What Every Director Should Know About Financial Statement Materiality

The concept of financial statement materiality is no stranger to the boardroom. In a world where financial literacy is increasingly expected of the full board, assessing materiality remains somewhat elusive despite its critical role in determining whether to record audit adjustments, restate financial statements or perform due diligence investigations. Making such judgments without seeking appropriate counsel may result in an increased risk of litigation and liability for the company and its directors. In the last two years, settlement funds for court-approved securities class action lawsuits have totaled $1.4 and $3.2 billion, respectively, with the median length of the lawsuits (from filing to settlement date) averaging approximately 3.5 years per suit. Against this backdrop, NACD Directorship *asked Gabriel Colwell, Esq., an attorney with Squire Sanders, and Stephen Bucci, CPA, director with Navigant's Disputes and Investigations practice, to provide their perspectives on financial statement materiality.*

What is financial statement materiality?

Though the verbiage differs slightly, the guidance issued by the Securities and Exchange Commission (SEC) and Financial Accounting Standards Board (FASB) agrees with the U.S. Supreme Court's finding and reaffirmation last year. In *Matrixx Initiatives, Inc. v. Siracusano*, the high court found that in the context of Rule 10b-5 investor suits that an item is 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."

How is materiality determined?

Legal and accounting standards do not provide a bright-line rule, but rather both indicate that the question of materiality is an inherently fact-specific inquiry. SEC Staff Accounting Bulletin No. 99 calls for registrants and auditors to consider both quantitative and qualitative factors. Simply applying a rule-of-thumb percentage (5 percent is common) to determine materiality is not appropriate. A percentage is often used in the preliminary assessment, but it cannot be used as a substitute for an analysis of all relevant quantitative and qualitative considerations. This can result in small-dollar value changes to key performance indicators being deemed material.

Who is responsible for determining what is deemed material?

Accurate financial reporting is the responsibility of the company. Consequently, management and the board are responsible to maintain materially accurate books and records (or cause such books to be accurately maintained). However, to say that the company can, or should, act in a vacuum regarding materiality is not accurate. In practice, the company's independent auditors must engage with the company to determine what is material to the financial statements.

Are all intentional errors material?

Not necessarily. While the intent of management alone does not render a mistatement material, it may provoke significant evidence of materiality and should be examined closely. Key questions that should be considered when making the determination of materiality when a quantitatively immaterial intentional error arises are, "Why does this intentional error exist?" and "What was management's involvement, motive and intent?"

What suggestions do you have for dealing with materiality questions where significant judgment is required?

Do not not be satisfied with only one source of information regarding materiality. Consider holding separate meetings with management, outside counsel and your auditors to ensure that you receive the benefit of a rigorous and independent analysis on the matters at issue. When in doubt, however, it is important to note that both the SEC and the Supreme Court have stated that if it is unclear whether an item is material, the company should err in favor of the investor and disclose.

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