Agenda Item A

Materiality

Executive summary

In August 2018 the FASB amended its definition of "materiality" to revert back to its original definition which had been in effect from 1980 until 2010 at which time the FASB revised its definition of materiality to converge with the IASB's definition.

The FASB's current definition of materiality is aligned with definitions held by the United States Supreme Court ("Supreme Court", "Court" or "TSC"), SEC and PCAOB.

The AICPA/ASB's definition of materiality is aligned with definitions held by the IASB and the IAASB.

The primary difference between the definitions held by the TSC, SEC, PCAOB and FASB vs. the definitions held by the AICPA/ASB, IASB and IAASB relate to the notion of "would influence" (TSC, SEC, PCAOB and FASB) vs. the notion of "could influence" (AICPA/ASB, IASB and IAASB).

Further, in its August 2018 revision to its definition of materiality, the FASB incorrectly stated that its revised definition of materiality is in substance identical to the definition held by the AICPA/ASB.

Question

Should the ASB adopt a limited scope project to consider revising the AICPA's definition of materiality to align with the definitions held by the SC, SEC, PCAOB and FASB?

Background

TSC v. Northway Defines Materiality in 1976

In *TSC Industries, Inc v. Northway, Inc. (426 U.S. 438, June, 14, 1976), ("TSC v. Northway"),* the Supreme Court defined materiality as the term was (and is) used in SEC Proxy Rule 14a-9. Rule 14a-9 requires that no proxy solicitation be made "which . . . is false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading . . . ." The Supreme Court opined:

> [A]n omitted fact is material if there is a substantial likelihood that a reasonable shareholder ***would*** consider it important in deciding how to vote. The standard is fully consistent Mills' general description of materiality as a requirement that 'the defect have a significant

> propensity to affect the voting process'. It 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 the substantial likelihood that, under all 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 face *would* have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available. (426 U.S. 438, 449) (emphasis added)

With this opinion, the Court reversed the United States Seventh Circuit Court of Appeals which had held that material facts included "all facts which a reasonable shareholder *might consider important*." (512 F2d 324 at 330) (emphasis added) The Court stated that the Seventh Circuit's formulation of the test for materiality set "too low a threshold for the imposition of liability under Rule 14a-9."

Recognizing that not all information that "*might* be considered important," (Seventh Circuit) "*would* be considered important" (TSC), the Supreme Court adopted a definition of materiality that is dramatically more stringent than the test applied by the Seventh Circuit. Facts that "*would* be considered important" by a reasonable person constitute a subset of facts that "*might* be considered important by a reasonable person.

FASB From 1973 Until 2010

FASB's first analysis of materiality was made in Statement of Financial Accounting Concepts No. 2 "Qualitative Characteristics of Accounting Information" ("FASCON 2", May 1980). In the Glossary to FASCON 2, FASB defined financial statement materiality as:

> the magnitude of an omission or misstatement of accounting information that, in 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. (FASCON 2, Page 6) (emphasis added)

Between 1980 and 2010, the FASB neither amended FASCON 2 nor issued a superseding Statement of Financial Accounting Concepts. However, as discussed below, FASB's definition of materiality changed in September 2010 when FASB issued FASCON 8.

The SEC and SAB 99

On August 12, 1999, the Staff of the Securities and Exchange Commission ("Staff") issued Staff Accounting Bulletin No. 99 "Materiality" ("SAB 99"). SAB 99 was written to provide guidance to preparers and independent auditors when evaluating materiality. SAB 99 in not a policy statement of the SEC and does not prescribe GAAP. As the linchpin for its observations, the Staff quoted the FASCON 2 Glossary definition of materiality and observed, "This formulation in the accounting literature is in substance identical to the formulation used by the courts in interpreting the federal securities laws." SAB 99 also quoted from and relied upon the definition of materiality set forth in *TSC v. Northway*, including the "*would* have been considered important" (emphasis added) analysis articulated there. The Staff concluded that *TSC v. Northway*, in conjunction with the FASCON 2 Glossary definition of materiality, constituted the GAAP definition of accounting materiality.

Auditing Standards Board Pronouncements and GAAP Materiality until 2011

In December 1983, the ASB issued Statement on Auditing Standards No. 47 "Audit Risk and Materiality in Conducting an Audit ("SAS 47")." SAS 47 quoted from and applied the FASCON 2 Glossary definition of materiality, which had been derived from *TSC v. Northway*, as guidance to independent auditors when considering financial statement materiality in the context of an audit of financial statements.

In March, 2006, the ASB issued SAS 107 which superseded SAS 47. For the purposes of defining materiality, SAS 107 bore the same title as SAS 47 and set forth the same definition of materiality as did SAS 47 (AU 312.04). The ASB's guidance to auditors did not change until SAS 122 was issued in 2011.

