

## **Comments of Robert F. Richter, CPA on the Draft Progress Report of the Advisory Committee on Improvements to Financial Reporting**

The Draft Progress Report of the Advisory Committee on Improvements to Financial Reporting, dated February 11, 2008, states the following on page 61:

### ***Developed Proposal 3.1: The FASB or the SEC, as appropriate, should issue guidance reinforcing the following concepts:***

- ***Those who evaluate the materiality of an error should make the decision based upon the perspective of a reasonable investor.***
- ***Materiality should be judged based on how an error affects the total mix of information available to a reasonable investor.***
- ***Just as qualitative factors may lead to a conclusion that a quantitatively small error is material, qualitative factors also may lead to a conclusion that a quantitatively large error is not material. The evaluation of errors should be on a “sliding scale.”***

***The FASB or the SEC, as appropriate, should also conduct both education sessions internally and outreach efforts to financial statement preparers and auditors to raise awareness of these issues and to promote more consistent application of the concept of materiality.***

We believe that those who judge the materiality of a financial statement error should make the decision based upon the interests, and the viewpoint, of a reasonable investor and based upon how that error impacts the total mix of information available to a reasonable investor. One must “step into the shoes” of a reasonable investor when making these judgments. We believe that too many materiality judgments are being made in practice without full consideration of how a reasonable investor would evaluate the error. When looking at how an error impacts the total mix of information, one must consider all of the qualitative factors that would impact the evaluation of the error. This is why bright lines or purely quantitative methods are not appropriate in determining the materiality of an error to annual financial statements. It is possible that an error that results in a misclassification on the income statement (without a change in net income) may not be deemed to be material, while an error of the same magnitude that impacts net income may be deemed material based on the effect of the error on the total mix of information available to a reasonable investor.

I recommend strengthening Proposal 3.1 by placing emphasis on the effect of an error on a reasonable investor's investment decision. Such effect may be implied by the requirement to consider a reasonable investor's perspective, but making it explicit would help with the understanding and implementation of the materiality standard.

The SEC already has two rules that go directly to that effect. Rule 12b-2 under the 1934 Act provides the following definition of the term *material*:

*Material.* The term “material,” when used to qualify a requirement for the furnishing of information as to any subject, limits the information required to those matters to which there is a substantial likelihood that a reasonable investor would attach importance in determining whether to buy or sell the securities registered.

Rule 405 under the 1933 Act has a similar definition:

*Material.* The term *material*, when used to qualify a requirement for the furnishing of information as to any subject, limits the information required to those matters to which there is a substantial likelihood that a reasonable investor would attach importance in determining whether to purchase the security registered.

CIFiR should give appropriate recognition to these definitions, which are good statements of principle.

The first sentence of the following paragraph in the Supreme Court’s decision in *TSC Industries, Inc. v. Northway, Inc.* states the court’s view of the best standard of materiality as it relates to shareholder voting in the case under review.

The general standard of materiality that we think best comports with the policies of Rule 14a-9 is as follows: An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote. This standard is fully consistent with Mills' general description of materiality as a requirement that "the defect have a significant propensity to affect the voting process." It does not require proof of a substantial likelihood that disclosure of the omitted fact would have caused the reasonable investor to change his vote. What the standard does contemplate is a showing of a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder. Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available.

Note the similarity of the standard in the first sentence to the definitions in Rules 12b-2 and 405. They all get to the effect of the matter on a decision to be made by the shareholder or investor – whether it be a purchase, sale, or voting decision.

The last sentence of the paragraph contains the “total mix of information” phrase. That sentence purports to restate the sentence that precedes it in “another way.” However, in so doing, the ultimate objective of considering the effect on “the deliberations of the reasonable shareholder” is lost. Instead, the objective becomes the effect on the total mix of information, rather than the effect on the investor’s decision.

Recognition of the total mix of information is important in evaluating the effect of an error, but it is not the ultimate objective.

I believe that the best definition of materiality of an error (or a misstatement or omission) would follow the Supreme Court's definition as modified to fit the circumstances of a reasonable investor's investment decision, as follows:

An error is material if there is a substantial likelihood that a reasonable investor would consider it important, in the light of all available information, for the purpose of making an investment decision, including whether to purchase or sell securities or to cast a vote relating to the securities.

Robert F. Richter, CPA – March 31, 2008