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November 19, 2015

Mary Jo White/Chair  
James Schnurr/Office of Chief Accountant  
Securities and Exchange Commission

Members  
Financial Accounting Standards Board

Via email

[director@fasb.org](mailto:director@fasb.org)

[rule-comments@sec.gov](mailto:rule-comments@sec.gov)

Re: “Materiality,” File Reference No. 2015-300

Dear officers,

On behalf of more than 400,000 members and supporters of Public Citizen, we write to express our strong opposition to the proposed concept release and notes to financial statements on Topic 235 regarding materiality. Public Citizen members are consumers of financial reports associated with public companies. As such, our members rely on the faithful disclosure of material information describing their investments. Further, our members are citizens dependent on an economy built on a market meant to allocate capital to its best use. That also turns on sound financial operating reports. As such, we believe our members represent precisely the class of “stakeholders” whose interests the FASB should serve in refining any definition of materiality.

With the establishment of the Securities Act of 1933, Congress declared that the bedrock of corporate accountability will be disclosure. This disclosure must honestly describe the operational results of the publicly traded firms. The Securities Exchange Act of 1934 assigned the SEC to determine accounting standards. Further, in describing these numerical financial results, managers must disclose “material” information.<sup>1</sup>

What then, is material, and who is responsible for this definition?

Congress declared that the Securities and Exchange Commission would administer disclosures and referee such issues as the definition of materiality.<sup>2</sup>

To inform its decisions, the SEC looks to the Financial Accounting Standards Board. FASB represents itself as a respected repository of thoughtful experts.<sup>3</sup> Because the SEC may ignore FASB’s initiatives, FASB presumably engages in iterative conversation with SEC officials as it proceeds to ensure acceptance of its standards and guidelines.<sup>4</sup>

We believe what this means in practice is that what the FASB promulgates carries the implicit imprimatur of the SEC. Consequently, our comment to FASB is also a comment to the SEC, as we view the institutions as collegial.

#### WHAT PROBLEM IS FASB SOLVING?

Currently, as described by the FASB, materiality means information that “could” influence investor decisions. Materiality applies to the notes in a financial statement, namely, the descriptive deconstruction by management of specific items that are part of the aggregate quantifications in the financial statement (either the income statement or balance sheet).<sup>5</sup>

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<sup>1</sup> The use of the term “material” occurs many times in the 1933 Act.

<sup>2</sup> [http://www.huffingtonpost.com/barbara-roper/sec-turns-disclosure-into\\_b\\_8462482.html](http://www.huffingtonpost.com/barbara-roper/sec-turns-disclosure-into_b_8462482.html)--Bulletin 99, Materiality, SEC (1999), available at: <https://www.sec.gov/interp/account/sab99.htm>

<sup>3</sup> On its website, FASB explains: “The FASB accomplishes its mission through a comprehensive and independent process that encourages broad participation, objectively considers all stakeholder views, and is subject to oversight by the Financial Accounting Foundation’s Board of Trustees.” See <http://www.fasb.org/jsp/FASB/Page/SectionPage&cid=1351027215692>

<sup>4</sup> Tom Selling, a professor and former SEC staffer with the Office of Chief Accountant, explains that “The probability that [SEC Chief Accountant James] Schnurr isn’t fully supportive of the FASB proposals is essentially zero. Hence, it strains credibility that Mr. Schnurr didn’t provide at least some initial direction to the FASB. Otherwise, why would the FASB want to be sticking its nose in the PCAOB’s business?” The Accounting Onion, by Tom Selling (2015), available at: [available at: http://accountingonion.com/2015/10/fasbs-proposed-materiality-clarifications-are-backfiring.html](http://accountingonion.com/2015/10/fasbs-proposed-materiality-clarifications-are-backfiring.html)

<sup>5</sup> One imagines that the accounting industry might have developed a manual that establishes numerical metrics. The question of materiality is undoubtedly informed by the hundreds of independent auditor hours expended each year at many thousands of public companies, a ritual that has taken place for many decades.

Comes now a proposal to change the definition of materiality from what “could” influence an investor, to what “would” influence the investor.

The question then becomes, why is FASB proposing this change, and why now?

FASB explains that this new description of materiality stems from a long-term FASB “project” titled “Disclosure Framework.” FASB states that the “Board hopes that a sharper focus on important information will result in reduced volume in most cases.”<sup>6</sup> We disagree that this is a worthy goal, and believe that such a goal misreads history. In general, more disclosure is better than less disclosure, according to Joseph Carcello, Ernst and Young and Business Alumni Professor and department head of accounting and information management in the Haslam College of Business at the University of Tennessee. Carcello is also a member of the Securities and Exchange Commission’s Investor Advisory Committee.<sup>7</sup> This view is echoed by others.<sup>8,9</sup> Finance-based problems stem from a lack of disclosure, from “reduced volume.” Enron deceived investors by failing to disclose important information. Bernie Madoff’s Ponzi scheme thrived through non-disclosure. The 2008 financial crisis depended on material risk masked from investors.

