FINANCIAL ACCOUNTING STANDARDS BOARD

Public Roundtable Meeting
Disclosure Framework—Entity's Decision Process—Materiality
March 17, 2017
1:00 p.m.–2:55 p.m.

Financial Accounting Standards Board
401 Merritt 7
Norwalk, Connecticut

AGENDA

1. The FASB Board and staff have arranged this roundtable meeting to listen to views and to further develop their understanding of the issues raised or the alternatives proposed in comment letters.

Background on Materiality Definition

2. Along with the development of a framework that promotes consistent decisions by the Board about disclosure requirements, achieving the objective of improving the effectiveness of notes includes the appropriate exercise of discretion by reporting entities. The Board issued two proposed Updates on the entity's decision process:
   a. Proposed Accounting Standards Update, *Notes to the Financial Statements (Topic 235): Assessing Whether Disclosures Are Material*
   b. Proposed FASB Concepts Statement, *Conceptual Framework for Financial Reporting—Chapter 3: Qualitative Characteristics of Useful Financial Information (FASB Concepts Statement)*.
3. Those proposals would refer to materiality as a legal concept. The Board initially decided to:
   a. Reference that the concept of materiality has been defined by the U.S. Supreme Court. The intent was to reduce the confusion potentially caused by differing views on materiality.
   b. Provide the U.S. Supreme Court's definition in the context of the antifraud provisions of U.S. securities laws. That definition can be summarized by stating that disclosures generally should be evaluated as material if there is a substantial likelihood that the omitted or misstated disclosure would have been viewed by a reasonable resource provider as having significantly altered the total mix of information available in making a decision.
   c. Note that the U.S. Supreme Court's definition is established by and may change from court decisions and interpretations; therefore, no single definition of materiality can be relied on to identify what may be material in every specific circumstance.
4. However, the Board ultimately decided that the *FASB Accounting Standards Codification*® only would state that materiality is a legal concept for the following reasons:

a. A legal concept may be established or changed through legislative, executive, or judicial action.
b. Although the Board observes a portion of the legal definition in one context, the Board does not promulgate a definition of materiality.

Summary of Comment Letter Feedback Received

5. Some respondents noted that the current definition of materiality in FASB Concepts Statement is not an accurate definition. Many commented that the U.S. Supreme Court's definition of materiality is suitable for use in financial reporting, noting that the U.S. Supreme Court's summary definition is included in both the U.S. Security and Exchange Commission's (SEC) Staff Accounting Bulletin (SAB) No. 99, *Materiality,* and the Public Company Accounting Oversight Board's (PCAOB) Auditing Standard No. 11, *Consideration of Materiality in Planning and Performing an Audit.*
6. However, many respondents disagreed with including the U.S. Supreme Court's definition because (a) it is in the context of antifraud provisions of securities law rather than in the context of financial reporting and (b) it contains a higher threshold for materiality than the current definition in Concepts Statement 8. Some respondents also said that the legal and financial reporting definitions of materiality do not have to be aligned and that the Board should set its own definition of materiality in the context of financial reporting.
7. Some respondents said that the Board should retain the current definition of materiality in Concepts Statement 8. However, others suggested replacing the definition of materiality with that in one of the following:

   a. FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information*[1]
   b. U.S. Supreme Court Decisions in two cases: *TSC Industries v. Northway, Inc.,* 426 U.S. 438 (1976) and *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988)[2]
   c. SAB 99.

   See Appendix A for discussions about materiality contained in these sources.

8. Additionally, some respondents said that the definition of materiality should be incorporated in Topic 235 because the Concepts Statements are nonauthoritative and, therefore, only including the definition in Concepts Statement 8 could result in diversity in practice.

<u>Background on Statement That Omission of Immaterial Disclosure Is Not an Error</u>

9. The amendments in the proposed Update on Topic 235 state that the omission of an immaterial-required disclosure would not be an accounting error. An often-cited obstacle to removing immaterial information from the notes to the financial statements is communicating the omission to the audit committee as an error.
10. Auditors aggregate and communicate to the entity's audit committee the misstatements (a) that

[1]Superseded by FASB Concepts Statement No. 8, *Conceptual Framework for Financial Reporting*, but could be reinstated or included in an Accounting Standards Update on disclosures.
[2]Information from Staff Accounting Bulletin Topic No. 1M, "Materiality—Assessing Materiality".

