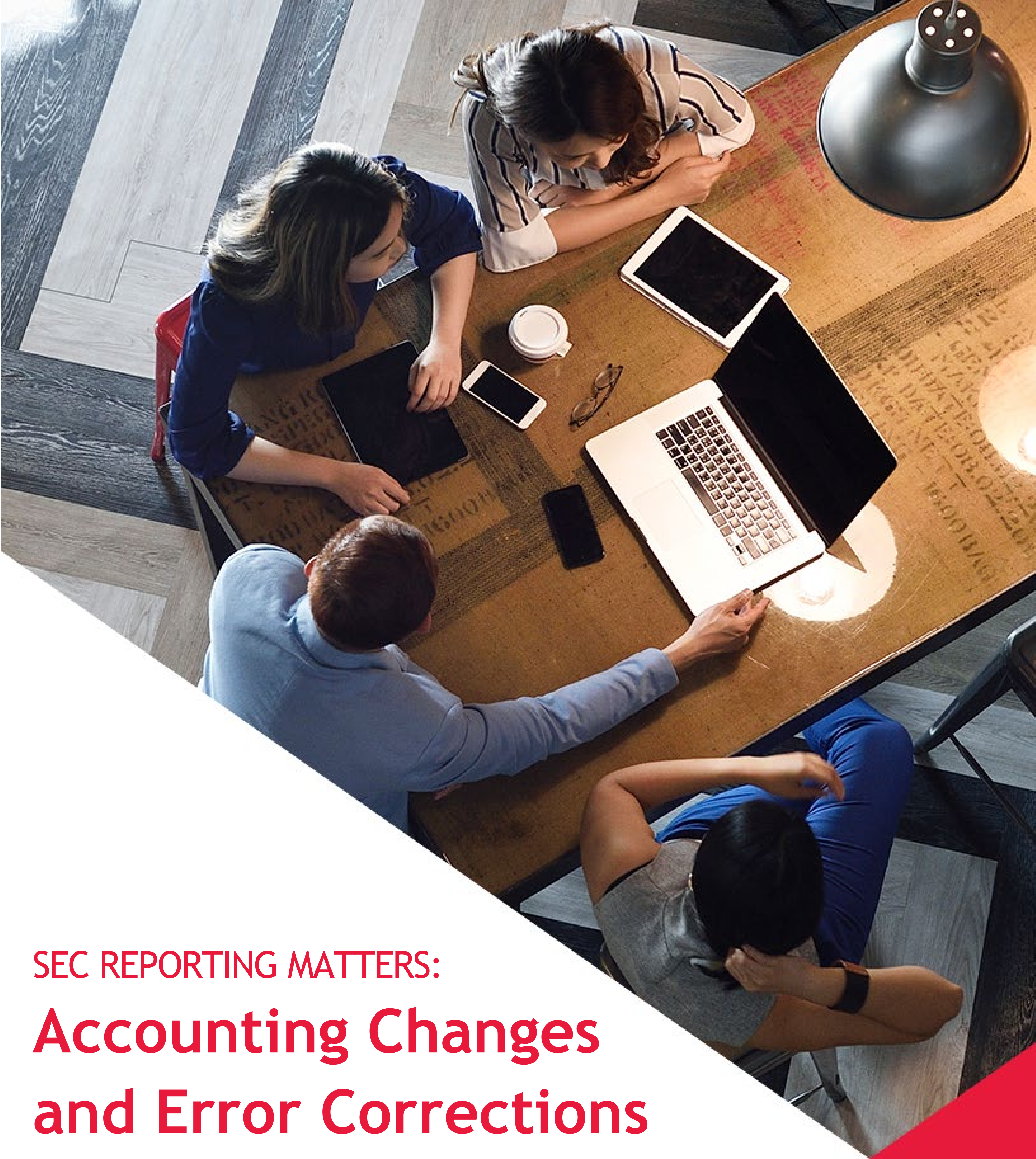

SEC REPORTING MATTERS:

Accounting Changes and Error Corrections

September 2024

TABLE OF CONTENTS

INTRODUCTION

The financial markets depend on high quality financial reporting. A fundamental pillar of high quality financial reporting is reliable and comparable financial statements that are free from material misstatement. Accounting changes and errors in previously filed financial statements can affect the comparability of financial statements.