Disputes about materiality are common. Even as FASB proposes to change this pivotal concept, in October, 2015, the SEC found that The St Joe Co. omitted material information regarding the declining value of its residential real estate developments during the financial crisis. St. Joe reported materially overstated earnings and assets in 2009 and 2010.<sup>10 11</sup> Also this fall, shareholders significantly revalued the share price of Valeant Pharmaceuticals International

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Further, the stock market provides a minute-by-minute evaluation of information that changes stock prices. Given this one might hope that a concept so basic as materiality would enjoy a more muscular description than what seems little beyond a tautology, namely, that which could change an investor’s view.

<sup>6</sup> See FASB Project Update, (website visited October 2015), Available at: [http://www.fasb.org/cs/ContentServer?c=FASBContent\\_C&pagename=FASB%2FFASBContent\\_C%2FProjectUpdatePage&cid=1176156344894](http://www.fasb.org/cs/ContentServer?c=FASBContent_C&pagename=FASB%2FFASBContent_C%2FProjectUpdatePage&cid=1176156344894)

<sup>7</sup> See press release, Univ of Tennessee, available at: <http://tntoday.utk.edu/2015/10/29/carcello-speaks-proposed-rules-limiting-disclosure/>

<sup>8</sup> Damon Silvers, policy director for the AFL-CIO, a union umbrella whose members’ retirement plans are valued in the trillions of dollars Comment at SEC, Investor Advisory Group, (October 2015), available at: <https://www.sec.gov/spotlight/investor-advisory-committee-2012.shtml>

<sup>9</sup> Silvers also serves on the SEC’s Investor Advisory Committee, and the Standing Advisory Group of the Public Company Accounting Oversight Board See PCAOB press release, available at: [http://pcaobus.org/News/Releases/Pages/11292011\\_SAGMembers.aspx](http://pcaobus.org/News/Releases/Pages/11292011_SAGMembers.aspx)

<sup>10</sup> SEC release, St Joe, available at: <http://www.sec.gov/news/pressrelease/2015-247.html>

<sup>11</sup> See “Hedge Fund manager has scored ultimate victory,” by Julia LA Roche, Business Insider (October, 2015), available at: <http://www.businessinsider.com/einhorn-st-joe-short-gets-shout-out-from-the-sec-2015-10>

when they learned information previously omitted by the firm because it was considered “immaterial.”<sup>12 13</sup>

As to the claim that investors suffer from information overload, we need only point to such devices as search engines on computers, and the availability of Wall Street industry analysts who can cut through the chaff of corporate reports. Issuers may complain, but we are unaware of any petition to the SEC regarding disclosure where the message is, “Tell us less.” On the contrary, a petition that has drawn more signatures than any other at the SEC calls for additional disclosure regarding corporate political spending.<sup>14</sup> Another petition calls for fuller disclosure of the source of minerals for production.<sup>15</sup>

We are concerned that FASB adopted its goal of winnowing corporate reports with the help of and because of those it recruited to advise it. FASB explains that its “Disclosure Framework” project results from the advice of a “resource group.”<sup>16</sup> This resource group generally decided that information that “could be useful to investors ...” was considered too broad and too low a threshold. Participants generally favored using “would be useful” instead of “could be useful.” Who were these participants? Not one of them could be described primarily as an investor, or consumers of material information. Instead they are all corporate stock issuers (Safeway, GE, Xerox, IBM, Intel, Sprint Nextel), their law firms (Hogan Lovells, Cravath, Swaine & Moore), and their accountants (Deloitte, KPMG). In response to Public Citizen inquiry, FASB representatives pointed to three “stakeholders” that were not “issuers” or accountants. These are representatives from a. The Center for Financial Research and Analysis; b. Standard & Poors; and c. Lazard Freres. The first is a group that specializes in forensic accounting, a business model that profits from finding what’s not transparent. The other two cannot be considered independent consumers of financial information, as their clients are issuers<sup>17</sup>

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<sup>12</sup> “Valeant’s Newest Disclosure,” by Francine McKenna, MarketWatch (October 26, 2015), available at: <http://www.marketwatch.com/story/valents-newest-disclosure-the-100-million-option-to-buy-a-company-for-nothing-2015-10-26>

<sup>13</sup> On a different plane, many investors with views informed by issues beyond short-term dividend projections, such as climate change or global military conflicts that may ultimately be profound value determinants have long struggled with corporate managers about needed disclosure. Some firms, such as Exxon, are finally ceding that added disclosure can only help See “Private Empire,” by Steve Coll.