are not “clearly trivial” and (b) that an entity has not corrected. AICPA AU-C Sections 450.05 and 450.A2, *Evaluation of Misstatements Identified During the Audit—Accumulation of Identified Misstatements*, point out that “clearly trivial” is not equivalent to “not material.” Clearly trivial matters are “clearly inconsequential, whether taken individually or in the aggregate and whether judged by any criteria of size, nature, or circumstances.” Put plainly, if an omitted disclosure has been discussed between the reporting entity and its auditor, it is more than clearly trivial. Misstatements that are immaterial are not considered in qualifying or altering an audit opinion, but are merely discussed with the entity’s board. However, in practice, if a misstatement is brought to the audit committee, it is viewed as an error. Therefore, entities would like the FASB to make it clear that only material misstatements are errors regardless of auditor-audit committee communication. The Board concluded that because excluding immaterial disclosures can improve effectiveness of the financial statements, omitting an immaterial-required disclosure should not constitute an error. The Board is not amending, nor does it have the ability to amend, AICPA Auditing Standards.

Summary of Comment Letter Feedback Received

11. The majority of comment letter respondents agreed with the proposed amendment because it may lessen the obstacles that reporting entities encounter to omit immaterial information from the notes. Some said that without explicitly stating that omitting an immaterial disclosure is not an accounting error, some preparers will continue to disclose all required disclosures regardless of the materiality assessment.
12. However, some comment letter respondents to the amendments in the proposed Update on Topic 235 expressed concerns that auditor communication would be reduced because of the proposed amendments. Some view the proposed amendments as being based on the belief that auditors and management should have the discretion to omit immaterial disclosures without communicating them to the audit committee.

Questions for Participants

1. Is a misaligned definition in the FASB Concepts Statements problematic?

2. Should materiality be discussed and/or defined in FASB Concepts Statements or Topic 235? If so, which definition in the following literature should be used:

   a. Concepts Statement 8
   b. Concepts Statement 2
   c. SAB 99?

   Are there any other suggestions?

3. In which of the following should the definition and/or discussion of materiality be located?

   a. In the Codification
   b. In the Conceptual Framework
   c. In both?

4. Should the Board explicitly state that the omission of an immaterial-required disclosure is not an accounting error?

5. How will promoting the use of discretion by reporting entities when complying with disclosure requirements (subject to the suggestions and ideas discussed on the definition, discussion, and location of materiality) improve financial reporting?

6. What other materiality issues should the Board consider?

Appendix A: Materiality Descriptions

Concepts Statement 2

Materiality

Materiality is a pervasive concept that relates to the qualitative characteristics, especially relevance and reliability. Materiality and relevance are both defined in terms of what influences or makes a difference to a decision maker, but the two terms can be distinguished. A decision not to disclose certain information may be made, say, because investors have no need for that kind of information (it is not relevant) or because the amounts involved are too small to make a difference (they are not material). 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. The Board's present position is that no general standards of materiality can be formulated to take into account all the considerations that enter into an experienced human judgment. Quantitative materiality criteria may be given by the Board in specific standards in the future, as in the past, as appropriate.

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.

[Footnote reference omitted.]

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.

U.S. Supreme Court

[A fact is material if there is] a substantial likelihood that…the…fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available.[3]

[Footnote reference omitted.]

In *TSC Industries*, this Court explained:

[Determinations of materiality require] delicate assessments of the inferences a 'reasonable shareholder' would draw from a given set of facts and the significance of those inferences to him….[4]

Concepts Statement 8

QC11. 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. Consequently, the Board cannot specify a uniform quantitative threshold for materiality or predetermine what could be material in a particular situation.

SAB 99

1. Assessing Materiality

[3] *TSC Industries v. Northway, Inc.*, 426 U.S. 439, 449 (1976).
[4] *Basic, Inc. v. Levinson*, 485 U.S. 236 (1988).

Facts: During the course of preparing or auditing year-end financial statements, financial management or the registrant's independent auditor becomes aware of misstatements in a registrant's financial statements. When combined, the misstatements result in a 4% overstatement of net income and a $.02 (4%) overstatement of earnings per share. Because no item in the registrant's consolidated financial statements is misstated by more than 5%, management and the independent auditor conclude that the deviation from generally accepted accounting principles ("GAAP") is immaterial and that the accounting is permissible**.**

Question: Each Statement of Financial Accounting Standards adopted by the Financial Accounting Standards Board ("FASB") states, "The provisions of this Statement need not be applied to immaterial items." In the staff's view, may a registrant or the auditor of its financial statements assume the immateriality of items that fall below a percentage threshold set by management or the auditor to determine whether amounts and items are material to the financial statements?

