

Financial reporting developments

A comprehensive guide

Accounting changes and error corrections

Revised July 2025



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Accounting Standards Codification (ASC) 250, *Accounting Changes and Error Corrections*, includes financial accounting and reporting guidance for changes in accounting. Changes in accounting include changes in accounting principle, changes in estimates and changes in reporting entity. ASC 250 also provides financial accounting and reporting guidance for error corrections.

This publication is designed to assist professionals in understanding the financial reporting issues associated with accounting changes as well as error corrections. This publication includes excerpts from and references to ASC 250, interpretive guidance and examples. It also provides insights from the Securities and Exchange Commission (SEC) staff and our interpretive guidance.

This publication has been updated to provide further clarifications and enhancements to our interpretive guidance. Refer to Appendix D for a summary of substantive updates to this publication.

We hope this publication will help you understand and apply the accounting and reporting guidance for accounting changes and error corrections. EY professionals are prepared to assist you in your understanding and are ready to discuss your concerns and questions.

The logo for Ernst & Young LLP, featuring the company name in a stylized, handwritten-style script.

July 2025

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Notice to readers:

This publication includes excerpts from and references to the Financial Accounting Standards Board (FASB or Board) Accounting Standards Codification (Codification or ASC). The Codification uses a hierarchy that includes Topics, Subtopics, Sections and Paragraphs. Each Topic includes an Overall Subtopic that generally includes pervasive guidance for the Topic and additional Subtopics, as needed, with incremental or unique guidance. Each Subtopic includes Sections that in turn include numbered Paragraphs. Thus, a Codification reference includes the Topic (XXX), Subtopic (YY), Section (ZZ) and Paragraph (PP).

Throughout this publication references to guidance in the Codification are shown using these reference numbers. References are also made to certain pre-Codification standards (and specific sections or paragraphs of pre-Codification standards) in situations in which the content being discussed is excluded from the Codification.

This publication has been carefully prepared, but it necessarily contains information in summary form and is therefore intended for general guidance only; it is not intended to be a substitute for detailed research or the exercise of professional judgment. The information presented in this publication should not be construed as legal, tax, accounting, or any other professional advice or service. Ernst & Young LLP can accept no responsibility for loss occasioned to any person acting or refraining from action as a result of any material in this publication. You should consult with Ernst & Young LLP or other professional advisors familiar with your particular factual situation for advice concerning specific audit, tax or other matters before making any decisions.

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1

Introduction

Excerpt from Accounting Standards Codification

Accounting Changes and Error Corrections – Overall

Overview and Background

General

250-10-05-1

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

Accounting Changes

250-10-05-2

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

250-10-05-3

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

Error Corrections

250-10-05-4

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

250-10-05-5

This Subtopic also:

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

ASC 250 provides guidance on the accounting for and reporting of accounting changes, including a change in accounting principle, a change in accounting estimate and a change in reporting entity. ASC 250 provides that a change in accounting estimate that is effected by a change in accounting principle (e.g., a change in

depreciation method for long-lived assets) is accounted for as a change in estimate. ASC 250 also applies to changes required by an Accounting Standards Update (ASU) in the rare case that the ASU does not include specific transition provisions. When an ASU includes specific transition provisions, those provisions are followed. ASC 250 also addresses the correction of an error in previously issued financial statements. A correction of an error in previously issued financial statements is not an accounting change. However, similar to retrospectively reporting changes in accounting, the reporting of an error correction may involve adjustments to previously issued financial statements depending on the materiality of the error to the current period and prior period(s) financial statements.

There is a general presumption that an accounting principle, including methods of applying a principle, once adopted should not be changed. That presumption may be overcome only if the company justifies the use of an alternative acceptable accounting principle on the basis that it is preferable in accordance with ASC 250. See section 3, *Change in accounting principle*, for additional detail.

ASC 250 requires retrospective application to prior periods' financial statements of changes in accounting principle unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. When it is impracticable to determine the period-specific effects of an accounting change on one or more individual prior periods presented, ASC 250 requires that the new accounting principle be applied to the balances of assets and liabilities as of the beginning of the earliest period for which retrospective application is practicable and that a corresponding adjustment be made to the opening balance of retained earnings (or other appropriate components of equity or net assets in the statement of financial position) for that period rather than being reported in an income statement. When it is impracticable to determine the cumulative effect of applying a change in accounting principle to all prior periods, ASC 250 requires that the new accounting principle be applied as if it were adopted prospectively from the earliest date practicable.

Excerpt from Accounting Standards Codification**Accounting Changes and Error Corrections – Overall*****Scope and Scope Exceptions******Entities******250-10-15-2***

The guidance in this Subtopic applies to all entities.

Other Considerations***250-10-15-3***

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

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

250-10-15-4

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

ASC 250 applies to financial statements of all entities, including public and private business entities and not-for-profit organizations (collectively referred to herein as “entities”). ASC 250 also applies to historical summaries of information based on the primary financial statements that include an accounting period in which an accounting change or error correction is reflected, such as the selected financial data SEC registrants may elect to disclose in their filings. For example, if the company presents a table with five years of selected financial data, the table should be adjusted to reflect the accounting change or error correction so that all periods are presented using the same basis of accounting, not just the years included in the basic financial statements. While its application is not required, the ASC 250 guidance also may be appropriate in presenting financial information in other forms or for other special purposes. Generally, the provisions of ASC 250 will not be applicable to the initial application of new ASUs. In most instances, specific transition guidance is included in an ASU. However, in the rare case that specific transition guidance is not included in an ASU, the provisions of ASC 250 would be applicable.

3 Change in accounting principle

Excerpt from Accounting Standards Codification

Accounting Changes and Error Corrections – Overall

Other Presentation Matters

Change in Accounting Principle

250-10-45-1

A presumption exists that an accounting principle once adopted shall not be changed in accounting for events and transactions of a similar type. Consistent use of the same accounting principle from one accounting period to another enhances the utility of financial statements for users by facilitating analysis and understanding of comparative accounting data. Neither of the following is considered to be a **change in accounting principle**:

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

250-10-45-2

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

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

250-10-45-3

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

250-10-45-4

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

250-10-45-5

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

- a. The cumulative effect of the change to the new accounting principle on periods prior to those presented shall be reflected in the carrying amounts of assets and liabilities as of the beginning of the first period presented.

- b. An offsetting adjustment, if any, shall be made to the opening balance of retained earnings (or other appropriate components of equity or net assets in the statement of financial position) for that period.
- c. Financial statements for each individual prior period presented shall be adjusted to reflect the period-specific effects of applying the new accounting principle.

250-10-45-6

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

250-10-45-7

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

250-10-45-8

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

ASC 250 presumes that, once adopted, an accounting principle (including the method of applying that principle) shall not be changed in accounting for events or transactions of a similar type. ASC 250-10-45-1 provides that the following are not changes in accounting principle:

- a. The initial adoption of an accounting principle in recognition of events or transactions occurring for the first time or that previously were immaterial in their effect.

And

- b. The adoption or modification of an accounting principle necessitated by transactions or events that are clearly different in substance from those previously occurring.

ASC 250-10-45-2 requires that an entity change an accounting principle only if (a) the change is required by a newly issued Codification update or (b) the entity can justify the use of an allowable alternative accounting principle on the basis that it is preferable. For further discussion of preferability considerations, see section 3.4, *Justification for a change in accounting principle*.

The transition provisions for newly issued Codification updates that do not provide specific transition requirements would follow the guidance in ASC 250 (i.e., retrospective application of the new principle to prior periods). Although ASC 250-10-45-1 establishes the default transition provisions for all newly issued ASUs, the FASB expects that new ASUs will normally provide specific transition requirements and, therefore, application of ASC 250 to newly issued ASUs is expected to be rare.

Some examples of voluntary changes in accounting principle include, but are not limited to, the following:

1. Change in inventory valuation method (i.e., from last-in-first-out (LIFO) to first-in-first-out (FIFO), retail inventory method to weighted-average cost)
2. Change in method of amortizing actuarial gains and losses pursuant to ASC 715-30, *Defined Benefit Plans – Pension*, and/or ASC 715-60, *Defined Benefit Plans – Other Postretirement*
3. Change in measurement date for conducting annual goodwill impairment test
4. Change in accounting principle to one required for a public company in anticipation of the filing of an initial public offering registration statement in the future

Changes in the method of applying an accounting principle (e.g., changing the method of applying a significant estimation process such as changing the number of LIFO pools used in a LIFO calculation) also would be subject to the accounting described in section 3.1, *Accounting for a change in accounting principle*, and the preferability requirements described in section 3.4, *Justification for a change in accounting principle*.

3.1

Accounting for a change in accounting principle

Excerpt from Accounting Standards Codification

Accounting Changes and Error Corrections – Overall

Glossary

250-10-20

Retrospective Application

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

Restatement

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

ASC 250 requires entities to report a change in accounting principle through retrospective application of the new principle to all prior periods unless it is impracticable to do so.

ASC 250-10-20 draws a distinction between retrospective application and restatement. This distinction is intended to reflect the conclusion that (1) it is preferable to use the same terms as International Financial Reporting Standards (IFRS) whenever possible to reduce the potential for inconsistent application of accounting principles and (2) a terminology change would better distinguish changes in amounts reported for prior periods related to a voluntary change in accounting principle (presumed to be “good” changes based on preferability) from those changes related to the correction of an error. It is anticipated that the distinction in terminology will help eliminate the negative connotation associated with all changes to prior-period financial statements and reserve the term “restatement” for those changes required by the correction of an error.

Retrospective application of a change in accounting principle requires the following:

- a. The cumulative effect of the change to the new accounting principle on periods prior to those presented is reflected in the carrying amounts of assets and liabilities as of the beginning of the first period presented.

- b. An offsetting adjustment, if any, is made to the opening balance of retained earnings (or other appropriate components of equity or net assets in the statement of financial position) for that period.
- c. Financial statements for each individual prior period presented are adjusted to reflect the period-specific effects of applying the new accounting principle.

As discussed further below, ASC 250 also requires a change in accounting principle made in an interim period to be reported by retrospective application.

Use of the retrospective application approach, as if a newly adopted accounting principle had always been used, results in greater consistency of financial information reported across periods. Further, with regard to recognizing the cumulative effect of a change in accounting principle in opening retained earnings, the FASB concluded in the Basis for Conclusions (paragraph B12) of FASB Statement No. 154, *Accounting Changes and Error Corrections* (codified as ASC 250), that it would be inappropriate to record the cumulative effects on prior periods in net income of the period of change because none of the effects relate to that period. Accordingly, while new ASUs may, under certain circumstances, require recognizing a cumulative effect as of a specific date as the transition method, that cumulative effect will be recognized in retained earnings as opposed to net income in the period of the change. The below illustration is reproduced from Example 1 in ASC 250-10-55.

Illustration 3-1: Retrospective application of a change in accounting principle

ABC Company decides at the beginning of 20X7 to adopt the FIFO method of inventory valuation. ABC Company had used the LIFO method for financial and tax reporting since its inception on 1 January 20X5 and had maintained records that are adequate to apply the FIFO method retrospectively. ABC Company concluded that the FIFO method is the preferable inventory valuation method for its inventory. The change in accounting principle is reported through retrospective application.

The effects of the change in accounting principle on inventory and cost of sales are presented in the following table:

Date	Inventory determined by		Cost of sales determined by	
	LIFO method	FIFO method	LIFO method	FIFO method
1-1-20X5	\$ 0	\$ 0	\$ 0	\$ 0
12-31-20X5	100	80	800	820
12-31-20X6	200	240	1,000	940
12-31-20X7	320	390	1,130	1,100

This example is based on the following assumptions:

- a. For each year presented, sales are \$3,000 and selling, general and administrative costs are \$1,000. ABC Company's effective income tax rate for all years is 40 percent, and there are no permanent or temporary differences under ASC 740-10, *Income Taxes – Overall*, prior to the change.
- b. ABC Company has a nondiscretionary profit-sharing agreement in place for all years. Under that agreement, ABC Company is required to contribute ten percent of its reported income before tax and profit sharing to a profit-sharing pool to be distributed to employees. For simplicity, it is assumed that the profit-sharing contribution is not an inventoriable cost.
- c. ABC Company determined that its profit-sharing expense would have decreased by \$2 in 20X5 and increased by \$6 in 20X6 if it had used the FIFO method to compute its inventory cost since inception. The terms of the profit-sharing agreement do not address whether ABC Company is required to adjust its profit-sharing accrual for the incremental amounts.¹ At the time of the accounting change, ABC Company decides to contribute the additional \$6 attributable to 20X6 profits and to make no adjustment related to 20X5 profit. The \$6 payment is made in 20X7.

- d. Profit sharing and income taxes accrued at each year-end under the LIFO method are paid in cash at the beginning of each following year.
- e. ABC Company's annual report to shareholders provides two years of financial results, and ABC Company is not subject to the requirements of ASC 260, *Earnings Per Share*.

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

Income statement

	20X6	20X5
Sales	\$ 3,000	\$ 3,000
Cost of goods sold	1,000	800
Selling, general, and administrative expenses	<u>1,000</u>	<u>1,000</u>
Income before profit sharing and income taxes	1,000	1,200
Profit sharing	<u>100</u>	<u>120</u>
Income before income taxes	900	1,080
Income taxes	<u>360</u>	<u>432</u>
Net income	<u>\$ 540</u>	<u>\$ 648</u>

- ¹ In accordance with ASC 250-10-45-8, recognized indirect effects of a change in accounting principle are recorded in the period of change. That provision applies even if recognition of the indirect effect is explicitly required by the terms of the profit-sharing contract. See section 3.3, *Direct and indirect effects of retrospective application*, for a discussion of direct and indirect effects of a change in accounting principle.

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

Income statement

	20X7	20X6 as adjusted
Sales	\$ 3,000	\$ 3,000
Cost of goods sold	1,100	940
Selling, general, and administrative expenses	<u>1,000</u>	<u>1,000</u>
Income before profit sharing and income taxes	900	1,060
Profit sharing	<u>96</u>	<u>100</u>
Income before income taxes	804	960
Income taxes	<u>322</u>	<u>384</u>
Net income	<u>\$ 482</u>	<u>\$ 576</u>

3.1.1

Financial statement presentation

We often receive inquiries about how to label column headings in financial statements when periods have been adjusted to reflect the retroactive application of an accounting principle (e.g., a voluntary change in accounting principle). We believe the prior period column headings are labeled "As Adjusted" and such labeling should be encouraged as the most appropriate financial reporting. However, it is not required for the retrospective application of a change in accounting principle pursuant to ASC 250. ASC 250-10-45-5(c) and ASC 250-10-50-1 require, among other things, that the financial statements of each individual prior period presented be adjusted to reflect the change in accounting principle. However, ASC 250 is silent as to whether each prior period's column headings in the financial statements should be labeled "As Adjusted." Although the example in ASC 250-10-55-10, which illustrates a change in accounting principle, does in fact label the prior period income statement "As Adjusted (Note A)," ASC 250-10-55-2 states that the examples in the appendix do not establish additional requirements. This issue was discussed at the 26 September 2006 joint meeting of the AICPA SEC Regulations Committee and the SEC staff. At that meeting the SEC staff agreed that, while not explicitly required, labeling of columns "As Adjusted" upon retrospective application of a change in accounting principle is considered a best practice to facilitate as much transparency as possible.

Regardless of whether the column headings are labeled “As Adjusted,” we believe a financial statement user should be provided the most relevant information to understand that a change in accounting principle has occurred and its resulting effect. See section 3.8, *Disclosures for a change in accounting principle*, for discussion of disclosures required for changes in accounting principle.

3.2

Impracticability provisions

Excerpt from Accounting Standards Codification

Accounting Changes and Error Corrections – Overall

Other Presentation Matters

Impracticability

250-10-45-9

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

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

250-10-45-10

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

ASC 250 provides an impracticability exception to the retrospective application requirement that may result in limited, or in some cases no, retrospective application of the accounting change to prior periods. Specifically, there are two situations described in ASC 250-10-45-6 and 45-7 that affect an entity’s ability to retrospectively apply a change in accounting principle as follows:

1. The cumulative effect of applying a change in accounting principle to all prior periods can be determined, but it is impracticable to determine the period-specific effects of that change on all prior periods presented (Scenario 1), and;
2. It is impracticable to determine the cumulative effect of applying a change in accounting principle to any prior period (Scenario 2).

In the case of Scenario 1, ASC 250-10-45-6 requires that the change to the new accounting principle be applied to the carrying amounts of assets and liabilities as of the beginning of the earliest period to which the new accounting principle can be applied. The cumulative effect of applying the new principle, if any, shall be recognized as an adjustment to the opening balance of retained earnings (or other appropriate components of equity or net assets in the statement of financial position) for that period. Under Scenario 2, ASC 250-10-45-7

requires that the new accounting principle be applied as if the change was made prospectively as of the earliest date practicable. The paragraph illustrates the type of change encompassed in Scenario 2 with a change from the FIFO method of inventory valuation to the LIFO method (see Illustration 3-1).¹

To enhance consistency in applying the retrospective application method, ASC 250 provides guidance limiting the use of the impracticability exception. Accordingly, an entity shall deem it impracticable to apply the effects of a change in accounting principle retrospectively only if any of the following conditions exist:

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

Given the potentially significant effort required to retrospectively apply some changes in accounting principle, the application of the impracticability provisions of the standard can be the most contentious aspect of applying ASC 250. Determining whether "every reasonable effort" has been made to apply a change in accounting principle retrospectively will require judgment on the part of management and the independent auditors, after considering all relevant facts and circumstances of each specific situation. We believe the following factors should be considered in assessing whether it is impracticable to apply an accounting change retrospectively:

- a. Whether data was collected in prior periods in a way that allows retrospective application. If not, whether it is impracticable to recreate the data/information in a manner that supports retrospective application (e.g., whether raw data were embedded in historical operating or accounting records and can be re-created in a manner that allows retrospective application).
- b. Whether applying the new accounting principle retrospectively requires the use of hindsight on the part of management, either in making assumptions about what management's intentions would have been in a prior period or estimating the amounts recognized, measured, or disclosed (e.g., an estimate of fair value based on inputs that are not derived from observable market sources and were not used for other accounting measurements at that time).
- c. Whether, in light of the expected costs and perceived benefits, retrospective application would involve undue cost and effort.

We believe that the impracticability exceptions are truly exceptions and, therefore, entities should avail themselves of these exceptions only in limited circumstances. Accordingly, if an entity concludes that applying a change in accounting principle retrospectively is impracticable, we would expect that this conclusion be supported by a thoroughly documented analysis of the provisions of ASC 250 providing for the impracticability exception, as well as the additional factors outlined above. As required by ASC 250, an entity reaching this conclusion would be required to disclose in its financial statements the reasons for concluding that it is impracticable to report a change in accounting principle via retrospective application to prior periods.

¹ The paragraph does not imply that such a change is preferable and does not alter ASC 250's requirement that voluntary changes in accounting must be preferable.

² An entity is not precluded from retrospectively applying a change in accounting simply because contemporaneous documentation supporting the new accounting method was not maintained for the prior years.

The impracticability exception provided in ASC 250-10-45-9 cannot be applied to the interim periods of the fiscal year in which the accounting change is made. When an entity determines that retrospective application to the pre-change interim periods of the fiscal year of the change is impracticable, the desired change may only be made as of the beginning of the subsequent fiscal year. See further discussion in section 3.5, *Accounting changes in interim periods*.

We frequently receive questions regarding whether a voluntary change in accounting principle related to the date selected for the annual goodwill impairment testing should be applied retrospectively. We believe that applying such a change retrospectively would require making assumptions and estimations with the use of hindsight. As such, a voluntary change in goodwill impairment testing date is applied prospectively.

Excerpt from Accounting Standards Codification

Accounting Changes and Error Corrections – Overall

Implementation Guidance and Illustrations

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

250-10-55-12

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

Illustration 3-2: Reporting an accounting change when determining the cumulative effect for all prior years is not practicable

ABC Company's (Entity A from excerpt above) disclosure related to the accounting change is presented below:

Note 1: Change in method of accounting for inventory valuation

On 1 January 20X4, ABC Company elected to change its method of valuing inventory to the LIFO method, whereas in all prior years inventory was valued using the FIFO method. The Company believes that the LIFO method of inventory valuation is preferable under the current economic environment of high inflation as the LIFO costing method provides a better matching of current costs with current revenues, which the company believes is preferable in these circumstances. The Company determined that it is impracticable to determine the cumulative effect of applying this change retrospectively because records of inventory purchases and sales are no longer available for all prior periods. Accordingly, the Company did not recognize a cumulative effect adjustment in retained earnings related to this change. Sufficient information exists to apply the LIFO method beginning 1 January 20X1. As such, the new method has been applied prospectively to the Company's inventory balances beginning 1 January 20X1 and comparative financial statements of prior years have been adjusted to give effect to the new method. The following financial statement line items for fiscal years 20X2, 20X3 and 20X4 were affected by the change in accounting principle.

Note: Detailed disclosures of the affected financial statement line items have not been included for purposes of this illustration. ABC Company would present information consistent with that presented in Illustration 3-7 to disclose the impact on the affected income statement and statement of cash flow line items for 20X2, 20X3 and 20X4 and the affected balance sheet line items for 20X3 and 20X4. Assuming that ABC Company is a public entity, the impact of this change on earnings per share for all periods presented also would be disclosed.

3.3 Direct and indirect effects of retrospective application

Excerpt from Accounting Standards Codification

Accounting Changes and Error Corrections – Overall

Glossary

250-10-20

Direct Effects of a Change in Accounting Principle

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

Indirect Effects of a Change in Accounting Principle

Any changes to current or future cash flows of an entity that result from making a change in accounting principle that is applied retrospectively. An example of an indirect effect is a change in a nondiscretionary profit sharing or royalty payment that is based on a reported amount such as revenue or net income.

ASC 250 requires that retrospective application only include the direct effects of a change in accounting principle, including any related income tax effects, in prior period financial statements. Any indirect effects that would have been recognized if the newly adopted accounting principle had been followed in prior periods are not included in the retrospective application. If, as a result of retrospective application, any indirect effects of a change in accounting principle result, those indirect effects are incurred, and shall be recognized, in the period in which the accounting change is made. That is, any indirect effects would be recognized in the period of the accounting change and not in the prior period that is affected by the retrospective application.

Illustration 3-3: Direct and indirect effects of retrospective application

Assume that Company XYZ had a nondiscretionary profit-sharing plan that required a profit-sharing payout to the plan's participants equal to 10% of net income before consideration of the profit-sharing contribution for a given year. Assume further that the provisions of the plan require that the company make additional payments to the participants in the event that prior period financial statements are retroactively changed for any reason, within a period of two years, and the retroactive change would have resulted in an increased payout to the participants. In 20X5, Company XYZ makes a voluntary change in accounting principle that, upon retrospective application, results in additional net income in each of the years 20X4 and 20X3 of \$1,000,000 (the direct effect). As a result of this change, participants in the plan are owed \$200,000 (the indirect effect), before income taxes, for the incremental profit-sharing payments for those years. The \$1,000,000 direct effect of the change in accounting principle in each of the prior years is recognized by retrospective application to the respective years. The indirect effect of the change (\$200,000 incremental profit-sharing obligation) is recognized in the year of the change in accounting principle, or 20X5 in this example.

Note: In accordance with ASC 250-10-45-8, recognized indirect effects of a change in accounting principle are recorded in the period of change. That provision applies even if recognition of the indirect effect is not explicitly required by the terms of the profit-sharing plan but the entity elects to make the additional payments as a result of the voluntary change in accounting principle.

3.4

Justification for a change in accounting principle

Excerpt from Accounting Standards Codification

Accounting Changes and Error Corrections – Overall

Other Presentation Matters

Justification for a Change in Accounting Principle

250-10-45-11

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

250-10-45-12

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

250-10-45-13

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

ASC 250 presumes that once an accounting policy is adopted it is used consistently in accounting for similar events or transactions. Further, ASC 250 requires that an entity may voluntarily change an accounting principle only if it justifies the use of an allowable alternative accounting principle on the basis that it is preferable. However, a method of accounting that was previously adopted for a type of transaction or event that is being terminated or that was a single, non-recurring event in the past shall not be changed. Similarly, a change in accounting method necessitated by a change in the underlying facts and circumstances surrounding a transaction or a type of transaction is not an accounting change that should be applied on a retrospective basis, see section 3.1, *Accounting for a change in accounting principle*, for further details.

ASC 250-10-45-13 also provides that the issuance of a new Codification update that requires use of a new accounting principle, interprets an existing principle, expresses a preference for an accounting principle or rejects a specific principle constitutes sufficient support to justify making a change in accounting principle.

3.4.1

Voluntary change in accounting principle – preferability considerations (updated July 2025)

A voluntary change in accounting principle can be a change from one generally accepted accounting principle to another generally accepted accounting principle when there are two or more generally accepted accounting principles that apply. An example of this type of change is a change from LIFO to FIFO for inventory valuation purposes. In addition, a voluntary change may result from a change from an

acceptable accounting method to a different acceptable accounting method (e.g., change in depreciation method, change in the number of pools used in the application of LIFO or change in the method of applying LIFO from dollar-value LIFO to specific goods LIFO).

Some companies may consider changing an accounting principle to conform with a proposed amendment to the Codification. A proposed amendment to the Codification does not provide authoritative support for an accounting principle not currently acceptable. Therefore, such a proposed amendment to the Codification should not be used as the basis for a voluntary change in accounting principle. In addition, proposed amendments to the Codification that would adopt one existing generally accepted accounting principle to the exclusion of other currently accepted principles remain subject to change in the process of developing and approving a Codification update, including the exposure process. Therefore, it is not advisable to make a change solely to conform to such a proposed amendment to the Codification. This view would also apply for companies considering a change in accounting principle solely based upon an anticipated, but not required, adoption of IFRS. Nevertheless, if a company decides to change to an accounting principle (presumably a currently generally accepted principle) proposed to be adopted in a proposed amendment to the Codification, the change would be made in accordance with the provisions for a voluntary change in an accounting principle of ASC 250 rather than in accordance with the transition provisions of the proposed amendment to the Codification. The proposed amendment is not authority for deviating from the provisions of ASC 250. Companies that make a voluntary change in accounting principle that aligns with a proposed amendment should be aware that further changes in the financial statements may be required if the final Codification update (1) differs from that exposed or (2) specifies a method of applying the adopted principle that differs from the method used by the company.

When filing an initial public offering (IPO) registration statement, a company is required to change its accounting principles to those required for public companies. Because this type of change is not voluntary, a company is not required to evaluate whether the change is preferable. However, some private companies may consider changing an accounting principle (e.g., a private company alternative) to one required for public companies before filing an IPO registration statement. If a company voluntarily changes an accounting principle in anticipation of filing an IPO registration statement in the future, it is required to evaluate whether the change is preferable.

A decision by a company to make a voluntary change of an accounting principle imposes a special obligation on management and the company's auditors with regard to establishing the preferability of the change. The Public Company Accounting Oversight Board (PCAOB) Auditing Standard No. 2820, *Evaluating Consistency of Financial Statements*, states "the auditor should evaluate a change in accounting principle to determine whether:

- a. The newly adopted accounting principle is a generally accepted accounting principle,
- b. The method of accounting for the effect of the change is in conformity with generally accepted accounting principles,
- c. The disclosures related to the accounting change are adequate, and
- d. The company has justified that the alternative accounting principle is preferable."

