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U.S. Securities and Exchange Commission, Paul Munter, Acting Chief Accountant, Office of the Chief Accountant, Public Statement, Assessing Materiality: Focusing on the Reasonable Investor When Evaluating Errors (March 9, 2022)

Statement

Assessing Materiality: Focusing on the Reasonable Investor When Evaluating Errors

Paul Munter
Acting Chief Accountant

March 9, 2022

Introduction[1]

Under our federal securities laws, public companies are required to disclose certain financial and other information to investors. The basic premise of this disclosure-based regulatory regime is that if investors have timely, accurate, and complete financial and other information, they can make informed, rational investment decisions.

Accordingly, providing investors with high quality financial information, including financial statements prepared in compliance with generally accepted accounting principles ("GAAP"), should be the focus of all those involved in financial reporting. Management is responsible for providing investors with GAAP-compliant financial statements, so whenever a material error is identified in previously-issued financial statements,[2] investors must be notified promptly and the error must be corrected. The determination of whether an error is material is an *objective assessment* focused on whether there is a substantial likelihood it is important to the reasonable investor.[3]

Concept of Materiality and the Correction of Material Errors

Central to the process a registrant must follow when an error is identified in its historical financial statements is determining whether the error is *material* to those historical financial statements. The Supreme Court 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."[4]

When an error is determined to be material to previously-issued financial statements, the error must be corrected by restating the prior-period financial statements.[5] This type of restatement is sometimes referred to colloquially as a reissuance restatement or a "Big R" restatement.

If the error is not material to previously-issued financial statements, but either correcting the error or leaving the error uncorrected would be material to the current period financial statements, a registrant must still correct the error, but is not precluded from doing so in the current period comparative financial statements by restating the

prior period information and disclosing the error. This type of restatement is sometimes referred to colloquially as a revision restatement or a "little r" restatement.

It is important to note that both of these methods—reissuance and revision, or "Big R" and "little r"—constitute restatements to correct errors in previously-issued financial statements as those terms are defined in U.S. GAAP.[6] In either case, such errors should be transparently disclosed to investors.

Objective Assessment of Materiality

Since the concept of materiality is focused on the total mix of information from the perspective of a reasonable investor, those who assess the materiality of errors, including registrants, auditors, audit committees, and others, should do so through the lens of the reasonable investor. To be consistent with the concept of materiality, this assessment must be objective. A materiality analysis is not a mechanical exercise, nor should it be based solely on a quantitative analysis. Rather, registrants, auditors, and audit committees need to thoroughly and objectively evaluate the total mix of information. Such an evaluation should take into consideration all relevant facts and circumstances surrounding the error, including both quantitative and qualitative factors, to determine whether an error is material to investors.

An objective analysis should put aside any potential bias of the registrant, auditor, or audit committee that would be inconsistent with the perspective of a reasonable investor. For example, a restatement of previously-issued financial statements may result in the clawback of executive compensation, reputational harm, a decrease in the registrant's share price, increased scrutiny by investors or regulators, litigation, or other impacts. An assessment where a registrant's, auditor's, or audit committee's biases based on such impacts influenced a determination that an error is not material to previously-issued financial statements so as to avoid a Big R restatement would not be objective and would be inconsistent with the concept of materiality.

One area where the staff in OCA have observed an increased need for objectivity is in the assessment of qualitative factors. The interpretive guidance on materiality in SAB No. 99 speaks to circumstances where a quantitatively small error could, nevertheless, be material because of qualitative factors. However, we are often involved in discussions where the reverse is argued—that is, a quantitatively significant error is nevertheless immaterial because of qualitative considerations. We believe, however, that as the quantitative magnitude of the error increases, it becomes increasingly difficult for qualitative factors to overcome the quantitative significance of the error.

We also note that the qualitative factors that may be relevant in the assessment of materiality of a quantitatively significant error would not necessarily be the same qualitative factors noted in SAB No. 99 when considering whether a quantitatively small error is material. So it might be inappropriate for a registrant to simply assess those qualitative factors in reverse when evaluating the materiality of a quantitatively significant error. Such a scenario highlights the importance of a holistic and objective assessment from a reasonable investor's perspective.

Observations from Recent Interactions with Registrants and Auditors on Materiality

In considering recent restatement trends, we note that while the total number of restatements by registrants declined each year from 2013 to 2020, "little r" restatements as a percentage of total restatements rose to nearly 76% in 2020, up from approximately 35% in 2005.[7] While some attribute that trend primarily to improvements in the effectiveness of internal control over financial reporting ("ICFR") and audit quality, we continue to monitor this and other restatement trends to understand the nature and prevalence of accounting errors and how they are corrected.

