



OFFICE OF THE  
INVESTOR ADVOCATE

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

July 11, 2017

**Submitted Electronically**

Technical Director  
FASB  
401 Merritt 7  
PO Box 5116  
Norwalk, CT 06856-5116

RE: File Reference No. 2015-300, Proposed Amendments by the Financial Accounting Standards Board (“FASB”) to Concepts Statement No. 8, Conceptual Framework for Financial Reporting

Dear FASB Members:

The Office of the Investor Advocate at the U.S. Securities and Exchange Commission (“SEC”) monitors developments in accounting and auditing, and we strive to ensure that the interests of investors are appropriately considered as rules are modified.<sup>1</sup> We appreciate this opportunity to provide comments in regard to Proposed Amendments by the Financial Accounting Standards Board (“FASB”) to Concepts Statement No. 8, Conceptual Framework for Financial Reporting (“the Exposure Draft”).<sup>2</sup> We submit these comments to encourage FASB to consider a different path to address the perceived deficiencies in its definition of materiality.

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<sup>1</sup> This letter expresses solely the views of the Investor Advocate. It does not necessarily reflect the views of the Commission, the Commissioners, or staff of the Commission, and the Commission disclaims responsibility for this letter and all analyses, findings, and conclusions contained herein. Nor does it necessarily reflect the views of the SEC Investor Advisory Committee.

<sup>2</sup> *Proposed Amendments to Statement of Financial Accounting Concepts No. 8, Conceptual Framework for Financial Reporting, Chapter 3: Qualitative Characteristics of Useful Financial Information*, FIN. ACCOUNTING STANDARDS BD. (Sept. 24, 2015), [http://www.fasb.org/jsp/FASB/Document\\_C/DocumentPage?cid=1176166402450&acceptedDisclaimer=true](http://www.fasb.org/jsp/FASB/Document_C/DocumentPage?cid=1176166402450&acceptedDisclaimer=true) [hereinafter FASB, *Proposed Amendments to Statement of Financial Accounting Concepts No. 8, Chapter 3*]. At the same time, FASB also issued a companion Exposure Draft titled *Proposed Accounting Standards Update, Notes to Financial Statements (Topic 235): Assessing Whether Disclosures Are Material*, FIN. ACCOUNTING STANDARDS BD. (Sept. 24, 2015), [http://www.fasb.org/jsp/FASB/Document\\_C/DocumentPage?cid=1176166402325&acceptedDisclaimer=true](http://www.fasb.org/jsp/FASB/Document_C/DocumentPage?cid=1176166402325&acceptedDisclaimer=true). The proposed amendments to Topic 235 Update would: (1) state that materiality is applied to quantitative and qualitative disclosures individually and in the aggregate in the context of the financial statements taken as a whole; (2) refer to materiality as a legal concept; and (3), state specifically that an omission of immaterial information is not an accounting error.

## Background

The Exposure Draft explains that the current definition of materiality in Chapter 3 of Concepts Statement 8 is “inconsistent with the legal concept of materiality in the United States” and proposes amendments to eliminate the inconsistencies. In short, it appears that Concepts Statement No. 8 was adopted to align the definition of materiality with international standards, but it has resulted in some inconsistency with U.S. law.<sup>3</sup>

To address this problem, FASB has proposed to eliminate the definition in Concepts Statement No. 8 and merely state that materiality is a legal concept. According to the Exposure Draft, “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 broad observation of the U.S. Supreme Court’s definition in the context of the antifraud provisions of the U.S. securities laws.”<sup>4</sup>

As you know, a significant number of investors and investor organizations, including the SEC Investor Advisory Committee, have submitted comment letters in opposition to the proposed change. Among other things, investors have advanced the following arguments:

- Why make a change, and why now?<sup>5</sup> FASB has failed to justify the need for change, some commenters asserted. Moreover, some commenters suggested that the proposed amendments do not reflect the interests of investors and instead appear motivated to accommodate preparers.<sup>6</sup>

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<sup>3</sup> *Proposed Statement of Financial Accounting Concepts No. 8, Conceptual Framework for Financial Reporting, Chapter 7: Presentation*, FIN. ACCOUNTING STANDARDS BD. at 1 (Aug. 11, 2016), [http://www.fasb.org/jsp/FASB/Document\\_C/DocumentPage?cid=1176168366904&acceptedDisclaimer=true](http://www.fasb.org/jsp/FASB/Document_C/DocumentPage?cid=1176168366904&acceptedDisclaimer=true).

