FASB Issues Exposure Drafts on Determinations of Materiality

The Financial Accounting Standards Board (the "Board") recently issued two exposure drafts that recommend a series of amendments related to determinations of materiality.[1] These efforts form part of the Board's ongoing disclosure framework project, an initiative dedicated to improving the quality and effectiveness of disclosures in the notes to financial statements.[2]

Fundamental to this objective are (1) the development of a framework that enables a clear and consistent understanding of disclosure requirements and (2) the appropriate exercise of discretion by reporting entities in deciding which information to communicate to investors.[3] Towards these ends, the Board has proposed to clarify the definition of "materiality" itself, referencing the legal standard established by the U.S. Supreme Court in *Basic Inc. v. Levinson*,[4] as well as provide reporting entities with additional guidance about how to appropriately consider materiality when assessing their disclosure obligations under U.S. GAAP. These changes are designed to encourage organizations to undertake a more robust materiality assessment when crafting the commentary to financial statements and, as a result, limit the disclosure of immaterial information that has the potential of obscuring the communications that are most important to investors.[5]

I. Proposed Amendments

Materiality Definition

The Board decided to revisit the concept of materiality after respondents in past invitations to comment indicated that its existing definition is inconsistent with the legal concept as applied in the context of the antifraud provisions of the federal securities laws.[6] In Concepts Statement No. 8, *Conceptual Framework for Financial Reporting* (the "Concepts Statement"), a publication in which the Board identifies certain objectives and qualitative characteristics that underlie sound financial reporting,[7] information is deemed material "if omitting it or misstating it *could* influence decisions that users make on the basis of the financial information of a specific reporting entity."[8] This has been perceived as establishing a lower threshold – and requiring the disclosure of greater information – than the standard as expressed by the courts, where information is generally considered

[1] FASB Exposure Draft, *Proposed Amendments to Statement of Financial Accounting Concepts*, *No. 2015-300*, available at http://www.fasb.org/jsp/FASB/Document_C/DocumentPage?cid=1176166402450&acceptedDisclaimer=true (the "Conceptual Framework Exposure Draft"), and FASB Exposure Draft, *Proposed Accounting Standards Update*, *No. 2015-310*, available at http://www.fasb.org/jsp/FASB/Document_C/DocumentPage?cid=1176166402325&acceptedDisclaimer=true (the "Proposed Accounting Standards Update").

[2] Financial Accounting Standards Board, *Why Did the FASB Decide to Add a Disclosure Framework Project to its Agenda?*, available at http://www.fasb.org/jsp/FASB/Page/BridgePage&cid=1176163875549.

[3] Proposed Accounting Standards Update, at 1.

[4] 485 U.S. 224 (1988).

[5] *See* Proposed Accounting Standards Update, at 9.

[6] *See* Conceptual Framework Exposure Draft, at 1.

[7] Although non-authoritative, the Concepts Statement is influential in that it provides the Board and its constituents with a framework for determining the appropriate content and presentation of financial reporting.

[8] Concepts Statement, at 17 (emphasis added).

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."[9]

This inconsistency has presented important administrative challenges for reporting entities, the Board and investors alike. In the first instance, doubt over the appropriate standard has generated "uncertainty about organizations' abilities to interpret what disclosures are material; and the Board's ability to identify and evaluate disclosure requirements in accounting standards."[10] Perhaps more importantly, the low threshold has negatively impacted the end users of financial statements by discouraging organizations from conducting a meaningful and thorough evaluation of materiality. The result is a reporting environment that is prone to "disclosure overload"[11] and, in turn, the heightened risk that material information will be diluted by immaterial disclosures.[12]

The Conceptual Framework Exposure Draft addresses the longstanding inconsistency and clarifies the appropriate standard of materiality that organizations should apply moving forward. In the proposal, the Board expressly states that it "does not promulgate definitions of materiality."[13] That concept is legal in nature and its meaning can only be prescribed through legislative, executive or judicial action.[14] With this understanding, the Board suggests that the existing description of materiality in the Concepts Statement be replaced with a general summary of the definition endorsed by the U.S. Supreme Court.[15]

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[9] Conceptual Framework Exposure Draft, at 3 (emphasis added).

[10] Financial Accounting Standards Board, *FASB Proposes Improvements to Materiality to Make Financial Statement Disclosures More Effective*, available at http://www.fasb.org/cs/ContentServer?c=FASBContent_C&pagename=FASB%2FFASBContent_C%2FNewsPage&cid=1176166401832&pf=true.