In this publication, we provide an overview of the types of accounting changes that affect financial statements, as well as the disclosure and reporting considerations for error corrections. While the guidance included herein is not a substitute for the exercise of professional judgment or professional accounting advice, we hope that you find it a useful starting point when assessing the financial reporting ramifications of accounting changes and errors in previously issued financial statements.

1 ACCOUNTING CHANGES

Accounting Standards Codification (ASC) Topic 250, *Accounting Changes and Error Corrections*, addresses certain circumstances that require special accounting or disclosure, including:

- Change in Accounting Principle;
- Change in Accounting Estimates;
- Change in Reporting Entity; and
- Correction of an Error in Previously Issued Financial Statements.

The first three categories above represent "accounting changes." In order to understand the accounting and disclosure obligations for each of these categories, it is helpful to begin with a basic understanding of their meaning.

Change in Accounting Principle

A change in accounting principle is defined as:

> *"a change from one generally accepted accounting principle to another generally accepted accounting principle when (a) there are two or more generally accepted accounting principles that apply; or (b) 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."*

A change in accounting principle is applied for two types of changes:

- Mandatory changes required by a newly issued Accounting Standards Update (ASU); or
- Voluntarily changes from one acceptable accounting principle to another preferable accounting principle.

Newly issued ASUs include specific transition and disclosure guidance for the period of adoption. Voluntary changes in accounting principles should be applied retroactively to the beginning of the earliest period presented in the financial statements (i.e., comparative financial statements should reflect the application of the principle as if it had always been used), unless it is impracticable to do so. If retrospective application is impractical, the change should be adopted as of the beginning of a fiscal year. Whether it impracticable to apply a new principle on a retrospective basis requires a considerable level of judgment.[1]

NOTE:

ASC 250 presumes that an entity will apply accounting principles consistently unless new ASUs are issued. The preferability analysis required to justify a change from one generally accepted accounting principle to another generally accepted principle also requires a considerable level of judgment and coordination with an entity's independent accountant. An SEC registrant is required to file a preferability letter from its independent accountant concurring with its conclusion that such a change was preferable. Additional guidance and information with respect to the preferability assessment can be found in ASC 250-10-S99-4 (codified from Staff Accounting Bulletin 6.G(2)(b)1).

It is important to distinguish the treatment from a change in accounting principle, as defined above, from a change that results from moving from an accounting principle that is not generally accepted to one that is generally accepted. This type of change is an error correction – refer to **Section 2** for further discussion.

Disclosures

An entity is required to disclose the nature of, and reason for, the change in accounting principle, including a discussion of why the new principle is preferable. The method of applying the change, the impact of the change to affected financial statement line items (including income from continuing operations and earning per share), and the cumulative effect to opening retained earnings (if applicable) must be disclosed. Indirect effects of the change in accounting principle require additional disclosures. Financial statements of subsequent periods are not required to repeat these disclosures. If the change in accounting principle does not have a material effect in the period of change, but is expected to in future periods, any financial statements that include the period of change should disclose the nature of and reasons for the change in accounting principle.

Change in Accounting Estimate

A change in accounting estimate is:

> *"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 management's periodic assessment of information used in the preparation of its financial statements. Changes in accounting estimates result from new information. Common examples of such changes include changes in the useful lives of property and equipment and estimates of expected credit losses, obsolete inventory, and warranty obligations, among others. Sometimes, a change in estimate is affected by a change in accounting principle (e.g., a change in the depreciation method for equipment). A change of this nature may only be made if the change in accounting principle is also preferable.

NOTE:

A critical element of analyzing whether a change should be accounted for as a change in estimate relates to the nature and timing of the information that is driving the change. Companies should carefully assess whether such information is truly "new" information identified in the reporting period or corrects inappropriate assumptions or estimates in prior periods (which would be evaluated under the error correction guidance in **Section 2**). For example, a change made to the allowance for credit losses to include data that was accidentally omitted from the original estimate or to correct a mathematical error or formula represents an error correction. Conversely, a change

[1] Further considerations about the impracticability exception can be found in ASC 250-10-45-9.

made to the same allowance to incorporate updated economic data (e.g., unemployment figures) and the impact it could have on the customer population would represent a change in estimate.