However, very little guidance in the accounting literature exists for evaluating the reasonableness of management's justification for a voluntary change in accounting principle. In one of the few examples, ASC 330-10-30-14, discussing methods of costing inventory, offers some general guidance on preferability, as follows: "although selection of the method should be made on the basis of the individual circumstances, financial statements will be more useful if uniform methods of inventory pricing are adopted by all entities within a given industry." Further, ASC 250-10-55-1 states "... preferability among accounting principles shall be determined on the basis of whether the new principle constitutes an improvement in financial reporting and not on the basis of the income tax effect alone." In other cases, accounting

standards describe alternative methods that are acceptable but rarely note which is preferable. However, when they do (such as the presentation of the statement of cash flows under the direct versus indirect method) such statements are determinative.

ASC 250 requires that a voluntary change in accounting principle be preferable. Although guidance on determining the preferability of voluntary changes is limited and although we have not considered all possible circumstances in which an accounting principle might be changed, we generally find a voluntary change to be preferable if the following three criteria are met:

1. Authoritative and non-authoritative support

The new accounting method is specifically supported by one of the following items:

- a. FASB Accounting Standards Codification
- b. FASB Concepts Statements (non-authoritative)
- c. AICPA Issues Papers (non-authoritative)
- d. International Financial Reporting Standards (non-authoritative)
- e. GASB Statements, Interpretations of Governmental Accounting Standards, and Technical Bulletins (only applicable to an entity that is not otherwise required to apply Governmental Accounting Standards as promulgated by the GASB)
- f. Pronouncements of other professional associations and regulatory agencies (non-authoritative)
- g. AICPA Technical Practice Aids (non-authoritative)
- h. Accounting textbooks, handbooks and articles (non-authoritative)

2. Rationality

Management's justification for the change is rational, both in general and in the particular circumstances, in terms of presenting financial position and results of operations (as distinguished from other considerations, such as reducing taxes). Among the factors that may be considered in evaluating a change in terms of this criterion are the following:

a. Conformity with broad concepts of accounting.

Some accounting principles may be justified as being preferable because they accord better with certain broad concepts of accounting, such as:

- (i) More accurate reflection of assets and liabilities
- (ii) Better matching of costs and revenues
- (iii) Better correspondence with the substance of the event being recognized
- (iv) More accurate allocation of costs of physical assets to periods in which the assets are consumed
- (v) Extension of accrual accounting or refinement of accrual methods

In most circumstances, it is necessary for criterion "a." to be met in order to consider that a change is preferable.

b. Consistency among components of an entity.

Some accounting changes are made to conform accounting methods used by various components of a single business entity. This is common, for example, following a business combination. Such changes usually increase the usefulness of financial reporting and may be justified as preferable on that basis. Refer to section 8.6, *Conforming accounting policies*, of our Financial reporting developments (FRD) publication, ***Business combinations***, for additional discussion of conforming accounting policies in a business combination.

c. Suitability in light of business circumstances, plans and policies.

Business circumstances and management's plans and policies may affect accounting principles in a number of ways. For example, the actual pattern of decline in the economic value of depreciable assets may more nearly approximate an accelerated depreciation pattern than a straight-line depreciation pattern; an internally developed index usually will more closely reflect the composition of a company's inventory for LIFO costing purposes than a publicly available index. Considerations such as these may help to justify an accounting change as preferable.

d. Practicability.

In some circumstances, it may not be practical to continue using an accounting method; continuing it may result in substantial measurement, realization, or administrative problems. However, this factor alone would not establish preferability.

3. Industry practice.

The new accounting method is a widely recognized or prevalent practice in the industry in which the company operates.³ We believe the industry peers considered should generally be consistent with internally and externally available information, including a registrant's most recent proxy statement.

A proposed change in accounting principle in situations where there are no established principles may meet the first and second criteria but fails to meet the third (i.e., a change that is justified in terms of authoritative support and rationality but not in terms of accepted industry practice). Such a change merits particularly careful consideration. Justification for such changes might be reasonable in some, but not in all, circumstances. Often a great deal of judgment based on the facts and circumstances is involved in determining whether a voluntary change in accounting principle is preferable in these circumstances.

The following are some examples of changes in accounting principles that are often considered preferable (however, as facts and circumstances vary, so will such conclusions).

- ▶ Change was made from the accelerated method to the straight-line method of depreciation. Straight-line was the predominant method used in the industry and change was considered rational for the company; in the company's circumstances the straight-line method appeared more appropriate based on the asset's usage.
- ▶ Change was made from using a U.S. Bureau of Labor Statistics index to an internally developed index in costing LIFO inventories. The internally developed index more closely reflected the composition of the company's inventory.

³ Industry practice does not provide significant support for some types of accounting changes, such as changes in a company's goodwill impairment assessment date. Such changes do not improve or otherwise change the comparability of financial statements among companies in an industry.

- Change was made from LIFO to FIFO. The preferability decision was based on declining inventory prices. However, it should be noted that there have been other instances where we have concluded that such a change is not preferable, particularly where we had previously issued a preferability letter for that client's initial change from FIFO to LIFO, or that the primary purpose of the company's proposed accounting change is based on resulting tax benefits to the company.

A method of applying an accounting principle that is appropriate for tax purposes does not, in itself, indicate it is preferable for financial reporting purposes.

Excerpt from Accounting Standards Codification

Accounting Changes and Error Corrections – Overall

Implementation Guidance and Illustrations

Change in the Composition of Inventory Costs

ASC 250-10-55-1

A change in composition of the elements of cost included in inventory is an accounting change. An entity that makes such a change for financial reporting shall conform to the requirements of this Subtopic, including justifying the change on the basis of preferability as specified by paragraphs 250-10-45-11 through 45-13. In applying the guidance in this Subtopic, preferability among accounting principles shall be determined on the basis of whether the new principle constitutes an improvement in financial reporting and not on the basis of the income tax effect alone.

Question 1-1

Can a change in accounting policy be justified based on the expected income tax benefits expected to be derived from the new policy?

Answer: No. As noted in ASC 250-10-55-1, the preferability of a new accounting policy should be evaluated based on whether the change represents “an improvement in financial reporting and not on the basis of the income tax effect alone.” A proposed change in accounting policy that is intended to align with an entity's jurisdictional tax reporting does not, in itself, indicate that accounting policy is preferable. ASC 330-10-55-4 illustrates this point in the context of considering policies to capitalize or expense inventory costs and states that “the fact that a cost is capitalizable for tax purposes does not, in itself, indicate that it is preferable, or even appropriate, to capitalize that cost for financial reporting purposes.”

3.4.2

SEC considerations for a voluntary change in accounting principle

Excerpt from Accounting Standards Codification

Accounting Changes and Error Corrections – Overall

SEC Materials

SAB Topic 6.G(2)(b)1, Reporting Requirements for Accounting Changes

250-10-S99-4

The following is the text of SAB Topic 6.G.2.b, Reporting Requirements for Accounting Changes.

- b. Reporting requirements for accounting changes.
 1. Preferability.

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

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

Interpretive Response: In such cases, where objective criteria for determining the preferability among alternative accounting principles have not been established by authoritative bodies, the determination of preferability should be based on the particular circumstances described by and discussed with the registrant. In addition, the independent accountant should consider other significant information of which he is aware. ^{FN5}

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

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

Question 3: What responsibility does the independent accountant have for evaluating the business judgment and business planning of the registrant?

Interpretive Response: Business judgment and business planning are within the province of the registrant. Thus, the independent accountant may accept the registrant's business judgment and business planning and express reliance thereon in his letter. However, if either the plans or judgment appear to be unreasonable to the independent accountant, he should not accept them as justification. For example, an independent accountant should not accept a registrant's plans for a major expansion if he believes the registrant does not have the means of obtaining the funds necessary for the expansion program.

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

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

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

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

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

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

Question 7: If a registrant changes its accounting to one of two methods specifically approved by the FASB in the Accounting Standards Codification, need the independent accountant express his view as to the preferability of the method selected?

Interpretive Response: If a registrant was formerly using a method of accounting no longer deemed acceptable, a change to either method approved by the FASB may be presumed to be a change to a preferable method and no letter will be required from the independent accountant. If, however, the registrant was formerly using one of the methods approved by the FASB for current use and wishes to change to an alternative approved method, then the registrant must justify its change as being one to a preferable method in the circumstances and the independent accountant must submit a letter stating that in his view the change is to a principle that is preferable in the circumstances.

2. Filing of a letter from the accountants.

Facts: The registrant makes an accounting change in the fourth quarter of its fiscal year. Rule 10-01(b)(6) of Regulation S-X requires that the registrant file a letter from its independent accountants stating whether or not the change is preferable in the circumstances in the next Form 10-Q. Item 601(b)(18) of Regulation S-K provides that the independent accountant's preferability letter be filed as an exhibit to reports on Forms 10-K or 10-Q.

Question: When the independent accountant's letter is filed with the Form 10-K, must another letter also be filed with the first quarter's Form 10-Q in the following year?

Interpretive Response: No. A letter is not required to be filed with Form 10-Q if it has been previously filed as an exhibit to the Form 10-K.

^{FN5} Registrants also are reminded that FASB ASC paragraph 250-10-50-1 (Accounting Changes and Error Corrections Topic) requires that companies disclose the nature of and justification for the change as well as the effects of the change on net income for the period in which the change is made. Furthermore, the justification for the change should explain clearly why the newly adopted principle is preferable to the previously-applied principle.

SAB Topic 6.G(2)(b)1, *Reporting Requirements for Accounting Changes* (codified in ASC 250-10-S99-4), provides additional information to help assess management's obligation in evaluating whether a proposed accounting change is preferable. The SAB indicates that management's plans and judgments that are made in good faith are major considerations in determining whether a change is to a preferable accounting principle. The SAB goes on to state that the following circumstances could have a bearing on determining preferability:

- ▶ Management's expectations about the effect of general economic trends on its business (e.g., the impact of inflation);
- ▶ Management's expectations about expanding consumer demand for the company's products; or
- ▶ Plans for a change in marketing methods.

SAB Topic 6.G also provides guidance on the following situations involving an accounting change:

- ▶ Change in management's plans and judgments that were used as the basis for justifying the accounting change: A registrant makes a preferable accounting change based on certain plans and judgments but later discovers that it must abandon its plans or change its business judgments due to economic or other factors. As long as the registrant's justification for the accounting change was based on the facts and circumstances at the time of the change, a subsequent change in circumstances does not nullify the previous justification for the accounting change.
- ▶ Ability of a registrant to revert to the original accounting method: Any time a registrant changes its accounting method, the change must be justified as preferable under the existing circumstances. Therefore, a registrant is not allowed to revert to a previous accounting method unless the change would be preferable under the existing circumstances.
- ▶ Ramification of preferability letters issued by accounting firms: If a registrant makes an accounting change and files a preferability letter from the independent accountant, this would not preclude other clients of that accounting firm from making the opposite accounting change (e.g., one client justifies a change from FIFO to LIFO and another client justifies a change from LIFO to FIFO). Each registrant must justify a change based on its own facts and circumstances. However, if registrants in apparently similar circumstances make changes in opposite directions, the SEC staff will inquire about the factors that each registrant and independent accountant considered in determining why the change was preferable. However, the SEC staff understands that the justification for the accounting change is based on management's business plans and judgments and may, in good faith, differ among similar registrants (see section 3.9, *Preferability letter*, for further preferability letter discussion).

3.4.3

Assessing reclassifications for a voluntary change in accounting principle

ASC 250 does not provide specific discussion on determining whether a reclassification would be considered a change in accounting principle. However, while PCAOB Auditing Standard No. 2820, *Evaluating Consistency of Financial Statements* (AS No. 2820), is applicable to auditors, it may provide constructive information for entities to consider. Under AS No. 2820, changes in classification in previously issued financial statements do not require recognition in the auditor's report unless the change represents the correction of a material misstatement or a change in accounting principle. A material change in financial statement classification and the related disclosure should be evaluated to determine whether the change is a permissible reclassification (see section 6.1.2, *Error correction versus a reclassification*), a change in accounting principle (see section 3.4, *Justification for a change in accounting principle*) or a correction of a material misstatement (see section 6, *Correction of an error in previously issued financial statements*). An example of a correction of a misstatement may be a reclassification of cash flows from the operating activity category to the financing activity category if the initial inclusion in the operating category was not in accordance with US GAAP.

Entities should also determine whether the applicable ASC Topic addresses the accounting for classifications. For example, ASC 740-10-45-25 states that penalties associated with an uncertain tax position may be classified as either income tax expense or another expense classification based on an accounting policy election. If the entity changes the classification from the accounting policy decision, that would be considered a change in accounting principle. We believe changes in classification among key financial statement sections (e.g., a change in the classification of shipping and handling activities on the income statement) would generally be considered a change in accounting principle. See section 4.1.2, *Shipping and handling activities*, in our FRD, *Revenue from contracts with customers (ASC 606)*, for further guidance on the classification of shipping and handling activities. Otherwise, when US GAAP is silent about presentation, and a company changes from one acceptable presentation to another, the change generally represents a reclassification and is not a change in accounting principle. For example, if US GAAP does not provide specific alternatives, we believe a change in cash flow classification on the statement of cash flows from one acceptable classification to another is a reclassification and not a voluntary change in accounting principle.

3.5

Accounting changes in interim periods

Excerpt from Accounting Standards Codification

Accounting Changes and Error Corrections – Overall

Other Presentation Matters

Reporting a Change in Accounting Principle Made in an Interim Period

250-10-45-14

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

250-10-45-15

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

250-10-45-16

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

Consistent with changes made in annual periods, ASC 250 requires that a change in accounting principle made in an interim period be reported by retrospective application, both to the prior years, as well as to the interim periods within the fiscal year that the accounting change was adopted. However, the impracticability exception provided in ASC 250-10-45-9 cannot be applied to the interim periods of the fiscal year in which the accounting change is made. When an entity determines that retrospective application to the pre-change interim periods of the fiscal year of the change is impracticable, the desired change may only be made as of the beginning of the subsequent fiscal year.

Illustration 3-4: Accounting change in interim period

Assume that in 20X6 a calendar year-end company makes a voluntary change in accounting principle in its third quarter. The effect of the change must be applied retrospectively to the first and second quarters of 20X6 and to the prior fiscal years presented for comparative purposes in its third quarter interim report. If the company determines that it is impracticable to apply the new principle to its 20X5 and prior financial statements, the cumulative effect of the change would be recognized as a component of opening retained earnings in 20X6 and the appropriate disclosure surrounding the adoption would be included in its financial statements reported in 20X6. Alternatively, if the company determined that it was impracticable to apply the new accounting principle retrospectively to the first and second quarters of 20X6, it would be precluded from making the accounting change in the third quarter. If the company still elected to pursue the change in accounting principle, it could only be made (at the earliest) as of 1 January 20X7 (the beginning of the subsequent fiscal year) by recognizing the cumulative effect of the change in opening retained earnings as of 1 January 20X7.

3.5.1**Fourth-quarter accounting changes (updated July 2025)**

Regarding changes in an accounting principle made in the fourth quarter of the fiscal year, ASC 250-10-45-15 requires that if a public company that regularly reports interim information makes an accounting change during the fourth quarter of its fiscal year and does not report the data required by ASC 270-10-50-1 (the minimum requirements for summarized interim financial data) in a separate fourth-quarter report or quarterly reporting in its annual report, that entity is required to include disclosure of the effects of the accounting change on prior interim-period results, as required by ASC 250-10-50-1, in a note to the annual financial statements for the fiscal year in which the change is made. The information required by ASC 250-10-50-1 may be disclosed in a separate footnote (see section 3.8, *Disclosures for a change in accounting principle*).

When there are one or more retrospective changes to the statements of comprehensive income for any of the quarters within the most recent two fiscal years that individually or in the aggregate are material, Item 302(a) of Regulation S-K requires registrants⁴ to provide an explanation of the reasons for the changes and disclose, for each affected quarterly period and the fourth quarter in the affected year, summarized financial information related to the statements of comprehensive income (as specified in Rule 1-02(bb)(1)(ii) of Regulation S-X⁵) and earnings per share reflecting the changes. Summarized financial information may be included outside the financial statements as supplementary information in annual shareholders' reports and in SEC filings, or in an unaudited note to the annual financial statements. If the registrant elects to include the summarized financial information in an unaudited note to the financial statements, the registrant may combine the disclosure required by ASC 250 and Item 302(a) of Regulation S-K in a single footnote (see illustration 3-5 below).

⁴ Item 302(a) of Regulation S-K applies to all companies that have securities registered under Sections 12(b) (except mutual life insurance companies) or 12(g) of the Securities and Exchange Act of 1934 (Exchange Act), except smaller reporting companies and foreign private issuers. The disclosure is required in annual reports on Form 10-K, in certain registration statements under the Securities Act of 1933 and in registration statements that have securities registered under Section 12 of the Exchange Act.

⁵ Rule 1-02(bb) of Regulation S-X provides flexibility for registrants to use the same line item captions that appear in their financial statements, if necessary, in lieu of the line item captions prescribed in Rule 1-02(bb).

Illustration 3-5: Example disclosure reflecting accounting change made in the fourth quarter – combined disclosure required by ASC 250 and Item 302(a) of Regulation S-K

Below is an example disclosure of quarterly results of operations included in the annual financial statements reflecting the change from LIFO to FIFO. For purposes of this example, quarterly financial information for fiscal year 20X8 is not presented but would be required. Additionally, any other affected financial statement line items (e.g., inventory) and the cumulative effect of the change on retained earnings or other components of equity or net assets, which are not presented, would also be required. There were no indirect effects recognized for this change in accounting principle.

Quarterly results of operations

The following is a summary of the quarterly results of operations for the year ended 31 December 20X9.

	Previously reported 31 Mar.	Adjusted 31 Mar.	Previously reported 30 Jun.	Adjusted 30 Jun.	Previously reported 30 Sept.	Adjusted 30 Sept.	31 Dec.
(In thousands, except per share data)							
20X9							
Net sales	\$ 47,500	\$ 47,500	\$ 35,000	\$ 35,000	\$ 42,500	\$ 42,500	\$ 37,500
Cost of products sold ⁽¹⁾	36,000	35,900	24,500	24,420	32,000	31,880	28,000
Income from continuing operations	2,400	2,300	1,900	1,820	2,200	2,080	2,350
Net income	1,200	1,100	1,000	920	1,100	980	1,170
Net income per common share:							
Basic	1.20	1.10	1.00	.92	1.10	.98	1.17
Diluted	1.20	1.10	1.00	.92	1.10	.98	1.17

⁽¹⁾ In December 20X9, the Company changed its method of determining inventory cost to the FIFO method from the LIFO method. The Company believes that this change is preferable because (1) the costs of the Company's inventories have remained fairly level during the past several years, which has substantially negated the benefits of the LIFO method (a better matching of current costs with current revenues in periods of rising costs), (2) the FIFO method results in the valuation of inventories at current costs on the consolidated balance sheet, which provides a more meaningful presentation for investors and financial institutions, (3) the change conforms to a single method of accounting for all of the Company's inventories and (4) FIFO is prevalent in the industry in which ABC Company operates. Comparative financial statements of prior years have been adjusted to apply the new method retrospectively. In accordance with ASC 250 the quarterly information for the first three quarters of 20X9, which had been previously reported, has been adjusted on a retrospective basis to reflect that change in principle.

A registrant that adopts a change in accounting principle in the fourth quarter is not required to amend its previous filings on Form 10-Q to reflect the retrospectively adjusted interim financial statements.

3.5.2

Interim periods after a change in accounting principle

ASC 250-10-50-3 requires that in the fiscal year in which a voluntary change in accounting principle occurs or a new accounting principle is adopted, financial information reported for interim periods after the date of such a change or adoption should disclose the effect of the change on income from continuing operations, net income (or other appropriate captions of changes in the applicable net assets or performance indicator) and related per-share amounts, if applicable, for the post-change interim periods. That is, for subsequent interim periods in the fiscal year of an accounting change, the registrant must determine and disclose the amounts that would have been reported under the "old" accounting principle had it not made the accounting change. See section 3.8, *Disclosures for a change in accounting principle*, for discussion of disclosure requirements for interim changes in accounting principle.

3.5.3 Adjustments to prior interim periods of the current fiscal year (added April 2024)

Excerpt from Accounting Standards Codification

Accounting Changes and Error Corrections – Overall

Other Presentation Matters

Corrections Related to Prior Interim Periods of the Current Fiscal Year

250-10-45-25

For purposes of this Subtopic, an adjustment related to prior interim periods of the current fiscal year is an adjustment or settlement of litigation or similar claims, of income taxes (except for the effects of retroactive tax legislation), of renegotiation proceedings, or of utility revenue under rate-making processes provided that the adjustment or settlement meets all of the following criteria:

- a. The effect of the adjustment or settlement is material in relation to income from continuing operations of the current fiscal year or in relation to the trend of income from continuing operations or is material by other appropriate criteria.
- b. All or part of the adjustment or settlement can be specifically identified with and is directly related to business activities of specific prior interim periods of the current fiscal year.
- c. The amount of the adjustment or settlement could not be reasonably estimated prior to the current interim period but becomes reasonably estimable in the current interim period.

The criterion in (b) is not met solely because of incidental effects such as interest on a settlement. The criterion in (c) would be met by the occurrence of an event with currently measurable effects such as a final decision on a rate order. Treatment as adjustments related to prior interim periods of the current fiscal year shall not be applied to the normal recurring corrections and adjustments that are the result of the use of estimates inherent in the accounting process. Changes in provisions for doubtful accounts shall not be considered to be adjustments related to prior interim periods of the current fiscal year even though the changes result from litigation or similar claims.

250-10-45-26

If an item of profit or loss occurs in other than the first interim period of the entity's fiscal year and all or a part of the item of profit or loss is an adjustment related to prior interim periods of the current fiscal year, as defined in the preceding paragraph, the item shall be reported as follows:

- a. The portion of the item that is directly related to business activities of the entity during the current interim period, if any, shall be included in the determination of net income for that period.
- b. Prior interim periods of the current fiscal year shall be restated to include the portion of the item that is directly related to business activities of the entity during each prior interim period in the determination of net income for that period.
- c. The portion of the item that is directly related to business activities of the entity during prior fiscal years, if any, shall be included in the determination of net income of the first interim period of the current fiscal year.

ASC 250-10-45-25 states an adjustment related to prior interim periods of the current fiscal year is an adjustment or settlement of (1) litigation or similar claims, (2) income taxes (except for the effects of retroactive tax legislation), (3) renegotiation proceedings or (4) utility revenue under rate-making processes, provided that the adjustment or settlement meets all of the following criteria:

- ▶ The effect of the adjustment or settlement is material in relation to income from continuing operations of the current fiscal year or in relation to the trend of income from continuing operations, or is material by other appropriate criteria.
- ▶ All or part of the adjustment or settlement can be specifically identified with and is directly related to business activities of specific prior interim periods of the current fiscal year.
 - ▶ This criterion would not be met solely because of incidental effects, such as interest on a settlement.
- ▶ The amount of the adjustment or settlement could not be reasonably estimated prior to the current interim period but becomes reasonably estimable in the current interim period (e.g., in the third quarter, the registrant receives a final decision on a rate order)

When an event that qualifies for prior-period treatment occurs in the second, third or fourth quarter and relates to prior interim periods of the current fiscal year, the company should report the item in ASC 250-10-45-26. Events that do not qualify for prior-period treatment (e.g., the event does not relate to prior interim periods of the current fiscal year) are recognized in the period of the event.

Prior-period treatment should not be applied to normal recurring adjustments resulting from changes in accounting estimates. For example, changes in provisions for doubtful accounts resulting from litigation or similar claims should not be treated as a prior-period adjustment.

3.6 Changes in accounting principle – materiality considerations

Like all standards issued by the FASB, ASC 250 need not be applied to immaterial items. Like all materiality assessments, assessing materiality in the context of changes in accounting principle requires the exercise of judgment and careful consideration of all the relevant facts and circumstances associated with the change.

An entity may make a change in accounting principle and conclude that the change is not material to the prior years and, therefore, will not apply the change on a retrospective basis. In this case, the entity is required to apply the new principle to the assets and liabilities affected by the change and recognize the cumulative effect of the change as an operating item in the income statement for the period of the change. The entity would not be permitted to recognize the cumulative effect on a separate line in the income statement, nor would it be permitted to recognize the cumulative effect in beginning of the period retained earnings.

Accordingly, for an entity to conclude that the effect of a change in accounting principle should not be applied retrospectively on the grounds that it is immaterial, it would have to conclude that the effect of the change is immaterial to the prior years and that the cumulative effect of the change is immaterial to the financial statements in the period of the change. Even if an entity concludes that the effect of a change in accounting principle should not be applied retrospectively on the grounds that it is immaterial, if there is a change to a previously disclosed accounting principle, a preferability letter may still be required. Refer to section 3.9, *Preferability letter*, for further preferability letter discussion.

3.6.1 Materiality of an interim change in accounting principle

Excerpt from Accounting Standards Codification

Accounting Changes and Error Corrections – Overall

SEC Materials

SAB Topic 5.F, Accounting Changes Not Retroactively Applied Due to Immateriality

250-10-S99-3

The following is the text of SAB Topic 5.F, Accounting Changes Not Retroactively Applied Due to Immateriality.

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

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

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

ASC 270-10-45-16 provides guidance on assessing materiality for accounting changes or error corrections made in an interim period and states that materiality 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 the trend of earnings should be separately disclosed in the interim period of the change. See the discussion in section 3.8, *Disclosures for a change in accounting principle*, regarding the disclosure requirements of ASC 250 in those situations where an entity concludes that an accounting change is immaterial to the current and/or prior periods, but the change is expected to be material to future periods.

For SEC registrants, SAB Topic 5.F, *Accounting Changes Not Retroactively Applied Due to Immateriality*, (Topic 5.F) (codified in ASC 250-10-S99-3), provides guidance on accounting for changes that are deemed immaterial and is consistent with the position articulated in the preceding paragraph. In accordance with Topic 5.F, if a registrant determines that the accounting change does not have a material effect on prior periods' financial statements and elects not to apply the change on a retrospective basis, the registrant may not adjust retained earnings at the beginning of the current fiscal year for the cumulative effect of prior periods. The registrant must report the cumulative effect of the change within operations in the interim period that the change is made with separate disclosure if material to that interim period. However, consistent with ASC 270-10-45-16, if the cumulative effect of the change is material to the registrant's estimated income for the full fiscal year or to the trend of earnings, Topic 5.F indicates that the registrant should apply the accounting change on a retrospective basis to the income statements for all periods presented (current and prior year).

3.7 Inclusion of cumulative effect of accounting changes in comprehensive income

The underlying principle in ASC 250 is that a cumulative effect of a change in accounting principle does not relate to the period in which a change is made. As such, cumulative effect adjustments should not be included as a component of comprehensive income, either through inclusion in net income or as a separate component of comprehensive income, in the period a change is made.

ASC 250 requires that the cumulative effect of a change in accounting principle be applied to the carrying amounts of assets and liabilities as of the beginning of the earliest period to which the new accounting principle can be applied with an offsetting adjustment, if any, made to the opening balance of retained earnings (or other appropriate components of equity or net assets in the statement of financial position) for that period. Additionally, new codification updates may provide specific transition requirements that require a similar adjustment be reported in retained earnings or accumulated other comprehensive income.

ASC 220-10-45-10B states that “[i]tems required to be reported as direct adjustments to paid-in capital, retained earnings, or other nonincome equity accounts” are not to be included as components of comprehensive income. This seems to indicate that cumulative effect adjustments such as those described above should be excluded from comprehensive income in the period of change. This conclusion is also consistent with what the FASB had originally deliberated within the Basis for Conclusions of FASB Statement No. 130, *Reporting Comprehensive Income*, as to whether the effect of prior-period adjustments reflected as adjustments of the opening balance of retained earnings should be included in comprehensive income for that period. In its Basis for Conclusions, the FASB stated, “that because of the requirement for retroactive restatement of earlier period financial statements, items accounted for as prior period adjustments are effectively included in comprehensive income of earlier periods and, therefore, should not be displayed in comprehensive income of the current period.”

