CFA Institute

MATERIALITY

Investor Perspectives

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Materiality is an important aspect of disclosure reform that has received growing interest from the accounting and auditing standard-setting and regulatory bodies. In addition, the industry is demanding greater clarity on how to apply materiality to financial statement disclosures in the face of perceived proliferation of disclosures. Furthermore, materiality needs to be evaluated closely because investors have indicated that financial statements do not include an obvious amount of immaterial information.

EXECUTIVE SUMMARY

The Financial Accounting Standards Board (FASB) has recently issued two proposals related to the application of materiality as it relates to financial statement disclosures.[1] In addition, the International Accounting Standards Board (IASB) has recently issued the *IFRS Practice Statement: Application of Materiality to Financial Statements*. All are in response to an increasing interest in the concept of the application of materiality.

In 2013, CFA Institute issued a thought leadership piece on disclosures: *Financial Reporting Disclosures: Investor Perspectives on Transparency, Trust, and Volume* (referred to here as the "Disclosure Report").[2] Chapter 7 of the Disclosure Report—"Materiality: Where Is All the Immaterial Information?"—is an analysis and discussion of the recent commentary regarding materiality, its definition, and the perception that financial statements are full of immaterial clutter that obscures key messages from an investor perspective. Included within the Disclosure Report are the results of a 2012 CFA Institute member survey on disclosures, including results of several survey questions on the concept of materiality. We have excerpted this chapter here because we believe the analysis, discussion, and investor perspectives are particularly relevant to the current discussion on materiality that has emerged in response to the aforementioned FASB proposals and IASB Practice Statement.

[1]FASB's 2015 Proposed Amendments to Statement of Financial Accounting Concepts for the *Conceptual Framework for Financial Reporting*, Chapter 3: "Qualitative Characteristics of Useful Financial Information" and FASB's 2015 "Notes to Financial Statements (Topic 235): Assessing Whether Disclosures Are Material."
[2]Mohini Singh and Sandra J. Peters, *Financial Reporting Disclosures: Investor Perspectives on Transparency, Trust, and Volume* (Charlottesville, VA: CFA Institute, 2013): http://www.cfapubs.org/doi/pdf/10.2469/ccb.v2013.n12.1.

As we note in this report, the dialogue on materiality, specifically as it relates to disclosures, needs to consider that materiality judgments are made by heterogeneous groups—preparers, auditors, and users—that are likely to have dissimilar views on materiality thresholds. Research demonstrates that, in general, users have lower materiality thresholds than preparers and auditors. Materiality is, however, to be assessed in the eyes of the user of financial statements.

The results of our 2012 and 2010 surveys suggest that a vast majority (76%) of respondents do not currently observe the inclusion of obviously immaterial information in disclosures and that 82% would support the disclosure of how auditors determine or assess materiality.

Furthermore, as we note in the 2013 Disclosure Report, there have been many generalized claims with respect to the inclusion of immaterial information within financial statements; however, investors see a need for more precise empirical research to identify and demonstrate specific examples of inclusion of immaterial information and the basis for its inclusion so as to identify and address its causes. More specific examples of the inclusion of immaterial information may facilitate reconciliation of differences in perspective between preparers and users.

As we consider the materiality issue in the aggregate, we can see that a perception has emerged among preparers and auditors that financial statements are filled with immaterial information. The investors we surveyed, however, do not find an obvious overabundance of immaterial information. Issues relating to boilerplate information or lack of entity-specific information are of greater concern to investors.

This disconnect in materiality assessments likely stems from a lack of communication regarding the materiality measures and thresholds made by management and auditors. The knowledge and expectations gaps are obvious and natural by-products of the lack of communication. Without greater communication of materiality measures and thresholds, the inability of users to provide feedback regarding materiality and its impact on their decision making is likely to persist.

MATERIALITY: WHERE IS ALL THE IMMATERIAL INFORMATION?

We explore recent commentary on materiality, provide investor perspectives, and make recommendations.

