



Ernst & Young LLP  
5 Times Square  
New York, NY 10036

Tel: +1 212 773 3000  
ey.com

2015-300  
Comment Letter No. 49

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

23 December 2015

**Re: Proposed Amendments to Statement of Financial Accounting Concepts No. 8, *Conceptual Framework for Financial Reporting, Chapter 3: Qualitative Characteristics of Useful Financial Information* (File Reference No. 2015-300)**

Dear Ms. Cospers:

We appreciate the opportunity to comment on the Proposed Amendments to Statement of Financial Accounting Concepts No. 8, *Conceptual Framework for Financial Reporting, Chapter 3: Qualitative Characteristics of Useful Financial Information* (the Proposed Amendment).

We support efforts by the Financial Accounting Standards Board (FASB or Board) to align its definition of materiality with that of the Securities and Exchange Commission (SEC) and the Public Company Accounting Oversight Board (PCAOB). We believe the FASB, in lieu of the Proposed Amendment, should instead consider reverting back to the definition and discussion of materiality that was previously included in Concepts Statement No. 2 (CON 2), *Qualitative Characteristics of Accounting Information* (Appendix A includes the definition and discussion of materiality from CON 2 that we reference herein). We are concerned that focusing on materiality solely as a legal concept in the Proposed Amendment could lead to materiality decisions becoming legal determinations, when in fact they should be accounting determinations. We believe it is appropriate for the definition referenced by the FASB to be aligned with existing regulatory guidance from the SEC and PCAOB and Supreme Court decisions.

In fulfilling its mission to establish and improve standards of financial accounting and reporting that provides decision-useful information to investors and other users of financial reports, the FASB is often provided with diverse views on how to best accomplish this objective. The FASB should continue to engage with investors and other users of financial information through a variety of mechanisms to solicit their feedback on proposed changes to its Codification. Also as part of the process, the FASB should provide clear communication on the impact that any change to either the FASB Codification or to non-authoritative literature, such as the Concepts Statements, would have on the application of its standards to amounts reported by preparers.

## Definition of materiality

The current definition of materiality referenced by the FASB contains the concept of “...*could* (emphasis added) influence decisions that users make...,” which differs from the materiality definition applied by the Supreme Court, which contains the concept of “...*would* (emphasis added) have been viewed by a reasonable resource provider as having significantly altered...” While the proposed definition would address this inconsistency, we believe the definition of materiality that was included in the superseded CON 2 is directionally consistent with the Supreme Court’s definition and provides a better definition of materiality. CON 2 defined materiality as “the magnitude of an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement.” The superseded CON 2 also provided useful information to highlight the difference between materiality (paragraphs 123-132) and relevance (paragraphs 46-57). The Proposed Amendment is not clear on how to distinguish between these two concepts.

As indicated above, while we understand the benefits of aligning the accounting definition of materiality with the legal concept as determined by the Supreme Court and regulators, focusing the Proposed Amendment on materiality solely as a legal concept may result in materiality decisions becoming legal determinations and entities, and auditors, needing to obtain legal advice for purposes of making materiality assessments (e.g., determining what information to include in the notes to the financial statements). While we agree the accounting definition of materiality should be directionally consistent with the legal concept of materiality, it should not be viewed solely as a legal concept. This should be clarified in the Proposed Amendment.

\* \* \* \* \*

We would be pleased to discuss our comments with Board members or the FASB staff at your convenience.

Very truly yours,



**Appendix A – Definition and discussion of materiality from Concepts Statement No. 2 (CON 2),  
*Qualitative Characteristics of Accounting Information***

**Materiality (definition)**

The magnitude of an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement.

**Relevance**

46. In discussions of accounting criteria, relevance has usually been defined in the dictionary sense, as pertaining to or having a bearing on the matter in question. That broad definition is satisfactory as far as it goes—information must, of course, be logically related to a decision in order to be relevant to it. Mistaken attempts to base decisions on logically unrelated information cannot convert irrelevant information into relevant information any more than ignoring relevant information makes it irrelevant. However, the meaning of relevance for financial reporting needs to be made more explicit. Specifically, it is information's capacity to "make a difference" that identifies it as relevant to a decision.

