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December 8, 2015

Via E-Mail: director@fasb.org

Susan M. Cospers
Technical Director
Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk, CT 06856-5116

Dear Ms. Cospers:

**RE: FILE NO. 2015-300 – PROPOSED AMENDMENTS TO STATEMENT OF
FINANCIAL ACCOUNTING CONCEPTS NO. 8 - CONCEPTUAL FRAMEWORK**

On behalf of the California Public Employees' Retirement System (CalPERS), thank you for the opportunity to provide our comments on the Financial Accounting Standards Board's (FASB, Board) Exposure Draft (ED) dated September 24, 2015, titled *Proposed Amendments to Statement of Financial Accounting Concepts No. 8. Conceptual Framework for Financial Reporting, Chapter 3. Qualitative Characteristics of Useful Financial Information*.

CalPERS is the largest public defined benefit pension fund in the United States with approximately \$300 billion in global assets. CalPERS' Investment Office mission is to manage its assets in a cost effective, transparent and risk –aware manner in order to generate returns to pay benefits. We manage these assets on behalf of more than 1.72 million public employees, retirees, and beneficiaries.¹

CalPERS adopted a set of ten Investment Beliefs intended to provide a basis for strategic management of CalPERS investment portfolio in its fiduciary role as an asset owner and manager. Investment belief 4 states, "Long-term value creation requires effective management of three forms of capital – financial, physical and human."²

¹ CalPERS Facts at a Glance, November 2015. <https://www.calpers.ca.gov/docs/forms-publications/facts-at-a-glance.pdf>

² Investment Committee, Agenda Item 6a, Adoption of CalPERS Investment Beliefs, September 16, 2013. <https://www.calpers.ca.gov/docs/forms-publications/calpers-beliefs.pdf>

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Accordingly, we are strong advocates of reform that ensures the continual improvement and integrity of financial reporting.³ CalPERS also developed financial markets principles focused on transparency, systemic risk, and governance. We reviewed the ED in light of our principles.

The ED asks “Do the proposed amendments improve Concept Statement 8? If so, how? If not, why?” We believe the amendments substantially weaken Concept Statement 8 for the reasons stated below:

The Board does not explain why it cannot continue to define “materiality” given that it has done so for decades.

The proposed QC11 reads in part as follows:

Materiality is a legal concept. In the United States, a legal concept can be established or changed through legislative, executive, or judicial action. The Board observes but does not promulgate definitions of materiality.

There is no argument that materiality is a legal concept, but materiality is certainly much more than just a legal concept. In his article, *A review on the evolution of materiality*, Professor H. Gin Chong lists more than a dozen non-legislative and non-court bodies that adopted a materiality definition between 1954 and 2004. Defining materiality has not been limited to legislative, executive, or judicial action. Accounting and auditing boards all over the world have defined materiality involving financial statements and other issues in line with their expertise.

In discussing FASBs 1980 materiality definition, Professor Chong states,

The 1980 definition becomes the capstone to help shape the landscape and dimension of defining materiality by accounting professional bodies worldwide. For example, South African Institute of Chartered Accountants (1984), Australian Accounting Research Foundation (1985), New Zealand Society of Accountants (1985), Canadian Institute of Chartered Accountants (1987, 1992)¹, Chartered Institute of Management Accountants, UK (1988), and Accounting Standards Board (1995) and Auditing Practices Board (1995) and Auditing and Assurance Board (2004) in the UK have a similar emphasis on the impact of an item due to its omissions or misstatements to the third parties.⁴

³ CalPERS Global Governance Principles, California Public Employees' Retirement System, Section 4. Integrity of Financial Reporting, Updated March 16, 2015. <https://www.calpers.ca.gov/docs/forms-publications/global-principles-corporate-governance.pdf>

⁴ H. Gin Chong, *A review on the evolution of the definitions of materiality*, International Journal economics and Accounting, Vol 6, No.1, 2015. http://www.researchgate.net/profile/H_Gin_Chong/publications

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FASB has a long history of defining materiality and most recently defined materiality in 2010. In fact, the existing Concept Statement 8 is in effect, so FASB is currently defining materiality. It is unclear why all of the prior FASB Boards were wrong when adopting definitions of materiality. Establishing that FASB cannot produce a definition as a standard setter is a dangerous precedent given that courts define terms in numerous contexts that may conflict with terms defined by FASB.

The US Supreme Court has provided a definition of materiality in two particular contexts, proxy solicitations and securities fraud, but the court has not provided a materiality definition regarding financial statements or involving any party other than a voting shareholder.

