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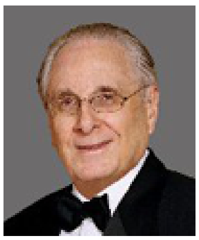
What Is Materiality? SEC & PCAOB *v.* FASB & ASB



BY SAMUEL P. GUNTHER

Following a United States Supreme Court ("Supreme Court" or "Court") decision in 1976 and the issuance by the Financial Accounting Standards Board ("FASB") of Statement of Financial Accounting Concepts No. 2 in 1980, it appeared that the definition of financial statement materiality ("materiality") under generally accepted accounting principles ("GAAP") was clear.

However, the FASB, in 2010, and the Auditing Standards Board ("ASB") of the American Institute of Certified Public Accountants ("AICPA"), in 2011, acting to converge United States accounting and auditing standards with international accounting and auditing standards, adopted changes that affected the definition of financial statement materiality from accounting and auditing perspectives. This article tracks developments in the definition of financial statement materiality and reaches disturbing conclusions.

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TSC v. Northway Defines Materiality in 1976 In *TSC Industries, Inc v. Northway, Inc.* (426 U.S. 438, June, 14, 1976), ("*TSC v. Northway*" or "*TSC*"), 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 with *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 a *substantial likelihood* that, under all the 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 fact *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)

Significantly, 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." Moreover, the Court observed that the Seventh Circuit's test had been rejected by panels of the Second and Fifth Circuits which had "opted for the conventional tort test of materiality – whether a reasonable man *would attach importance* to the fact misrepresented or omitted in determining his course of action.'' (426 US 446) (emphasis added)

See Restatement (Second) of Torts 538(2) (a) (Tent. Draft No. 10, April 20, 1964. See also American Law Institute, Federal Securities Code S 256(a) (Tent. Draft No. 2, 1973).

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.[1] That significant distinction and its implications are as important today as they were in 1976.

TSC v. Northway provides the definition of materiality when interpreting the federal securities laws. Subsequently, in *Basic, Inc. v. Levinson*, 485 U.S. 224, 225 (1988), a 10b-5 case, the Court held that under ''The standard set forth in *TSC* . . . an omitted fact is material if there is a substantial likelihood that its disclosure *would have been considered significant* by a reasonable investor . . .'' (emphasis added)

More recently, in *Matrixx Initiatives, Inc. v. Siracusano*, 131 S. Ct. 1309, 1318-9 (2011), the Court quoted the ''put another way'' articulation of materiality set forth in *TSC* and reaffirmed its position in *TSC* that the materiality standard is satisfied when there is ''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.'' (emphasis added)

FASB From 1973 Until 2010 FASB was created in 1973. 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). FASCON 2 was the second of a series of Statements of Financial Accounting Concepts. As stated in FASCON 1 ''Objectives of Financial Reporting by Business Enterprises,'' ''Statements of Financial Accounting Concepts are intended to establish the objectives and concepts that the Financial Accounting Standards Board will use in developing standards of financial accounting and reporting.'' (FASCON 1, Nov. 1978, CON1-3). ''Unlike a Statement of Financial Accounting Standards, a Statement of Financial Accounting Concepts does not establish accounting principles and therefore is not intended to invoke the application of Rule 203 of the Rules of Conduct of the Code of Professional Ethics of the American Institute of Certified Public Accountants . . .'' (CON 1-3)

In FASCON 2, the FASB described two earlier cases that concluded information is material if ''. . . the trading judgment of reasonable investors *would not have been left untouched* upon receipt of such information'' *Mitchell v. Texas Gulf Sulphur Co.* 446 F. 2d 90, at 99-100 (10th Circuit, 1971) (emphasis added) and a material fact is one ''which if it had been correctly stated or disclosed *would have deterred or tended to deter* the average prudent investor from purchasing the securities in question'' *Escott v. Bar Chris Construction Corporation et al*, (283 F. Supp. 681, District Ct. SDNY, NY, 1968) (emphasis added) (FASCON 2, Par. 163). FASB stated that *TSC v. Northway* gave ''added authority to that view [referring to the two cases just cited] of materiality'' (FASCON 2, Par. 164). FASB concluded that:

''Until such time as the Supreme Court returns to this question, the *Northway* case provides the most authoritative judicial definition of what constitutes a material omitted fact.'' (FASCON 2, Par. 165). Ultimately, in the Glossary to FASCON 2, FASB defined financial statement materiality as:

> the magnitude of an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it *probable* that the *judgment of a reasonable person relying* on the information *would have been changed or influenced* by the omission or misstatement. (FASCON 2, Page 6) (emphasis added)

It is not surprising that, after the Supreme Court's *TSC v. Northway* decision, the FASB adopted a ''would have been changed or influenced'' formulation of materiality. That language is substantially the same as the language in *TSC v. Northway*.

