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If an error in previously issued financial statements is immaterial to both the interim and annual periods in which the error originated, then the error can be corrected as an out-of-period adjustment in a subsequent interim period unless the out-of-period adjustment is expected to introduce a material error into the financial statements for the year in which the error would be corrected (see below). If an out-of-period adjustment is material to the interim financial statements in which it is effected, then those interim financial statements should contain transparent disclosure of the nature and effect of the out-of-period adjustment.

If the out-of-period adjustment would introduce a material error into the financial statements for the year of correction, then the error should be corrected by revising the previously issued interim and annual financial statements in which the error originated the next time they are filed. Depending on the facts and circumstances, the issuer may determine, on its own consideration or upon the advice of counsel, that it should revise its financial information before the next interim or annual period filing. Disclosure relating to the revision should be transparent.

**Question 3: Should the materiality of a misstatement that does not affect net earnings (or another key performance metric) be evaluated differently from a misstatement that does affect net earnings (or another key performance metric)?**

**Response:** The basic framework for evaluating the materiality of a misstatement should be consistent regardless of the nature of the misstatement. Specifically, the evaluation should consider the impact of the misstatement on the totality of financial information based on the financial statements taken as a whole. It should not be based on a consideration of any element of the financial statements in isolation from other information within the financial statements. As with other misstatements, the materiality of a misstatement that does not affect net earnings (or another key performance metric) should be evaluated in light of all the surrounding facts and circumstances to determine whether there is a substantial likelihood that the misstatement would be important to a reasonable investor in making an investment decision. However, the nature of the misstatement (e.g., disclosure/classification-only vs. impacting net earnings) is an important factor to be considered when evaluating all the surrounding facts and circumstances.

A misstatement that only impacts the classification between or among line items (including subtotals) within a particular financial statement might properly be viewed as immaterial even if the misclassification is large in magnitude. That is not to say that classification and subtotals are

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<sup>5</sup> Although the appropriate level of disclosure will depend on facts and circumstances, investors should generally be provided sufficient information to be able to understand the nature of the misstatement and the impact on key elements of the affected financial statements. This disclosure should be included in the financial statements. Additionally, issuers might need to supplement the financial statement disclosure with similar disclosure in its MD&A.

unimportant. Rather, it is a recognition that the materiality evaluation must be made in the context of what a reasonable investor would consider important in making an investment decision and should consider the financial statements taken as a whole and not necessarily the impact on a single financial statement line item.

For instance, a relatively large misclassification between financing and investing cash flows might properly be viewed as immaterial if a reasonable investor would consider the misclassification unimportant. This might be the case when reasonable investors are focused less on the investing and financing designations/subtotals that are prescribed by the accounting literature and more on the transparency around the types and amounts of cash flows that a company generates/expends. Misclassifications that affect operating cash flows might require further analysis if the net operating cash flows subtotal is an important metric. When correcting a large, but immaterial, misclassification, issuers should provide transparent disclosure so investors understand what has changed.

Conversely, a relatively small misclassification between cost of goods sold and general/administrative expense might properly be viewed as material if reasonable investors consider gross profit percentage to be an important metric and the misclassification has an important impact on gross profit percentage.

A misstatement that only impacts note disclosure might properly be determined to be immaterial even if the misstatement is large in magnitude or the note disclosure is omitted altogether. That is not to say that note disclosures are unimportant. Rather, just as with classification matters, it is a recognition that the materiality evaluation must be made in the context of what a reasonable investor would consider important in light of all the surrounding facts and circumstances. Likewise a misstatement in terms of identification of segments or information within the segment disclosure (even a segment that is viewed as important to the registrant's current performance and prospects for growth) must be made in the context of what a reasonable investor would consider important in light of all the surrounding facts and circumstances.

**Question 4: How should offsetting misstatements be considered when evaluating materiality?**

**Response:** When a particular accounting period is impacted by more than one misstatement, issuers should consider the misstatements individually and in the aggregate as one component of the materiality analysis. As with all materiality analyses, the evaluation should be oriented toward determining whether there is a substantial likelihood that the misstatements would be important to a reasonable investor in light of all the surrounding facts and circumstances.

In this context, the surrounding circumstances could include the fact that the effect of one misstatement is mitigated by the effect of another misstatement.

The evaluation should not be directed solely at determining whether any one of the misstatements would be material in isolation. Rather, it should be focused on whether a reasonable investor would consider the financial statements (taken as a whole) to be misstated in an important way.

The existence of two equal but offsetting errors might raise valid questions about whether a material weakness in the company's internal control over financial reporting exists. However, it might not necessarily indicate the financial statements contain a material misstatement.

For instance, two misstatements of equal but opposite magnitude might properly be determined to be immaterial if they both relate to the same financial statement line item and would not require any changes in disclosures (e.g., two equal but opposite revenue cut-off errors at period end in the same business unit). Although there may be valid questions relating to internal control over financial reporting, in this example the financial statements do not contain any material misstatement. Conversely, two misstatements of equal but opposite magnitude which affect multiple financial statement line items might be properly viewed as material because of their individual impact on the particular line items<sup>6</sup>.

**Question 5: How should materiality be evaluated in periods of significant earnings change?**

**Response:** A misstatement relating to the financial statements for a period of significant earnings change is material if there is a substantial likelihood that a reasonable investor would consider it important in light of all the surrounding facts and circumstances.

The key drivers leading to the significant earnings change will generally be important factors to consider when evaluating the surrounding facts. For instance if a company with a stable earnings history experiences a significant change in earnings because of a large impairment, restructuring charge or gain that is not expected to recur, then the materiality of a particular misstatement might be properly evaluated against results excluding the non-recurring item. If the key driver of the significant earnings change results from an item which is expected to recur (e.g., a change in capital structure from the issuance of a substantial amount of long-term debt) then materiality would likely be considered based on the actual results.

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<sup>6</sup> As indicated in the Response to Question 3, the materiality evaluation must be made in the context of what a reasonable investor would consider important in making an investment decision and should consider the financial statements taken as a whole and not necessarily the impact on a single line item.