisions of FASB Statement No. 154, *Accounting Changes and Error Corrections*~~APB Opinion No. 20, *Accounting Changes*~~.

b. Paragraph 25:

> ~~Certain changes in accounting principle, such as those described in paragraphs 4 and 27 of APB Opinion 20, require retroactive restatement of previously issued financial statements. Paragraph 26 of APB Opinion No. 9, *Reporting the Results of Operations,* requires similar treatment for prior period adjustments. Previously issued financial statements must also be restated for a change in the reporting entity (see paragraphs 34-35 of APB Opinion No. 20) and for correction of an error (see paragraphs 36-37 of APB Opinion No. 20). Previously issued interim financial information should be similarly restated. APB Opinion Nos. 9 and 20 specify the required disclosures.~~

c. Paragraph 26:

> The effect of a change in an accounting estimate, including a change in the estimated effective annual tax rate, should be accounted for in the period in which the change in estimate is made. No restatement of previously reported interim information should be made for changes in estimates, but the effect on

earnings of a change in estimate made in a current interim period should be reported in the current and subsequent interim periods, if material in relation to any period presented and should 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 should conform with paragraph 22 of Statement 154.~~paragraph 33 of APB Opinion No. 20.~~

d. Paragraphs 27–27D, footnote 5 to paragraph 27C, and the related headings:

~~**Cumulative Effect Type Accounting Changes Other Than Changes to LIFO**~~

~~27. If a cumulative effect type accounting change is made during the *first* interim period of an enterprise's fiscal year, the cumulative effect of the change on retained earnings at the *beginning of that fiscal year* shall be included in net income of the first interim period (and in last-twelve-months-to-date financial reports that include that first interim period).~~

~~27A. If a cumulative effect type accounting change is made in *other than the first* interim period of an enterprise's fiscal year, *no* cumulative effect of the change shall be included in net income of the period of change. Instead, financial information for the pre-change interim periods of the fiscal year in which the change is made shall be restated by applying the newly adopted accounting principle to those pre-change interim periods. The cumulative effect of the change on retained earnings at *the beginning of that fiscal year* shall be included in restated net income of the first interim period of the fiscal year in which the change is made (and in any year-to-date or last-twelve-months-to-date financial reports that include the first interim period). Whenever financial information that includes those pre-change interim periods is presented, it shall be presented on the restated basis.~~

~~27B. The following disclosures about a cumulative effect type accounting change shall be made in interim financial reports:~~

~~a. In financial reports for the interim period in which the new accounting principle is adopted, disclosure shall be made of the nature of and justification for the change.~~
~~b. In financial reports for the interim period in which the new accounting principle is adopted, disclosure shall be made of the effect of the change on income from continuing operations, net income, and related per share amounts for the interim period in which the change is made. In addition, when the change is made in other than the first interim period of a fiscal year, financial reports for the period of change shall also disclose (i) the effect of the change on income from continuing operations, net income, and related per share amounts for each pre-change interim period of that fiscal year and (ii) income from continuing operations, net income, and related per share amounts for each pre-change interim period restated in accordance with paragraph 27A of this Opinion.~~
~~c. In financial reports for the interim period in which the new accounting principle is adopted, disclosure shall be made of income from continuing operations, net income, and related per share amounts computed on a pro forma basis for (i) the interim period in which the change is made and (ii) any interim periods of prior fiscal years for which financial information is being presented. If no financial information for interim periods of prior fiscal years is being presented, disclosure shall be made, in the period of change, of the actual and pro forma amounts of income from continuing operations, net income, and related per share amounts for the interim period of the immediately preceding fiscal year that corresponds to the interim period in which the change is made. In all cases, the pro forma amounts shall be computed and presented in conformity with paragraphs 19, 21, 22, and 25 of *APB Opinion No. 20*.~~
~~d. In year-to-date and last-twelve-months-to-date financial reports that include the interim period in which the new accounting principle is adopted, the disclosures specified in the first sentence of subparagraph (b) above and in subparagraph (c) above shall be made.~~
~~e. In financial reports for a subsequent (post-change) interim period of the fiscal year in which the new accounting principle is adopted, disclosure shall be made of the effect of the change on income from continuing operations, net income, and related per share amounts for that post-change interim period.~~

~~**Changes to the LIFO Method of Inventory Pricing and Similar Situations**~~

~~27C. Paragraph 26 of *APB Opinion No. 20* indicates that in rare situations—principally a change to the LIFO method of inventory pricing[5]—neither the cumulative effect of the change on retained earnings at the beginning of the fiscal year in which the change is made nor the pro forma amounts can be computed. In those situations, that paragraph requires an explanation of the reasons for omitting (a) accounting for a cumulative effect and (b) disclosure of pro forma amounts for prior years. If a change of that type is made in the *first* interim period of an enterprise's fiscal year, the disclosures specified in paragraph 27B of this Opinion shall be made (except the pro forma amounts for interim periods of prior fiscal years called for by paragraph 27B(c) of this Opinion will not be disclosed).~~