Accounting Errors and Materiality

Through our monitoring of restatements, and recent discussions with registrants and auditors regarding their assessment of the materiality of accounting errors, we have observed that some materiality analyses appear to be

biased toward supporting an outcome that an error is not material to previously-issued financial statements, resulting in “little r” revision restatements.

For example, the staff in OCA have, not infrequently, been presented with arguments that financial statements or specific line items in financial statements are irrelevant to investors’ investment decisions. One variation of this argument is that certain elements of financial statements prepared in accordance with U.S. GAAP or International Financial Reporting Standards (“IFRS”) do not provide useful information to investors, so an error in those elements cannot be material. A related argument is that historical financial statements, or specific line items in those financial statements, are irrelevant to investors’ current investment decisions. We have not found these types of arguments to be persuasive because such views could be used to justify a position that many errors in previously-issued financial statements could never be material regardless of their quantitative significance or other qualitative factors. In this regard, we note that Commission rules generally require audited financial statements to be prepared in accordance with U.S. GAAP or IFRS, and to be included for each period specified in those rules. We also note that comparative financial statements facilitate an investor’s trend analysis to identify changes in financial results of a registrant over time and to inform investment decisions. Accordingly, we view financial statements prepared in accordance with U.S. GAAP or IFRS, as required by Commission rules, to be the starting point for any objective materiality analysis.

However, this does not imply that the effects of errors on certain key non-GAAP measures that are important to users of the registrant’s financial statements should not also be considered in the registrant’s analysis. Rather, analysis of key non-GAAP measures, where applicable, should be performed in addition to, but not as a substitute for, the analysis of materiality to the financial statements.

OCA staff have also observed materiality analyses that argued that an error is not material to previously-issued financial statements because the error was also made by other registrants, and therefore reflects a widely-held view rather than an intention to misstate. This type of argument has been raised by registrants in various industries and with various structures, including special purpose acquisition companies. SAB No. 99 states that while the intent of management does not render a misstatement material, it may provide significant evidence of materiality. We have not found persuasive, however, arguments that attempt to apply that SAB No. 99 premise in reverse—that is, that the lack of intentional misstatement is viewed as providing evidence that the error is not material.

We further note that registrants often argue that an error is not material because its effect is offset by other errors. As noted in SAB No. 99, registrants and their auditors first should consider whether each misstatement is material, irrespective of its effect when combined with other misstatements. The aggregated effects should then also be considered to determine whether an otherwise immaterial error, when aggregated with other misstatements, renders the financial statements taken as a whole to be materially misleading. However, we do not believe this analysis of the aggregate effects should serve as the basis for a conclusion that individual errors are immaterial.

Accounting Errors and Internal Control over Financial Reporting

We note that the identification of an accounting error also impacts management’s assessment of the effectiveness of ICFR, and that the principles mentioned here regarding an objective assessment similarly apply to the ICFR analysis as to the severity of the control deficiency. Management’s ICFR effectiveness assessment must consider the magnitude of the potential misstatement that *could* result from a control deficiency, and we note that the actual error is only the starting point for determining the potential impact and severity of a deficiency. Therefore, while the existence of a material accounting error is an indicator of the existence of a material weakness, a material weakness may also exist without the existence of a material error. Management’s assessment of the effectiveness of ICFR should therefore be focused on a holistic, objective analysis of what *could* happen in the context of current and evolving financial reporting risks.

We continue to emphasize the importance of identifying and communicating material weaknesses to investors promptly. We encourage ongoing attention, including audit committee participation and training, as needed, regarding the adequacy of and basis for a registrant’s ICFR effectiveness assessment—particularly where there

are close calls in the assessment of whether a deficiency is a significant deficiency (and only required to be reported to the audit committee) or a material weakness (required to be disclosed to investors).

Other Auditor Considerations

A registrant's auditor plays an important role in the assessment of the materiality of accounting errors. In addition to the observations noted above, when auditors evaluate the materiality of uncorrected misstatements, it is important for the audit firm to consider whether its systems of quality control are suitably designed to provide reasonable assurance that its professionals comply with applicable professional standards. For example, the audit firm should have policies and processes in place to ensure that the appropriate individuals are involved in the supervision and review in evaluating the significant judgments made about materiality and the effects of identified accounting errors. This includes the engagement quality reviewer[8] and other consulting parties, as appropriate. In this regard, audit firms need to ensure that their system of quality control includes policies and procedures to provide reasonable assurance that individuals being consulted have the appropriate levels of knowledge, competence, judgment, and authority.[9] We continue to emphasize the importance of effectively designed and implemented systems of quality control by audit firms in support of continued enhancements to audit quality.

