February 13, 2008

Mr. Robert C. Pozen
Chairman
SEC Advisory Committee on
Improvements to Financial Reporting
c/o Nancy M. Morris
Federal Advisory Committee Management Officer
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington D.C. 20549

File: 265-24

Dear Chairman Pozen:

Attached please find a paper prepared for the purpose of providing the SEC Advisory Committee on Improvements to Financial Reporting (the Advisory Committee) with a perspective on certain matters relating to the subject of materiality. The paper was prepared by an *ad hoc* task force comprised of the individuals listed below and was furnished to the Advisory Committee's *Subcommittee III: Audit Process and Compliance* during December 2007. We are providing a copy of the paper to you so the full Advisory Committee will have the opportunity to review the paper in connection with its on-going deliberations.

If you or any member of the Advisory Committee has any questions, please feel free to contact any of the task force members.

Sincerely,

The Members of the *Ad Hoc* Materiality Task Force,

Diann D. Gross
John J. Huber
Teresa E. Iannaconi
Gregory J. Jonas
Phillip R. Jones
H. Stephen Meisel
Guy W. Moore
Lawrence J. Salva
Scott A. Taub

Frequently Asked Questions Regarding Materiality

December 2007

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<u>Materiality Task Force</u>:

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<u>Question 1</u>: Staff Accounting Bulletin No. 99, "Materiality" (SAB 99) sets forth the view that a misstatement that is small (in magnitude) may, nonetheless, be material based on a complete analysis of all the surrounding facts and circumstances. Can surrounding facts and circumstances also lead to a conclusion that a large misstatement is immaterial?

<u>Response</u>: Yes. A misstatement is material if there is a substantial likelihood that a reasonable investor would consider it important in making an investment decision[1] in light of all the surrounding facts and circumstances. Quantitative characteristics are an important element to consider, however, the analysis of whether a particular misstatement is material does not rest solely on quantitative factors. This is true whether the misstatement is small or large.

SAB 99 is limited in its focus to the analysis of surrounding facts and circumstances (sometimes referred to as qualitative factors) that may indicate that a small misstatement is material. However, the converse is also true: a misstatement that is large in magnitude might, nonetheless, be properly viewed as immaterial based on a full analysis of the surrounding facts and circumstances.

SAB 99 lists examples of some of the qualitative factors that may be relevant when considering whether a small misstatement is material. The list, however, is not exhaustive and there can be other surrounding circumstances to consider.

The absence of the qualitative factors outlined in SAB 99 does not necessarily mean that a large misstatement is immaterial. Rather, each misstatement must be analyzed in light of <u>all</u> the surrounding facts and circumstances--weighted as appropriate. The nature of the misstatement (e.g., classification-only vs. impacting earnings), the nature of the affected financial statements (interim vs. annual), the effects on trends relating to key financial metrics and other characteristics are important factors to consider. The following are examples[2] of qualitative factors that could be considered when evaluating whether a large misstatement is, nonetheless, immaterial:

- The misstatement only impacts metrics that do not drive a reasonable investor's conclusions or are not important to a reasonable investor's valuation models.

- Misstatements that reasonable investors view as affecting a single period rather than affecting an ongoing trend.

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[1] All references in this document to "materiality" and "importance" are intended to be viewed from the perspective of a reasonable investor making an investment decision considering all the surrounding facts and circumstances. Similarly, all references to an "investor" are intended to mean a reasonable investor in making an investment decision.

[2] These factors are included for illustrative purposes only and are not intended to represent an exhaustive listing of the qualitative factors that might be considered when evaluating whether a large misstatement is, nonetheless, immaterial. Similarly, these examples should not be used as a "checklist" whereby the presence of any one of the qualitative factors would automatically lead to a conclusion that a large misstatement is immaterial.

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- The misstatement does not significantly impact a reasonable investor's impressions of important trends.

- The misstatement does not impact a business segment or other portion of the registrant's business that a reasonable investor sees as driving valuation or risks. That is, the misstatement does not significantly impact a reasonable investor's assessment of the entity's financial condition or performance considering the segments or other portion of the registrant's business within the context of the whole business.

- Misstatements that relate to financial statement items whose measurement are inherently highly imprecise.

Materiality is a highly subjective matter that requires well-reasoned professional judgment to determine whether a particular misstatement (whether large or small) is material to a reasonable investor making an investment decision. When appropriate, materiality analyses should consider items beyond traditional financial statement metrics to evaluate how a misstatement impacts the fundamental value drivers of the business.

Issuers may consider investment or credit analysis models and other available information that would be informative in assessing materiality from a reasonable investor's perspective. Two errors of equal quantitative magnitude may have different effects on a reasonable investor's behavior. For instance, the failure to identify and disclose the impairment of a key intangible asset relating to a developing technology or product may have greater consequences from a reasonable investor's perspective than an error with the same historical financial statement impact relating to a technical misapplication of derivative instrument accounting standards.

