Investor Environmental Health Network

HEALTHY PEOPLE...HEALTHY BUSINESS

December 8, 2015

Susan M. Cosper
Technical Director
FASB
401 Merritt 7, PO Box 5116,
Norwalk, CT 06856-5116

Via email director@fasb.org
File References No. 2015-300; 2015-310
RE: Exposure Drafts on Notes to Financial Statements - Topic 253 and Chapter 3: Qualitative Characteristics of Useful Financial Information

Dear Ms. Cosper,

Thank you for the opportunity to comment on the FASB exposure drafts regarding assessment of whether disclosures are material (Notes to Financial Statements - Topic 253 and Chapter 3: Qualitative Characteristics of Useful Financial Information).

I am writing on behalf of the Investor Environmental Health Network (IEHN). IEHN is a collaborative partnership of investment managers ($50B AUM) concerned with financial and public health risks associated with corporate toxic chemicals policies. Engaging through dialogue and shareholder resolutions, IEHN members encourage companies to adopt policies to continually and systematically reduce and eliminate the toxic chemicals in their products and activities. Recent focus issues included risks and opportunities associated with toxic materials in products and the environmental impacts of hydraulic fracturing, including governance and disclosure issues related to these and similar matters.

Underlying both of the FASB proposals issued September 24, 2015 is a sense that current rules result in too much disclosure of "immaterial" information. We believe that this is a fundamental misinterpretation of current disclosure issues and an incorrect direction for FASB and SEC policymaking.

If there is a materiality issue that FASB can address, it is the lack of clarity and transparency regarding the decision-making factors that go into a firm's materiality assessments. Current FASB and judicial interpretations are directed toward information that would influence the judgment of a "reasonable person" or a "reasonable investor." There is no single template for a "reasonable investor;" the determination of materiality is currently decided with opaque determinations to decide materiality – what investors, time horizons, types of risks considered or excluded based on uncertainty, magnitude of risk to the firm, etc. **Failure to clarify these factors causes confusion in materiality assessment and contributes to the misperception that current disclosures include "excess" or "immaterial" disclosures.**

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Our comments below recommend that instead of eliminating the current FASB definition of materiality and the existing language regarding materiality being a "minimum," **FASB should require transparency regarding factors in a reporting company's materiality determinations.**

The Flawed Approach of the Exposure Drafts

The exposure drafts would eliminate the existing FASB statement of materiality which currently provides:

> 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 relates in the context of an individual entity's financial report.

This would be replaced with the statement that "materiality is a legal concept" and simply refer to the judicial definitions of materiality for purposes of determining fraud, i.e., the *Basic v. Levinson* definition of materiality developed for purposes of finding fraud in violations of Rule 10b-5 -- whether there is a substantial likelihood that a reasonable investor would viewed omitted disclosures as altering the "total mix" of information made available. [1] This is a substantial narrowing from the existing FASB guidance and has a clear effect of narrowing expected disclosures.

The exposure draft on Topic 235, Notes to Financial Statements, also proposes amendments to diverse existing rules, notably that:

3. Existing phrases like "an entity shall at a minimum provide," which may make it difficult to justify omitting immaterial disclosures, would be replaced with less prescriptive language.

Together the proposals would result in extensive elimination of disclosures that might considered by some inside the reporting entity to be "at the margins" of materiality. As we will discuss below and as demonstrated in the chart accompanying these comments, those "margins" contain extensive information of substantial importance to investors.

Fixing the Wrong Problem

These proposals to narrow disclosure seem contrary to the tenor our times -- the era of Big Data and of increasingly sophisticated tools for information retrieval and analysis. As data management tools have made the sifting of large volumes of information increasingly feasible, the interest of shareholders is in *more* disclosure not less, to allow application of those sophisticated tools. Given other means for gathering information, the quality of which varies, it is in the interest of every reporting company to ensure that it is providing relevant and reliable information to the array of its relevant investors.

The underlying assumption of the proposals is that current disclosure creates information overload. In truth, the amount of information disclosed by companies is a small fraction of the information investors use to make their decisions. Framing the problem as one of "information

[1] https://www.law.cornell.edu/supremecourt/text/485/224

overload" is mistaken. The actual problem is one that investors have very little insight into how a company determines what is material. As a result, they have little guidance in assessing the relevance of what is disclosed.