Recent Commentary on Materiality

Recent publications have observed that annual reports are full of immaterial clutter that can obscure key messages or make important information hard to find. These publications encourage a continuing debate about what "materiality" means from a disclosure perspective and have made recommendations to enhance the use of materiality in financial reporting disclosures and to delete disclosures that do not contain material information.

New Terms: "Essential" Information

Certain standard setters and others have suggested that the disclosure framework should require only disclosures that are essential to investors. In a joint effort, the Institute of Chartered Accountants of Scotland (ICAS) and the New Zealand Institute of Chartered Accountants (NZICA) issued a report titled "Losing the Excess Baggage: Reducing Disclosures in Financial Statements to What's Important" (which we refer to as the ICAS/NZICA "Excess Baggage" report).[3] The co-chair of the joint working party that produced the ICAS/NZICA "Excess Baggage" report said,

> The current excess disclosure baggage carries the penalties of extra cost and poorer communication. We are recommending that preparers pack only the *essentials* into their reports. (p. 7)

The report recommends deletion of merely "encouraged" disclosures.

What is unclear is how "essential" is being defined. Does essential equate with material? We believe that what is essential is that all material information be disclosed in the financial statements. We also believe that care should be taken not to bandy about additional terms to define the threshold for the level of information to be provided in the disclosures when, already, we hear calls for clarification of the definition of "materiality" with respect to disclosure.

New Distinction: Material Item vs. Material Information

The ICAS/NZICA "Excess Baggage" report supports strict application of materiality and proposes the following:

> … a refinement of how materiality is considered by distinguishing material items (being items in the statements of financial position, cash flows, comprehensive income and changes in equity) and material information which appears in additional notes to those statements: even though an item might be material, and therefore require separate disclosure on the face of the financial statements or in the notes, it does not follow that additional information about that item is necessarily material. (p. 2)

The report is unclear, however, about how to distinguish between a material item and the materiality of the information that pertains to that item. If an item is material enough to appear on the face of the financial statements, then it would seem essential that investors have the necessary information to understand the nature of the balance or amount presented on the face of the financial statements. Rarely would the financial statement caption be sufficiently descriptive to provide information on all the characteristics of the account balance.

[3]"Losing the Excess Baggage: Reducing Disclosures in Financial Statements to What's Important," ICAS and NZICA (2011): https://www.icas.com/technical-resources/losing-the-excess-baggage.

New Applications: Exclusion vs. Inclusion

The UK Financial Reporting Council (FRC) "Cutting Clutter: Combating Clutter in Annual Reports" report goes further and argues that the application of materiality to disclosures should focus on exclusion of information, not inclusion.[4] The report states,

> It isn't just preparers' behavior that is creating barriers to cutting clutter. Those involved in setting standards, regulating, auditing and advising preparers about their preparation of annual reports are also contributing. Examples include the ICAEW's [Institute of Chartered Accountants in England and Wales's] guidance on materiality, which currently focuses on what to include rather than what could be taken out. (p. 14)

CFA Institute believes that, given the importance of disclosures as a complement to the basic financial statements, the focus should principally be on what information to include—not what information to exclude. A focus on exclusion could lead to the loss of valuable information for the investor community.

Continuing Concerns: SEC and Audit Comments

According to the KPMG and Financial Executive Institute's (FEI's) Financial Executive Research Foundation (FERF) "Disclosure Overload and Complexity: Hidden in Plain Sight" report, preparers identified concerns about materiality as contributing to increased disclosure volume.[5] Preparers have articulated that concerns over Securities and Exchange Commission (SEC) or auditor comments lead them to include immaterial information in the financial statements:

> Although both SEC rules and FASB standards make it clear that rules and standards need not be applied to immaterial items, we observed many companies providing these and other apparently immaterial disclosures. Based on the survey results as well as anecdotal conversations, companies are reluctant to omit disclosures other than those that are clearly immaterial, out of concern that an SEC comment or auditor comment will require the issuer to revise its reporting to include the immaterial item. (p. 21)

The report recommends that the SEC issue an interpretive release to address this concern. A possible solution identified in the report would be to include a single footnote that briefly identifies disclosures omitted based on their immateriality.