Question 2: Should a misstatement relating to previously issued interim financial statements be evaluated for materiality differently than a misstatement in previously issued annual financial statements?

Response: The materiality analysis does not change simply because the misstatement relates to interim financial statements rather than annual financial statements. Accordingly, a materiality analysis with respect to a misstatement in previously issued interim financial statements should follow the same general framework that would be used to evaluate the materiality of a misstatement in previously issued annual financial statements. That is, the analysis should consider the misstatement in light of all the surrounding circumstances to determine whether the error affects the total mix of information and whether there is a substantial likelihood that the misstatement is important to a reasonable investor making an investment decision.

When performing a materiality analysis with respect to a misstatement in previously issued interim financial statements, issuers should consider the qualitative differences between interim and annual financial statements. Frequently, interim financial statements derive their usefulness from their

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relationship to the annual financial statements and in depicting trends. Accordingly, a materiality analysis with respect to interim financial statements should generally focus more on the relationship of the misstatement to the annual period and on trends than on the discrete interim period. This means that an error of a given relative magnitude (e.g., percentage of pre-tax income) in an interim period might properly be considered immaterial with respect to that interim period even if a misstatement of the same relative magnitude/percentage in the annual financial statements would be considered material. That is not to suggest that interim financial statements are unimportant. Rather, it is an acknowledgement that certain factors are evaluated differently in the materiality analysis relating to interim financial statements. Investors frequently use interim financial statements differently than they use annual financial statements and these differences should be recognized when considering the materiality of a particular misstatement. This notion is also supported by the concept of integrated disclosure in which interim reports are intended to build upon information previously disclosed in the annual report[3].

The materiality analysis with respect to a misstatement in previously issued interim financial statements should generally consider the misstatement from two different perspectives: as an originating error and as an out-of-period correction.

If the annual financial statements in which an error originated are materially misstated, then those financial statements should be restated promptly. The restatement would usually be accomplished by amending prior reports but is sometimes effected by restating the financial statements being presented for comparative purposes in a current filing if that filing is imminent.

If annual financial statements in which an error originated are not materially misstated but the interim financial statements include an error which, after considering the qualitative factors described above, is determined to be material, then the interim and annual financial statements should be revised[4] no later than the next time they are filed. Depending on the facts and circumstances, the issuer may determine, on its own consideration or upon the advice of counsel, that it should revise its previously issued financial information before the next interim period filing that requires the comparative interim period financial statements that contained the misstatement. The previously issued misstated annual financial statements would be revised no

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[3] Specifically, integrated disclosure presumes investors have information from the latest annual report and does not require certain repetition in the interim reports. Therefore, interim information can be presumed to be evaluated by investors who already have knowledge of the registrant's annual performance and trends as set forth in the latest annual report. Said another way, interim misstatements need not be evaluated on a stand alone basis but should be evaluated on the assumption that the investor or other user would view the misstatement in the context of the annual periods set forth in the latest annual report.

[4] In the context of this document, the word "revise" means to correct the previously filed financial statements the next time the financial data of a prior period is presented (e.g., for comparative purposes). Issuers should also consider whether disclosure of the pending revision should be made prior to the time the revised financial statements are filed. Revising financial statements is contrasted with "amending" prior reports.

later than the next time they are presented in a filing. Disclosure around the revision should be transparent. [5]

If an error in previously issued financial statements is immaterial to both the interim and annual periods in which the error originated, then the error can be corrected as an out-of-period adjustment in a subsequent interim period unless the out-of-period adjustment is expected to introduce a material error into the financial statements for the year in which the error would be corrected (see below). If an out-of-period adjustment is material to the interim financial statements in which it is effected, then those interim financial statements should contain transparent disclosure of the nature and effect of the out-of-period adjustment.

If the out-of-period adjustment would introduce a material error into the financial statements for the year of correction, then the error should be corrected by revising the previously issued interim and annual financial statements in which the error originated the next time they are filed. Depending on the facts and circumstances, the issuer may determine, on its own consideration or upon the advice of counsel, that it should revise its financial information before the next interim or annual period filing. Disclosure relating to the revision should be transparent.

Question 3: Should the materiality of a misstatement that does not affect net earnings (or another key performance metric) be evaluated differently from a misstatement that does affect net earnings (or another key performance metric)?