A change in estimate is 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 is not accounted for by restating or retrospectively adjusting amounts reported in previously issued financial statements or by reporting pro forma amounts for prior periods.

Disclosures

An entity must disclose the impact of the change in accounting estimates on its income from continuing operations and net income (including per share amounts) of the current period. If the change in estimate is made in the ordinary course of accounting for items such as uncollectible accounts or inventory obsolescence, disclosure is not required unless the effect is material. If the change in estimate does not have a material effect in the period of change, but is expected to in future periods, any financial statements that include the period of change should disclose a description of the change in estimate.

Change in Reporting Entity

A change in reporting entity is:

> *"a change that results in financial statements that, in effect, are those of a different reporting entity."*

A change in reporting entity is generally limited to the following types of changes:

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

Changes in the reporting entity mainly transpire from significant restructuring activities and transactions. Neither business combinations accounted for by the acquisition method nor the consolidation of a variable interest entity are considered changes in the reporting entity.

Disclosures

For financial statements of periods in which there has been a change in reporting entity, an entity should disclose the nature of and reasons for the change. 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. If the change in reporting entity does not have a material effect in the period of change, but is expected to in future periods, any financial statements that include the period of change should disclose the nature of and reasons for the change in reporting entity.

2 ERROR CORRECTIONS

Step 1 – Identify an Error

Accounting changes should be distinguished from error corrections. An error in previously issued financial statements is:

> *"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."*

Accordingly, a change in an accounting policy from one that is not generally accepted by GAAP to one that is generally accepted by GAAP is considered an error correction, not a change in accounting principle. Likewise, if information is misinterpreted or old data is used when more current information is available in developing an estimate, an error exists, not a change in estimate. Moreover, as it relates to the classification and presentation of account balances on the face of the financial statements, "reclassifications" are often confused with errors. Changing the classification of an account balance from an incorrect presentation to the correct presentation is considered an error correction, not a reclassification (see **Section 3** below for more on reclassifications).

Step 2 – Assess Materiality of Error

Once an error is identified, the accounting and reporting conclusions will depend on the materiality of the error(s) to the financial statements. In connection with decisions related to the interpretation of federal securities laws, the Supreme Court has concluded that an item is considered 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." While assessing the materiality of an error is not the subject of this publication, companies (particularly SEC registrants) are directed to consider both the quantitative and qualitative considerations outlined in the extensive materiality guidance set forth in SEC Staff Accounting Bulletin ("SAB") Topics **1.M** and **1.N** (formerly referred to as SAB Nos. 99 and 108, respectively). Materiality should be assessed with respect to the misstatement's impact on prior period financial statements and, in the event prior period financial statements are not restated or adjusted, with respect to the impact of the misstatement's correction on the current period financial statements. Additionally, when evaluating the materiality of an error in interim period financial statements, the estimated income for the full fiscal year and the effect on earnings trends should be considered. Earnings trends may include consecutive quarter, year to date and year over year comparisons. The correction of an error may also impact other trends, such as changing net income to a net loss (or vice versa) or causing a registrant to miss analyst expectations.

NOTE:

The SEC staff is focused on registrants' evaluation of materiality when assessing errors in previously issued financial statements. The staff has **publicly emphasized** the need for registrants to carefully and objectively consider all relevant facts and circumstances, both quantitative and qualitative, when evaluating errors. In certain cases, it may be difficult to overcome the materiality of a quantitatively large error with qualitative factors. Arguments that the SEC staff has **not** found persuasive when evaluating the materiality of errors include those that specify:

- The passage of time is relevant to the assessment due to the availability of more recent financial statements;
- Certain elements of GAAP or IFRS do not provide useful information to investors;
- Historical financial statements or specific line items in the financial statements are not relevant to investors' current investment decisions;
- A similar error was made by other registrants, and therefore, reflects a widely-held view rather than an intention to misstate; or
- An individual error is not material because the effect is offset by other errors.

