

## **Securities Law Developments**

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### **A BROADER VIEW OF MATERIALITY: THE SEC'S RECENT STAFF ACCOUNTING BULLETIN**

On August 12, 1999, the staff of the Securities and Exchange Commission ("SEC") issued an important and long awaited Staff Accounting Bulletin ("SAB") concerning the concept of materiality as applied in the preparation of financial statements and the performance of audits.<sup>1</sup> This accounting bulletin represents one of a number of steps the SEC is taking or planning to take to combat what it sees as the problem of earnings management. Contrary to assurances that the bulletin is not an attempt to create new law or new standards, SAB 99 in fact sets forth some new interpretations by the SEC staff that represent a departure from current industry practice.

One of the principal purposes of the SAB is to provide interpretive guidance in order to clarify the concept of materiality; that is, the significance of an item to the reader of a financial statement and whether the reader would consider the item important in making an investment decision. Yet rather than clarifying the definition of "materiality," the SAB clouds its meaning by the rejection of any bright line standards. In place of those bright line standards, the SEC staff sets forth a type of "facts and circumstances" test that will prove somewhat cumbersome in operation. In light of the broad scope of the SAB, there are several important issues that issuers, auditors, and all persons who prepare financial statements should bear in mind. Key highlights include the following:

- The SAB rejects any numerical test for the determination of materiality, including the often cited 5% materiality threshold; even relatively small misstatements in a financial statement may be material, especially if they are intentional.
- Anticipated market reaction is an important factor in determining materiality.
- Misstatements in a financial statement must be analyzed on their own and in conjunction with misstatements elsewhere in that financial statement or prior years' financial statements.
- Intentional immaterial misstatements may violate the SEC's books and records provisions.

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<sup>1</sup> SEC Staff Accounting Bulletin No. 99 – Materiality, Release No. SAB 99, 64 Fed. Reg. 45150-01 (Aug. 12, 1999) (to be codified at 17 C.F.R. pt. 211, subpt. B). The release can also be found at the SEC's web site located at <http://www.sec.gov/rules/acctreps/sab99.htm>.

- Any intentional misstatement deemed as an “illegal act” (whether material or not) may require an auditor to take steps pursuant to Section 10A(b) of the Exchange Act.<sup>2</sup>

While the SAB fails to provide any concrete interpretive advice, as discussed below, a few effects are clear. Financial statements may take longer to prepare and to audit, because the scope of audits may have to be expanded to meet the SEC’s shifting materiality analysis. As a direct result, audit costs are likely to increase.

## **NO BRIGHT LINE TEST**

The SAB clearly sets forth the views of the SEC staff that there is no quantitative bright line test for determining materiality. This includes the 5% measure of determining materiality that has been widely used in the past by both the industry and the SEC staff. Instead, the SEC staff indicates that any consideration of materiality requires an examination of *both* the quantitative impact of a misstatement *and* the qualitative impact of the misstatement.

Although the SAB states that a numerical threshold, such as 5%, may be used as a basis for a preliminary assumption that a particular item is or is not material, it nonetheless requires consideration of all relevant circumstances. While the release is short in specifics, it does indicate that there are a number of factors that could cause a misstatement below 5% to be material. They include:

- whether the misstatement arises from an item capable of precise measurement or whether it arises from an estimate and, if so, the degree of imprecision inherent in the estimate;
- whether the misstatement masks a change in earnings or other trends;
- whether the misstatement hides a failure to meet analysts' consensus expectations for the enterprise;
- whether the misstatement changes a loss into income or vice versa;
- whether the misstatement concerns a segment or other portion of the registrant's business that has been identified as playing a significant role in the registrant's operations or profitability;
- whether the misstatement affects the registrant's compliance with regulatory requirements;

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<sup>2</sup> *Id.*

- whether the misstatement affects the registrant's compliance with loan covenants or other contractual requirements;
- whether the misstatement has the effect of increasing management's compensation, for example, by satisfying requirements for the award of bonuses or other forms of incentive compensation; and
- whether the misstatement involves concealment of an unlawful transaction.<sup>3</sup>

The SAB indicates that these factors are not to be considered exhaustive and must be considered along with whatever particular facts are present, including management's intent and the potential market reaction to the information. What is clear from the SAB is that any misstatement that becomes known in a financial statement must be carefully analyzed by both management and the auditors in order to determine whether the information is material. The SAB expressly rejects the ability to use any type of quick measurement or yardstick.

## POTENTIAL MARKET REACTION

The SAB also states that potential market reaction to the misstatement is another factor to be considered in determining materiality. As the staff acknowledges, "potential market reaction to disclosure of a misstatement is by itself 'too blunt an instrument to be depended on' in considering whether a fact is material."<sup>4</sup> Yet, the SAB goes on to state that

[W]hen . . . management or the independent auditor expects (based, for example, on a pattern of market performance) that a known misstatement may result in a significant positive or negative market reaction, that expected reaction should be taken into account when considering whether a misstatement is material.<sup>5</sup>

This requirement places management and its auditors in the difficult position of trying to predict whether and when information will have an impact on the market or what that impact will be. When any potential impact is known or believed to be known, it must be considered along with the other facts, including the factors set forth above. Conversely, that the registrant and the auditors do not believe that the information will have any impact on the market for the company's stock is not, by itself, enough to render information immaterial.