<sup>4</sup> FASB, *Proposed Amendments to Statement of Financial Accounting Concepts No. 8, Chapter 3*, *supra* note 2.

<sup>5</sup> CFA Institute, Comment Letter on Conceptual Framework for Financial Reporting – Chapter 3: Qualitative Characteristics of Useful Financial Information, (Jan. 21, 2016), [http://www.fasb.org/cs/BlobServer?blobkey=id&blobnocache=true&blobwhere=1175832674224&blobheader=application%2Fpdf&blobheadername2=Content-Length&blobheadername1=Content-Disposition&blobheadervalue2=533025&blobheadervalue1=filename%3DDISFR-C.ED.0050.CFA\\_INSTITUTE\\_CDPC\\_SANDRA\\_J.\\_PETERS\\_ASHWINPAUL\\_C.\\_SONDHI.pdf&blobcol=urldata&blobtable=MungoBlobs](http://www.fasb.org/cs/BlobServer?blobkey=id&blobnocache=true&blobwhere=1175832674224&blobheader=application%2Fpdf&blobheadername2=Content-Length&blobheadername1=Content-Disposition&blobheadervalue2=533025&blobheadervalue1=filename%3DDISFR-C.ED.0050.CFA_INSTITUTE_CDPC_SANDRA_J._PETERS_ASHWINPAUL_C._SONDHI.pdf&blobcol=urldata&blobtable=MungoBlobs) [hereinafter CFA Institute].

<sup>6</sup> *See, e.g.*, Council of Institutional Investors, Comment Letter on File Nos. 2015-300, 2015-310, (Dec. 3, 2015), [http://www.fasb.org/cs/BlobServer?blobkey=id&blobnocache=true&blobwhere=1175832307297&blobheader=application%2Fpdf&blobheadername2=Content-Length&blobheadername1=Content-Disposition&blobheadervalue2=580175&blobheadervalue1=filename%3DDISFR-C.ED.0010.COUNCIL\\_OF\\_INSTITUTIONAL\\_INVESTORS\\_AMY\\_BORRUS.pdf&blobcol=urldata&blobtable=MungoBlobs](http://www.fasb.org/cs/BlobServer?blobkey=id&blobnocache=true&blobwhere=1175832307297&blobheader=application%2Fpdf&blobheadername2=Content-Length&blobheadername1=Content-Disposition&blobheadervalue2=580175&blobheadervalue1=filename%3DDISFR-C.ED.0010.COUNCIL_OF_INSTITUTIONAL_INVESTORS_AMY_BORRUS.pdf&blobcol=urldata&blobtable=MungoBlobs) [hereinafter Council of Institutional Investors].

- The proposals are based in part on the mistaken premise that investors are suffering from information overload, but that is not what investors themselves are saying.<sup>7</sup> In the name of disclosure simplification for the purported benefit of investors, the proposals would reduce the flow of information that investors use and need.<sup>8</sup>
- The proposals would move decision-making on materiality from accountants to lawyers. The SEC’s Investor Advisory Committee,<sup>9</sup> in a theme echoed by other investors,<sup>10</sup> warned in its comment letter of the risk “that, by replacing the current, differentiated professional accounting standard with a case-law driven legal standard, close questions of judgment will ultimately devolve to lawyers rather than accountants.”<sup>11</sup>
- The proposals would encourage excessive management discretion. For example, the Investor Advisory Committee argues: “Granting issuers greater latitude to use discretion in evaluating the materiality of disclosures in the absence of a framework is fraught with the risk that disclosures that are unfavorable to the issuer are disproportionately viewed as immaterial and as a result excluded from the financial statements. Such a result is not in the best interest of investors, and is anathema to investor protection, capital formation, and the efficient functioning of the capital markets.”

### Seeking to Reconcile FASB’s Goal with Investor Concerns

In my view, it would be useful for FASB to address the misalignment between Concepts Statement No. 8 and the definition of materiality under U.S. law. While the existing Concepts Statement No. 8 definition may be advantageous to investors in certain respects, I believe it is

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<sup>7</sup> The CFA Institute, for example, identifies investors’ greatest concern as a lack of disclosure related to the most important financial statement captions –revenues and expenses. Moreover, the CFA Institute argues that FASB’s discussion fails to address the use of technology to address ostensible disclosure overload. CFA Institute, *supra* n. 5.

<sup>8</sup> Council of Institutional Investors, *supra* n. 6.

