I. Introduction

The SEC's Advisory Committee on Improvements to Financial Reporting (Committee) issued a progress report (Progress Report) on February 14, 2008.[1] In chapter 3 of the Progress Report, the Committee discussed its work-to-date in the area of audit process and compliance, namely, its developed proposals related to providing guidance with respect to the materiality and correction of errors; and judgments related to accounting matters.

Since the issuance of the Progress Report, the audit process and compliance subcommittee (Subcommittee III) has received a considerable amount of public comment regarding the developed proposals included in the Progress Report. This public input includes feedback obtained during the panel discussions regarding the developed proposals in Chapter 3 of the Progress Report held during Committee's March 13 open meeting, feedback obtained when certain members of the subcommittee met with the PCAOB Standing Advisory Group (SAG) on February 27, 2008, feedback obtained when the subcommittee met with market participants at our subcommittee meetings and the numerous comment letters received by the Committee. Based on this considerable public feedback, Subcommittee III believes that there are several areas related to the Committee's original developed proposals that warrant clarification by the Committee as well as some additional items that need to be considered by the Committee. This report represents Subcommittee III's latest thinking related to the developed proposals in Chapter 3 of the Progress Report and reflects the subcommittee's proposed clarifications for the Committee's consideration related to the original developed proposals. Subject to further public comment and Committee input, Subcommittee III will recommend these revised developed proposals to the Committee for its consideration in developing the final report, which is expected to be issued in July 2008.

II. Financial Restatements

In the Progress Report, the Committee issued three developed proposals (developed proposals 3.1, 3.2 and 3.3) related to financial restatements. These developed proposals have been the subject of public debate and the subject of many comment letters received by the Committee. Subcommittee III believes that one cause of the debate surrounding these developed proposals relates to a lack of clarity regarding the developed proposals.

First, the developed proposals were not intended to recommend elimination of the guidance currently contained in SAB Topic 1M. Instead, the developed proposals were intended to enhance the guidance in SAB Topic 1M. As stated in the summary of SAB 99, which was codified in SAB Topic 1M, "This staff accounting bulletin expresses the views of the staff that exclusive reliance on certain quantitative benchmarks to assess

[1] Refer to Progress Report at http://www.sec.gov/rules/other/2008/33-8896.pdf.

materiality in preparing financial statements and performing audits of those financial statements is inappropriate; misstatements are not immaterial simply because they fall beneath a numerical threshold." Subcommittee III believes that that the guidance in SAB Topic 1M is appropriate and accomplishes what it was intended to do, which is to address situations where errors were not being evaluated for materiality simply due to the relatively small size of the error. As the SEC staff noted in SAB 99, this concept was not consistent with the total mix standard established by the Supreme Court. SAB Topic 1M was not written to address all situations one must consider when determining if an error is material, yet in practice, SAB Topic 1M is often cited as the guidance to use in all materiality decisions. Because SAB Topic 1M primarily addresses one issue, which was to correct the misperception in practice at the time that small errors need not be evaluated for materiality solely based on their size, Subcommittee III believes that this has resulted in less consideration to the total mix of information in the evaluation of whether an error is material or not. Since this is not consistent with the standard established by the Supreme Court or as we understand it the intent of SAB Topic 1M, Subcommittee III believes that additional guidance is needed to supplement the guidance contained in SAB Topic 1M.

Second, there have been some additional studies of restatements that have been published since the issuance of the Progress Report. The most significant study is the study commissioned by the U.S. Treasury entitled "*The Changing Nature and Consequences of Public Company Financial Restatements 1997-2006*", conducted by Professor Susan Scholz of the University of Kansas. Subcommittee III believes that the results of this study are not inconsistent with the developed proposals in the Committee's Progress Report.

Third, Subcommittee III believes clarifications are needed related to the use of the term current investor in the Progress Report. Some have concluded that this term only refers to investors who currently own securities of a company. Subcommittee III did not intend the Committee's developed proposal to convey such a narrow definition of current investor, so there are proposed edits to the developed proposal to reflect that the correction of an error should be based on the needs of all investors making current investment decisions.

Fourth, there were several public comments related to the use of the term "sliding scale" in the developed proposals in the Progress Report. Many of these comments were concerned that this term was confusing and did not help explain the principles in the developed proposal. Subcommittee III does not believe that the use of this term is critical to the principles articulated in the developed proposals in the Progress Report. Therefore Subcommittee III proposes to remove the use of this term in the developed proposals.

Finally, because Subcommittee III believes that issues related to the dark period, most notably the potential high cost to investors during the dark period, are very important, a new developed proposal is being recommended by the subcommittee to highlight the importance of this issue. This new developed proposal contains substantially the same wording that was included in the Progress Report, but has been moved to give more prominence to this important issue.

III. Judgment

Similar to the reaction to the Committee's developed proposals related to restatements in the Progress Report (Developed Proposals 3.1, 3.2 and 3.3), there has been much public comment related to the Committee's developed proposal 3.4 in the Progress Report related to professional judgment. Subcommittee III believes that the comments it has received during this process have been very helpful to its continuing deliberations on this matter. Based on the comments received, Subcommittee III believes that some changes are necessary to the developed proposal 3.4 in the Progress Report to allow the developed proposal to meet the goals established in that Progress Report without the risks that the subcommittee has been concerned about from the beginning, such as the risk that the developed proposal devolve into a checklist based approach to making judgments and the risk that the proposed framework could be used as a shield to protect unreasonable judgments.

The primary change that Subcommittee III believes should be made is to refocus the developed proposal away from a recommendation for a framework. While Subcommittee III believes that there is great merit in the idea of a framework, the term framework can imply a mechanistic process. Making and evaluating judgments can involve a process, but the notion of a process is dangerous because it implies that an outcome can be achieved. Indeed, no matter how robust a process one uses to make judgments, there can be no guarantee that the outcome will be reasonable. Instead, Subcommittee III believes that a preferable way to accomplish the goals set forth in the Progress Report would be to have the SEC formally articulate in a statement of policy how the SEC evaluates judgments, including the factors that it uses as part of its evaluation. Therefore, Subcommittee III believes the developed proposal should be changed to formally propose such as statement of policy to be issued.