Step 3 – Report Correction of Error

Reporting the correction of the error(s) depends on the materiality of the error(s) to both the current period and prior period financial statements. The error is corrected through one of the following three methods:

- **Out-of-period adjustment** – An error is corrected within the current period as an out-of-period adjustment when it is considered to be clearly immaterial to both the current and prior period(s). Disclosures are generally not required for immaterial out-of-period adjustments. However, there may be circumstances in which the out-of-period adjustment stands out (e.g., it appears as a reconciling item in the rollforward of an account balance) that may warrant consideration of disclosure about the item’s nature.

- **“Little r restatement” -** An error is corrected through a “Little r restatement” (also referred to as a revision restatement) when the error is immaterial to the prior period financial statements; however, correcting the error in the current period would materially misstate the current period financial statements (e.g., this often occurs as a result of an immaterial error that has been uncorrected for multiple periods and has aggregated to a material number within the current year). Under this approach, the entity would correct the error in the current year comparative financial statements by adjusting the prior period information and adding disclosure of the error.

- **“Big R Restatement”** – An error is corrected through a “Big R restatement” (also referred to as re-issuance restatements) when the error is material to the prior period financial statements. A Big R restatement requires the entity to restate and reissue its previously issued financial statements to reflect the correction of the error in those financial statements. Correcting the prior period financial statements through a Big R restatement is referred to as a “restatement” of prior period financial statements.

Little R Restatements

Communication

As the prior period financial statements are not determined to be materially misstated, the entity is not required to notify users that they can no longer rely on the prior period financial statements.

Reporting Approach

Previously issued Form 10-Ks and 10-Qs are not amended for Little r restatements (as the financial statements included therein may continue to be relied upon). Under this approach, the entity would correct the error in the current year comparative financial statements by adjusting the prior period information and adding disclosure of the error, as described below.[2]

Disclosures

Correcting the prior period financial statements through a Little r restatement is referred to as an “adjustment” or “revision” of prior period financial statements. As previously reported financial information has changed, we believe clear and transparent disclosure about the nature and impact on the financial statements should be included within the financial statement footnotes. As the effect of the error corrections on the prior periods is by definition, immaterial, column headings are not required to be labeled. Moreover, the auditor’s opinion is generally not revised to include an explanatory paragraph in a Little r restatement scenario.

[2] However, plans to file a registration statement that incorporates previously filed financial statements before the prior periods are revised may impact this approach.

Big R Restatements

Communication

When a Big R restatement is appropriate, the previously issued financial statements cannot be relied upon. Therefore, the entity is obligated to notify users of the financial statements that those financial statements and the related auditor's report can no longer be relied upon. For an SEC registrant, this is accomplished by filing an Item 4.02 Form 8-K (*Non-reliance on previously issued financial statements or a related audit report or completed interim review*) within 4 business days of the determination by the entity or its auditor that a Big R restatement is necessary.[3]

Reporting Approach

Big R restatements require the entity to restate previously issued prior period financial statements. An SEC registrant will generally correct the error(s) in such statements by amending its Annual Report on Form 10-K and/or Quarterly Reports on Form 10-Q (i.e., filing a Form 10-K/A and Form 10-Q/As for the relevant periods). When the issuance of the financial statements accompanied by the audit report for a subsequent period is imminent such that disclosure will not be delayed, appropriate disclosure of the restatement's effect on the prior annual and interim periods is often made in such statements in lieu of filing Form 10-K/A or Form 10-Q/As (this is commonly referred to as a Super Form 10-K).