Another solution identified in the SEC Advisory Committee on Improvements to Financial Reporting (CIFiR) 2008 report would be for the SEC and the Public Company Accounting Oversight Board (PCAOB) to adopt policy statements on how these regulators evaluate the reasonableness of judgments:[6]

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[4]FRC, "Cutting Clutter: Combating Clutter in Annual Reports," Financial Reporting Council (2011): http://www.frc.org.uk/Our-Work/Publications/FRC-Board/Cutting-Clutter-Combating-clutter-in-annual-report.aspx.

[5]KPMG and FEI, "Disclosure Overload and Complexity: Hidden in Plain Sight" (2011): www.kpmg.com/us/en/issuesandinsights/articlespublications/pages/disclosure-overload-complexity.aspx.

[6]CIFiR, "Final Report of the Advisory Committee on Improvements to Financial Reporting to the United States Securities and Exchange Commission," CIFiR (1 August 2008): www.sec.gov/about/offices/oca/acifr/acifr-finalreport.pdf.

> We believe that adoption of these policy statements would not only provide more transparency into how the SEC and the PCAOB evaluate the reasonableness of a judgment, but also encourage preparers and auditors to follow a disciplined process in making judgments. (p. 7)

Books and Records Violations: Materiality vs. Reasonable Detail

SEC Staff Accounting Bulletin 99 (SAB 99), "Materiality," requires consideration of the books and records provisions under the Securities Exchange Act of 1934. Following these provisions, registrants have to keep books and records in reasonable detail to provide reasonable assurance to prudent officials. This threshold of "reasonable detail" under securities law is not necessarily the same as the materiality threshold under accounting standards. Indeed, in certain instances, "reasonable detail" could be a lower threshold. SAB 99 states,

> Even if misstatements are immaterial, registrants must comply with Sections 13(b)(2)–(7) of the Securities Exchange Act of 1934 (the "Exchange Act"). Under these provisions, each registrant with securities registered pursuant to Section 12 of the Exchange Act, or required to file reports pursuant to Section 15(d), must make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of assets of the registrant and must maintain internal accounting controls that are sufficient to provide reasonable assurances that, among other things, transactions are recorded as necessary to permit the preparation of financial statements in conformity with GAAP [generally accepted accounting principles]. In this context, determinations of what constitutes "reasonable assurance" and "reasonable detail" are based not on a "materiality" analysis but on the level of detail and degree of assurance that would satisfy prudent officials in the conduct of their own affairs. Accordingly, failure to record accurately immaterial items, in some instances, may result in violations of the securities laws.

Some contend that complying with this books and records provision of the Exchange Act and meeting the threshold of reasonable detail have resulted in immaterial information being included in financial statements. Before concluding that this provision is, in fact, a cause of the inclusion of immaterial disclosures, investors want to know whether preparers and auditors can clearly point to immaterial disclosures that have been included in financial statements merely to comply with the books and records provision. Investors have not seen a direct link between these provisions and the inclusion of immaterial disclosures in financial statements. Furthermore, investors question why greater disaggregation (detail) is not provided in financial statements if this requirement drives disclosures.

Materiality: A New Concept?

The application of materiality to disclosure requirements is not a new idea. Materiality has long been applied to financial disclosures by preparers and auditors alike. What appears to be changing in the current debate over the application of materiality to disclosures is the rather strict application recommended in recent reports.

In the materiality spectrum, certain items are clearly material and others are clearly immaterial. In the large grey area in between, however, significant judgment is needed when determining necessary disclosures. And information in this grey area that is useful for investment decision making should not be omitted from the footnotes. Without such decision-useful information, investors are ill-equipped when they make their resource allocation decisions. What investors have not seen—even in the post–Sarbanes–Oxley Act environment with its disclosure audit differences—is a substantial increase in disclosures of immaterial information. Linkage of this assertion to the inclusion of immaterial information needs to be demonstrated.