ASC 220-10-20 defines comprehensive income to “include[s] all changes in equity during a period except those resulting from investments by owners and distributions to owners.” This seems to indicate that cumulative effect adjustments, such as those described above, should be included in comprehensive income in the period of change. Questions have arisen in practice relating to whether cumulative effect adjustments should be reported as a component of comprehensive income in the period the change is recognized.

When the FASB originally deliberated Statement No. 154, it considered requiring the cumulative effect of accounting changes be included in net income of the period in which the change was made. However, the FASB “rejected that alternative on the basis that the cumulative effect of the change in accounting principle does not relate to the period in which the change was made. Therefore, it would be inappropriate to record the cumulative effects on prior periods in net income of the period of change since none of the effects relate to that period” (paragraph B12 of Statement 154).

Based on this rationale, we believe cumulative effect adjustments such as those which are described above should be excluded from comprehensive income in the period of change. We believe such adjustments relate to prior periods and are not items affecting the current period’s results. Therefore, such adjustments should be excluded from any current period measurements of income, including both net income and comprehensive income. We understand that this view is consistent with the views of the FASB as noted above and SEC staff in SAB Topic 5.F (codified in ASC 250-10-S99-3).

Illustration 3-6: Cumulative effect of accounting change not included in comprehensive income**Example 1**

Assume a company adopted a new accounting standard effective 1 January 200Y. A \$1,000,000 cumulative effect of adoption of the standard is recognized as an adjustment to the 31 December 200X balance of retained earnings. The cumulative effect of adoption of the new accounting standard should not be included in comprehensive income for the year ending 31 December 200Y but rather as an adjustment to retained earnings, as illustrated in the table below (other components of stockholders' equity are not presented for ease of illustration):

	Accumulated other comprehensive income	Retained earnings	Total
Balance at 31 December 200X	\$ 5,000,000	\$ 10,000,000	\$ 15,000,000
Cumulative effect of accounting change	<u>-</u>	<u>1,000,000</u>	<u>1,000,000</u>
Balance at 31 December 200X, as adjusted	\$ 5,000,000	\$ 11,000,000	\$ 16,000,000
Components of comprehensive income			
Net Income	-	3,000,000	3,000,000
Other comprehensive income	<u>100,000</u>	<u>-</u>	<u>100,000</u>
Total comprehensive income			<u>3,100,000</u>
Balance at 31 December 200Y	<u>\$ 5,100,000</u>	<u>\$ 14,000,000</u>	<u>\$ 19,100,000</u>

Example 2

Assume the same facts as Example 1, except that the transition provisions of the new accounting standard effective 1 January 200Y requires the cumulative effect of adoption to be recognized as an adjustment to the 31 December 200X balance of accumulated other comprehensive income. The cumulative effect of adoption of the new accounting standard should not be included in comprehensive income for the year ending 31 December 200Y but rather as an adjustment to accumulated other comprehensive income as previously reported for the year ending 31 December 200X, as illustrated in the table below (other components of stockholders' equity are not presented for ease of illustration):

	Accumulated other comprehensive income	Retained earnings	Total
Balance at 31 December 200X	\$ 5,000,000	\$ 10,000,000	\$ 15,000,000
Cumulative effect of accounting change	<u>1,000,000</u>	<u>-</u>	<u>1,000,000</u>
Balance at 31 December 200X, as adjusted	<u>\$ 6,000,000</u>	<u>\$ 10,000,000</u>	<u>\$ 16,000,000</u>
Components of comprehensive income			
Net Income	-	3,000,000	3,000,000
Other comprehensive income	<u>100,000</u>	<u>-</u>	<u>100,000</u>
Total comprehensive income			<u>3,100,000</u>
Balance at 31 December 200Y	<u>\$ 6,100,000</u>	<u>\$ 13,000,000</u>	<u>\$ 19,100,000</u>

3.8 Disclosures for a change in accounting principle (updated April 2024 and July 2025)

Excerpt from Accounting Standards Codification

Accounting Changes and Error Corrections – Overall

Disclosure

Change in Accounting Principle

250-10-50-1

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

- a. The nature of and reason for the change in accounting principle, including an explanation of why the newly adopted accounting principle is preferable.
- b. The method of applying the change, including all of the following:
 1. A description of the prior-period information that has been retrospectively adjusted, if any.
 2. The effect of the change on income from continuing operations, net income (or other appropriate captions of changes in the applicable net assets or performance indicator), any other affected financial statement line item, and any affected per-share amounts for the current period and any prior periods retrospectively adjusted. Presentation of the effect on financial statement subtotals and totals other than income from continuing operations and net income (or other appropriate captions of changes in the applicable net assets or performance indicator) is not required.
 3. The cumulative effect of the change on retained earnings or other components of equity or net assets in the statement of financial position as of the beginning of the earliest period presented.
 4. If **retrospective application** to all prior periods is impracticable, disclosure of the reasons therefore, and a description of the alternative method used to report the change (see paragraphs 250-10-45-5 through 45-7).
- c. If **indirect effects of a change in accounting principle** are recognized both of the following shall be disclosed:
 1. A description of the indirect effects of a change in accounting principle, including the amounts that have been recognized in the current period, and the related per-share amounts, if applicable
 2. Unless impracticable, the amount of the total recognized indirect effects of the **accounting change** and the related per-share amounts, if applicable, that are attributable to each prior period presented. Compliance with this disclosure requirement is practicable unless an entity cannot comply with it after making every reasonable effort to do so.

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

250-10-50-2

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

250-10-50-3

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

Interim Reporting – Overall***Other Presentation Matters******Accounting Changes in Interim Periods*****270-10-45-12**

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

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

Pending Content:

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

Each report of interim financial information shall indicate any **change in accounting principles**, change in practices, or **change in the reporting entity** from those applied in any of the following:

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

ASC 250-10-50-1 requires an entity to make the disclosures above in the fiscal period in which a change in accounting principle is made.

Under SEC Rule 10-01(b)(7) of Regulation S-X, registrants are required to provide disclosure of any material retroactive prior-period adjustments made during any period covered by the interim financial statements, together with the effect thereof on net income, total and per share, of any prior period included and on the balance of retained earnings. If results of operations, for any period presented, have been adjusted retroactively by such an item subsequent to the initial reporting of such period, the registrant is required to provide similar disclosure of the effect of the change. Additionally, Rule 3-04 of Regulation S-X requires that a registrant state separately the adjustments to the balance at the beginning of the earliest period presented for items that were retroactively applied to periods prior to that period.

Financial statements of subsequent periods need not repeat the required disclosures initially made in the period of an accounting change. However, entities that issue interim financial statements must provide the required disclosures in the financial statements of both the interim and annual periods that include the direct or indirect effects of a change in accounting principle. For example, a public business entity that makes a change in accounting principle in the second quarter of 20X6 must include the required disclosures in its second and third quarter interim financial statements. The entity must also include the required disclosures for the annual period in its annual financial statements for 20X6. That is, the second and third quarter year-to-date interim financial statements, as well as the 20X6 annual financial statements, include the initial period of the change, and, therefore, the disclosures remain applicable. These disclosures are not required in the financial statements for any interim or annual periods after 20X6.

If a change in accounting principle does not have a material effect in the period of the change but is reasonably certain to have a material effect in later periods, the disclosures required in ASC 250-10-50-1(a) above (i.e., nature of and reason why the change is preferable) are provided whenever the financial statements of the period of change are presented. This is a limited exception to the requirement that the required disclosures be provided only in the interim and annual period of a change in principle. This limited disclosure is required for all periods that include the period of the change in a set of financial statements to inform the user that a change in accounting was made in a previous period. However, the other accounting and disclosure requirements of ASC 250 are not included in the period of the change because the effects were immaterial in those prior periods. A voluntary change in accounting principle may be immaterial to prior periods, but have a profound effect on future periods, and this disclosure provides the financial statement user with the information necessary to assess that impact.

When the cumulative effect of a change in accounting principle is reported on a net of tax basis on the income statement, SAB Topic 6.I.3, *Net of Tax Presentation* (codified in ASC 740-10-S99-1), states that additional disclosure of the nature of the tax component should be provided by reconciling the tax component associated with the cumulative effect adjustment to the applicable statutory Federal income tax rate or rates.

ASC 250-10-50-3 requires that in the fiscal year in which a new accounting principle is adopted, financial information reported for interim periods after the date of adoption disclose the effect of the change on income from continuing operations, net income (or other appropriate captions of changes in the applicable net assets or performance indicator), and related per-share amounts, if applicable, for the post-change interim periods. That is, for subsequent interim periods in the fiscal year of an accounting change, an entity must determine and disclose the amounts that would have been reported under the “old” accounting principle had it not made the accounting change. For the indirect effects of a change in accounting principle, an entity is required to disclose a description of the indirect effects, the amounts recognized in the current period and the related per share amounts, as well as, unless impracticable,⁶ the total recognized indirect effects of the accounting change and the related per share amounts attributable to each prior period presented.

Illustration 3-7: Disclosures for retrospective application of a change in accounting principle

Based on Illustration 3-1, ABC Company decides at the beginning of 20X7 to adopt the FIFO method of inventory valuation. ABC Company had used the LIFO method for financial and tax reporting since its inception on 1 January 20X5 and had maintained records that are adequate to apply the FIFO method retrospectively. ABC Company concluded that the FIFO method is the preferable inventory valuation method for its inventory.

ABC Company determined that its profit-sharing expense would have decreased by \$2 in 20X5 and increased by \$6 in 20X6 if it had used the FIFO method to compute its inventory cost since inception. The terms of the profit-sharing agreement do not address whether ABC Company is required to adjust its profit-sharing accrual for the incremental amounts. At the time of the accounting change, ABC Company decides to contribute the additional \$6 attributable to 20X6 profits and make no adjustment related to 20X5 profit. The \$6 payment is made in 20X7.

⁶ ASC 250-10-50-1(C) (2) requires compliance with disclosure requirements related to indirect effects of a change in accounting principle unless an entity cannot comply after making every reasonable effort to do so.

Note 1: Change in method of accounting for inventory valuation

On 1 January 20X7, ABC Company elected to change its method of valuing its inventory to the FIFO method, whereas in all prior years' inventory was valued using the LIFO method. The Company believes that the FIFO method of inventory valuation is preferable because (1) the costs of the Company's inventories have remained fairly level during the past several years, which has substantially negated the financial reporting benefits of the LIFO method, which provides a better matching of current costs with current revenues in periods of rising costs, (2) the FIFO method results in the valuation of inventories at more current costs on the consolidated balance sheet, which proves a more meaningful presentation for investors, (3) the change conforms to a single method of accounting for all of the Company's inventories and (4) FIFO is prevalent in the industry in which ABC Company operates. Comparative financial statements of prior years have been adjusted to apply the new method retrospectively. The following financial statement line items (see note below) for fiscal years 20X7 and 20X6 were affected by the change in accounting principle.

Income Statements

Year ended December 31, 20X7

	As reported under FIFO	As computed under LIFO	Effect of change
Sales	\$ 3,000	\$ 3,000	\$ 0
Cost of goods sold	1,100	1,130	(30)
Selling, general, and administrative expenses	1,000	1,000	0
Income before profit sharing and income taxes	900	870	30
Profit sharing	96 ¹	87	9
Income before income taxes	804	783	21
Income taxes	322	313	9
Net income	<u>\$ 482</u>	<u>\$ 470</u>	<u>\$ 12</u>

Year ended December 31, 20X6

	As adjusted	As originally reported	Effect of change
Sales	\$ 3,000	\$ 3,000	\$ 0
Cost of goods sold	940	1,000	(60)
Selling, general, and administrative expenses	1,000	1,000	0
Income before profit sharing and income taxes	1,060	1,000	60
Profit sharing	100	100	0
Income before income taxes	960	900	60
Income taxes	384	360	24
Net income	<u>\$ 576</u>	<u>\$ 540</u>	<u>\$ 36</u>

¹ This amount includes a \$90 profit-sharing payment attributable to 20X7 profits and \$6 profit-sharing payment attributable to adjusted 20X6 profits, which is an indirect effect of the change in accounting principle. The incremental payment attributable to 20X6 would have been recognized in 20X6 if ABC Company's inventory had originally been accounted for using the FIFO method.

Balance Sheets

December 31, 20X7

	As reported under FIFO	As computed under LIFO	Effect of change
Cash	\$ 2,732	\$ 2,738	\$ (6)
Inventory	390	320	70
Total assets	<u>\$ 3,122</u>	<u>\$ 3,058</u>	<u>\$ 64</u>
Accrued profit sharing	90	87	3
Income tax liability	338	313	25
Total liabilities	428	400	28
Paid-in capital	1,000	1,000	0
Retained earnings	1,694	1,658	36
Total stockholders' equity	<u>2,694</u>	<u>2,658</u>	<u>36</u>
Total liabilities and stockholders' equity	<u>\$ 3,122</u>	<u>\$ 3,058</u>	<u>\$ 64</u>

December 31, 20X6

	As adjusted	As originally reported	Effect of change
Cash	\$ 2,448	\$ 2,448	\$ 0
Inventory	240	200	40
Total assets	<u>\$ 2,688</u>	<u>\$ 2,648</u>	<u>\$ 40</u>
Accrued profit sharing	100	100	0
Income tax liability	376	360	16
Total liabilities	476	460	16
Paid-in capital	1,000	1,000	0
Retained earnings	1,212	1,188	24
Total stockholders' equity	<u>2,212</u>	<u>2,188</u>	<u>24</u>
Total liabilities and stockholders' equity	<u>\$ 2,688</u>	<u>\$ 2,648</u>	<u>\$ 40</u>

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

Statement of cash flows

Year ended December 31, 20X7

	As reported under FIFO	As computed under LIFO	Effect of change
Net income	\$ 482	\$ 470	\$ 12
Adjustments to reconcile net income to net cash provided by operating activities			
Increase in inventory	(150)	(120)	(30)
Decrease in accrued profit sharing	(10)	(13)	3
Decrease in income tax liability	(38)	(47)	9
Net cash provided by operating activities	<u>284</u>	<u>290</u>	<u>(6)</u>
Net increase in cash	284	290	(6)
Cash, January 1, 20X7	<u>2,448</u>	<u>2,448</u>	<u>0</u>
Cash, December 31, 20X7	<u>\$ 2,732</u>	<u>\$ 2,738</u>	<u>\$ (6)</u>

Year ended December 31, 20X6

	As adjusted	As originally reported	Effect of change
Net income	\$ 576	\$ 540	\$ 36
Adjustments to reconcile net income to net cash provided by operating activities			
Increase in inventory	(160)	(100)	(60)
Decrease in accrued profit sharing	(20)	(20)	0
Decrease in income tax liability	(48)	(72)	24
Net cash provided by operating activities	348	348	0
Net increase in cash	348	348	0
Cash, January 1, 20X6	2,100	2,100	0
Cash, December 31, 20X6	\$ 2,448	\$ 2,448	\$ 0

Illustration 3-8: Retrospective application of a change in accounting principle – public entity with three year comparative income statements and statements of cash flows presented

Assume the same facts as Illustration 3-1, however, ABC Company has been in existence for many years and elects to adopt the FIFO method of inventory valuation on 1 January 20X7. Assume further that ABC Company is an SEC registrant that is required to present three years of comparative income statements, statements of cash flows, and is required to present earnings per share information related to its outstanding common stock and common stock equivalents. In this example, the change in accounting principle is applied retrospectively to the financial statements for the years 20X5 and 20X6 (including interim reporting periods) and the cumulative effect of the change is recognized in retained earnings as of 1 January 20X5.

Application and disclosure of the change in accounting principle in this example would be the same as Illustration 3-2 and Illustration 3-7, except that an additional year of disclosures related to the income statement and statement of cash flow changes for 20X5 is included in the ABC Company's disclosures. Disclosure of the effect of the change on earnings per share for all years presented is also required. Further, the cumulative effect of the change in accounting principle recognized in retained earnings on 1 January 20X5 is recognized as a component of retained earnings in ABC Company's 20X5 statement of changes in shareholder's equity. The change in accounting principle is applied retrospectively to the financial statements for the years 20X5 and 20X6. With respect to 20X7 (the period of change), ABC Company is required to disclose the effect of the change on income from continuing operations, net income and the related per-share amounts for each of its quarterly financial statements issued during 20X7. The disclosures required by ASC 250 are not required in financial statements issued for periods subsequent to 20X7 because all periods are presented on the same basis of accounting.

The example disclosure in Illustration 3-7 illustrates disclosure of the financial statement line items affected by the change in accounting principle in a tabular format. While there is no required method of disclosing the information required by ASC 250-10-50-1(b) and 50-1(c), we believe that a tabular presentation provides the most useful information to financial statement users. However, it is also acceptable to disclose the required information in a narrative format if the facts and circumstances support such a presentation.

Item 302(a) of Regulation S-K requires certain disclosures when there has been a material retrospective change (or changes that are material in the aggregate) affecting comprehensive income. See section 3.5.1, *Fourth quarter accounting changes*, for additional discussion of the Item 302(a) of Regulation S-K disclosure requirement and an example (illustration 3-5) of the combined disclosure required by ASC 250 and Item 302(a) of Regulation S-K.

3.8.1

Disclosures before the effective date of a final codification update (updated April 2024)

Excerpt from Accounting Standards Codification

Accounting Changes and Error Corrections – Overall

SEC Materials

SAB Topic 11.M, Disclosure of the Impact that Recently Issued Accounting Standards Will Have on the Financial Statements of the Registrant when Adopted in a Future Period

250-10-S99-5

The following is the text of SAB Topic 11.M, Disclosure of the Impact that Recently Issued Accounting Standards Will Have on the Financial Statements of the Registrant when Adopted in a Future Period.

Facts: An accounting standard has been issued^{FN5} that does not require adoption until some future date. A registrant is required to include financial statements in filings with the Commission after the issuance of the standard but before it is adopted by the registrant.

Question 1: Does the staff believe that these filings should include disclosure of the impact that the recently issued accounting standard will have on the financial position and results of operations of the registrant when such standard is adopted in a future period?

Interpretive Response: Yes. The Commission addressed a similar issue and concluded that registrants should discuss the potential effects of adoption of recently issued accounting standards in registration statements and reports filed with the Commission.^{FN6} The staff believes that this disclosure guidance applies to all accounting standards which have been issued but not yet adopted by the registrant unless the impact on its financial position and results of operations is not expected to be material.^{FN7} MD&A^{FN8} requires registrants to provide information with respect to liquidity, capital resources and results of operations and such other information that the registrant believes to be necessary to understand its financial condition and results of operations. In addition, MD&A requires disclosure of presently known material changes, trends and uncertainties that have had or that the registrant reasonably expects will have a material impact on future sales, revenues or income from continuing operations. The staff believes that disclosure of impending accounting changes is necessary to inform the reader about expected impacts on financial information to be reported in the future and, therefore, should be disclosed in accordance with the existing MD&A requirements. With respect to financial statement disclosure, GAAS^{FN9} specifically address the need for the auditor to consider the adequacy of the disclosure of impending changes in accounting principles if (a) the financial statements have been prepared on the basis of accounting principles that were acceptable at the financial statement date but that will not be acceptable in the future and (b) the financial statements will be retrospectively adjusted in the future as a result of the change. The staff believes that recently issued accounting standards may constitute material matters and, therefore, disclosure in the financial statements should also be considered in situations where the change to the new accounting standard will be accounted for in financial statements of future periods, prospectively or with a cumulative catch-up adjustment.

Question 2: Does the staff have a view on the types of disclosure that would be meaningful and appropriate when a new accounting standard has been issued but not yet adopted by the registrant?

Interpretive Response: The staff believes that the registrant should evaluate each new accounting standard to determine the appropriate disclosure and recognizes that the level of information available to the registrant will differ with respect to various standards and from one registrant to another. The objectives of the disclosure should be to (1) notify the reader of the disclosure documents that a standard has been issued which the registrant will be required to adopt in the future and (2) assist the reader in assessing the significance of the impact that the standard will have on the financial statements of the registrant when adopted. The staff understands that the registrant will only be able to disclose information that is known.

The following disclosures should generally be considered by the registrant:

A brief description of the new standard, the date that adoption is required and the date that the registrant plans to adopt, if earlier.

A discussion of the methods of adoption allowed by the standard and the method expected to be utilized by the registrant, if determined.

A discussion of the impact that adoption of the standard is expected to have on the financial statements of the registrant, unless not known or reasonably estimable. In that case, a statement to that effect may be made.

Disclosure of the potential impact of other significant matters that the registrant believes might result from the adoption of the standard (such as technical violations of debt covenant agreements, planned or intended changes in business practices, etc.) is encouraged.

SEC Staff Announcement at Emerging Issues Task Force (EITF) Meetings

SEC Staff Announcement: Disclosure of the Impact That Recently Issued Accounting Standards Will Have on the Financial Statements of a Registrant When Such Standards Are Adopted in a Future Period (in accordance with Staff Accounting Bulletin [SAB] Topic 11.M)

ASC 250-10-S99-6

The following is the text of SEC Staff Announcement: Disclosure of the Impact That Recently Issued Accounting Standards Will Have on the Financial Statements of a Registrant When Such Standards Are Adopted in a Future Period (in accordance with Staff Accounting Bulletin [SAB] Topic 11.M).

This announcement applies to Accounting Standards Update (ASU) No. 2014-09, Revenue from Contracts with Customers (Topic 606); ASU No. 2016-02, Leases (Topic 842); and ASU No. 2016-13, Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments.^{FN1}

SAB Topic 11.M provides the SEC staff view that a registrant should evaluate ASUs that have not yet been adopted to determine the appropriate financial statement disclosures^{FN2} about the potential material effects of those ASUs on the financial statements when adopted. Consistent with Topic 11.M, if a registrant does not know or cannot reasonably estimate the impact that adoption of the ASUs referenced in this announcement is expected to have on the financial statements, then in addition to making a statement to that effect, that registrant should consider additional qualitative financial statement disclosures to assist the reader in assessing the significance of the impact that the standard will have on the financial statements of the registrant when adopted. In this regard, the SEC staff expects the additional qualitative disclosures to include a description of the effect of the accounting policies that the registrant expects to apply, if determined, and a comparison to the registrant's current accounting policies. Also, a registrant should describe the status of its process to implement the new standards and the significant implementation matters yet to be addressed.

^{FN5} Some registrants may want to disclose the potential effects of proposed accounting standards not yet issued, (e.g., exposure drafts). Such disclosures, which generally are not required because the final standard may differ from the exposure draft, are not addressed by this SAB. See also FRR 26.

^{FN6} FRR 6, Section 2.

^{FN7} In those instances where a recently issued standard will impact the preparation of, but not materially affect, the financial statements, the registrant is encouraged to disclose that a standard has been issued and that its adoption will not have a material effect on its financial position or results of operations.

^{FN8} Item 303 of Regulation S-K.

^{FN9} See AU 9410.13-18.

^{FN1} This announcement also applies to any subsequent amendments to guidance in the ASUs that are issued prior to a registrant's adoption of the aforementioned ASUs.

^{FN2} Topic 11.M provides SEC staff views on disclosures that registrants should consider in both Management's Discussion & Analysis (MD&A) and the notes to the financial statements. MD&A may contain cross references to these disclosures that appear within the notes to the financial statements.

Questions may arise regarding what disclosures, if any, should be made related to the expected effects of an impending accounting change in financial statements issued after the codification update is issued but before it is effective.

The FASB has not dealt specifically with these disclosure questions. However, the AICPA AU Section No. 9410 Section 3 (AU 9410 Section 3), *The Impact on an Auditor's Report of an FASB Statement Prior to the Statement's Effective Date (rescinded)*, considered it with regard to financial statements (which include related notes) issued before the effective date of an issued accounting pronouncement by concluding that "[f]or financial statements that are prepared on the basis of accounting principles that are acceptable at the financial-statement date but that will not be acceptable in the future, the auditor should consider whether disclosure of the impending change in principle and the resulting restatement are essential data." AU 9410 Section 3 suggests there will be circumstances when the effect of a new accounting pronouncement would be so material that disclosure would be required. Such disclosure might be made by supplementing the historical financial statements with pro forma financial data, either in comparative columnar form, in the notes, or as separate financial statements.

Also, AICPA Auditing Standards Section No. 708 (AU-C 708), *Consistency of Financial Statements*, states: "If a change in accounting principle does not have a material effect on the financial statements in the current year but the change is expected to have a material effect in later years, the auditor is not required to recognize the change in the auditor's report in the current year. The applicable financial reporting framework may include a requirement for the entity to disclose such situations in the notes to the financial statements ..." While AU 9410 Section 3 is directed to the disclosure of the impending effect of a retroactive restatement (referred to herein as retrospective application subsequent to the issuance of ASC 250), and AU-C 708, which focuses on auditor's responsibility but also mentions the disclosure requirement, applies to the year in which an accounting change is made, the conclusions reached may be applied to disclosures of all accounting changes that will result from the adoption of accounting pronouncements that have already been issued but are not yet effective for the entity.

While it is impractical to give guidance on the need to disclose the effects of pending accounting changes that will address every possible situation, we believe the following general guidance will provide a useful framework for dealing with specific cases:

1. A codification update is issued but not effective for the financial statements being issued:

- a. Change will be given effect by either retrospective application or a cumulative catch-up adjustment to retained earnings.

The impending change and an approximate quantification, if known, normally would be disclosed if either of the following conditions are present:

- ▶ Either the change will materially affect important balance sheet items such as shareholders' equity, working capital, certain ratios such as debt-to-equity, or it may cause defaults under debt or other agreements as to which waivers are not yet obtained or agreements are not amended, if the consequences of the default would be material to the financial statements, or
- ▶ The change will materially affect the reported results of operations for any of the most recent years (usually the last three years), including the current year on an actual (retrospectively applied) basis.

- b. Change will be given effect prospectively.

The impending change would be disclosed if the effect on financial position or results of operations is expected to be material. The MD&A disclosures would indicate the expected magnitude of the effect of the change on future periods, while the financial statement notes should disclose the anticipated effect of a new standard on historical financial statements.

2. An amendment to the codification is in the exposure period, or that period has ended but a final codification update has not yet been issued.

Generally, no disclosure is required because exposure drafts do not establish GAAP and it is usually uncertain whether an amendment to the codification will be issued in substantially the same form as proposed. Disclosure of the potential effects of a proposed accounting standards update may be appropriate only in those rare situations in which adopting the update in the form in which the proposed update is exposed would change drastically the reported financial position or level of profitability shown by the financial statements.

Many companies whose financial statements are likely to be significantly affected by a codification update will determine at least the approximate effects as soon as the update is issued and will wish to provide users of their financial statements with information quantifying the expected effects of the impending change. It is acceptable to disclose that the effect of the change has not yet been determined in situations when the effect of the change has not been determined since the company can only disclose information that is known at the time the disclosure is made. However, if more than one reporting date is involved before the effective date of the update to the codification, disclosure should improve as the effective date approaches.

