

Technical Director  
File Reference Nos. 2015-300 and 2015-310  
FASB  
401 Merritt 7  
PO Box 5116  
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Re: Proposed Amendments to Statement of Financial Accounting Concepts & Notes to Financial Statements

Ladies & Gentlemen:

On behalf of the Investor Advisory Committee, we are writing to express concern over the proposed amendments by the Financial Accounting Standards Board (“FASB”) to Concepts Statement No. 8, Conceptual Framework for Financial Reporting<sup>1</sup> (“Conceptual Framework”) and Notes to Financial Statements (Topic 235) (“Notes”) (collectively “Proposals”) and to encourage FASB to significantly alter the approach set out in the Proposals.<sup>2</sup>

The two Proposals seek to “clarify” the disclosure standard by changing the definition of materiality.<sup>3</sup> The changes set out in the Proposals are not, however, clarifications but entail a significant and substantive alteration to the current definition. The approach taken in the Proposals is explicitly designed to reduce disclosure and in doing so has the potential to adversely affect the quality of financial disclosure.

While we strongly support efforts to improve the quality and transparency of financial disclosure, we do not believe that the approach, at least as currently drafted, will accomplish this goal. We believe that the Proposals need to be entirely reconsidered, with any future proposals preceded by the development of a more complete record that sets out the concerns giving rise to, and the consequences of, any change in the definition. Finally, with respect to any future proposals in this area, we encourage FASB to more clearly alert the public as to the significance of such changes.

## I. Proposal – “Conceptual Framework”

### A. Overview

The “Conceptual Framework” Proposal fundamentally seeks to rewrite the definition of materiality. While we acknowledge and appreciate that the Conceptual Framework is not intended for use by issuers to assess concepts of materiality as applied to their financial statements, in the absence of a more coherent framework for issuers, it is likely in our view that

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<sup>1</sup> [http://www.fasb.org/jsp/FASB/Document\\_C/DocumentPage?cid=1176166402450&acceptedDisclaimer=true](http://www.fasb.org/jsp/FASB/Document_C/DocumentPage?cid=1176166402450&acceptedDisclaimer=true)

<sup>2</sup> [http://www.fasb.org/jsp/FASB/Document\\_C/DocumentPage?cid=1176166402325&acceptedDisclaimer=true](http://www.fasb.org/jsp/FASB/Document_C/DocumentPage?cid=1176166402325&acceptedDisclaimer=true)

<sup>3</sup> See Statement by James Schnurr, IAC Meeting, Oct. 15, 2015 (“There clearly was some feedback from the preparer community, the auditors as well as audit committees that question about how you apply it.”), *available at* <http://www.sec.gov/news/otherwebcasts/2015/investor-advisory-committee-101515.shtml>

the Conceptual Framework will be a source of guidance at least by analogy and as such have at least an indirect impact on issuer's reporting and disclosure.

As currently formulated, materiality is defined as information that "could influence decisions that users make on the basis of the financial information of a specific reporting entity." Materiality is also described as "an entity specific aspect of relevance based on the nature or magnitude or both of the items to which the information relates in the context of an individual entity's financial report."<sup>4</sup>

The "Conceptual Framework" Proposal would replace this definition. Describing materiality as "a legal concept," the Proposal borrows from the language used by the Supreme Court in interpreting the antifraud provisions under the securities laws.<sup>5</sup> Information will be material "if there is a substantial likelihood that the omitted or misstated item would have been viewed by a reasonable resource provider as having significantly altered the total mix of information."

## B. Analysis – "Conceptual Framework"

The "Conceptual Framework" Proposal raises a number of concerns.

First, the Proposal characterizes the changes as an effort to "clarify" the concept of materiality. In fact, the Proposal does not clarify but substantially alters the definition in a manner that will narrow its application. In paragraph QC11, the Proposal strikes the reference to "relevance," leaving application of the concept entirely unclear, focuses on "resource provider" rather than "user" and replaces the need to determine whether information "could influence decisions" with the need to determine whether the information "would" have "significantly" altered the "total mix."<sup>6</sup>

Second, the "Conceptual Framework" Proposal does not adequately discuss the impact of the change on the disclosure process, including the increased costs that will likely result. In particular, the Proposal does not sufficiently take into account that, by "clarifying" the legal nature of the definition, counsel will likely have an increased role in the process. Whatever the current role,<sup>7</sup> issuers wanting greater comfort on the proper application of the "legal concept of materiality" will presumably have an increased incentive to seek the views or opinions of counsel. Particularly if this type of review becomes common, the additional costs may be significant. Beyond costs, the risk exists that, by replacing the current, differentiated

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<sup>4</sup> See QC11. Statement of Financial Accounting Concepts No. 8 (Sept. 2010), available at [http://www.fasb.org/jsp/FASB/Document\\_C/DocumentPage?cid=1176157498129&acceptedDisclaimer=true](http://www.fasb.org/jsp/FASB/Document_C/DocumentPage?cid=1176157498129&acceptedDisclaimer=true)

<sup>5</sup> The Proposal relied on definitions from two Supreme Court cases, *TSC industries v. Northway*, 426 US 438 (1976) and *Basic v. Levinson*, 485 US 224 (1988).