~~27D. If the change is made in *other than* the first interim period of an enterprise's fiscal year, the disclosure specified in paragraph 27B of this Opinion shall be made (except the pro forma amounts for interim periods of prior fiscal years called for by paragraph 27B(c) of this Opinion will not be disclosed) and in addition, financial information for the pre-change interim periods of that fiscal year shall be restated by applying the newly adopted accounting principle to those pre-change interim periods. Whenever financial information that includes those pre-change interim periods is presented, it shall be presented on the restated basis.~~

~~[5]In making disclosures about changes to the LIFO method, enterprises should be aware of the limitations the Internal Revenue Service has placed on such disclosures.~~

C6. APB Opinion No. 30, *Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions*, is amended as follows:

a. Paragraph 25, as amended by FASB Statements No. 16, *Prior Period Adjustments*, and No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets:*

> Circumstances attendant to extraordinary items frequently require estimates, for example, of associated costs and occasionally of associated revenue, based on judgment and evaluation of the facts known at the time of first accounting for the event. Each adjustment in the current period of an element of an extraordinary item that was reported in a prior period should be separately disclosed as to year of origin, nature, and amount and classified separately in the current period in the same manner as the original item. If the adjustment is the correction of an error, the provisions of FASB Statement No. 154, *Accounting Changes and Error Corrections*, paragraphs 25 and 26 ~~APB Opinion No. 20, *Accounting Changes*, paragraphs 36 and 37~~ should be applied.

C7. FASB Statement No. 16, *Prior Period Adjustments*, is amended as follows:

a. Footnote 3, as amended by FASB Statements No. 96, *Accounting for Income Taxes*, and No. 109, *Accounting for Income Taxes:*

> As defined in paragraph 2 of FASB Statement No. 154, *Accounting Changes and Error Corrections*~~paragraph 13 of *APB Opinion No. 20*~~. That paragraph also describes the distinction between a correction of an error and a change in accounting estimate.

b. Footnote 6, as amended by FASB Statement No. 141, *Business Combinations:*

> ~~In addition to transition requirements of these pronouncements, accounting changes resulting in restatement of previously issued financial statements of prior periods include a change in the reporting entity described in paragraph 34 of *APB Opinion No. 20*, and special changes in accounting principle described in paragraphs 27 and 29 of *APB Opinion No. 20*. See also footnote 5 to *APB Opinion No. 20*.~~

C8. FASB Statement No. 19, *Financial Accounting and Reporting by Oil and Gas Producing Companies*, is amended as follows:

a. Paragraph 30, as effectively amended by FASB Statement No. 69, *Disclosures about Oil and Gas Producing Activities:*

> Capitalized acquisition costs of proved properties shall be amortized (depleted) by the unit-of-production method so that each unit produced is assigned a pro rata portion of the unamortized acquisition costs. Under the unit-of-production method, amortization (depletion) may be computed either on a property-by-property basis or on the basis of some reasonable aggregation of properties with a common geological structural feature or stratigraphic condition, such as a reservoir or field. When an enterprise has a relatively large number of royalty interests whose acquisition costs are not individually significant, they may be aggregated, for the purpose of computing amortization, without regard to commonality of geological structural features or stratigraphic conditions; if information is not available to estimate reserve quantities applicable to royalty interests owned (paragraph 59E), a method other than the unit-of-production method may be used to amortize their acquisition costs. The unit cost shall be computed on the basis of the total estimated units of proved oil and gas reserves. (Joint production of both oil and gas is discussed in paragraph 38.) Unit-of-production amortization rates shall be revised whenever there is an indication of the need for revision but at least once a year; those revisions shall be accounted for prospectively as changes in accounting estimates—see paragraphs 19–22 of FASB Statement No. 154, *Accounting Changes and Error Corrections*.~~paragraphs 31-33 of *APB Opinion No. 20*, "Accounting Changes."~~

b. Paragraph 35:

> Capitalized costs of exploratory wells and exploratory-type stratigraphic test wells that have found proved reserves and capitalized development costs shall be amortized (depreciated) by the unit-of-production method so that each unit

produced is assigned a pro rata portion of the unamortized costs. It may be more appropriate, in some cases, to depreciate natural gas cycling and processing plants by a method other than the unit-of-production method. Under the unit-of-production method, amortization (depreciation) may be computed either on a property-by-property basis or on the basis of some reasonable aggregation of properties with a common geological structural feature or stratigraphic condition, such as a reservoir or field. The unit cost shall be computed on the basis of the total estimated units of proved *developed* reserves, rather than on the basis of all proved reserves, which is the basis for amortizing acquisition costs of proved properties. If significant development costs (such as the cost of an off-shore production platform) are incurred in connection with a planned group of development wells before all of the planned wells have been drilled, it will be necessary to exclude a portion of those development costs in determining the unit-of-production amortization rate until the additional development wells are drilled. Similarly it will be necessary to exclude, in computing the amortization rate, those proved developed reserves that will be produced only after significant additional development costs are incurred, such as for improved recovery systems. However, in no case should future development costs be anticipated in computing the amortization rate. (Joint production of both oil and gas is discussed in paragraph 38.) Unit-of-production amortization rates shall be revised whenever there is an indication of the need for revision but at least once a year; those revisions shall be accounted for prospectively as changes in accounting estimates~~—see~~ paragraphs 19–22 of Statement 154.~~paragraphs 31-33 of *APB Opinion No. 20*.~~