In addition, in SAB Topic 11.M, *Disclosure of the Impact that Recently Issued Accounting Standards Will Have on the Financial Statements of the Registrant When Adopted in a Future Period* (Topic 11.M), the SEC staff stated that disclosure of impending accounting changes due to recently issued codification updates is necessary to inform the reader about the expected effects on financial information to be reported when such codification update is adopted in the future and, therefore, should be disclosed in accordance with existing MD&A requirements. The SEC staff believes that recently issued codification updates may constitute material matters and, therefore, disclosure in the financial statements also should be considered in situations when the change to the new codification update will be adopted in the future. The objectives of financial statement disclosure should be to (1) notify the reader of the disclosure that a codification update has been issued that the registrant will be required to adopt in the future and (2) assist the reader in assessing the significance of the effect that the new codification update will have on the financial statements of the registrant when adopted, including whether the financial statements will be retrospectively adjusted in the future as a result of the change.

The SEC staff noted that Topic 11.M disclosures are only required if the registrant reasonably expects a new codification update to have a material effect on its financial statements. That is, the SEC staff only expects a registrant to disclose pending codification updates that will require adoption via material retroactive adjustments to the historical financial statements (to be disclosed in the financial statement notes) or which will have a material effect on future financial statements via prospective adoption (to be disclosed in MD&A). A registrant should consider the full scope of new standards to evaluate if adoption of the standard is material. This would include presentation and disclosure in addition to recognition and measurement of transactions.

If a recently issued codification update with a delayed effective date allows for its early adoption, we believe the Topic 11.M disclosures should include a description of when and how the codification update is expected to be initially applied. In effect, by allowing for early adoption, the new accounting standard creates a new accounting policy election. That is, during the early-adoption period there may be multiple acceptable accounting policies. For example, following the issuance of a new accounting pronouncement a company may have the option of continuing to follow their previous accounting policy, or electing to apply the requirements of the new codification update before its effective date.

At the September 2016 Emerging Issues Task Force (EITF) Meeting, the SEC staff announced disclosure considerations that are applicable to ASU 2014-09, *Revenue from Contracts with Customers* (Topic 606), ASU 2016-02, *Leases* (Topic 842) and ASU 2016-13, *Financial Instruments—Credit Losses* (Topic 326):

Measurement of Credit Losses on Financial Instruments. The SEC staff stated that, consistent with Topic 11.M, if a registrant does not know or cannot reasonably estimate the impact that adoption of these ASUs is expected to have on the financial statements it should make a statement to that effect and consider providing qualitative disclosures to assist the reader in assessing the significance of the impact that the standard will have on the financial statements of the registrant when adopted. Those qualitative disclosures should include a description of the new standard's effect of the registrant's accounting policies and provide a comparison to the registrant's current accounting policies. A registrant should also describe the status of its process to implement the new standards and the significant implementation matters yet to be addressed. Also consistent with Topic 11.M, the SEC staff expects an entity's disclosures to evolve in each reporting period as more information about the effects of these new standards becomes available.

3.9 Preferability letter

When an SEC registrant makes a voluntary change in accounting principle, it generally is required to include a preferability letter issued by its independent registered public accounting firm as Exhibit 18 to its first periodic report filed subsequent to the accounting change (e.g., Quarterly Report on Form 10-Q if the change is made in an interim period other than the fourth quarter, Annual Report on Form 10-K if the change is made in the fourth quarter). ASC 250 has no effect on this requirement. The SEC staff has taken the position that a preferability letter is needed for each situation in which a registrant discloses a voluntary change in accounting principle, even though the auditors may consider the change to not be material and do not comment thereon in their report.

Item 601 of Regulation S-K states that a preferability letter is not required when an accounting change is made in response to standards adopted by the FASB.

Goodwill impairment date testing

In a December 2014 speech at the AICPA Conference on Current SEC and PCAOB Developments, an SEC staff member⁷ stated the following: "... the staff has observed that some registrants may view a change in goodwill impairment testing date to not represent a material change to a method of applying an accounting principle, even if goodwill is material to the financial statements, because the change in impairment testing date is not viewed to have a material effect on the financial statements in light of the registrant's internal controls and requirements under Topic 350 to assess goodwill impairment upon certain triggering events. The staff acknowledges that judgment is required when assessing materiality and the assessment of whether a change in accounting principle is material may include considerations beyond the quantitative significance of the financial statement line items. Accordingly, if a registrant determines that a change in goodwill impairment testing date does not represent a material change to its method of applying an accounting principle, the staff will no longer request a preferability letter to be obtained and filed, provided that such change is prominently disclosed in the registrant's financial statements. The staff also reserves the right to ask questions based on the registrant's specific facts and circumstances, which may include situations where it appears that a registrant's goodwill impairment testing date is frequently changed."

We believe this exception to the requirement to include a preferability letter as an exhibit to the first periodic report filed subsequent to the accounting change is limited to voluntary changes in accounting principle related to the date the annual goodwill impairment assessment is performed. It is inappropriate to analogize to this view for other types of voluntary changes in accounting principle.

A registrant should determine that the appropriate processes and controls are designed and operating at a precision level sufficient to monitor goodwill and timely identify triggering events that indicate goodwill may be impaired prior to determining that a change in goodwill impairment assessment date is appropriate.

⁷ Carlton Tartar, Associate Chief Accountant, Office of the Chief Accountant

As a reminder, while an accounting change may not require a preferability letter (e.g., private companies, certain changes to goodwill impairment testing dates), the change must still be preferable. See section 3.4, *Justification for a change in accounting principle* for further discussion on preferability.

Private Company Council (PCC) alternatives

The FASB issued ASU No. 2016-03, which eliminates the effective dates of four PCC alternatives.⁸ A private company that adopts an alternative is voluntarily changing an accounting principle. Such a change normally triggers the requirements in ASC 250, including a preferability assessment. That would have been costly and complex for private companies. ASU No. 2016-03 allows private companies to forgo a preferability assessment the first time they elect each of these alternatives. After the initial election of a PCC alternative, subsequent accounting changes will require a preferability assessment.

Summary of requirements

The following is a summary of frequent situations in which an accounting change is reflected along with a summary of whether or not such change in accounting principle requires a preferability letter:

Description	Preferability letter requirement
Voluntary change in accounting principle in a recurring SEC filing.	A preferability letter is required for all material voluntary changes in accounting principle in a recurring SEC filing (e.g., 10-Q, 10-K, N-SAR filings). A preferability letter is not required when an accounting change is made in response to standards adopted by the FASB (i.e., codification update). However, when two accounting alternatives are specifically approved by the FASB and the registrant subsequently changes from one alternative to the other, a preferability letter is required.
An immaterial voluntary change in accounting principle that has been disclosed in a recurring SEC filing.	<p>The SEC staff expects and requires a preferability letter for accounting changes that are disclosed (whether in the financial statements or by other means) or that result in a change in the description of accounting policies. The SEC staff believes that although a change might not be material enough to require a reference to consistency in the auditor's report or retrospective adoption, if it is important enough to be disclosed or to have caused a change in disclosure, it should be supported by a preferability letter. We believe companies should consider the completeness and relevance of their material accounting policy disclosures as part of preparing their interim and annual financial statements.</p> <p>If the change in accounting principle is not disclosed due to immateriality (i.e., the pre-existing policy was not disclosed), we believe no preferability letter would be required.</p> <p>A change to a previously disclosed accounting principle, regardless of whether that accounting principle was material, would generally require a preferability letter. This is because it is assumed all disclosed accounting principles are material.</p> <p>As described above, a preferability letter may not be required for voluntary changes in a goodwill impairment assessment date provided that such change is prominently disclosed in the registrant's financial statements.</p>

⁸ ASU No. 2016-03 *Intangibles – Goodwill and Other Topics (Topics 350); Business combinations (Topic 805); Consolidation (Topic 810); Derivatives and Hedging (Topic 815); Effective Date and Transition Guidance (a Consensus of the Private Company Council)*

Description	Preferability letter requirement
Change in accounting in an initial public offering (previously financial statements were not filed with the SEC).	Preferability letters are not required in 1933 Act filings. ⁹
Voluntary change in accounting principle by an entity's subsidiary or equity method investee.	When an entity's subsidiary or equity method investee makes a voluntary change in accounting principle, a preferability letter may be needed depending on the materiality of the change to the consolidated financial statements.
A change in accounting estimate effected by a voluntary change in an accounting principle in a recurring SEC filing.	Like other voluntary changes in accounting principle, a change in accounting estimate that is effected by a change in an accounting principle may be made only if the new accounting principle is justifiable on the basis that it is preferable. However, the SEC staff does not require a preferability letter for a change in accounting estimate that is effected by a change in accounting principle. ¹⁰
A voluntary change in accounting disclosed in a Form 20-F.	Form 20-F does not have a requirement for a preferability letter. Therefore, no preferability letter is required of a foreign private issuer for a change in home country or US GAAP accounting principles included in a Form 20-F. However, Instruction B of Form 6-K requires a foreign private issuer to furnish material information disclosed or required to be disclosed in the foreign jurisdiction. That is, if there is a regulatory requirement for the foreign private issuer to file a preferability letter in its home jurisdiction, then the letter must also be furnished as part of filing Form 6-K.
A change in accounting principle made to conform an acquired entity's accounting policy to that of the acquirer.	As a limited exception, the SEC staff has indicated that a preferability letter generally is not required after a business combination when changes in the acquired entity's accounting are made to conform to those of the acquiring entity. ¹¹ For example, when a company acquires a registrant that continues as a reporting entity (e.g., the acquired registrant guarantees public debt of the parent and does not qualify for financial statement relief under Rule 3-10) and the acquired registrant makes an accounting change to conform to that of the parent, a preferability letter generally is not required.

3.10

Internal control over financial reporting considerations (updated July 2025)

Financial statement risks related to changes in accounting principle including voluntary changes in accounting principle as well as changes required by newly issued ASUs should be appropriately mitigated by internal controls. The concepts of ASC 250 are pervasive (i.e., not limited to a single account, disclosure or process) and it will often be necessary to evaluate and test an appropriate mix of controls (e.g., entity level controls) across various levels of the entity to mitigate the risks of material misstatement related to changes in accounting principle.

Entity-level controls: The risk that inconsistent policies are applied is often mitigated through entity-level controls. For example, multinational companies will often have a set of global accounting policies and require quarterly confirmation by subsidiaries that such policies are consistently applied. Subsidiary reporting packages may assist in the identification of a change in policy in a period that may require accounting and reporting under ASC 250.

⁹ Although not required, a preferability letter may be requested by the SEC staff.

¹⁰ SEC Financial Reporting Manual – Division of Corporation Finance, Section 4230.2.c.4.

¹¹ SEC Financial Reporting Manual – Division of Corporation Finance, Section 4230.2.c.3.

Transaction-level controls: Similar to other infrequent transactions (e.g., business combinations, impairment charges), in a period where a company has a voluntary change in accounting policy, it may be necessary to document the process for initiating, implementing and reporting the voluntary change and related controls. Controls that may be identified include management's assessment and documentation of the preferability of the proposed voluntary change in accounting policy and review of the calculation of retrospective adjustments. Additionally, for public business entities, the Audit Committee may approve voluntary changes in accounting.

4 Change in accounting estimate

Excerpt from Accounting Standards Codification

Accounting Changes and Error Corrections – Overall

Other Presentation Matters

Change in Accounting Estimate

250-10-45-17

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

250-10-45-18

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

250-10-45-19

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

250-10-45-20

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

ASC 250-10-45-17 requires a change in accounting estimate to be accounted for in (1) the period of change if the change affects that period only or (2) the period of change and future periods if the change affects both. As such, a change in accounting estimate shall not be accounted for by restating or retrospectively applying the change to prior periods or by reporting pro forma amounts for prior periods.

Common examples of changes in accounting estimates include, but are not limited to the following:

1. Change in the estimated useful life or salvage value of a long-lived asset
2. Change in estimated allowance for loan losses or bad debts (referred to as allowance for expected credit losses upon the adoption of ASU No. 2016-13, *Financial Instruments – Credit Losses (Topic 326)*)
3. Change in estimated liability for warranties
4. Change in estimates of obsolete and excess inventory
5. Change in method of depreciating long-lived assets (presumed to be a change in estimate pursuant to ASC 250-10-45-18)

ASC 250 describes when the effect of the change in accounting principle, or the method of applying it, may be inseparable from the effect of the change in accounting estimate. One example of this type of change is a change in method of depreciation, amortization or depletion of long-lived, nonfinancial assets. Since changes of this type often are related to the continuing process of obtaining additional information and revising estimates of the pattern of consumption, such changes are considered changes in estimates for purposes of applying ASC 250.

Consistent with other changes in accounting principle, a change in accounting estimate that is effected by a change in accounting principle may be made only if the new accounting principle is justifiable on the basis that it is preferable. For example, an entity that concludes the pattern of consumption of the expected benefits of a long-lived asset has changed and believes that a new depreciation method better reflects that consumption pattern, may be justified in making a change in accounting estimate effected by the change in accounting principle (e.g., a change in depreciation method).

In contrast, an entity that makes a change from one method of depreciation to another could not justify the change as preferable if the reason for the change was simply that the new method was more prevalent in the industry in which the reporting entity operates. Better reflecting the pattern of economic consumption of the asset being depreciated should be the sole basis for determining the preferable depreciation method. That said, if industry practice is to depreciate similar assets on a different basis than that used by a particular entity, that fact may cause the company to challenge whether their depreciation method for those assets best reflects their pattern of economic consumption. However, industry practice alone cannot be the basis for a change in accounting principle.

4.1 Disclosures for a change in accounting estimate

Excerpt from Accounting Standards Codification

Accounting Changes and Error Corrections – Overall

Disclosure

Change in Accounting Estimate

250-10-50-4

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

estimate does not have a material effect in the period of change but is reasonably certain to have a material effect in later periods, a description of that change in estimate shall be disclosed whenever the financial statements of the period of change are presented.

Change in Estimate Used in Valuation Technique

250-10-50-5

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

For a change in accounting estimate that affects several future periods, entities are required to disclose the effect of the change on income from continuing operations, net income (or other appropriate captions of changes in the applicable net assets or performance indicator), and any related per-share amounts of the current period. An example of a change that would affect several future periods is a change in service lives of depreciable assets. In contrast, disclosure of the effects is not necessary for estimates made each period in the ordinary course of accounting for items such as uncollectible accounts or inventory obsolescence. However, disclosure is required if the effect of such a change in estimate is material.

Illustration 4-1: Evaluating a change in accounting estimate

Assume a company evaluates the collectibility of accounts receivable based on several factors. During the year, collections of outstanding receivables notably deteriorated compared to previous years causing the company to recognize a material increase in its allowance for credit losses. As a result, the company concludes disclosure of the change in the allowance is required. As an example, the company could disclose the following in the notes to its financial statements:

In the year ended 20X6, due to deteriorations in collections of receivables, the Company changed its estimates of the allowance for credit losses related to its customers, primarily based on historical experience of write-offs of outstanding accounts receivable. The result of this change in estimate resulted in an increase compared to the year ended 31 December 20X5 to the allowance for credit losses by approximately \$9 million (\$6 million net of tax) in the year ended 20X6, or \$0.42 per share (basic and diluted) for the three and twelve months ended 31 December 20X6.

When an entity changes an accounting estimate by changing an accounting principle, the required disclosures for a change in accounting estimate and a change in accounting principle are made.

If a change in estimate does not have a material effect in the period of change but is reasonably certain to have a material effect in later periods, a description of that change in estimate shall be disclosed whenever the financial statements of the period of change are presented.

Illustration 4-2: Reporting a change in accounting estimate

Effective 1 January 20X6, Widget Company changed its estimates of the useful lives of certain machinery and equipment in its manufacturing plants. The following is an example disclosure of this change, in accordance with the provisions of ASC 250, that Widget Company would include in its 20X6 financial statements. If Widget Company was a publicly traded enterprise, a similar disclosure would be made in each of its interim financial statements throughout 20X6.

Note 1: Change in depreciable lives of property and equipment

In accordance with its policy, the Company reviews the estimated useful lives of its fixed assets on an ongoing basis. This review indicated that the actual lives of certain machinery and equipment at its manufacturing plants were longer than the estimated useful lives used for depreciation purposes in the Company's financial statements. As a result, effective 1 January 20X6, the Company changed its estimates of the useful lives of its machinery and equipment to better reflect the estimated periods during which these assets will remain in service. The estimated useful lives of the machinery and equipment that previously averaged ten years were increased to an average of 15 years, while those that previously averaged six to eight years were increased to an average of ten years. The effect of this change in estimate was to reduce 20X6 depreciation expense by \$500,000, increase 20X6 net income by \$300,000, and increase 20X6 basic and diluted earnings per share by \$0.03.

4.2**Internal control over financial reporting considerations**

Financial statement risks related to changes in estimates should be appropriately mitigated by internal controls over financial reporting. Management should understand the significant assumptions, methods, data and controls related to estimates and how necessary changes in those assumptions, methods and data are timely identified by controls.

A key consideration of the design of controls over an estimation process is timely performance. Timely performance makes sure that a necessary change in estimate is identified as new information becomes available. For example, assume a company has a control that the accounts receivable aging is reviewed to identify collection issues. The control is designed to mitigate risks to the completeness and valuation assertions associated with the accounts receivable allowance. If this control is not performed timely, a necessary change in estimate may not be identified as of the end of a reporting period. If the change in estimate is identified in a later reporting period, the adjustment may represent the correction of a prior-period error. See discussion in section 6.1.1, *Error correction versus a change in accounting estimate*.

5

Change in reporting entity

Excerpt from Accounting Standards Codification

Accounting Changes and Error Corrections – Overall

Glossary

250-10-20

Change in the Reporting Entity

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

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

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

Other Presentation Matters

Change in Reporting Entity

250-10-45-21

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

ASC 250-10-45-21 requires entities to reflect a change in the reporting entity (i.e., financial statements that are, in effect, the statements of a different reporting entity), by retrospective application to the financial statements of all prior periods presented to show financial information for the new reporting entity. Further, the change in reporting entity shall be applied to previously issued interim financial information on a retrospective basis. One exception is that the amount of interest cost previously capitalized through application of ASC 835-20, *Capitalization of Interest*, shall not be changed when retrospectively applying the accounting change to the financial statements of prior periods.

Common examples of an accounting change that is a change in reporting entity are mainly limited to the following:

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

Neither a business combination accounted for under ASC 805, *Business Combinations*, nor the consolidation or deconsolidation of a variable interest entity (VIE) pursuant to ASC 810-10, *Consolidation – Overall*, is a change in reporting entity. For example, assume a company consolidates a VIE pursuant to ASC 810-10 in its consolidated financial statements for the year ended 20X8. On 1 January 20X9, because of the addition of a new investor in the VIE that is given contractual rights to make decisions, the company is no longer considered the primary beneficiary for the VIE. As such, the company deconsolidates the VIE and prospectively accounts for the VIE using the equity method of accounting pursuant to ASC 323, *Investments – Equity Method and Joint Ventures*. As the change in accounting for the VIE is the result of an event that has economic substance, the change does not meet the definition of a change in reporting entity. That is, the change in accounting for the VIE was not a result of a voluntary accounting change as contemplated by ASC 250 and retrospective application of a change in reporting entity is not required or permitted.

5.1 Change in reporting entity (common control transactions)

Common control transactions include transfers of net assets or exchanges of equity interests between entities under common control. Such transactions commonly occur as a result of reorganizations, spin-offs and IPOs. Generally, a common control transaction involving the transfer of a business represents a change in reporting entity under ASC 250 for the receiving entity, which requires retrospective adjustment of the consolidated financial statements. However, we believe it would generally not be appropriate to apply a change in reporting entity for the transferring entity (even if the assets transferred or shares exchanged constitute a business). Refer to Appendix C, *Accounting for common control transactions*, of our FRD, *Business combinations*, for additional discussion.

5.2 Disclosures for a change in reporting entity (updated April 2024)

Excerpt from Accounting Standards Codification

Accounting Changes and Error Corrections – Overall

Disclosure

Change in Reporting Entity

250-10-50-6

When there has been a **change in the reporting entity**, the financial statements of the period of the change shall describe the nature of the change and the reason for it. In addition, the effect of the change on income from continuing operations, net income (or other appropriate captions of changes in the applicable net assets or performance indicator), other comprehensive income, and any related per-share amounts shall be disclosed for all periods presented. Financial statements of subsequent periods need not repeat the disclosures required by this paragraph. If a change in reporting entity does not have a material effect in the period of change but is reasonably certain to have a material effect in later periods, the nature of and reason for the change shall be disclosed whenever the financial statements of the period of change are presented. (Sections 805-10-50, 805-20-50, 805-30-50, and 805-740-50 describe the manner of reporting and the disclosures required for a business combination.)

Pending Content:

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

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

components of equity or net assets in the statement of financial position as of the beginning of the earliest period presented also shall be disclosed. Financial statements of subsequent periods need not repeat the disclosures required by this paragraph. If a change in reporting entity does not have a material effect in the period of change but is reasonably certain to have a material effect in later periods, the nature of and reason for the change shall be disclosed whenever the financial statements of the period of change are presented. See paragraph 270-10-45-12 for additional guidance related to accounting changes in interim periods. (Sections 805-10-50, 805-20-50, 805-30-50, and 805-740-50 describe the manner of reporting and the disclosures required for a business combination.)

Additionally, under SEC Rule 10-01(b)(7) of Regulation S-X, registrants are required to provide disclosure of any material retroactive prior-period adjustments made during any period covered by the interim financial statements, together with the effect thereof on net income, total and per share, of any prior period included and on the balance of retained earnings.

If results of operations, for any period presented, have been adjusted retroactively by such an item the initial reporting of such period, the registrant is required to provide similar disclosure of the effect of the change. Additionally, Rule 3-04 of Regulation S-X requires that a registrant state separately the adjustments to the balance at the beginning of the earliest period presented for items that were retroactively applied to periods prior to that period.

5.3 Internal control over financial reporting considerations

The financial statement risk related to changes in reporting entity should be appropriately mitigated by internal controls over financial reporting. A key consideration of the controls associated with a change in reporting entity is timely identifying the change in reporting entity. Additionally, when a change in reporting entity occurs, it may be necessary for management to reconsider the controls associated with consolidation and intercompany transactions.

6

Correction of an error in previously issued financial statements

Once an error is identified, a company must assess the appropriate means to account for the correction of that error. A decision whether that correction should be reflected in a restatement of prior financial statements and how to reflect that restatement or if the error correction can be recognized in the current period financial statements is based on the materiality of the error to the current period and prior period(s) financial statements.

There are three primary considerations upon discovery of a potential error:

1. Determining whether an error exists (instead of an acceptable reclassification, change in estimate or change in accounting principle) – See section 6.1, *Determining whether an error exists*
2. Assessing the materiality of an error (also includes internal control considerations) – See section 6.2, *Assessing the materiality of an error*
3. Reporting an error in previously issued financial statements – See section 6.3, *Reporting an error in previously issued financial statements*

6.1 Determining whether an error exists

Excerpt from Accounting Standards Codification

Accounting Changes and Error Corrections – Overall

Glossary

250-10-20

Error in Previously Issued Financial Statements

An error in recognition, measurement, presentation, or disclosure in financial statements resulting from mathematical mistakes, mistakes in the application of generally accepted accounting principles (GAAP), or oversight or misuse of facts that existed at the time the financial statements were prepared. A change from an accounting principle that is not generally accepted to one that is generally accepted is a correction of an error.

Errors may occur in the recognition, measurement, presentation or disclosure of transactions or events. Determining whether an adjustment is an error versus a change in estimate, acceptable reclassification or change in accounting principle is an important determination. Examples of corrections of errors in previously issued financial statements include, but are not limited to, the following:

- ▶ A change from an accounting principle that is not generally accepted to one that is generally accepted
- ▶ Corrections of mistakes in the application of US GAAP
- ▶ Corrections of mathematical mistakes
- ▶ Oversight or misuse of facts that existed at the time the financial statements were prepared

6.1.1 Error correction versus a change in accounting estimate

In some cases, it can be difficult to distinguish an error from a change in accounting estimate. A change in accounting estimate is defined in the ASC Master Glossary as “a change that has the effect of adjusting the carrying amount of an existing asset or liability or altering the subsequent accounting for existing or future assets or liabilities. A change in accounting estimate is a necessary consequence of the assessment, in conjunction with the periodic presentation of financial statements, of the present status and expected future benefits and obligations associated with assets and liabilities. Changes in accounting estimates result from new information.” See section 4, *Change in accounting estimate*, for further information about accounting for a change in estimate.

Developing and applying accounting estimates is a necessary part of accounting and financial reporting. Numerous accounting pronouncements require entities to develop accounting estimates and assess on an ongoing basis whether the underlying assumptions have changed. Examples of estimates include uncollectible receivables, inventory obsolescence and warranty obligations. By their very nature, such estimates will and should change over time as new information and experience develops. However, the fact that the accounting treatment involves an estimation process does not mean that all changes related to an estimation process are changes in estimates. If the actual results do not support the assumptions used to develop the accounting estimate, an entity should evaluate whether an error (rather than a change in accounting estimate) has occurred.

Determining whether an adjustment is a change in accounting estimate or an error requires the use of judgment and is often a matter of degree. We often receive questions regarding whether the use of “new information” represents a change in estimate or an error correction. The response depends on when the information was reasonably available, when the estimate was updated for the information, how the information was interpreted, etc. For example, not changing an estimate’s underlying assumptions in a timely fashion as new information is available or circumstances change could result in an error. Additionally, misinterpreting information used to develop or support an estimate in a previously issued set of financial statements is an error.

6.1.2 Error correction versus a reclassification

A reclassification is a change in classification of the amount presented in financial statements to conform the presentation of prior period(s) to the current period. Such a change maintains comparability among the periods presented. A reclassification is a change from one presentation that complies with US GAAP to another presentation that complies with US GAAP.

Excerpt from Accounting Standards Codification

Presentation of Financial statements – Overall

Other Presentation Matters

205-10-45-3

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

Disclosure

205-10-50-1

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

An assessment of whether a reclassification is a change in accounting principle (e.g., a change in the classification of interest and penalties associated with an uncertain tax position) should also be considered. See section 3.4.3, *Assessing reclassifications for a voluntary change in accounting principle*.

The SEC staff has observed¹² that some entities improperly conclude that certain prior-period adjustments to the financial statements are reclassifications rather than error corrections. If the presentation of the prior period does not conform with US GAAP, then the change represents an error correction, not a reclassification.

Illustration 6-1: Error correction vs. reclassification

In 20X2, Company ABC changes the presentation of a certain type of revenue from gross reporting to net reporting. ASC 606, *Revenue from contracts with customers*, provides specific guidance to determine if gross or net reporting is appropriate. The company determines that the change is a result of a misapplication of US GAAP and should be treated as a correction of an error, even though its previously reported net income would not change.

In the same year, the company determines that the self-insurance accrual provides decision-useful information for investors and wants to include the amounts on the face of the balance sheet even though such separately identified information is not required based on US GAAP or SEC rules. In the prior year, the self-insurance accrual balance was included in the other liabilities line item. To conform the presentation of the prior year balance sheet, the company adds a self-insurance accrual line item and adjusts the prior year other liabilities line item. This change in line item amounts presented in the prior year balance sheet is a reclassification.

6.1.3

Error correction and a change in accounting principle

A change in accounting principle occurs when an entity changes from one generally accepted accounting principle to another generally accepted accounting principle or when an entity changes the method of applying an accounting principle. A change from one acceptable accounting principle to another is not an accounting error. See section 3, *Change in accounting principle*, for additional information on a change in accounting principle.

In the period of a change in accounting principle, an entity may discover an error as described in section 6.1, *Determining whether an error exists*. It is not acceptable to encompass the correction of an error within the accounting for a change in accounting principle. Similar to all other errors, the entity should separately assess the materiality of the error and account for the correction of the error in accordance with ASC 250 and other related guidance as described in the following sections.

