Financial Regulatory Alert

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Coming to Terms with Materiality Judgments for SEC Financial Statements

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Materiality in the context of the federal securities laws has been a topic of repeated focus by the Securities and Exchange Commission (SEC) and the courts over the years (see here). That attention, however, has not necessarily produced the clarity that capital market participants have sought on the subject. Most recently, the acting Chief Accountant of the SEC, Paul Munter spoke to materiality from the perspective of the "reasonable investor" as it is applied to errors in financial statements (see here). While Munter's comments offer important reminders about the SEC staff's take on materiality, his remarks do not suggest new insights into how the reasonable investor arrives at materiality judgments. Thus, judgments about whether information is material for purposes of the disclosure requirements under SEC rules and the antifraud provisions of the federal securities laws remain very challenging. At the same time, errors in making those judgments can and do result in SEC enforcement actions and private civil liability.

In this article, we highlight aspects of Mr. Munter's remarks on materiality. In addition, we discuss how audit committees and external auditors approach these materiality judgments. Finally, we offer some practical tips for how the SEC registrants can best make materiality determinations in the context of errors in financial statements.

SEC OCA Sends Up A Warning Flare

As mentioned, Munter recently addressed materiality from the reasonable investor perspective as it applies to errors in financial statements. Quoting the Supreme Court, Munter noted 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.'"[1] Munter outlined two possible outcomes for correcting an error in financial statements, both of which qualify as restatements. First, when a material accounting error has been identified, the error must be corrected by restating prior-period financial statements, i.e., a "Big R" restatement. Alternatively, if the identified error is not material to previously-issued financial statements, the registrant may instead correct it in the current period by correcting the prior period information, i.e., a "little r" restatement.

Munter emphasized that the analysis of whether an error is material depends on "an

objective assessment focused on whether there is a substantial likelihood it is important to the reasonable investor. (emphasis in original).” That analysis is not purely quantitative according to Munter, rather, an appropriate materiality analysis takes into account “all relevant facts and circumstances” regarding the error, “including both quantitative and qualitative factors.”

What’s driving this recent SEC staff pronouncement on materiality? Several factors seem to be prompting Munter’s remarks.[2]

First, parties have asserted to the Office of the Chief Accountant (OCA) staff that a “quantitatively significant error” is not material due to qualitative factors. According to Munter, this stands in contrast to SAB No. 99 where it addresses how a quantitatively small error, could be material based on qualitative errors. Munter also remarked that the qualitative factors which may be relevant to assessing the materiality of a quantitatively significant error are not necessarily the same qualitative factors when assessing a quantitatively small error.

Second, Munter suggested that SEC staff are concerned about how “little r” restatements now are dominating the percentage of recent restatements.[3] While Munter gave a nod to improvements in internal control over financial reporting and outside audits as a factor in this trend, his comments belie a degree of skepticism that such improvements are the best explanation for this development. From Munter’s perspective, based on OCA’s discussions with registrants and their auditors, “little r” restatements may be the result of a bias toward concluding that an error is not material.

Further, OCA has encountered the following arguments on materiality, which it has found unpersuasive:

- Investors don’t care about the identified errors: Portions of financial statements prepared in accordance with U.S. GAAP or International Financial Reporting Standards (IFRS) do not provide helpful information to investors, so an error in those portions cannot be material; or historical financial statements, or specific line items in those financial statements, are irrelevant to investors’ current investment decisions.
  - OCA counterpoint: This argument overlooks important fundamentals. Financial statements must be prepared in accordance with GAAP or IFRS and form the beginning of any materiality analysis. In addition, comparative financial statements allow for an investor’s trend analysis.
- Other SEC filers have made the same innocent mistake: An error is immaterial to previously-issued financial statements because the error was also made by other SEC filers, suggesting no intention to misstate.
  - OCA counterpoint: The lack of intent does not inform materiality. SAB No. 99 points out that the intent of management to misstate may provide “significant evidence of materiality” but, the inverse is not persuasive, i.e., the lack of an intentional misstatement provides evidence that the error is not material.
- All the identified errors zero each other out: SEC filers maintain that the error is not material because its impact is “offset by other errors.”
  - OCA counterpoint: Each individual error stands on its own and cannot be judged

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– to be immaterial by aggregating it with other errors. According to SAB No. 99, the materiality of each misstatement first should be considered, regardless whether in combination with other misstatements its effect is not material. The cumulative effects of all errors should then also be analyzed to determine whether an otherwise immaterial error, when combined with other misstatements, "renders the financial statements taken as a whole to be materially misleading."

