SEC Advisory Committee on Improvements to Financial Reporting
Subcommittee III: Audit Process and Compliance
Report for Discussion at November 2, 2007 Full Committee Meeting

Introduction

Subsequent to the August 2, 2007 meeting of the SEC Advisory Committee on Improvements to Financial Reporting (Advisory Committee), committee members have formed four subcommittees to address the issues raised in Robert Pozen's discussion paper dated July 31, 2007 (Discussion Paper).

The attached report summarizes the efforts of the Audit Process and Compliance subcommittee thus far. At the November 2, 2007 full committee meeting, the subcommittee will present this report for discussion by the full committee.

Members: Mike Cook, Chair
Ed Nusbaum
Greg Jonas
Linda Griggs

Observers: Larry Smith, FASB (Observer for FASB Chairman Robert Herz)
Dan Goelzer, PCAOB (Observer for PCAOB Chairman Mark Olson)

Scope of Work Plan

Based on the Discussion Paper, the subcommittee identified the following areas for further deliberation:

- Financial Restatements
- Use of Judgment
- Regulation and Compliance issues including
    - PCAOB
    - SEC
    - Audit Firms

The subcommittee has concentrated its efforts to date primarily on the subject of Financial Restatements and whether the provision of guidance with respect to the materiality of errors would be beneficial, with some limited discussion on the Use of Judgment and whether a judgment framework would enhance the exercise of judgment. The Subcommittee intends to finalize recommendations on Financial Restatements for the January full committee meeting, and then focus on the impact of the PCAOB, the SEC and audit firms on complexity of financial reporting and the exercise of judgment.

<u>Questions for the Full Committee</u>:

1) Does the full committee agree with the subcommittee's preliminary scope, which we believe is consistent with the original discussion paper?

Deliberations and Preliminary Hypotheses

<u>Financial Restatements</u>

Potential causes of restatements

A significant and increasing number of restatements have occurred in the U.S. financial markets over the past few years. Some have attributed these restatements to more rigorous interpretations of accounting and reporting standards by preparers, outside auditors, the SEC and the PCAOB, while others believe the concept of materiality[1] (and discussions regarding materiality in SEC Staff Accounting Bulletin (SAB) 99 (as codified in SAB topic 1M)) is applied too broadly (i.e. resulting in errors being deemed to be material when an investor may not find them to be important). The subcommittee considered the potential causes of restatements and concluded that complex accounting standards, such as classification of equity instruments as liabilities or equity, do create an environment that leads to an increased potential for restatements. The subcommittee believes that standard setters should closely monitor restatement trends to determine if there are particular areas where the current accounting standards could be improved (for example, the FASB could consider prioritizing its liabilities and equity project due to the high number of restatements in this area) to prevent restatements. The subcommittee understands from Chairman Pozen's Discussion Paper that another CIFiR subcommittee is looking into the standard setting process. The subcommittee believes that there is potential benefit in the short term in examining the concept, application and guidance regarding materiality, and the process for restatements.

Research by Subcommittee

The subcommittee undertook a review of several publicly available studies on restatements, including the U.S. Government Accountability Office (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*

[1] 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).

Restatements A Six Year Comparison" (February 2007) and "*Financial Restatements and Market Reactions*" (October 2007). The subcommittee also reviewed findings from the PCAOB's Office of Research and Analysis's (ORA) working paper released October 18, 2007, "Changes in Market Responses to Financial Statement Restatement Announcements in the Sarbanes-Oxley Era," understanding that ORA's findings are still preliminary in nature as the study is still going through a peer review process. The subcommittee understands that the Treasury Department also has recently announced the selection of University of Kansas Professor Susan Scholz to conduct an examination of the impact of and the reasons behind public company financial restatements. The subcommittee will monitor the Treasury Department's study and incorporate its findings as they are made available.

The restatement studies reviewed all indicate that the number of restatements has increased in recent years. The subcommittee believes that market reaction can be one factor relevant in evaluating materiality, and based on these studies it would appear that there may be many restatements occurring that investors do not consider important due to a lack of a statistically significant market reaction. While there are limitations to using market reaction as a proxy for materiality, the subcommittee believes that these studies indicate that a reduction in the number of restatements is appropriate and worth trying to achieve. Examples of the limitations 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) that the impact on the market of factors other than the restatement and 3) the disclosure at the time of the restatement of positive information, such as an earnings release, that may have an offsetting positive market reaction. The subcommittee believes that additional guidance on applying materiality in the context of determining whether a restatement is necessary may be beneficial to achieve that outcome.