Through silence, FASCON 8 treated *TSC v. Northway* as if it had never been decided.

It is unfortunate that the FASB's conclusion in FASCON 2 was issued in a Concepts Statement rather than a Statement of Financial Accounting Standards. Indeed, the FASB has never defined materiality in any authoritative document. Nevertheless, each FASB Statement of Financial Accounting Standards included the caveat that ''The provisions of this Statement need not be applied to immaterial items.'' That caveat is now included in FASB's Accounting Standards Codification that, in 2009, superseded all prior GAAP[2]. Thus, FASB has traditionally told financial statement preparers and users that they were expected to understand what is immaterial without providing authoritative FASB guidance to determine that which is material.

Between 1980 and 2010, the FASB neither amended FASCON 2 nor issued a superseding Statement of Financial Accounting Concepts. During that period, the *TSC v. Northway*/FASCON 2 definition of materiality became commonly applied GAAP by companies that issued GAAP financial statements. As discussed later in this article, FASB's definition of materiality changed in September 2010 when FASB issued FASCON 8.

The SEC and SAB 99

Historically, the SEC's Regulation S-X has stated: ''The term 'material' when used to qualify a requirement for the furnishing of information as to any subject,

[1] If the ''might consider important'' test were instead articulated as a ''could consider important'' test, that word change would not alter the results noted in *TSC v. Northway*. ''Might'' and ''could'' are conditional, but ''would'' is not conditional. Regardless of whether the word ''might'' or ''could'' were used, information that ''would be considered important'' constitutes a subset of facts that ''might'' or ''could'' be considered important. In a litigation context, the difference between the meaning of ''would be considered'' important and ''might'' or ''could'' be considered important cannot be overstated.

[2] Codification 105-10-05-6

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limits the information required to those matters about which an average prudent investor *ought* reasonably to be informed.[3]" (emphasis added) Although the Commission used "ought" (a synonym for "should") in that definition, the language provides no guidance to explain why information "ought" to be provided. The definition is a conclusion, not guidance.

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 is 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*." (emphasis added) 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" and the "significantly altered the total mix of information made available" 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. That view remains in effect and is consistent with the GAAP definition of materiality as applied in practice by SEC filing companies and as used by independent auditors.[4]

Auditing Standards Board Pronouncements and GAAP Materiality until 2011

In December 1983, the ASB, the AICPA's senior committee for promulgating generally accepted auditing standards, issued Statement on Auditing Standards No. 47 "Audit Risk and Materiality in Conducting an Audit ("SAS 47")." SAS 47 was immediately incorporated as AU 312 in the AICPA's Codification of Statements on Auditing Standards. 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.

Materiality in International Pronouncements and Convergence: The FASB and the Auditing Standards Board React, the PCAOB Acts

I. International Standards

A. IASB. In 2010 the "Conceptual Framework for Financial Reporting" issued by the International Accounting Standards Board" ("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)

The definition of materiality in the IASB Framework just quoted is substantially the same as the definition of material in International Accounting Standards No. 8 ("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 the basis of the financial statements.

(emphasis added)

The IAS 8, paragraph 5 definition has been in effect at least since January 1, 2005.

A Glossary of Terms extracted from International Financial Reporting Standards as of December 31, 2009 defines materiality:

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

(emphasis added)

B. 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 International Auditing and Assurance Board ("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 IAASB apply a "could influence" standard for financial statement materiality which differs significantly from the "would influence" standard in the United States.

II. 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 with the International Accounting Standard Board (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 FASCON 8).

(emphasis added)

FASCON 8 further says that:

> The Board recognizes that in certain respects current generally accepted accounting principles may be inconsistent with those that may derive from the objectives and fundamental concepts set forth in Concepts Statements. However, a Concepts Statement does not (a) require a change in existing U.S. GAAP; (b) amend, modify, or interpret the Accounting Standards Codification; or (c) justify either changing existing generally accepted accounting and reporting practices or interpreting the Accounting Standards Codification based on personal interpretations of the objectives and concepts in the Concepts Statements."

[3] Regulation S-X- Rule 1-02(0).

[4] SAB 99 has been included as Topic 1-M of the Codification of Staff Accounting Bulletins.

(Unnumbered page in FASCON 8 headed ''Statements of Financial Accounting Concepts''.)

In the section of FASCON 8 that superseded FASCON 2, FASB abruptly and 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.

