Dear Ms. Cosper,

We, the University of Washington Bothell Master of Science Accounting Class of 2016, deeply appreciate the opportunity to comment on Proposed Accounting Standards Update, Notes to Financial Statements (Topic 235): Assessing Whether Disclosures Are Material. We support the Board’s efforts to improve footnote disclosure effectiveness, but our analysis indicates that the proposed update is more likely than not to be detrimental to this objective.

First, subordinating a broad accounting concept such as materiality to a narrower legal definition disregards the distinctive roles of accounting norms and legal norms in open economies with common law systems. This is an unfortunate precedent for the Board to set. Second, the Board has not presented objective evidence that current disclosure requirements are inefficient leading to concerns that the proposal is an ad-hoc response to preparer pressure. We recommend the Board collect and analyze evidence on the extent to which current disclosure burdens are unreasonably onerous and carefully document the need for disclosure reduction.

Third, the proposal does not set out how defining materiality as a legal construct will improve disclosure effectiveness. We recommend the Board outline, as it usually does with illustrative examples, how the proposed change in the definition of materiality will have the desired effect of improving disclosure effectiveness. Fourth, although convergence with International Accounting Standards is no longer a key agenda item for the Board, restricting the definition of materiality is likely to make future convergence more difficult. Specifically, allowing U.S. accounting and financial reporting norms to evolve under a more-restrictive legal definition can be expected to make it more difficult to eventually align U.S. norms with global norms that will have evolved under broader definitions. We recommend the Board explain more fully and carefully why it is in the public interest to modify the Codification at this time in a way that can be expected to make future convergence more difficult.

We further detail below these concerns and some related recommendations.

INSPIRING BUSINESS EXCELLENCE
Declaring materiality to be a legal concept is likely to be counterproductive

Defining materiality – for financial reporting purposes – as a legal concept confuses the role of legal and accounting norms in a society with open capital markets and a common law system. First, economic conditions evolve continuously and spontaneously. Common law, by contrast, evolves slowly, by fits and starts and after much adversarial deliberation. As a result, judicial determinations under a common law system are frequently too slow and ponderous to keep pace with financial statement users’ ever-evolving information needs. Second, in a common law system, individual judges’ interpretation of the prudent investor rule vary widely and must eventually be resolved – usually after much delay and further adversarial deliberation – by a superior court. Such divergence and uncertainty across legal jurisdictions is noxious to capital market functioning. Third, judicial opinions speak only to the specific plaint before the court and therefore only to the information needs of those who have moved the court. It is, therefore, not clear that the legal definition of materiality can be expected to accommodate the broad information needs of all users who rely upon general purpose financial reports.

Accounting notions of materiality, by contrast, adopt a comprehensive view that encompasses the likely information needs of financial statement users in general. By redefining materiality more narrowly and rejecting a more-comprehensive accounting view of materiality that has evolved over eight decades of vigorous discussion and debate, the Board is empowering preparers to limit disclosure to items that *would* – rather than *could* – impact a reasonable resource provider’s decisions. Such a change is likely to be problematic because the interests of preparers (managers) and different groups of resource providers (e.g., shareholders and bondholders) are heterogeneous and often conflict. For this reason, preparer arguments that market forces will compel them to choose the correct level of disclosures are not very credible. To the contrary, given the conflicts of interest inherent in the principal-agent relationship between resource providers and managers, there is every reason to believe that the proposal will give rise to a “disclosure lottery” – akin to the “audit lottery” that many preparers already play with the IRS – in which preparers omit material disclosures (i.e., “would” disclosures) with the rational expectation that only a fraction of these omissions are likely to be successfully challenged.¹ Such a reduction in the flow of information will increase corporate cost of capital, an impact that although difficult to quantify even after the fact, imposes a very real tax on investors. Related, adopting a more-restrictive definition of materiality than do international accounting standards can be expected to raise U.S. registrants’ cost of capital, imposing an invisible but very real tax on their owners. We recommend the Board conduct an analysis that explicitly addresses these *prima facie* well-founded user concerns about management’s incentives to ensure adequate disclosure once the proposed changes have been adopted.