Interpretive Response: No. The staff is aware that certain registrants, over time, have developed quantitative thresholds as "rules of thumb" to assist in the preparation of their financial statements, and that auditors also have used these thresholds in their evaluation of whether items might be considered material to users of a registrant's financial statements. One rule of thumb in particular suggests that the misstatement or omission[2] of an item that falls under a 5% threshold is not material in the absence of particularly egregious circumstances, such as self-dealing or misappropriation by senior management. The staff reminds registrants and the auditors of their financial statements that exclusive reliance on this or any percentage or numerical threshold has no basis in the accounting literature or the law.

The use of a percentage as a numerical threshold, such as 5%, may provide the basis for a preliminary assumption that – without considering all relevant circumstances – a deviation of less than the specified percentage with respect to a particular item on the registrant's financial statements is unlikely to be material. The staff has no objection to such a "rule of thumb" as an initial step in assessing materiality. But quantifying, in percentage terms, the magnitude of a misstatement is only the beginning of an analysis of materiality; it cannot appropriately be used as a substitute for a full analysis of all relevant considerations. Materiality concerns the significance of an item to users of a registrant's financial statements. A matter is "material" if there is a substantial likelihood that a reasonable person would consider it important. In its Statement of Financial Accounting Concepts No. 2, the FASB stated the essence of the concept of materiality as follows:

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.

This formulation in the accounting literature is in substance identical to the formulation used by the courts in interpreting the federal securities laws. The Supreme Court has held that a fact is material if there is –

a substantial likelihood that the . . . fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available.

Under the governing principles, an assessment of materiality requires that one views the facts in the context of the "surrounding circumstances," as the accounting literature puts it, or the "total mix" of information, in the words of the Supreme Court. In the context of a misstatement of a financial statement item, while the "total mix" includes the size in numerical or percentage terms of the misstatement, it also includes the factual context in which the user of financial statements would view the financial statement item. The shorthand in the accounting and auditing literature for this analysis is that financial management and the auditor must consider both "quantitative" and "qualitative" factors in assessing an item's materiality. Court decisions, Commission rules and enforcement actions, and accounting and auditing literature have all considered "qualitative" factors in various contexts.

The FASB has long emphasized that materiality cannot be reduced to a numerical formula. In its Concepts Statement No. 2, the FASB noted that some had urged it to promulgate quantitative materiality guides for use in a variety of situations. The FASB rejected such an approach as representing only a "minority view," stating –

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.

The FASB noted that, in certain limited circumstances, the Commission and other authoritative bodies had issued quantitative materiality guidance, citing as examples guidelines ranging from one to ten percent with respect to a variety of disclosures. And it took account of contradictory studies, one showing a lack of uniformity among auditors on materiality judgments, and another suggesting widespread use of a "rule of thumb" of five to ten percent of net income. The FASB also considered whether an evaluation of materiality could be based solely on anticipating the market's reaction to accounting information.

The FASB rejected a formulaic approach to discharging "the onerous duty of making materiality decisions” in favor of an approach that takes into account all the relevant considerations. In so doing, it made clear that –

[M]agnitude 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.

Evaluation of materiality requires a registrant and its auditor to consider *all* the relevant circumstances, and the staff believes that there are numerous circumstances in which misstatements below 5% could well be material. Qualitative factors may cause misstatements of quantitatively small amounts to be material; as stated in the auditing literature:

As a result of the interaction of quantitative and qualitative considerations in materiality judgments, misstatements of relatively small amounts that come to the auditor's attention could have a material effect on the financial statements.

Among the considerations that may well render material a quantitatively small misstatement of a financial statement item are –

- whether the misstatement arises from an item capable of precise measurement or whether it arises from an estimate and, if so, the degree of imprecision inherent in the estimate
- whether the misstatement masks a change in earnings or other trends
- whether the misstatement hides a failure to meet analysts' consensus expectations for the enterprise
- whether the misstatement changes a loss into income or vice versa
- whether the misstatement concerns a segment or other portion of the registrant's business that has been identified as playing a significant role in the registrant's operations or profitability
- whether the misstatement affects the registrant's compliance with regulatory requirements
- whether the misstatement affects the registrant's compliance with loan covenants or other contractual requirements
- whether the misstatement has the effect of increasing management's compensation – for example, by satisfying requirements for the award of bonuses or other forms of incentive compensation
- whether the misstatement involves concealment of an unlawful transaction.