In *TSC Industries, Inc. v. Northway, Inc.*, the Supreme Court stated the following:

The general standard of materiality that we think best comports with the policies of Rule 14a-9 is as follows: **An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote. (emphasis added)** This standard is fully consistent with Mills' general description of materiality as a requirement that "the defect have a significant propensity to affect the voting process." The standard does not require proof of a substantial likelihood that disclosure of the omitted fact would have caused the reasonable investor to change his vote. What the standard does contemplate is a showing of a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder. **Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available (emphasis added)**⁵.

Interestingly, FASB selectively chose one of the two sub-tests applied in TSC as the FASB materiality definition. In plain English, the first highlighted portion above references when an omitted fact is material in the context of a proxy solicitation, "An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote." The court then takes two sentences to further explain the holding making it clear that it is consistent with the Mills decision and does not require a changed vote. The court then offers two sub-tests. FASB adopts the second sub-test as its materiality definition. FASB gives no explanation for this approach.

⁵ 426 U.S. 438 (1976), *TSC Industries, Inc. v. Northway, Inc.*, June 14, 1976.
<https://supreme.justia.com/cases/federal/us/426/438/>

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In *Basic Inc. et al. v Levinson et al* (1988), the court extended the definition of materiality to a second context by stating the following:

The Court also explicitly defined a standard of materiality under the securities laws, see *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 96 S.Ct. 2126, 48 L.Ed.2d 757 (1976) **concluding in the proxy-solicitation context 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." (emphasis added)** *Id.*, at 449, 96 S.Ct., at 2132. ⁷ Acknowledging that certain information concerning corporate developments could well be of "dubious significance," *id.*, at 448, 96 S.Ct., at 2132, the Court was careful not to set too low a standard of materiality; it was concerned that a minimal standard might bring an overabundance of information within its reach, and lead management "simply to bury the shareholders in an avalanche of trivial information—a result that is hardly conducive to informed decision making." *Id.*, at 448-449, 96 S.Ct., at 2132. The court further explained that to fulfill the materiality requirement "there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." *Id.*, at 449, 96 S.Ct., at 2132. **We now expressly adopt the TSC Industries standard of materiality for the § 10(b) and Rule 10b-5 context. (emphasis added)**⁶

The Supreme Court in TSC made clear that it was defining materiality in particular contexts, proxy solicitation and § 10(b) and Rule 10b-5. It does not appear that a definition has been adopted in any other context. We have found no court case forcing FASB to adopt the definition of materiality used in TSC. In the absence of such requirement, FASB can adopt a definition of materiality. The FASB is choosing to adopt the second sub-test of the definition of materiality in the TSC case as the definition of materiality for FASB purposes. Given that the FASB has a choice in changing the definition of materiality; our preference is to leave the definition unchanged. After the financial crisis of 2008, much work was done to develop the current materiality definition. The additional transparency provided by the current definition was necessary in light of the accounting problems that aided in the financial crisis.

The amendment is not consistent with the rest of Concept Statement 8.

Concept Statement 8 sets "forth certain objectives and fundamental concepts that will be the basis for development of financial accounting and reporting guidance. The

⁶ *Basic, Inc. V. Levinson*, 485 U.S. 224, March 7, 1988.
<https://supreme.justia.com/cases/federal/us/485/224/case.html>

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objectives identify the goals and purposes of financial reporting.”⁷ Objective 4 (OB4) of Concept Statement 8 reads as follows:

To assess an entity’s prospects for future net cash inflows, existing and potential investors, lenders, and other creditors need information about the resources of the entity, claims against the entity, and how efficiently and effectively the entity’s management and governing board have discharged their responsibilities to use the entity’s resources. Examples of such responsibilities include: (a) protecting the entity’s resources from unfavorable effects of economic factors such as price and technological changes; and (b) ensuring that the entity complies with applicable laws, regulations, and contractual provisions. Information about management’s discharge of its responsibilities is also useful for decisions by existing investors, lenders, and other creditors who have the right to vote on or otherwise influence management’s actions.⁸

The proposed definition of materiality is not consistent with OB4. In fact, OB4 and many other provisions in Concept Statement 8 would have to be changed to fit with the proposed definition which does not apply to non-voting stakeholders. TSC and Basic focus on voting shareholders. The notion of influencing management in any way would also be severely limited because such influence requires detailed information that would not be provided because it would not be considered material under the proposed definition, which uses a securities fraud standard. The proposed definition will also result in less information being disclosed to board members and investors. The prong regarding influencing management’s actions is totally forsaken given that management would not be obligated to communicate important information to the board as long as management deems information to be immaterial.