Some commenters have stated that developed proposal 3.4 in the Progress Report advocates a safe harbor be established for the exercise of professional judgment. Subcommittee III did not intend to advocate any particular way for the implementation of developed proposal 3.4. Instead, this decision was left to the SEC. With the change in focus outlined above, Subcommittee III believes that a statement of policy would be the preferred way to implement the revised proposal and therefore, there should be no reference to a safe harbor in the revised Chapter 3.

Subcommittee III also proposes to remove the use of the term professional when referring to judgment. Subcommittee III believes that there could be a misunderstanding that the term professional implies that one must have a professional certification in order to make or evaluate a professional judgment. While Subcommittee III believes that such professional certifications are important, it did not intend to suggest such a requirement for the application or evaluation of accounting judgments.

Appendix A

Subcommittee III has included as Appendix A to this update a revised version of Chapter 3 from the Progress Report that reflects the proposed edits for the Committee's consideration

CHAPTER 3: AUDIT PROCESS AND COMPLIANCE

I. Introduction

We have concentrated our efforts to date regarding audit process and compliance on the subjects of financial restatements, including the potential benefits from providing guidance with respect to the materiality[2] and correction of errors; and judgments related to accounting matters: specifically, whether guidance on the evaluation of judgments would enhance the quality of judgments and the willingness of others to respect judgments made.

II. Financial Restatements

II.A. Background

Likely Causes of Restatements

The number of financial restatements[3] in the U.S. financial markets has been increasing significantly over recent years, reaching approximately 1,600 companies in 2006.[4] Restatements generally occur because errors that are determined to be material are found in a financial statement previously provided to the public. Therefore, the increase in restatements appears to be due to an increase in the identification of errors that were determined to be material.

The increase in restatements has been attributed to various causes. These include more rigorous interpretations of accounting and reporting standards by preparers, outside auditors, the SEC, and the PCAOB; the considerable amount of work done by companies to prepare for and improve internal controls in applying the provisions of section 404 of the Sarbanes-Oxley Act; and the existence of control weaknesses that companies failed to identify or remediate. Some have also asserted that the increase in restatements is the

[2] A fact is material if there is a substantial likelihood that a reasonable investor in making an investment decision would consider it as having significantly altered the total mix of information available. *Basic, Inc*. v. *Levinson*, 485 U.S. 224, 231–32 (1988); *TSC Industries, Inc*. v. *Northway, Inc.*, 426 U.S. 438, 449 (1976).
[3] For the purposes of this chapter, a restatement is the process of revising previously issued financial statements to reflect the correction of a material error in those financial statements. An amendment is the process of filing a document with revised financial statements with the SEC to replace a previously filed document. A restatement could occur without an amendment, such as when prior periods are revised in a current filing with the SEC.
[4] U.S. Government Accountability Office (GAO) study, *Financial Restatements: Update of Public Company Trends, Market Impacts, and Regulatory Enforcement Updates* (March 2007), and Audit Analytics study, *2006 Financial Restatements A Six Year Comparison* (February 2007).

result of an overly broad application of the concept of materiality and misinterpretations of the existing guidance regarding materiality in SAB 99, *Materiality* (as codified in SAB Topic 1M). SAB Topic 1M was written to primarily address a specific issue, when seemingly small errors could be material due to qualitative factors, however, the guidance in SAB Topic 1M is often utilized in all materiality decisions. As a result of this overly broad application of SAB Topic 1M, errors may have been deemed to be material when an investor[5] may not consider them to be important.

It is essential that companies, auditors, and regulators strive to reduce the frequency and magnitude of errors in financial reporting. When material errors occur, however, companies should restate their financial statements to correct errors that are important to current investors. Investors need accurate and comparable data, and restatement is the only means to achieve those goals when previously filed financial statements contain material errors. Efforts to improve company controls and audit quality in recent years should reduce errors, and there is evidence this is currently occurring.[6] We believe that public companies should focus on reducing errors in financial statements. At the same time, we believe that some of our developed proposals in the areas of substantive complexity, as discussed in chapter 1, and the standards-setting process, as discussed in chapter 2, will also be helpful in reducing some of the frequency of errors in financial statements.

While reducing errors is the primary goal, it is also important to reduce the number of restatements that do not provide important information to investors making current investment decisions. Restatements can be costly for companies and auditors, may reduce confidence in reporting, and may create confusion that reduces the efficiency of investor analysis. This portion of this chapter describes our proposals regarding: (1) additional guidance on the concept and application regarding materiality, and (2) the process for and disclosure of the correction of errors.

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[5] We use the term investor to include all people using financial statements to make investment decisions.
[6] A Glass Lewis & Co. report, *The Tide is Turning* (January 15, 2008), shows that restatements in companies subject to section 404 of the Sarbanes Oxley Act have declined for two consecutive years.

Our Research

We have considered several publicly-available studies[7] on restatements. The restatement studies we have reviewed all indicate that the total number of restatements has increased in recent years. The studies also indicate that there are many different types of errors that result in the need for restatements. Market reaction to restatements may be one indicator as to whether restatements contain information considered by investors to be material. Based on these studies, it appears to us that there may be restatements that investors may not consider important. We draw this conclusion in part based upon the lack of a statistically significant market reaction, particularly as it relates to certain types of restatements such as reclassifications and restatements affecting non-core expenses[8]. While there are limitations[9] to using market reaction as a proxy for materiality, other trends in these studies are not inconsistent with our conclusion - - the trend toward restatements involving correction of smaller amounts, including amounts in the cash flow statement, and the trend toward restatements in cases where there is no evidence of fraud or intentional wrongdoing[10]. Also, while there is recent evidence[11] that the number of restatements has declined in 2007, we note that the total number of restatements is still significant. We, therefore, believe supplementing existing guidance on determining whether an error is material and providing additional guidance on when a restatement is necessary for certain types of errors, would be beneficial in reducing the frequency of