C9. FASB Statement No. 25, *Suspension of Certain Accounting Requirements for Oil and Gas Producing Companies,* is amended as follows:

a. Paragraph 4 and its related footnote 1, as effectively amended by Statement 69:

> The effective date for application of paragraphs 11–41, 44–47, and 60 of *FASB Statement No. 19* is suspended insofar as those paragraphs pertain to a *required* form of successful efforts accounting. Those paragraphs are not suspended insofar as they provide definitions of terms in paragraph 11 or provide direction and guidance for financial statement disclosures required by paragraphs 59M–59R. Statement No. 19, including paragraphs 11–47, continues in effect as an accounting pronouncement~~a Statement issued by the FASB~~ for the purpose of applying paragraphs 12–14 of FASB Statement No. 154, *Accounting Changes and Error Corrections.*~~paragraph 16 of *APB Opinion No. 20*, "Accounting Changes."~~~~1~~

~~1Paragraph 16 of *APB Opinion No. 20* states in part: "The presumption that an entity should not change an accounting principle may be overcome only if the enterprise justifies the use of an alternative acceptable accounting principle on the basis that it is preferable. . . . The issuance of [a Statement of Financial Accounting Standards] that creates a new accounting principle, that expresses a preference for an accounting principle, or that rejects a specific accounting principle is sufficient support for a change in accounting principle. The burden of justifying other changes rests with the entity proposing the change."~~

C10. FASB Statement No. 52, *Foreign Currency Translation,* is amended as follows:

a. Paragraph 45:

> Once a determination of the functional currency is made, that decision shall be consistently used for each foreign entity unless significant changes in economic facts and circumstances indicate clearly that the functional currency has changed. (FASB Statement No. 154, *Accounting Changes and Error Corrections,* paragraph 5~~APB Opinion No. 20, *Accounting Changes,* paragraph 8~~, states that "adoption or modification of an accounting principle necessitated by transactions or events that are clearly different in substance from those previously occurring" is not a change in accounting principle~~s~~.)

C11. FASB Statement No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects,* is amended as follows:

a. Paragraph 12:

> Estimates and cost allocations shall be reviewed at the end of each financial reporting period until a project is substantially completed and available for sale. Costs shall be revised and reallocated as necessary for material changes on the basis of current estimates.[8] Changes in estimates shall be reported in accordance with paragraphs 19–22 of FASB Statement No. 154, *Accounting Changes and Error Corrections*~~paragraph 31 of APB Opinion No. 20, *Accounting Changes*~~.

C12. FASB Statement No. 71, *Accounting for the Effects of Certain Types of Regulation,* is amended as follows:

a. Paragraph 31:

> ~~Opinion 20~~FASB Statement No. 154, *Accounting Changes and Error Corrections,* defines various types of accounting changes and establishes guidelines for

reporting each type. Other authoritative pronouncements specify the manner of reporting initial application of those pronouncements.

C13. FASB Statement No. 123 (revised December 2004), *Share-Based Payment*, is amended as follows:

a. Paragraph 38:

> A nonpublic entity shall make a policy decision of whether to measure all of its liabilities incurred under share-based payment arrangements at fair value or to measure all such liabilities at intrinsic value.[23] Regardless of the method selected, a nonpublic entity shall remeasure its liabilities under share-based payment arrangements at each reporting date until the date of settlement. The fair-value-based method is preferable for purposes of justifying a change in accounting principle under FASB Statement No. 154, *Accounting Changes and Error Corrections*~~APB Opinion No. 20, *Accounting Changes*~~. Illustration 10 (paragraphs A127–A133) provides an example of accounting for an instrument classified as a liability using the fair-value-based method. Illustration 11(c) (paragraphs A143–A148) provides an example of accounting for an instrument classified as a liability using the intrinsic value method.

b. Paragraph A23:

> Assumptions used to estimate the fair value of equity and liability instruments granted to employees should be determined in a consistent manner from period to period. For example, an entity might use the closing share price or the share price at another specified time as the "current" share price on the grant date in estimating fair value, but whichever method is selected, it should be used consistently. The valuation technique an entity selects to estimate fair value for a particular type of instrument also should be used consistently and should not be changed unless a different valuation technique is expected to produce a better estimate of fair value. A change in either the valuation technique or the method of determining appropriate assumptions used in a valuation technique is a change in accounting estimate for purposes of applying FASB Statement No. 154, *Accounting Changes and Error Corrections*~~APB Opinion No. 20, *Accounting Changes*~~, and should be applied prospectively to new awards.

