Ross Roundtable

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Assessing Materiality: The FASB's Proposed Accounting Standards Update

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True to its mission, the Ross Roundtable invited representatives ranging from professional accountants, academics, standard setters, financial statement preparers, analysts, investors, and more to discuss a controversial topic that is high on the FASB's agenda, with potentially widespread effects: assessing materiality in financial statements. For many years, the Roundtables have successfully generated public dialogue, engaging in topics that benefit many sectors of society and this event proved to be no different.

Professor Paul Zarowin, Director of the Ross Institute and moderator of the panel, began the event with a poignant tribute to Claire Eckstein, acknowledging her deep contributions to both NYU and the Ross Roundtables. "Claire truly loved the search for knowledge and truth…this is what this institute is all about…she will be deeply missed but not forgotten." Other participants echoed his sentiments and added personal stories of her professional devotion and personal friendship; as Professor Baruch Lev commented, "Behind her resume was a wonderful human being". Claire's children graciously and gratefully accepted a plaque acknowledging her dedication and contributions.

Background on the topic:

The FASB's proposal to assess materiality is a component of the broader Disclosure Framework project. The materiality proposal would effectively change the definition of materiality, and thus what corporations would be required to disclose. Under the proposed standard, materiality would be based on a legal definition, as cited by the Supreme Court in cases of securities fraud. The new guidelines may give companies more discretion for determining their disclosures. This may decrease the amount of information disclosed, possibly rendering financial statements less informative and markets less efficient. Alternatively, the guidelines may reduce the proliferation of irrelevant information, improving disclosure effectiveness. As described in *The New York Times*[1], the proposal has generated significant controversy among the FASB, major accounting firms, corporations and investors.

Professor Zarowin kicked off the discussion by providing historical data indicating the significant increase in disclosures over time and inviting the representatives to share their diverse perspectives on this issue.

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[1] http://www.nytimes.com/2016/01/03/business/fasb-proposes-to-curb-what-companies-must-disclose.html?_r=0

Note that the panelists provided their personal viewpoints and they do not necessarily represent the opinions of their organizations.

Viewpoints from the FASB:

Nicholas Cappiello, FASB, Supervising Project Manager on the Disclosure Framework project:

Nick launched the discussion by providing an historical explanation of how the Board came to the project on materiality. The Board is pursuing 2 routes to improve effectiveness of disclosures that appear in the Notes that accompany financial statements. First, the Board released a proposed concept statement documenting the need for a consistent and comprehensive approach to how the Board sets disclosures. Second, in response to feedback from the proposed concept statement, the Board is working to clarify how materiality should be viewed in the context of making disclosures in the notes. The Board is considering how individual disclosures indicate materiality thresholds, providing preparers with more discretion in determining disclosures, and more guidance on assessing materiality. The Board has also revised Concept Statement 8 to specify that the Board observes the Supreme Court definition of materiality. Currently, the materiality project is focusing on the following 4 specific disclosure areas to incorporate notions of materiality into the wording: income taxes, inventory, pensions and fair value measurement disclosures.

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Marc Siegel, FASB Member of the Board:

Marc was the final speaker of the panel, providing a full circle discussion that started and ended with the FASB. He reiterated that the Disclosure Framework is much broader than materiality and it is explicitly not intended to address the volume of disclosures. This project is about effective communication, trying to improve upon the current "checklist mentality" of getting through the footnotes into creating disclosures that serve as a meaningful communication vehicle. He encouraged the audience to review the original discussion paper regarding the principles of the footnotes. The feedback from this paper highlighted the need to clarify materiality as it relates to the footnotes. The feedback also highlighted that when the FASB changed its description of materiality to converge with IASB in 2010, this created a conflict between the new FASB definition as compared to the definitions used by the SEC, the audit literature and the Supreme Court. Thus, the FASB felt the need to review this issue more thoroughly and clarify the expectations. Once the Board has a chance to review feedback on the 4 disclosure areas mentioned above, they will decide how to finalize these elements within the Disclosure Framework project.

Viewpoints from the Big 4 Accounting Firms:

Neri Bukspan, Partner, EY:

Neri revisited the data provided by Professor Zarowin regarding the exponential growth of disclosures. "There are ways to create efficiencies in how we sort through the information…the issue is right-sizing, right-providing and right-depicting…in 20 years we will not be discussing pages, it will be swipes and clicks". Neri focused on the overarching principle and expressed that materiality goes to the heart of the entire financial reporting process in its ability to effectively fulfill its purpose and mission in the marketplace. Materiality impacts not only the constituents gathered today, it also transcends the accounting world to standard-setters that consider what information should be provided to investors, such as sustainability data. He recommended approaching the project from a broad view of the financial statements and the footnotes. "What should be in them and why? What is important?" Neri stressed the importance of clarifying the nomenclature to avoid confusion regarding "could" vs "would" standards. Under current FASB guidance, a "could" standard applies which means materiality relates to information that "*could*" influence decisions that users make on the basis of the financial information of a specific reporting entity." Under the new proposal, information would be considered 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."[2] Neri also recommended clarifying *what* is included, for example, identify if the footnotes and MD&A are different from the financial statements and if so, how? Address the relationship of materiality to immateriality; are they inverse? How do we identify the "dividing line" between materiality and immateriality?

