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Technical Director
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Notes to Financial Statements (Topic 235) - Assessing Whether Disclosures are Material

Dear Director:

This letter contains my comments on the exposure draft of the Proposed Accounting Standards Update, "Notes to Financial Statements (Topic 235) - Assessing Whether Disclosures are Material (ED)." The ED observes that many in practice apparently are not aware of the statement in Topic 105 that provisions of the Codification need not be applied to immaterial items or at least are unsure whether and, if so, how that statement applies to disclosure. That observation, as well as the other factors noted that discourage omitting disclosure of immaterial information, lead to too many situations where the sheer length and detail of footnotes may obscure what is most important to users' understanding.

One could argue that Topic 105 already provides sufficient guidance. The words, "The provisions of the Codification need not be applied to immaterial items," seem unambiguous to me. However, as FASB Assistant Director J T Ball once stated, "sometimes the FASB just has to say that straight-line means straight-line." That was in the context of what led to FTB 88-1, Issues Relating to Accounting for Leases, Time Pattern of the Physical Use of the Property in an Operating Lease. Preexisting GAAP called for rent expense to be spread equally over the life of the lease but somehow practice was allowing a different interpretation. The Technical Bulletin, in effect, confirmed that "GAAP meant what it said."

Therefore, I am very supportive of this project and the general thrust of the ED. Disclosure effectiveness was a personal concern when I served as FASB Chairman and the first project on this topic that led to Statement 132, " Employers' Disclosures about Pensions and Other Postretirement Benefits," began during my final year at the Board. However, I must observe that I and a large portion of the Board's constituency believed then (and probably believe even more now) that the real issue was simply disclosure overload and not effectiveness as the Board termed it. I recognize that the FASB is concerned about balancing the desires of users of financial statements for ever increasing information with the costs and other considerations of doing so raised by preparers. Adopting the position in the ED will help preparers support judgments to omit truly immaterial individual disclosures.

However, I urge the Board to keep the bigger picture in mind with respect to disclosures. As noted in BC7, "The Board added the disclosure framework project to its agenda in July 2009 with the intent of making financial statement disclosures more effective and coordinated and reducing redundant disclosures." The reduction of redundant disclosures objective has been stated on many occasions in the past twenty-five years or so. However, in spite of what I understand to be work done by both the SEC and FASB staff over the years, no comprehensive proposals to reduce the numerous identified redundancies have been issued. Surely it is time for that to be done.

One of my concerns is that after finalizing the current ED, the FASB will, in effect, have provided itself "permission" to issue even more elaborate disclosure requirements in future projects. The Board's thinking could be along the lines of: "If it's immaterial in an individual situation to a company they don't have to worry about it. So we might as well be very comprehensive in what we think might be useful and let companies make their own judgments on leaving out the less important stuff." I don't think that outcome is consistent with the stated objective in BC7 of making disclosures "more effective and coordinated." But the work done to date on the overall disclosure framework project doesn't seem all that promising in identifying a way to winnow the vast number of possible disclosures to a more effective and efficient grouping.

The Questions for Respondents in the ED are directed more to preparers and to a lesser extent users or auditors. Given that I don't fall into any of those categories I'm not going to respond to all of the Questions. But I will respond to a couple as well as make a few other points about modifications that I believe can improve a final ASU.

<u>Question 6</u>

I fully agree with eliminating phrases like "an entity shall at a minimum provide." Such elimination is certainly consistent with the logic of applying judgment with respect to materiality for individual disclosures. At the same time, the Board should also consider eliminating phrases like "An entity shall aggregate or disaggregate disclosures so that useful information is not obscured by either the inclusion of a large amount of insignificant detail or the aggregation of items that have substantially different characteristics (from the revenue recognition ASU)." I think all guidance on materiality of disclosures should reside in one place in the Codification, namely Topic 235. And this language about "too much detail" really isn't helpful in making practical disclosure decisions.