[11] Comment Letter to Financial Accounting Standards Board, available at http://www.fasb.org/cs/BlobServer?blobkey=id&blobnocache=true&blobwhere=1175825267794&blobheader=application%2Fpdf&blobheadername2=Content-Length&blobheadername1=Content-Disposition&blobheadervalue2=1533664&blobheadervalue1=filename%3DDISFR.DP.0044.INTEL_CORPORATION_JAMES_G._CAMPBELL.pdf&blobcol=urldata&blobtable=MungoBlobs, at 3 ("Comment Letter").

[12] *See* Comment Letter (stating that "[m]ateriality assessments for disclosures are not occurring as often as they should" and relatedly that "the increasing rate of footnote disclosures is unsustainable") and David M. Katz, *FASB Wants Clarity on 'Materiality' Definition*, available at http://ww2.cfo.com/financial-reporting-2/2015/09/fasb-wants-clarity-materiality-definition/. The adverse consequences of disclosure overload have long captured the attention of the U.S. Securities and Exchange Commission as well. In a 2013 speech entitled "The Path Forward on Disclosure," SEC Chair Mary Jo White acknowledged information overload as a real concern and cited corporate disclosure requirements that have become "more and more specific and more and more detailed . . ." as the primary driver. Mary Jo White, "The Path Forward on Disclosure" (Speech at the National Association of Corporate Directors - Leadership Conference on October 15, 2013), available at http://www.sec.gov/News/Speech/Detail/Speech/1370539878806. SEC Commissioner Daniel Gallagher has also expressed his support for improvements in the corporate disclosure system, stating: "Today's mandated disclosure documents are no longer efficient mechanisms for clearly conveying material information to investors, particularly ordinary, individual investors—myself included. . . . The complexity of today's disclosure requirements give [sic] the Commission cause for self-examination." H.R. Rep. No. 113-642 (2014), available at http://thomas.loc.gov/cgi-bin/cpquery/?&sid=cp113WUZzm&r_n=hr642.113&dbname=cp113&&sel=TOC_6836&.

[13] Conceptual Framework Exposure Draft, at 3.

[14] *Id*.

[15] *Id*. at 3 and 4.

Assessing Whether Disclosures are Material

Having clarified the definition of materiality, the Board next turns to its application. In the second exposure draft, the Board seeks to promote the appropriate use of discretion by reporting entities. While the Proposed Accounting Standards Update would not change the technical disclosure requirements applicable to reporting entities, the draft proposes a number of tailored modifications that would eliminate additional obstacles to efficient disclosure.

Required Communications to Audit Committees

Under current guidance, the omission of information on the basis of materiality constitutes an accounting error and must be communicated to the audit committee.[16] In an earlier field study, organizations frequently attributed their reluctance to omit immaterial information to this obligation.[17] An entity may be particularly likely to retain the disclosure if the cost of preparing the note is not extensive relative to the cost of defending the omission before its auditor.[18] To alleviate this concern, the amendments in the Proposed Accounting Standards Update would expressly state that the omission of immaterial information is not an accounting error.[19]

Judgments Concerning Qualitative Disclosures

The Board has also found that reporting entities are more comfortable with assessing the materiality of quantitative information than qualitative disclosures.[20] In certain cases, respondents even inquired if qualitative information was eligible to be considered on the basis of materiality.[21] The Proposed Accounting Standards Update would therefore specify that both quantitative and qualitative disclosures can be analyzed for materiality.[22]

Evaluating Materiality Individually and in the Aggregate

The Proposed Accounting Standards Update further states that organizations have developed the false perception that all disclosures within a particular topic are required if that topic relates to a material element in their financial statements.[23] The amendments would provide that materiality should be applied "individually and in the aggregate in the context of financial statements taken as a whole . . . ." [24] Preparers are therefore instructed to consider whether each applicable disclosure, rather than the topic itself, is material in the particular circumstances of the company; "some, all or none" of the disclosures in a particular section may be material.[25]

[16] Proposed Accounting Standards Update, at 2.

[17] *See id*.

[18] *See id*. at 12.

[19] *Id.* at 2.

[20] *Id*. at 11-12.

[21] *Id*. at 12.

[22] *Id.* at 2.

[23] *See id*. at 12.

[24] *Id*. at 7.

[25] *Id*.

II. Significance of the Proposed Amendments

Meaningful disclosure requires a measured application of materiality. If implemented, the proposed amendments would assist individual entities in reducing the volume of immaterial information and help to ensure that material disclosures are more readily apparent in notes to the financial statements.

Comments on both proposals are due by December 8, 2015.

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Charles A. Gilman at 212.701.3403 or cgilman@cahill.com; Jon Mark at 212.701.3100 or jmark@cahill.com; John Schuster at 212.701.3323 or jschuster@cahill.com; or Tyler A. O'Reilly at +44.20.7920.9819 or toreilly@cahill.com.