<sup>9</sup> SEC, Investor Advisory Committee, Comment Letter on Proposed Amendments to Statement of Financial Accounting Concepts & Notes to Financial Statements (Jan. 21, 2016), [http://www.fasb.org/cs/BlobServer?blobkey=id&blobnocache=true&blobwhere=1175832725818&blobheader=application%2Fpdf&blobheadername2=Content-Length&blobheadername1=Content-Disposition&blobheadervalue2=661871&blobheadervalue1=filename%3DDDISFR-C.ED.0051.SEC\\_INVESTOR\\_ADVISORY\\_COMMITTEE.pdf&blobcol=urldata&blobtable=MungoBlobs](http://www.fasb.org/cs/BlobServer?blobkey=id&blobnocache=true&blobwhere=1175832725818&blobheader=application%2Fpdf&blobheadername2=Content-Length&blobheadername1=Content-Disposition&blobheadervalue2=661871&blobheadervalue1=filename%3DDDISFR-C.ED.0051.SEC_INVESTOR_ADVISORY_COMMITTEE.pdf&blobcol=urldata&blobtable=MungoBlobs) [hereinafter SEC, IAC].

<sup>10</sup> *See, e.g.*, Council of Institutional Investors, *supra* note 6; R.G. Associates, Inc., Comment Letter on File Reference No. 2015-300, 2015-310 (Dec. 7, 2015), [http://www.fasb.org/cs/BlobServer?blobkey=id&blobnocache=true&blobwhere=1175832346526&blobheader=application%2Fpdf&blobheadername2=Content-Length&blobheadername1=Content-Disposition&blobheadervalue2=546438&blobheadervalue1=filename%3DDDISFR-C.ED.0015.R.G.\\_ASSOCIATES\\_INC.\\_JACK\\_T.\\_CIESIELSKI.pdf&blobcol=urldata&blobtable=MungoBlobs](http://www.fasb.org/cs/BlobServer?blobkey=id&blobnocache=true&blobwhere=1175832346526&blobheader=application%2Fpdf&blobheadername2=Content-Length&blobheadername1=Content-Disposition&blobheadervalue2=546438&blobheadervalue1=filename%3DDDISFR-C.ED.0015.R.G._ASSOCIATES_INC._JACK_T._CIESIELSKI.pdf&blobcol=urldata&blobtable=MungoBlobs).

<sup>11</sup> SEC, IAC, *supra* note 9.

best to maximize consistency in the treatment of materiality in various contexts to eliminate any confusion or inefficiency.

Nonetheless, I do not believe it is necessary or prudent to simply “punt” the definition to the courts. The case law definition of materiality originally developed in an anti-fraud context, where courts were deciding whether the failure to disclose a particular fact rose to the level of fraud. FASB need not contradict the courts’ guidance, but it also should not feel bound to adopt a standard that would say, in effect, “Disclose only what is necessary to avoid committing fraud.” FASB could and should illustrate how to properly apply materiality in an accounting context. Providing insightful explanations and examples of making reasonable materiality judgments would be of benefit to all stakeholders, including investors and preparers alike. In doing so, FASB would be encouraging disclosure that is robust and useful.

I am a member of the SEC’s Investor Advisory Committee and was present during its discussion of this issue during its public meeting on January 21, 2016.<sup>12</sup> In an attempt to find a constructive path forward, I asked one question at that meeting: In lieu of FASB’s proposed amendments to Concepts Statement No. 8, would it be a viable alternative for the Board to go back to the concepts of materiality articulated in Concepts Statement No. 2<sup>13</sup> (the predecessor to Concepts Statement No. 8)?

I thank FASB for including this alternative proposal in its Questions for Participants at the Public Roundtable Meeting at your headquarters on March 17, 2017. Let me also take this opportunity to applaud FASB for holding the Roundtable, which enhanced the transparency of the process and afforded investors and other interested parties the opportunity to express their views in a thoughtful discussion. I personally benefited from the dialogue.

Participants at the Roundtable appeared to reach—or at least approach—consensus favoring a return to the concept of materiality as expressed in Concepts Statement No. 2. Based on that discussion, as well my reflections on the matter, I have concluded that this would indeed be the best approach. I believe also that the SEC’s Staff Accounting Bulletin No. 99 (“SAB 99”) should help inform FASB’s discussion of materiality and that the revised Concept Statement should specifically reference SAB 99.<sup>14</sup>

Concepts Statement No. 2, unlike the 2015 Exposure Drafts, offers a useful discussion of the nuances of making materiality judgments in the context of specific facts and circumstances in preparing, auditing, and correcting any mistakes in financial statements.

