FASB FINANCIAL ACCOUNTING STANDARDS BOARD

FASB Memo No.	**80 IASB Agenda Paper 17D**
Issue Date	**September 11, 2015**
Meeting Date	**Joint BM September, 23, 2015**

Memo

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Project	**Disclosure Framework**
Project Stage	**Initial Deliberations**
Issue(s)	**Entity's Decision Process**

Introduction

1. The objective and primary focus of the disclosure framework project are to improve the effectiveness of disclosures in notes to financial statements by facilitating clear communication of the information required by generally accepted accounting principles (GAAP) that is most important to users of each entity's financial statements. Achieving the objective of improving the effectiveness of notes to financial statement requires reporting entities to have the appropriate amount of discretion when evaluating disclosure requirements set forth by the Board.

2. To promote discretion, the Board is issuing additional guidance on materiality for the following three reasons:

   (a) Respondents to past requests for comments on guidance in proposed Accounting Standards Updates often have stated that while certain proposed disclosures may be relevant to other entities, those disclosures do not provide relevant information in their own circumstances.

   (b) Respondents to the FASB Invitation to Comment, *Disclosure Framework*, and the guidance in the proposed FASB Concepts Statement, *Conceptual Framework for Financial Reporting—Chapter 8: Notes to Financial Statements*, requested

that facilitating discretion and assessments of materiality be addressed in the *FASB Accounting Standards Codification*®.

(c) The results of the 2013 disclosure framework field study conducted by the FASB staff indicated that:

(i) Additional explanation about how to appropriately consider materiality or entity-specific relevance in deciding which information to provide in notes could be effective in reducing or eliminating irrelevant disclosures.

(ii) A reduction in volume of immaterial information would improve the effectiveness of the notes to financial statements.

3. FASB Concepts Statement No. 8, *Conceptual Framework for Financial Reporting,* currently defines *materiality* as follows:

> 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.

The Accounting Standards Codification does not contain a definition of materiality.

4. The discussion that follows highlights the potential changes to Topic 235, Notes to Financial Statements, the potential changes to Chapter 3, *Qualitative Characteristics of Useful Financial Information*, of Concepts Statement 8, and how the potential changes differ from IFRS.

Potential changes to the Accounting Standards Codification

5. The potential changes to the Accounting Standards Codification are intended to address some of the concerns expressed about exercising discretion in providing information in notes to financial statements. Specifically, the potential changes would clarify that reporting entities need not disclose immaterial information even if that information is cited in a list of disclosure requirements GAAP. The potential changes to the Accounting

Standards Codification would state that:

(a) Materiality would be applied to quantitative and qualitative disclosures individually and in the aggregate in the context of the financial statements as a whole; some, all, or none of the requirements in a disclosure Section may be material.

(b) Materiality would be identified as a legal concept.

(c) Omitting a disclosure of immaterial information would not be an accounting error.

6. The amendments to the Accounting Standards Codification would apply only in the context of disclosure requirements. Therefore, it would be inappropriate to apply the amendments by analogy to other Sections (for example, Recognition, Presentation, and Measurement) within the Accounting Standards Codification.

7. Because the Board is trying to promote the use of discretion, it wants GAAP requirements to be stated in a way that would not impede the use of materiality in assessing whether an entity must provide disclosures. Therefore, the Board decided that the following changes should be made to the disclosure Sections within the Accounting Standards Codification:

(a) Each Topic would state that an entity should provide required disclosures if they are material.

(b) Each disclosure Section would refer readers to Topic 235 on notes to financial statements, as amended by the forthcoming proposed Update on Topic 235, for discussion of the appropriate exercise of discretion.

(c) Existing phrases like *shall, at a minimum, include,* which make it difficult to justify omitting immaterial disclosures, would be replaced with less prescriptive language.

Basis for the Potential Changes to the Accounting Standards Codification

8. 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 the U.S. securities laws. That definition can be summarized by stating that disclosures generally should be evaluated as material on the basis of 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.

(c) Note that the U.S. Supreme Court's definition is established by court decisions and interpretations and may change; therefore, no single definition of materiality can be relied on to identify what may be material in every specific circumstance.

