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"Could" v. "Would" and Other Issues: The Definition of Materiality in Light of Disclosure Reforms

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The year of disclosure reforms is upon us. Public financial disclosures, increasingly riddled with boilerplate, repetitious, and irrelevant information, have been criticized for "disclosure overload," where too much noise drowns out critical information for investors, shareholders, and the public. In light of congressional urging, the SEC has recently sought public comments on financial disclosure requirements in Regulations S-K and S-X. The comments showcase the issues with reform from minor changes, such as document-compatibility upload in EDGAR, to overarching conceptual issues regarding requirements across administrative agencies. Disclosure effectiveness is seen as a multi-issued problem that requires a comprehensive solution.

At its core, disclosure requires a careful balancing between transparency and relevance. The current worry is that the rules have tipped the scale too much in favor of transparency, which has snowballed regulatory interests into an avalanche of paper.

The Financial Accounting Standards Board ("FASB") has decided to boldly jump into the fray. To stem the proliferation of notes, the Board has released two exposure drafts attempting to redefine what constitutes "material information." Noting concern by "shareholders" regarding the various definitions of materiality and their potential inconsistency, the Board has essentially proposed three changes: (1) abandon its definition of materiality, (2) maintain that materiality is a legal concept and adopt the Supreme Court's definition, and (3) no longer maintain as error a non-disclosure of immaterial information. The goals are to eliminate uncertainty, heighten discretion, and allow companies to "focus communication with users on the material, relevant items," Chairman Golden said.

However, as well-intentioned as the proposals are, they face heavy backlash. The New York Times has equated the proposal to "miniature Molotov cocktail[s] into the usually staid world of audit standards." The eighty public comments have been uniformly critical. Legal commentary has taken note as well. The SEC has even criticized it.

As elementary as "materiality" is to accounting, its definition has always been elusive in the greater world of finance and law. In the regulatory scheme, three definitions are in play. First, the Supreme Court, in *TSC Inds.* v. *Northway, Inc.*, 426 U.S. 438, 449 (1979), defined a fact as material if there is "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." Second, the SEC changes it slightly: "Materiality concerns the significance of an item to users of a registrant's financial statements. A matter is 'material' if there is a substantial likelihood that a reasonable person would consider it important." Third, prior to its current proposals, the FASB defines information as material "if omitting it or misstating it could influence decisions that users make on the basis of the financial information of a specific reporting entity."

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If the FASB's proposals were enacted, not only would the third definition be removed from guidelines, but the Board would endorse the Supreme Court's definition and state that materiality is a purely legal concept. The effect of the changes in the definition are primarily two-fold: (1) materiality changes from facts that "*could* influence the decision of users" to facts that have a "substantial likelihood that the disclosure . . . *would* have been viewed by the reasonable investor" as significant;" and, (2) the focus of the fact is not line-by-line but in the context of the "total mix" of information made available.

Additionally, the change in definition allows for greater relevancy in disclosures. By reviewing the disclosure statement as a whole, the omission of a fact may be immaterial due to the inclusion of other similar disclosures. The change also enhances the discretion of auditing professionals. By setting an arguably lower threshold to a material fact as one that with a "substantial likelihood" a reasonable investor "would" have viewed as significant, the inclusion of additional facts is left to the judgment of the company.

It is precisely these changes, however, that have been significantly criticized. Among others, the SEC Investor Advisory Committee has dismissed the proposal's characterization as "clarifications," and argues that they instead "entail a significant and substantive alteration." The Auditing Standards Committee of the American Accounting Association has attacked the notion that materiality is solely a legal concept. They argue that the effect of greater discretion will not reduce uncertainty but instead increase it. Declaring that materiality is a "legal" concept will substitute the discretion of lawyers and the courts, through a process of piece-meal and non-expert change, for the expertly trained discretion of the accountants. Though it might reduce non-relevant disclosures overall, and it is contested whether this is an issue, substituting the definitions and discretion creates significant uncertainty at the margins for industry experts and investors alike.

Given the vitriolic response, Marc Siegel, a member of the FASB, noted that the Board has "committed to slow down" and rethink its proposal. However, the Board has also noted a real issue underlying public disclosures on more than a surface level: what is a "material" note? Who should determine this? If it is left to companies and its accountants, why is there a need for multiple definitions? In time, the discussion may come to shed light on the accounting industry's most elementary, but ever elusive, standard.