<sup>6</sup> The textual changes in language support a conclusion that the Proposal contains a definition of materiality that is more narrow than the current definition. This is also consistent with the goal of the Proposal to facilitate the ability to omit immaterial disclosure. It is also consistent with commentators. See Proposal, at BC3.18C (noting that in commenting on the IASB definition, which is identical to current FASB definition of materiality, "[s]ome stakeholders also have observed that the IASB's definitions of materiality generally would require disclosure of more information than would the legal concept of materiality in the United States.").

<sup>7</sup> To date, counsel has apparently not been significantly involved in the process. See Schnurr Testimony, supra note 3, at 3:06:30 ("where I can tell you from my own, you know, 40 years of experience in the profession that the attorneys are not involved in any significant way in the determination of whether something is material").

professional accounting standard with a case-law driven legal standard, close questions of judgment will ultimately devolve to lawyers rather than accountants.

Third, the Proposal justifies the revision as necessary to “eliminate inconsistencies” between the current definition with the one developed by the Supreme Court under the antifraud provisions.<sup>8</sup> The Proposal does not explain the basis for this determination of inconsistency. To the extent that “inconsistent” means incompatible, the current definition is not inconsistent. The current definition is broader than the one used in the antifraud provisions. Thus, information captured by the Supreme Court’s definition is captured in the existing definition.

Indeed, the Securities and Exchange Commission (“Commission”) recognized that an earlier version of materiality employed by FASB, one that closely resembles the current standard, was consistent with the Supreme Court’s definition.<sup>9</sup> As the Commission noted, the “formulation in the accounting literature is in substance identical to the formulation used by the courts in interpreting the federal securities laws.”<sup>10</sup>

Finally, the Supreme Court’s interpretation of materiality has arisen in the context of the antifraud provisions under the federal securities laws. We believe that the existing terminology used by the FASB provides a better framework for determining the content of financial disclosure.

## II. Proposal – “Notes”

### A. Discussion

The “Notes” Proposal would change U.S. GAAP by applying the definition of materiality set out in the Conceptual Framework to the notes that accompany audited financial statements.<sup>11</sup> As a result, the amendment would assist in “reducing or eliminating irrelevant disclosures” by “helping reporting entities omit immaterial information.” Reducing the amount of immaterial information, in turn, “would improve the effectiveness of the notes to financial statements.”<sup>12</sup>

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<sup>8</sup> Although unexplained in the Proposal, this is apparently based upon the use of the word “could” in the existing definition rather than the word “would” as used by the Supreme Court.

<sup>9</sup> As with the current definition, the earlier definition emphasized the importance of relevance and looked to whether the information would have “changed or influenced” the judgment of the person relying on the information. The definition applied not to any “resource provider” but a “person.” See

[http://www.fasb.org/jsp/FASB/Document\\_C/DocumentPage?cid=1218220132599&acceptedDisclaimer=true](http://www.fasb.org/jsp/FASB/Document_C/DocumentPage?cid=1218220132599&acceptedDisclaimer=true)

<sup>10</sup> See SEC Staff Accounting Bulletin: No. 99, Aug. 12, 1999, available at <https://www.sec.gov/interps/account/sab99.htm>

<sup>11</sup> In promoting the goal of reducing irrelevant disclosures, the “Notes” Proposal would also clarify that the omission of immaterial disclosures is not an accounting error. As a result, immaterial information need not be disclosed and would no longer be presented to the audit committee as an error. We express no opinion on this change.

[http://www.fasb.org/jsp/FASB/Document\\_C/DocumentPage?cid=1176166402325&acceptedDisclaimer=true](http://www.fasb.org/jsp/FASB/Document_C/DocumentPage?cid=1176166402325&acceptedDisclaimer=true) (“In particular, many participants in the field study stated that they would be reluctant to eliminate immaterial disclosures if the omission is required to be communicated to the audit committee as an error.”).

<sup>12</sup> [http://www.fasb.org/jsp/FASB/Document\\_C/DocumentPage?cid=1176166402325&acceptedDisclaimer=true](http://www.fasb.org/jsp/FASB/Document_C/DocumentPage?cid=1176166402325&acceptedDisclaimer=true) It is important to note that it is not necessarily generally accepted that disclosures are uniformly excessive. In fact, only 50 percent of large firm partners “agree that current footnote disclosures about measurement uncertainty are adequate” (p. 32). See Steven M. Glover, Mark H. Taylor, & Yi-Jing Wu, *Mind the Gap: Factors Contributing to*

## B. Analysis

The “Notes” Proposal raises at least two significant concerns.