[7] Studies considered include the study commissioned by the Department of the Treasury, *The Changing Nature and Consequences of Public Company Financial Restatements 1997-2006*, by Professor Susan Scholz, *An Analysis of the Underlying Causes of Restatements* by Professors Marlene Plumlee and Teri Yohn, GAO study, *Financial Restatements: Update of Public Company Trends, Market Impacts, and Regulatory Enforcement Updates* (March 2007); Glass Lewis & Co. study, *The Errors of Their Ways* (February 2007); and two Audit Analytics studies, *2006 Financial Restatements A Six Year Comparison* (February 2007) and *Financial Restatements and Market Reactions* (October 2007). We have also considered findings from the PCAOB's Office of Research and Analysis's (ORA) working paper, *Changes in Market Responses to Financial Statement Restatement Announcements in the Sarbanes-Oxley Era* (October 18, 2007), understanding that ORA's findings are still preliminary in nature as the study is still going through a peer review process.

[8] Professor Scholz's study defines restatements related to non-core expenses as "Any restatement including correction of expense (or income) items that arise from accounting for non-operation or non-recurring activities". This definition includes restatements related to debt and equity instruments, derivatives, gain or loss recognition, inter-company investments, contingency and commitments, fixed and intangible asset valuation or impairment and income taxes.

[9] Examples of the limitations in using market reaction as a proxy for materiality include (1) the difficultly of measuring market reaction because of the length of time between when the market becomes aware of a potential restatement and the ultimate resolution of the matter, (2) the impact on the market price of factors other than the restatement, and (3) the disclosure at the time of the restatement of other information, such as an earnings release, that may have an offsetting positive market reaction.

[10] These trends are addressed in Professor Scholz's study.

[11] Glass Lewis & Co. report, *The Tide is Turning* (January 15, 2008) indicates that approximately 1 out of every 11 public companies had a restatement during 2007.

restatements that do not provide important information to investors making current investment decisions.

We have also considered input from equity and credit analysts and others about investors' views on materiality and how restatements are viewed in the marketplace. Feedback we have received included:

- Bright lines are not really useful in making materiality judgments. Both qualitative and quantitative factors should be considered in determining if an error is material.
- Companies often provide the market with little financial data during the time between a restatement announcement and the final resolution of the restatement. Limited information seriously undermines the quality of investor analysis, and sometimes triggers potential loan default conditions or potential delisting of the company's stock.
- The disclosure provided in connection with restatements is not consistently adequate to allow an investor to evaluate the likelihood of errors in the future. Notably, disclosures often do not provide enough information about the nature and impact of the error, and the resulting actions the company is taking.
- Interim periods should be viewed as more than just a component of an annual financial statement for purposes of making materiality judgments.

<u>II.B. Developed Proposals</u>

Based on our work to date, we believe that, in addressing a financial statement error, it is helpful to consider two sequential questions: (1) Was the error in the financial statement material to those financial statements when originally filed? and (2) How should a material error in previously issued financial statements be corrected? We believe that framing the principles necessary to evaluate these questions would be helpful. We also believe that in many circumstances investors could benefit from improvements in the nature and timeliness of disclosure in the period between identifying an error and filing restated financial statements.

With this context, we have developed the following proposals regarding the assessment of the materiality of errors to financial statements and the correction of financial statements for errors.[12]

[12] We have developed principles that we believe will be helpful in addressing financial statement errors. In developing these principles, we have not determined if the principles are inconsistent with existing GAAP, such as SFAS No. 154, *Accounting Changes and Error Corrections,* or APB Opinion No. 28, *Interim Financial Reporting*. To the extent that the implementation of our proposals would require a change to GAAP, the SEC should work with the FASB to revise GAAP.

<u>Developed Proposal 3.1:</u> The FASB or the SEC, as appropriate, should supplement existing guidance to reinforce the following concepts:

- ***Those who evaluate the materiality of an error should make the decision based upon the perspective of a reasonable investor.***
- ***Materiality should be judged based on how an error affects the total mix of information available to a reasonable investor.***

Just as qualitative factors may lead to a conclusion that a small error is material, qualitative factors also may lead to a conclusion that a large error is not material. The FASB or the SEC, as appropriate, should also conduct both education sessions internally and outreach efforts to financial statement preparers and auditors to raise awareness of these issues and to promote more consistent application of the concept of materiality.

The Supreme Court has established that "a fact is material if there is a substantial likelihood that a reasonable investor in making an investment decision would consider it as having significantly altered the total mix of information available." We believe that those who judge the materiality of a financial statement error should make the decision based upon the interests, and the viewpoint, of a reasonable investor and based upon how that error impacts the total mix of information available to a reasonable investor. One must "step into the shoes" of a reasonable investor when making these judgments. We believe that too many materiality judgments are being made in practice without full consideration of how a reasonable investor would evaluate the error. When looking at how an error impacts the total mix of information, one must consider all of the qualitative factors that would impact the evaluation of the error. This is why bright lines or purely quantitative methods are not appropriate in determining the materiality of an error to annual financial statements.

We believe that the current materiality guidance in SAB Topic 1M is appropriate in making most materiality judgments; We believe that, in current practice, however, this materiality guidance is being interpreted generally as being one-directional, that is, as providing that qualitative considerations can result in a small error being considered material, but that a large error is material without regard to qualitative factors. This one-directional interpretation is not consistent with the standard established by the Supreme Court, which requires an assessment of the total mix of information available to the investor making an investment decision. We believe that, in general, qualitative factors not only can increase, but also can decrease, the importance of an error to the reasonable investor, although we acknowledge that there will probably be more times when qualitative considerations will result in a small error being considered material than they will result in a large error being considered not to be material[13]. Therefore, we recommend that the existing materiality guidance be enhanced to clarify that the total mix of information available to investors should be the main focus of a materiality judgment and that qualitative factors are relevant in analyzing the materiality of both large and small errors. We view this recommendation as a modest clarification of the existing guidance to conform practice to the standard established by the Supreme Court and not a wholesale revision to the concepts and principles embedded in existing SEC staff guidance in SAB Topic 1M.