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<sup>12</sup> *Investor Advisory Committee Meeting*, SEC Webcast (Jan. 21, 2016), [https://www.sec.gov/video/webcast-archive-player.shtml?document\\_id=investor-advisory-committee-012116](https://www.sec.gov/video/webcast-archive-player.shtml?document_id=investor-advisory-committee-012116).

<sup>13</sup> *Statement of Financial Accounting Concepts No. 2, Qualitative Characteristics of Accounting Information (As Amended)*, FIN. ACCOUNTING STANDARDS BD. (May 1980), [http://www.fasb.org/jsp/FASB/Document\\_C/DocumentPage?cid=1218220132599&acceptedDisclaimer=true](http://www.fasb.org/jsp/FASB/Document_C/DocumentPage?cid=1218220132599&acceptedDisclaimer=true).

<sup>14</sup> SEC Staff Accounting Bulletin No. 99, 64 Fed. Reg. 45150 (Aug. 12, 1999).

Likewise, SAB 99 provides a helpful framework for evaluating materiality decisions related to financial statements. SAB 99 makes clear that companies must take into account quantitative factors as well as qualitative facts when considering questions of materiality. The guidance offers examples of how the same quantity may be less than material in one context and yet rise to that level in another.

As you know, SAB 99 already references both the Supreme Court definition of materiality and the relevant content in Concepts Statement No. 2.<sup>15</sup> In addition, as noted by one of the FASB members in an article in late 2016, Concepts Statement No. 2 is more closely aligned than Concepts Statement No. 8 with both SAB 99 and court decisions:

The definition of materiality currently in Concepts Statement 8 does not conform to any of the others currently in place in the U.S. financial reporting system. The Securities and Exchange Commission (SEC) rules and guidance (including Staff Accounting Bulletin 99), auditing standards, and decisions made by courts are more similar to our prior definition in Concepts Statement 2, which was replaced in 2010 by Concepts Statement 8.<sup>16</sup>

A fresh approach based on Concepts Statement No. 2 and SAB 99 would address several investor concerns. It would illustrate how to apply the general definition of materiality and make reasonable materiality judgments in various accounting contexts. This would include examples in which an item is small in magnitude but nonetheless important in the context of trends or other qualitative factors, such as turning a loss into a profit. This approach should be seen as encouraging disclosures of material items, rather than oversimplifying or reducing them. The revised language could also remove or alleviate concerns over encouraging excessive management discretion or devolving accounting decisions to lawyers.<sup>17</sup>

In summary, I believe that an alternative approach, based on Concepts Statement No. 2 and SAB 99, would satisfy FASB's goals of correcting a misalignment in the definition of materiality

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<sup>15</sup> *Id.*

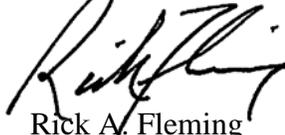
<sup>16</sup> The Board member went on to portray the 2015 Exposure Drafts as aligned more closely with Concepts Statement No. 2: "The 2015 Exposure Drafts comes much closer to aligning the definitions already in place—closer to the prior, longstanding definition from Concepts Statement 2." In my view however, there is still a significant difference, Concepts Statement No. 2 provides illustrations and examples that are missing in the Exposure Drafts. Marc Siegel, *For the Investor: Disclosure Effectiveness – How Materiality Fits In*, FIN. ACCOUNTING STANDARDS BD. (2016 Q1), <http://www.fasb.org/cs/ContentServer?c=Page&pagename=FASB%2FPage%2FSectionPage&cid=1176167771326>.

<sup>17</sup> The scope of SAB 99 overlaps with, but is not identical to, FASB's purview. While SAB 99 applies only to firms reporting to the Commission, FASB must also consider non-reporting entities that nonetheless use GAAP, including private for-profit and not-for-profit firms. If the Board adopts the approach recommended here, it may wish to consider how this difference in scope would affect any incorporation of the discussion in SAB 99. In addition, the Board may wish to take the opportunity to update portions of Concepts Statement No. 2, such as the list of court cases and the Examples of Quantitative Materiality Guidelines.

while at the same time addressing valid objections that investors have raised to the current proposals.

Thank you, again, for the opportunity to submit my comments regarding this important matter. Should you have any questions, please do not hesitate to contact me or Stephen Deane, who handles audit and accounting matters on my staff, at (202) 551-3302.

Sincerely,

A handwritten signature in black ink, appearing to read "Rick Fleming". The signature is fluid and cursive, with a large initial "R" and a long, sweeping underline.

Rick A. Fleming  
Investor Advocate