<sup>14</sup> See “

Comments on Rulemaking Petition:

Petition to require public companies to disclose to shareholders the use of corporate resources for political activities.” Available at: <https://www.sec.gov/comments/4-637/4-637.shtml>

<sup>15</sup> See Fact Sheet on conflict minerals, SEC, available at:

<https://www.sec.gov/divisions/corpfin/guidance/conflictminerals-faq.htm>

<sup>16</sup> FASB Resource group:

[http://www.fasb.org/cs/ContentServer?c=Document\\_C&pagename=FASB%2FDocument\\_C%2FDocumentPage&cid=1176160567809](http://www.fasb.org/cs/ContentServer?c=Document_C&pagename=FASB%2FDocument_C%2FDocumentPage&cid=1176160567809)

<sup>17</sup>. Email from FASB available upon request

We believe that personnel shapes policy. Consequently, participants whose motives may include a wish to insulate themselves from litigation or the need to disclose inconvenient information may be the wrong constituency to advise FASB on the type of information that best serves investors.

Former SEC Enforcement staffer Richard Brodsky agrees that FASB's materiality initiative is "too narrowly focused on seeking responses from issuers. Users of financial statements also have a stake in the process by which issuers make disclosure decisions."<sup>18</sup>

## DILUTING THE STANDARD

With an unsupportable goal we find ill-advised, it is not surprising that the proposed change by FASB threatens serious harm.

FASB's proposed change would lead to less disclosure of material information in two important ways. First, it devalues the standard of information from what "could" influence a capital provider, to information that would "substantially alter" the views of the capital provider. By itself, this higher hurdle will mean that some information currently described in the notes will now go missing. As Brodsky, now a Florida attorney specializing in accounting cases explains, the change is "providing nothing more than an attempt to afford issuers a safe harbor against unwelcome SEC Staff comments, SEC investigations or litigation about the possible improper omission or misstatement of facts."<sup>19</sup>

Second, FASB declares that the concept of materiality is a legal concept. A legal concept is one that can be altered by Congress, by the courts, or by an administrative agency. We believe this is a momentous retreat from a concept that otherwise exists in multiple venues.<sup>20</sup> We agree that

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<sup>18</sup> See Brodsky letter, FASB, (October 2015), available at: [www.fasb.org/cs/BlobServer?blobkey=id&blobnocache=true&blobwhere=1175832089658&blobheader=application%2Fpdf&blobheadername2=Content-Length&blobheadername1=Content-Disposition&blobheadervalue2=654650&blobheadervalue1=filename%3DDISFR-M.ED.0006.RICHARD\\_E.\\_BRODSKY.pdf&blobcol=urldata&blobtable=MungoBlobs](http://www.fasb.org/cs/BlobServer?blobkey=id&blobnocache=true&blobwhere=1175832089658&blobheader=application%2Fpdf&blobheadername2=Content-Length&blobheadername1=Content-Disposition&blobheadervalue2=654650&blobheadervalue1=filename%3DDISFR-M.ED.0006.RICHARD_E._BRODSKY.pdf&blobcol=urldata&blobtable=MungoBlobs) Brodsky once worked for Public Citizen.

<sup>19</sup> Brodsky continues: "This conclusion is strengthened by reference in the release to the "obstacles" supposedly faced by issuers in seeking to omit immaterial information. These "obstacles" are the means by which issuers' disclosures are policed. These are not obstacles; they are counter-balances to natural tendencies of issuers to attempt to omit or soft-soap harmful information. "

<sup>20</sup> These venues include the law, facts, and markets, which can be influence by emotion. Information contained in print may have a different impact than video. For example, it may be immaterial that a CEO is arrested for DUI. However, if this arrest is captured on video, this may lead to a different impression of the same information. See discussion, available at: <http://www.theconglomerate.org/2010/10/is-your-ceo-being-arrested-for-dwidui-material.html>. In another case, a CEO was caught on a surveillance camera abusing his dog. This became public, and the company was forced to issue a statement condemning its CEO. See San

each of these venues for the expression of law do serve a purpose in shaping the contours of materiality, but we do not concede that they should be the exclusive venue. Indeed, FASB, which is comprised of accountants, might consider itself a body that could help identify the parameters of materiality.<sup>21</sup>

It is instructive, telling, and ultimately self-defeating that FASB should choose a 40 year old Supreme Court case to inform contemporary markets.