47. To be relevant to investors, creditors, and others for investment, credit, and similar decisions, accounting information must be capable of making a difference in a decision by helping users to form predictions about the outcomes of past, present, and future events or to confirm or correct expectations. "Event" is a happening of consequence to an enterprise (Exposure Draft on elements, paragraph 67), and in this context can mean, for example, the receipt of a sales order or a price change in something the enterprise buys or sells. "Outcome" is the effect or result of an event or series of events and in this context can mean, for example, that last year's profit was \$X or the expectation that this year's profit will be \$Y. The event in question may be a past event the outcome of which is not already known, or it may be a future event the outcome of which can only be predicted.

48. Information need not itself be a prediction of future events or outcomes to be useful in forming, confirming, or changing expectations about future events or outcomes. Information about the present status of economic resources or obligations or about an enterprise's past performance is commonly a basis for expectations (Concepts Statement 1, paragraph 42).

49. Information may confirm expectations or it may change them. If it confirms them, it increases the probability that the results will be as previously expected. If it changes them, it changes the perceived probabilities of the previous possible outcomes. Either way, it makes a difference to one who does not already have that information. Decisions already made need not be changed, nor need a course of action already embarked on be altered by the information. A decision to hold rather than to sell an investment is a decision, and information that supports holding can be as relevant as information that leads to a sale. Information is relevant if the degree of uncertainty about the result of a decision that has already been made is confirmed or altered by the new information; it need not alter the decision.

50. One of the more fundamental questions raised by the search for relevance in accounting concerns the choice of attribute to be measured for financial reporting purposes. Will financial statements be more relevant if they are based on historical costs, current costs, or some other attribute? The question must be left for consideration in other parts of the conceptual framework project; but because of lack of experience with information providing measures of several of those attributes and differences of opinion about their relevance and reliability, it is not surprising that agreement on the question is so difficult to obtain.

### **Feedback Value and Predictive Value as Components of Relevance**

51. Information can make a difference to decisions by improving decision makers' capacities to predict or by confirming or correcting their earlier expectations. Usually, information does both at once, because knowledge about the outcome of actions already taken will generally improve decision makers' abilities to predict the results of similar future actions. Without a knowledge of the past, the basis for a prediction will usually be lacking. Without an interest in the future, knowledge of the past is sterile.

52. The same point can be made by saying that information is relevant to a situation if it can reduce uncertainty about the situation. Information that was not known previously about a past activity clearly reduces uncertainty about its outcome, and information about past activities is usually an indispensable point of departure for attempts to foresee the consequences of related future activities. Disclosure requirements almost always have the dual purpose of helping to predict and confirming or correcting earlier predictions. The reporting of business results by segments is a good example of accounting reports whose relevance is believed to lie both in the information they convey about the past performance of segments and in their contribution to an investor's ability to predict the trend of earnings of a diversified company. Another example is to be found in interim earnings reports, which provide both feedback on past performance and a basis for prediction for anyone wishing to forecast annual earnings before the year-end.

53. To say that accounting information has predictive value is not to say that it is itself a prediction. It may be useful here to draw an analogy between the financial information that analysts and others use in predicting earnings or financial position and the information that meteorologists use in forecasting weather. Meteorologists gather and chart information about actual conditions—temperatures, barometric pressures, wind velocities at various altitudes, and so on—and draw their conclusions from the relationships and patterns that they detect. Success in forecasting the weather has increased as new methods of gathering information have been developed. New kinds of information have become available, and with greater speed than was previously possible. To the simple sources of information available to our ancestors have been added satellite photographs, radar, and radiosondes to give information about the upper atmosphere. New information makes possible more sophisticated predictive models. When a meteorologist selects from among the alternative sources of information and methods of gathering information—about existing conditions, since future conditions cannot be known—those sources and methods that have the greatest predictive value can be expected to be favored. So it is with information about the existing financial state of a company and observed changes in that state from which predictions of success, failure, growth, or stagnation may be inferred. Users can be expected to favor those sources of information and analytical methods that have the greatest predictive value in achieving their specific objectives. Predictive value here means value as an input into a predictive process, not value directly as a prediction.