The subcommittee also gathered input from equity and credit analysts and others about investor's views on materiality and how restatements are viewed in the marketplace. Feedback 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 or not.
- One of the major costs of restatements for investors is the amount of time between the restatement announcement and the final resolution of the restatement, including potential delisting of the company's stock.
- The disclosure provided on restatements is not adequate. Notably, the disclosure does not clearly explain how the error was detected and why the restatement occurred.
- Interim periods should be viewed as discrete periods for purposes of making materiality judgments.

Prospective Accounting for Errors

Some have suggested that current investors would be better served if certain accounting changes were made prospectively (for purposes of this discussion, prospective accounting refers only to the method by which an error is corrected, specifically a cumulative correction in the current period, and not the timing of when the correction is made, such as when a filing is amended with the Commission), rather than through restatement. This would reserve restatements for only the most severe errors (i.e., those that were made intentionally, involved fraud, significantly misrepresented a company's financial performance, etc.). Under such a view, misapplications of technical accounting literature would perhaps not always result in restatements of prior period financial statements. Under SFAS 154 (and previously APB 20), a correction of a material error must be reflected as a restatement. Since current GAAP requires that any material error be accounted for as a restatement, this issue may be inseparable from the consideration of materiality standards.

The subcommittee looked into the option of prospective accounting for errors and considered the following issues associated with prospective accounting treatment:

- If changes were made to SFAS 154 to allow for the prospective treatment of certain material errors, yet retrospective accounting for other material errors, adding another choice to the process could potentially increase the complexity related to the restatement process and would force people to make judgments regarding not only the materiality of an error, but also the severity of the error.
- If some or all material errors were accounted for as a cumulative correction in a current period, then the impact on historical periods would not be presented to investors. Investors may use historical periods in part to obtain information to project the future of a company. If an error is material, in that it would alter the total mix of information an investor would consider, then prospective accounting treatment may not provide sufficiently complete information to investors.
- In evaluating whether prior financial statements should be restated, should the needs of both current and prior investors be considered? A material error may be less important to a current investor due to, for example, the amount of time that has passed since the period in which the error originated, but would have been important to an investor during the originating period.

Based on consideration of the above issues and feedback that the subcommittee received during its deliberations, the subcommittee's preliminary finding is that the determination whether historical financial statements should be restated should be based on the interests of current investors, with sufficient disclosure to inform prior investors about errors that were not determined to be important to current investors. The subcommittee also believes that, if an error in a period that is still relevant to current investors is material, then retrospective treatment is generally the appropriate method of accounting for the error.

Preliminary findings regarding Restatements

Based on its work to date, the subcommittee has developed the following list of preliminary findings for consideration by the full committee.

A. Materiality

1. The subcommittee believes that those who judge the need for restatement of financial statements because of an error should make the decision based upon the current investor's interests. The subcommittee believes that too many restatement judgments are being made in practice without full consideration of how a current investor would evaluate the error. One improvement to this process could be to look at analysts' investment models or credit rating models to determine the impact of an error. For example, the major credit rating agencies publish their credit ratings models (as do many sell-side investment analysts). One could take these models and determine the impact of the error on a company's indicated credit rating (or analyst estimated market price). Another potential improvement to making judgments with respect to the need for restatement to correct an error would be for a company to consult with independent valuation experts (such as firms that would provide fairness opinions) to evaluate the potential impact of an error from an investor's perspective.
2. The subcommittee believes that quantitatively significant errors are presumptively material but that, in certain circumstances, qualitative factors can make a quantitatively significant error not be material (See Appendix A to this memorandum for a listing of certain qualitative factors the subcommittee believes would be relevant to this evaluation). The subcommittee believes that, in current practice, materiality guidance such as SAB Topic 1M is interpreted as being one-directional in that qualitative considerations can make a quantitatively insignificant error material, but a quantitatively significant error is material without regard to qualitative factors. The subcommittee believes that materiality guidance should be similar in both directions. Specifically, the subcommittee believes that there should be a "sliding scale" for evaluating errors. On this scale, the higher the quantitative significance of an error, the stronger the qualitative factors must be to result in a judgment that the error is not material. Conversely, the lower the quantitative significance of an error, the stronger the qualitative factors must be to result in a judgment that the error is material. For example, depending on the individual circumstances of a company, errors that were less than 5%

of pretax earnings would have a rebuttable presumption that the error is not material, while errors that were in excess of 10% of pretax earnings would have a rebuttable presumption that the error is material. The subcommittee believes that judgments regarding the need for a restatement of financial statements should be made based on the total mix of information available to investors.