To be consistent with the elimination of these phrases, I strongly recommend that the sample paragraph 718-10-50-2 for stock option disclosures - <u>and all like it</u> - be amended by omitting the sentence, "In some circumstances, an entity may need to disclose information that is not listed in the requirements because that information is material and would help achieve the disclosure objectives." This type of language puts companies on the defensive with respect to including not only all of the listed disclosures in an accounting standard but others that individual users, SEC reviewers, litigants, or others might dream up. Including such language seems to contradict the basic objective of encouraging companies to exercise judgment to eliminate disclosures that simply clutter financial reports rather than inform.

Question 7

I also fully agree with the proposed amendment that would explicitly state that the omission of an immaterial required disclosure is not an accounting error. I have always thought that the regular "materiality box" in FASB standards made clear that immaterial matters - whether recognition/measurement or disclosure - need not be reported in accordance with GAAP. After all, that was the purpose of the materiality box - to state that for practical reasons companies could ignore theoretical niceties. For example, a company with a single small lease that would otherwise meet capitalization criteria could account for it as an operating lease. Or a company with a retirement plan only for one key individual could ignore all the GAAP actuarial determination, etc. requirements if the plan was inconsequential to the company's overall financials.

However, these waters were muddied when the SEC issued Staff Accounting Bulletin No. 99 on Materiality in 1999 without, in my opinion, appropriate consultation with the FASB. That Bulletin, which is now codified as part of Topic 1, "Financial Statements, Section M" of the Staff Accounting Bulletins, states in footnote 51, "FASB ASC paragraph 105-10-05-6 states that '(t)he provisions of the Codification need not be applied to immaterial items.' This SAB is consistent with that provision of the Codification. In theory, this language is subject to the interpretation that the registrant is free intentionally to set forth immaterial items in financial statements in a manner that plainly would be contrary to GAAP if the misstatement were material. The staff believes that the FASB did not intend this result."

I tried on a few occasions while at the FASB and after I left to have the SEC rescind that footnote as I believe it directly conflicts with the intent of Board members in regularly using the materiality box. Assuming the ED is adopted as a final ASU including an explicit statement that the omission of an immaterial required disclosure is not an accounting error, I urge the Board to formally request the SEC to eliminate footnote 51 as noted above.

I also suggest the FASB add language to Codification Section 105-10-05-06, which presently states, "The provisions of the Codification need not be applied to immaterial items." Some may perceive a different materiality standard between recognition and measurement matters vs. disclosure matters if Codification section 235-10-50-9 stating that the omission of immaterial disclosures is not an accounting error is adopted without the inclusion of similar language in the general material guidance in Section 105. I believe it is the Board's intent that not following GAAP for an immaterial recognition or measurement matter is not an accounting error but that ought to be made clear, particularly while the footnote to the SEC's Staff Accounting Bulletin remains outstanding.

Definition of Materiality

Proposed paragraph 235-10-50-8 states that, "Materiality is a legal concept." In the Basis for Conclusions the ED explains that the Board decided not to elaborate on this statement because a legal concept is subject to change over time and it did not wish to "promulgate a definition of materiality." Certainly this concept has been subject to a great deal of discussion in legal, accounting, and other circles over time. Therefore, it is understandable why the Board may be hesitant to provide a specific definition. However, I think the Board owes those who will apply a final ASU some further explanation of the implication of the limited statement that materiality is a legal concept.

In proposed 235-10-50-7, the ED notes that materiality is applied to quantitative and qualitative disclosures both individually and in the aggregate in the concept of the financial statements taken as a whole. It then goes on to provide the implication of that assertion: "therefore, some, all, or none of the requirements in a disclosure Section may be material." In the following proposed language of 235-10-50-8, an assertion is made that materiality is a legal concept but no guidance is given as to the implications of that statement. I urge the Board to consider including some of the language from BC14 in what will be adopted in the Codification. In particular, BC14b's second sentence could be stated (or paraphrased) in the Codification: "That definition can be summarized by stating that disclosures generally should be evaluated as material based on whether there is a substantial likelihood that the omitted or misstated disclosure would have been viewed by a reasonable resource provider as having significantly altered the total mix of information available in making a decision."