C14. FASB Statement No. 143, *Accounting for Asset Retirement Obligations*, is amended as follows:

a. Paragraph 15:

> Changes resulting from revisions to the timing or the amount of the original estimate of undiscounted cash flows shall be recognized as an increase or a decrease in (a) the carrying amount of the liability for an asset retirement obligation and (b) the related asset retirement cost capitalized as part of the carrying amount of the related long-lived asset. Upward revisions in the amount of undiscounted estimated cash flows shall be discounted using the current credit-adjusted risk-free rate. Downward revisions in the amount of undiscounted estimated cash flows shall be discounted using the credit-adjusted risk-free rate that existed when the original liability was recognized. If an entity cannot identify the prior period to which the downward revision relates, it may use a weighted-average credit-adjusted risk-free rate to discount the downward revision to estimated future cash flows. When asset retirement costs change as a result of a revision to estimated cash flows, an entity shall adjust the amount of asset retirement cost allocated to expense 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 more than one period as required by FASB Statement No. 154, *Accounting Changes and Error Corrections* (paragraphs 19–22)~~APB Opinion No. 20, *Accounting Changes* (paragraph 31)~~, for a change in estimate.

C15. FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, is amended as follows:

a. Paragraph 9 and its related footnote 7:

> When a long-lived asset (asset group) is tested for recoverability, it also may be necessary to review depreciation estimates and method as required by FASB Statement No. 154, *Accounting Changes and Error Corrections*~~APB Opinion No. 20, *Accounting Changes*~~, or the amortization period as required by FASB Statement No. 142, *Goodwill and Other Intangible Assets*.[7] Any revision to the remaining useful life of a long-lived asset resulting from that review also shall be considered in developing estimates of future cash flows used to test the asset (asset group) for recoverability (paragraph 18). However, any change in the

accounting method for the asset resulting from that review shall be made only after applying this Statement.

---

[7]Paragraphs 19–22 of Statement 154 address the accounting for changes in estimates, including changes in the method of depreciation, amortization, and depletion.~~Paragraphs 10 and 31–33 of Opinion 20 address the accounting for changes in estimates; paragraphs 23 and 24 of Opinion 20 address the accounting for changes in the method of depreciation.~~ Paragraph 11 of Statement 142 addresses the determination of the useful life of an intangible asset.

b. Paragraph 28:

For purposes of this Statement, a long-lived asset to be abandoned is disposed of when it ceases to be used. If an entity commits to a plan to abandon a long-lived asset before the end of its previously estimated useful life, depreciation estimates shall be revised in accordance with paragraphs 19–22 of Statement 154~~Opinion 20~~ to reflect the use of the asset over its shortened useful life (refer to paragraph 9).[16] A long-lived asset that has been temporarily idled shall not be accounted for as if abandoned.

c. Footnote 24:

This caption shall be modified appropriately when an entity reports an extraordinary item or the cumulative effect of a change in accounting principle or both~~in accordance with Opinion 20~~. If applicable, the presentation of per-share data will need similar modification.

C16. FASB Interpretation No. 1, *Accounting Changes Related to the Cost of Inventory,* is amended as follows:

a. Paragraph 1:

~~*Accounting Principles Board (APB) Opinion No. 20*~~FASB Statement No. 154, *Accounting Changes and Error Corrections,* specifies how changes in accounting principles should be reported in financial statements and what is required to justify such changes. Under that ~~Opinion~~Statement, the term *accounting principle* includes "not only accounting principles and practices but also the methods of applying them."

b. Paragraph 5:

A change in composition of the elements of cost included in inventory is an accounting change. A company which makes such a change for financial reporting shall conform to the requirements of FASB Statement No. 154, *Accounting Changes and Error Corrections*~~*APB Opinion No. 20*~~, including justifying the change on the basis of preferability as specified by paragraphs 12–14 of that Statement~~paragraph 16 of *APB Opinion No. 20*~~. In applying Statement 154~~*APB Opinion No. 20*~~, 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.