The following are examples of some of the qualitative factors that could result in a conclusion that a large error is not material. (Note that this is not an exhaustive list of factors, nor should this list be considered a "checklist" whereby the presence of any one of these items would make an error not material. Companies and their auditors should continue to look at the totality of all factors when making a materiality judgment):

- The error impacts metrics that do not drive investor conclusions or are not important to investor models.
- The error is a one time item and does not alter investors' perceptions of key trends affecting the company.
- The error does not impact a business segment or other portion of the registrant's business that investors regard as driving valuation or risks.

Finally, we recommend that the enhanced guidance suggest some factors that are relevant to the analysis of errors in the cash flow statement and the balance sheet. We note that the existing guidance suggests factors that are relevant primarily to the analysis of the materiality of an error in the income statement.

Internal education and external outreach efforts can be instrumental in increasing the awareness of these concepts and ensuring more consistent application of materiality. Many of the issues with materiality in practice are caused by misunderstandings by preparers, auditors and regulators. Elimination of these misunderstandings would be a significant step toward reducing restatements that do not provide useful information to investors.

[13] Some have argued that, under such guidance, a very large error that affects meaningful financial statement metrics could be deemed immaterial by virtue of qualitative factors. The Committee believes that when one focuses on the total mix of information, the probability of this situation occurring is remote.

Developed Proposal 3.2: ***The FASB or the SEC, as appropriate, should issue guidance on how to correct an error consistent with the principles outlined below:***

- ***All errors, other than clearly insignificant errors, should be promptly corrected no later than in the financial statements of the period in which the error is discovered. All material errors should be disclosed when they are corrected.***
- ***Prior period financial statements should only be restated for errors that are material to those prior periods.***
- ***The determination of how to correct a material error should be based on the needs of current investors. For example, a material error that has no relevance to a current investment decision would not require amendment of the annual financial statements in which the error occurred, but would need to be promptly corrected and disclosed in the current period.***
- ***There may be no need for the filing of amendments to previously filed annual or interim reports to reflect restated financial statement, if the next annual or interim period report is being filed in the near future and that report will contain all of the relevant information.***
- ***Restatements of interim periods do not necessarily need to result in a restatement of an annual period.***
- ***Corrections of large errors should always be disclosed, even if the error was determined not to be material.***

We believe that all errors, excluding clearly insignificant errors, should be corrected no later than in the financial statements of the annual or interim period in which the error is discovered. The correction of errors, even errors that are not material, should not be deferred to future periods. Rather, companies should be required to correct all errors promptly and make appropriate disclosures about the correction, particularly when the errors are material, and should not have the option to defer recognition of errors until future financial statements. Notwithstanding the foregoing, immaterial errors discovered shortly before the issuance of the financial statements may not need to be corrected until the next annual or interim period being reported upon when earlier correction is impracticable.[14]

The current guidance that is detailed in SAB 108 (as codified in SAB Topic 1N) may result in the restatement of prior annual periods for immaterial errors occurring in those

[14] We understand that sometimes there may be immaterial differences between a preparer's estimate of an amount and the independent auditor's estimate of an amount that exist when financial statements are issued. These differences might or might not be errors, and may require additional work to determine the nature and actual amount of the error. This additional work is not necessary for the preparer or the auditor to agree to release the financial statements. Due care should be taken in developing any guidance in this area to provide an exception for these legitimate differences of opinion, and to ensure that any requirement to correct all "errors" would not result in unnecessary work for preparers or auditors.

periods because the cumulative effect of these prior period errors would be material to the current annual period, if the prior period errors were corrected in the current annual period. By correcting small errors when they are identified, a company will eliminate the possibility that the continuation of the error over a period of time will result in the total amount of the error becoming material to a company's financial statements and requiring correction at that time. Newly discovered errors that had occurred over a period of time when they were not material, however, would still trigger the need for correction. In the process of reflecting these immaterial corrections to prior annual periods, some believe that the prior annual period financial statements should indicate that they have been restated. There is diversity in practice on this issue, and clarification is needed from the SEC on the intent of SAB Topic 1N. We believe that prior annual period financial statements should not be restated for errors that are immaterial to the prior annual period. Instead of the approach specified in Topic 1N, we believe that, where errors are not material to the prior annual periods in which they occurred but would be material if corrected in the current annual period, the error could be corrected in the current annual period[15] with appropriate disclosure at the time the current annual period financial statements are filed with the SEC.

We believe that the determination of how errors should be corrected should be based on the needs of investors making current investment decisions. This determination should take into account the facts and circumstances of each error. For example, a prior period error that was material to that prior period but that does not affect the annual financial statements or financial information included within a company's most recent filing with the SEC may not need to be corrected through an amendment to prior period filings if the financial statements that contain the error are determined to be irrelevant to investors making current investment decisions. Such errors would be corrected in the period in which they are discovered with appropriate disclosure about the error and the periods impacted. This approach provide investors making current investment decisions with more timely financial reports and avoid the costs to investors of delaying prompt disclosure of current financial information in order for a company to correct multiple prior filings.

For material errors that are discovered within a very short time period prior to a company's next regularly scheduled reporting date, it may be appropriate in certain instances to report the restatement in the next filing with appropriate disclosure of the

[15] We are focused on the principle that prior periods should not be restated for errors that are not material to those periods. Correction in the current period of errors that are not material to prior periods could be accomplished through an adjustment to equity or to current period income (which might potentially require an amendment to GAAP). We believe that there are merits in both approaches and that the FASB and the SEC, as appropriate, should carefully weigh both approaches before determining the actual approach to utilize.

error and its impact on prior periods, instead of amending previous filings with the SEC. This option should be further studied with regard to the possibility of abuse and, if appropriate, should be included in the overall guidance on how to correct errors.

