

COMPLIANCE WEEK

SAB 108 Study Finds Not All Bad News

By Tammy Whitehouse — December 4, 2007

Following new requirements by the Securities and Exchange Commission to clean up lingering mistakes in financial statements, an early analysis shows nearly one-third of those errors are arising from flawed estimates in liabilities, payables, reserves and accruals, or in tax issues.

The findings are the first look at how SEC Staff Accounting Bulletin No. 108, *Considering the Effects of Prior Year Misstatements When Quantifying Misstatements in Current Year Financial Statements*, has taken a toll on public companies. SAB 108 took effect for fiscal years ending on or after Nov. 15, 2006, and requires companies to examine both the income statement and the balance sheet when deciding whether a mistake warrants a correction. Typically, companies approached error corrections by analyzing one or the other financial statement, but not both.

According to the research firm Audit Analytics, 296 entities—about 4.7 percent of all public registrants—have made adjustments to beginning retained earnings to comply with SAB 108. The 296 entities corrected a total of 625 errors, with slightly more than half of those focused on liabilities, taxes, leases, and revenue recognition. Of the 625 errors, one-third of them resulted in a positive adjustment to retained earnings.



Cheffers

Mark Cheffers, chief executive of Audit Analytics, says SEC staff instructions regarding how to correct the errors—by making an adjustment to beginning retained earnings without correcting prior period financial statements—represents a twist in traditional accounting mentality.

“When you make an adjustment to beginning retained earnings in a particular year, that represents essentially your net operating results of your business through its entire history,” he explains. “Instead of going back and saying I’ll correct it in the year it occurred, I’ll leave those years alone and won’t reflect it anywhere. If you allowed that as a general course, you can imagine how that would be subject to manipulation. Net income wouldn’t mean anything.”


The percentage of adjustments that increased retained earnings, Cheffers says, suggests that companies allowed errors to linger even when correcting them sooner might have bolstered the companies’ overall financial picture.


But given the conservative nature of accounting, those positive adjustments to retained earnings do seem plausible, says Brian Markley, managing director for CFO services firm SolomonEdwards Group.

“A good accountant is a conservative accountant,” Markley says. “Culturally, the accounting


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 SEC Publication of Staff Accounting Bulletin 108 (Sept. 13, 2006)


 Fin 48: *Accounting for Uncertainty in Income Taxes* (June 2006)

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Markley

profession has tended to overestimate accruals and to record liabilities perhaps in excess of actual exposure, to assure there won't be any unforeseen negative surprises. SAB 108 doesn't discriminate between positive and negative adjustments. It's created a situation where accountants who are conservative by nature are forced to look at over-accruals in the same way they look at under-accruals."

Walter Viola of the consulting firm Jefferson Wells says that same conservatism likely drove management and external auditors to review those positive adjustments quite carefully before recording them.



Viola

"When a new provision like SAB 108 is released, the CPA firms today are addressing those issues with much conservatism," he says. "The profession has lost much of its cowboy nature since the Enron days, so if the end result is a positive impact to retained earnings, you better believe they reran the scenario several times before signing off on the adjustment."

The KPMG Quirk

Cheffers says the SAB 108 analysis revealed some distinctions among companies in different sectors and among the clients of different accounting firms. Financial services companies, for example, represented 28.7 percent of all companies who recorded SAB 108 adjustments, according to the data.

Ernie Ten Eyck, senior managing director at FTI Consulting, says that could be explained simply by the nature of companies in the sector; financial services companies do have a lot of reserves, he says. "Their financials statements are riddled with accounting estimates for valuations and accruals for things like litigation."

The Audit Analytics data also shows that the adjustments were not smoothly distributed among accounting firms, but instead were concentrated more heavily among a few firms—most notably, KPMG. Clients of the Big 4 firm were 38.5 percent of all entities recording SAB 108 adjustments, and 13.7 percent of all KPMG clients recorded such adjustments, according to the study.



Ten Eyck

Theories differ on why there might be such unevenness among accounting firms. Ten Eyck says it could stem from KPMG's client base; more of the firm's clients are concentrated in fields like financial services, which is more prone to SAB 108 adjustments.

KPMG spokesman George Ledwith, however, says the firm attributes its concentration of SAB 108 adjustments to its historic use of the "rollover," or income-statement focused, method of accumulating potential audit adjustments. "We do not believe that our views on materiality are inconsistent with those of other firms," he says.

Markley agrees with that rationale. A rollover-centric approach means the audit focuses primarily on income statement activity, and adjustments to the balance sheet fall from adjustments to the income statement.

With the advent of Sarbanes-Oxley and the Public Company Accounting Oversight Board, however, Markley says audit practices have become much more uniform—and, theoretically, that would imply that SAB 108 corrections should be more evenly dispersed among accounting firms. Or maybe, he adds, KPMG represents the lion's share of adjustments just because the firm has been more aggressive in assuring its clients are complying with the requirements of SAB 108.

Audit Analytics also found a large number of adjustments related to tax issues, which represented the second-

largest category of corrections. Cheffers says some experts had speculated that companies would seek to make adjustments in tax figures via SAB 108 to avoid the more detailed disclosures recently required by Financial Interpretation No. 48: *Accounting for Uncertainty in Income Taxes*.

Markley agrees. "There's a fear on the part of the profession that those disclosures may give the Internal Revenue Service a roadmap to audit taxes," he says. "As a result, the SAB 108 adjustments may have been a way for companies to clean up some of their tax issues rather than have them disclosed under FIN 48 requirements."

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