54. An important similarity and an important difference between predicting the weather and predicting financial performance may be noted. The similarity is that the meteorologist's information and the information derived from financial reporting both have to be fed into a predictive model before they can throw light on the future. Financial predictions, like weather forecasts, are the joint product of a model and the data that go into it. A choice between alternative accounting methods on the basis of their predictive value can be made only if the characteristics of the model to be used are generally known. For example, the econometric models now used for economic forecasting are designed to use as data financial aggregates (among other things) as those aggregates are compiled at present. They might work less well if price-level adjusted data were used. However, it might be possible to revise the model for use with that kind of data so that even better predictions could be made. The point is that the predictive value of information cannot be assessed in the abstract. It has to be transformed into a prediction, and the nature of the transformation as well as the data used determine the outcome.

55. The important difference between meteorological and financial predictions is that only exceptionally can meteorological predictions have an effect on the weather, but business or economic decision makers' predictions often affect their subjects. For example, the use of financial models to predict business failures looks quite successful judged in the light of hindsight by looking at the financial history of failed firms during their last declining years. But a prediction of failure can be self-fulfilling by restricting a company's access to credit. The prediction could also bring about a recovery by initiating action by managers or bankers to avert failure. Because information affects human behavior and because different people react differently to it, financial information cannot be evaluated by means of a simple tally of the correct predictions that are based on it. Nevertheless, predictive value is an important consideration in distinguishing relevant from irrelevant accounting information.

### **Timeliness**

56. Timeliness is an ancillary aspect of relevance. If information is not available when it is needed or becomes available only so long after the reported events that it has no value for future action, it lacks relevance and is of little or no use. Timeliness in the present context means having information available to decision makers before it loses its capacity to influence decisions. Timeliness alone cannot make information relevant, but a lack of timeliness can rob information of relevance it might otherwise have had.

57. Clearly, there are degrees of timeliness. In some situations, the capacity of information to influence decisions may evaporate quickly, as, for example, in a fast-moving situation such as a take-over bid or a strike, so that timeliness may have to be measured in days or perhaps hours. In other contexts, such as routine reports by an enterprise of its annual results, it may take a longer delay to diminish materially the relevance and, therefore, the usefulness of the information. But a gain in relevance that comes with increased timeliness may entail sacrifices of other desirable characteristics of information, and as a result there may be an overall gain or loss in usefulness. It may sometimes be desirable, for example, to sacrifice precision for timeliness, for an approximation produced quickly is often more useful than precise information that takes longer to get out. Of course, if, in the interest of timeliness, the reliability of the information is sacrificed to a material degree, the result may be to rob the information of much of its usefulness. What constitutes a material loss of reliability is discussed in later paragraphs. Yet, while every loss of reliability diminishes the usefulness of information, it will often be possible to approximate an accounting number to make it available more quickly without making it materially unreliable. As a result, its overall usefulness may be enhanced.

## Materiality

123. Those who make accounting decisions and those who make judgments as auditors continually confront the need to make judgments about materiality. Materiality judgments are primarily quantitative in nature. They pose the question: Is this item large enough for users of the information to be influenced by it? However, the answer to that question will usually be affected by the nature of the item; items too small to be thought material if they result from routine transactions may be considered material if they arise in abnormal circumstances.

124. Throughout this Statement, emphasis has been placed on relevance and reliability as the primary qualitative characteristics that accounting information must have if it is to be useful. Materiality is not a primary characteristic of the same kind. In fact, the pervasive nature of materiality makes it difficult to consider the concept except as it relates to the other qualitative characteristics, especially relevance and reliability.

125. Relevance and materiality have much in common—both are defined in terms of what influences or makes a difference to an investor or other decision maker. Yet the two concepts can be distinguished. A decision not to disclose certain information may be made, say, because investors have no interest in that kind of information (it is not relevant) or because the amounts involved are too small to make a difference (they are not material). But as was noted above, magnitude by itself, without regard to the nature of the item and the circumstances in which the judgment has to be made, will not generally be a sufficient basis for a materiality judgment.

126. Materiality judgments are concerned with screens or thresholds. Is an item, an error, or an omission large enough, considering its nature and the attendant circumstances, to pass over the threshold that separates material from immaterial items? An example of an applicant for employment who is negotiating with an employment agency will illustrate the relationship of the materiality concept to relevance and reliability. The agency has full information about a certain job for which the applicant is suited and will furnish any item of information about it. The applicant will certainly want information about the nature of the duties, the location of the job, the pay, the hours of work, and the fringe benefits. Information about vacations and job security may or may not be important enough to affect a decision concerning accepting the job. Further, the applicant may not be concerned at all with whether the office floor is carpeted or about the quality of the food in the cafeteria. All of those items are, in the broadest sense, relevant to an evaluation of the job. But some of them make no difference in a decision to accept it or not. The values placed on them by the applicant are too small for them to be material. They are not important enough to matter.