9. However, the Board ultimately decided that the Accounting Standards Codification would only 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, it does not promulgate a definition of materiality.

10. Errors and omissions often are assessed on a quantitative basis in the context of an audit. Practice has influenced the way in which preparers view materiality judgments on disclosures. That is, preparers participating in the 2013 field study demonstrated that they were more comfortable with assessing quantitative disclosures in the notes to financial statements as compared with assessing whether a qualitative disclosure was material. In some cases, they questioned whether qualitative disclosures were eligible to be assessed on the basis of materiality. Therefore, the potential changes would clarify that the materiality of both quantitative and qualitative disclosures can be assessed.

11. Some preparers state that they perceive all disclosures in a Topic to be required if that Topic relates to a material element in their entity's financial statements. The potential changes would state that materiality should be applied to disclosures individually and in

the aggregate. Therefore, preparers (as well as auditors and regulators) should be evaluating whether the disclosure is material, not the Topic itself. This is consistent with U.S. Securities and Exchange Commission (SEC) Staff Accounting Bulletin (SAB) Topic 1.M, *Financial Statements—Materiality.*

12. SAB Topic 1.M states that "…registrants and the auditors of their financial statements should consider each misstatement separately and the aggregate effect of all misstatements" (footnote reference omitted). SAB Topic 1.M is not limited to assessments of materiality about disclosures. SAB Topic 1.M goes on to state that "registrants and their auditors first should consider whether each misstatement is material, irrespective of its effect when combined with other misstatements." SAB Topic 1.M also states the following:

> 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.

13. Similarly, both AU-C Section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Generally Accepted Auditing Standards,* (which applies to private companies) and PCAOB Auditing Standard No. 14, *Evaluating Audit Results*, state that materiality should be considered individually and in the aggregate and that judgments about materiality involve both qualitative and quantitative considerations.

14. Field study participants and others consistently cited two obstacles to omitting immaterial disclosures—auditor objections and required communications to audit committees. A few field study participants also stated that if a particular note was not costly to prepare (for example, the accounting policy note), they would be inclined to retain the disclosure instead of incur the costs of defending to the auditor or communicating to the audit committee the removal of the disclosure. The Board concluded that because excluding immaterial disclosures can improve the effectiveness of the financial statements, omitting an immaterial disclosure should not constitute an error.

Differences between the Accounting Standards Codification and IFRS

15. IAS 1, *Presentation of Financial Statements*, states that an entity need not provide a disclosure if the information is immaterial even if a requirement is worded in a way that appears to limit an entity's ability to omit any of the disclosures. The potential changes to the Accounting Standards Codification would state that the omission of disclosures is not an accounting error if the omitted information is immaterial, individually or in the aggregate. IAS 1 and the potential changes to the Accounting Standards Codification appear to be consistent even though IAS 1 makes a blanket statement about restrictive wording. (The FASB expects to remove phrases such as *disclose at a minimum* that might appear to override the materiality provisions of Topic 235.)

16. Paragraphs 30 and 30A of IAS 1 include the following discussions of matters that are not addressed in the potential changes to the Accounting Standards Codification:

> 30. If a line item is not individually material, it is aggregated with other items either in those statements or in the notes. An item that is not sufficiently material to warrant separate presentation in those statements may warrant separate presentation in the notes.
>
> 30A. An entity shall not reduce the understandability of its financial statements by obscuring material information with immaterial information or by aggregating material items that have different natures or functions.

17. IAS 1 requires an entity to consider providing additional disclosures if necessary to enable financial statement users to understand the entity's financial position and financial performance.

18. Some Topics in the Accounting Standards Codification include statements that an entity may need to disclose information beyond the requirements, but for which there is no overarching principle. SEC Regulation S-X, Rule 4-01, *Rules of General Application: Form, Order, and Terminology*, states that registrants have the responsibility to disclose any additional information necessary to ensure that the required statements are not misleading.

Changes to Concepts Statement 8

19. The main amendment to Concepts Statement 8 would state that:

(a) Materiality is a legal concept.

(b) In the United States, a legal concept may be established or changed through legislative, executive, or judicial action.

(c) The Board observes but does not promulgate definitions of materiality.