Perception vs. Reality: Research Needed to Demonstrate Increase in Immaterial Disclosures

In short, many generalized claims have been made that immaterial disclosures are being included in financial statements and that information needs to be curtailed to only what is essential. We believe, however, that more specific research is needed to find examples of inclusion of immaterial information before the conclusion can be drawn that extensive amounts of immaterial information are indeed being included in financial statements. For example, a review of the financial statements of the Dow Jones Industrial Average 30 companies could be performed to identify whether, or the extent to which, any immaterial disclosures have been made and, if so, why. Furthermore, investors and preparers for these entities could be interviewed and results developed based on both empirical and anecdotal evidence.

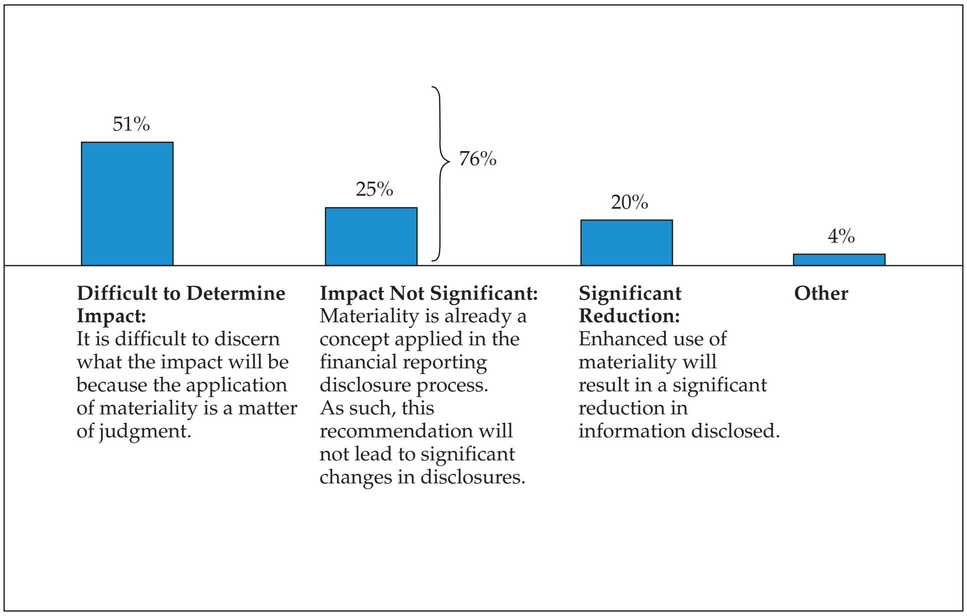
Investor View: No Obvious Inclusion of Immaterial Information

In 2012, we surveyed members to gain their views regarding the impact of the enhanced use of materiality in financial reporting disclosures. The results displayed in **Figure 1** indicate the following:

- The majority (51%) of respondents believe it is difficult to discern what the impact will be because the application of materiality is a matter of judgment. If there was an obvious inclusion of immaterial information, investors would not find it difficult to discern whether enhanced use of materiality and deletion of disclosures would be significant.
- Another 25% of respondents indicated that the impact will not be significant.
- Only 20% indicated that the enhanced use of materiality will result in a significant reduction in information disclosed.

In summary, 76% of respondents do not currently observe the inclusion of obviously immaterial information in financial statements.

FIGURE 1. INVESTORS SURVEYED SEE NO OBVIOUS INCLUSION OF IMMATERIAL INFORMATION



Notes: Participants were asked the following: Which of the following statements most accurately describes your view regarding enhanced use of materiality in financial reporting disclosures as well as the deletion of disclosures that do not contain material information? As for responses, *N* = 301.