C17. FASB Interpretation No. 7, *Applying FASB Statement No. 7 in Financial Statements of Established Operating Enterprises,* is amended as follows:

a. Paragraph 5:

Except in the circumstances described in the preceding paragraph, the effect of a development stage subsidiary's change in accounting principle to conform its accounting to the requirements of *Statement No. 7* generally would be reflected in an established operating enterprise's consolidated financial statements that include that subsidiary. When a development stage subsidiary adopts a new accounting principle to conform its accounting to the requirements of *Statement No. 7* and the effect of that subsidiary's accounting change is also reflected in an established operating enterprise's consolidated financial statements that include that subsidiary, the provisions of paragraph 14 of *Statement No. 7* apply. In that situation, the established operating enterprise's consolidated financial statements for periods prior to the period in which the subsidiary's accounting change is made and financial summaries and other data derived therefrom shall be restated by prior period adjustment. It should be noted that *Statement No. 7* does not address the question of how an established operating enterprise should report accounting changes adopted with respect to the revenue and costs related to activities of the parent company or any subsidiaries that are not in the development stage; that question is covered by FASB Statement No. 154, *Accounting Changes and Error Corrections.*~~*APB Opinion No. 20,* "Accounting Changes."~~

C18. FASB Interpretation No. 18, *Accounting for Income Taxes in Interim Periods*, is amended as follows:

a. Footnote 1, as replaced by Statement 144:

> The terms used in this definition are described in ~~APB Opinion No. 20, *Accounting Changes*, in~~ APB Opinion No. 30, *Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions*, ~~and~~ in FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, and in FASB Statement No. 154, *Accounting Changes and Error Corrections*. See paragraph 10 of Opinion 30 for *extraordinary items* and paragraph 26 for *unusual items* and *infrequently occurring items*. See paragraph 7(a) of Statement 154~~20 of Opinion 20~~ for *cumulative effects of changes in accounting principles*. See paragraphs 41–44 of Statement 144 for *discontinued operations*.

b. Paragraph 21 and the heading preceding it:

> **~~Cumulative Effects of Changes in Accounting Principles~~**
>
> ~~*FASB Statement No. 3*, "Reporting Accounting Changes in Interim Financial Statements," specifies that the cumulative effect of a change in accounting principle on retained earnings at the beginning of the year shall be reported in the first interim period of the fiscal year. *APB Opinion No. 20*, "Accounting Changes," specifies that the related income tax effect of a cumulative-effect-type accounting change shall be computed as though the new accounting principle had been applied retroactively for all prior periods that would have been affected.~~

c. Paragraph 64:

> When an enterprise makes an ~~cumulative-effect-type~~ accounting change in other than the first interim period of the enterprise's fiscal year, paragraph 15 of FASB Statement No. 154, *Accounting Changes and Error Corrections*, ~~paragraph 10 of *FASB Statement No. 3*, "Reporting Accounting Changes in Interim Financial Statements,"~~ requires that financial information for the pre-change interim periods of the fiscal year shall be reported by retrospectively~~restated by~~ applying the newly adopted accounting principle to those pre-change interim periods. The tax (or benefit) applicable to those pre-change interim periods shall be recomputed. The revised~~restated~~ tax (or benefit) shall reflect the year-to-date amounts and annual estimates originally used for the pre-change interim periods, modified only for the effect of the change in accounting principle on those year-to-date and estimated annual amounts.

C19. Many pronouncements issued by the Accounting Principles Board and the FASB contain references to the cumulative effect of a change in accounting principle. All such references appearing in paragraphs that establish standards or illustrate their application are hereby amended to include the following footnote:

> After the effective date of FASB Statement No. 154, *Accounting Changes and Error Corrections*, voluntary changes in accounting principle will no longer be reported via a cumulative-effect adjustment through the income statement of the period of change.

That conclusion requires amendments to the following existing pronouncements:

a. Opinion 28
b. Opinion 30
c. FASB Statement No. 128, *Earnings per Share*
d. FASB Statement No. 130, *Reporting Comprehensive Income*
e. FASB Statement No. 131, *Disclosures about Segments of an Enterprise and Related Information*
f. Statement 141
g. Statement 144
h. Interpretation 18.

Restatements

- “Accounting Irregularities”
  - Intentional misstatements or omissions of amounts or disclosures in the financial statements
- “Errors”
  - Unintentional misstatements or omissions of amounts or disclosures in the financial statements
  - Data processing mistakes
  - Incorrect accounting estimates
  - Misapplication of accounting principles

Restatement Considerations

- SAB 99: Materiality
  - Quantitative and Qualitative
- Iron Curtain Method
- Rollover Method
- SAB 108: Dual Method
  - **Correction** of prior year financial statements
  - **Restatement** of prior year financial statements

Regulatory Considerations

- Filing and Disclosure Requirements
  - Form 8-K must be filed within 4 days
  - Form 12b-25 may only be filed where registrant intends to file Form 10-Q within 5 days or Form 10-K within 15 days
- SOX Implications
  - Management's assessment of internal controls over financial reporting
  - Disclosure of material weaknesses

Practical Considerations

- Disclosure to the SEC Division of Corporation Finance
  - January 2007 Carol Stacey letter
  - Sept 19, 2006 OCA letter
- Internal investigations
  - Management vs. Independent Counsel
- SEC Division of Enforcement and DOJ
- Dealing with independent auditors and forensic "shadow" teams