Assuming that there is an error in an interim period within an annual period for which financial statements have previously been filed with the SEC, the following guidance should be utilized:

- If the error is not material to either the previously issued interim period or to the previously issued annual period, the previously issued financial statements should not be restated.
- If the prior period error is determined to be material only to the previously issued interim period, but not the previously issued annual period, then only the previously issued interim period should be restated (i.e., the annual period that is already filed should not be restated and the Form 10-K should not be amended). However, there should be appropriate disclosure in the company's next Form 10-K to explain the discrepancy in the results for the interim periods during the previous annual period on an aggregate basis and the reported results for that annual period.

We believe that investors should be informed about all large errors when they are corrected. Even if a large error is determined to be not material because of qualitative factors, there should be appropriate disclosure about the error in the period in which the error is corrected.

We believe that the issuance by the FASB or the SEC, as appropriate, of guidance on how to correct and disclose errors in previously issued financial statements will provide to investors higher quality and more timely information (e.g., less delay occasioned by the need for restatement of prior period financial statements for errors that are not material and for errors that have no relevance to investors making current investment decisions) and reduce the burdens on companies related to the preparation of amended reports. Since our proposal would require prompt correction and full disclosure about all material errors, all large errors that are considered to be not material as well as many other types of errors, it would enhance transparency of accounting errors and help to eliminate the phenomenon of so called "stealth restatements" – when an error impacts past financial statements without disclosure of such error in current financial filings.

Developed Proposal 3.3: ***The FASB or the SEC, as appropriate, should issue guidance on disclosure during the period in which the restatement is being prepared, about the need for a restatement and about the restatement itself, to improve the adequacy of this disclosure based on the needs of investors:***

Typically, the restatement process involves three primary reporting stages:

1. The initial notification to the SEC and investors that there is a material error and that the financial statements previously filed with the SEC can no longer be relied upon;
2. The "dark period" or the period between the initial notification to the SEC and the time restated financial statements are filed with the SEC; and
3. The filing of restated financial statements with the SEC.

We believe that a major effect on investors due to restatements is the lack of information when companies are silent during stage 2, or the "dark period." This silence creates significant uncertainty regarding the size and nature of the effects on the company of the issues leading to the restatement. This uncertainty often results in decreases in the company's stock price. In addition, delays in filing restated financial statements may create default conditions in loan covenants; these delays may adversely affect the company's liquidity. We understand that, in the current legal environment, companies are often unwilling to provide disclosure of uncertain information. However, we believe that when companies are going through the restatement process, they should be encouraged to continue to provide any reasonably reliable financial information that they can, accompanied by appropriate explanations of ways in which the information could be affected by the restatement. Consequently, regulators should evaluate the company's disclosures during the "dark period," taking into account the difficulties of generating reasonably reliable information before a restatement is completed.

We believe that the current disclosure surrounding a restatement is often not adequate to allow investors to evaluate the company's operations and the likelihood that such errors could occur in the future. Specifically, we believe that all companies that have a restatement should be required to disclose information related to: (1) the nature of the error, (2) the impact of the error, and (3) management's response to the error, to the extent known, during all three stages of the restatement process. Some suggestions of disclosures that would be made by companies include the following:

Nature of error

- Description of the error
- Periods affected and under review
- Material items in each of the financial statements subject to the error and pending restatement
- For each financial statement line item, the amount of the error or range of potential error
- Identity of business units/locations/segments/subsidiaries affected

Impact of error

- Updated analysis on trends affecting the business if the error impacted key trends

This report has been prepared by the individual subcommittee and does not necessarily reflect either the views of the Committee or other members of the Committee, or the views or regulatory agenda of the Commission or its staff.

- Loan covenant violations, ability to pay dividends, and other effects on liquidity or access to capital resources
- Other areas, such as loss of material customers or suppliers

Management Response

- Nature of the control weakness that led to the restatement and corrective actions, if any, taken by the company to prevent the error from occurring in the future
- Actions taken in response to covenant violations, loss of access to capital markets, loss of customers, and other consequences of the restatement

If there are material developments related to the restatement, companies should update this disclosure on a periodic basis during the restatement process, particularly when quarterly or annual reports are required to be filed, and provide full and complete disclosure within the filing with the SEC that includes the restated financial statements.

Developed Proposal 3.4: ***The FASB or the SEC, as appropriate, should develop and issue guidance on applying materiality to errors identified in prior interim periods and how to correct these errors. This guidance should reflect the following principles:***

- ***Materiality in interim period financial statements must be assessed based on the perspective of the reasonable investor***
- ***When there is a material error in an interim period, the guidance on how to correct that error should be consistent with the principles outlined in developed proposal 3.2.***

Based on prior restatement studies, approximately one-third of all restatements involved only interim periods. Authoritative accounting guidance on assessing materiality with respect to interim periods is currently limited to paragraph 29 of APB Opinion No. 28, *Interim Financial Reporting*.[16] Differences in interpretation of this paragraph have resulted in variations in practice that have increased the complexity of financial reporting. This increased complexity impacts preparers and auditors, who struggle with determining how to evaluate the materiality of an error to an interim period, and also impacts investors, who can be confused by the inconsistency between how companies evaluate and report errors. We believe that guidance as to how to evaluate errors related to interim periods would be beneficial to preparers, auditors and investors.

[16] Paragraph 29 of APB Opinion No. 28, *Interim Financial Reporting*, states the following:

> In determining materiality for the purpose of reporting the cumulative effect of an accounting change or correction of an error, amounts should be related to the estimated income for the full fiscal year and also to the effect on the trend of earnings. Changes that are material with respect to an interim period but not material with respect to the estimated income for the full fiscal year or to the trend of earnings should be separately disclosed in the interim period.

