The SEC's Acting Chief Accountant's Perspective

Assessing Materiality: Focusing on the Reasonable Investor When Evaluating Errors

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On March 9, 2022, the Office of the Chief Accountant ("OCA"), released a statement regarding assessing the materiality of financial reporting errors. The OCA used this statement to rehash guidance on the concept of materiality and the correction of material errors, evaluate methods of performing an objective assessment of materiality, and state observations from recent interactions with registrants and auditors on materiality. The concept of a material fact as one that "would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available"[1] has long been established by the Supreme Court. When an error is determined to be material to previously-issued financial statements, the error can either be corrected by a reissuance or revision of the relevant financial statement in line with U.S. GAAP. The OCA noted that an objective materiality analysis combines both quantitative and qualitative considerations, taking into account all relevant facts and circumstances relating to the error and putting aside the personal bias of the registrant, auditor, or audit committee. In circumstances where a quantitatively small error could be material because of qualitative factors (and vice versa), the OCA finds that as the quantitative magnitude of the error increases, it may increasingly outweigh qualitative considerations. Nevertheless, a holistic and objective assessment from a reasonable investor's perspective is still of the utmost importance. The OCA included some significant observations from recent interactions with registrants and auditors on materiality:

- **Accounting Errors and Materiality**: The fact that a misstatement may have been unintentional does not negate the possible materiality of the error. Even if an aggregate effects analysis of an individual error finds that its effect is offset by other errors, that should *not* serve as the basis for a conclusion that individual errors are immaterial.

- **Accounting Errors and Internal Control over Financial Reporting ("ICFR")**: The OCA notes that management should continue to steadfastly report any material weakness in the effectiveness of ICFR in a holistic and objective manner, noting the magnitude of the potential misstatement that *could* result from any control deficiencies.

- **Other Auditor Considerations**: Audit firms should pay special attention to having policies and procedures in place to ensure that any materiality analysis is carried out in compliance with applicable professional standards by the appropriate individuals.

[1] *TSC Industries v. Northway, Inc*., 426 U.S. 438, 449 (1976); *see Basic, Inc. v. Levinson*, 485 U.S. 224 (1988) (as the Supreme Court has noted, determinations of materiality require "delicate assessments of the inferences a 'reasonable shareholder' would draw from a given set of facts and the significance of those inferences to him...." *TSC Industries*, 426 U.S. at 450).