Current disclosure levels are unlikely to be overwhelming for investors as a whole

An argument has been advanced that current disclosures are so numerous and complex as to overwhelm any individual investor or financial statement user’s ability to comprehend and disclosure reduction is likely to reduce investors’ cognitive burden. We are skeptical of this argument and encourage the Board to be so as well. First, objective evidence that current disclosures do in fact overwhelm individual users’ processing capabilities, let alone those of the large and sophisticated institutions active in U.S. capital markets, is scant to non-existent. Second, scholarly research over the past fifty years establishes that securities prices respond

continuously and rapidly to information that is often far more indirect and complex than the disclosures contained in corporate financial reports. Given this body of evidence, and the well-accepted notion that information is the life-blood of well-functioning capital markets, the burden of proof that current disclosure levels are overly onerous rests on those who would restrict the scope of disclosure. We recommend the Board collect and analyze such evidence and in the Appendix to this letter we outline an experiment to collect such evidence.

**Clarify how the proposed change will reduce disclosure burdens**
Likewise the Board has not explained with the examples and meticulous details that are the hallmark of its usual standard setting initiatives how adopting this definition will improve disclosure effectiveness. Absent convincing explanations supported by detailed examples, the Board’s stated rationales for so radically altering the status quo with respect to materiality fail, in our opinion, to meet the test of persuasive justification.

**Forever shutting the door on convergence is not in the public interest**
The proposed change effectively shuts the door on global convergence of accounting standards. The U.S. Supreme Court, as a matter of policy, takes little note of legal norms and precedents in other jurisdictions, let alone of accounting norms in foreign countries and markets. Adopting a legal definition of materiality will make it more onerous than it already is to converge US standards and disclosure practices with those of other countries. The Board has not explained why it is in the public interest to take steps that make future convergence more difficult.

**Concluding remarks**
We appreciate that the Board faces a difficult task in reconciling the vastly different views of what constitutes adequate disclosure for capital markets as rich, vibrant and complex as those that obtain in the United States. The definition of materiality is indeed a vexed and vexing question that has engaged the accounting profession and accounting regulators since long before the creation of the Securities Acts. Predecessor Boards and, before them, the Committee on Accounting Procedures as well as the Accounting Principles Board have deliberated long and hard and concluded, albeit not entirely satisfactorily for some tastes, that materiality in general purpose financial reports is a context-specific construct that is likely impossible – and perhaps even counter-productive – to define any too closely.

The elusiveness of a definitive materiality criterion despite decades of discussion and debate suggests strongly that materiality assessments for the purposes of general purpose financial reporting are best left to accountants’ professional judgment. In depicting materiality as a purely legal construct, the Board is harkening back to a definition that pre-dates the passage of the Securities Acts, when accountants were apt to treat materiality as a primarily legal construct. We believe that such a reading of materiality ignores the evolution of financial reporting since the early 1900s and the concomitant shifts in financial statement user expectations.

In sum, the current proposal reverses hard-won conceptual progress made over a century of vigorous accounting debate, underestimates the role of the accountant’s professional judgement in ensuring the well-functioning of capital markets and is a clear retreat from the Board’s mandate to promulgate financial reporting standards that safeguard the overall interests of financial statement users as a whole. We therefore recommend that till such time as a much more persuasive case can be made for restricting the definition of materiality, the Board retain unchanged the current definition of materiality, arrived at after considerable deliberation.
Thank you for the opportunity to comment on this project. We hope the Staff and the Board will consider our arguments and find our comments useful in further deliberations. If you have any questions, please contact Professor Rajib Doogar at 425-352-3332, or doogar@uw.edu.