We have observed that a large part of the dialogue about interim materiality has focused on whether an interim period should be viewed as a discrete period or an integral part of an annual period. Consistent with the view expressed at the outset of this section, we believe that the interim materiality dialogue could be greatly simplified if that dialogue were refocused to address two sequential questions: (1) What principles should be considered in determining the materiality of an error in interim period financial statements? and (2) How should errors in previously issued interim financial statements be corrected? We believe that additional guidance on these questions, which are extensions of the basic principles outlined in developed proposals 3.1 and 3.2 above, would provide useful guidance in assessing and correcting interim period errors. We believe that while these principles would assist in developing guidance related to interim periods, additional work should also be performed to fully develop robust guidance regarding errors identified in interim periods.

We believe that the determination of whether an interim period error is material should be made based on the perspective of a reasonable investor, not whether an interim period is a discrete period, an integral part of an annual period, or some combination of both. An interim period is part of a larger mix of information available to a reasonable investor. As one example, a reasonable investor would use interim financial statements to assess the sustainability of a company's operations and cash flows. In this example, if an error in interim financial statements did not impact the sustainability of a company's operations and cash flows, the interim period error may very well not be material given the total mix of information available. Similarly, just as a large error in annual financial statements does not determine by itself whether an error is material, the size of an error in interim financial statements should also not be necessarily determinative as to whether an error in interim financial statements is material.

We believe that applying the principles set forth above would reduce restatements by providing a company the ability to correct in the current period immaterial errors in previously issued financial statements and as a practical matter obviate the need to debate whether the interim period is a discrete period, an integral part of an annual period, or some combination of both.

We also note that these principles will provide a mechanism, other than restatement, to correct through the current period a particular error that has often been at the center of the interim materiality debate – a newly discovered error that has accumulated over one or more annual or interim periods, but was not material to any of those prior periods.

III. Judgment

III.A. Background

Overview

Judgment is not new to the areas of accounting, auditing, or securities regulation – the criteria for making and evaluating judgment have been a topic of discussion for many years. The recent increased focus on judgment, however, comes from several different developments, including changes in the regulation of auditors and a focus on more "principles-based" standards – for example, FASB standards on fair value and IASB standards. Investors will benefit from more emphasis on "principles-based" standards, since "rules-based" standards (as discussed in chapters 1 and 2) may provide a method, such as through exceptions and bright-line tests, to avoid the accounting objectives underlying the standards. If properly implemented, "principles-based" standards should improve the information provided to investors while reducing the investor's concern about "financial engineering" by companies using the "rules" to avoid accounting for the substance of a transaction. While preparers appear supportive of a move to less prescriptive guidance, they have expressed concern regarding the perception that current practice by regulators in evaluating judgments does not provide an environment in which such judgments may be generally respected. This, in turn, can lead to repeated calls for more rules, so that the standards can be comfortably implemented.

Many regulators also appear to encourage a system in which preparers can use their judgment to determine the most appropriate accounting and disclosure for a particular transaction. Regulators assert that they do respect judgments, but may also express concerns that some companies may attempt to inappropriately defend certain errors as "reasonable judgments." Identifying standard processes for making judgments and criteria for evaluating those judgments, after the fact, may provide an environment that promotes the use of judgment and encourages consistent evaluation practices among regulators.

Goals of Potential Guidance on Judgments

The following are several issues that any potential guidance related to judgments may help address:

a. Investors' lack of confidence in the use of judgment – Guidance on judgments may provide investors with greater comfort that there is an acceptable rigor that companies follow in exercising reasonable judgment.

b. Preparers' concern regarding whether reasonable judgments are respected – In the current environment, preparers may be afraid to exercise judgment for fear of having their judgments overruled, after the fact by regulators.

c. Lack of agreement in principle on the criteria for evaluating judgments – The criteria for evaluating reasonable judgments, including the appropriate role of hindsight in the evaluation, may not be clearly defined and thus may lead to increased uncertainty.

d. Concern over increased use of "principles-based" standards – Companies may be less comfortable with their ability to implement more "principles-based" standards if they are concerned about how reasonable judgments are reached and how they will be assessed.

Categories of Judgments that are Made in Preparing Financial Statements

There are many categories of accounting and auditing judgments that are made in preparing financial statements, and any guidance should encompass all of these categories, if practicable. Some of the categories of accounting judgment are as follows:

1. Selection of accounting standard

   In many cases, the selection of the appropriate accounting standard under GAAP is not a highly complex judgment (e.g., leases would be accounted for using lease accounting standards and pensions would be accounted for using pension accounting standards). However, there are cases in which the selection of the appropriate accounting standard can be highly complex.

   For example, the standards on accounting for derivatives contain a definition of a derivative and provide scope exceptions that limit the applicability of the standard to certain types of derivatives. To evaluate how to account for a contract that has at least some characteristics of a derivative, one would first have to determine if the contract met the definition of a derivative in the accounting standard and then determine if the contract would meet any of the scope exceptions that limited the applicability of the standard. Depending on the nature and terms of the contract, this could be a complex judgment to make, and one on which experienced accounting professionals can have legitimate differing, yet acceptable, opinions.

2. Implementation of an accounting standard

   After the correct accounting standard is identified, there are judgments to be made during its implementation.

> Examples of implementation judgments include determining if a hedge is effective, if a lease is an operating or a capital lease, and what inputs and methodology should be utilized in a fair value calculation. Implementation judgments can be assisted by implementation guidance issued by standards-setters, regulators, and other bodies; however, this guidance could increase the complexity of selecting the correct accounting standard, as demonstrated by the guidance issued on accounting for derivatives.

Further, many accounting standards use wording such as "substantially all" or "generally." The use of such qualifying language can increase the amount of judgment required to implement an accounting standard. In addition, some standards may have potentially conflicting statements.

3. <u>Lack of applicable accounting standards</u>

   There are some transactions that may not readily fit into a particular accounting standard. Dealing with these "gray" areas of GAAP is typically highly complex and requires a great deal of judgment and accounting expertise. In particular, many of these judgments use analogies from existing standards that require a careful consideration of the facts and circumstances involved in the judgment.

