

Via E-mail

December 3, 2015

Technical Director  
Financial Accounting Standards Board  
P.O. Box 5116  
Norwalk, CT 06856-5116

Re: File Nos. 2015-300, 2015-310

Dear Director:

The Council of Institutional Investors (CII) is a non-profit, non-partisan association of pension funds, other employee benefit funds, endowments and foundations with more than \$3 trillion in investments. We write to object strongly to the Financial Accounting Standards Board's ("FASB's") proposal to radically change the definition of materiality in the Exposure Draft proposing an amendment to "Conceptual Framework for Financial Reporting Concepts Statement 8, Chapter 3: Qualitative Characteristics of Useful Financial Information" (the "Concept Draft") and Proposed Accounting Standards Update, Notes to Financial Statements (Topic 235) Assessing Whether Disclosures are Material (the "Update").

As the leading voice for effective corporate governance and strong shareowner rights, CII believes that accurate and reliable audited financial statements, including footnote disclosures, are critical to investors making informed investment decisions and integral to the overall functioning of our capital markets. CII's membership-approved policy on the independence of accounting and auditing standard setters reflects that belief:

Audited financial statements including related disclosures are a critical source of information to institutional investors making investment decisions. The efficiency of global markets—and the well-being of the investors who entrust their financial present and future to those markets—depends, in significant part, on the quality, comparability and reliability of the information provided by audited financial statements and disclosures.<sup>1</sup>

We agree with former Securities and Exchange Commission Chief Accountant Lynn Turner that FASB's proposed change to the materiality definition "runs to the heart of

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<sup>1</sup> Council of Institutional Investors, Policies on Other Issues, Independence of Accounting and Auditing Standard Setters (adopted Oct. 7, 2008)(available at [http://www.cii.org/policies\\_other\\_issues#indep\\_acct\\_audit\\_standards](http://www.cii.org/policies_other_issues#indep_acct_audit_standards)).

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the credibility of financial statements.”<sup>2</sup> In our view, the proposed approach inappropriately shifts the presumption from inclusion to exclusion of information, sets too high a bar for inclusion and, as a result, will make financial statements less useful to investors. We urge FASB to seek meaningful input from financial statement users and to be concrete and transparent about any potential benefits, in the form of additional required disclosures, of redefining materiality.

At present, Chapter 3 of Concepts Statement 8 provides that “Information is 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. In other words, materiality is an entity-specific aspect of relevance based on the nature or magnitude or both of the items to which the information related in the context of an individual entity’s financial report.”<sup>3</sup> The Draft would replace that language with the following:

Materiality is a legal concept. . . . [t]he Board observes that the U.S. Supreme Court’s definition of materiality, in the context of the antifraud provisions of the U.S. securities laws, generally states that information is 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.”<sup>4</sup>

The Update adds language to the Accounting Standards stating that “Materiality is a legal concept.”<sup>5</sup>

The Draft and Update refer several times to the proposed changes being clarifications. While the release does clarify that materiality applies to qualitative as well as quantitative disclosures, a point on which preparers were apparently confused, nothing else about the proposed changes could be fairly characterized as a clarification. To the contrary, the Draft and Update would fundamentally change how materiality is defined in three ways.

First, the existing definition of materiality provides that information should be included as long as it “could influence” a user’s decision; in other words, if there is a question about an item’s power to influence decision making, it should be included. The Supreme Court’s definition, by contrast, assumes that an item is not material unless numerous

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<sup>2</sup> <http://www.nakedcapitalism.com/2015/10/sec-poised-to-gut-corporate-disclosure-in-financial-statements.html>

<sup>3</sup> Draft, at 3.

<sup>4</sup> *Id.*

<sup>5</sup> Update, at 7.

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requirements are satisfied. In this way, the legal standard begins with a presumption that an item is not material.

Such a presumption makes sense in the context of fraud litigation, where the plaintiff has the burden of proof. It is inappropriate, however, as a lens through which issuers and preparers should view decisions about inclusion of information in financial reports. In our view, this shift in emphasis, together with the higher substantive standard discussed below, will support exclusion of items that are not unquestionably material, but fall into a gray area.

Second, it is far from obvious that the accounting and legal definitions of materiality must be perfectly aligned, as the Draft and Update assume. The legal definition of materiality serves the purpose of delineating a group of actors who should be subjected to criminal and/or civil penalties for misleading investors. Criminal fraud penalties can include jail time, and financial penalties can be large. Neither should be imposed lightly.

The definition of materiality applied in the financial reporting setting serves a different purpose: It is intended to “provide financial information about the reporting entity that is useful to existing and potential investors, lenders, and other creditors in making decisions about providing resources to the entity.”<sup>6</sup> We believe that the quality of financial reporting will deteriorate, to the detriment of investors, if the desired outcome shifts from providing useful information to avoiding conviction.

Third, the new definition would dramatically raise the bar for materiality. The legal definition’s “substantial likelihood” is undoubtedly a more stringent standard than “could influence.” The legal definition imposes additional hurdles as well, including the reasonableness of the investor and the significance of the information. This heightened standard will increase the influence of lawyers in the process of preparing the financial statement notes, which has up to now been the domain of issuers and preparers.

Finally, we object to the lack of investor input in FASB’s process. The Draft and Update refer numerous times to complaints and suggestions coming from the issuer and preparer communities, but they make no mention of investor views. At the October 2015 meeting of the SEC’s Investor Advisory Committee meeting at which the proposed changes were discussed, SEC Chief Accountant Jim Schnurr, who has oversight responsibility for FASB, reportedly cited comments from issuers, preparers and audit committee members.<sup>7</sup> FASB’s own investor advisory committee, which Schnurr said

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<sup>6</sup> FASB Concepts Statement No. 8, Conceptual Framework Financial Reporting—Chapter 1, The Objective of General Purpose Financial Reporting, paragraph OB2, quoted in Draft, at 8.

<sup>7</sup> <http://www.marketwatch.com/story/investor-advocates-protest-to-sec-proposals-limiting-disclosure-2015-10-19>

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had reviewed the proposed changes, does not include any representative of an institutional investor with long-term investment horizons such as a pension fund, mutual fund complex or foundation/endowment.<sup>8</sup>

It has been suggested that if FASB cannot redefine materiality as it now proposes to do, it will be unable to adopt new mandatory disclosure requirements investors would likely favor. In essence, investors are being told they need to give something up without knowing what they will get in return. If FASB views the changes proposed in the Draft and Update as part of a larger package, the net result of which will produce more useful financial statements, it should be forthright about all of its plans.

CII appreciates your consideration of our views regarding the Draft and Update. Please do not hesitate to contact me, at amy@cii.org, if you have any questions or would like any additional information about the content of this letter.

Sincerely,



Amy Borrus  
Interim Executive Director

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<sup>8</sup> <http://www.fasb.org/jsp/FASB/Page/SectionPage&cid=1175801857697>