Paul | Weiss

CLIENT MEMORANDUM

March 29, 2022

Acting SEC Chief Accountant Issues Statement Regarding Assessing Materiality of Financial Statement Errors

The SEC's acting Chief Accountant has issued a statement on "Assessing Materiality: Focusing on the Reasonable Investor When Evaluating Errors" (available here). This statement addresses the assessment of the materiality of financial statement errors, and describes a number of scenarios encountered by the SEC's Office of Chief Accountant ("OCA"), in addition to emphasizing other important considerations during the materiality assessments.

Materiality

The determination of the materiality of a financial statement error will impact the corrective actions a registrant must take. Where an error is material to previously-issued financial statements, it must be corrected by restating and reissuing the prior period financial statements (a "Big R" restatement, or reissuance statement). Where the error is not material to previously-issued financial statements, but correcting the error, or leaving it uncorrected, would be material to current period financial statements, the registrant may correct the error in the current period financial statements (a "little r" restatement, or revision restatement). The OCA has noted that "little r" restatements have significantly increased as a proportion of restatements in recent years, from approximately 35% in 2005, to approximately 76% in 2020. While acknowledging that this may be due to audit and internal control improvements, the OCA is monitoring this trend.

Objectivity

The materiality of an accounting error should be assessed from the perspective of a reasonable investor, and must be objective, considering all relevant facts and circumstances, including quantitative and qualitative factors. To be objective, the analysis must avoid any bias on the part of the registrant, its auditor or audit committee that would be inconsistent with such a perspective – for example, concern about the negative impact on executive compensation as a result of clawbacks, reputational harm to the registrant, a decrease in the registrant's share price, increased scrutiny by investors or regulators, or litigation. Allowing such impacts to influence a materiality assessment would not be objective and thus not consistent with the concept of materiality.

Specific OCA Observations Regarding Materiality Assessments

Assessment of qualitative factors: Staff Accounting Bulletin 99 ("SAB 99") contemplates that quantitatively small errors may be considered material as a result of qualitative factors. The converse, that quantitatively significant errors are immaterial as a result of qualitative considerations, is an unlikely outcome – as the OCA noted, "as the quantitative magnitude of the error increases, it becomes increasingly difficult for qualitative factors to overcome the quantitative significance of the error." Registrants should also consider the qualitative factors they are using in their materiality assessment – the qualitative factors that may be relevant in the assessment of materiality of a quantitatively significant error would not necessarily be the same qualitative factors noted in SAB No. 99 when considering whether a quantitatively small error is material.

Usefulness of information: The lack of usefulness of certain information required to be presented under U.S. GAAP or IFRS does not render an error immaterial. Because audited financial statements must be prepared in accordance with U.S. GAAP or IFRS, and the importance of the comparability of financial statements to investors' ability to identify and understand trends over time, "financial statements prepared in accordance with U.S. GAAP or IFRS, as required by Commission rules, [are] the starting point for any objective materiality analysis."

Non-GAAP Measures: Registrants should also consider the impact of errors on key non-GAAP measures as part of their materiality analysis.

Intention and common errors: While intentionality may contribute to a finding that an error is material, the lack of intentional misstatement is not evidence that the error is not material. This argument is often made in the case where other registrants have made a similar error (reflecting a "widely held view" rather than an intentional error).

Aggregation: The analysis of the aggregate effects of multiple errors should not serve as the basis for a conclusion that individual errors are immaterial. Each error or misstatement must first be evaluated individually to determine whether it is material. The aggregated effects of immaterial errors should then also be considered to determine whether an immaterial error, together with other misstatements, renders the financial statements taken as a whole materially misleading.

Internal Control over Financial Reporting

Objectivity is important also to the assessment of the effectiveness of internal control over financial reporting ("ICFR"). While the existence of a material accounting error is an indicator of the existence of a material weakness, a material weakness may also exist without the existence of a material error. As part of its ICFR effectiveness assessment, management must consider not just the error but also the magnitude of the potential misstatement that could result. Management's ICFR effectiveness assessment should be a holistic, objective analysis of the potential impact and severity of a deficiency. The OCA urged additional focus on the adequacy of and basis for registrants' ICFR effectiveness assessments, especially when considering whether deficiencies are significant deficiencies (that must be reported to the audit committee) or a material weakness (that must be publicly disclosed).

Auditor Policies

Because of the vital role of auditors in assessing the materiality of financial statement errors, auditors should consider their quality control systems to ensure that they are adequately designed to ensure that its professionals comply with applicable professional standards.

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Questions concerning issues addressed in this memorandum should be directed to:

Christopher J. Cummings
+1-212-373-3434
ccummings@paulweiss.com

David S. Huntington
+1-212-373-3124
dhuntington@paulweiss.com

Brian M. Janson
+1-212-373-3588
bjanson@paulweiss.com

John C. Kennedy
+1-212-373-3025
jkennedy@paulweiss.com

Raphael M. Russo
+1-212-373-3309
rrusso@paulweiss.com

Tracey A. Zaccone
+1-212-373-3085
tzaccone@paulweiss.com

Practice Management Consultant Jane Danek contributed to this Client Memorandum.