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FASB Proposes Changes to Materiality for More Effective Disclosures

The FASB recently issued two exposure drafts as part of its Disclosure Framework project that would provide more flexibility and discretion for entities to provide material information in the notes to the financial statements.[1]

Key Facts

- Materiality as described in FASB Concepts Statement 8 would be aligned with the legal concept of materiality.[2]
- The Board would observe the U.S. Supreme Court definition of materiality as its current definition of materiality.
- ASC Topic 235 would be revised to clarify disclosure requirements in the context of materiality as described in FASB Concepts Statement 8.[3]
- The proposed changes would apply to all entities (including public and private companies, not-for-profit organizations, and employee benefit plans).
- The proposed amendments would be effective upon issuance.
- Prospective or retrospective application would be permitted.
- Comments are due by December 8, 2015.

Key Impacts

- Entities would be encouraged to use appropriate discretion when making disclosures.
- Materiality would be applied to disclosures individually and in the aggregate, in the context of the financial statements as a whole.
- Disclosures would not be required for immaterial information; non-disclosure due to immateriality would not be considered an accounting error.

Contents

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[1] Proposed Accounting Standards Update, Notes to Financial Statements (Topic 235): Assessing Whether Disclosures Are Material, and Proposed Concepts Statement, *Conceptual Framework for Financial Reporting Chapter 3: Qualitative Characteristics of Useful Financial Information*, both available at www.fasb.org.

[2] FASB Concepts Statement No. 8, Conceptual Framework for Financial Reporting – Chapter 3, Qualitative Characteristics of Useful Financial Information, available at www.fasb.org.

[3] FASB ASC Topic 235, Notes to Financial Statements, available at www.fasb.org.

The objective of the Disclosure Framework is to make the communication of information that is most important to financial statement users more effective.

Background

The notes to financial statements may not always effectively convey the information that is most important to financial statement users. Some believe that disclosures described in FASB accounting standards must be provided even if the related information is not relevant, resulting in disclosure overload. Others believe not enough relevant information is provided.

In 2004 the IASB and FASB began working on a joint conceptual framework project that would have included disclosures. However, due to the demands of other joint convergence projects, the Boards delayed and ultimately removed the conceptual framework from their standard-setting agendas.[4] The FASB added the Disclosure Framework project to its technical agenda in July 2009. The project's primary objective is to produce more effective and useful disclosures in the financial statements. Reducing the volume of notes to financial statements is not the primary focus but may be a by-product of providing more effective disclosures.

In July 2012, the FASB issued a discussion paper soliciting public comments.[5] The discussion paper described the FASB's decision process when it evaluates disclosure requirements. In March 2014, the Board issued a proposed Concepts Statement to set the guidelines to be used when establishing disclosure requirements for the notes to financial statements.[6]

The Disclosure Framework has two components:

- The Board's Decision Process – intended to help the FASB develop disclosure requirements in new standards and evaluate existing disclosure requirements more consistently.
- The Entity's Decision Process - intended to promote the appropriate use of discretion by preparers of financial statements.

The FASB is currently considering the comments received on its proposed Concepts Statement chapter and reviewing four specific disclosure areas to evaluate how to modify its proposed chapter. The disclosure areas being reviewed are:

- Fair value measurements,
- Defined benefit plans,
- Income taxes, and
- Inventory.

[4] See further discussion in KPMG's Defining Issues No. 14-16, FASB Proposes Disclosure Framework, available at www.kpmginstitutes.com.

[5] FASB Discussion Paper, Disclosure Framework, July 2012, available at www.fasb.org.

[6] FASB Proposed Statement of Financial Accounting Concepts: Conceptual Framework for Financial Reporting, Chapter 8: Notes to Financial Statements, March 4, 2014, available at www.fasb.org.

KPMG Observations

Financial statement disclosures have received considerable attention by financial statement users, preparers, and accounting standard setters in recent years. The Jumpstart Our Business Startups (JOBS) Act required the SEC to review its existing disclosure requirements. The SEC plans to issue a concept release on its disclosure initiative in 2015. The IASB also has a Disclosure Initiative project with a goal of allowing preparers more flexibility to "tell the story" to investors in the financial statements and notes, rather than solely focusing on reducing disclosure.[7] Publications by other organizations also addressed the topic.

The FASB's proposal would describe materiality as a legal concept; the FASB would *observe* materiality, not promulgate it.

Materiality

The objective of the Disclosure Framework – Entity's Decision Process is to enable preparers of financial statements to move from a checklist compliance mindset to focusing on the effectiveness of information communicated in the notes to financial statements. To that end, the Board proposes amendments that focus on the role of materiality in Chapter 3 of Concepts Statement 8 and ASC Topic 235.

The FASB received feedback during outreach that the definition of materiality in Concepts Statement 8 could be considered inconsistent with the U.S. Supreme Court definition, which creates uncertainty in assessing materiality.