Communications with Audit Committees

The ED notes that one of the "often-cited obstacles in the current system that may affect an entity's incentive and ability to omit immaterial disclosures" is "The requirement to communicate omissions of immaterial disclosures as errors to audit committees." This requirement comes from PCAOB Auditing Standard No. 16, that states in paragraph 18, "The auditor should provide the audit committee with the schedule of uncorrected misstatements related to accounts and disclosures (emphasis added)." AS 16 replaced earlier guidance that required auditors to report to the audit committee uncorrected misstatements determined by management to be immaterial. No specific mention was made of disclosures as I read that earlier literature, although it's possible that the PCAOB inspections staff may have evolved a broader definition of "uncorrected misstatements" over time. Having served on a number of public company audit committees for several years, it was my experience that under the old guidance auditors virtually never reported disclosures that were not made because they were deemed immaterial.

While I had limited audit committee experience subsequent to the 2013 effective date of AS 16, I saw very few examples of immaterial omitted disclosures being reported by auditors. Frankly, I don't think that typical audit committees care much about that information. They, particularly Audit Committee Financial Experts serving on them, care more about the total mix of information presented in the footnotes to the financial statements. The audit committee starts with the assumption that management and the auditors have properly completed a GAAP checklist with its hundreds, if not thousands, of specific disclosures that might be applicable. And the audit committee typically inquires about the procedures that a company's disclosure committee has followed in order to determine what should be presented in the footnotes.

At that point, audit committee members would read the draft financial statements and related footnotes to ascertain that those statements and footnotes appear to be a proper reflection of the company's financial position and operating results based on their understanding of what happened in the business during the period in question. The members would keep in mind their understanding of GAAP requirements, particularly any standards newly applicable to the company, to see that the statements comply with accounting standards to the best of their knowledge. But given the proliferation of overly detailed disclosure requirements in recent years, it's probably more common for an audit committee member to ask, "why do we have to provide such and such nit picking detail," rather than their asking, "don't you think we should disclosure even more information about such and such?"

The above observations probably don't impact what the FASB might include in a final ASU on this matter. My real concern here is that the PCAOB has included such a long list of matters in required communications with audit committees that such communications may have lost their real value. At a recent meeting with a number of current audit committee members, one observed (with much head shaking agreement from the others in the room), that he gets these "42 page letters from auditors that no one really reads or understands." That should be a call to make such communications more efficient and effective. But by analogy, it might be a good observation on the state of today's footnotes to financial statements. Have they become so long and detailed that they've lost at least some of their real power to inform?

Assuming adoption of a final ASU clarifying that omission of an immaterial disclosure is not an accounting error, the FASB should consider suggesting that the PCAOB amend AS 16 to remove reference to omitted disclosures. Presumably, there would be no need for such guidance as only omitted <u>material</u> disclosures would then rise to the level of auditor concern and those would need to be made by the company or the auditor would have to issue a qualified opinion.

<u>Summary</u>

I repeat my strong support for the adoption of a final ASU along the lines of the ED, sooner rather than later. In that regard, I was dismayed to read reports on the October meeting of the SEC's Investor Advisory Committee in which certain individuals who purport to speak for users suggested that adoption of the ED would result in backtracking in the U.S. on a fuller disclosure approach. That point of view would seem to disagree with <u>any</u> elimination from existing footnotes, no matter how trivial. The Board should demonstrate the courage of its convictions to help improve the total mix of information included in financial statement footnotes through timely issuance of a final ASU.

At the same time, I urge the Board to keep in mind the broader objectives of the disclosure framework project, particularly eliminating redundant disclosures. And the Board should be careful to not allow the adoption of a final standard on materiality of individual disclosures to become an invitation to adopt less relevant disclosures in future projects. Finally, I believe adoption of the few changes to the ED that I suggest will lead to a better final product overall.

Please let me know if you have any questions about this letter or if I can provide any further input on this important project.

Sincerely,

Dennis R Beresford

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