If the definition of materiality is changed, there is a need to rewrite Concept Statement 8 to better fit with the new definition. The revisions would have to extend well beyond an amendment to the materiality definition. Concept Statement 8 was more investor friendly. Modifying the definition of materiality changes the entire tenor of Concept Statement 8 and makes stakeholders worse off.

⁷ Concept Statement 8 Preamble, March 7, 1988.

<http://www.fasb.org/cs/BlobServer?blobcol=urldata&blobtable=MungoBlobs&blobkey=id&blobwhere=1175822892635&blobheader=application%2Fpdf>

⁸ FASB Conceptual Framework, Statement of Financial Accounting Concepts No. 8, OB4., page 2, September 2010.
http://www.fasb.org/jsp/FASB/Document_C/DocumentPage?cid=1176157498129&acceptedDisclaimer=true

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The change appears to promote a shift in the burden of proof.

Details matter. Others have questioned, including at the most recent SEC Investor Advisory Committee meeting, why FASB has chosen to shift the burden of proof in cases involving materiality. The changes would provide that a shareowner will have to prove a particular omitted or misstated item is in fact material rather than the registrant having to prove that a particular item is not material. FASB should expressly clarify whether it intends to shift the burden of proof. It is troubling that this important issue was not made clear. We strongly believe that there is no cause for burden shifting and that this should not be a part of the ED.

FASB is stepping back from the investor protection objectives established after the financial crisis and its mission.⁹

The drift away from providing transparent disclosures concerns CalPERS. The financial crisis clearly had an impact on the language in Concept Statement 8. The current amendment takes a giant step away from the positive investor principles included in Concept Statement 8. The final paragraph highlights that companies would be required to disclose more under International Accounting Standards Board than under FASB. FASB has argued that the change is necessary because the current definition of materiality is not consistent with the legal concept in the United States. We have searched but have not found a single source to confirm this conclusion. In fact, a casual review of the cases and what commenters have written would easily lead to a different conclusion, especially given that courts have referenced the FASB materiality definition in decisions.¹⁰

Given technological advancements since 1976, it is not clear why FASB would move to a framework providing substantially less transparency. We have less concern with information overload given that very few ever read disclosures from cover to cover. Many rely on search engines, service providers or document comparisons to determine what to focus on. Registrants are better able to be more precise. This is important given the shareowners vote on directors and need to be able to verify that the directors are providing the proper oversight. Interestingly, the two Exposure Drafts taken together make clear that, as a result of the proposed changes, directors will receive less information regarding operations.

⁹ FASBs Mission, "...foster financial reporting by nongovernmental entities that provides decision-useful information to investors and other users of financial reports."
<http://www.fasb.org/facts/index.shtml#mission>

¹⁰ *Ganino v. Citizens Utilities Company* (2000), 228 F. 3d 154, September 6, 2000.
http://scholar.google.com/scholar_case?case=13652608653559035365&q=GANINO+v.+CITIZENS+UTILITIES+COMPANY&hl=en&as_sdt=2006&as_vis=1

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Shareowners also undertake say on pay votes. These votes often involve bonuses that are based on performance and/or exceeding market guidance. In many cases, companies barely meet the projected target. It appears clear that with the amendment change investors would become more likely victims to what SAB 99¹¹ warned against, managed earnings. It is important to note that for say on pay votes, a penny per share in earnings would be material.

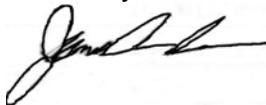
Next Steps

Addressing this ED is difficult given the fundamental changes that occur to a disclosure framework that was apparently settled soon after the financial crisis. FASB has yet to verify that it is no longer able to continue defining materiality as it has done so for decades. If FASB must use the Supreme Court definition as applied in TSC it should use the holding which states, "An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote." FASB should also make clear that the new definition applies to all voting, including say on pay and others that require exceptional precision.

The revised definition of materiality is not merely an amendment. It constitutes a major shift that reduces transparency and likely shifts the burden of proof. It appears that there are many questions to answer prior to making any change. It would be best to reconsider the changes and take steps to better socialize the project with investors. For CalPERS to better manage a portfolio of long-term investments, our expectation for disclosure effectiveness leads to greater transparency. The current ED moves in the opposite direction. For the reasons above, we believe the amendment to the definition of materiality makes Concept Statement 8 far worse.

Thank you for the opportunity to provide our comments. If you have any questions, please do not hesitate to contact me at (916) 795-9058 or James.Andrus@calpers.ca.gov.

Sincerely,



JAMES ANDRUS
Investment Manager
Global Governance

¹¹ SEC Staff Accounting Bulletin No. 99 Materiality (SAB 99), August 12, 1999.
<http://www.sec.gov/interp/account/sab99.htm>