Sincerely,

The University of Washington Bothell Master of Science Accounting Class of 2016*

Khalid Hussain Alahmaridi
Zeyad Abdullah Almujaybil
Hengyue Chen
Keyi Chen
Marie-Angeli Sales Del Valle
Zachary Mark Faller
Wenjie Fang
Seyedeh Tannaz Fatemieh
Aaron M Feldhaus
Yue Feng
Kendall Rose Fenske
Paulus Julizar Hartanto
Yaya Jiang

and

Rajib Doogar,
Associate Professor,
School of Business,
University of Washington, Bothell

* We thank fellow students and faculty colleagues at University of Washington, Bothell and others who provided valuable feedback on earlier drafts of this comment letter. All errors and omissions are our responsibility.
APPENDIX

A policy experiment to assess whether current disclosure burdens are inefficient

We recommend that the Board, with the concurrence of the SEC, provide a three-year safe harbor during which preparers would be required to classify footnote disclosures as essential, material and immaterial. This experiment will permit the Board, preparers, users and other interested parties to develop a shared understanding of the extent to which current footnote disclosures are, in fact, immaterial and the extent to which perceptions of immateriality are congruent (or incongruent) across preparers and resource providers. In addition, preparers could be encouraged to report estimated cost savings from the elimination of all disclosures they deem to be immaterial. Since it requires no additional disclosures beyond the status quo, this experiment is unlikely to impose any significant additional cost burdens on preparers.

Alternatively, users could be asked to indicate their relative preferences for the different footnotes in a preparer’s report by allocating a fixed number of total points in proportion to the perceived value of each disclosure. As in the first proposal, firms would also indicate which disclosures they consider immaterial and the expected cost savings from eliminating such disclosures. In years two and three of the experiment firms would allowed to eliminate the least demanded disclosures. Users could also be asked to evaluate the substance of the footnote disclosures by allocating a fixed number of total points in proportion to the relative substance of each footnote. The Board could monitor this process by hosting the poll on its servers.

No matter which of the experiments is conducted, a three year window would allow the Board to gather valuable evidence on the level of wasteful disclosures presently being made. In our view, any Board determination based on such evidence would be a significant improvement over the current situation where the Board is relying on a priori and ad-hoc arguments that are inherently inconclusive about the merits of the case.

HOW WILL THE EXPERIMENT BENEFIT COMPANIES, STAKEHOLDERS AND CAPITAL MARKETS

BENEFITS TO COMPANIES
The experiment allows companies to identify how the proposed change will affect their financial statements. Specifically, it should motivate preparers to evaluate objectively which disclosures are unnecessary and to also obtain a deeper understanding of the costs and benefits of making a particular disclosure (or group of disclosures). Such a deeper understanding is, in any case, necessary to achieve the Board’s goal of enhancing disclosure effectiveness. Another benefit is that in deciding to classify disclosures as essential, material or immaterial, preparers would have to account for the likely impact of eliminating a particular disclosure on their corporate cost of capital. This assessment is likely to vary across preparers and industries and be reflected in differences in how preparers classify particular disclosures. Such differences should, in turn, be informative to the disclosing firms themselves.

BENEFITS TO USERS
The first experiment will allow users to learn which disclosures preparers consider immaterial. Both similarities and dissimilarities in preparer classification across firms within an industry and across industries will help users to better understand preparer perspectives, particularly if
preparers indicate the expected cost savings that could be realized by eliminating immaterial disclosures. The second experiment will force users to likewise think about the value they place on particular disclosures.

CAPITAL MARKET IMPACTS
By maintaining current disclosure norms “as is” while providing information about perceptions of both preparers and users, the experiment will minimize the risk of any potential disruption that might result from the discontinuation of disclosures preparers deemed to be immaterial but that are, in reality, material. By the same token, any investor learning about the disclosures that others consider material or immaterial can be expected to improve capital market efficiency and to reduce the cost of capital for firms that make efficient disclosure choices and raise it for firms that make inefficient disclosure choices.