When formulating its materiality definition in FASCON 2, FASB adopted the rationale and language of *TSC v. Northway*. In FASCON 8, FASB did not discuss what had occurred in practice since FASCON 2 was issued. Nevertheless,FASB abandoned the reasoning of *TSC* and adopted the position of the IASB and effectively agreed with the thinking of the Seventh Circuit which the Supreme Court rejected in 1976.

Strikingly, FASB said *nothing* in FASCON 8 about *TSC v. Northway* which the FASB applied in FASCON 2 as the basis for its analysis of materiality. Through silence, FASCON 8 treated *TSC v. Northway* as if it had never been decided. This absence of an analysis is important for a number of reasons. One is that the FASB has never provided an authoritative definition of materiality but now, without explanation, has changed its prior non-authoritative guidance in FASCON 2, without considering the effects FASCON 2/*TSC v. Northway* has had on practice.

Second, perhaps the FASB believes that FASCONs, which do not constitute US GAAP and which purportedly do not change existing US GAAP, are not taken seriously in applying existing GAAP, but should be evaluated only as ''concepts that will underlie guidance on future accounting practices and in due course will serve as a basis for evaluating existing guidance and practices.'' (FASCON 8, second unnumbered page)

The FASB presents no good reason for its dramatic shift in the FASCON definition of materiality. Apparently, the FASB has not evaluated the impact of thirty years of practice following the issuance of FASCON 2 which was *based on* the language of *TSC v. Northway*. FASCONs have affected GAAP in practice and that impact should have been analyzed *before* ''conforming frameworks.''

Third, perhaps FASB simply conformed its definition of materiality to the international accounting standards definition. That disregarded the need for a discussion of why the FASCON 8 position was an improvement on the FASCON 2/*TSC v. Northway* standard.

III. PCAOB Issues Auditing Standard No. 11 In December, 2010 Two other significant events occurred after September 2010. The first was the issuance on December 23, 2010, by the Public Company Accounting Oversight Board (''PCAOB'') of its 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 obviously rejected the FASCON 8 definition of materiality issued shortly before Auditing Standard No. 11 was issued. The PCAOB's position was consistent with the conclusion in SAB 99.

IV. SAS 122 A second significant event occurred in October 2011. In SAS 122 ''Clarification and Recodification,'' effective for audits of financial statements for periods ending on and after December 15, 2012, the ASB of the 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, effective for audits of financial statements of non-SEC reporting companies for periods ending on or after December 15, 2002; see also paragraph 320.07 of AU-C Section 320 re effective date) (emphasis added)

In SAS 122, the ASB adopted almost verbatim the IAASB definition of materiality, which was consistent with the IASB definition of materiality and with the FASCON 8 definition of materiality. When the ASB issued SAS 122, the ASB must have been aware of the recent positions taken by the IASB, the IAASB, and the FASB in FASCON 8. The ASB was, or should have been, aware of the different position adopted by the PCAOB which expressly relied upon the ''would have'' language of *TSC*, in its Auditing Standard No. 11. Indeed, the Convergence paragraph under the Foreward to SAS 122 stated:

> Consistent with the ASB's *strategy to converge* its SASs with International Standards on Auditing (ISAs) promulgated by the International Auditing and Assurance Standards Board while *avoiding unnecessary conflict with standards of the Public Company Accounting Oversight Board*, clarified SASs have been developed using equivalent ISAs as a base, when applicable. Substantive differences in objectives, definitions, or requirements between a clarified SAS and the equivalent ISA are identified in an exhibit to each applicable clarified SAS. (emphasis added)

Apparently, the ASB simply adopted the IAASB definition of materiality (*i.e.* the same definition of materiality as that which also appears in non-authoritative FASCON 8 and as defined by the IASB). Inferentially, when issuing SAS 122, the ASB must have deemed the different definition of materiality perpetuated by the PCAOB in its Auditing Standard No. 11 as having placed the ASB in the position of having to create a ''*necessary* conflict'' between the ASB and the PCAOB.

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At the end of 2012, the position taken by the ASB, by redefining ''materiality in the context of an audit,'' will differ in practice from the PCAOB definition of ''materiality in the context of an audit.'' If the financial statements of a public company are audited, an independent auditor will apply the ''would have assumed actual significance test'' of *TSC v. Northway* when determining materiality. If the financial statements of a non-SEC filing company are audited, an independent auditor will be required by SAS 122 to apply the ''*could* reasonably be expected to *influence*'' test. If a hypothetical U.S. company has an SEC filing obligation, the standard of that which is material to the financial statements of that company will differ from that which is material to that same company if it were not obliged to file with the SEC. That is as inappropriate as defining assets and liabilities of SEC filing companies different from assets and liabilities of non-filing entities that purport to fairly present financial statements in accordance with GAAP. The ASB provides no reason for that salient difference. Simply adopting an international standard does not provide a substantive analysis.