4. <u>Financial Statement Presentation</u>

   The appropriate method to present, classify and disclose the accounting for a transaction in a financial statement can be highly subjective and can require a great deal of judgment.

5. <u>Estimating the actual amount to record</u>

   Even when there is little debate as to which accounting standard to apply to a transaction, there can be significant judgments that need to be made in estimating the actual amount to record.

   For example, opinions on the appropriate standard to account for loan losses or to measure impairments of assets typically do not differ. However, the assumptions and methodology used by management to actually determine the allowance for loan losses or to determine an impairment of an asset can be a highly judgmental area.

6. Evaluating the sufficiency of evidence

   Not only must one make a judgment about how to account for a transaction, the sufficiency of the evidence used to support the conclusion must be evaluated. In practice, this is typically one of the most subjective and difficult judgments to make.

   Examples include determining if there is sufficient evidence to estimate sales returns or to support the collectability of a loan.

Levels of Judgment

There are many levels of judgment that occur related to accounting matters. Preparers must make initial judgments about uncertain accounting issues; the preparer's judgment may then be evaluated or challenged by auditors, investors, regulators, legal claimants, and even others, such as the media. Therefore, in developing potential guidance, differences in role and perspective between those who make a judgment and those who evaluate a judgment should be carefully considered. Guidance should not make those who evaluate a judgment re-perform the judgment according to the guidance. Instead, guidance should provide clarity to those who would make a judgment on factors that those who would evaluate the judgment would consider while making that evaluation.

Hindsight

The use of hindsight to evaluate a judgment where the relevant facts were not available at the time of the initial release of the financial statements (including interim financial statements) is not appropriate. Determining at what point the relevant facts were known to management, *or should have been known,*[17] can be difficult, particularly for regulators who are often evaluating these circumstances after substantial time has passed. Therefore, the use of hindsight should only be used based on the facts reasonably available at the time the annual or interim financial statements were issued.

Form of Potential Guidance

We believe that there are many different ways that potential guidance on judgment could be provided. To be successful, however, we believe that guidance on judgment should not eliminate debate, nor be inflexible or mechanical in application. Rather, the guidance should encourage preparers to organize their analysis and focus preparers and others on areas to be addressed; thereby improving the quality of the judgment and likelihood that

[17] We believe that those making a judgment should be expected to exercise due care in gathering all of the relevant facts prior to making the judgment.

regulators will accept the judgment. Any guidance issued should be designed to stimulate a rigorous, thoughtful and deliberate process rather than a checklist-based approach for making and evaluating judgments.

One potential way to accomplish the goals we set forth earlier as well as to guard against the potential that such guidance would develop into a checklist-based approach is for the SEC to formally state its approach to evaluating judgments. As discussed earlier in this report, one of the major concerns surrounding the use of judgment is the possibility of a regulator "second guessing" the reasonableness of a judgment after the fact. We believe that a primary cause of this concern is a lack of clarity and transparency into the process the SEC uses to evaluate the reasonableness of judgments. The SEC has articulated its policies in the past with success. Examples of previous articulations of policy by the SEC include the "Seaboard" report (October 23, 2001) relating to the impact of a company's cooperation on a potential SEC enforcement case and the SEC's framework for assessing the appropriateness of corporate penalties (January 4, 2006). We believe that a statement of policy could implement the goals we have articulated and therefore recommend that the SEC and the PCAOB issue statements of policy describing how they evaluate the reasonableness of accounting and auditing judgments.

The Nature and Limitations of GAAP:

Some have suggested that potential judgment guidance for the selection and implementation of GAAP be a requirement to reflect the economic substance of a transaction or be a standard of selecting the "high road" in accounting for a transaction. We agree that qualitative standards for GAAP such as these would be desirable and we encourage regulators and standards-setters to move financial reporting in this direction. However, such standards are not always present in financial reporting today and we cannot recommend the articulation of such standards in an SEC statement of policy without anticipating a fundamental long-term revision of GAAP – a change that would be beyond our purview and one that would not be doable in the near- or intermediate-term.

For example, there is general agreement that accounting should follow the substance and not just the form of a transaction or event. Many believe that this fundamental principle should be extended to require that all GAAP judgments should reflect economic substance. However, reasonable people disagree on what economic substance actually is, and many would conclude that significant parts of current GAAP do not require and do not purport to measure economic substance (e.g., accounting for leases, pensions, certain financial instruments and internally developed intangible assets are often cited as examples of items reported in accordance with GAAP that would not meet many reasonable definitions of economic substance).

Similarly, some would like financial reporting to be based on the "high road" – a requirement to use the most preferable principle in all instances. Unfortunately, today a preparer is free to select from a variety of acceptable methods allowed by GAAP (e.g., costing inventory, measuring depreciation, and electing to apply hedge accounting are just some of the many varied methods allowed by GAAP) without any qualitative standard required in the selection process. In fact, a preferable method is required to be followed only when a change in accounting principle is made, and a less preferable alternative is fully acceptable absent such a change.

We believe that adopting a requirement that accounting judgments reflect economic substance or the "high road" would require a revolutionary change not achievable in the foreseeable future. Our suggestion that the SEC issue a statement of policy relating to its evaluation of judgments could and we believe would enhance adherence to GAAP, but it cannot be expected to correct inherent weaknesses in the standards to which it would be applied.

