SAB 99: The SEC Defines “Materiality”

On August 12, the staff of the Securities and Exchange Commission released Staff Accounting Bulletin No. 99 (SAB 99) to address the use of “materiality” thresholds in the preparation and audit of financial statements. SAB 99 is styled as a summary of the practices currently followed by the Staff at the Office of the Chief Accountant and the Division of Corporation Finance in administering the disclosure requirements of the federal securities laws. However, SAB 99’s importance extends beyond financial statements and could be applicable to all “materiality” determinations. As such, it is must reading for all securities lawyers and other participants in the preparation of disclosure documents for use in the U.S. capital markets.

SAB 99 was issued in response to two perceived staff concerns: 1) the increasing practice by registrants and their auditors of using quantitative thresholds as rules of thumb in assessing materiality when preparing financial statements; and 2) the increasing practice of some registrants to attempt to “manage” reported earnings through what they consider to be immaterial audit adjustments to financial statements. Part One of SAB 99 states that sole reliance on numerical or quantitative thresholds in determining the materiality of a specific item is insufficient. If SAB 99 had gone no further, there would have been little controversy. Instead, it proposes a methodology for materiality analysis. While registrants and auditors may look to quantitative thresholds as an initial step in determining the materiality of a particular item, “qualitative” factors must also be considered. In addition, accountants must give weight to the context in which a user of the financial statements would view the item. SAB 99 purports to reiterate extant concepts of materiality expressed in federal case law and accounting literature to support the proposed analytical methodology.

Existing Case Law

While both the rules under the Securities Act of 1933 and the Exchange Act of 1934 utilize the concept of “materiality,” its meaning has been fully addressed by case law. In TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438 (1976), the Supreme Court of the United States articulated the standard of materiality under the proxy rules. The Court held that a fact is material “if there is a substantial likelihood that a reasonable shareholder would consider it important…. Put another way, there must be 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.” Northway, 426 U.S. at 449.

Following Northway, courts applied this standard of materiality in contexts other than proxy solicitations. In Basic Inc. v. Levinson, 485 U.S. 224 (1988), the Supreme Court adopted the Northway standard in the context of Rule 10b-5. The Basic Court clarified its position regarding circumstances that make corporate developments material, adopting the probability/magnitude test of SEC v. Texas Gulf Sulpher Co., 401 F.2d 833, 849 (2d Cir. 1968), cert.denied, 394 U.S. 976 (1969). The Court held that if a significant corporate development is “certain and clear,” the corporation must disclose it; when, however, its occurrence is speculative, materiality “will depend at any given time upon a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity.” Basic, 485 U.S. at 238. (citing Texas Gulf Sulphur, 401 F.2d at 849).

Existing Accounting Literature
The Financial Accounting Standards Board’s Statement of Financial Accounting Concept No. 2, Qualitative Characteristics of Accounting Information (1980) states that: “[t]he omission or misstatement of an item in a financial report is material if, in the light of surrounding circumstances, the magnitude of the item is such that it is probable that the judgment of a reasonable person relying upon the report would have been changed or influenced by the inclusion or correction of the item.” SAB 99 compares this standard to the probability magnitude test set forth in Basic and concludes that the “total mix” concept employed in Northway is comparable to the “surrounding circumstances” concept used in the accounting literature. SAB 99, however, takes the analysis one step beyond the case law and the accounting literature when it concludes that a proper assessment of materiality requires equal consideration of both quantitative and qualitative factors. Recognition that materiality cannot be reduced to a numerical formula does not necessarily lead to the conclusion that qualitative factors are a mandatory component of a materiality analysis.

The SAB 99 Standard
While the first step in assessing materiality under SAB 99 may be a quantitative analysis, it must be followed by a consideration of qualitative factors. SAB 99 sets forth a non-exclusive list of qualitative factors that might cause a misstatement of a small percentage to be deemed material, such as:

- whether the misstatement masks a change in earnings or other corporate trends,
- whether the misstatement hides a failure to meet analysts’ consensus expectations for the business,
- whether the misstatement changes a loss into income or vice versa.

Significantly, SAB 99 identifies possible market reaction as a factor to be considered in assessing materiality. Under SAB 99, intent may provide evidence of materiality and make an otherwise immaterial fact or event material.

SAB 99 also focuses on segments and netting issues. When a misstatement involves a segment, the registrant should consider not only the size of the misstatement but also the significance of the segment information to the financial statements taken as a whole. In other words, the fact that a division that management has emphasized as important has turned unprofitable may be material even if the impact on overall profitability of the larger enterprise is quantitatively immaterial. After assessing each item separately, SAB 99 asserts that registrants must analyze the aggregate effect of all of the immaterial items, which when taken as a whole may be materially misleading.

Part Two of SAB 99 takes the position that an immaterial misstatement, whether intentional or unintentional, can constitute a violation of Section 13(b)(2)-(7) of the Exchange Act—the books and records provisions. These
provisions require each company with securities registered pursuant to Section 12 of the Exchange Act, or required to file periodic reports pursuant to Section 15(d) of the Exchange Act, to make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of assets of the company. These companies must also maintain internal accounting controls that are sufficient to provide reasonable assurances that, among other things, transactions are recorded as necessary to permit the preparation of financial statements in conformity with GAAP. SAB 99 emphasizes that reasonableness, a determination based on the level of detail and degree of assurance that would satisfy prudent officials in the conduct of their own affairs, rather than materiality, is the standard. Furthermore, criminal liability may be imposed if a person knowingly circumvents or knowingly fails to implement a system of internal accounting controls or knowingly falsifies books, records, or accounts.

Part Two of SAB 99 also reminds accountants that Section 10A of the Exchange Act requires an auditor upon discovery of “an illegal act” to take certain actions (which can include informing management, the audit committee or the board of directors) unless “the illegal act is clearly inconsequential.” Section 10A specifies that the auditor’s obligations are triggered irrespective of whether the illegal acts are perceived to have a material effect on the company’s financial statements and the Staff further reminds accountants of their obligation to report the illegal act to the audit committee irrespective of any “netting” of the misstatements with other financial statement items.

A New Standard of Materiality?

Since its release, SAB 99 has generated much discussion as to its meaning and reach. Does SAB 99 create a new standard of materiality or merely recite existing law, accounting and auditing principles? Will SAB 99 be limited in scope to accounting matters or will it be applied in other areas, such as insider trading, press releases for material events and disclosure generally?

Does SAB 99 constitute a helpful guideline to persons responsible for preparing and auditing financial statements or does it draw a line in the sand by putting registrants and their accountants on notice that enforcement cases will be brought for violating the Staff Accounting Bulletin? Ultimately, what are the effects of SAB 99?

- Audits will take longer and cost more;
- There will be more disclosure of less meaningful information;
- Materiality analysis may become even more difficult; and
- SAB 99 will be used as an enforcement tool by the Commission and may be cited by plaintiffs in civil litigations.

For a further discussion of the background and impact of SAB 99, see “SAB 99: Materiality as We Know it or Brave New World for Securities Laws,” John J. Huber and Brian Cartwright, available on our website at www.lw.com/pubs/SAB99.htm.

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Endnotes

1 While a Staff Accounting Bulletin only represents the views of the Staff, the Commission’s filing of an amicus brief in Joseph A. Ganino v. Citizens Utilities Company citing SAB 99 in October 1999 represents the Commission’s adoption of SAB 99.
If you have any questions about this Client Alert, please contact Kirk A. Davenport, John J. Huber, Kim K. Azzarelli or any of the other attorneys listed at the right: