

Snapshot

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SEC staff issues statement on assessing materiality

On March 9, 2022, Paul Munter, Acting Chief Accountant of the SEC's Office of the Chief Accountant (OCA), issued a [statement](#) summarizing the OCA staff's views on assessing materiality when evaluating errors. Following on the heels of similar commentary at the 2021 AICPA and CIMA Conference on Current SEC and PCAOB Developments, Mr. Munter noted that the SEC staff continues to scrutinize how registrants evaluate and disclose errors identified in previously issued financial statements and provided considerations for an objective assessment of materiality.

Evaluating prior-period errors

Mr. Munter stated that a materiality assessment should take into consideration "all relevant facts and circumstances surrounding the error, including both quantitative and qualitative factors," in determining whether an error would be material to investors. He stressed that an assessment of materiality should be objective and should focus on whether there is a "substantial likelihood" that the error would be important to a reasonable investor. Central to Mr. Munter's statement is making a distinction between material versus immaterial errors, as follows:

- When an error identified in previously issued financial statements is deemed to be material, the issuer must file a non-reliance Form 8-K, and restate and reissue the prior-period financial statements (a "Big R" restatement).
- When an error identified in previously issued financial statements is deemed to be immaterial to the prior period but would be material to the

current period, the issuer may correct the error in the current filing by revising the comparative-period information and disclosing the immaterial error (a "little r" restatement).

OCA staff observed that while the number of restatements declined between 2013 to 2020, the number of "little r" restatements as a percentage of total restatements spiked to approximately 76 percent. On the surface, this trend might seem to indicate improvements in internal control over financial reporting (ICFR) and audit quality. However, the OCA staff has observed that some materiality analyses appear to be biased toward supporting a "little r" conclusion due to an overreliance on qualitative factors.

Objectivity in assessing materiality

According to Staff Accounting Bulletin (SAB) 99, *Materiality*, misstatements cannot be deemed immaterial simply because they do not reach a specific quantitative threshold without considering qualitative factors. OCA staff noted that registrants have used this logic in reverse, arguing that a quantitatively significant error is immaterial primarily due to qualitative factors. Mr. Munter called for greater objectivity in the assessment of qualitative factors because, as the quantitative magnitude of an error increases, it becomes difficult to overcome the significance of the error by relying on qualitative considerations. Further, the qualitative factors outlined in SAB 99 do not necessarily address all factors that might be relevant to a materiality assessment.

Additionally, two other potential stumbling blocks discussed by Mr. Munter are situations when an error is offset by other errors and when the error is the result of following industry practice. With respect to the aggregation of errors, SAB 99 requires each error to be evaluated individually, irrespective of the total impact when considered holistically with other misstatements. While errors must be evaluated in aggregate to ensure that when collectively considered, the financial statements are not materially misstated, aggregation should not be used to offset the impact of otherwise individually material errors.

With respect to industry practice, OCA staff has observed materiality analyses that conclude an error in previously issued financial statements is not material primarily because the same error was made by other registrants and was, therefore, unintentional. Such an

argument has been observed more often in recent times, spurred on by the volume of transactions involving special purpose acquisition companies. Regardless of what may be recorded in the financial statements of another company and accepted within an industry, registrants must evaluate appropriate accounting for their transactions in accordance with generally accepted accounting principles. According to OCA's statement, the lack of intent to misstate by following industry practice does not provide evidence that an error is not material.

Finally, OCA staff noted that registrants must evaluate the impact of an accounting error on the effectiveness of ICFR based on the potential error that *could* happen. Accordingly, an accounting error that is deemed to be immaterial does not preclude the existence of a material weakness.

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