¹² Remarks before the 2011 AICPA National Conference on Current SEC and PCAOB Developments, Nili Shah and Craig Olinger, Deputy Chief Accountants, Division of Corporation Finance, 6 December 2011

6.1.4 Error corrections and industry practice

Excerpt from Accounting Standards Codification

Accounting Changes and Error Corrections – Overall

SEC Materials

SAB Topic 1.M, Assessing Materiality

250-10-S99-1

GAAP precedence over industry practice.

Some have argued to the staff that registrants should be permitted to follow an industry accounting practice even though that practice is inconsistent with authoritative accounting literature. This situation might occur if a practice is developed when there are few transactions and the accounting results are clearly inconsequential, and that practice never changes despite a subsequent growth in the number or materiality of such transactions. The staff disagrees with this argument. Authoritative literature takes precedence over industry practice that is contrary to GAAP.^{FN72}

^{FN72} See AU 411.05.

To support a selected accounting treatment, some cite industry practice as the basis for supporting a particular accounting treatment, even when that practice is contrary to the requirements of US GAAP. SAB Topic 1.M acknowledges that industry practice may initially be applied to a few transactions that are clearly inconsequential to a reporting entity. However, if industry practice is inconsistent with US GAAP, SAB Topic 1.M explicitly states that authoritative literature takes precedence over industry practice. Therefore, the misapplication of US GAAP (despite consistency of such misapplication within an industry) should be evaluated as an error.

6.1.5 Pre-filing communications with the SEC staff

Excerpt from Accounting Standards Codification

Accounting Changes and Error Corrections – Overall

SEC Materials

SAB Topic 1.M, Assessing Materiality

250-10-S99-1

General comments.

This SAB is not intended to change current law or guidance in the accounting or auditing literature.^{FN73} This SAB and the authoritative accounting literature cannot specifically address all of the novel and complex business transactions and events that may occur. Accordingly, registrants may account for, and make disclosures about, these transactions and events based on analogies to similar situations or other factors. The staff may not, however, always be persuaded that a registrant's determination is the most appropriate under the circumstances. When disagreements occur after a transaction or an event has been reported, the consequences may be severe for registrants, auditors, and, most importantly, the users of financial statements who have a right to expect consistent accounting and reporting for, and disclosure of, similar transactions and events. The staff, therefore, encourages registrants and auditors to discuss on a timely basis with the staff proposed accounting treatments for, or disclosures about, transactions or events that are not specifically covered by the existing accounting literature.

^{FN73} The FASB Discussion Memorandum, "Criteria for Determining Materiality," states that the financial accounting and reporting process considers that "a great deal of the time might be spent during the accounting process considering insignificant matters.... If presentations of financial information are to be prepared economically on a timely basis and presented in a concise intelligible form, the concept of materiality is crucial." This SAB is not intended to require that misstatements arising from insignificant errors and omissions (individually and in the aggregate) arising from the normal recurring accounting close

processes, such as a clerical error or an adjustment for a missed accounts payable invoice, always be corrected, even if the error is identified in the audit process and known to management. Management and the auditor would need to consider the various factors described elsewhere in this SAB in assessing whether such misstatements are material, need to be corrected to comply with the FCPA, or trigger procedures under Section 10A of the Exchange Act. Because this SAB does not change current law or guidance in the accounting or auditing literature, adherence to the principles described in this SAB should not raise the costs associated with recordkeeping or with audits of financial statements.

Authoritative literature does not specifically address all of the novel and complex business transactions that may occur. If registrants choose to account for these unique transactions by analogy, the SEC staff may challenge the accounting and ultimately conclude that an error occurred. Registrants are encouraged to discuss with the SEC staff on a timely basis proposed accounting treatments for, or disclosures about, transactions or events that are not covered by the existing accounting literature. This communication is typically performed through a written pre-filing submission. The SEC staff has published protocols and requirements for pre-filing submissions that are available on the SEC website at <https://www.sec.gov/about/divisions-offices/office-chief-accountant/form-delivery-content-correspondence-consultations>.

6.2 Assessing the materiality of an error (updated July 2025)

For all identified errors, entities need to determine in which annual period or periods the error occurred. A materiality analysis should be performed for each historical annual period affected.

Excerpt from Accounting Standards Codification

Accounting Changes and Error Corrections – Overall

Other Presentation Matters

Materiality Considerations for Correction of an Error

250-10-45-27

In considering materiality for the purpose of reporting the correction of an error, amounts shall be related to the estimated income for the full fiscal year and also to the effect on the trend of earnings. (See paragraph 250-10-50-12.)

Materiality is a key consideration in financial reporting. However, the FASB Codification provides limited guidance on assessing the materiality of financial statement errors but states “... for the purposes of reporting the correction of an error, amounts shall be related to the estimated income for the full fiscal year and also to the effect on the trend of earnings.” The FASB Statement of Financial Accounting Concepts No. 8 (CON 8) (non-authoritative) also discusses materiality and provides some insight as to the lack of prescriptive materiality guidance and the use of judgment when assessing materiality.

Excerpt from Statement of Concepts (non-authoritative)

FASB Statement of Financial Accounting Concepts No. 8, Chapter 3, Qualitative Characteristics of Useful Financial Information

Paragraphs QC11 to QC11B

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

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

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

CON 8's key concept is that magnitude (i.e., a quantitative assessment) on its own is generally insufficient in the assessment of materiality. The nature of the item and other facts and circumstances also must be assessed. Because the FASB believed that no general materiality standard could be formulated given the unique facts and circumstances of each situation, both qualitative and quantitative factors as well as the use of judgment are necessary in assessing materiality.

As part of decisions made in interpreting federal securities laws, the US Supreme Court has held that (1) information is material if there is a substantial likelihood that a reasonable investor would consider it important in deciding how to vote or make an investment decision¹³ and (2) an omitted fact is material if there is a substantial likelihood that disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information available.¹⁴ The US Supreme Court also noted that determinations of materiality require "delicate assessments of the inferences a 'reasonable shareholder' would draw from a given set of facts and the significance of those inferences to him [...]."¹⁵

The SEC staff provided further guidance on how to consider the US Supreme Court and FASB views on materiality by publishing two Staff Accounting Bulletins (SABs).

- ▶ SAB Topic 1.M (SAB 99) – states that the assessment of the materiality of errors should consider both qualitative and quantitative considerations and discusses more specific aspects of the qualitative considerations.
- ▶ SAB Topic 1.N (SAB 108) – addresses quantifying the financial statement effects of errors (i.e., the quantitative analysis) and provides guidance on the correction of errors, including the correction of immaterial errors existing in prior period financial statements.

Combined, the SAB Topics require that a materiality analysis for errors generally includes all of the following:

- ▶ Qualitative analysis (Topic 1.M)
- ▶ Iron curtain method quantitative analysis (Topic 1.N)
- ▶ Rollover method quantitative analysis (Topic 1.N)

¹³ *Basic Inc. v. Levinson*, 485 U.S. 224, 231, 232, and 240 (1988)

¹⁴ *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976)

¹⁵ *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976)

Private company considerations when assessing the materiality of a prior-period error

Although the SEC staff's views expressed in SAB Topic 1.M and SAB Topic 1.N are applicable only to public registrants, we believe private companies should consider this materiality guidance when assessing a prior-period error and whether and how to restate. The SAB Topics provide the most comprehensive materiality guidance issued by a standard setter or regulator available and provide a well-thought-out framework for assessing the concepts of relevance (i.e., qualitative) and magnitude (i.e., quantitative) set forth in CON 8.

6.2.1

Assessing materiality in annual financial reporting periods

A decision of whether to restate and how to reflect that restatement is based on a careful evaluation of the error, which requires a holistic, well-reasoned and objective analysis that includes both qualitative and quantitative considerations. While US GAAP provides little guidance as it relates to assessing materiality, the SEC staff has issued fairly extensive guidance and made various statements on the topic. SAB Topic 1.M makes it clear that using quantitative rules of thumb, such as 5% of net income, is only the first step in assessing materiality.

Excerpt from Accounting Standards Codification

Accounting Changes and Error Corrections – Overall

SEC Materials

SAB Topic 1.M, Assessing Materiality

250-10-S99-1

The following is the text of SAB Topic 1.M, Assessing Materiality.

1. Assessing materiality

Facts: During the course of preparing or auditing year-end financial statements, financial management or the registrant's independent auditor becomes aware of misstatements in a registrant's financial statements. When combined, the misstatements result in a 4% overstatement of net income and a \$.02 (4%) overstatement of earnings per share. Because no item in the registrant's consolidated financial statements is misstated by more than 5%, management and the independent auditor conclude that the deviation from GAAP is immaterial and that the accounting is permissible.^{FN24}

Question: FASB ASC paragraph 105-10-05-6 (Generally Accepted Accounting Principles Topic) states, "The provisions of the Codification need not be applied to immaterial items." In the staff's view, may a registrant or the auditor of its financial statements assume the immateriality of items that fall below a percentage threshold set by management or the auditor to determine whether amounts and items are material to the financial statements?

Interpretive Response: No. The staff is aware that certain registrants, over time, have developed quantitative thresholds as "rules of thumb" to assist in the preparation of their financial statements, and that auditors also have used these thresholds in their evaluation of whether items might be considered material to users of a registrant's financial statements. One rule of thumb in particular suggests that the misstatement or omission^{FN25} of an item that falls under a 5% threshold is not material in the absence of particularly egregious circumstances, such as self-dealing or misappropriation by senior management. The staff reminds registrants and the auditors of their financial statements that exclusive reliance on this or any percentage or numerical threshold has no basis in the accounting literature or the law.

The use of a percentage as a numerical threshold, such as 5%, may provide the basis for a preliminary assumption that – without considering all relevant circumstances – a deviation of less than the specified percentage with respect to a particular item on the registrant’s financial statements is unlikely to be material. The staff has no objection to such a “rule of thumb” as an initial step in assessing materiality. But quantifying, in percentage terms, the magnitude of a misstatement is only the beginning of an analysis of materiality; it cannot appropriately be used as a substitute for a full analysis of all relevant considerations. Materiality concerns the significance of an item to users of a registrant’s financial statements. A matter is “material” if there is a substantial likelihood that a reasonable person would consider it important. In its Concepts Statement 2, Qualitative Characteristics of Accounting Information, the FASB stated the essence of the concept of materiality as follows:

The omission or misstatement of an item in a financial report is material if, in the light of surrounding circumstances, the magnitude of the item is such that it is probable that the judgment of a reasonable person relying upon the report would have been changed or influenced by the inclusion or correction of the item. ^{FN26}

This formulation in the accounting literature is in substance identical to the formulation used by the courts in interpreting the federal securities laws. The Supreme Court has held that a fact is material if there is -

a substantial likelihood that the...fact would have been viewed by the reasonable investor as having significantly altered the “total mix” of information made available. ^{FN27}

Under the governing principles, an assessment of materiality requires that one views the facts in the context of the “surrounding circumstances,” as the accounting literature puts it, or the “total mix” of information, in the words of the Supreme Court. In the context of a misstatement of a financial statement item, while the “total mix” includes the size in numerical or percentage terms of the misstatement, it also includes the factual context in which the user of financial statements would view the financial statement item. The shorthand in the accounting and auditing literature for this analysis is that financial management and the auditor must consider both “quantitative” and “qualitative” factors in assessing an item’s materiality. ^{FN28} Court decisions, Commission rules and enforcement actions, and accounting and auditing literature ^{FN29} have all considered “qualitative” factors in various contexts.

The FASB has long emphasized that materiality cannot be reduced to a numerical formula. In its Concepts Statement 2, the FASB noted that some had urged it to promulgate quantitative materiality guides for use in a variety of situations. The FASB rejected such an approach as representing only a “minority view, stating -

The predominant view is that materiality judgments can properly be made only by those who have all the facts. The Board’s present position is that no general standards of materiality could be formulated to take into account all the considerations that enter into an experienced human judgment. ^{FN30}

The FASB noted that, in certain limited circumstances, the Commission and other authoritative bodies had issued quantitative materiality guidance, citing as examples guidelines ranging from one to ten percent with respect to a variety of disclosures. ^{FN31} And it took account of contradictory studies, one showing a lack of uniformity among auditors on materiality judgments, and another suggesting widespread use of a “rule of thumb” of five to ten percent of net income. ^{FN32} The FASB also considered whether an evaluation of materiality could be based solely on anticipating the market’s reaction to accounting information. ^{FN33}

The FASB rejected a formulaic approach to discharging “the onerous duty of making materiality decisions” ^{FN34} in favor of an approach that takes into account all the relevant considerations. In so doing, it made clear that -

[M]agnitude by itself, without regard to the nature of the item and the circumstances in which the judgment has to be made, will not generally be a sufficient basis for a materiality judgment. ^{FN35}

Evaluation of materiality requires a registrant and its auditor to consider all the relevant circumstances, and the staff believes that there are numerous circumstances in which misstatements below 5% could well be material. Qualitative factors may cause misstatements of quantitatively small amounts to be material; as stated in the auditing literature:

As a result of the interaction of quantitative and qualitative considerations in materiality judgments, misstatements of relatively small amounts that come to the auditor’s attention could have a material effect on the financial statements. ^{FN36}

^{FN24} AU 312 states that the auditor should consider audit risk and materiality both in (a) planning and setting the scope for the audit and (b) evaluating whether the financial statements taken as a whole are fairly presented in all material respects in conformity with GAAP. The purpose of this SAB is to provide guidance to financial management and independent auditors with respect to the evaluation of the materiality of misstatements that are identified in the audit process or preparation of the financial statements (i.e., (b) above). This SAB is not intended to provide definitive guidance for assessing “materiality” in other contexts, such as evaluations of auditor independence, as other factors may apply. There may be other rules that address financial presentation. See, e.g., Rule 2a-4, 17 CFR 270.2a-4, under the Investment Company Act of 1940.

^{FN25} As used in this SAB, “misstatement” or “omission” refers to a financial statement assertion that would not be in conformity with GAAP.

^{FN26} Concepts Statement 2, paragraph 132. See also Concepts Statement 2, Glossary of Terms – Materiality.

^{FN27} TSC Industries v. Northway, Inc., 426 U.S. 438, 449 (1976). See also Basic, Inc. v. Levinson, 485 U.S. 224 (1988). As the Supreme Court has noted, determinations of materiality require “delicate assessments of the inferences a ‘reasonable shareholder’ would draw from a given set of facts and the significance of those inferences to him....” TSC Industries, 426 U.S. at 450.

^{FN28} See, e.g., Concepts Statement 2, paragraphs 123-124; AU 312A.10 (materiality judgments are made in light of surrounding circumstances and necessarily involve both quantitative and qualitative considerations); AU 312A.34 (“Qualitative considerations also influence the auditor in reaching a conclusion as to whether misstatements are material.”). As used in the accounting literature and in this SAB, “qualitative” materiality refers to the surrounding circumstances that inform an investor’s evaluation of financial statement entries. Whether events may be material to investors for non-financial reasons is a matter not addressed by this SAB.

^{FN29} See, e.g., Rule 1-02(o) of Regulation S-X, 17 CFR 210.1-02(o), Rule 405 of Regulation C, 17 CFR 230.405, and Rule 12b-2, 17 CFR 240.12b-2; AU 312A.10 -.11, 317.13, 411.04 n. 1, and 508.36; In re Kidder Peabody Securities Litigation, 10 F. Supp. 2d 398 (S.D.N.Y. 1998); Parnes v. Gateway 2000, Inc., 122 F.3d 539 (8th Cir. 1997); In re Westinghouse Securities Litigation, 90 F.3d 696 (3d Cir. 1996); In the Matter of W.R. Grace & Co., Accounting and Auditing Enforcement Release (“AAER”) 1140 (June 30, 1999); In the Matter of Eugene Gaughan, AAER 1141 (June 30, 1999); In the Matter of Thomas Scanlon, AAER 1142 (June 30, 1999); and In re Sensormatic Electronics Corporation, Sec. Act Rel. No. 7518 (March 25, 1998).

^{FN30} Concepts Statement 2, paragraph 131.

^{FN31} Concepts Statement 2, paragraphs 131 and 166.

^{FN32} Concepts Statement 2, paragraph 167.

^{FN33} Concepts Statement 2, paragraphs 168-169.

^{FN34} Concepts Statement 2, paragraph 170.

^{FN35} Concepts Statement 2, paragraph 125.

^{FN36} AU 312.11.

Companies cannot solely assess errors based on quantitative factors. The SEC staff has emphasized the need to qualitatively evaluate information and in SAB Topic 1.M provided several qualitative considerations. The qualitative factors listed in SAB Topic 1.M (see section 6.2.2, *Qualitative analysis*) are not all-inclusive nor are they intended to be a checklist. Registrants, as well as private companies, that discover an error should consider the total mix of information (i.e., quantitative and qualitative factors) that an investor would consider to determine whether the error is material.

6.2.2

Qualitative analysis (updated April 2024)

Excerpt from Accounting Standards Codification**Accounting Changes and Error Corrections – Overall****SEC Materials****SAB Topic 1.M, Assessing Materiality****250-10-S99-1****1. Assessing materiality [continued]**

Among the considerations that may well render material a quantitatively small misstatement of a financial statement item are -

- whether the misstatement arises from an item capable of precise measurement or whether it arises from an estimate and, if so, the degree of imprecision inherent in the estimate ^{FN37}
- whether the misstatement masks a change in earnings or other trends
- whether the misstatement hides a failure to meet analysts' consensus expectations for the enterprise
- whether the misstatement changes a loss into income or vice versa
- whether the misstatement concerns a segment or other portion of the registrant's business that has been identified as playing a significant role in the registrant's operations or profitability
- whether the misstatement affects the registrant's compliance with regulatory requirements
- whether the misstatement affects the registrant's compliance with loan covenants or other contractual requirements
- whether the misstatement has the effect of increasing management's compensation – for example, by satisfying requirements for the award of bonuses or other forms of incentive compensation
- whether the misstatement involves concealment of an unlawful transaction.

This is not an exhaustive list of the circumstances that may affect the materiality of a quantitatively small misstatement. ^{FN38} Among other factors, the demonstrated volatility of the price of a registrant's securities in response to certain types of disclosures may provide guidance as to whether investors regard quantitatively small misstatements as material. Consideration of potential market reaction to disclosure of a misstatement is by itself "too blunt an instrument to be depended on" in considering whether a fact is material. ^{FN39} When, however, management or the independent auditor expects (based, for example, on a pattern of market performance) that a known misstatement may result in a significant positive or negative market reaction, that expected reaction should be taken into account when considering whether a misstatement is material. ^{FN40}

^{FN37} As stated in Concepts Statement 2, paragraph 130: Another factor in materiality judgments is the degree of precision that is attainable in estimating the judgment item. The amount of deviation that is considered immaterial may increase as the attainable degree of precision decreases. For example, accounts payable usually can be estimated more accurately than can contingent liabilities arising from litigation or threats of it, and a deviation considered to be material in the first case may be quite trivial in the second. This SAB is not intended to change current law or guidance in the accounting literature regarding accounting estimates. See, e.g., Accounting Principles Board Opinion 20, Accounting Changes 10, 11, 31-33 (July 1971) [Subtopic 250-10].

^{FN38} The staff understands that the Big Five Audit Materiality Task Force ("Task Force") was convened in March of 1998 and has made recommendations to the Auditing Standards Board, including suggestions regarding communications with audit committees about unadjusted misstatements. See generally Big Five Audit Materiality Task Force. "Materiality in a Financial Statement Audit – Considering Qualitative Factors When Evaluating Audit Findings" (August 1998).

^{FN39} See Concepts Statement 2, paragraph 169.

^{FN40} If management does not expect a significant market reaction, a misstatement still may be material and should be evaluated under the criteria discussed in this SAB.

As discussed in 6.2, *Assessing materiality of an error*, an item is material if there is a substantial likelihood that a reasonable person would consider it important. SAB Topic 1.M includes a list of possible qualitative and quantitative factors that an entity might consider when assessing how a reasonable investor considers materiality. They include, but are not limited to, the evaluation of whether the misstatement:

- ▶ arises from an item that can be precisely measured or is an estimate
- ▶ results in a change of earnings trend or other trends
- ▶ results in a failure to meet analysts' consensus expectations
- ▶ changes income to a loss or a loss into income
- ▶ affects segment information and related trends
- ▶ affects compliance with regulatory requirements
- ▶ affects compliance with loan covenants or other contractual requirements
- ▶ has the effect of increasing management's compensation, and
- ▶ conceals an unlawful act

SAB Topic 1.M notes that other items also may affect the determination of whether a misstatement is material. For example, the SEC staff suggests that companies consider "demonstrated volatility" of the registrant's securities prices, and the potential reaction to the misstatement as additional factors in assessing materiality. The SEC staff has indicated (1) the mere fact that the market may react one way or another is not necessarily the guide as to what is material, (2) there has to be a well-established pattern of market reaction to news before causes for such market reaction can be judged (e.g., a well-established pattern where, for the last six quarters, a positive or negative variance of one cent in actual EPS compared to expectations led to a 20% change positively or negatively in stock market value) and (3) the entity is not supposed to speculate or guess at market reactions.

Entities should not take a "checklist" approach to assessing qualitative factors. Instead, an entity should consider all quantitative and qualitative factors that may be relevant in its circumstances, regardless of whether such factor is included in SAB Topic 1.M examples. The following SEC staff speeches provide their views on qualitative factors.

Extract from SEC staff speech by Mr. Mark Mahar

8 December 2008

AICPA National Conference on Current SEC and PCAOB Developments

The staff does appreciate that materiality decisions necessarily involve the use of judgment. Specific to this circumstance, judgment includes developing a robust analysis that steps into the investors' shoes, identifying what is significant to investors' decisions and should not be limited to the factors provided in SAB 99 because those factors are neither exhaustive nor intended to preclude conclusions that quantitatively larger errors may be considered not material. Rather, evaluators of materiality should consider the relevant information considered important to investors which may include non-SAB 99 specified circumstances ... when I say such as, let us be clear there could be other circumstances, so such as considering:

- ▶ company specific trends and performance metrics that may influence investment decisions; or
- ▶ when a factor important to a reasonable investor is impacted by an unrelated circumstance. For example, when an error in the income statement is magnified simply by occurring during a period in which net income is abnormally small as compared to historical and expected future trends.

Extract from statement by SEC Acting Chief Accountant Paul Munter

9 March 2022

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

One area where the staff in [the Office of the Chief Accountant] have observed an increased need for objectivity is in the assessment of qualitative factors. The interpretive guidance on materiality in SAB No. 99¹⁶ speaks to circumstances where a quantitatively small error could, nevertheless, be material because of qualitative factors. However, we are often involved in discussions where the reverse is argued – that is, a quantitatively significant error is nevertheless immaterial because of qualitative considerations. We believe, however, that as the quantitative magnitude of the error increases, it becomes increasingly difficult for qualitative factors to overcome the quantitative significance of the error.

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

The SEC staff has also mentioned¹⁷ that, when performing a qualitative assessment, they have observed some entities have improperly concluded that an error in previously issued financial statements is no longer material once a more recent set of financial statements is issued (i.e., a “passage of time” argument). The staff noted this view assumes investors are solely focused on current financial results rather than both historical and current financial statements, and they further emphasized that investors consider a registrant’s history of discovering and correcting accounting errors an indicator of the reliability of the current financial results.

As previously noted, the qualitative factors in SAB Topic 1.M are not all-inclusive. Examples of considerations not explicitly mentioned in SAB Topic 1.M include, but are not limited to, whether the error:

- ▶ Affects entity-specific trends and performance metrics (e.g., non-GAAP measurements) that may influence investment decisions
- ▶ Affects metrics that are important to investor models
- ▶ Is a one-time item and does not alter investors’ perceptions of key trends affecting the entity
- ▶ Affects a business segment or other portion of the registrant’s business that investors regard as driving valuation or risks

¹⁶ SAB Topic 1.M

¹⁷ Remarks during the 2021 AICPA National Conference on Current SEC and PCAOB Developments, Lindsay McCord, Chief Accountant, Division of Corporation Finance

- ▶ Relates to items involving related parties or known users (e.g., whether the external parties to the transaction are related to the entity's management)
- ▶ Causes the disclosures to not be adequate or omit information not specifically required by US GAAP but is important to the understanding of the financial statements or conveys something in a false or misleading manner
- ▶ Affects other information communicated in documents containing the audited financial statements that may reasonably be expected to influence the economic decisions of the users of the financial statements (e.g., information included in management's discussion and analysis of financial condition and results of operations)
- ▶ May have a material effect on the next interim financial statements that are publicly issued (even though the misstatement is immaterial to the current period financial statements)
- ▶ Relates to the incorrect selection or application of an accounting policy that has an immaterial effect on the current period's financial statements but is likely to have a material effect on future periods' financial statements
- ▶ Relates to a transaction that was highly structured with the intention to achieve a specific accounting objective

Extract from statement by then SEC Acting Chief Accountant Paul Munter

9 March 2022

... comparative financial statements facilitate an investor's trend analysis to identify changes in financial results of a registrant over time and to inform investment decisions. Accordingly, we view financial statements prepared in accordance with U.S. GAAP or IFRS, as required by Commission rules, to be the starting point for any objective materiality analysis. However, this does not imply that the effects of errors on certain key non-GAAP measures that are important to users of the registrant's financial statements should not also be considered in the registrant's analysis. Rather, analysis of key non-GAAP measures, where applicable, should be performed in addition to, but not as a substitute for, the analysis of materiality to the financial statements.

Extract from statement by SEC Chief Accountant Paul Munter

4 December 2023

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

The SEC staff has requested additional information about a registrant's materiality assessment when it discloses the correction of an immaterial error in previously issued financial statements. Evaluating whether any item or items are material requires judgment. The existence of quantitative or qualitative factors is individually considered in the materiality assessment. However, as highlighted in the extracts above, the SEC staff has challenged registrants' over-reliance on qualitative factors to overcome that a quantitatively large error is immaterial. Likewise, a quantitatively small error may be material based on qualitative factors.

The SEC staff's comments highlight the importance of considering all relevant factors related to a financial statement error, including the impact the misstatement may have on reported non-GAAP measures. The following illustration includes various qualitative factor considerations when evaluating the materiality of an error:

Illustration 6-2: Qualitative factor considerations

Consideration A

A quantitatively insignificant error that has the effect of increasing management's compensation is a qualitative factor. For example, qualitative factors include when the error resulted in satisfying the threshold for an award of bonuses or other form of incentive compensation for management or resulted in the claw back of management's incentive compensation.

Consideration B

It would not be appropriate to conclude that a quantitatively significant error cannot be material because the financial statement line item impacted is not important or useful to investors. This is because the starting point for assessing materiality is always the initial financial results as required under US GAAP.

Consideration C

It would not be appropriate to conclude that a quantitatively significant error that was made in the financial statements of a number of registrants is immaterial due to the qualitative factor that the misstatement reflected a widely held view rather than an intention to misstate. A "lack of intent" is generally not a qualitative factor to support that a misstatement is not material. While this scenario evaluated the "lack of intent," when there is the existence of intent, it is an indicator that a misstatement may be material (also see section 6.2.2.1 for additional discussion on intentional misstatements).

Consideration D

A quantitatively insignificant error that masks a change in earnings or other trends is a qualitative factor. For example, if the error correction would result in revenue, which is considered a key metric by the users of the financial statements, to have decreased instead of the previously reported three-year increase in revenue, this is a qualitative factor. Similarly, if the error correction results in the three-year increase in revenue being substantially less than the previously reported trend, this is also a qualitative factor.