3. The subcommittee believes that the goal of companies should be to record errors, excluding clearly insignificant errors and errors resulting from normal accounting conventions, no later than in the financial statements of the period in which the error was discovered.

B. Restatement Process

1. The subcommittee believes that the current disclosure surrounding a restatement is not adequate. The subcommittee believes that all companies that have a restatement should be required to disclose the following information, in addition to the amount of the restatement and the periods impacted, with prominent location within a filing with the SEC:
   - How the restatement was discovered
   - Why the restatement occurred, including clear disclosure of any control weakness that led to the restatement, even if the control weakness was not determined to be a material weakness.
   - Corrective actions, if any, taken by the company to prevent the error from occurring in the future
2. The subcommittee believes that one of the major costs to investors related to restatements is the lack of information caused when companies are silent during the restatement process. The subcommittee understands that in the current legal environment, companies are often unwilling to provide disclosure of uncertain information. The subcommittee believes that when companies are going through the restatement process, they should be encouraged to continue to provide financial information so that investors understand the company's results and financial condition as much as possible. Therefore, the subcommittee is considering whether the full committee should recommend that the Commission consider establishing guidelines whereby a company could have a safe-harbor to disclose this information assuming the company provided appropriate disclosure to investors regarding the potential uncertainty of the information.
3. The subcommittee believes that the need to amend prior filings should be revisited. Currently, a restatement may result in the need for immediate amendment of many separate filings across multiple periods. The subcommittee believes that certain restatements may not require immediate action (the amendment could occur during the next regular periodic filing for

a company) and that in the majority of situations, only the financial statements that would be included in a company's most recent filing would require restatement. The subcommittee believes that the guidance in this area should be revisited to develop a framework that suits the needs of current investors.

C. Areas under Further Consideration

- Materiality related to interim periods – Based on the restatement studies the subcommittee examined, approximately one-third of all restatements related to interim periods. However, there is not currently much authoritative guidance on assessing materiality with respect to interim periods outside of paragraph 29 of APB 28, *Interim Financial Reporting*[2], which was issued over 30 years ago in an environment where interim reporting was viewed differently than today. Current practice on this issue is mixed. Some people view that APB 28 allows all materiality judgments to be made based on the impact of an error on the annual period. Others believe that errors in the current interim periods should be evaluated solely on the basis of the impact of the error on the interim period. The subcommittee is leaning towards a recommendation based on the latter view with the caveat that errors that originated in an interim period (these errors would be evaluated based on the impact to the interim period) would be distinguished from the cumulative effect of catching up a prior period error in the current interim period (these would be evaluated based on the impact to the current annual period). The subcommittee plans additional deliberations on this subject.
- Errors related to the cash flow statement and balance sheet and errors related solely to financial statement disclosures – Restatements due to classification errors continue to increase. SAB Topic 1M does not explicitly address errors in the cash flow statement or the balance sheet. Therefore, in practice, many preparers and auditors will evaluate the magnitude of a balance sheet or cash flow statement error in the same manner that they would evaluate an error that affected net income or total equity. This includes classification errors on the balance sheet or cash flow statement. The subcommittee plans to explore if additional guidance on evaluating the materiality of balance sheet and cash flow statement errors would be helpful and what quantitative or qualitative factors should be considered when evaluating these errors. In addition, the subcommittee plans to explore if additional guidance on evaluating errors that relate solely to a financial statement disclosure would be helpful in reducing restatements.

[2] "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."

Questions for the Full Committee:

1) Does the full committee agree with the subcommittee's preliminary findings regarding materiality guidance with respect to the need for restatements of historical financial statements? What changes, if any, would the full committee suggest?
2) Does the full committee agree with the subcommittee's preliminary recommendations regarding the restatement process? What changes, if any, would the full committee suggest?
3) Does the full committee agree with the subcommittee's leanings regarding the areas still under further consideration? What changes, if any, would the full committee suggest?

Professional Judgment

Companies and auditors agree, in principle, that a system in which professionals can use their judgment to determine the most appropriate accounting and disclosure for a particular transaction is preferable to a checklist-based approach. However, both groups continue to express skepticism that such a system could be fully successful without confidence that reasonable judgments would be respected. Regulators assert that they do respect reasonable judgments, but also express concern that companies and auditors attempt to defend certain clear cut errors as "reasonable judgments."