If the FASB's proposed changes are adopted, we believe they will encourage constriction of the amount of information disclosed, and in particular will shrink the disclosure of information material to some investors and not others. The proposals would have the effect of reducing disclosures that a registrant views as "at the margins" of materiality. Since those criteria for determining materiality are unarticulated, and disclosure of bad news in particular is typically only disclosed where auditors, accountants or lawyers assert a legal or accounting necessity, creating more discretion without requiring transparency in the materiality determination process means generating less disclosure. This is exacerbated by saying it is a legal concept – bringing the lawyers into a process previously dominated by accountants – and in their decision NOT to provide guidance saying that if it is unclear whether an item is material or not, disclose it. This suggests 'when in doubt, leave it out.' The default shifts to avoiding disclosure of immaterial items, rather than seeking to disclose all material items.

Materiality determinations are based on numerous, generally unarticulated assumptions -- much more of an art than a science. Materiality is not an objective determination and there should be no pretense that it is. Disclosure must meet the needs of a very diverse array of users with different risk tolerances, time horizons, strategies, perspectives and concerns. And, the determination is made by a gatekeeper with a strong interest in non-disclosure. A Harvard Business School working paper, Materiality in Corporate Governance: The Statement of Significant Audiences and Materiality by Robert G. Eccles Tim Youmans[2] suggests that registrants be required to file a "Statement of Significant Audiences and Materiality," ("The Statement") which would help in some instances to explain how materiality determinations are made. The authors noted:

> When issuing "The Statement" the board must make judgments, tough judgments, since it cannot claim that all audiences are significant. Saying "We will create value for our shareholders by meeting the needs of all of our stakeholders" is not a Statement, it is puffery. It is greenwashing. A corporation, no matter how large, has limited resources and has to set priorities in terms of how they are allocated. For example, a corporation may choose to lay off employees or cut back on its R&D expenses in order to meet its quarterly earnings target. Implicitly, this is making short-term shareholders a more significant audience than employees or than long-term shareholders who would benefit from this research. Or the firm can have a different view, such as cutting dividends before "downsizing." Short-term shareholders may not like this decision, but long-term investors (e.g., pension funds) might applaud it.
>
> The Statement should also be clear about the time frames in which the corporation evaluates the impact of its decisions on its significant audiences. A 10-year horizon is very different than a one-year horizon.

The determination of materiality may be based, for instance, on a company's assumption that short term investors are driving the company's stock price, and therefore the only information

[2] http://www.hbs.edu/faculty/Publication%20Files/16-023_f29dce5d-cbac-4840-8d5f-32b21e6f644e.pdf

that is deemed material is information relevant to quarterly returns, or more generously, a 3-5 year timeline. Alternatively, companies less concerned about meeting the quarterly earnings estimates of analysts and who are focused on delivering returns over a 3-5 year time frame are likely to consider a different set of information as material.

Determining materiality should consider the array of investors focused on the company and reading the report.[3] What are the array of investment scenarios and considerations that merit treatment as material? Does the firm consider investors that may hold shares in the company for the next 15 years? Does it consider investors that are using environmental, social and governance (ESG) matters as a proxy for management quality? Does it consider the investors who are making buy and sell decisions based on long-term considerations such as climate change, and therefore for instance, considering the extent to which a company is committed to growing its reserves of fossil fuels? Does it consider investors driven by ethical concerns, such as socially responsible, religious or mission driven investors?

There is strong evidence in today's financial statements, and in the record of the recent financial crisis, to support the conclusion that in the absence of transparency of materiality determinations, determinations of materiality and disclosure are commonly manipulated by, among other things, delayed quantification, narrowed time horizons, and narrow interpretation of the "reasonable investor" to whom the data is of interest. FASB is duty bound to rectify this problem.

Recommendation

We recommend that FASB require transparency regarding the process companies use to determine what they regard as material disclosures. This leaves substantial discretion to company management, which is appropriate. Each reporting company should include in its filing a description clarifying how it determines materiality:

- identify groups or categories of investors to whom materiality assessments are directed,
- relevant time frames,
- rationales and
- issues of known or potential interest to significant subgroups of its investors.