When the errors' effect on the financial statements cannot be determined without a prolonged investigation (or the preparation, and auditing, of the restated financial statements will simply take a longer period of time due to the nature of the errors), the issuance of the restated financial statements and auditor's report will necessarily be delayed. In some cases, the process may cause an SEC registrant to fall behind on its periodic reports. Questions often arise about the filing approach in this situation, particularly whether each "missing" periodic report should be filed, or a comprehensive report on Form 10-K can be filed (i.e., a Super Form 10-K). The Financial Reporting Manual of the SEC's Division of Corporation Finance contains the following **guidance** that SEC registrants may consider if they become delinquent in their filings (whether due to restatements or otherwise):

> *"Generally, the Division of Corporation Finance will not issue comments asking a delinquent registrant to file separately all of its delinquent filings if the registrant files a comprehensive annual report on Form 10-K that includes all material information that would have been included in those filings.*
>
> *The Division's decision not to seek the filing of additional reports when a registrant files a comprehensive annual report does not absolve a registrant from any liability under the Exchange Act for failing to file all required reports and would not foreclose enforcement action for the registrant's filing delinquencies. In addition, filing a comprehensive annual report does not result in the registrant being considered "current" for purposes of Regulation S, Rule 144, or Form S-8 registration statements. Also, the registrant would not be eligible to use Form S-3 until it establishes a sufficient history of making timely filings."*

In these situations, management should work closely with its securities counsel and auditors and may need to discuss its approach with the SEC staff, stock exchanges, or other regulatory agencies about the measures to be taken given the facts and circumstances.

[3] The specific disclosures and requirements to report non-reliance on previously issued financial statements can be found directly within Item 4.02 of Form 8-K and depend, in part, on which party (the registrant or auditor) determined that action should be taken to prevent reliance on the financial statements. Registrants, the audit committee and/or board or directors, and the auditors will work together on such filings to ensure the appropriate disclosures are made.

Disclosures

ASC 250 includes several presentation and disclosure requirements when financial statements are restated for error corrections. Each financial statement period / column and key footnote disclosures that are restated should be clearly labeled “as restated.” The entity shall disclose:

- Its previously issued financial statements have been restated;
- A description of the nature of the error;
- The effect of the correction on each financial statement line item and any per-share amounts affected for each prior period presented, and;
- The cumulative effect of the correction 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.

Disclosures also typically include other details about the cause of the error, how it was discovered and other direct and indirect impacts of the error. SEC registrants will also need to consider the impact, and/or disclosure, of the error corrections within other sections of their filings (e.g., Supplementary Financial Information and Management’s Discussion and Analysis). SEC registrants that do not qualify as smaller reporting companies are required to provide summarized quarterly financial information when there are one or more material retrospective changes (which would include material errors) to the statement of operations for any of the quarters within the two most recent fiscal years or any subsequent interim period for which financial statements are required to be included in the filing.[4]

When correcting the error under the Big R restatement approach, the auditor’s report will contain an explanatory paragraph that includes a statement that the previously issued financial statements have been restated for the correction of a material misstatement in the respective period as well as a reference to the footnote disclosure of the correction of the material misstatement. Additionally, an entity will need to consider the impact of such errors on its internal controls over financial reporting – refer to Section 4 below for further discussion.

Interim Reporting Disclosures

The correction of a misstatement related to interim periods of a prior fiscal year requires the same presentation and disclosures as the approaches discussed above. When an immaterial error correction relates to prior interim periods of the current fiscal year, subsequent interim financial statements which include the adjusted interim period should disclose the effect on income from continuing operations and net income (including per-share amounts) for each prior interim period of the current fiscal year and the resulting restated amounts.

Additionally, if an error correction is not material to the estimated income of the full fiscal year or earnings trends, but the adjustment is material to the interim period, the correction should be separately disclosed in the interim financial statements.

3 RECLASSIFICATIONS

Changes in the classification of financial statement line items in previously issued financial statements generally do not require restatements, unless the change represents the correction of an error (i.e., a misapplication of GAAP in the prior period). Reclassifications represent changes from one acceptable presentation under GAAP to another acceptable presentation.

---

[4] Refer to Item 302(a) of Regulation S-K.

Disclosures that indicate certain prior period financial information has been reclassified to conform with the current period presentation should be reserved solely for reclassifications that do not constitute errors. Consider the following examples:

- A company may have initially believed it was the principal in an arrangement and reported revenue on a gross basis. However, the company later concluded it was the agent and reported revenue on a net basis. In this scenario, the revision to reflect revenue on a net basis rather than gross would be a correction of an error, and it would be inappropriate to disclose this change as a reclassification.