Role of the Audit Committee

- Oversight of the restatement process
- Determine whether to retain its own counsel and forensic accountants
- Approve all audit services, including forensic involvement
- Review and discuss the restatement and public filings (including the MD&A) with management and the independent auditor

Real-Life Restatements

- O'Sullivan Industries
- Tyco International

Tax Sharing Agreement

TAX SHARING AND TAX BENEFIT REIMBURSEMENT AGREEMENT

Tax Sharing and Tax Benefit Reimbursement Agreement (the "Agreement") dated as of February 1, 1994, by and among Tandy Corporation, a Delaware corporation, having its principal office at 1800 One Tandy Center, Fort Worth, Texas 76102 ("Tandy"), TE Electronics Inc., a Delaware corporation and a wholly-owned subsidiary of Tandy having its principal office at 1800 One Tandy Center, Fort Worth, Texas 76102 ("TE") and O'Sullivan Industries Holdings, Inc., a Delaware corporation, having its principal office at 1900 Gulf Street, Lamar, Missouri 64759 ("Holdings").

WHEREAS, Tandy and certain of its subsidiaries, including Holdings, shall effect the initial public offering of the stock of Holdings (the "IPO") and certain related transactions described in the Registration Statement on Form S-1 under the Securities Act of 1933, dated November 24, 1993, and the Prospectus contained therein, as amended from time to time; and

WHEREAS, prior to the Contribution (as defined below), TE owned one hundred shares of Holdings common stock; and

WHEREAS, following the execution of the Underwriting Agreement, dated the date hereof, by and among TE, Holdings, Merrill Lynch & Co., Wheat First

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SEC Comment Letter

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549-0404

DIVISION OF
CORPORATION FINANCE

Via Fax & U.S. Mail

February 25, 2003

Mr. Phillip J. Pacey
Senior Vice President & Chief Financial Officer
O'Sullivan Industries Holdings, Inc.
1900 Gulf Street
Lamar, Missouri 64759-1899

RE: O'Sullivan Industries, Holdings, Inc.
Form 10-K for the year ended June 30, 2002
File No. 1-12754
O'Sullivan Industries, Inc.
Form 10-K for the year ended June 30, 2002
File No. 333-31282

Dear Mr. Pacey:

We reviewed the above filings and have the following comments. We limited our review to your financial statements and related disclosures. We think you should revise your future filings to comply with our comments. If you disagree, we will consider your explanation as to why our comment is inapplicable or a revision is unnecessary. Please be as detailed as necessary in your explanation. In some of our comments, we ask you to provide us supplemental information so

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Note12 – Income Taxes

3. Provide us with additional information regarding the Tax Sharing and Tax Benefit Reimbursement Agreement. Specifically tell us:

- How you originally reflected the agreement in 1994. What were the mechanics of recording this agreement in your financial statements? Tell us the authoritative literature you relied on.
- Tell us why it is appropriate to reflect payments you have made to RadioShack as Federal Income Tax Expense. In this regard, we note that RadioShack reflected the $27.7 million settlement as Other Income in their Form 10-Q for the quarter ended June 30, 2002. Tell us the authoritative literature you rely on.
- Explain in better detail the mechanics of how you recorded the RadioShack settlement. Clarify how the $27.7 million in payments resulted in a deferred tax asset. Clarify what this deferred tax asset represents and how you will realize this asset.

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O'Sullivan's Response

O'Sullivan Furniture
Furniture that fits.

By facsimile & U.S. Mail

April 28, 2003

Mr. John Hartz
Senior Assistant Chief Accountant
United States Securities and Exchange Commission
Division of Corporation Finance
450 Fifth Street, N.W.
Washington, D.C. 20549

Re: O'Sullivan Industries Holdings, Inc.
Annual Report on Form 10-K for the year ended June 30, 2002
File No. 1-12754
O'Sullivan Industries, Inc.
Annual Report on Form 10-K for the year ended June 30, 2002
File No. 333-31282

Dear Mr. Hartz:

This letter is provided on behalf of O'Sullivan Industries Holdings, Inc. and O'Sullivan Industries, Inc. in response to your written comments dated February 25, 2003. We appreciate your thoughts regarding how we can improve our disclosure. For ease of reference, we have repeated each of your comments, which precede our response to the comment.

Management's Discussion and Analysis

1. We note that you have presented EBITDA to "...provide additional information about [y]our operations". In future filings, explain to readers that this non-GAAP measure is typically used as a measure of liquidity. Provide a full explanation as to the additional information EBITDA provides your readers. Specifically explain to readers how this measure should be used in the context of analyzing your operations.