First, the Proposal would change the “default” approach with respect to the application of materiality to disclosures in the financial statement notes. Currently, U.S. GAAP states that “the provisions of the Codification need not be applied to immaterial items”. The formulation assumes disclosure absent an affirmative finding of immateriality. The Proposal would reverse this approach and instead provide “that an entity shall provide required disclosures if they are material” (p. 2).<sup>13</sup> Non-disclosure would, therefore, be presumed absent an affirmative finding of materiality. This is a significant change, and one that is fraught with risk from an investor perspective.

Second, the “Notes” Proposal provides no framework for evaluating whether a disclosure is material, nor does any framework exist in GAAP, particularly for those disclosures that are qualitative in nature.<sup>14</sup> This absence is notable given the substantial variation among issuers in the consideration of qualitative factors in evaluating the materiality of numeric disclosures, suggesting even greater variation in evaluating the materiality of text-based disclosures.<sup>15</sup> The absence of a framework ensures inconsistent application of the materiality standard.

The consequences of this absence is exacerbated by the stated goal of the Proposal to “promote the use of discretion” by issuers and auditors (p. 15).<sup>16</sup> The approach encourages a more frequent application of the materiality standard to disclosure in the notes. A stated goal of this increased review is a reduction in disclosure (p. 1).<sup>17</sup> While some of the discretion will no doubt be used to eliminate irrelevant disclosures, silence on how issuers (and auditors) are expected to evaluate the materiality of note information provides inadequate assurances that this will be the common or even likely result.

Granting issuers greater latitude to use discretion in evaluating the materiality of disclosures in the absence of a framework is fraught with the risk that disclosures that are unfavorable to the issuer are disproportionately viewed as immaterial and as a result excluded from the financial statements. Such a result is not in the best interest of investors, and is anathema to investor protection, capital formation, and the efficient functioning of the capital markets.

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*Reported Deficiencies in Auditing Complex Estimates Beyond Auditor Performance*, Working paper, Brigham Young University, Case Western Reserve University, and Texas Tech University (2015).

<sup>13</sup> [http://www.fasb.org/jsp/FASB/Document\\_C/DocumentPage?cid=1176166402325&acceptedDisclaimer=true](http://www.fasb.org/jsp/FASB/Document_C/DocumentPage?cid=1176166402325&acceptedDisclaimer=true)

<sup>14</sup> The U.S. Supreme Court defines an item as material “if there is a substantial likelihood that the omitted or misstated item would have been viewed by a reasonable resource provider as having significantly altered the total mix of information”. This general definition provides no operational guidance as to how to make this judgment.

<sup>15</sup> See Andrew A. Acito, Jeffrey J. Burks, & W. Bruce Johnson, *The Materiality of Accounting Errors: Evidence from SEC Comment Letters and Implications for Research Proxies*, Working paper, Michigan State University, University of Notre Dame, and University of Iowa (2015). The committee thanks Professor Lauren Cunningham for bringing this paper to our attention.

<sup>16</sup> [http://www.fasb.org/jsp/FASB/Document\\_C/DocumentPage?cid=1176166402325&acceptedDisclaimer=true](http://www.fasb.org/jsp/FASB/Document_C/DocumentPage?cid=1176166402325&acceptedDisclaimer=true)

<sup>17</sup> [http://www.fasb.org/jsp/FASB/Document\\_C/DocumentPage?id=1176166402325&acceptedDisclaimer=true](http://www.fasb.org/jsp/FASB/Document_C/DocumentPage?id=1176166402325&acceptedDisclaimer=true)

### III. Desired Action Steps

We appreciate the efforts of the Board and agree with the goal of improved disclosure. However, we believe the Board's proposals as drafted are flawed. We believe that FASB should:

1. Maintain the FASB's current definition of materiality; or
2. Withdraw the Proposals and precede any future proposals with a more complete record that sets out both the concerns requiring any changes to the definition of materiality and the implications of any such changes, and that more clearly alerts the public to the consequences of such revisions.

To the extent that FASB does not agree to these approaches, at a minimum we recommend that the FASB take the following steps:

1. In the "Notes" Proposal clarify that disclosures listed in the ASC are required unless the issuer (and the auditor) conclude that the disclosure is immaterial (i.e., the default should continue to be disclosure unless immaterial rather than no disclosure unless material).
2. Immediately begin an accelerated project to develop a framework for evaluating the materiality of disclosure, especially qualitative disclosures, and actively monitor the application such a framework on the quality of disclosure to investors.

cc: U.S. Securities and Exchange Commissioners