- A company that previously presented impairment charges on its intangible assets within selling, general, and administrative expense decides in the current reporting period to separately present the impairment charges within the statement of operations. In this scenario, the revision to break out impairment changes on intangible assets to its own line on the statement of operations would be a change in presentation from one acceptable method to another acceptable method, and it would be appropriate to disclose this change as a reclassification.

In financial statements which reflect both error corrections and reclassifications, clear and transparent disclosure about the nature of each should be included.

4 OTHER CONSIDERATIONS

Internal Controls Over Financial Reporting

Once the entity has identified an error, whether material or immaterial, the entity should consider whether and how the identified error affects the design and effectiveness of the entity's related internal controls. An evaluation of internal controls would be considered necessary even if the error does not result in a restatement or adjustment to prior period financial statements, as an error indicates that some aspect of the internal control design or execution was not properly functioning (i.e., a control deficiency). If it is determined that a control deficiency exists, management should evaluate whether it represents a deficiency, significant deficiency, or material weakness. In doing so, management should consider the existence of mitigating controls and as highlighted in the SEC's **interpretive release**,[5] whether those controls operate at a level of precision that would prevent or detect a misstatement that could be material.

NOTE:

When a Big R restatement is required, the presence of the material misstatement in previously issued financial statements will almost always result in the identification of a material weakness. When an out-of-period adjustment or Little r restatement is identified, the evaluation of what "could be material" is relevant to the assessment of whether the mitigating control operates at a level of precision that would prevent or detect a material misstatement.

Pursuant to Regulation S-K, an SEC registrant should also consider:

- S-K Item 307 - whether disclosures provided in previously filed Forms 10-K and 10-Q need to be modified to explain whether previous conclusions regarding the effectiveness of disclosure and control procedures continue to be appropriate.

[5] The **interpretive release** reflects the Commission's 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.

- S-K Item 308(a) - whether to revise its original report on the effectiveness of internal control over financial reporting in a previously filed Form 10-K (i.e., whether the original disclosures in management's report continue to be appropriate).
- S-K Item 308(c) - whether to report a change in internal control over financial reporting that was not previously identified in Forms 10-K and 10-Q. This reporting requirement could apply if there was a change in controls in the applicable fiscal quarter (fourth quarter for Form 10-K) that has materially affected, or is reasonably likely to materially affect, the entity's internal control over financial reporting.

Audit standards also require the auditor to assess the impact of identified errors on any previously issued opinions on a registrant's internal controls over financial reporting, which may ultimately require the reissuance of the opinion in certain circumstances.

Risk Factor Disclosures

The SEC staff has observed boilerplate risk factor disclosures related to financial statement errors. When risk factor disclosures include disclaimers about the accuracy of the accounting or the likelihood that a future auditor would agree with the accounting, the SEC staff may question management's ability to certify, and the current auditor's ability to opine, that the financial statements were prepared in accordance with GAAP.

SEC Checkbox Disclosures

SEC registrants listed on NYSE or Nasdaq are required to check the appropriate boxes on the cover page of their annual report (i.e., Forms 10-K, 20-F, or 40-F) to indicate:

- Whether the financial statements included in the filing reflect the correction of an error to previously filed financial statements and, if so,
- Whether such correction required a recovery analysis of incentive-based compensation received by executive officers of the company.

The SEC staff has provided its view that the first checkbox should be checked when the financial statements reflect the correction of an accounting error, as defined in GAAP (or IFRS), in the previously issued financial statements. This includes "Big R," "Little r," **and** voluntary restatements. The SEC staff indicated that voluntary restatements include corrections of immaterial errors in the financial statement footnotes. However, the first checkbox is not required to be checked for any out-of-period adjustments that are recorded in the financial statements of the current period.

CONTACTS

MICHAEL STEVENSON
Assurance National Managing Principal – Professional Practice and Audit
214-665-0673 / mstevenson@bdo.com

TIM KVIZ
Assurance Managing Principal – SEC Services
703-245-8685 / tkviz@bdo.com

ADAM BROWN
National Managing Principal - Accounting
214-665-0673 / abrown@bdo.com