December 8, 2015

Office of the Secretary  
Financial Accounting Standards Board

Dear Board Members:

The Auditing Standards Committee of the Auditing Section of the American Accounting Association is pleased to provide comments on the FASB Exposure Draft, Proposed Accounting Standards Update, “Notes to Financial Statements (Topic 235): Assessing Whether Disclosures are Material.”

The views expressed in this letter are those of the members of the Auditing Standards Committee and do not reflect an official position of the American Accounting Association. In addition, the comments reflect the overall consensus view of the Committee, not necessarily the views of every individual member.

We hope that our attached comments and suggestions are helpful and will assist the Board. If the Board has any questions about our input, please feel free to contact our committee chair for any follow-up.

Respectfully submitted,

Auditing Standards Committee  
Auditing Section – American Accounting Association

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Comments on FASB Exposure Draft of *Proposed Accounting Standard Update*  
Notes to Financial Statements (Topic 235): Assessing Whether Disclosures Are Material  
Issued: September 24, 2015

**Overview and Committee Perspective of the Three Main Proposals**

The stated objective of the proposed ASC Topic 235 Update is to improve the effectiveness of footnote disclosures important to users of an entity’s financial statements.

As noted in the Exposure Draft (ED), the main provisions of the update are:

1. Materiality would be applied to quantitative and qualitative disclosures individually and in the aggregate in the context of the financial statements as a whole; therefore, some, all, or none of the requirements in a disclosure Section may be material.
2. Materiality would be identified as a legal concept.
3. Omitting a disclosure of immaterial information would not be an accounting error.

In general, we support the first and third amendment listed above, but do not support the second. We support the first amendment that states materiality is applied to quantitative and qualitative disclosures individually and in the aggregate in the context of the financial statements taken as a whole. This amendment is consistent with both AU-C Section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Generally Accepted Auditing Standards*, and PCAOB Auditing Standard No. 14, *Evaluating Audit Results*. The third amendment listed above states specifically that an omission of immaterial information is not an accounting error. This amendment should remove or reduce the reluctance of entity management to eliminate immaterial disclosures because their non-disclosure would no longer be considered a disclosure error that is reportable to the audit committee. The combined effect of these two amendments would, after the initial materiality assessment, allow entities to reduce their costs by omitting immaterial disclosures. Additional benefits would also accrue to users of the financial statements because material information regarding the entity would not be obscured by immaterial information. Thus, excluding immaterial disclosures would be expected to improve disclosure effectiveness.

However, we generally do not support the amendment to identify materiality simply as a legal concept. While materiality is an elusive concept, it is fundamental to financial reporting in the U.S. The determination of materiality in GAAP has long been based on both quantitative and qualitative factors as determined by professional judgment. Financial statement preparers and auditors must determine whether the magnitude and qualitative characteristics of information would influence the decision of a reasonable person relying on the financial statements.

Under the current legal definition of materiality, a “disclosure generally should be evaluated as material based on whether 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” (FASB ED, Sept. 24, 2015). An issue that arises with defining materiality solely as a legal concept is that it is constructed by, and may be changed from, court decisions and interpretations. Therefore, no single definition of materiality can be relied on in every particular circumstance. This is particularly problematic for professionals preparing or auditing financial statements for organizations that span multiple legal jurisdictions.

We suggest that before the Board takes the step of defining materiality solely as a legal concept, it should consider three crucial questions: 1) whether the Board’s current definition of materiality conflicts with current judicial precedent in such a way as to make them incompatible, 2) whether the courts have set a minimum or maximum standard of behavior for legal liability, and 3) whether materiality is, by its very nature, a legal constraint, or, whether it is a property of individual decision making, which, due to the role of accounting in society, must be applied in an accounting context by professional accountants using professional judgment. In other words, did the Supreme Court of the United States define materiality, or simply recognize and elaborate on the nature of materiality?

In considering the first two questions, it is helpful to first consider the nature and duties of accounting as a profession. According to the Pathways Commission (2012) (jointly sponsored by the AICPA and American Accounting Association) the duty of accountants is to use critical thought and professional judgment to translate economic activity into useful information for decision making in society (Figure 1). If we accept the Pathways Commission’s description of accounting, then accountants are responsible for preparing reliable and relevant information for use in decision making by a wide variety of stakeholders.

It is also helpful to directly compare the various definitions of materiality provided by the Supreme Court of the United States (SCOTUS), the Securities and Exchange Commission (SEC), and the FASB itself (Exhibit 1). Examining the language and intent of the three definitions, we believe that the definitions are largely consistent, and from a professional accounting standpoint, compatible. All three definitions focus on the same three points, (1) an item’s importance to (2) reasonable users (3) in the context of economic decision making.