127. The employment agency example can also help to explain what is meant by a materiality threshold for reliability. Salary information accurate only to the nearest thousand dollars might not be acceptable to an applicant for an \$8,000 a year job, but will almost certainly be acceptable if the job pays \$100,000 a year. An error of a percentage point in the employee's rate of pension contribution would rarely make information about fringe benefits unacceptable. An error of a year in the retirement date of someone who would block the applicant's advancement might be quite material. An error of a year in the applicant's mandatory retirement date will probably be immaterial to a person 20 years old, but quite material to a 63-year-old person.

128. The more important a judgment item is, the finer the screen should be that will be used to determine whether it is material. For example:

- a. An accounting change in circumstances that puts an enterprise in danger of being in breach of covenant regarding its financial condition may justify a lower materiality threshold than if its position were stronger.
- b. A failure to disclose separately a nonrecurrent item of revenue may be material at a lower threshold than would otherwise be the case if the revenue turns a loss into a profit or reverses the trend of earnings from a downward to an upward trend.
- c. A misclassification of assets that would not be material in amount if it affected two categories of plant or equipment might be material if it changed the classification between a noncurrent and a current asset category.
- d. Amounts too small to warrant disclosure or correction in normal circumstances may be considered material if they arise from abnormal or unusual transactions or events.

129. Almost always, the relative rather than the absolute size of a judgment item determines whether it should be considered material in a given situation. Losses from bad debts or pilferage that could be shrugged off as routine by a large business may threaten the continued existence of a small one. An error in inventory valuation may be material in a small enterprise for which it cut earnings in half but immaterial in an enterprise for which it might make a barely perceptible ripple in the earnings. Some of the empirical investigations referred to in Appendix C throw light on the considerations that enter into materiality judgments.

130. Another factor in materiality judgments is the degree of precision that is attainable in estimating the judgment item. The amount of deviation that is considered immaterial may increase as the attainable degree of precision decreases. For example, accounts payable usually can be estimated more accurately than can contingent liabilities arising from litigation or threats of it, and a deviation considered to be material in the first case may be quite trivial in the second.

131. Some hold the view that the Board should promulgate a set of quantitative materiality guides or criteria covering a wide variety of situations that preparers could look to for authoritative support. That appears to be a minority view, however, on the basis of representations made to the Board in response to the Discussion Memorandum, Criteria for Determining Materiality. The predominant view is that materiality judgments can properly be made only by those who have all the facts. The Board's present position is that no general standards of materiality could be formulated to take into account all the considerations that enter into an experienced human judgment. However, that position is not intended to imply either that the Board may not in the future review that conclusion or that quantitative guidance on materiality of specific items may not appropriately be written into the Board's standards from time to time. That has been done on occasion already (for example, in the Statement on financial reporting by segments of a business enterprise), and the Board recognizes that quantitative materiality guidance is sometimes needed. Appendix C lists a number of examples of quantitative guidelines that have been applied both in the law and in the practice of accounting. However, whenever the Board or any other authoritative body imposes materiality rules, it is

substituting generalized collective judgments for specific individual judgments, and there is no reason to suppose that the collective judgments are always superior. In any case, it must be borne in mind that if, to take one example, some minimum size is stipulated for recognition of a material item (for example, a segment having revenue equal to or exceeding 10 percent of combined revenues shall be recognized as a reportable segment), the rule does not prohibit the recognition of a smaller segment. Quantitative materiality guidelines generally specify minima only. They, therefore, leave room for individual judgment in at least one direction.

132. Individual judgments are required to assess materiality in the absence of authoritative criteria or to decide that minimum quantitative criteria are not appropriate in particular situations. The essence of the materiality concept is clear. The omission or misstatement of an item in a financial report is material if, in the light of surrounding circumstances, the magnitude of the item is such that it is probable that the judgment of a reasonable person relying upon the report would have been changed or influenced by the inclusion or correction of the item.