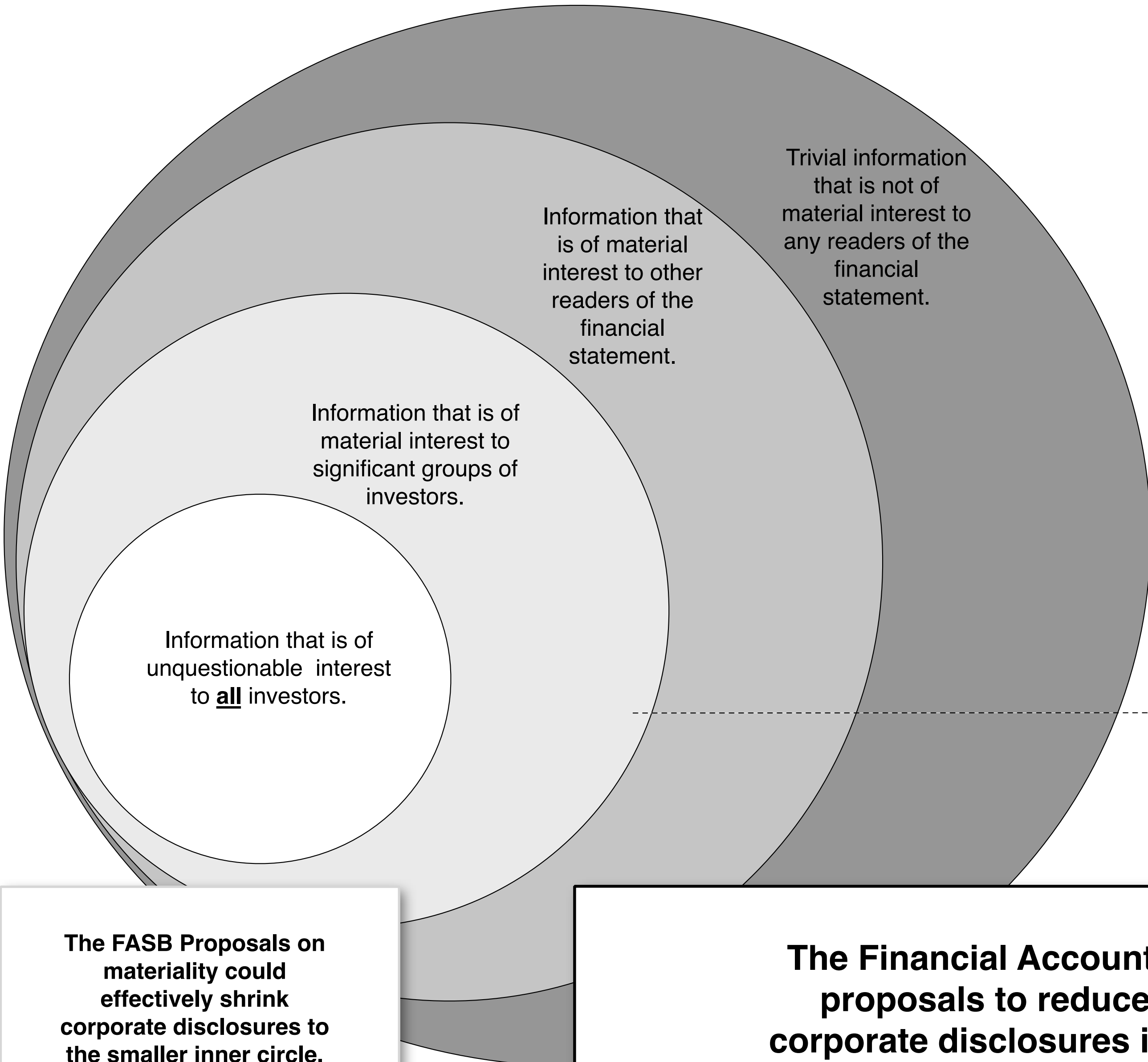
In addition, recognizing that financial disclosures are also a key source of information to other constituencies, FASB rules should allow reporting companies, in their discretion, to identify other audiences of investors or stakeholders to whom disclosures have also been addressed.

Sincerely,

Sanford Lewis
Counsel
Investor Environmental Health Network

[3] Also, in its fiduciary duty of impartiality, a board may not be allowed to favor, for example, short-term investors over long-term investors, but obliged to consider the group of "all investors". Disclosure of materiality considerations would aid companies and boards in documenting how they apply this fiduciary duty.

Cc:
Mary Jo White, Chair, SEC
Keith Higgins, Division of Corporation Finance, SEC
Investor Advisory Committee, SEC
Richard Liroff, Investor Environmental Health Network
Jonas Kron, Trillium Asset Management
Adam Kanzer, Domini Social Investments
Lynn Turner
Mindy Lubber, CERES
Robert Eccles, Harvard Business School



The Proposals could effectively allow elimination of disclosures in the gray areas including information which is of great interest to particular shareholder classes:

• long term shareholders such as pension funds, foundations, endowments, and certain mutual funds;
• investors concerned with risks that have a long time horizon, such as climate change and stranded assets;
• investors concerned with so-called externalities that have not yet been internalized or moral impacts (e.g. religious investors)
• trends and developments that have uncertain impact, even though the eventual impact could be severe (Black Swan

The FASB Proposals on materiality could effectively shrink corporate disclosures to the smaller inner circle.

Sanford Lewis, Attorney

The Financial Accounting Standards Board proposals to reduce information flow of corporate disclosures in financial statements are anachronistic in the age of Big Data. Shareholders seek MORE corporate data on which to analyze investments, not less.