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Patrick Durbin, Partner, PwC:

Pat stressed that this project should be focused on the importance of materiality in the context of financial reporting. This is a professional concept that should be decided by the financial reporting professionals and accountants, not the lawyers or the courts. "We are at an inflection point with regulatory pressures that have emerged over the last decade in the auditing profession… (there is) practical friction that creates the financial reporting process and also the explosion of the availability of information, complexity of business models and new ways to consume that information." Striking the right balance is the challenge we face.

[2]https://blogs.cfainstitute.org/marketintegrity/2016/01/25/sec-investor-advisory-group-to-fasb-materiality-is-material/

Viewpoints from preparers of financial statements:

Jason Hayes, Manager, Corporate Accounting Policy, Verizon:

Jason began his discussion expressing support for the FASB project as it is forward-looking and progressive, however, it is a process and there is still work to be done. Materiality is always a topic of debate due to the subjective nature and the need to consider whether to assess individually or in the aggregate. As preparers, they assess both ways so this project is really about codifying what is already in general practice. Materiality as a legal concept raises concerns due to the interpretation across jurisdictions and anti-fraud implications.

Viewpoints from legal perspective:

Stanley Siegel, Professor of Law Emeritus, NYU School of Law:

Professor Siegel stressed the need for the accounting profession to define materiality, not the lawyers and courts. "Materiality is ultimately a threshold test of what must or must not be disclosed …in some setting, it may be legal, professional, criminal, it is a standard and to suggest it is not a standard is to look the other way… it is a standard that underlies everything we do, what do we disclose, what do we not disclose. Materiality has meaning in several contexts: regulatory, legal, accounting, criminal…those meanings may not be the same in every context. It doesn't follow that what is material for a criminal case is material for accounting disclosure. We have many concepts in accounting and elsewhere where we are ready to accept a fact that a standard or concept is different in different settings... we have different depreciation rules for tax…for acquisitions…we have lived with different standards…those few who have tried to make them the same, such as Germany, failed and failed colossally. The reason they failed is the standards are purpose-driven…different contexts call for different approaches." Professor Siegel discussed the historical evolution of materiality and explained that there is not 1 legal standard, rather there are varying standards under State laws vs Federal law. The definition used by the US Supreme Court is not based on the Constitution, but is based on prominent cases under the 1934 Securities and Exchange Act. These cases were dealing with criminal cases, which requires a high degree of demonstration of inappropriate conduct. "Do we want to import into accounting the notion of materiality that is so high that by violating it, we find the law is criminal? Are we comfortable with judges deciding standards of disclosures in accounting?"

Professor Siegel went on to contrast the evolution of US GAAP accounting that was developed by the accounting professionals as compared to most of the rest of the world where accounting is part of the law that is written into statutes. He praised the unique structure and remarkable growth of accounting principles in the US that made it the "envy of the world". He cautioned against allowing this definition to become a legal decision, "In discussing materiality, we are discussing an undergirding principle of enormous importance, it affects every single disclosure that there is and if this (is) conceded by us as accountants as part of a federal structure of law, I think we have shifted the direction of development of accounting…the wrong way…It is we who ought, for our profession, to define what we need and what we think".

Viewpoints from analyst/investment community:

Sandra Peters, Head, Global Financial Reporting Policy Group, CFA Institute:

Sandra began her discussion by identifying the 2 primary issues the FASB proposal will address: the need to provide preparers' with discretion and the need to reduce the volume of disclosures. She questioned whether there is consensus that these are the correct issues to address. On one side, there is talk of information overload and thus investors are using their own non-GAAP analysis while on the other, they hear that the investors need more information. In response to these conflicting signals, the CFA Institute undertook a study to provide investor views on the effectiveness of financial reporting disclosures. The survey results, published in 2013, indicated that the top priorities for investors was emphasizing matters of importance ("tell us what's the biggest deal"), improve financial statement presentation so we can see how these transactions flow through the financial statements and increasing communication effectiveness through the use of tables/charts/cross-referencing. Investors clearly indicated that they were not interested in reducing volume or creating a framework for disclosures. Investors also indicated that they did not feel there was a significant amount of immaterial information currently disclosed. The CFA Institute senses there is a communication issue rather than a definition of materiality issue. Sandra moved on to the discussion of increasing the discretion used by preparers and she reiterated Neri's perspective of clarifying the nomenclature to avoid confusion. There are a few practical considerations and consequences of increasing discretion, such as the possibility that management will choose to omit parts of disclosures and this may not provide a comprehensive portrayal of a business activity. Conceptually, investors do not understand what triggered this project, "why this, why now and what is it going to do for me"? Ultimately, the CFA Institute feels that it is important to determine the real issues at hand in order to develop a meaningful solution.