The subcommittee is exploring the development of a recommendation to the full committee regarding a "professional judgment framework" that could potentially serve as a safe-harbor when accounting judgments are required. An agreed-upon framework may provide companies and auditors comfort that the chances of being second-guessed have been sufficiently mitigated. A framework could also potentially address concerns by investors and others by instilling discipline in management's processes.

Framework elements

The subcommittee is considering a framework with 3 broad elements; accounting; documentation; and disclosure. Are each of these elements valid? Should the Subcommittee consider other elements?

Accounting

- Should the proposed framework suggest that a judgment be made based on an assessment of the most transparent way to display the economic substance of the transaction or the accounting treatment that results in a "highest common denominator"? Would this imply that any conclusion that would not result in the most transparent way to display the economic substance of the transaction or the most preferable accounting could be questioned?

- Should the proposed framework suggest that a judgment be made based upon a reasonable analysis of the relevant accounting literature"?
- Should the framework include discussion of the business purpose related to the accounting or auditing issue subject to the judgment?
- Should the framework measure judgment against accounting principles and consistency of a judgment with those principles?
- Should the framework consider other accounting-related criteria?

Documentation

- Should the proposed framework require that <u>the basis for conclusions and alternatives considered and documented contemporaneously?</u> That is, was the issue thoroughly considered before management filed the financial statements with the Commission?
- Should the framework include guidance on the levels of review a professional judgment should go through (e.g., was the audit committee or were the external auditors involved, or did the judgment involve sufficient internal or external subject matter experts)?

Disclosure

- Should the proposed framework contain a standard of "<u>Was the accounting method transparently disclosed, such that all pertinent information was available to investors?</u>"

Other Issues

- Would a framework actually help with reducing the potential for second guessing related to professional judgments, or does it simply replace the evaluation of the original judgment with evaluations of the sufficiency of the accounting conclusion, the documentation, and the disclosure of the issue?
- How should the framework address the issue of hindsight (those who would evaluate the judgment would have more information available to them than the person(s) making the judgment)?
- Should the recommendation be that the framework be set up as a safe-harbor, or should the framework be guidance from the Commission that is intended to provide insight on what the Commission would consider when evaluating professional judgments? If this framework were set up as a safe-harbor, from what is it providing a safe-harbor?
- Should the subcommittee consider a similar framework for auditors? What types of factors should a framework for auditors include?

Questions for the Full Committee:

1) Does the full committee agree with the subcommittee's preliminary leanings that a professional judgment framework could be useful or should the subcommittee focus more on providing guidance on the use of professional judgment? What changes, if any, would the full committee suggest?
2) Does the full committee have any comments or inputs into the questions the subcommittee is deliberating regarding a potential professional judgment framework?

Current Status and Further Work

The subcommittee expects to finalize its findings regarding restatements and materiality guidance for the January 2008 full committee meeting.

The subcommittee expects to focus on the issue of professional judgment and attempt to have preliminary recommendations for the January 2008 full committee meeting.

The subcommittee plans to focus on regulation and compliance issues after the January 2008 full committee meeting.

Coordination with Other Subcommittees

The subcommittee is referring to Subcommittee II the issue of having standard setters review restatement studies to determine if there are areas, indicated by a high number of similar restatements, where either current standards need to be reassessed or new standards are needed.

Appendix A
Tentative List of Qualitative Factors that Could Result In Large Errors Being Immaterial

Concepts:

- By definition, materiality is judged through the eyes of a "reasonable" investor. Thus, those that judge materiality to an investor must understand investors' models and perspectives, to determine whether an error is material to an investors' valuation or assessment of risk.

- Qualitative factors about an error can both lower and raise its relative importance to a reasonable investor. Thus, it is possible that errors could be quantitatively large, but still not be important to investors. This view is in contrast to how SAB Topic 1M is often applied in practice, which tends to view qualitative factors as a one-way street that can only scope in more items as material.

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

- The error impacts metrics that do not drive the investors' conclusions or are not important to the investors' models.
- Errors that investors view as affecting a single period rather than affecting an ongoing trend.
- The misstatement does not impact investors' impressions of key trends they deem important.
- The misstatement does not impact a business segment or other portion of the registrant's business that investors see as driving valuation or risks.
- Errors that occurred in the distant past (e.g. more than 5 years ago) for which the correction would not be useful to current investors.
- Errors that relate to financial statement items whose measurement are inherently highly imprecise.
- The market's reaction to initial press release disclosures about the error are small.