There are three obvious differences among the materiality definitions in Exhibit 1. First, regarding reasonable users, SCOTUS uses the terms “reasonable shareholder” and “reasonable investor” in its definition. The SEC uses the terms “users of a registrant’s financial statements” along with “reasonable person” as a standard. The Board simply employs the term “users” while omitting “reasonable” from its definition. However, in order to construe this as a conflict in the definitions, one would have to assume that the Board intended to define materiality in terms of both reasonable and unreasonable users. Of course, we believe the Board had no such intention as defining materiality with unreasonable users as a benchmark would be an absurd and futile exercise.
Second, on its face, SCOTUS appears to limit the concept of materiality by using “shareholder” and “investor,” limitations not included in the SEC and FASB definitions. However, this makes the SCOTUS definition narrower in its consideration of users than the SEC and FASB definitions. But, does this create a practical conflict with the SCOTUS opinion on materiality? We believe it does not. If the purpose of the accounting profession is to provide society with reliable and relevant information to aid in economic decisions and accountability (Pathways Commission 2012), then the profession would fall short of its duty to society by only considering investors in materiality decisions rather than the broader class of users. In this light, the legal definition of materiality is only a minimum standard of behavior for accountants. As a principle of the profession, accountants ought to consider the lowest materiality threshold among the groups of reasonable financial statement users. If investors have the lowest materiality threshold, then accountants could set materiality limits in reference to investors without detriment to other users and without violating the SCOTUS decision. On the other hand, if other stakeholder groups have lower materiality thresholds than investors, accountants ought to set materiality to match the needs of those stakeholders. This lower level of materiality would also meet investors’ needs, and accountants would remain in compliance with both the SCOTUS opinion and their broader professional duty to society. Again, in this sense, the SCOTUS definition of materiality is clearly a minimum standard of behavior. Professional duty may require a higher standard of behavior, and accountants can choose to report information immaterial to investors if doing so serves other stakeholders. Therefore, stating that materiality is strictly a legal concept abandons the profession’s duty to all stakeholders.

Third, it is important to note that in all three definitions of materiality, the property making a piece of information material (whether by its omission or inclusion) is the information’s importance to the user’s judgment and decision making process. Gunther (2012) points out at length that the SCOTUS and SEC definitions of materiality take a “would consider” approach to determining the importance of information. SCOTUS uses phrases such as “substantial likelihood… a reasonable shareholder would consider it important.” In contrast, Gunther points out that the Board’s current definition (as well as those of the ASB, IASB, and IAASB) takes a “could consider” approach to the importance of material information by using phrases such as, “Information is material if… it could influence decisions”. Once again, we see that the SCOTUS definition sets a benchmark for materiality that is narrower than the definition crafted by the professional boards. In other words, the SCOTUS definition is a minimum standard of behavior. As a profession dedicated to providing information, we assert that accountants ought to err on the side of providing more rather than less information and allow users to filter information for themselves as necessary. Users cannot increase the granularity of information that has been condensed, though they can further condense more detailed information. Please note, we do not suggest accountants should be forced to provide financial information down to the penny. Rather, we suggest that a professional definition of materiality ought to incorporate a consideration of reasonable users and professional judgment as to the
magnitude and qualitative features of material information in a particular context (much as it currently does in practice).

While we believe we have demonstrated that the SCOTUS and FASB definitions of materiality are compatible, our third question remains – is materiality a legal constraint or a property of individual decision making? If materiality is simply a legal constraint, then it may be safely transferred to the legal realm, and a merely legal definition should suffice. However, if materiality is a property of individual decision making (an individual preference for what “matters”), then it can only be approximated and applied in a financial statement context, and we suggest that accountants, as professionals who are expert in financial information and financial decisions, may be the best suited to defining and determining materiality. In this case, the profession cannot safely abandon the concept of materiality to the legal profession.

Based on the materiality definitions in Exhibit 1, including the SCOTUS definition, materiality is determined by a class of individual financial statement users (i.e., the “reasonable person”). The reasonable user standard does not imply a high level of financial sophistication, and users are unlikely to possess deliberative algorithms for determining materiality, nor do any of the materiality definitions require such algorithms (Hicks 1964, Doxey et al. 2015). Rather, as Doxey et al. (2015, 3) point out:

“…the materiality definitions are based on users’ *prima facie* responses to information: can the information affect the user’s choice to invest, divest, or maintain the status quo? Thus, materiality may be a *revealed* preference based on investor choices under uncertainty rather than a *stated* preference based on exhaustive logic.”

Doxey et al. go on to demonstrate that materiality for non-professional investors exhibits properties consistent with theories of individual choice under uncertainty (namely, Prospect Theory, Cumulative Prospect Theory, and the more specific concept of loss aversion (Tversky and Kahneman 1992)). Further, while users appear to accept an auditor’s reported materiality level when stating a materiality preference, users continue to make investment choices in accordance with their personal materiality preferences. In other words, materiality appears to be connected to the way people actually make decisions.