(d) Currently, the Board observes that the U.S. Supreme Court's definition of materiality, in the context of the antifraud provisions of the U.S. securities laws, generally states that information is material if there is a substantial likelihood that the omitted or misstated item would have been viewed by a reasonable resource provider as having significantly altered the total mix of information.[1] Consequently, the Board cannot specify or advise specifying a uniform quantitative threshold for materiality or predetermine what could be material in a particular situation.

20. The definition of materiality in Chapter 3 of Concepts Statement 8 as originally issued was inconsistent with the legal definition of materiality in the United States. That inconsistency created uncertainty about the potential interpretations and how to reconcile the two when assessing materiality. The definition in Chapter 3 was not intended to be different from the legal concept of materiality. The Board decided that the simplest and most effective way to avoid creating uncertainty or confusion is to (a) make it clear that the Board should not define materiality and (b) remove the existing definition of materiality and replace it with a Board observation of the U.S. Supreme Court's definition.

Differences between the Potential Changes to Concepts Statement 8 and Existing and Proposed IFRSs

21. The existing definitions of materiality in Concepts Statement 8 and the IASB's *Conceptual Framework for Financial Reporting* were identical when they were issued. IAS 1 and IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors*, also

[1]TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438 (1976).
Basic Inc. v. Levinson, 485 U.S. 224 (1988).

include definitions of materiality. The proposed amendments to the FASB's Concepts Statement as well as recently proposed changes by the IASB on its Conceptual Framework (May 2015, IASB Exposure Draft, *Conceptual Framework for Financial Reporting)* would result in differing definitions.

22. IAS 1 currently states that:

> **Material 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. Materiality depends on the size and nature of the omission or misstatement judged in the surrounding circumstances. The size or nature of the item, or a combination of both, could be the determining factor.**
>
> Assessing whether an omission or misstatement could influence economic decisions of users, and so be **material**, requires consideration of the characteristics of those users. The *Framework for the Preparation and Presentation of Financial Statements* states in paragraph 25 that 'users are assumed to have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information with reasonable diligence.' Therefore, the assessment needs to take into account how users with such attributes could reasonably be expected to be influenced in making economic decisions. [Footnote reference omitted.]

23. The May 2015 IASB Exposure Draft proposes the following changes:

> 2.11 Information is material if omitting it or misstating it could influence decisions that the primary users of general purpose financial reports…make on the basis of financial information about 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~~IASB cannot specify a uniform quantitative threshold for materiality or predetermine what could be material in a particular situation.

24. Some of the most significant differences between the IASB's definitions and the FASB's proposed amendments (that are in the late drafting stages at the time this memo was issued) would include the following:

    (a) The use of the phrase *substantial likelihood…would* instead of *could reasonably be expected to*: IAS 1 states that materiality is assessed by taking into account how users could reasonably be expected to be influenced by information. The proposed amendments observe information as material if there is a substantial likelihood that it would alter a reasonable investor's views of the total mix of information available.

The term *could* suggests the potential that information might make a difference even if it ultimately does not. The term *would* is more restrictive, limiting the information to that which does make a difference. Modifying *would* with *substantial likelihood* inserts a notion of probability into the determination of what is material. On the other hand, *could reasonably be expected to* results in a less open-ended determination of what to disclose on the basis of the reasonable expectations of the preparer about what matters to users.

(b) Entity-specific aspect of relevance: IFRSs state that materiality is an entity-specific aspect of relevance. The FASB's proposed amendments would remove this wording.

(c) Total mix of information: IFRS' definition describes materiality as it applies to financial information about a specific reporting entity. The definition of materiality in the proposed amendments would apply to the total mix of information.

(d) Reasonable person: The proposed amendments would refer to the decisions of a "reasonable resource provider." IFRS' definition uses the term *primary user*, which references the users as described in its Exposure Draft on conceptual framework that "…have a reasonable knowledge of business and economic activities and who review and analyse the information diligently." IAS 1 references the reasonable expectations of the preparers about what would influence the primary users' decisions.

25. Furthermore, the IASB has expressed a tentative view (that would be exposed in a Discussion Paper on its project on principles of disclosure) that would define materiality as information that if omitted, misstated, or obscured could reasonably be expected to influence decisions. The FASB's proposed amendments do not specifically address obscured information.