

The SEC's Chief Accountant Talks "Materiality"

Any time that the SEC Staff talks "materiality," it's worth listening given the importance of that determination. Last week, the SEC's Acting Chief Accountant - Paul Munter - issued a [statement](#) regarding the correction of material errors in financials and how to assess materiality in this context. As always, when considering materiality in the financials context, you should refer to [SAB 99](#). The statement is worth reading as it reviews the applicable requirements and addresses the Staff's concerns about certain approaches that companies have taken in correcting errors. Here are five things to know about Paul's statement:

- 1. Reasonable investor test:** The determination of whether an error is material is an *objective assessment*. Not surprisingly, those who assess the materiality of errors should do so through the lens of the *reasonable investor*. The total mix of information, including all relevant facts and circumstances surrounding each error should be objectively evaluated by the company, audit committee, and independent auditor. Importantly, the Chief Accountant specifically cautions us to put aside any potential bias of the company, auditor, or audit committee that would be inconsistent with the perspective of a reasonable investor. Each misstatement's materiality should first be considered individually, irrespective of its effects 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 financials materially misleading.
- 2. Importance of both quantitative and qualitative analyses:** A materiality analysis is not solely a quantitative analysis. The Staff emphasizes an increased need for objectivity in the assessment of qualitative factors. A quantitatively small error could be considered material because of qualitative factors, pointing again to the guidance on materiality in SAB No. 99. At the same time, as the quantitative magnitude of the error increases, it becomes increasingly difficult for qualitative factors to overcome the quantitative significance of the error - in other words, it's often not sufficient to simply assess the SAB 99 qualitative factors in reverse when evaluating the materiality of a quantitatively significant error. So in essence, quantitative grows in importance compared to qualitative as quantitative grows.
- 3. Increase in little "r" revision restatements:** If an error is material to previously issued financial statements, it is colloquially referred to as a "big R" *reissuance* restatement, and the error must be corrected by restating and reissuing the prior-period financial statements. If an error is determined to be not material to previously issued financials, but the correction of the error or leaving the error uncorrected is material to the current period financials, then a company must still correct the error in the current period financials and disclose the error. This is considered a "little r" *revision* restatement. Since 2013, the total number of restatements has declined each year, but "little r" restatements have increasingly made up a larger percentage of the total number of restatements. While some attribute this trend toward "little r" restatements primarily to improvements in internal controls and audit quality, the Staff is skeptical and monitoring this trend. The Staff has observed that some materiality analyses appear to be biased toward supporting an outcome that an error is not material to previously-issued financials, resulting only in "little r" restatements.
- 4. Examples of unpersuasive arguments regarding immateriality:** Based on recent interactions with companies and auditors, the Staff has found the following arguments in support of a "little r" restatement to be unpersuasive: - Financial statements, or specific line items in financials, are irrelevant to investment decisions; - Certain elements of financial statements prepared in accordance with GAAP or International Financial Reporting Standards ("IFRS") do not provide useful information to investors, so an error in those elements cannot be material; - Historical financials, or specific line items in those financials, are irrelevant to current investment decisions; - An error is not material to previously-issued financials because the error was also made by other companies; - The lack of intentional misstatement as providing evidence that an error is not material; and - An error is not material because its effect is offset by other errors.
- 5. Material weakness and effectiveness of internal controls:** While a material accounting error can be an indicator of a

material weakness, a material weakness may also exist without the existence of a material error. Management's assessment of the effectiveness of internal controls should be focused on a holistic, objective analysis of what *could* happen from a control deficiency in the context of current and evolving financial reporting risks. The Staff emphasizes the importance of identifying and communicating material weaknesses to investors promptly and encourages ongoing attention, *including audit committee participation and training*, regarding the adequacy of - and basis for - an internal controls effectiveness assessment.

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