While this consideration uses revenue as an example, the same considerations would be applicable to other earnings-based measures (e.g., income from continuing operations, net income) and key financial statement-based metrics, including non-GAAP metrics, (e.g., gross margin, EBITDA, funds from operations, EPS) that are important to the users of the financial statements.

Consideration E

A quantitatively insignificant error that hides a failure to meet analysts' consensus expectations is a qualitative factor. For example, if the error correction results in a failure to meet analyst expectations that previously had been met, this is a qualitative factor. Additionally, the magnitude of the error should also be considered even if it does not impact whether a target was or was not met. For example, if the previously issued financial statements narrowly missed analysts' expectations, but the error correction results in significantly missing analysts' expectations, this is also a qualitative factor.

The considerations in the previous illustration indicate that evaluating an error solely based on quantitative or qualitative factors is not sufficient regardless of the quantitative results. Even if an error is small quantitatively, entities should objectively consider all qualitative factors in their materiality analyses,

which should not be solely limited to those listed in SAB Topic 1.M. In addition, qualitative factors also should be considered when an error is quantitatively large. However, we expect it is unusual that a quantitatively significant error is overcome through qualitative factors.

6.2.2.1

Qualitative analysis – small intentional misstatements

Excerpt from Accounting Standards Codification

Accounting Changes and Error Corrections – Overall

SEC Materials

SAB Topic 1.M, Assessing Materiality

250-10-S99-1

1. Assessing materiality [continued]

For the reasons noted above, the staff believes that a registrant and the auditors of its financial statements should not assume that even small intentional misstatements in financial statements, for example those pursuant to actions to “manage” earnings, are immaterial.^{FN41} While the intent of management does not render a misstatement material, it may provide significant evidence of materiality. The evidence may be particularly compelling where management has intentionally misstated items in the financial statements to “manage” reported earnings. In that instance, it presumably has done so believing that the resulting amounts and trends would be significant to users of the registrant’s financial statements.^{FN42} The staff believes that investors generally would regard as significant a management practice to over- or under-state earnings up to an amount just short of a percentage threshold in order to “manage” earnings. Investors presumably also would regard as significant an accounting practice that, in essence, rendered all earnings figures subject to a management-directed margin of misstatement.

^{FN41} Intentional management of earnings and intentional misstatements, as used in this SAB, do not include insignificant errors and omissions that may occur in systems and recurring processes in the normal course of business. See notes 37 and 49 infra.

^{FN42} Assessments of materiality should occur not only at year-end, but also during the preparation of each quarterly or interim financial statement. See, e.g., In the Matter of Venator Group, Inc., AAER 1049 (June 29, 1998).

The SEC staff is concerned about quantitatively small errors that may be material on a qualitative basis, including instances where management has intentionally misstated items in the financial statements to “manage” reported earnings or achieve some other result (e.g., achieve a bonus target).

Intentional but quantitatively small errors by management may have additional consequences, including violation of the books and records provisions of the Exchange Act. See additional information at section 6.2.4, *Intentional misstatements, including considerations of the books and records provision*.

6.2.2.2

Qualitative analysis – segments

Excerpt from Accounting Standards Codification

Accounting Changes and Error Corrections – Overall

SEC Materials

SAB Topic 1.M, Assessing Materiality

250-10-S99-1

1. Assessing materiality (continued)

The materiality of a misstatement may turn on where it appears in the financial statements. For example, a misstatement may involve a segment of the registrant’s operations. In that instance, in assessing materiality of a misstatement to the financial statements taken as a whole, registrants and their auditors

should consider not only the size of the misstatement but also the significance of the segment information to the financial statements taken as a whole. ^{FN43} “A misstatement of the revenue and operating profit of a relatively small segment that is represented by management to be important to the future profitability of the entity” ^{FN44} is more likely to be material to investors than a misstatement in a segment that management has not identified as especially important. In assessing the materiality of misstatements in segment information – as with materiality generally – situations may arise in practice where the auditor will conclude that a matter relating to segment information is qualitatively material even though, in his or her judgment, it is quantitatively immaterial to the financial statements taken as a whole. ^{FN45}

^{FN43} See, e.g., In the Matter of W.R. Grace & Co., AAER 1140 (June 30, 1999).

^{FN44} AU 9326.33.

^{FN45} Id.

The effect of the error(s) to segment information, both quantitatively and qualitatively, should be considered as part of the entity’s analysis of the effect on the financial statements taken as a whole.

The qualitative assessment of a misstatement related to a small segment that is important to future growth could differ from the assessment related to either another small segment that is not expected to grow significantly or a larger segment that is more mature.

6.2.3

Aggregation and netting

Excerpt from Accounting Standards Codification

Accounting Changes and Error Corrections – Overall

SEC Materials

SAB Topic 1.M, Assessing Materiality

250-10-S99-1

Aggregating and Netting Misstatements.

In determining whether multiple misstatements cause the financial statements to be materially misstated, registrants and the auditors of their financial statements should consider each misstatement separately and the aggregate effect of all misstatements. ^{FN46} A registrant and its auditor should evaluate misstatements in light of quantitative and qualitative factors and “consider whether, in relation to individual amounts, subtotals, or totals in the financial statements, they materially misstate the financial statements taken as a whole.” ^{FN47} This requires consideration of the significance of an item to a particular entity (for example, inventories to a manufacturing company), the pervasiveness of the misstatement (such as whether it affects the presentation of numerous financial statement items), and the effect of the misstatement on the financial statements taken as a whole.... ^{FN48}

Registrants and their auditors first should consider whether each misstatement is material, irrespective of its effect when combined with other misstatements. The literature notes that the analysis should consider whether the misstatement of “individual amounts” causes a material misstatement of the financial statements taken as a whole. As with materiality generally, this analysis requires consideration of both quantitative and qualitative factors.

If the misstatement of an individual amount causes the financial statements as a whole to be materially misstated, that effect cannot be eliminated by other misstatements whose effect may be to diminish the impact of the misstatement on other financial statement items. To take an obvious example, if a registrant’s revenues are a material financial statement item and if they are materially overstated, the financial statements taken as a whole will be materially misleading even if the effect on earnings is completely offset by an equivalent overstatement of expenses.

Even though a misstatement of an individual amount may not cause the financial statements taken as a whole to be materially misstated, it may nonetheless, when aggregated with other misstatements, render the financial statements taken as a whole to be materially misleading. Registrants and the auditors of their financial statements accordingly should consider the effect of the misstatement on subtotals or totals. The auditor should aggregate all misstatements that affect each subtotal or total and consider whether the misstatements in the aggregate affect the subtotal or total in a way that causes the registrant's financial statements taken as a whole to be materially misleading. ^{FN49}

The staff believes that, in considering the aggregate effect of multiple misstatements on a subtotal or total, registrants and the auditors of their financial statements should exercise particular care when considering whether to offset (or the appropriateness of offsetting) a misstatement of an estimated amount with a misstatement of an item capable of precise measurement. As noted above, assessments of materiality should never be purely mechanical; given the imprecision inherent in estimates, there is by definition a corresponding imprecision in the aggregation of misstatements involving estimates with those that do not involve an estimate.

Registrants and auditors also should consider the effect of misstatements from prior periods on the current financial statements. For example, the auditing literature states,

Matters underlying adjustments proposed by the auditor but not recorded by the entity could potentially cause future financial statements to be materially misstated, even though the auditor has concluded that the adjustments are not material to the current financial statements. ^{FN50}

This may be particularly the case where immaterial misstatements recur in several years and the cumulative effect becomes material in the current year.

^{FN46} The auditing literature notes that the "concept of materiality recognizes that some matters, either individually or in the aggregate, are important for fair presentation of financial statements in conformity with generally accepted accounting principles." AU 312.03. See also AU 312.04.

^{FN47} AU 312.34. Quantitative materiality assessments often are made by comparing adjustments to revenues, gross profit, pretax and net income, total assets, stockholders' equity, or individual line items in the financial statements. The particular items in the financial statements to be considered as a basis for the materiality determination depend on the proposed adjustment to be made and other factors, such as those identified in this SAB. For example, an adjustment to inventory that is immaterial to pretax income or net income may be material to the financial statements because it may affect a working capital ratio or cause the registrant to be in default of loan covenants.

^{FN48} AU 508.36.

^{FN49} AU 312.34.

^{FN50} AU 380.09.

In some circumstances, multiple errors exist relating to previously issued financial statements. SAB Topic 1.M does not prohibit offsetting. Rather, it provides guidance on how the offsetting of errors should be considered. The SAB discusses a "two-step process" that should be followed when evaluating offsetting errors.

First, each error should be evaluated separately (i.e., perform a quantitative and qualitative materiality analysis for each error individually). If an individual error causes the financial statements taken as a whole to be misstated, that error cannot be offset by other errors that diminish its effect.

Illustration 6-3: Multiple error analysis

An entity identifies the following errors:

- Overstatement of revenue due to using the incorrect unit of accounting
- Overstatement of a contingent liability

The entity performs an analysis of the overstatement of revenue individually and determines that the revenue error is material (e.g., quantitatively error overstates revenue and net income by 11% and 7%, respectively, and qualitative factors also indicate the error is material because the company and its analysts measure the company's results period to period based on revenue growth). Consideration of the offsetting effect of the overstatement of the contingent liability is not allowed.

Second, if each individual error is not material on a standalone basis, companies should combine the effect of all errors, including the effect of prior-period errors reversing in the current period (i.e., out-of-period amounts), and determine whether the aggregate effect is material based on quantitative and qualitative considerations.

In evaluating the materiality of errors, companies should consider the appropriateness of offsetting an error of an estimated amount with an error of an item capable of precise measurement (i.e., offsetting "hard" debits with "soft" credits). SAB Topic 1.M reminds companies that the assessments of materiality should never be purely mechanical and to exercise care when offsetting errors that can be precisely measured with errors involving significant judgmental estimates.

The evaluation of the materiality of errors, individually or in the aggregate, applied to an individual line item, sub-total, or total, should be applied in the same manner as to any other measure (e.g., pretax income or net income). That is, the effect of the errors on line items, subtotals and totals is only one of the factors to consider in assessing materiality. The company needs to evaluate the effect of the error or aggregated errors, as appropriate, on the financial statements taken as a whole considering both quantitative and qualitative factors. Thus, in determining whether an error(s) is material to the financial statements taken as a whole, the company should consider whether and to what extent the error(s) affects a line item or subtotal that is significant to the users of the financial statements.

Illustration 6-4: Aggregation of error analysis

An entity identifies the following errors:

- Understatement of costs of goods sold and accounts payable due to purchasing/receipt cut-off issues
- Understatement of costs of goods sold and warranty accrual due to a miscalculation of warranty costs

Each error was separately determined to be immaterial under a quantitative and qualitative analysis. The entity performs a materiality analysis on the combined effect of these errors (i.e., the cumulative understatement of costs of goods sold and current liabilities). The entity analyzes the combined effect of these errors to all related financial statement line items (e.g., cost of goods sold, operating income, net income, current liabilities) and qualitative considerations (e.g., effect on working capital ratio, debt covenants) to assess whether the aggregation of errors is material to the financial statements.

6.2.4

Intentional misstatements, including considerations of the books and records provision

Excerpt from Accounting Standards Codification**Accounting Changes and Error Corrections – Overall****SEC Materials****SAB Topic 1.M, Assessing Materiality****250-10-S99-1****2. Immaterial Misstatements that are Intentional**

Facts: A registrant's management intentionally has made adjustments to various financial statement items in a manner inconsistent with GAAP. In each accounting period in which such actions were taken, none of the individual adjustments is by itself material, nor is the aggregate effect on the financial statements taken as a whole material for the period. The registrant's earnings "management" has been effected at the direction or acquiescence of management in the belief that any deviations from GAAP have been immaterial and that accordingly the accounting is permissible.

Question: In the staff's view, may a registrant make intentional immaterial misstatements in its financial statements?

Interpretive Response: No. In certain circumstances, intentional immaterial misstatements are unlawful.

Considerations of the books and records provisions under the Exchange Act.

Even if misstatements are immaterial, ^{FN51} registrants must comply with Sections 13(b)(2) – (7) of the Securities Exchange Act of 1934 (the "Exchange Act"). ^{FN52} Under these provisions, each registrant with securities registered pursuant to Section 12 of the Exchange Act, ^{FN53} or required to file reports pursuant to Section 15(d), ^{FN54} must make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of assets of the registrant and must maintain internal accounting controls that are sufficient to provide reasonable assurances that, among other things, transactions are recorded as necessary to permit the preparation of financial statements in conformity with GAAP. ^{FN55} In this context, determinations of what constitutes "reasonable assurance" and "reasonable detail" are based not on a "materiality" analysis but on the level of detail and degree of assurance that would satisfy prudent officials in the conduct of their own affairs. ^{FN56} Accordingly, failure to record accurately immaterial items, in some instances, may result in violations of the securities laws.

The staff recognizes that there is limited authoritative guidance ^{FN57} regarding the "reasonableness" standard in Section 13(b)(2) of the Exchange Act. A principal statement of the Commission's policy in this area is set forth in an address given in 1981 by then Chairman Harold M. Williams. ^{FN58} In his address, Chairman Williams noted that, like materiality, "reasonableness" is not an "absolute standard of exactitude for corporate records." ^{FN59} Unlike materiality, however, "reasonableness" is not solely a measure of the significance of a financial statement item to investors. "Reasonableness," in this context, reflects a judgment as to whether an issuer's failure to correct a known misstatement implicates the purposes underlying the accounting provisions of Sections 13(b)(2) – (7) of the Exchange Act. ^{FN60}

In assessing whether a misstatement results in a violation of a registrant's obligation to keep books and records that are accurate "in reasonable detail," registrants and their auditors should consider, in addition to the factors discussed above concerning an evaluation of a misstatement's potential materiality, the factors set forth below.

The significance of the misstatement. Though the staff does not believe that registrants need to make finely calibrated determinations of significance with respect to immaterial items, plainly it is "reasonable" to treat misstatements whose effects are clearly inconsequential differently than more significant ones.

How the misstatement arose. It is unlikely that it is ever "reasonable" for registrants to record misstatements or not to correct known misstatements – even immaterial ones – as part of an ongoing effort directed by or known to senior management for the purposes of "managing" earnings. On the other hand, insignificant misstatements that arise from the operation of systems or recurring processes in the normal course of business generally will not cause a registrant's books to be inaccurate "in reasonable detail."^{FN61}

The cost of correcting the misstatement. The books and records provisions of the Exchange Act do not require registrants to make major expenditures to correct small misstatements.^{FN62} Conversely, where there is little cost or delay involved in correcting a misstatement, failing to do so is unlikely to be "reasonable."

The clarity of authoritative accounting guidance with respect to the misstatement. Where reasonable minds may differ about the appropriate accounting treatment of a financial statement item, a failure to correct it may not render the registrant's financial statements inaccurate "in reasonable detail." Where, however, there is little ground for reasonable disagreement, the case for leaving a misstatement uncorrected is correspondingly weaker.

There may be other indicators of "reasonableness" that registrants and their auditors may ordinarily consider. Because the judgment is not mechanical, the staff will be inclined to continue to defer to judgments that "allow a business, acting in good faith, to comply with the Act's accounting provisions in an innovative and cost-effective way."^{FN63}

^{FN51} FASB ASC paragraph 105-10-05-6 states that "[t]he provisions of the Codification need not be applied to immaterial items." This SAB is consistent with that provision of the Codification. In theory, this language is subject to the interpretation that the registrant is free intentionally to set forth immaterial items in financial statements in a manner that plainly would be contrary to GAAP if the misstatement were material. The staff believes that the FASB did not intend this result.

^{FN52} 15 U.S.C. 78m(b)(2) – (7).

^{FN53} 15 U.S.C. 78l.

^{FN54} 15 U.S.C. 78o(d).

^{FN55} Criminal liability may be imposed if a person knowingly circumvents or knowingly fails to implement a system of internal accounting controls or knowingly falsifies books, records or accounts. 15 U.S.C. 78m(4) and (5). See also Rule 13b2-1 under the Exchange Act, 17 CFR 240.13b2-1, which states, "No person shall, directly or indirectly, falsify or cause to be falsified, any book, record or account subject to Section 13(b)(2)(A) of the Securities Exchange Act."

^{FN56} 15 U.S.C. 78m(b)(7). The books and records provisions of section 13(b) of the Exchange Act originally were passed as part of the Foreign Corrupt Practices Act ("FCPA"). In the conference committee report regarding the 1988 amendments to the FCPA, the committee stated: The conference committee adopted the prudent man qualification in order to clarify that the current standard does not connote an unrealistic degree of exactitude or precision. The concept of reasonableness of necessity contemplates the weighing of a number of relevant factors, including the costs of compliance. Cong. Rec. H2116 (daily ed. April 20, 1988).

^{FN57} So far as the staff is aware, there is only one judicial decision that discusses Section 13(b)(2) of the Exchange Act in any detail, *SEC v. World-Wide Coin Investments, Ltd.*, 567 F. Supp. 724 (N.D. Ga. 1983), and the courts generally have found that no private right of action exists under the accounting and books and records provisions of the Exchange Act. See e.g., *Lamb v. Phillip Morris Inc.*, 915 F.2d 1024 (6th Cir. 1990) and *JS Service Center Corporation v. General Electric Technical Services Company*, 937 F. Supp. 216 (S.D.N.Y. 1996).

^{FN58}The Commission adopted the address as a formal statement of policy in Securities Exchange Act Release No. 17500 (January 29, 1981), 46 FR 11544 (February 9, 1981), 21 SEC Docket 1466 (February 10, 1981).

^{FN59}Id. at 46 FR 11546.

^{FN60}Id.

^{FN61}For example, the conference report regarding the 1988 amendments to the FCPA stated: The Conferees intend to codify current Securities and Exchange Commission (SEC) enforcement policy that penalties not be imposed for insignificant or technical infractions or inadvertent conduct. The amendment adopted by the Conferees [Section 13(b)(4)] accomplishes this by providing that criminal penalties shall not be imposed for failing to comply with the FCPA's books and records or accounting provisions. This provision [Section 13(b)(5)] is meant to ensure that criminal penalties would be imposed where acts of commission or omission in keeping books or records or administering accounting controls have the purpose of falsifying books, records or accounts, or of circumventing the accounting controls set forth in the Act. This would include the deliberate falsification of books and records and other conduct calculated to evade the internal accounting controls requirement. Cong. Rec. H2115 (daily ed. April 20, 1988).

^{FN62}As Chairman Williams noted with respect to the internal control provisions of the FCPA, "[t]housands of dollars ordinarily should not be spent conserving hundreds." 46 FR 11546.

^{FN63}Id., at 11547.

SAB Topic 1.M addresses situations where management intentionally misstates the financial statements by amounts that are not material in an effort to manage earnings. Intentional violations of the books and records provisions of the Exchange Act may be an unlawful act, and thus subject registrants and their independent auditors to the reporting requirements of Section 10A of the Exchange Act.

The books and records provisions of the Exchange Act, added by the Foreign Corrupt Practices Act of 1977, require registrants to make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of assets of the registrant. Registrants also must maintain internal accounting controls that are sufficient to provide reasonable assurances that, among other things, transactions are recorded as necessary to permit the preparation of financial statements in conformity with US GAAP.

In assessing whether a misstatement results in a violation of the books and records provisions (i.e., a violation of the registrant's obligation to keep books and records that are accurate in "reasonable detail"), SAB Topic 1.M indicates that companies consider the following factors in addition to the materiality assessment:

- ▶ the significance of the misstatement
- ▶ how the misstatement arose
- ▶ the cost of correcting the misstatement and
- ▶ the clarity of authoritative accounting guidance with respect to the misstatement.

Other indicators of reasonableness can also be considered. This analysis is judgmental.

In evaluating the four factors above, the SEC staff acknowledges that a registrant's books and records may contain inconsequential misstatements that arise from different circumstances. However, inconsequential items may still be problematic. Immaterial misstatements that arise from the operation of systems or recurring processes in the normal course of business (e.g., period-end closings) would be viewed differently than efforts by management to intentionally record or not correct known misstatements. SAB Topic 1.M also notes that situations where there is little cost to correct an error may be viewed differently than those that would require major delays in reporting or expenditures to correct. Finally, the SAB states that registrants whose financial statements contain errors that are clearly in contravention of the accounting literature may have a difficult time sustaining the argument that a books and records violation does not exist.

6.2.5

Quantitative analyses – Rollover and iron curtain

Excerpt from Accounting Standards Codification**Accounting Changes and Error Corrections – Overall****SEC Materials*****SAB Topic 1.N, Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements*****250-10-S99-2**

The following is the text of SAB Topic 1.N, Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements

(Added by SAB 108).

Facts: During the course of preparing annual financial statements, a registrant is evaluating the materiality of an improper expense accrual (e.g., overstated liability) in the amount of \$100, which has built up over 5 years, at \$20 per year. ^{FN74} The registrant previously evaluated the misstatement as being immaterial to each of the prior year financial statements (i.e., years 1-4). For the purpose of evaluating materiality in the current year (i.e., year 5), the registrant quantifies the error as a \$20 overstatement of expenses.

Question 1: Has the registrant appropriately quantified the amount of this error for the purpose of evaluating materiality for the current year?

Interpretive Response: No. In this example, the registrant has only quantified the effects of the identified unadjusted error that arose in the current year income statement. The staff believes a registrant's materiality evaluation of an identified unadjusted error should quantify the effects of the identified unadjusted error on each financial statement and related financial statement disclosure.

Topic 1M notes that a materiality evaluation must be based on all relevant quantitative and qualitative factors. ^{FN75} This analysis generally begins with quantifying potential misstatements to be evaluated. There has been diversity in practice with respect to this initial step of a materiality analysis.

The diversity in approaches for quantifying the amount of misstatements primarily stems from the effects of misstatements that were not corrected at the end of the prior year (prior year misstatements). These prior year misstatements should be considered in quantifying misstatements in current year financial statements.

The techniques most commonly used in practice to accumulate and quantify misstatements are generally referred to as the rollover and iron curtain approaches.

The rollover approach, which is the approach used by the registrant in this example, quantifies a misstatement based on the amount of the error originating in the current year income statement. Thus, this approach ignores the effects of correcting the portion of the current year balance sheet misstatement that originated in prior years (i.e., it ignores the carryover effects of prior year misstatements).

The iron curtain approach quantifies a misstatement based on the effects of correcting the misstatement existing in the balance sheet at the end of the current year, irrespective of the misstatements year(s) of origination. Had the registrant in this fact pattern applied the iron curtain approach, the misstatement would have been quantified as a \$100 misstatement based on the end of year balance sheet misstatement. Thus, the adjustment needed to correct the financial statements for the end of year error would be to reduce the liability by \$100 with a corresponding decrease in current year expense.

As demonstrated in this example, the primary weakness of the rollover approach is that it can result in the accumulation of significant misstatements on the balance sheet that are deemed immaterial in part because the amount that originates in each year is quantitatively small. The staff is aware of situations in which a registrant, relying on the rollover approach, has allowed an erroneous item to accumulate on the balance sheet to the point where eliminating the improper asset or liability would itself result in a material error in the income statement if adjusted in the current year. Such registrants have sometimes concluded that the improper asset or liability should remain on the balance sheet into perpetuity.

In contrast, the primary weakness of the iron curtain approach is that it does not consider the correction of prior year misstatements in the current year (i.e., the reversal of the carryover effects) to be errors. Therefore, in this example, if the misstatement was corrected during the current year such that no error existed in the balance sheet at the end of the current year, the reversal of the \$80 prior year misstatement would not be considered an error in the current year financial statements under the iron curtain approach. Implicitly, the iron curtain approach assumes that because the prior year financial statements were not materially misstated, correcting any immaterial errors that existed in those statements in the current year is the correct accounting, and is therefore not considered an error in the current year. Thus, utilization of the iron curtain approach can result in a misstatement in the current year income statement not being evaluated as an error at all.

The staff does not believe the exclusive reliance on either the rollover or iron curtain approach appropriately quantifies all misstatements that could be material to users of financial statements.

In describing the concept of materiality, Concepts Statement 2, Qualitative Characteristics of Accounting Information, indicates that materiality determinations are based on whether it is probable that the judgment of a reasonable person relying upon the report would have been changed or influenced *by the inclusion or correction of the item* (emphasis added).^{FN76} The staff believes registrants must quantify the impact of correcting all misstatements, including both the carryover and reversing effects of prior year misstatements, on the current year financial statements. The staff believes that this can be accomplished by quantifying an error under both the rollover and iron curtain approaches as described above and by evaluating the error measured under each approach. Thus, a registrant's financial statements would require adjustment when either approach results in quantifying a misstatement that is material, after considering all relevant quantitative and qualitative factors.

As a reminder, a change from an accounting principle that is not generally accepted to one that is generally accepted is a correction of an error.^{FN77}

The staff believes that the registrant should quantify the current year misstatement in this example using both the iron curtain approach (i.e., \$100) and the rollover approach (i.e., \$20). Therefore, if the \$100 misstatement is considered material to the financial statements, after all of the relevant quantitative and qualitative factors are considered, the registrant's financial statements would need to be adjusted.

^{FN74}For purposes of these facts, assume the registrant properly determined that the overstatement of the liability resulted from an error rather than a change in accounting estimate. See the FASB ASC Master Glossary for the distinction between an error and a change in accounting estimate.

^{FN75}Topic 1N addresses certain of these quantitative issues, but does not alter the analysis required by Topic 1M.

^{FN76}Concepts Statement 2, paragraph 132. See also Concepts Statement 2, Glossary of Terms – Materiality.

^{FN77}See definition of “error in previously issued financial statements” in the FASB ASC Master Glossary.

SAB Topic 1.N requires the materiality evaluation to quantify the effects of the error on each financial statement and related financial statement disclosure. For example, performing an analysis that quantifies the error only with respect to the current period income statement is insufficient. The techniques commonly used to accumulate and quantify errors include the “rollover” and “iron curtain” methods.

- ▶ The “rollover” method quantifies an error based on the effects of correcting the error existing in the current period income statement.
- ▶ The “iron curtain” method quantifies an error based on the effects of correcting the error existing in the balance sheet at the end of the reporting period being analyzed, regardless of the error’s period(s) of origin.

Illustration 6-5: Rollover and iron curtain methods

At the end of 20X5, a company determines that accumulated depreciation of a fixed asset is understated by \$75. Upon further analysis, the company determines that the error relates to multiple years in the following amounts:

- ▶ 20X3 – \$25
- ▶ 20X4 – \$25
- ▶ 20X5 – \$25

If the company performed the materiality analysis on the uncorrected error at the end of 20X5:

The rollover method would quantify the error to the current year income statement as an understatement of depreciation expense of \$25.

The iron curtain method would quantify the error as a \$75 understatement of accumulated depreciation with a corresponding increase in depreciation expense.

With its focus on the current period income statement only, the rollover method does not consider the accumulation of individually immaterial errors over time. However, the rollover method does include the reversing effect of prior-period errors in the current period income statement. In Illustration 6-5, each year’s \$25 error may not be material to each current year income statement; however, the errors accumulate on the balance sheet over time resulting in a \$75 balance sheet misstatement in 20X5. As a result, the error may grow so large on the balance sheet that it cannot be corrected in a future period without materially misstating the income statement in the period of correction.

In contrast, the iron curtain method focuses on the period-end balance sheet and therefore, does not consider the correction of prior-period errors in the current period. For example, if the \$75 accumulated depreciation error in Illustration 6-5 was corrected in 20X5, the year-end balance sheet does not contain any errors. If the company did not have any other errors, no errors would be included in the 20X5 iron curtain method analysis. The iron curtain method does not consider that the 20X5 income statement includes a \$50 overstatement of depreciation expense (i.e., 20X5 income statement includes \$25 of depreciation expense that relates to 20X3 and 20X4 each).