Response: We have already expanded our discussion of EBITDA and how it helps our readers understand our operations and covenant compliance in our quarterly report on Form 10-Q for the quarter ended December 31, 2002. We will further expand our discussion in future

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Revised Accounting Discussion

O'SULLIVAN INDUSTRIES HOLDINGS, INC.
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS
March 31, 2003

Note 2—Revised Accounting for Tax Sharing Agreement with Former Parent

In 1994, Former Parent, then Tandy Corporation, completed an initial public offering of O'Sullivan. In connection with the offering, O'Sullivan entered into a tax sharing and tax benefit reimbursement agreement with Former Parent. O'Sullivan and Former Parent made elections under Sections 338(g) and 338(h)(10) of the Internal Revenue Code with the effect that the tax basis of O'Sullivan's assets was increased to the deemed purchase price of the assets, and an equal amount of such increase was included as taxable income in the consolidated federal tax return of Former Parent. The result was that the tax basis of O'Sullivan's assets exceeded the historical book basis O'Sullivan used for financial reporting purposes.

The increased tax basis of O'Sullivan's assets results in increased tax deductions and accordingly reduced federal and state income taxes payable by O'Sullivan. Under the tax sharing agreement, O'Sullivan is contractually obligated to pay Former Parent nearly all of the federal tax benefit expected to be realized with respect to such additional basis. The payments under the agreement represent additional consideration for the stock of O'Sullivan Industries, Inc. and further increase the tax basis of its assets from the 1994 initial public offering when payments are made to Former Parent.

Hypothetical: Restatement of Long Term Compensation (LTC)

- Chief Accounting Officer informs in-house counsel of potential errors relating to the Company's historical accounting for long term compensation
- These errors appear to be material to prior period financial statements
- Management reports to Audit Committee and retains counsel to conduct independent investigation of historical stock option granting practices

Restatement Considerations

- What do you tell your CEO?
- When do you notify the Audit Committee and the rest of the Board?
- Should the internal investigation be conducted by management or by independent counsel under the oversight of a special committee?
- When do you call the SEC?
- Do you alert the ratings agencies?
- What do you tell your investors and when?
- How do you handle media inquiries?

Restatement Considerations

- Are there other internal actions that need to take place, such as:
  - instituting an insider trading blackout?
  - halting a stock buyback program?
  - imposing a moratorium on the issuance of options?
  - delaying a securities offering?
  - amending federal tax returns?
- How often do you need to communicate with regulators on the status of your investigation?

Restatement Considerations

- Who should communicate with the audit and forensic teams?
- Who determines that the restatement is complete?
- What are you required to disclose in your amended Form 10-K about:
  - The internal investigation?
  - Scope limitations?
  - The amount of the restatement?
  - The causes of the restatement?

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September 2006, No. 06-27

SEC Staff Guidance on Quantifying Financial Statement Misstatements

A new Staff Accounting Bulletin addresses how the effects of prior-year uncorrected misstatements should be considered when quantifying misstatements in current-year financial statements.[1] The SAB requires registrants to quantify misstatements using both the balance-sheet and income-statement approaches and to evaluate whether either approach results in quantifying an error that is material in light of relevant quantitative and qualitative factors. The SAB does not change the staff's previous guidance in SAB 99 on evaluating the materiality of misstatements.[2]

When the effect of initial adoption is determined to be **material**, the SAB allows registrants to record that effect as a cumulative-effect adjustment to **beginning-of-year** retained earnings. The requirements are effective for annual financial statements covering the first fiscal year ending after November 15, 2006. See Initial Adoption below.

Quantifying Misstatements

The new guidance applies when uncorrected misstatements in a previous year affect the current year, either because the misstatements carry over or reverse. The SAB provides the example of a liability that is overstated by \$100, because a \$20 misstatement occurred in each year of a five-year period, and discusses two methods currently used to quantify the current-year misstatement. These methods are commonly referred to as the "rollover" and "iron curtain" methods.

Under the rollover method, the current-year effect would be the amount by which the current-year income statement is misstated (i.e., \$20). Under the iron curtain method, the current-year effect would be the amount by which the year-end balance sheet is misstated (i.e., \$100). The SAB points out that the rollover method could cause a misstatement to accumulate until it is too large to be corrected in a single year, resulting in errors remaining in the balance

[1] Staff Accounting Bulletin No. 108 (Topic 1N), Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements, available at www.sec.gov.
[2] Staff Accounting Bulletin No. 99 (Topic 1M), Materiality, available at www.sec.gov.

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sheet. The SAB also points out that the iron curtain method does not consider the correction of prior-year misstatements in the current year. For example, if the $80 misstatement from the prior years in the example was corrected in the current year, the current-year income statement would be misstated by the $80 out-of-period correction, but the year-end balance sheet would not be misstated, and no uncorrected misstatement would exist at year-end.

In order to eliminate diversity in practice for quantifying misstatements and to address the shortfalls of each of the two methods, the SAB requires registrants to quantify misstatements using both methods, with adjustment required if either method results in a material error. The materiality of the quantified misstatement would be evaluated using the staff's previously published guidance in SAB 99.