This is not an exhaustive list of the circumstances that may affect the materiality of a quantitatively small misstatement. Among other factors, the demonstrated volatility of the price of a registrant's securities in response to certain types of disclosures may provide guidance as to whether investors regard quantitatively small misstatements as material. Consideration of potential market reaction to disclosure of a misstatement is by itself "too blunt an instrument to be depended on" in considering whether a fact is material. When, however, management or the independent auditor expects (based, for example, on a pattern of market performance) that a known misstatement may result in a significant positive or negative market reaction, that expected reaction should be taken into account when considering whether a misstatement is material.

For the reasons noted above, the staff believes that a registrant and the auditors of its financial statements should not assume that even small intentional misstatements in financial statements, for example those pursuant to actions to "manage" earnings, are immaterial. While the intent of management does not render a misstatement material, it may provide significant evidence of materiality. The evidence may be particularly compelling where management has intentionally misstated items in the financial statements to "manage" reported earnings. In that instance, it presumably has done so believing that the resulting amounts and trends would be significant to users of the registrant's financial statements. The staff believes that investors generally would regard as significant a management practice to over- or under-state earnings up to an amount just short of a percentage threshold in order to "manage" earnings. Investors presumably also would regard as significant an accounting practice that, in essence, rendered all earnings figures subject to a management-directed margin of misstatement.

The materiality of a misstatement may turn on where it appears in the financial statements. For example, a misstatement may involve a segment of the registrant's operations. In that instance, in assessing materiality of a misstatement to the financial statements taken as a whole, registrants and their auditors should consider not only the size of the misstatement but also the significance of the segment information to the financial statements taken as a whole. "A misstatement of the revenue and operating profit of a relatively small segment that is represented by management to be important to the future profitability of the entity" is more likely to be material to investors than a misstatement in a segment that management has not identified as especially important. In assessing the materiality of misstatements in segment information - as with materiality generally -

situations may arise in practice where the auditor will conclude that a matter relating to segment information is qualitatively material even though, in his or her judgment, it is quantitatively immaterial to the financial statements taken as a whole.

Aggregating and Netting Misstatements

In determining whether multiple misstatements cause the financial statements to be materially misstated, registrants and the auditors of their financial statements should consider each misstatement separately and the aggregate effect of all misstatements. A registrant and its auditor should evaluate misstatements in light of quantitative and qualitative factors and "consider whether, in relation to individual line item amounts, subtotals, or totals in the financial statements, they materially misstate the financial statements taken as a whole." This requires consideration of -

the significance of an item to a particular entity (for example, inventories to a manufacturing company), the pervasiveness of the misstatement (such as whether it affects the presentation of numerous financial statement items), and the effect of the misstatement on the financial statements taken as a whole ....

Registrants and their auditors first should consider whether each misstatement is material, irrespective of its effect when combined with other misstatements. The literature notes that the analysis should consider whether the misstatement of "individual amounts" causes a material misstatement of the financial statements taken as a whole. As with materiality generally, this analysis requires consideration of both quantitative and qualitative factors.

If the misstatement of an individual amount causes the financial statements as a whole to be materially misstated, that effect cannot be eliminated by other misstatements whose effect may be to diminish the impact of the misstatement on other financial statement items. To take an obvious example, if a registrant's revenues are a material financial statement item and if they are materially overstated, the financial statements taken as a whole will be materially misleading even if the effect on earnings is completely offset by an equivalent overstatement of expenses.

Even though a misstatement of an individual amount may not cause the financial statements taken as a whole to be materially misstated, it may nonetheless, when aggregated with other misstatements, render the financial statements taken as a whole to be materially misleading. Registrants and the auditors of their financial statements accordingly should consider the effect of the misstatement on subtotals or totals. The auditor should aggregate all misstatements that affect each subtotal or total and consider whether the misstatements in the aggregate affect the subtotal or total in a way that causes the registrant's financial statements taken as a whole to be materially misleading.