III.B. Developed Proposals

We have developed the following proposal:

> ***Developed Proposal 3.5:*** ***The SEC should issue a statement of policy articulating how it evaluates the reasonableness of accounting judgments and include factors that it considers when making this evaluation. The PCAOB should also adopt a similar approach with respect to auditing judgments.***
>
> ***The statement of policy applicable to accounting-related judgments should address the choice and application of accounting principles, as well as estimates and evidence related to the application of an accounting principle. We believe that a statement of policy that is consistent with the principles outlined in this developed proposal to cover judgments made by auditors based on the application of PCAOB auditing standards would be very beneficial to auditors. Therefore, we propose that the PCAOB develop and articulate guidance related to how the PCAOB, including its inspections and enforcement divisions, would evaluate the reasonableness of judgments made based on PCAOB auditing standards. The PCAOB statement of policy should acknowledge that the PCAOB would look to the SEC's statement of policy to the extent the PCAOB would be evaluating the appropriateness of accounting judgments as part of an auditor's compliance with PCAOB auditing standards.***

We believe that it would be useful if the SEC also set forth in the statement of policy factors that it looks to when evaluating the reasonableness of preparers accounting judgments.

The Concept of Judgment in Accounting Matters

Judgment, with respect to accounting matters, should be exercised by a person or persons who have the appropriate level of knowledge, experience, and objectivity and form an opinion based on the relevant facts and circumstances within the context provided by applicable accounting standards. Judgments could differ between knowledgeable, experienced, and objective persons. Such differences between reasonable judgments do not, in themselves, suggest that one judgment is wrong and the other is correct. Therefore, those who evaluate judgments should evaluate the reasonableness of the judgment, and should not base their evaluation on whether the judgment is different from the opinion that would have been reached by the evaluator.

We have listed below various factors that we believe preparers should consider when making accounting judgments. The SEC may want to take these factors into account in developing its statement of policy. We also believe that a suggestion by the SEC that preparers should carefully consider these factors when making accounting judgments would be beneficial in not only increasing the quality of judgments, but also in making sure that the SEC and preparers will be able to more efficiently resolve potential differences during the SEC's review of preparer's filings. The mere consideration by a preparer of these factors in a SEC statement of policy would not prevent a regulator from asking appropriate questions about the accounting judgments made by the preparer or asking companies to correct unreasonable judgments, however. In fact, there is no guarantee that the preparer's consideration of the SEC's suggested factors articulated in a statement of policy would result in a reasonable judgment being reached. Rather, the statement of policy should be designed to encourage preparers to organize their analysis and focus preparers and others on areas that would be the focus of the SEC's review, thereby improving the quality of the judgment and likelihood that regulators will accept the judgment. We encourage the SEC to seek to accept a range of alternative reasonable judgments when preparers make good faith attempts to reach a reasonable judgment. A preparer's failure to follow the SEC's suggested factors in its statement of policy, however, would not imply that the judgment is unreasonable.

We would expect that, in the evaluation of judgments made using the factors that are cited below, the focus would be on significant matters requiring judgment that could have a material effect on the financial statements taken as a whole. We recognize that the facts and circumstances of each judgment may indicate that certain factors are more important than others. These factors would have a greater influence in an evaluation of the reasonableness of a judgment made by a preparer.

Factors to Consider when Evaluating the Reasonableness of a Judgment

While we believe that the SEC should articulate the factors that it uses when evaluating the reasonableness of a judgment, we believe that the statement of policy would be even more useful to preparers if the SEC also made suggestions for ways in which accounting judgments could be made.

We believe that accounting judgments should be based on a critical and reasoned evaluation made in good faith and in a rigorous, thoughtful and deliberate manner. We believe that preparers should have appropriate controls in place to ensure adequate consideration of all relevant factors. Factors applicable to the making of an accounting judgment include the following:

1. The preparer's analysis of the transaction, including the substance and business purpose of the transaction
2. The material facts reasonably available at the time that the financial statements are issued
3. The preparer's review and analysis of relevant literature, including the relevant underlying principles
4. The preparer's analysis of alternative views or estimates, including pros and cons for reasonable alternatives
5. The preparer's rationale for the choice selected, including reasons for the alternative or estimate selected and linkage of the rationale to investors' information needs and the judgments of competent external parties
6. Linkage of the alternative or estimate selected to the substance and business purpose of the transaction or issue being evaluated
7. The level of input from people with an appropriate level of professional expertise[18]
8. The preparer's consideration of known diversity in practice regarding the alternatives or estimates[19]
9. The preparer's consistency of application of alternatives or estimates to similar transactions
10. The appropriateness and reliability of the assumptions and data used.
11. The adequacy of the amount of time and effort spent to consider the judgment.

[18] In many cases, input from professional experts would include consultation with a preparer's independent auditors or other competent external parties, such as valuation specialists, actuaries or counsel

[19] If there is not diversity in practice, it would be significantly harder to select a different alternative.

When considering these factors, it would be expected that the amount of documentation, disclosure, input from professional experts, and level of effort in making a judgment would vary based on the complexity, nature (routine versus non-routine) and materiality of a transaction or issue requiring judgment.

Material issues or transactions should be disclosed appropriately. We note that existing disclosure requirements should be sufficient to generate[20] transparent disclosure that enables an investor to understand the transaction and assumptions that were critical to the judgment. The SEC has provided in the past, and should continue to consider providing, additional guidance on existing disclosure requirements to encourage more transparent disclosure. In addition, when evaluating the reasonableness of a judgment, regulators should take into account the disclosure relevant to the judgment.

Documentation – The alternatives considered and the conclusions reached should be documented contemporaneously. The lack of contemporaneous documentation may not mean that a judgment was incorrect, but would complicate an explanation of the nature and propriety of a judgment made at the time of the release of the financial statements.

[20] Existing disclosure requirements would include the guidance on critical accounting estimates in the Commissions Release No. 33-8350 “Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations, the Commissions Release No. 33-8040 “Cautionary Advice Regarding Disclosure About Critical Accounting Policies” and Accounting Principles Board Opinion No. 22 “Disclosure of Accounting Policies”. We also encourage the SEC to continue to remind preparers of ways to improve the transparency of disclosure, such as through statements like the Sample Letter sent to Public Companies on MD&A Disclosure Regarding the Application of SFAS 157 (Fair Value Measurements) issued by the Division of Corporation Finance in March 2008.