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<sup>3</sup> *Id.*

<sup>4</sup> *Id.*

<sup>5</sup> *Id.*

## **AGGREGATING AND NETTING MISSTATEMENTS**

According to the SAB, the materiality inquiry does not simply end once a determination is made that a particular misstatement is not material. The staff expects a registrant and its auditors to aggregate all misstatements contained in the financial statements. The SAB reflects the SEC staff's view that misstatements cannot be made immaterial by other errors in the financial statements which have the effect of netting out all of the errors.

The staff expects registrants and auditors to analyze all of the misstatements together to determine whether or not the financial statements taken as a whole are materially misleading. Significantly, the SAB indicates that registrants and auditors should also consider the effect of misstatements from prior periods on the current financial statement. As the staff notes “[T]his may be particularly the case where immaterial misstatements recur in several years and the cumulative effect becomes material in the current year.”<sup>6</sup>

Thus, once confronted with a misstatement, a registrant and its auditors must consider the misstatement in light of the other representations in the current financial statements as well as financial statements over a number of years.

## **IMMATERIAL MISSTATEMENTS STILL MAY HAVE CONSEQUENCES**

The SEC staff takes the position that there still may be a violation of the SEC's books and records provisions if a misstatement is immaterial but is nonetheless made intentionally.<sup>7</sup> Those provisions require certain books and records to be kept in “reasonable detail” and also require that the registrant maintain internal accounting controls that are sufficient to provide reasonable assurances that the transactions are recorded as necessary to permit the preparation of financial statements in conformity with GAAP. Thus, once management and the auditor have concluded that a misstatement is not material, they must conduct further inquiry to ensure that the misstatement is not intentional.

The SAB provides that management and auditors should consider the following factors to determine whether an otherwise immaterial misstatement might run afoul of books and records requirements:

- The significance of the misstatement.
- How the misstatement arose (whether it was intentional).
- The cost of correcting the misstatement.

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<sup>6</sup> *Id.*

<sup>7</sup> Sections 13(b)(2)-(7) of the Securities Exchange Act of 1934, 15 U.S.C. §§ 78m(b)(2)-(7).

- The clarity of authoritative accounting guidance with respect to the misstatement.<sup>8</sup>

Although these factors provide little concrete guidance, management and auditors can take some comfort from the SEC's acknowledgment that

[B]ecause the judgment is not mechanical, the staff will be inclined to continue to defer to judgments that "allow a business, acting in good faith, to comply with the Act's accounting provisions in an innovative and cost-effective way."<sup>9</sup>

This analysis could prove especially difficult for auditors, because it appears as though the SEC staff expects at least some kind of inquiry on the part of the auditor into the intent behind a particular misstatement in the financial statements. Such an inquiry will clearly lead to longer and more costly audits. Auditors should keep a detailed record of whatever inquiry is pursued in order to protect themselves in the event of a later disagreement with the SEC staff.

## **INTENTIONAL MISSTATEMENTS MAY REQUIRE AUDITOR TO TAKE ACTION**

One of the most significant reminders and warnings contained in the SAB is that the SEC staff expects auditors to follow the steps set forth in Section 10A(b) of the Exchange Act relating to the discovery of illegal acts whenever the auditor discovers an intentional misstatement. The staff expects such action even if the intentional misstatement is not material. Thus, an intentional violation of the books and records provisions will trigger the requirement that the auditor, at a minimum, inform management and the audit committee of the conduct.

## **ACCOUNTING LITERATURE TAKES PRECEDENCE OVER INDUSTRY PRACTICE**

Finally, the SAB states that it is the staff's view that authoritative accounting literature takes precedence over any industry practice that is contrary to GAAP. The SAB clearly articulates the staff's view that simply because a practice has developed in the industry does not mean that it should be followed if the practice does not conform with GAAP. Auditors and others preparing financial statements should determine whether their practices comply with GAAP and not simply rely on industry practice.

## **CONCLUSION**

The SAB issued by the SEC staff represents a departure from prior industry practice and sets forth a materiality standard that seems to raise more questions than it answers. Corporate officers, employees and auditors who develop financial statements must have a heightened awareness of the

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<sup>8</sup> Release No. SAB 99, 64 Fed. Reg. 45150-01.

<sup>9</sup> *Id.*

potential accusations of earnings management and how the information may impact the market for the company's stock. While not explicitly changing audit procedures, the SAB may cause auditors to expend more time and resources to develop a much higher comfort level with a registrant's financial statements.

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If you have any questions about the issues addressed in this newsletter, please call William McLucas (202) 663-6622, Harry Weiss (202) 663-6993 or William White (202) 663-6033.

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