The staff believes that, in considering the aggregate effect of multiple misstatements on a subtotal or total, registrants and the auditors of their financial statements should exercise particular care when considering whether to offset (or the appropriateness of offsetting) a misstatement of an estimated amount with a misstatement of an item capable of precise measurement. As noted above, assessments of materiality should never be purely mechanical; given the imprecision inherent in estimates, there is by definition a corresponding imprecision in the aggregation of misstatements involving estimates with those that do not involve an estimate.

Registrants and auditors also should consider the effect of misstatements from prior periods on the current financial statements. For example, the auditing literature states,

Matters underlying adjustments proposed by the auditor but not recorded by the entity could potentially cause future financial statements to be materially misstated, even though the auditor has concluded that the adjustments are not material to the current financial statements.

This may be particularly the case where immaterial misstatements recur in several years and the cumulative effect becomes material in the current year.

2. Immaterial Misstatements That are Intentional

Facts: A registrant's management intentionally has made adjustments to various financial statement items in a manner inconsistent with GAAP. In each accounting period in which such actions were taken, none of the individual adjustments is by itself material, nor is the aggregate effect on the financial statements taken as a whole material for the period. The registrant's earnings "management" has been effected at the direction or acquiescence of management in the belief that any deviations from GAAP have been immaterial and that accordingly the accounting is permissible.

Question: In the staff's view, may a registrant make intentional immaterial misstatements in its financial statements?

Interpretive Response: No. In certain circumstances, intentional immaterial misstatements are unlawful.

Considerations of the Books and Records Provisions Under the Exchange Act

Even if misstatements are immaterial, registrants must comply with Sections 13(b)(2) - (7) of the Securities Exchange Act of 1934 (the "Exchange Act"). Under these provisions, each registrant with securities registered pursuant to Section 12 of the Exchange Act, or required to file reports pursuant to Section 15(d), must make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of assets of the registrant and must maintain internal accounting controls that are sufficient to provide reasonable assurances that, among other things, transactions are recorded as necessary to permit the preparation of financial statements in conformity with GAAP. In this context, determinations of what constitutes "reasonable assurance" and "reasonable detail" are based not on a "materiality" analysis but on the level of detail and degree of assurance that would satisfy prudent officials in the conduct of their own affairs. Accordingly, failure to record accurately immaterial items, in some instances, may result in violations of the securities laws.

The staff recognizes that there is limited authoritative guidance regarding the "reasonableness" standard in Section 13(b)(2) of the Exchange Act. A principal statement of the Commission's policy in this area is set forth in an address given in 1981 by then Chairman Harold M. Williams. In his address, Chairman Williams noted that, like materiality, "reasonableness" is not an "absolute standard of exactitude for corporate records." Unlike materiality, however, "reasonableness" is not solely a measure of the significance of a financial statement item to investors. "Reasonableness," in this context, reflects a judgment as to whether an issuer's failure to correct a known misstatement implicates the purposes underlying the accounting provisions of Sections 13(b)(2) - (7) of the Exchange Act.

In assessing whether a misstatement results in a violation of a registrant's obligation to keep books and records that are accurate "in reasonable detail," registrants and their auditors should consider, in addition to the factors discussed above concerning an evaluation of a misstatement's potential materiality, the factors set forth below.

- **The significance of the misstatement**. Though the staff does not believe that registrants need to make finely calibrated determinations of significance with respect to immaterial items, plainly it is "reasonable" to treat misstatements whose effects are clearly inconsequential differently than more significant ones.
- **How the misstatement arose**. It is unlikely that it is ever "reasonable" for registrants to record misstatements or not to correct known misstatements – even immaterial ones – as part of an ongoing effort directed by or known to senior management for the purposes of "managing" earnings. On the other hand, insignificant misstatements that arise from the operation of systems or recurring processes in the normal course of business generally will not cause a registrant's books to be inaccurate "in reasonable detail."
- **The cost of correcting the misstatement**. The books and records provisions of the Exchange Act do not require registrants to make major expenditures to correct small misstatements. Conversely, where there is little cost or delay involved in correcting a misstatement, failing to do so is unlikely to be "reasonable."
- **The clarity of authoritative accounting guidance with respect to the misstatement**. Where reasonable minds may differ about the appropriate accounting treatment of a financial statement item, a failure to correct it may not render the registrant's financial statements inaccurate "in reasonable detail." Where, however, there is little ground for reasonable disagreement, the case for leaving a misstatement uncorrected is correspondingly weaker.