Munter also addressed, at a high level, how gatekeepers such as audit committees and auditors should consider materiality in performing their functions. We elaborate here on how materiality determinations figure into these gatekeepers' roles.

Audit Committees and Materiality

In furtherance of their oversight of a company's financial reporting, audit committees should have a good grasp of how management applies materiality and, specifically, how it uses materiality to decide whether to restate previously-issued financial statements. Audit committees which understand how management approaches materiality as to disclosure items and determining the severity of an internal control deficiency, when the time comes, will be in a better position to evaluate management's assessment of the materiality of an identified error in financial statements. Further, the SEC has a renewed focus on implementing the provisions of Dodd-Frank relating to listing standards for SEC registrants to develop and implement "claw backs" of incentive-based executive compensation.[4] To the extent the company already has policies to "clawback" compensation from management following a restatement, an audit committee is well advised to understand how such policies could impact management's judgments as to materiality.

Similarly, the audit committee should understand the external auditor's view of materiality. In particular, audit committees should discuss materiality thresholds with the outside auditors and appreciate how the auditors assess materiality in the context of financial reporting and disclosure issues arising in the audit. To the extent the external auditors have a different view of materiality from management, audit committees should explore the basis for those differences. Further, audit committees need to be armed with an appropriate view of materiality given that auditors are required to inquire about their knowledge of risks of material misstatement. (PCAOB Audit Standard ("AS") 2110.05f and .54-.57).

Auditors and Materiality

Auditors use materiality to make judgments about a range of audit procedures. Materiality is used by auditors to determine which classes of accounts and disclosures should be subject to audit procedures. (AS 2105.06.) Further, materiality figures into an auditor's determination whether a company should record an audit adjustment. (AS 2810.17) And if the company does not record those adjustments, the auditor is required to discuss with the audit committee, or confirm that management has addressed with the audit committee, the basis for concluding that the uncorrected misstatements were immaterial. (AS 1301.18) Finally, the auditor uses materiality to decide whether a control deficiency is a material weakness for purposes of the audit of management's assessment on the effectiveness of the company's internal control over financial reporting. (AS 2201.62).

In the context of a restatement, the materiality discussions between the audit committee and auditor likely will be more involved. If the error is traceable to a

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fraudulent act, often the audit committee will conduct its own investigation of the matter, and auditors will look to the outcome of that investigation as part of its audit procedures. But even where no fraud is involved, if the errors on their face are potentially significant, management will need to understand all the more the underlying facts and circumstances behind the errors and come to judgments on how the errors should be corrected, which will be subject to the auditor's review.

Tips and Takeaways for SEC Filers

Munter's remarks highlight the centrality of materiality analysis for the process of correcting errors in financial statements. Working with the principle-based standard of materiality, SEC registrants should evaluate all the relevant facts and circumstances around an identified error to determine its materiality. This evaluation should include appropriate communications among and between management, audit committees and auditors around how the company arrived at its materiality determinations. As always, when considering materiality in the context of an identified error, companies should refer to SAB 99. SEC registrants should expect that their materiality judgments will be stress-tested by the SEC staff and, specifically, management's analysis under SAB No. 99 will be scrutinized. It is particularly important that any SAB No. 99 analysis has documented support for its conclusions.

[1] TSC Industries v. Northway, Inc., 426 U.S. 438, 449 (1976).

[2] Munter's remarks came on the heels of a report that SEC Chair Gensler was ensuring that the SEC's climate proposal relied on a "legally defensible definition of materiality." See here.

[3] "…[W]e 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. [citing Audit Analytics, 2020 Financial Restatements: A Twenty-Year Review (November 2021).]"

[4] https://www.sec.gov/news/public-statement/gensler-clawbacks-2021-10-14

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