Need for Investor Perspective in Materiality Determination

We underscore that the perspective of an investor must be central to the definition of materiality. We have long argued that materiality assessments for the level of information to be provided in the financial statements and disclosures should use the standard of whether the item or information disclosed would make a difference to the decision making of an informed investor. Investors' information requirements should determine the materiality threshold as articulated in Principle 6, Investor Materiality Threshold, of the *Comprehensive Business Reporting Model* (*CBRM*).[7]

The CIFiR report affirms this position in stating that materiality should be based on the "perspective of a reasonable investor" (p. 12). This view is echoed in Aqel:[8]

[7]CFA Institute, *A Comprehensive Business Reporting Model* (Charlottesville, VA: CFA Institute, 2007): www.cfapubs.org/toc/ccb/2007/2007/6.

[8]Saher Aqel, "Auditors' Assessments of Materiality between Professional Judgment and Subjectivity," *Acta Universitatis Danubius Oeconimica*, vol. 7, no. 4 (2011): 72–88.

> The concept of materiality is directly linked to the decision-making requirements of financial statement users. Materiality has been defined by the FASB in Statement of Accounting Concepts No. 2, Qualitative Characteristics of Accounting Information as… "The omission or misstatement of an item is material in a financial report, if, in light of surrounding circumstances, the magnitude of the item is such that it is probable that the judgment of a reasonable person relying upon the report would have been changed or influenced by the inclusion or correction of an item." (p. 73)

The European Securities and Markets Authority (ESMA) consultation paper on materiality ("Considerations of Materiality in Financial Reporting" 2011) addresses what is needed in the assessment of materiality as follows:

> An assessment of materiality requires an understanding of the characteristics of the users of the financial statements of an entity, the attributes of the information required by those users, the purpose of the information being disclosed as well as other matters outlined in this Paper. (p. 7)

We also note that SAB 99 refers to investors and their assessments of materiality in reaching conclusions regarding materiality. We have found, however, that preparers and auditors have little training in investment analysis and decision making or interaction with investors. Thus, they may find evaluating materiality with reference to how investors might perceive materiality to be challenging.

Assessing Materiality: Expectations and Knowledge Gaps

Aqel (2011) identifies three problems in arriving at a materiality definition:

1. *All stakeholders make materiality decisions*. Materiality decisions are made by preparers, auditors, and users. These heterogeneous groups are likely to have dissimilar views concerning materiality. Aqel states,

   > Some studies have observed investors' materiality threshold based on their reactions to new earnings announcements. Cho et al., 2003, for example, investigated empirically investors' perceptions of materiality in the context of several materiality criteria that include percentage of pretax earnings, percentage of sales, and percentage of total assets by observing stock price reactions when unexpected information is revealed to stock market participants. The study pointed out that users demonstrate lower materiality thresholds than auditors.[9] This indicates the existence of [an] expectation gap regarding materiality. (p. 84)

   One of the main conclusions drawn from the responses to the ESMA consultation paper on materiality is that the majority of all respondents believe that the concept of materiality is generally well understood but they see diversity in application. Diversity in application was attributed to management judgment, separate perspectives of different stakeholder groups, and general difficulties in applying the concept to certain issues.

[9]Aqel is referring to S.Y. Cho, S.N. Hagerman, and E.R. Patterson, "Measuring Stockholders Materiality," *Accounting Horizons*, vol. 17 (2003).

2. *Limited information on how preparers and auditors make materiality judgments*. Limited knowledge is available about how materiality judgments are made by preparers and auditors and how they affect users' decision making.

3. *Limited understanding by preparers and auditors about the use of financial statements*. Very little is known about the ways financial statements are used by users in making their credit and investment decisions:

   > Little information is known on how materiality judgments made by preparers and auditors will affect the users' decision making because limited knowledge is available on how financial statements are utilized by users in investment and credit decision making.[10]

   Aqel explains his findings as follows:

   > The FASB definition of materiality explicitly addresses decision usefulness of the financial statements users. However, in practice users are not involved in the concept at all. Users don't have enough knowledge about auditors' responsibilities. Furthermore the auditor's report does not include detailed information related to materiality. (p. 84)

To address these gaps in expectations and knowledge, education is needed on how investors use financial statements and how investors are affected by materiality judgments made by auditors and preparers.