There may be other indicators of "reasonableness" that registrants and their auditors may ordinarily consider. Because the judgment is not mechanical, the staff will be inclined to continue to defer to judgments that "allow a business, acting in good faith, to comply with the Act's accounting provisions in an innovative and cost-effective way."

The Auditor's Response to Intentional Misstatements

Section 10A(b) of the Exchange Act requires auditors to take certain actions upon discovery of an "illegal act." The statute specifies that these obligations are triggered "whether or not [the illegal acts are] perceived to have a material effect on the financial statements of the issuer . . . ." Among other things, Section 10A(b)(1) requires the auditor to inform the appropriate level of management of an illegal act (unless clearly inconsequential) and assure that the registrant's audit committee is "adequately informed" with respect to the illegal act.

As noted, an intentional misstatement of immaterial items in a registrant's financial statements may violate Section 13(b)(2) of the Exchange Act and thus be an illegal act. When such a violation occurs, an auditor must take steps to see that the registrant's audit committee is "adequately informed" about the illegal act. Because Section 10A(b)(1) is triggered regardless of whether an illegal act has a material effect on the registrant's financial statements, where the illegal act consists of a misstatement in the registrant's financial statements, the auditor will be required to report that illegal act to the audit committee irrespective of any "netting" of the misstatements with other financial statement items.

The requirements of Section 10A echo the auditing literature. See, for example, Statement on Auditing Standards No. ("SAS") 54, "Illegal Acts by Clients," and SAS 82, "Consideration of Fraud in a Financial Statement Audit." Pursuant to paragraph 38 of SAS 82, if the auditor determines there is evidence that fraud may exist, the auditor must discuss the matter with the appropriate level of management. The auditor must report directly to the audit committee fraud involving senior management and fraud that causes a material misstatement of the financial statements. Paragraph 4 of SAS 82 states that "misstatements arising from fraudulent financial reporting are intentional misstatements or omissions of amounts or disclosures in financial statements to deceive financial statement users." SAS 82 further states that fraudulent financial reporting may involve falsification or alteration of accounting records; misrepresenting or omitting events, transactions or other information in the financial statements; and the intentional misapplication of accounting principles relating to amounts, classifications, the manner of presentation, or disclosures in the financial statements. The clear implication of SAS 82 is that immaterial misstatements may be fraudulent financial reporting.

Auditors that learn of intentional misstatements may also be required to (1) re-evaluate the degree of audit risk involved in the audit engagement, (2) determine whether to revise the nature, timing, and extent of audit procedures accordingly, and (3) consider whether to resign.

Intentional misstatements also may signal the existence of reportable conditions or material weaknesses in the registrant's system of internal accounting control designed to detect and deter improper accounting and financial reporting. As stated by the National Commission on Fraudulent Financial Reporting, also known as the Treadway Commission, in its 1987 report,

The tone set by top management - the corporate environment or culture within which financial reporting occurs - is the most important factor contributing to the integrity of the financial reporting process. Notwithstanding an impressive set of written rules and procedures, if the tone set by management is lax, fraudulent financial reporting is more likely to occur.

An auditor is required to report to a registrant's audit committee any reportable conditions or material weaknesses in a registrant's system of internal accounting control that the auditor discovers in the course of the examination of the registrant's financial statements.

GAAP Precedence Over Industry Practice

Some have argued to the staff that registrants should be permitted to follow an industry accounting practice even though that practice is inconsistent with authoritative accounting literature. This situation might occur if a practice is developed when there are few transactions and the accounting results are clearly inconsequential, and that practice never changes despite a subsequent growth in the number or materiality of such transactions. The staff disagrees with this argument. Authoritative literature takes precedence over industry practice that is contrary to GAAP.

General Comments

This SAB is not intended to change current law or guidance in the accounting or auditing literature. This SAB and the authoritative accounting literature cannot specifically address all of the novel and complex business transactions and events that may occur. Accordingly, registrants may account for, and make disclosures about, these transactions and events based on analogies to similar situations or other factors. The staff may not, however, always be persuaded that a registrant's determination is the most appropriate under the circumstances. When disagreements occur after a transaction or an event has been reported, the consequences may be severe for registrants, auditors, and, most importantly, the users of financial statements who have a right to expect consistent accounting and reporting for, and disclosure of, similar transactions and events. The staff, therefore, encourages registrants and auditors to discuss on a timely basis with the staff proposed accounting treatments for, or disclosures about, transactions or events that are not specifically covered by the existing accounting literature.

[Footnote references omitted.]