FASB points to the 1976 Supreme Court decision *TSC Industries v. Northway*, an opinion authored by Justice Thurgood Marshall.<sup>22</sup> Here, the court opined that “an omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote.”<sup>23</sup>

The *TSC* opinion did not address the issue of material information affecting daily valuation of a company on the public markets based on available information. Instead, this involved information relevant to those making a binary decision as to whether to sell the company or not—a vote. The case involved whether the omitted information was of such moment as to require the courts to award the plaintiff monetary compensation. Surely, the test of materiality should not be whether an investor would prevail in court and win damages sufficient at least to cover the court costs. Justice Marshall agreed that his description of materiality related to litigation where the financial remedy “can be great indeed.” Justice Marshall also recognized that the “standard of materiality” should serve a “remedial purpose.” That means the purpose of a standard should be not only to offer a judicial recourse for a disclosure omission, but a “prophylactic” so that “doubts” about when to disclose are “resolved” in favor of investors.

(We note that in this case, even the many justices on the several courts could not agree with one another on the definition of materiality.)

In its effort to update and improve the understanding of materiality, it is deflating that FASB should ignore the 40 years of financial advances since this case was decided.

Defining materiality as a legal concept also makes a firm’s legal officer the pivotal arbiter of the issue. Currently an independent auditor might take a contest over whether an item should be discussed in the notes to the firm’s board audit committee. With this dynamic in force, the company’s financial officer might tend to accept the auditor’s recommendation instead of facing board arbitration. Under the new FASB rubric, a dispute between the auditor and in-house finance official will be settled by the in-house counsel. With this dynamic, the company’s auditor

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Diego Union, available at: <http://www.sandiegouniontribune.com/news/2014/aug/25/centerplate-ceo-dog-kicking-san-diego-contracts/>

<sup>21</sup> DELETE OR REWRITE

<sup>22</sup> <https://www.law.cornell.edu/supremecourt/text/426/438>

<sup>23</sup> <https://www.law.cornell.edu/supremecourt/text/426/438>

is less likely to contest the omission of what she might consider material information. In short, this dynamic will result in less information.

Even where the omission does, in fact, involve material information; it is not clear how a plaintiff will seek a remedy or how a court will weigh the evidence. If a company obtains a legal opinion from its in-house counsel, a plaintiff may need to establish the legal incompetence of the in-house counsel. The issue of accounting competency will be irrelevant. Accountant Peter Kennedy agrees that his profession will be disenfranchised from this crucial accounting determination under the legal standard. “I am not an attorney. I cannot practice law or make legal determinations.” Changing materiality to a legal concept is a significant flaw which will appear to “subordinate the judgement of the preparer and auditor to any attorney, regardless of their capacity or area of expertise,” he explained.<sup>24</sup>

### FASB, THE SEC, AND THE LARGER CONTEXT

Finally, we are unable to ignore the public declarations by thoughtful observers of the SEC that this exercise in diluting the disclosure of material information stems from an intent that does not advance shareholder interests. For example, esteemed Columbia University Securities Law Professor John Coffee observed, “The current Chief Accountant, James Schnurr, is a retired Deloitte partner who seems to have taken the protection of the industry as his priority.”<sup>25</sup>

We urge FASB to withdraw its proposal. We ask that it reconstitute a broad-based advisory panel composed of financial information users. The concept of materiality is important, and we look forward to a good faith effort to better help issuers to inform their investors.

For questions, please contact Bartlett Naylor at [bnaylor@citizen.org](mailto:bnaylor@citizen.org), or 202.580.5626

Sincerely,

Public Citizen

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<sup>24</sup> See comment, Peter Kennedy, FASB (October 2015), available at: [www.fasb.org/cs/BlobServer?blobkey=id&blobnocache=true&blobwhere=1175832098514&blobheader=application%2Fpdf&blobheadername2=Content-Length&blobheadername1=Content-Disposition&blobheadervalue2=640349&blobheadervalue1=filename%3DDISFR-M.ED.0010.COVER\\_%26\\_ROSSITER\\_P.A.\\_PETER\\_S.\\_KENNEDY.pdf&blobcol=urldata&blobtable=MungoBlobs](http://www.fasb.org/cs/BlobServer?blobkey=id&blobnocache=true&blobwhere=1175832098514&blobheader=application%2Fpdf&blobheadername2=Content-Length&blobheadername1=Content-Disposition&blobheadervalue2=640349&blobheadervalue1=filename%3DDISFR-M.ED.0010.COVER_%26_ROSSITER_P.A._PETER_S._KENNEDY.pdf&blobcol=urldata&blobtable=MungoBlobs)

<sup>25</sup> “Backstabbing in Washington,” by John Coffee, *The New York Law Journal* (September 17, 2015), available at: <http://www.newyorklawjournal.com/id=1202737222254/Backstabbing-in-Washington-The-Curious-Case-of-the-PCAOB?slreturn=20150929151450>