Correcting Errors

The new SAB addresses the mechanics of correcting misstatements that include effects from prior years. The SAB indicates that the current-year correction of a material error that includes prior-year effects may result in the need to correct prior-year financial statements, even if the misstatement in the prior year or years is considered immaterial. For example, if the $100 error in the above example was determined to be material in the current year, the current-year correction would result in an $80 misstatement of the current-year income statement (the portion of the $100 error that originated in prior years). In this case, the prior-year financial statements would need to be corrected, even though the misstatement had been considered, and continues to be, immaterial to the prior-year's financial statements.

The SAB points out that "correcting prior-year financial statements for immaterial errors would not require previously filed reports to be amended." The "correction may be made the next time the registrant files the prior year financial statements." The correction could therefore be made in subsequent filings by adjusting the prior-year financial statements, as long as the adjustments made to those financial statements are considered immaterial. Although the subject is not specifically addressed in the SAB, the prior-year financial statements reflecting immaterial corrections need not be labeled "restated," and the adjustments would not necessarily require mention in the auditors' report. Registrants should, however, disclose the fact that they have adjusted the prior-year financial statements and provide appropriate context for the adjustments made so that readers can understand why the comparative financial statements presented in the current-year report do not agree with the previously issued financial statements.

Previously Undetected Misstatements

Misstatements originating in years subsequent to the issuance of the SAB that are not detected in the years they arose will be evaluated using the method outlined in the SAB to determine whether the prior-year financial statements were materially misstated. Financial statements that are found to be materially misstated would be restated in accordance with Statement 154.[3]

In the previous example regarding the overstated liability that grew by $20 per year over a five-year period, assume that the misstatement was not identified until year five. The registrant would need to use the approach outlined in the SAB to separately evaluate each year affected by the misstatement and determine whether individual prior years were materially misstated. If, for example, the fourth year was found to be materially misstated, the financial statements for year four would have to be restated and labeled as restated. If the misstatements in the first three years were determined to be immaterial, financial statements for those years could be adjusted without labeling them restated.

Initial Adoption

A registrant applying the new guidance for the first time that identifies **material** errors in existence at the beginning of the first fiscal year ending after November 15, 2006, may correct those errors through a one-time cumulative-effect adjustment to **beginning-of-year** retained earnings. The cumulative-effect alternative is available only if the application of the new guidance results in a conclusion that a material error exists as of the beginning of the first fiscal year ending after November 15, 2006, and those misstatements were determined to be immaterial based on a proper application of the registrant's previous method for quantifying misstatements.

Because of the beginning-of-year recognition of the cumulative-effect adjustment, misstatements occurring in the year of adoption cannot be included in that adjustment. The cumulative-effect adjustment may be reflected in a Form 10-K for the year of adoption or, if early adoption is chosen, the adjustment may be reflected in any Form 10-Q filed after issuance of the SAB. For example, a registrant with a June 30 year-end may wait until it issues its Form 10-K for the year ending June 30, 2007, to reflect the cumulative-effect adjustment, or it may reflect the adjustment in its first, second, or third quarter Form 10-Q for the fiscal year ending June 30, 2007. In any event, the cumulative-effect adjustment would be calculated as of July 1, 2006, the first day of the fiscal year of adoption.

The SAB requires the following disclosures if a cumulative-effect adjustment is recorded:

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

The cumulative-effect adjustment is available only for prior-year uncorrected misstatements. The adjustment should not include amounts related to changes in accounting estimates.

Companies that issue reports before the SAB is adopted should make the disclosures required by SAB 74.[4]

Foreign Private Issuers

The SAB's guidance applies to all SEC registrants. A foreign private issuer that presents its primary financial statements on a basis other than U.S. GAAP will need to determine how the adoption of the SAB will affect its primary financial statements and the related U.S. GAAP reconciliation because the cumulative-effect adjustment accommodation provided by the SEC may not be acceptable for preparation of its primary financial statements. We expect this implementation issue to require additional discussion with the SEC staff.

Non-SEC Registrants

The SAB's guidance does not apply to non-SEC registrants. It is currently not clear whether the FASB will consider the cumulative-effect treatment under U.S. GAAP.

Registrants should not consider the descriptive and summary statements above about the Staff Accounting Bulletin, or any other cited requirements, as a substitute for the text of SEC or FASB requirements. Registrants should refer to the texts of the SEC and FASB requirements, consider their particular circumstances, and consult their accounting and legal advisors when considering the implications of the SAB.

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Earlier editions are available at:
www.aro.kpmg.com

[3] FASB Statement No.154, Accounting Changes and Error Corrections, May 2005, available at www.fasb.org.

[4] Staff Accounting Bulletin No. 74 (Topic 11M), Disclosure Of The Impact That Recently Issued Accounting Standards Will Have On The Financial Statements Of The Registrant When Adopted In A Future Period, available at www.sec.gov.