SAB Topic 1.N states that exclusive reliance on one method biased toward either the income statement or the balance sheet is inappropriate. Instead, companies must quantify the effects on the current year financial statements of correcting all errors, including both the carryover (i.e., accumulating) and reversing (i.e., turnaround) effects of uncorrected prior year errors. Mechanically, the SEC staff believes that the quantitative materiality analysis can be accomplished by quantifying and evaluating errors under both the rollover and iron curtain methods. Some entities develop a combined analysis that captures both methods. Any method applied by an entity should consider all affected financial statements equally.

Illustration 6-6: Example quantitative materiality analysis (includes both methods)

Assume the following errors were identified pertaining to 20X6 (12/31 calendar year-end):

- ▶ \$100 understatement of accrued liabilities due within one year as of 12/31/X6, of which \$60 relates to 20X5 (i.e., a carryover or accumulating error)
- ▶ \$30 overstatement of 20X5 interest, corrected in 20X6 (i.e., a reversing or turnaround error)
- ▶ \$80 overstatement of 20X6 revenue

The marginal tax rate for all errors is 35%.

Because there are multiple errors, the company separately analyzed each error and found each error to be immaterial (quantitatively and qualitatively) on a standalone basis. The company prepared the following cumulative quantitative analysis for 20X6 that considers both the rollover and iron curtain method:

Account	Analysis of misstatements Debit/(Credit)								
	Assets current	Assets non-current	Liabilities current	Liabilities non-current	Income effect of correcting the balance sheet as of the end of the:				Other – (e.g., equity)
					Current period		Prior period		
Operating expense					100		60		
Accrued liabilities			(100)						
Interest expense							(30)		
Accounts receivable	(80)								
Revenue					80				
Balance sheet totals	(80)	0	(100)	0					0
Financial statement amounts	8,000	2,000	5,000	2,000					3,000
Effect of uncorrected misstatements on F/S amounts	1%	0%	2%	0%					0
Income effect of uncorrected misstatements (before tax)					180	}	30		Iron curtain method ^A
Memo: Non-taxable items (marked 'X' above)									
Less: Tax effect at current year marginal rate					(63)		(11)		
Cumulative effect of uncorrected misstatements before turnaround effect					4%	117	}	19	
Turnaround effect of prior period uncorrected misstatements (after tax)						(19)			
Cumulative effect of uncorrected misstatements, after turnaround effect					3%	98			Rollover method
Current year net income						2,925			

Prior to concluding on the materiality analysis, the effect of netting errors and qualitative factors should be considered. In addition, if the accrued liabilities or interest expense error pertaining to 20X5 was newly identified, a separate materiality analysis would be required for 20X5 to make sure that the previously issued 20X5 financial statements are not materially misstated.

^A The iron curtain method considers the aggregate balance sheet restatement (including the effect of errors arising in the current period) while disregarding the income statement effect of correcting prior year errors.

Financial statements would need to be adjusted when either the rollover or iron curtain method results in quantifying a misstatement that is material, after considering all relevant quantitative and qualitative factors.

6.2.6 Correcting an error

Excerpt from Accounting Standards Codification

Accounting Changes and Error Corrections – Overall

SEC Materials

SAB Topic 1.N, Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements

250-10-S99-2

[Note: this extract is a continuation from the SAB extract included in section 6.2.5. The relevant facts in the example are the following: During the course of preparing annual financial statements, a registrant is evaluating the materiality of an improper expense accrual (e.g., overstated liability) in the amount of \$100, which has built up over 5 years, at \$20 per year. The registrant previously evaluated the misstatement as being immaterial to each of the prior year financial statements (i.e., years 1-4).]

It is possible that correcting an error in the current year could materially misstate the current years income statement. For example, correcting the \$100 misstatement in the current year will:

- ▶ Correct the \$20 error originating in the current year;
- ▶ Correct the \$80 balance sheet carryover error that originated in Years 1 through 4; but also
- ▶ Misstate the current year income statement by \$80.

If the \$80 understatement of current year expense is material to the current year, after all of the relevant quantitative and qualitative factors are considered, the prior year financial statements should be corrected, even though such revision previously was and continues to be immaterial to the prior year financial statements. Correcting prior year financial statements for immaterial errors would not require previously filed reports to be amended. Such correction may be made the next time the registrant files the prior year financial statements.

The following example further illustrates the staff's views on quantifying misstatements, including the consideration of the effects of prior year misstatements:

Facts: During the course of preparing annual financial statements, a registrant is evaluating the materiality of a sales cut-off error in which \$50 of revenue from the following year was recorded in the current year, thereby overstating accounts receivable by \$50 at the end of the current year. In addition, a similar sales cut-off error existed at the end of the prior year in which \$110 of revenue from the current year was recorded in the prior year. As a result of the combination of the current year and prior year cut-off errors, revenues in the current year are understated by \$60 (\$110 understatement of revenues at the beginning of the current year partially offset by a \$50 overstatement of revenues at the end of the current year). The prior year error was evaluated in the prior year as being immaterial to those financial statements.

Question 2: How should the registrant quantify the misstatement in the current year financial statements?

Interpretive Response: The staff believes the registrant should quantify the current year misstatement in this example using both the iron curtain approach (i.e., \$50) and the rollover approach (i.e., \$60). Therefore, assuming a \$60 misstatement is considered material to the financial statements, after all relevant quantitative and qualitative factors are considered, the registrants financial statements would need to be adjusted.

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

If only the \$60 understatement of revenues were to be corrected in the current year, then the overstatement of current year end accounts receivable would increase to \$110; or

If only the \$50 overstatement of accounts receivable were to be corrected in the current year, then the understatement of current year revenues would increase to \$110.

If the misstatement that exists after recording the adjustment in the current year financial statements is material (considering all relevant quantitative and qualitative factors), the prior year financial statements should be corrected, even though such revision previously was and continues to be immaterial to the prior year financial statements. Correcting prior year financial statements for immaterial errors would not require previously filed reports to be amended. Such correction may be made the next time the registrant files the prior year financial statements.

If the cut-off error that existed in the prior year was not discovered until the current year, a separate analysis of the financial statements of the prior year (and any other prior year in which previously undiscovered errors existed) would need to be performed to determine whether such prior year financial statements were materially misstated. If that analysis indicates that the prior year financial statements are materially misstated, they would need to be restated in accordance with FASB ASC Topic 250, Accounting Changes and Error Corrections.^{FN78}

^{FN78}FASB ASC paragraph 250-10-45-23.

As previously discussed in section 6.2.1, *Assessing materiality in annual financial reporting periods*, when an entity identifies an error relating to the prior period, a separate materiality analysis (considering all relevant quantitative and qualitative factors) is required for each reporting period (i.e., the current and affected prior period(s)). It would be inappropriate to assess materiality solely for the current period.

SAB Topic 1.N provides guidance on whether and how to restate prior years when an error has been identified. The need to restate is dependent on the materiality of the errors to the prior year(s) and current year. The following table summarizes the potential outcomes.

Whether and how to restate	Error is material to:	
	Prior year(s)	Current year
"Big R restatement" of prior periods	X	
"Little r restatement" of prior periods		X
No restatement – allowable to correct in the current period		

A "Big R restatement" – When the error is material to the prior period(s) financial statements, the error is corrected through a "Big R restatement." The error also may be material to current period financial statements but that fact is not determinative in assessing whether a "Big R restatement" is appropriate. A "Big R restatement" corrects all material errors including the correction of material errors relating to classification and disclosure. A "Big R restatement" requires an entity to revise previously issued financial statements (e.g., via a Form 10-K/A filing or in some cases the next Form 10-K filing) to reflect the correction of the error in those financial statements. When an entity concludes a "Big R restatement" is appropriate, the prior financial statements cannot be relied upon and therefore the entity must notify users of the financial statements that those financial statements can no longer be relied upon. See section 6.2.7, *Considerations for error analysis conclusions*, for a discussion of the notification of non-reliance requirements, including Form 8-K filing requirements for SEC registrants. The auditor issues a

modified opinion upon reissuance of the amended prior period financial statements. The following illustration provides an example of certain qualitative and quantitative considerations when evaluating the materiality of an error.

Illustration 6-7: “Big R restatement”

In 20X4, Company XYZ identifies an inventory valuation and corresponding cost of goods sold error related to 20X3. The company performs a materiality analysis for 20X3 and determines:

- Inventory is overstated by 40%.
- Costs of goods sold is understated by 12%.
- Net income is overstated by 8%.
- Inventory-related metrics (e.g., turnover, working capital), which are monitored closely by investors and other financial statement users, were significantly affected and trends altered.
- The error pertained to a new product that is expected to grow significantly.

Based on its quantitative and qualitative analysis, Company XYZ determines that the 20X3 financial statements contain a material error and it must restate the previously issued 20X3 financial statements.

A “Little r restatement” – In some cases, an error is immaterial to the prior period(s) financial statements; however, correcting the error in the current period would materially misstate the current period financial statements (i.e., the turn-around effect of the error correction is material to the current period income statement or statement of comprehensive income). This situation often occurs when an immaterial error remains uncorrected for multiple periods and aggregates to a material number.

Because correcting the error in the current year would materially misstate those financial statements, the prior period(s) financial statements should be corrected, even though such revision previously was and continues to be immaterial to the prior period(s) financial statements. However, correcting prior period(s) financial statements for immaterial errors would not require previous filings to be amended (e.g., no Form 10-K/A required). Such correction may be made the next time the registrant files the prior period(s) financial statements.¹⁸ This type of “Little r restatement” provides for correcting the error in the current period financial statements by adjusting the prior period information and adding disclosure of the error. Because the prior period financial statements were not materially misstated, the entity is not required to notify users that they can no longer rely on the prior financial statements and the auditor’s opinion is not modified when the prior period information is next presented.

Noteworthy is that the type of errors that were contemplated by Topic 1.N as giving rise to a “Little r restatement” were accumulating income statement errors that resulted in a balance sheet error. Correcting the balance sheet would result in a material error correction to that period’s income statement. The SEC staff provides in Topic 1.N a means to correct this type of error without materially misstating the current period income statement (i.e., “Little r restatement”). This concept of accumulating errors also applies when considering items of other comprehensive income. The concept of accumulating errors does not, however, apply to errors solely in classification or disclosure in prior periods’ financial statements as such correction does not affect (nor would such correction materially misstate) the current period financial statements. Instead, errors solely in classification and disclosure are evaluated as either giving rise to a “Big R restatement” or representing immaterial error corrections.

¹⁸ This timing assumes that a registrant does not plan on filing a registration statement that includes or incorporates by reference previously filed financial statements before the next periodic filing (e.g., Form 10-Q or Form 10-K).

The SEC staff further clarified the application of SAB Topic 1.N (i.e., SAB Topic 108) in a 2008 SEC staff speech.

Extract from SEC staff speech by Mr. Mark Mahar

8 December 2008

AICPA National Conference on Current SEC and PCAOB Developments

Before I begin this dive into the conceptual world of materiality, I want to clarify an important point about the effect the method of quantifying an error has on assessing the materiality of an error existing in previously filed financial statements. Question 1 of SAB 108 addresses a circumstance where, during the course of preparing its financial statements, a registrant discovers an improper \$100 expense accrual which has built up at a rate of \$20 per year over the course of the previous 5 years, inclusive of the Year 5 financial statements currently being prepared.

Let us assume that the error existing on each balance sheet and income statement is not material, quantitatively or qualitatively, to any of the previous Years 1 through 4. However, correcting the cumulative \$100 balance sheet error in Year 5 would introduce an \$80¹ error in the Year 5 income statement which would materially misstate Year 5.

In that circumstance, SAB 108 indicates the “prior year financial statements should be corrected even though such revision previously was and continues to be immaterial to the prior year financial statements.” However, the response also notes that “correcting prior year financial statements for immaterial errors would not require previously filed reports to be amended.” Said another way, if a restatement of previously issued financial statements is required, but such restatement would not result in the previous year financial statements changing materially, then the company can restate those financial statements the next time they are presented without amendment to the previous filings or the issuance of an Item 4.02 8-K.

In evaluating whether the Year 2, 3 or 4 financial statements are materially misstated, we understand that some look to the response in Question 2. That response states that a “separate analysis of the financial statements of the prior year (and any other prior year in which previously undiscovered errors existed) would need to be performed to determine whether such prior year financial statements were materially misstated” (emphasis added). Despite the guidance, some registrants and auditors have interpreted this to mean that when evaluating Years 2, 3 or 4 separately, if the effect of correcting the error that exists in each balance sheet² materially impacts the income statement of each year, then the registrant must amend those previously filed financial statements.

This is not how the staff applies SAB 108. The discovery of a material error generally requires restatement consistent with SFAS No. 154.³ However, SAB 108 contemplated that in some circumstances restatements could be included in a company’s next filing rather than via an amendment to the previous filing or filings when the effect of restating the previously issued financial statements does not result in a material change to those financial statements.

Using my example, recall that the balance sheet and income statement effect [sic] of the error is not material to any given period however an out-of-period correction of the cumulative balance sheet error in any particular year might have been material. If that is true, then the restatements would not materially alter the previous financial statements, as reported, and therefore those financial statements could still be relied upon. Therefore, the registrant could include the restatement with the next filing⁴ without amending the previous filings.

¹ \$80 = the cumulative effect of the annual \$20 error included in the Years 1-4 financial statements.

² Assuming no other errors exist, the balance sheet error in Years 2, 3 and 4 would be \$40, \$60 and \$80 respectively.

³ Statement of Financial Accounting Standard No. 154, *Accounting Changes and Error Corrections*, paragraph 25.

⁴ The correction would typically be effectuated by adjustments to the effected prior annual and quarterly periods, including any selected financial data and supplementary financial information such as information required by Items 301 and 302 of Regulation S-K [N.B.: this speech was given prior to Release 33-10890, which amended Items 301 and 302 of Regulation S-K].

The SEC staff believes that errors should be corrected timely and has provided a means to do so even when the errors are not material to any one of the primary financial statements in any given year. The following illustration provides an example of when a “Little r restatement” is appropriate.

Illustration 6-8: “Little r restatement”

In 20X9, a company identifies an accumulated error of \$3,000 related to the understatement of a deferred tax liability that had built up ratably over the previous three years (i.e., \$1,000 error per year). No other current or prior-period errors exist. To assess the error, the company:

- ▶ Performs a materiality analysis for the 20X7 financial statements (i.e., the first year of the error). The \$1,000 error is concluded to be immaterial (both quantitatively and qualitatively) and no “Big R restatement” is necessary.
- ▶ Performs a materiality analysis for the 20X8 financial statements (i.e., the second year of the error). The company determines the error is immaterial from a qualitative perspective. In addition, the company concludes that the \$1,000 error from the understatement of 20X8 tax expense and the \$2,000 cumulative error of the deferred tax liability are quantitatively immaterial.
- ▶ The Company identifies the error in 20X9. However, if the company corrects the error by recording an adjustment in the 20X9 financial statements, the company concludes that the \$2,000 overstatement of tax expense (related to 20X7 and 20X8 activity) would be material to the 20X9 income statement.

Because the 20X7 and 20X8 financial statements continue to be fairly presented in all material respects, but correcting the error in the 20X9 financial statements (i.e., current period financial statements) would cause the 20X9 income statement to be materially misstated, a “Little r restatement” is appropriate. The company would not be required to notify users that the 20X7 and 20X8 financial statements can no longer be relied upon. The 20X7 and 20X8 comparative information would be corrected when issued with the 20X9 financial statements, with appropriate disclosure of the nature and effect of the error correction, in accordance with ASC 250 (see section 6.3, *Reporting an error in previously issued financial statements*, for additional information).

In assessing whether a “Big R restatement” or “Little r restatement” is appropriate, the company does not need to include in its materiality assessment the “what if” scenario that the error was corrected in 20X8. In other words, the company would not assess whether recording the \$2,000 cumulative error in 20X8 would cause the 20X8 income statement to be materially misstated.

Often individually immaterial errors accumulate over years and become material to a financial reporting period resulting in the need to restate financial statements. An effective way to reduce the risk of restatements (“Big R restatements” or “Little r restatements”) is to record all known errors, including those that are not material in the period the error is first identified.

See section 6.2.7, *Considerations for error analysis conclusions*, for additional information about reporting requirements and other considerations for a “Little r restatement.”

Immaterial errors – When the error is immaterial to the prior period(s) financial statements and correcting the error in the current period is not material to the current period financial statements, the error is generally corrected in the current period with no restatement of prior period(s) financial statements. The concept of correcting prior-period errors in the current period refers solely to errors that accumulate and would be corrected via an out-of-period adjustment in the current period. If the out-of-period adjustment is immaterial with respect to the estimated income for the full fiscal year or to the trend on earnings, but material to the quarter in which it is recorded, it can still be recorded in that quarter, but would require disclosure in accordance with ASC 250-10-50-12. See section 6.4, *Interim reporting considerations* for further information.

Illustration 6-9: Immaterial errors

In the prior year, an entity understated interest income by \$500 related to a note receivable the entity received in exchange for a piece of equipment. The entity corrected the error in the current year. The effect on the individual income statement line item, subtotals and net income was quantitatively immaterial (the prior year error as well as the effect of recording the error correction in the current year). The effect on all applicable line items on the prior year's balance sheet was also quantitatively immaterial. In addition, no qualitative factors indicate that the error is material to either year. The additional \$500 of interest income is recognized in the current year and no restatement of prior year financial statements is required.

If errors relate to the previously filed interim financial statements, see section 6.4, *Interim reporting considerations*, for further information.

Corrections of immaterial errors also include prior period financial statement classification errors (e.g., classification errors within the balance sheet, income statement, statement of cash flow, statement of comprehensive income and statement of shareholders' equity) that have been assessed as immaterial to prior period financial statements. These error corrections are not the result of an accumulation of the immaterial errors and therefore are evaluated as either giving rise to a "Big R restatement" or represent immaterial error corrections.

If an entity chooses to correct immaterial prior-period errors (inclusive of classification errors) in the current year comparative financial statements, such immaterial error corrections should be disclosed as they represent changes to prior year financial statements.

When errors (or omissions) in disclosure in prior year financial statements are discovered, they are also evaluated to determine if they are so significant as to give rise to a "Big R restatement" (i.e., a restatement to revise previously issued financial statements (e.g., via a Form 10-K/A filing or in some cases the next Form 10-K filing) in which the auditor issues a modified opinion upon reissuance of the amended prior period financial statements). The materiality analysis for disclosure errors should be similar to all other materiality analyses (i.e., the analysis described in sections 6.2.1 through 6.2.5), including considerations of similar quantitative and qualitative factors. However, the evaluation of disclosure-only errors is often more heavily weighted to qualitative factors. It is not uncommon for such omission or disclosure errors to be considered immaterial to the prior year financial statements given that the evaluation of the misstatement is based on the financial statements taken as a whole. If the error or omission were determined to be immaterial to the previously issued financial statements, it can be corrected by changing the footnote in the current period comparative financial statements.

6.2.7**Considerations for error analysis conclusions (updated July 2025)**

The following table summarizes the items that management should consider for each error analysis conclusion. In addition, management must assess whether any control deficiencies identified in connection with the error(s), individually and when assessed with other control deficiencies, represent significant deficiencies or material weaknesses. For further description of a "Big R restatement," "Little r restatement" and immaterial errors that would result in no restatement, see section 6.2.6, *Correcting an error*.

	"Big R restatement"	"Little r restatement"
Financial statement reporting requirements	X	X
Notification of non-reliance requirements (including Form 8-K filings)	X	

Financial statement reporting requirements

See section 6.3, *Reporting an error in previously issued financial statements*, for information on financial statement reporting requirements.

Notification of non-reliance requirements

AU-C Section 560, *Subsequent Events and Subsequently Discovered Facts*, paragraphs A.18-A.26, *Subsequently Discovered Facts That Became Known to the Auditor After the Report Release Date*, provides guidance on the procedures an auditor must perform when a material error to prior period financial statements is identified and such financial statements and related audit report can no longer be relied upon (i.e., when a “Big R restatement” is required). The audit standard states that the preparer of the financial statements should take steps to make sure that anyone in receipt of the audited financial statements is informed of the situation, including that the audited financial statements are not to be relied upon. Among other requirements, this includes issuing revised financial statements with appropriate disclosure of the matter. The actual method to communicate non-reliance varies based on the specific facts and circumstances. The auditor has responsibilities to communicate non-reliance of the financial statements if the preparer does not perform the required communications.

For SEC registrants, an Item 4.02 Form 8-K, *Non-reliance on previously issued financial statements or a related audit report or completed interim review*, is required to be filed when (1) a registrant’s board of directors, a committee of the board (e.g., the audit committee) or other board authorized officer(s) concludes that any previously issued annual or interim financial statements should no longer be relied upon because of an error in such financial statements or (2) a registrant receives notice from its current or former independent auditor that action should be taken to prevent future reliance on a previously issued audit report or completed interim review (i.e., in either case, a “Big R restatement”). The Form 8-K filing requirement is not affected by whether the “Big R restatement” is or will be included in a Form 10-K or Form 10-K/A. An Item 4.02 Form 8-K is generally not required for a “Little r restatement.” See section 8.6.5.2, *Item 4.02 Non-reliance on previously issued financial statements or a related audit report or completed interim review*, of our SEC Manual for additional information.

6.2.8

Internal control over financial reporting considerations (updated April 2024 and July 2025)

All entities (public or private) that identify an error assess whether and how the identified error affects its conclusions on the effectiveness of the related internal controls. This is because the error, if not timely detected by management’s internal controls, indicates that a control deficiency may exist in the design or operation of a control(s). When it is determined that a deficiency exists, the entity should consider whether it represents just a deficiency, a significant deficiency or a material weakness (i.e., evaluating the severity of the control deficiency).

Extract from SEC staff speech by Mr. Tom W. Collens, Professional Accounting Fellow

December 2018

AICPA National Conference on Current SEC and PCAOB Developments

A material weakness is a control deficiency, or a combination of control deficiencies, such that there is a reasonable possibility that a material misstatement of the financial statements will not be prevented or detected on a timely basis.¹⁹ The critical determination when evaluating the severity of a control deficiency is whether or not that deficiency, either alone or in combination with other identified control deficiencies, rises to the level of a material weakness. When making this determination, management should evaluate the level of detail and assurance needed to support their conclusions by considering what the views of a “prudent official” would be in conducting their own affairs. Specifically, management should consider the level of detail and degree of assurance that would satisfy a prudent official looking to obtain reasonable assurance that the financial statements are in conformity with GAAP.²⁰ I believe that consistently applying this mindset will help management perform a more holistic and effective evaluation of the severity of control deficiencies compared to some of the more narrow evaluations we have seen in some instances through our consultations at OCA.

As part of evaluating the severity of the control deficiency, an entity should consider the potential magnitude of error that could have resulted from the control deficiency and not just the actual error. The evaluation of the severity of a deficiency should also consider if there is a reasonable possibility that the entity’s controls will fail to prevent or detect a material misstatement on a timely basis. The entity should also consider various qualitative factors (e.g., indication of fraud) in its evaluation as well as the existence of any compensating controls, including whether such controls operated at a level of precision that could have prevented or detected a misstatement that could be material, and whether the entity has sufficient evidence that the compensating controls were operating effectively and at the appropriate level of precision.

For SEC registrants subject to management’s annual requirement to assess and report on internal control over financial reporting (ICFR), an error that results in a restatement of previously issued financial statements to correct a material misstatement represents a presumptive indicator of a material weakness. Specifically, because a material weakness exists when it is reasonably possible that the entity’s controls would fail to detect a material error, and a material error has in fact occurred in a “Big R restatement,” a material weakness is presumed to exist. As such, when a registrant identifies an error that results in a “Big R restatement,” it is an extremely high hurdle to conclude that a material weakness does not exist. However, it is important to highlight that a deficiency related to an error that results in a “Little r restatement” or no restatement should still be evaluated when determining whether the control deficiency, or combination of control deficiencies, rises to the level of a material weakness.

¹⁹ See Rule 12b-2 of the Securities Exchange Act of 1934 (Exchange Act) and Rule 1-02(a)(4) of Regulation S-X.

²⁰ See “Commission Guidance Regarding Management’s Report on Internal Control Over Financial Reporting Under Section 13(a) or 15(d) of the Securities Exchange Act of 1934” (June 27, 2007) (Commission Guidance), at 37-38, available at <https://www.sec.gov/rules/interp/2007/33-8810.pdf>.

The following extracts further emphasize the expectations of the SEC staff on how registrants should evaluate the severity of a control deficiency when there is an accounting error:

Extract from SEC Statement by Acting Chief Accountant Mr. Paul Munter

9 March 2022

We note that the identification of an accounting error also impacts management's assessment of the effectiveness of ICFR, and that the principles mentioned here regarding an objective assessment similarly apply to the ICFR analysis as to the severity of the control deficiency. Management's ICFR effectiveness assessment must consider the magnitude of the potential misstatement that could result from a control deficiency, and we note that the actual error is only the starting point for determining the potential impact and severity of a deficiency. Therefore, while the existence of a material accounting error is an indicator of the existence of a material weakness, a material weakness may also exist without the existence of a material error. Management's assessment of the effectiveness of ICFR should therefore be focused on a holistic, objective analysis of what could happen in the context of current and evolving financial reporting risks.

Extract from Commission guidance regarding management's report on internal control over financial reporting under section 13(a) and 15(d) of the Securities Exchange Act of 1934

Release No 33-8810, June 27, 2007

Management should evaluate whether the following situations indicate a deficiency in ICFR exists and, if so, whether it represents a material weakness:

- ▶ Identification of fraud, whether or not material, on the part of senior management;
- ▶ Restatement of previously issued financial statements to reflect the correction of a material misstatement;
- ▶ Identification of a material misstatement of the financial statements in the current period in circumstances that indicate the misstatement would not have been detected by the company's ICFR; and
- ▶ Ineffective oversight of the company's external financial reporting and internal control over financial reporting by the company's audit committee.

The SEC's guidance is consistent with PCAOB Auditing Standard No. 2201, *An audit of internal control over financial reporting that is integrated with an audit of financial statements* (AS No. 2201). Auditors should consider the same indicators of a material weakness in internal control over financial reporting when evaluating the effectiveness of a registrant's internal control over financial reporting. The auditor also has responsibility with respect to internal control considerations when an error has been identified.

In addition, SEC registrants should consider the following to the extent an identified error results in a restatement:

- ▶ Whether the disclosures provided under S-K 307 in prior filings need to be modified, supplemented or corrected in order to explain whether management's previous conclusions regarding the effectiveness of disclosure and control procedures continue to be appropriate in light of the assessment to restate financial statements.

- ▶ Whether to revise its original report on the effectiveness of internal control over financial reporting (S-K 308). There is no requirement for a company to reevaluate the effectiveness of its internal control and/or reissue a revised management's report on internal control over financial reporting when a company restates its financial statements. However, a company may need to consider whether or not its original disclosures in management's report continue to be appropriate in light of the error(s) and should modify or supplement its original disclosure to include any other material information that is necessary for such disclosures to not be misleading in light of the restatement.
- ▶ Whether registrants should report a change in internal control over financial reporting under S-K 308(c). This reporting requirement could apply if a material change in controls led to an error in the current period or if any material weakness was remediated during the period.