Conclusion

In our disclosure-based regime, investors have a right to financial statements prepared in accordance with GAAP. When an error is identified, it is important for registrants, auditors, and audit committees to carefully assess whether the error is material by applying a well-reasoned, holistic, objective approach from a reasonable investor's perspective based on the total mix of information. To be objective, those involved in the process must eliminate from the analysis their own biases, including those related to potential negative impacts of a restatement, that would be inconsistent with a reasonable investor's view. Additionally, the objective analysis should consider all relevant facts and circumstances including both quantitative and qualitative factors.

When investor needs are not adequately considered, investors can lose confidence in financial reporting, threatening a foundational principle upon which our capital markets system is built. It is therefore imperative that registrants—including management, boards of directors, audit committees, and every individual involved in the registrant's financial reporting process—and their auditors each fulfill their respective financial reporting roles and responsibilities with investors' needs in mind.

The staff of OCA remain available for consultation on conclusions regarding the correction of accounting errors, and we encourage stakeholders to contact our office with questions.[10] We value our interactions with registrants and other stakeholders on issues they are facing, and we will continue to be informed by such feedback as we focus on investors' need for high quality financial information, consistent with the SEC's mission.

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[1] This statement represents the views of the staff of the Office of the Chief Accountant ("OCA"). It is not a rule, regulation, or statement of the Securities and Exchange Commission ("SEC" or the "Commission"). The Commission has neither approved nor disapproved its content. This statement, like all staff statements, has no legal force or effect: it does not alter or amend applicable law, and it creates no new or additional obligations for any person. "Our" and "we" are used throughout this statement to refer to OCA staff.

[2] *See* Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") Topic 250, *Accounting Changes and Error Corrections*, which defines an "error in previously issued financial statements" as an error in recognition, measurement, presentation, or disclosure in financial statements resulting from mathematical mistakes, mistakes in the application of GAAP, or oversight or misuse of facts that existed at the time the financial statements were prepared.

[3] *See* Staff Accounting Bulletin ("SAB") No. 99, *Materiality* (Aug. 12, 1999); *see also* SAB No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements*

(Sept. 13, 2006).

[4] *TSC Industries v. Northway, Inc*., 426 U.S. 438, 449 (1976); *see Basic, Inc. v. Levinson*, 485 U.S. 224 (1988) (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...." *TSC Industries*, 426 U.S. at 450); *see also* FASB, *Amendments to Statement of Financial Accounting Concepts No. 8—Conceptual Framework for Financial Reporting—Chapter 3, Qualitative Characteristics of Useful Financial Information* (Aug. 2018), available at https://fasb.org/jsp/FASB/Document_C/DocumentPage?cid=1176171111614; *see also* SAB No. 99.

[5] *See* ASC Topic 250; s*ee also* Item 4.02(a) of Form 8-K, which requires timely disclosure when the registrant's board of directors, a committee of the board of directors, or the officer or officers of the registrant authorized to take such action if board action is not required, concludes that any previously-issued financial statements, covering one or more years or interim periods for which the registrant is required to provide financial statements under Regulation S-X (17 CFR 210) should no longer be relied upon because of an error, as addressed in ASC Topic 250, in such financial statements.

[6] *See* supra at n. 2; *see also* ASC Topic 250, which defines "restatement" as "the process of revising previously issued financial statements to reflect the correction of an error in those financial statements."

[7] *See* Audit Analytics, *2020 Financial Restatements: A Twenty-Year Review* (November 2021).

[8] *See* Public Company Accounting Oversight Board ("PCAOB") AS 1220, *Engagement Quality Review*, paragraph .10.

[9]*See* PCAOB Quality Control Section 20 ("QC 20"),*System of Quality Control for a CPA Firm's Accounting and Auditing Practice*, available at https://pcaobus.org/oversight/standards/qc-standards/details/QC20. As required by PCAOB QC 20.19, the audit firm's "policies and procedures should also be established to provide reasonable assurance that personnel refer to authoritative literature or other sources and consult, on a timely basis, with individuals within or outside the firm, when appropriate (for example, when dealing with complex, unusual, or unfamiliar issues). Individuals consulted should have appropriate levels of knowledge, competence, judgment, and authority. The nature of the arrangements for consultation depends on a number of factors, including the size of the firm and the levels of knowledge, competence, and judgment possessed by the persons performing the work."

[10] More information about how to initiate a dialogue with OCA, what to expect from the consultation process, and what information should be included in a consultation submission in order for OCA to most quickly address a company's or auditor's question is available on OCA's webpage, available at https://www.sec.gov/page/communicating-oca.

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