International Standards – IASB

In 2010 the "Conceptual Framework for Financial Reporting" issued by the IASB defined materiality:

> Information is material if omitting or misstating *could* influence decisions that users make as the basis of financial information about a specific reporting entity. (Par. QC 11) (emphasis added).

This definition of materiality in the IASB Framework is substantially the same as the definition of material in the IAS 8, at paragraph 5, which states:

> Omissions or misstatements of items are material if they *could*, individually or collectively, influence the economic decisions that users make on this basis of the financial statements. (emphasis added)

International Standards – IAASB

Effective for audits of financial statements for periods beginning on or after December 15, 2009 performed in accordance with International Standards of Auditing issued by the IAASB, "Materiality in the Context of an Audit" (Section 320 of the IAASB Standards), the IAASB has defined financial statement materiality:

> Misstatements, including omissions, are considered to be material if they, individually or in the aggregate, *could* reasonably be expected to influence the economic decision of users taken on the basis of the financial statements. (IAAS, Section 320, paragraph 2) (emphasis added)

Thus, the IASB and the IAASB apply a "*could* influence" standard for financial statement materiality which differs significantly from the "*would* influence" standard in the United States.

FASB Issues FASCON 8 in September 2010

In September 2010, the FASB issued FASCON 8, "Conceptual Framework for Financial Reporting", which is "a replacement of" FASCON 1 and FASCON 2. As stated in FASCON 8, "the Board has undertaken a project which the IASB to improve and converge their frameworks."

The FASCON 8 definition of materiality states:

> 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." (Par QC11, chapter 3 of FASCON8). (emphasis added)

In the section of FASCON 8 that superseded FASCON 2, FASB fundamentally changed its prior definition of materiality set forth in FASCON 2 from a "would influence" standard to a "could influence" standard. Thus, the FASCON 8 definition of financial statement materiality is the same as the definitions previously adopted by the IASB and the IAASB.

PCAOB Issues Auditing Standards No. 11 in December 2010

In December 2010 the PCAOB issued Auditing Standard No. 11, "Consideration of Materiality in Planning and Performing an Audit, " which set forth the PCAOB's position for evaluating "materiality in the context of an audit" as it applies to auditors of the financial statements of SEC registrants. The PCAOB states:

> In interpreting the federal securities laws, the Supreme Court of the United States 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'. As the Supreme Court has noted, 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 . . . (PCAOB, Auditing Standard No. 11, paragraph 2, December 23, 2010). (emphasis added)

PCAOB Auditing Standard No. 11, issued with the approval of the SEC, expressly relies on *TSC v. Northway* as the basis for its definition of materiality. In Auditing Standard No. 11, the PCAOB made no reference to superseded FASCON 2 or to FASCON 8. The PCAOB seemed to reject the FASCON 8 definition of materiality issued shortly before Auditing Standard No. 11 was issued and instead held a position that was consistent with the conclusion in SAB 99.

ASB Issues SAS 122

In SAS 122 "Clarification and Recodification", the ASB/AICPA announced its revised position for evaluating "materiality in the context of an audit" of non-SEC registrants. SAS 122 states:

> Financial reporting frameworks often discuss the concept of materiality in the context of the preparation and fair presentation of financial statements. Although financial reporting frameworks may discuss materiality in different terms, they generally explain that:
>
> - misstatements, including omissions, are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users made on the basis of the financial statements. (SAS No. 122, AU-C Section 320, paragraph 2) (emphasis added)

In SAS 122, the ASB adopted almost verbatim the IAASB definition of materiality, which as consistent with the IASB definition of materiality and with the FASCON 8 definition of materiality.

FASB issues FASCON 10 in August 2018

In August 2018, the FASB issued FASCON 10, "Conceptual Framework for Financial Reporting", which amends FASCON 8. As stated in FASCON 10, "The main amendment [of

FASCON 10] reinstates the definition of materiality that was in [FASCON 2], which was superseded in 2010 by [FASCON 8]."

The FASCON 10 definition of materiality states:

> The omission or misstatement of an item in a financial report is material if, in 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. (emphasis added)

In the section of FASCON 10 that amended FASCON 8, FASB reverted back to its prior definition of materiality set forth in FASCON 2. Thus, the FASCON 10 definition of financial statement materiality is aligned with definitions held by the Supreme Court, SEC and PCAOB and does not align with the definition of financial statement materiality held by the AICPA/ASB, IASB and IAASB.

Further, in its August 2018 revision to its definition of materiality, the FASB incorrectly stated that its revised definition of materiality is in substance identical to the definition held by the AICPA/ASB.