A number of research articles similarly find that materiality exhibits properties consistent with individual decision making and is not limited to accounting (Hicks 1964, Lev 1968). For example, Firth (1979) demonstrates that materiality judgments vary significantly both among and within groups of accountants (preparers, auditors, and users). Rose et al. (1970) demonstrate that individual user materiality approximates the Weber-Fechner law of stimulus response, which describes cognitive reactions to physical stimuli. Materiality is not something that can be pre-determined and pushed down to a group of users. Such preferences cannot be legislated. Rather, they must be considered with careful professional judgment when compiling and attesting to financial information if accountants are to live up to their professional duties.

Further, with XBRL-tagged financial information, investors may compare financial statement line items across companies (Plumlee and Plumlee 2008; Vasarhelyi et al. 2012), thus materiality may also be applied at the individual financial statement line item level rather than solely at the financial statement level.
Comments on Questions for Respondents

**Question 1.** Would assessing materiality subject to the proposed changes to paragraphs 235-10-50-7 through 50-8 be any easier than under current GAAP? If yes, explain why.

**Comment 1.** Based on the responses to the 2013 disclosure framework field study there is a need for further guidance on exercising reporting discretion and in assessing materiality. However, as noted above, we contend that adoption of the statement that “Materiality is a legal concept” would only increase rather than reduce the confusion in applying an already elusive concept. Instead of providing additional clarity and guidance to the extant literature, adopting this statement would only serve to make assessing materiality all the more difficult by seemingly requiring the advice of legal counsel in applying the concept, or in requiring legal counsel review once decisions regarding materiality have been made.

In addition, from an external financial statement audit perspective, adding the proposed sentence in paragraph 235-10-50-8 would raise the issue of whether determining materiality decisions when planning and conducting the financial statement audit would need to be specifically reviewed by legal counsel, which is probably not done at present by most audit firms on all financial statement audit engagements. Requiring additional legal review of these decisions would lead to additional costs to the audit in terms of additional time and legal fees.

**Questions 2.** Would applying the amendments in this proposal Update significantly increase or reduce costs of preparing the notes to financial statements? Why or why not?

**Comment 2.** We agree with respondent auditors that the cost of complying would decrease significantly after the initial materiality assessment under the Topic 235 Update. Based on the field study, preparers and auditors noted moderate costs that could be incurred to determine whether an omitted disclose is material such as implementing new control procedures and additional effort to support the decisions made when a disclosure is omitted. There is also reduced cost if preparers do not feel obliged to disclose immaterial items. Further, the benefits to resource providers will justify cost of complying with the update because material information would not be obscured by immaterial information.

**Question 3.** Would the amendments in this proposed Update change the information you otherwise would include in the notes to financial statements? Why or why not? If yes, how would that increase, diminish, or otherwise change the notes’ usefulness to investors, creditors, and other financial statement users?
Comment 3. See initial discussion above in the Committee Overview section regarding the benefits that would accrue to users of the financial statements because material information regarding the entity would not be obscured by reporting unnecessary immaterial information. Thus, excluding immaterial disclosures would be expected to improve disclosure effectiveness and enhance disclosure usefulness to financial statement users.

Question 5. How would you disclose information in comparative financial statements if your assessments of materiality differed in different years?

Comment 5. We (the AAA Committee) feel that the ability to compare financial information from period to period provides useful information to investors, creditors, and other users of the financial statements. Therefore, if an item is usually material, but occasionally immaterial, then comparability should override the materiality concept and the immaterial item should be consistently reported for comparability purposes.

Question 6. Should the Board eliminate from the Accounting Standards Codification phrases like “an entity shall at a minimum provide” and other wording that could appear to limit an entity’s discretion to omit immaterial disclosures? Are there particular Topics or Sections in which those changes should not be made? Are there additional paragraphs within the Accounting Standards Codification in which the wording is particularly restrictive and is not identified in Appendix B of this proposed Update? If so, please identify them.

Comment 6. The Committee concurs with the elimination of the phrase, “an entity shall at a minimum provide,” in each disclosure section within the Accounting Standard Codification. Eliminating this phrase from the ASC is consistent with the objectives of the proposed update and would promote reporting discretion on the part of reporting entities. Currently, such language could appear to limit an entity’s discretion and make it difficult to justify omitting immaterial disclosures. Further, requiring any minimum disclosures according to a predetermined list would also reduce reporting discretion as not all reporting areas may be material for every entity or in every situation. Once the phrase is eliminated, we encourage the FASB to provide other guidance appropriate in the circumstance for each reporting area similar to that illustrated in Appendix A of the ED. In addition, the Committee agrees that: 1) each Accounting Standards Codification Topic would state that required disclosures shall be provided if material and 2) each disclosure section would refer readers to amended Topic 235 for discussion of the appropriate exercise of discretion.
References


FIGURE 1

This is accounting!
EXHIBIT 1


“An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote,” and “a substantial likelihood that... the omitted fact would have assumed significance in the deliberations of the reasonable shareholder,” and “a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information made available.”

SEC (SAB No. 99):

“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.”

FASB (SFAC No. 8):

“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.”