Furthermore, the CIFiR report recommends that the FASB or the SEC, as appropriate, conduct education sessions internally and make outreach efforts to financial statement preparers and auditors to raise awareness of materiality issues and to promote consistent application of the concept of materiality.[11]

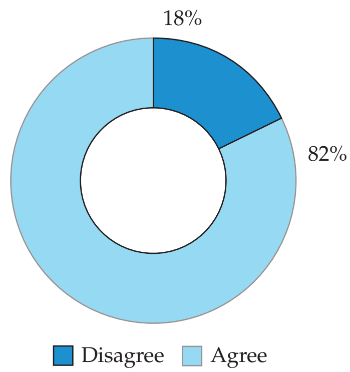
Need for Communication: Disclosure of Materiality Judgments and Thresholds

Given the lack of consensus on materiality thresholds among auditors, preparers, and users, many users believe disclosures should be made in the financial statements regarding (1) the materiality judgments exercised by management and (2) the materiality thresholds applied by auditors in the conduct of their work in the auditor's report. Such disclosures would provide transparency and enable users to more easily assess the information presented in the financial statements. This practice would also resolve the knowledge and expectations gaps.

In March 2010, CFA Institute asked a group of members with an expressed interest in financial reporting issues their views on the disclosure of auditor materiality thresholds. As reflected in the survey report, "Independent Auditor's Report Survey Results," 82% of respondents agreed that the method by which the auditor determines/assesses materiality should be disclosed. **Figure 2** shows this finding.

[10]G.L. Holstrum and W. Messier, "A Review and Integration of Empirical Research on Materiality," *Auditing: Journal of Practice & Theory*, vol. 2 (Fall 1982): 48.
[11]See the CIFiR report, p. 12.

FIGURE 2. DISCLOSURE OF AUDITOR ASSESSMENT OF MATERIALITY



Notes: Participants were asked the following: Do you agree or disagree that the method by which the auditor determines/assesses materiality should be disclosed? As for responses, $N = 144$.

Representative respondent quotes include the following:

- This will help the user understand what level of tolerable error to allow for analysis of the income statement and balance sheet. Importantly it should also be disclosed whether one materiality level has been applied across the income statement and balance sheet or whether there are differences.
- I would consider the materiality definition one of the most important matters, esp. in light of cases like HealthSouth.
- This is a key issue. GAAP calls on management to determine materiality. The auditors then provide judgment about management's determination. Managements need to make materiality hurdles clear and investors need to know what the auditor thinks.

The ESMA consultation paper on materiality proposes an accounting policy note disclosing materiality judgments exercised by preparers:

> An entity shall disclose, in the summary of significant accounting policies or other notes, the judgments, apart from those involving estimations, that management has made in the process of applying the entity's accounting policies and that have the most significant effect on the amounts recognized in the financial statements. In this context a view could be taken that preparers of financial reports should carefully consider making disclosures regarding materiality judgments exercised in preparing financial reports with a view to providing the primary users with information that is relevant to the primary users' understanding of those financial reports. (p. 11)

The summary of responses to the ESMA consultation paper on materiality states that, although the inclusion of such information by other parties has little support, "a number of user representatives did see merit in the provision of such [accounting policy disclosure] information, either in the notes to the financial statements or as part of the report to the audit committee" (p. 4).

Concluding Thoughts on Materiality

As we consider the materiality issue in the aggregate, we can see that a perception has emerged among preparers and auditors that financial statements are filled with immaterial information. This perception has been communicated to standard setters through the reports cited in this document. The investors we surveyed, however, do not find an obvious overabundance of immaterial information. Issues relating to boilerplate information or lack of entity-specific information are of greater concern to investors.

This disconnect in materiality assessments likely stems from a lack of communication regarding the materiality measures and thresholds made by management and auditors. The knowledge and expectations gaps are obvious and natural by-products of the lack of communication. Without greater communication of materiality measures and thresholds, the inability of users to provide feedback regarding materiality and its impact on their decision making will persist.