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Gerald White, President, Grace & White, Inc:

As an analyst who reads financial statements to make sound investment decisions for his clients, Gerald agrees with the court definition in that materiality cannot be a quantitative threshold as there could be minimal amounts that are still very material. Materiality means that a prudent investor would want to have that information before making investment decisions. Gerald discussed a few issues that he feels are always material, such as acquisitions and dispositions, measurement changes ("these don't happen by chance, there is always a motivation for changes in accounting and it is important to understand why a company made this change"), compensation/benefit plans and so on. He went on to discuss the issue of materiality varying over time and something that is immaterial now may become material in the future. As an analyst, it is important to be aware of this change. Materiality may also vary among industries and entities, however, standard-setters rarely differentiate. Gerald concluded by challenging the disclosure overload myth by stating that there is not enough usable information. "We all have computers…and we don't have to read every word of every disclosure document…. There are search functions, we can look at what we think is important at that time". Analysts need the information so they can ask better questions.

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Jack Ciesielski, Owner, R.G. Associates, Inc and Publisher, "The Analyst's Accounting Observer":

"It is hard to see (how) investors are served by this project which is going to result in more discretion to remove non-material information unless you completely ascribe to the paternalistic view that investors can't handle what they are being given now…that there is a disclosure overload". He reiterated opinions of panelists, Gerald White and Sandra Peters, that disclosure overload is a myth. There has been a legitimate increase in disclosures as there have been more complex business activity, such as derivatives and fair value disclosures. He does not agree that effectiveness is through reducing page numbers as he has not found that investors express frustration with the volume of disclosures. To the contrary, it is important that we have all of the right disclosures and as much meaningful information as possible to allow investors to do their job. Jack wants the FASB to devote its resources towards more meaningful projects that benefit investors.

Question and Answer Highlights

A dynamic (and sometimes humorous) Q&A session followed the panelists' remarks. Below are some highlights of the discussion.

"I don't understand the need for a materiality standard….if we think the manager is too stupid to recognize what information is relevant, a standard won't help cure that stupidity. If management knows what is relevant but he does not choose to disclose it because he does not want to be truthful, then hopefully there would be mechanisms or incentives to induce truthful and relevant disclosures through possibly the litigation". Professor Joshua Ronan, NYU

"I find the real challenge for auditors is they generally have never talked to an investor … so they don't know what the decision parameters that are important to the investors actually are…being able to put yourself in the shoes of the investors and make those actual decisions." Sandra Peters, CFA Institute

"The elephant in the room is that in a society like the US if you leave the imposition of standards of materiality to lawyers, you get lawsuits. And the lawsuits do much more than merely hold people liable…they change conduct … they make it expensive and difficult to disclose the kind of material information that you and I want disclosed." Professor Stanley Siegal, NYU

“Having been very much involved in putting this on the FASB agenda in 2009….it was looked at in a much more holistic way of FASB working with the SEC on (an) improved communication package, both the content and the whole flow of what gets disclosed...there are all sorts of practical reasons why visionary things do not happen…I have a lot of whiplashes on my back about those kinds of things but I do agree … that probably this is not the highest and best use of the Board’s time in this effort to improve effective disclosures. We had debates about this…what’s more operational, a “would” standard or a “could” standard from a standard-setting perspective ... that’s a difficult question…. Standard-setters might say that (“would”) is a high burden of proof, I have to affirmatively prove that 9 out of 10 investors it would matter to…”could” on the other hand could be a “flabby” concept … it’s a very difficult issue for the Board to pin down…sometimes there’s beauty in purposeful vagueness.” Professor Bob Herz, Columbia University and former FASB Chairman

“It’s all really about the preparer and the investor being able to communicate together and it’s already shown results … (the Big 4 firms) are talking about it with their clients, clients have changed some of their disclosures…they’re trying to do effective communication today because the people at this table are trying to push the market demand for more effective communication.” Marc Siegel, FASB Member of the Board

“Our concern is that much of the information that investors are using is coming from outside the financial statements and that sort of proliferation of information outside the financial statements is becoming more useful, not only for what it is, but also for the behavior characteristics that it is conveying of management; how much they are willing to push the non-GAAP measure disclosures.” Sandra Peters, CFA Institute

“Discretion applies both ways … (it) does not necessary connote taking things out; discretion should equally apply to bringing things in.” Neri Bukspan, Partner, EY

“One kind of discretion is worse for an investor than another. If you look at non-GAAP information, you get a great view into the kind of discretion that is out there being used.” Jack Ciesielski, Owner, R.G. Associates, Inc and Publisher, “The Analyst’s Accounting Observer”

“If people are speeding on the road, you can close the road and it will prevent speeding…we need to find clever ways to control abuse rather than close the road.” Neri Bukspan

Summary

What began as a seemingly benign proposal to improve the effectiveness of disclosures has turned into a more controversial topic than the FASB expected. Once all feedback has been submitted regarding the 4 specific disclosure areas mentioned above, the Board will host additional roundtables to continue the dialogue. We will look forward to the continued debate regarding how the FASB will satisfy the needs of a diverse set of constituents. As **René**

Descartes once said, “Divide each difficulty into as many parts as is feasible and necessary to resolve it.”