The Board therefore proposed that materiality would be a legal concept. The FASB would *currently* observe the U.S. Supreme Court definition of materiality in the context of the antifraud provisions of the U.S. securities laws. Materiality would be a living concept that can change based on executive, legislative, and judicial actions.

Current Description in Concepts Statement No. 8

"Information is 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. In other words, materiality is an entity-specific aspect of relevance based on the nature or magnitude or both of the items to which the information relates in the context of an individual entity's financial report."

[7] IASB Disclosure Initiative, available at www.ifrs.org.

U.S. Supreme Court Description

"A fact is material if there is a substantial likelihood that the disclosure of the omitted fact would have been viewed by a reasonable investor as having significantly altered the total mix of information made available."

KPMG Observations

Instead of setting the definition of materiality, the Board would observe that materiality is a legal concept. Although the FASB and IASB definition of materiality are currently identical, the FASB's proposed changes would create differences. The Board considers these differences necessary because the IASB's definition of materiality is not consistent with the legal concept of materiality in the United States. The FASB and IASB met on September 23, 2015, to discuss the progress on their respective projects, including disclosure initiatives. At that meeting, the IASB staff noted it was performing new research on a definition of materiality as part of its *Disclosure Initiative*, in part to align the definition consistently across its conceptual framework. It is currently unclear whether the definition of materiality will be converged when the IASB completes its project.

Because the FASB and IASB's definition of materiality would be different, the SEC may have to consider applying different materiality thresholds for foreign private issuers filing financial statements using IFRS in the United States.

It is also unclear whether and how the U.S. Supreme Court definition of materiality would apply in certain circumstances, such as U.S. GAAP financial statements prepared and used solely in a foreign country.

The Board believes that the proposed amendments would remove the barriers that prevent entities from exercising discretion in determining the disclosures in their financial statement notes.

ASC Topic 235

Current disclosure requirements include prescriptive language, such as "an entity shall at a minimum provide…" To encourage entities to use discretion and make disclosure requirements more flexible, the proposed amendments would clarify that disclosure requirements need not be applied to immaterial items. The materiality evaluation for possible disclosures would be made individually and in the aggregate, considering both quantitative and qualitative factors, in the context of the financial statements as a whole. Thus, an entity may determine that some, all, or none of the quantitative or qualitative disclosures in a topic may be material. An omission of immaterial information would not be an accounting error.

The proposed amendments to ASC Topic 235 would more closely align U.S. GAAP to IAS 1.[8]

The Board will evaluate the comments received on the proposed changes and then consider whether to make changes to existing disclosure requirements in the Accounting Standards Codification.

[8] IAS 1, Presentation of Financial Statements.

The Board is applying its Disclosure Framework to four disclosure areas to identify missing disclosures or those that do not add value. It also will determine whether its Disclosure Framework should be revised.

KPMG Observations

ASC paragraph 105-10-05-06 states that "[t]he provisions of the Codification need not be applied to immaterial items." However, for various reasons including language used in specific disclosure requirements (e.g., "shall disclose at a minimum…"), preparers do not always consider materiality in determining which disclosures to provide. The FASB's proposed amendments attempt to resolve these issues.

The IASB faced similar issues and made a step in that direction last year when it issued revisions to IAS 1 clarifying that materiality applies to the financial statements as a whole, including the notes. Before the IAS 1 amendments, some preparers believed that when an accounting standard requires a specific disclosure, the concept of materiality does not apply to that disclosure.

The FASB's proposed amendments would only apply to disclosure requirements and would not apply by analogy to other ASC sections such as presentation and measurement. This may result in different materiality assessments in the basic financial statements, which could create additional complexities in financial reporting.

The assessment of materiality could also potentially be different depending on the individual topic being evaluated for disclosure. Entities may need to have a more robust documentation of the materiality assessment and why certain disclosures were not provided. Entities also may have to update their processes and controls over disclosures.

Finally, the Board may need to provide additional guidance for circumstances where a disclosure is material in one year and not in other years presented.

Disclosure Reviews

The FASB indicated that when using the Disclosure Framework to determine the disclosures required for the four topics subject to review (see *Background* section), it found both missing disclosures as well as those that may not add value to users. The FASB also said that both its process and the entity's decision process would be evaluated together as it determines what changes to make.

The Board expects to issue an exposure draft in the fourth quarter of 2015 for changes to the disclosure requirements of defined benefit plans in employers' financial statements.

KPMG Observations

The overall feedback provided to the FASB staff for defined benefit plans indicated that no substantial revisions were needed for disclosures. However, the FASB will propose revisions based on the application of its Disclosure Framework.

While the timing of exposure drafts for the disclosure reviews of the remaining topics is less certain, the Board continues to consider potential revisions to the existing disclosure requirements for these topics by applying its Decision Framework.

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