Commencing with audits of calendar year 2012 financial statements, the ASB elected to adopt a new definition of materiality (applicable only to non-SEC filing companies) that has never been, and is not now, authoritative in the United States. Peculiarly, by relying on non-authoritative FASCON 8, IASB and IAASB pronouncements, while at the same time rejecting the long standing *TSC v. Northway* standard previously applied and now required by the PCAOB to be applied by independent auditors of SEC filing companies, the ASB has effectively imposed a soon-to-be applicable back door GAAP definition of materiality as guidance to U.S. auditors of non-public U.S. companies. The SAS 122 guidance will directly contradict the historical definition of materiality as applied in practice for more than 30 years (which remains unchanged for SEC filing companies).

The author is not aware of any U.S. company (or any U.S. auditor) that has ever applied to U.S. GAAP financial statements the IASB or IAASB definition of materiality or the new non-authoritative FASCON 8 definition of materiality. For the purpose of conforming to international standards, the ASB has redefined materiality by applying a standard never before and not now used in the United States. Moreover, the ASB did not articulate its thought process that enabled the ASB to conclude that its new position did *not* cause ''unnecessary conflict'' with PCAOB Auditing Standard No. 11 and with prior practice. This conflict with the PCAOB and with the historical accounting practice definition of materiality is grave and important. The correct approach for the ASB to have followed on this critical subject would have been to ''converge'' with the approach that the ASB knew, or should have known, had been adopted by the PCAOB (which continues to apply the long used standard and well understood definition of materiality for all U.S. companies) and let others ''converge'' with that better standard.

Observations and Conclusions Efforts by the FASB to converge its accounting framework with that of the IASB and similar efforts by the ASB to converge its statements on auditing standards with international auditing standards promulgated by the IAASB have created inconsistent definitions of accounting materiality in the US.

By issuing FASCON 8, which conformed to the IASB's accounting framework and to the IAS 8 definition of materiality, the FASB rejected FASCON 2. FASCON 2 had relied on and tracked the thinking and the language of *TSC v. Northway*. In contrast to FASCON 8, in Auditing Standard No. 11 issued by the PCAOB, with required SEC approval, the PCAOB affirmed the continued application of the *TSC* definition of materiality and continued the application of historical auditing guidance to independent auditors for evaluating materiality in the context of an audit. Accordingly, the positions of the SEC and the PCAOB contradict the current view of financial statement materiality held by the FASB and the ASB.

This strange split between the PCAOB/SEC and the FASB/IASB/IAASB/ASB raises difficult questions for companies that might make filings with the SEC that include financial statements prepared using international accounting standards.

What will the SEC's position be if the IASB definition of financial statement materiality applied by registrants in those filings differs from the *TSC v. Northway*/PCAOB definition? How will independent auditors who are subject to auditing standards issued by the PCAOB be able to conform to PCAOB Auditing Standard No. 11 while also conforming to current Section 320 of IAASB Auditing Standards, if those respective standards define materiality differently?

Differences in definitions of financial statement materiality will have a more immediate effect on companies in the U.S. that do not have SEC filing obligations and on independent auditors who audit those financial statements. When auditing calendar year 2012 financial statements, the ASB's AU-C 320.07 will require use of a standard for measuring materiality in the context of an audit that will differ from the historical definition of materiality established by *TSC* and by more than thirty years of practice.[5]

What definition of financial statement materiality will be applied by those companies? In executing letters from auditors to counsel for information about litigation and in lawyers' letters in response to those auditors, how will the term ''material'' be defined? Why will independent auditors of domestic companies that do not have SEC filing obligations be required to apply a different definition of financial statement materiality from auditors of comparable companies that have filing obligations with the SEC?

Reducing differences between accounting and auditing standards in the United States and comparable international standards are worthwhile objectives. Unfortunately, recent positions taken by the FASB and the ASB concerning the definition of financial statement materiality will not help achieve those objectives. Instead, simply conforming FASB and ASB pronouncements on this subject with their international counter-

[5] In 2011, the AICPA issued a booklet entitled ''The Clarity Project: Background and Resources'' to inform auditors about changes covered by the Project and by the ASB's convergence of U.S. Generally Accepted Auditing Standards with International Standards on Auditing. When describing the difference between the ''could'' influence language in new AU-C 320 (SAS 122) and the ''would'' influence language in superseded AU 312 (SAS 107), the writers of the booklet stated that ''The clarified SAS does not change or expand existing requirements in extant AU 312 in any significant respect.'' (P. 51)

parts will cause mischief in the United States when attempting to apply a definition of materiality.

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