For additional information, refer to our SEC annual reports – Form 10-K publication section 4.6.1, *Item 307 Disclosure controls and procedures*, section 4.6.2, *Item 308 (a) & (b) Internal control over financial reporting*, and section 4.6.3, *Item 308(c) Changes in internal control over financial reporting*.

6.3 Reporting an error in previously issued financial statements

6.3.1 Presentation requirements for restatements

Excerpt from Accounting Standards Codification

Accounting Changes and Error Corrections – Overall

Glossary

250-10-20

Restatement

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

Other Presentation Matters

Correction of an Error in Previously Issued Financial Statements

250-10-45-22

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

250-10-45-23

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

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

250-10-45-24

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

Historical Summaries of Financial Data**250-10-45-28**

It has become customary for business entities to present historical, statistical-type summaries of financial data for a number of periods—commonly 5 or 10 years. Whenever error corrections have been recorded during any of the periods included therein, the reported amounts of net income (and the components thereof), as well as other affected items, shall be appropriately restated, with disclosure in the first summary published after the adjustments. (See paragraph 250-10-50-7A.)

Pursuant to ASC 250-10-45-23, restatement of prior period financial statements requires that:

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

Unlike reporting the retrospective application of a change in accounting principle, reporting the correction of a material error when re-issuing prior year financial statements (i.e., reporting a “Big R restatement” as described further in section 6.2.6, *Correcting an error*) is characterized as a restatement. For “Big R restatements,” entities should label the prior period column headings of applicable financial statements and related footnote disclosures “As restated.”

When a “Little r restatement” (as described further in section 6.2.6, *Correcting an error*) is appropriate, the error is corrected in the current-period financial statements by adjusting the prior-period information similar to the requirements in ASC 250-10-45-23. The prior period column headings are not generally labeled as restated given the prior year adjustment is, by definition, immaterial. However, we believe entities should provide transparent disclosure related to the nature and impact of the error(s). Other information may be included within or along with financial statements. The information may be provided at management’s discretion in conjunction with the issuance of the financial statements (e.g., a 10-year summary of financial data provided by private companies). For “Big R restatements” and “Little r restatements,” other information affected by the error correction also should be restated. For example, if a company includes a selected financial data table and the correction of a material error affects the previous years included in the table, the historical data for each corresponding year on the selected financial data table should be restated and labeled as such.

When there has been a material (individually or in the aggregate) retrospective change affecting comprehensive income (e.g., correction of an error) for any of the quarters within the most recent two fiscal years, Item 302(a) of Regulation S-K requires the disclosure of quarterly financial data within Form 10-K. A registrant is required to provide an explanation of the reasons for the material change and disclose, for each affected quarterly period and the fourth quarter in the affected year, summarized financial information related to the statements of comprehensive income (as specified in Rule 1-02(bb)(ii) of Regulation S-X) and earnings per share reflecting such changes.

For additional information on the process and related requirements of filing an amended Form 10-K, refer to our SEC annual reports – Form 10-K publication section 2.13.1, *Amendments*.

6.3.1.1

SEC clawback rule (updated April 2024 and July 2025)

In June 2023, the SEC approved listing standards proposed by the New York Stock Exchange (NYSE) and Nasdaq that require listed companies to recover, or “claw back,” incentive-based compensation erroneously received by current and former executive officers in the event of a required accounting restatement, including both “Big R” and “Little r” restatements. The standards became effective on 2 October 2023, and registrants listed on those exchanges were required to adopt compliant clawback policies by 1 December 2023.

The rules require companies to disclose their clawback policies and any compensation subject to clawback in annual reports and in proxy and information statements. Companies are also required to check boxes on the cover page of their annual reports to indicate whether (1) the financial statements included in the filing reflect the correction of an error to previously issued financial statements and (2) any of those restatements required a recovery analysis of incentive-based compensation received by any of the registrant’s executive officers during the relevant recovery period.

Companies must check box No. 1 if the prior-period financial statements included in Form 10-K reflect the correction of an accounting error as defined under ASC 250 (i.e., “Big R” or “Little r” restatements). The SEC staff has expressed its belief that this box must also be checked if a registrant voluntarily corrects an immaterial error in the financial statements for prior periods, which could include corrections in classification or revisions to footnote disclosures (although they would not have to check box No. 2 in this scenario).

Companies do not need to check box No. 1 for the adoption of a new accounting standard with retrospective application, voluntary reclassifications of prior-year amounts to conform to the current year presentation or out-of-period adjustments, since these changes are not prior-period accounting error corrections.

The clawback rule did not change the disclosures about restatements required under ASC 250.

6.3.2

Disclosures for restatements (updated April 2024)

Excerpt from Accounting Standards Codification

Accounting Changes and Error Corrections – Overall

Disclosure

Correction of an Error in Previously Issued Financial Statements

250-10-50-7

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

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

250-10-50-7A

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

250-10-50-8

When prior period adjustments are recorded, the resulting effects (both gross and net of applicable income tax) on the net income of prior periods shall be disclosed in the annual report for the year in which the adjustments are made and in interim reports issued during that year after the date of recording the adjustments.

250-10-50-9

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

250-10-50-10

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

Error Correction Related to Prior Interim Periods of the Current Fiscal Year**250-10-50-11**

The following disclosures shall be made in interim financial reports about an adjustment related to prior interim periods of the current fiscal year. In financial reports for the interim period in which the adjustment occurs, disclosure shall be made of both of the following:

- a. The effect on income from continuing operations, net income, and related per-share amounts for each prior interim period of the current fiscal year
- b. Income from continuing operations, net income, and related per-share amounts for each prior interim period restated in accordance with paragraph 250-10-45-26.

ASC 250-10-50-7 through 50-11 provides disclosure requirements for “Big R restatements” (see section 6.2.6, *Correcting an error*, for additional information about “Big R restatements”).

Disclosure requirements related to an accumulation of immaterial errors (i.e., “Little r restatements” as described at section 6.2.6, *Correcting an error*) are not specifically addressed in ASC 250. We believe that when correcting an error that was not material to the prior period financial statements by adjusting previously issued financial statements, such correction should be disclosed. Including disclosure of the error correction facilitates transparency of financial reporting. The SEC staff frequently requests a registrant’s materiality assessment, particularly when the registrant has not disclosed that the error is immaterial to prior periods.

In addition, the SEC staff also believes that transparent reporting of the error includes disclosure of how the error was identified.

Extract from SEC staff speech by Mr. Scott Taub**17 November 2006****Remarks regarding restatements before the Financial Executives International Meeting**

In addition to analyzing what caused the error, we were also interested in how the error was found so that it could be corrected. Unfortunately, about half of the restatement disclosures did not report any information on this point. As it strikes me that market participants would likely be interested in this information, I wonder whether something should be done to encourage its disclosure. Even when information was provided, about half the time the disclosures indicate that the company identified the error with little further discussion of how that occurred.

Financial statements for the period following the correction of an error need not repeat the required disclosures initially made in the period of the error correction. However, entities that issue interim financial statements must provide the required disclosures in the financial statements of both the interim and annual periods that include the correction of an error. Such disclosure is consistent with changes in accounting principle. See section 3.8, *Disclosures for a change in accounting principle*, for additional discussion.

For the correction of an error, a question arises about whether the required disclosures must be repeated after the restated financial statements have been filed. For example, assume a public entity determines in the second quarter of 20X6 (prior to issuance of the second quarter 20X6 financial statements) that it needs to restate its prior financial statements, including its 20X5 Quarterly Reports on Form 10-Q for the second and third quarters and its 20X5 Annual Report on Form 10-K, for the correction of an error and in 20X6 files Forms 10-Q/A and 10-K/A to correct the 20X5 financial statements. The question that arises is whether the disclosures from the restated 20X5 financial statements should be repeated in the 20X6 financial statements that include comparative 20X5 information. That is, should the 20X6 quarterly and annual financial statements include the same required disclosures for the correction of an error as the 20X5 financial statements as the error was identified in 20X6? Alternatively, does the issuance of restated financial statements eliminate the need to repeat the disclosures in 20X6?

This issue is not specifically addressed in ASC 250. However, we believe the filing of the restated 20X5 financial statements prior to issuing the 20X6 financial statements (including the restated comparative 20X5 financial statements) eliminates the need for presentation of the disclosures in the 20X6 financial statements as these disclosures were included in the restated 20X5 financial statements, previously filed with the SEC. That is, once the 20X5 restated financial statements are filed, we do not believe detailed disclosures required by ASC 250-10-50-7 are required. However, we believe it is preferable to include disclosure of the restatement and the nature of the corrected error in future filings made during 20X6 (e.g., the second and third quarter quarterly reports and the 20X6 Annual Report). Financial statements filed for periods subsequent to 20X6 do not need to repeat the disclosures describing the restated financial statements.

Additionally, under SEC Rule 10-01(b)(7) of Regulation S-X, registrants are required to provide disclosure of any material retroactive prior-period adjustments made during any period covered by the interim financial statements, together with the effect thereof on net income, total and per share, of any prior period included and on the balance of retained earnings.

If results of operations, for any period presented, have been adjusted retroactively by such an item the initial reporting of such period, the registrant is required to provide similar disclosure of the effect of the change. Additionally, Rule 3-04 of Regulation S-X requires that a registrant state separately the adjustments to the balance at the beginning of the earliest period presented for items that were retroactively applied to periods prior to that period.

6.3.3 Reporting retrospective accounting changes in a Form 10-K/A filed to correct an error

The SEC staff believes that once an entity files interim information reflecting retrospective accounting changes, any subsequent Form 10-K/A to correct an error also should reflect the retrospective accounting. The financial statements in Form 10-K/A should clearly distinguish the effects of the material error from those of any subsequent accounting change.²¹

Illustration 6-10: Reporting a correction of an error and a subsequent event requiring retrospective application

An entity adopts a new accounting standard with retrospective application reflected in its first quarter Form 10-Q and subsequently discovers a material error in its prior year financial statements. The entity's amended financial statements should be filed on a Form 10-K/A and should reflect BOTH the retrospective application of the new accounting standard AND the correction of the material error. The disclosures included in Form 10-K/A should clearly segregate the effects of these two items.

The SEC staff also indicated that a registrant should not delay the filing of a Form 10-K/A to correct an error, even when it expects to file a Form 10-Q in the near future that will retrospectively apply a new accounting standard.²² For example, if a calendar year entity discovers an error in early April before it files its first quarter Form 10-Q and it is able to determine the effect of that error on its prior period financial statements, it should not delay filing Form 10-K/A until after filing its first quarter Form 10-Q.

6.3.3.1 Evaluating prior-period errors when adopting a new accounting standard

When an entity adopts a new accounting standard, it may identify errors in prior-period accounting as part of its evaluation of the retrospective application of the new accounting standard's transition provisions (if applicable). The errors may be unrelated (i.e., the errors relate to the misapplication of GAAP in previously issued financial statements) or related (i.e., the errors result from its retrospective application of the new accounting standard in the year of adoption) to the implementation of the new accounting standard. Questions have arisen regarding how to evaluate those errors, and how to correct them, if material.

Errors unrelated to the implementation of a new accounting standard

If an entity identifies errors in prior period financial statements, those errors should be evaluated using the materiality thresholds that were relevant in the prior period and under the prior accounting method. That is, the entity should not apply materiality thresholds that have since been revised following the application of the new accounting method because the errors are unrelated to the adoption of the new standard. The entity should consider the newly identified errors both individually and in the aggregate with other unrecorded prior-period adjustments in order to determine whether the prior period financial statements were materially misstated. If so, a public entity should correct the errors by filing a 10-K/A, as described in section 6.3.3, *Reporting retrospective accounting changes in a Form 10-K/A filed to correct an error*. Refer to section 6.2, *Assessing the materiality of an error*, for further discussion of accounting errors and materiality.

²¹ SEC Financial Reporting Manual – Division of Corporation Finance, Section 13110.6

²² 23 June 2009 Center for Audit Quality SEC Regulations Committee meeting

Errors related to the implementation of a new accounting standard (prior to the issuance of the financial statements)

If an entity identifies errors in prior periods that resulted from its retrospective application of a new accounting standard in the year the standard is adopted, it would evaluate those errors using revised materiality thresholds (i.e., thresholds set following the application of the new accounting standard). These errors should be corrected prior to the issuance of the financial statements in the period of adoption. Refer to section 6.2, *Assessing the materiality of an error*, for further discussion of accounting errors and materiality.

6.3.4

Initial public offering restatement reporting requirements

At times, a correction of an error pursuant to ASC 250 is required for an IPO Form S-1 pre-effective amendment. The SEC staff provided guidance²³ that after initially disclosing an error correction in a pre-effective amendment, an entity is required to continue to provide the restatement disclosures and labeling in subsequent Form S-1 amendments until the registration statement is updated to include a new fiscal year's annual financial statements. This view applies equally to amendments to initial registration statements that are submitted confidentially under the Jumpstart Our Business Startups (JOBS) Act, which was enacted in April 2012.²⁴

Illustration 6-11: IPO restatement reporting

A company files an IPO registration statement, including audited financial statements for the three years ended 31 December 20X8. The issuer identifies and corrects a material error in its 20X7 financial statements and files a pre-effective amendment, which includes restated financial statements for 20X7 and accompanying disclosures. To remove the restatement labeling and disclosure prior to effectiveness, the financial statements for the 12 months ending 31 December 20X9 would need to be filed in the IPO registration statement.

The SEC staff believes an objective of ASC 250 is to provide sufficient time for investors to consider restatement disclosures. Therefore, the SEC staff also suggests that, if an entity plans to include restatement disclosures for a very short time before updating its annual financial statements in a registration statement, the entity should discuss its plan in advance with the SEC staff.

6.4

Interim reporting considerations

Excerpt from Accounting Standards Codification

Accounting Changes and Error Corrections – Overall

Disclosure

Materiality Considerations for Correction of an Error

250-10-50-12

In considering materiality for the purpose of reporting the correction of an error, amounts shall be related to the estimated income for the full fiscal year and also to the effect on the trend of earnings. Changes that are material with respect to an interim period but not material with respect to the estimated income for the full fiscal year or to the trend of earnings shall be separately disclosed in the interim period. (See paragraph 250-10-45-27.)

²³ 2011 AICPA National Conference on Current SEC and PCAOB Developments

²⁴ SEC 21 December 2015 (revised) Jumpstart Our Business Startup Act Frequently Asked Questions, Generally Applicable Questions on Title I of the JOBS Act, FAQ 38

ASC 250 provides limited guidance on assessing materiality to interim reporting. However, the SEC staff expects the guidance to be applied to interim financial reporting as well.

Extract from SEC staff speech by Mr. Mark Mahar

8 December 2008

AICPA National Conference on Current SEC and PCAOB Developments

If consideration of the total mix of information and how a reasonable investor might consider such information is the premise of materiality evaluations, then whether an error appears within annual or interim financial information should not alter that premise. Rather, each error should be evaluated in light of the surrounding circumstances as a reasonable investor would. The same effort to identify and evaluate the relevant information in annual financial information should be applied to interim financial information, appreciating that the relevant information for annual and interim periods may not always be the same.

See section 6.2, *Assessing the materiality of an error*, for further information about SAB Topics 1.M and 1.N.

ASC 250-10-50-12 addresses materiality in the context of interim financial reporting and states that the materiality assessment should include an assessment of the error relative to the effect on the trend of earnings and relative to estimated income for the full fiscal year.

Evaluating the quarterly materiality for trends is subjective and should consider both quantitative and qualitative trends. Examples of trend of earnings considerations include quarterly earnings trends (i.e., consecutive quarter and year to date trends as well as trends comparing quarterly information year to year), changing from net income to a loss or vice versa as well as comparing to analysts' expectations (e.g., meeting or exceeding analysts' expectations before an error is corrected and not meeting those expectations after the error is corrected).

Whether an entity should use interim or expected annual results in making materiality judgments depends on the circumstances. For example, an entity may encounter situations where an uncorrected error identified in the interim period is material to interim results but is not material to expected annual results. In those situations, management should consider the nature of the error and whether the interim period is representative of historical and expected financial trends of the entity. If the interim reporting period historically is a loss period due to seasonality or other factors (for what is otherwise a highly profitable business), we generally believe management would look to expected annual results when making quantitative judgments about materiality. Depending on the circumstances, we believe management also may choose to evaluate errors based on expected annual results when a significant portion of the errors are due to the effects of prior interim or annual period errors reversing in the current period (i.e., out-of-period amounts). If subsequent analysis shows that annual results were less than expected, a previously immaterial error may now be considered material, resulting in a restatement at that time.

If the correction of an error is material to income of the current interim period, but not material to the estimated income of the current full fiscal year or to the trend of earnings, the correction of the error should be disclosed separately in the interim period.

Form 8-K filing and other filing requirements

When a registrant identifies a misstatement that materially affected a prior interim period, it should consider whether it must file an Item 4.02 Form 8-K. Item 4.02 of Form 8-K applies to both annual and interim period financial statements that should no longer be relied upon due to a misstatement. See section 6.2.7, *Considerations for error analysis conclusions*, for additional information on the notification of non-reliance requirements.

Typically, the correction of a material error to prior interim filings (i.e., a “Big R restatement” as described in section 6.2.6, *Correcting an error*) is made by filing a Form 10-Q/A.

Error correction reporting

Correcting an error for interim financial statements of previous fiscal years requires the same presentation (ASC 250-10-45-22 through 45-24) and disclosures (ASC 250-10-50-7 through 50-9) as annual periods. If the error correction relates to the prior interim period(s) of the current fiscal year, different disclosures are required as described in ASC 250-10-50-11. See section 6.3, *Reporting an error in previously issued financial statements*, for additional information.

Adjustments to prior interim periods of the current year

Certain types of adjustments related to prior interim periods of the current fiscal year require entities to retroactively adjust their prior interim periods. For additional information, see section 3.5.3, *Adjustments to prior interim periods of the current fiscal year*.

A

Abbreviations used in this publication

Abbreviation	<i>FASB Accounting Standards Codification</i>
ASC 205	FASB ASC Topic 205, <i>Presentation of Financial Statements</i>
ASC 220	FASB ASC Topic 220, <i>Income Statement – Reporting Comprehensive Income</i>
ASC 250	FASB ASC Topic 250, <i>Accounting Changes and Error Corrections</i>
ASC 260	FASB ASC Topic 260, <i>Earnings Per Share</i>
ASC 270	FASB ASC Topic 270, <i>Interim Reporting</i>
ASC 323	FASB ASC Topic 323, <i>Investments – Equity Method and Joint Ventures</i>
ASC 326	FASB ASC Topic 326, <i>Financial Instruments – Credit Losses</i>
ASC 330	FASB ASC Topic 330, <i>Inventory</i>
ASC 350	FASB ASC Topic 350, <i>Intangibles – Goodwill and Other</i>
ASC 606	FASB ASC Topic 606, <i>Revenue from Contracts with Customers</i>
ASC 715	FASB ASC Topic 715, <i>Compensation – Retirement Benefits</i>
ASC 740	FASB ASC Topic 740, <i>Income Taxes</i>
ASC 805	FASB ASC Topic 805, <i>Business Combinations</i>
ASC 810	FASB ASC Topic 810, <i>Consolidation</i>
ASC 835-20	FASB ASC Subtopic 835-20, <i>Interest – Capitalization of Interest</i>
ASU No. 2014-09	FASB Accounting Standards Update No. 2014-09, <i>Revenue from Contracts with Customers (Topic 606)</i>
ASU No. 2016-02	FASB Accounting Standards Update No. 2016-02, <i>Leases (Topic 842)</i>
ASU No. 2016-03	FASB Accounting Standards Update No. 2016-03, <i>Intangibles – Goodwill and Other (Topic 350); Business Combinations (Topic 805); Consolidation (Topic 810); Derivatives and Hedging (Topic 815): Effective Date and Transition Guidance</i>
ASU No. 2016-13	FASB Accounting Standards Update No. 2016-13, <i>Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments</i>
Abbreviation	<i>Other Authoritative Standards</i>
AS No. 2201	PCAOB Auditing Standard No. 2201, <i>An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements</i>
AS No. 2820	PCAOB Auditing Standard No. 2820, <i>Evaluating Consistency of Financial Statements</i>
SAB Topic 1.M (SAB 99)	SEC Staff Accounting Bulletin Topic 1.M, <i>Financial Statements – Materiality</i>
SAB Topic 1.N (SAB 108)	SEC Staff Accounting Bulletin Topic 1.N, <i>Financial Statements – Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements</i>
SAB Topic 5.F	SEC Staff Accounting Bulletin Topic 5.F, <i>Miscellaneous Accounting – Accounting Changes Not Retroactively Applied Due to Immateriality</i>
SAB Topic 6.G	SEC Staff Accounting Bulletin Topic 6.G, <i>Interpretations of Accounting Series Releases and Financial Reporting Releases – Accounting Series Releases 177 and 286 – Relating to Amendments to Form 10-Q Regulation S-K, and Regulations S-X Regarding Interim Financial Reporting</i>

Abbreviation	<i>Other Authoritative Standards</i>
SAB Topic 6.I.3	SEC Staff Accounting Bulletin Topic 6.I.3, <i>Interpretations of Accounting Series Releases and Financial Reporting Releases – Accounting Series Release No. 149 – Improved Disclosure Of Income Tax Expense (Adopted November 28, 1973 And Modified By ASR 280 Adopted On September 2, 1980) – Net of Tax Presentation</i>
SAB Topic 11.M	SEC Staff Accounting Bulletin Topic 11.M, <i>Miscellaneous Disclosure – Disclosure Of The Impact That Recently Issued Accounting Standards Will Have On The Financial Statements Of The Registrant When Adopted In A Future Period</i>
Rule 1-02	SEC Regulation Rule S-X 1-02, <i>Definitions of terms used in Regulation S-X</i>
Rule 3-04	SEC Regulation Rule S-X 3-04, <i>Changes in Stockholders' Equity and Noncontrolling Interests</i>
Rule 3-10	SEC Regulation Rule S-X 3-10, <i>Financial Statements of Guarantors and Issuers of Guaranteed Securities Registered or Being Registered</i>
Rule 10-01	SEC Regulation Rule S-X 10-01, <i>Interim Financial Statements</i>
Item 4.02 Form 8-K	SEC Form 8-K 4.02, <i>Non-Reliance on Previously Issued Financial Statements or a Related Audit Report or Completed Interim Review</i>
Item 302	SEC Regulation S-K: Standard Instructions for Filing Forms Under Securities Act of 1933, Securities Exchange Act of 1934 and Energy Policy and Conservation Act of 1975, Item 302, <i>Supplementary financial information</i>
Item 303	SEC Regulation S-K: Standard Instructions for Filing Forms Under Securities Act of 1933, Securities Exchange Act of 1934 and Energy Policy and Conservation Act of 1975, Item 303, <i>Management's discussion and analysis of financial condition and results of operations</i>
Item 307	SEC Regulation S-K: Standard Instructions for Filing Forms Under Securities Act of 1933, Securities Exchange Act of 1934 and Energy Policy and Conservation Act of 1975, Item 307, <i>Disclosure controls and procedures</i>
Item 308	SEC Regulation S-K: Standard Instructions for Filing Forms Under Securities Act of 1933, Securities Exchange Act of 1934 and Energy Policy and Conservation Act of 1975, Item 308, <i>Internal control over financial reporting</i>
Item 601	SEC Regulation S-K: Standard Instructions for Filing Forms Under Securities Act of 1933, Securities Exchange Act of 1934 and Energy Policy and Conservation Act of 1975, Item 601, <i>Exhibits</i>
Abbreviation	<i>Non-authoritative Standards</i>
Statement No. 2	FASB Statement No. 2, <i>Qualitative Characteristics of Accounting Information (Superseded)</i>
Statement No. 8	FASB Statement No. 8, <i>Conceptual Framework for Financial Reporting</i>
Statement No. 130	FASB Statement No. 130, <i>Reporting Comprehensive Income</i>
Statement No. 154	FASB Statement No. 154, <i>Accounting Changes and Error Corrections a replacement of APB Opinion No. 20 and FASB Statement No. 3</i>
Auditing Interpretation No. 3	Auditing Standards Board, Interpretation No. 3, <i>The Impact on an Auditor's Report of a FASB Statement Prior to the Statement's Effective Date</i>

B

Glossary

Excerpt from Accounting Standards Codification

Accounting Changes and Error Corrections – Overall

Glossary

250-10-20

Accounting Change

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

Change in Accounting Estimate

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

Change in Accounting Estimate Effected by a Change in Accounting Principle

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

Change in Accounting Principle

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

Change in the Reporting Entity

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

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

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

Direct Effects of a Change in Accounting Principle

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

Error in Previously Issued Financial Statements

An error in recognition, measurement, presentation, or disclosure in financial statements resulting from mathematical mistakes, mistakes in the application of generally accepted accounting principles (GAAP), or oversight or misuse of facts that existed at the time the financial statements were prepared. A change from an accounting principle that is not generally accepted to one that is generally accepted is a correction of an error.

Indirect Effects of a Change in Accounting Principle

Any changes to current or future cash flows of an entity that result from making a change in accounting principle that is applied retrospectively. An example of an indirect effect is a change in a nondiscretionary profit sharing or royalty payment that is based on a reported amount such as revenue or net income.

Restatement

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

Retrospective Application

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

C

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105-10-05-6	6.2.1	Assessing materiality in annual financial reporting periods
105-10-05-6	6.2.4	Intentional misstatements, including considerations of the books and records provision
205-10-45-3	6.1.2	Error correction versus a reclassification
205-10-50-1	6.1.2	Error correction versus a reclassification
220-10-20	3.7	Inclusion of cumulative effect of accounting changes in comprehensive income
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250-10-45-4	3	Change in accounting principle
250-10-45-5	3	Change in accounting principle
250-10-45-5(c)	3.1.1	Financial statement presentation
250-10-45-6	3	Change in accounting principle
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D

Summary of important changes

The following highlights the topics for which substantive updates have been made in recent editions of this publication. Other non-substantive or clarifying changes are not listed.

Section 3: Change in accounting principle

- ▶ Section 3.4.1 was updated with additional considerations. (July 2025)
- ▶ Section 3.5.1 was updated to clarify the requirements of ASC 250-10-50-1 and Item 302(a) of Regulation S-K. (July 2025)
- ▶ Section 3.5.3 was added to provide guidance on corrections related to certain prior interim periods of the current fiscal year. (April 2024)
- ▶ Section 3.8 was updated to address the SEC Regulation S-X disclosure requirements and provide additional clarification. (April 2024 and July 2025)
- ▶ Section 3.8.1 was updated to reflect updates to the AICPA Auditing Standard. (April 2024)
- ▶ Section 3.10 was updated for additional clarification on evaluating and testing controls across the entity. (July 2025)

Section 5: Change in reporting entity

- ▶ Section 5.2 was updated to address the SEC Regulation S-X disclosure requirements. (April 2024)

Section 6: Correction of an error in previously issued financial statements

- ▶ Section 6.2 was updated for additional clarification on materiality. (July 2025)
- ▶ Section 6.2.2 was updated for SEC staff statements on assessing whether statement of cash flows classification errors are material to a reasonable investor. (April 2024)
- ▶ Section 6.2.7 was updated to clarify when an Item 4.02 8-K is required. (July 2025)
- ▶ Section 6.2.8 was updated for an SEC staff statement on evaluating the severity of control deficiencies. (April 2024 and July 2025)
- ▶ Section 6.3.1.1 was updated to provide guidance on the SEC's final clawback rule on incentive-based compensation, which became effective in 2023. (April 2024 and July 2025)
- ▶ Section 6.3.2 was updated to address the SEC Regulation S-X disclosure requirements. (April 2024)

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