Response: The basic framework for evaluating the materiality of a misstatement should be consistent regardless of the nature of the misstatement. Specifically, the evaluation should consider the impact of the misstatement on the totality of financial information based on the financial statements taken as a whole. It should not be based on a consideration of any element of the financial statements in isolation from other information within the financial statements. As with other misstatements, the materiality of a misstatement that does not affect net earnings (or another key performance metric) should be evaluated in light of all the surrounding facts and circumstances to determine whether there is a substantial likelihood that the misstatement would be important to a reasonable investor in making an investment decision. However, the nature of the misstatement (e.g., disclosure/classification-only vs. impacting net earnings) is an important factor to be considered when evaluating all the surrounding facts and circumstances.

A misstatement that only impacts the classification between or among line items (including subtotals) within a particular financial statement might properly be viewed as immaterial even if the misclassification is large in magnitude. That is not to say that classification and subtotals are

[5] Although the appropriate level of disclosure will depend on facts and circumstances, investors should generally be provided sufficient information to be able to understand the nature of the misstatement and the impact on key elements of the affected financial statements. This disclosure should be included in the financial statements. Additionally, issuers might need to supplement the financial statement disclosure with similar disclosure in its MD&A.

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unimportant. Rather, it is a recognition that the materiality evaluation must be made in the context of what a reasonable investor would consider important in making an investment decision and should consider the financial statements taken as a whole and not necessarily the impact on a single financial statement line item.

For instance, a relatively large misclassification between financing and investing cash flows might properly be viewed as immaterial if a reasonable investor would consider the misclassification unimportant. This might be the case when reasonable investors are focused less on the investing and financing designations/subtotals that are prescribed by the accounting literature and more on the transparency around the types and amounts of cash flows that a company generates/expends. Misclassifications that affect operating cash flows might require further analysis if the net operating cash flows subtotal is an important metric. When correcting a large, but immaterial, misclassification, issuers should provide transparent disclosure so investors understand what has changed.

Conversely, a relatively small misclassification between cost of goods sold and general/administrative expense might properly be viewed as material if reasonable investors consider gross profit percentage to be an important metric and the misclassification has an important impact on gross profit percentage.

A misstatement that only impacts note disclosure might properly be determined to be immaterial even if the misstatement is large in magnitude or the note disclosure is omitted altogether. That is not to say that note disclosures are unimportant. Rather, just as with classification matters, it is a recognition that the materiality evaluation must be made in the context of what a reasonable investor would consider important in light of all the surrounding facts and circumstances. Likewise a misstatement in terms of identification of segments or information within the segment disclosure (even a segment that is viewed as important to the registrant's current performance and prospects for growth) must be made in the context of what a reasonable investor would consider important in light of all the surrounding facts and circumstances.

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<u>Question 4</u>: How should offsetting misstatements be considered when evaluating materiality?

Response: When a particular accounting period is impacted by more than one misstatement, issuers should consider the misstatements individually and in the aggregate as one component of the materiality analysis. As with all materiality analyses, the evaluation should be oriented toward determining whether there is a substantial likelihood that the misstatements would be important to a reasonable investor in light of all the surrounding facts and circumstances.

In this context, the surrounding circumstances could include the fact that the effect of one misstatement is mitigated by the effect of another misstatement.

The evaluation should not be directed solely at determining whether any one of the misstatements would be material in isolation. Rather, it should be focused on whether a reasonable investor would consider the financial statements (taken as a whole) to be misstated in an important way.

The existence of two equal but offsetting errors might raise valid questions about whether a material weakness in the company's internal control over financial reporting exists. However, it might not necessarily indicate the financial statements contain a material misstatement.

For instance, two misstatements of equal but opposite magnitude might properly be determined to be immaterial if they both relate to the same financial statement line item and would not require any changes in disclosures (e.g., two equal but opposite revenue cut-off errors at period end in the same business unit). Although there may be valid questions relating to internal control over financial reporting, in this example the financial statements do not contain any material misstatement. Conversely, two misstatements of equal but opposite magnitude which affect multiple financial statement line items might be properly viewed as material because of their individual impact on the particular line items[6].

<u>Question 5</u>: How should materiality be evaluated in periods of significant earnings change?

Response: A misstatement relating to the financial statements for a period of significant earnings change is material if there is a substantial likelihood that a reasonable investor would consider it important in light of all the surrounding facts and circumstances.

The key drivers leading to the significant earnings change will generally be important factors to consider when evaluating the surrounding facts. For instance if a company with a stable earnings history experiences a significant change in earnings because of a large impairment, restructuring charge or gain that is not expected to recur, then the materiality of a particular misstatement might be properly evaluated against results excluding the non-recurring item. If the key driver of the significant earnings change results from an item which is expected to recur (e.g., a change in capital structure from the issuance of a substantial amount of long-term debt) then materiality would likely be considered based on the actual results.

[6] As indicated in the Response to Question 3, the materiality evaluation must be made in the context of what a reasonable investor would consider important in making an investment decision and should consider the financial statements taken as a whole and not necessarily the impact on a single line item.