**Federal Accounting Standards Advisory Board**

# MATERIALITY

AMENDING STATEMENT OF FEDERAL FINANCIAL ACCOUNTING CONCEPTS (SFFAC) 1, *OBJECTIVES OF FEDERAL FINANCIAL REPORTING*, AND SFFAC 3, *MANAGEMENT'S DISCUSSION AND ANALYSIS*

**Statement of Federal Financial Accounting Concepts**

**Exposure Draft**

Staff Draft – Not for Public Comment

## THE FEDERAL ACCOUNTING STANDARDS ADVISORY BOARD

The Secretary of the Treasury, the Director of the Office of Management and Budget (OMB), and the Comptroller General established the Federal Accounting Standards Advisory Board (FASAB or "the Board") in October 1990. FASAB is responsible for promulgating accounting standards for the United States government. These standards are recognized as generally accepted accounting principles (GAAP) for the federal government.

Accounting standards are typically formulated initially as a proposal after considering the financial and budgetary information needs of citizens (including the news media, state and local legislators, analysts from private firms, academe, and elsewhere), Congress, federal executives, federal program managers, and other users of federal financial information. The proposed standards are published in an exposure draft for public comment. In some cases, a discussion memorandum, invitation for comment, or preliminary views document may be published before an exposure draft is published on a specific topic. A public hearing is sometimes held to receive oral comments in addition to written comments. The Board considers comments and decides whether to adopt the proposed standards with or without modification. After review by the three officials who sponsor FASAB, the Board publishes adopted standards in a Statement of Federal Financial Accounting Standards. The Board follows a similar process for Statements of Federal Financial Accounting Concepts, which guide the Board in developing accounting standards and formulating the framework for federal accounting and reporting.

Additional background information is available from FASAB or its website:

- Memorandum of Understanding among the Government Accountability Office, the Department of the Treasury, and the Office of Management and Budget, on Federal Government Accounting Standards and a Federal Accounting Standards Advisory Board
- Mission Statement: Federal Accounting Standards Advisory Board, exposure drafts, Statements of Federal Financial Accounting Standards and Concepts, FASAB newsletters, and other items of interest are posted on FASAB's website at: www.fasab.gov.

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Federal Accounting Standards Advisory Board

ISSUE DATE XX

TO: ALL WHO USE, PREPARE, AND AUDIT FEDERAL FINANCIAL INFORMATION

Your comments on the exposure draft of a proposed Statement of Federal Financial Accounting Concepts, entitled *Materiality: Amending Statement of Federal Financial Accounting Concepts (SFFAC) 1, Objectives Of Federal Financial Reporting, and SFFAC 3, Management's Discussion and Analysis*, are requested. Specific questions for your consideration appear on page three, but you are welcome to comment on any aspect of this proposal. If you do not agree with the proposed approach, your response would be more helpful to the Board if you explain the reasons for your position and any alternative you propose. Responses are requested by DUE DATE.

All comments received by FASAB are considered public information. Those comments may be posted to FASAB's website and will be included in the project's public record.

Mail delivery is delayed by screening procedures. Therefore, please provide your comments in electronic form by email to fasab@fasab.gov. If you are unable to email your responses, we encourage you to fax the comments to (202) 512-7366. Alternatively, you may mail your comments to:

Wendy M. Payne, Executive Director
Federal Accounting Standards Advisory Board
441 G Street, NW, Suite 1155
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We will confirm receipt of your comments. If you do not receive confirmation, please contact our office at 202.512.7350 to determine if your comments were received.

The Board's rules of procedure provide that it may hold one or more public hearings on any exposure draft. No hearing has yet been scheduled for this exposure draft.

Notice of the date and location of any public hearing on this document will be published in the Federal Register and in FASAB's newsletter.

Sincerely,

D. Scott Showalter

Chair

# STATEMENTS OF FEDERAL FINANCIAL ACCOUNTING CONCEPTS

Statements of Federal Financial Accounting Concepts (SFFACs) set forth objectives and fundamentals on which financial accounting and reporting standards are based. The objectives identify the goals and purposes of financial reporting and the fundamentals are the underlying concepts of financial accounting—concepts that guide the selection of transactions, events, and circumstances to be accounted for; their recognition and measurement; and the means of summarizing and communicating them to interested parties.

Concepts statements guide the Board's development of accounting and reporting standards by providing the Board with a common foundation and basic reasoning on which to consider the merits of alternatives. Also, knowledge of the objectives and concepts the Board considers should help users and others who are affected by or interested in federal financial accounting and reporting standards to understand better the purposes, content, and qualitative characteristics of information provided by federal financial accounting and reporting.

The conceptual framework addresses many of the fundamentals needed to support standards setting. FASAB developed the core of its conceptual framework in the early 1990s. At that time, financial management legislation and administrative directives focused on component entity reporting. Hence, FASAB's second concepts statement, *Entity and Display*, focused on the basis for defining a reporting entity and the display of component entity financial statements. Other concepts statements address financial reporting objectives, qualitative characteristics of information, the intended audience for the consolidated financial report of the U.S. Government (CFR), elements of accrual basis statements and their measurement attributes, communication methods, and managerial cost accounting.

Through its ongoing conceptual framework project, FASAB has reviewed its early concepts statements and is establishing new statements as needed. The *FASAB Handbook of Accounting Standards and Other Pronouncements, As Amended* (*FASAB Handbook*) provides a full discussion of FASAB's SFFACs. The FASAB Handbook discusses the difference between SFFACs and GAAP and can be accessed at http://www.fasab.gov/accounting-standards.

# EXECUTIVE SUMMARY

## WHAT IS THE BOARD PROPOSING?

With this Statement, the Federal Accounting Standards Advisory Board proposes concepts regarding materiality in the unique federal financial reporting environment. This concepts statement would

- provide materiality concepts,
- specify the scope of materiality, and
- list factors to consider when applying materiality.

## HOW WOULD THIS PROPOSAL IMPROVE FEDERAL FINANCIAL REPORTING AND CONTRIBUTE TO MEETING THE FEDERAL FINANCIAL REPORTING OBJECTIVES?

A reporting entity considers materiality in the application of specific requirements to information in its general purpose federal financial reports. This proposed materiality section would clarify the materiality guidance. It would clearly define the users, scope, and factors to consider when applying materiality in a federal environment. It would help federal financial report preparers apply the materiality concepts and provide relevant and consistent information in federal financial reports.

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# QUESTIONS FOR RESPONDENTS

The Federal Accounting Standards Advisory Board (FASAB or "the Board") encourages you to become familiar with all proposals in the Statement before responding to the questions in this section. In addition to the questions below, the Board also welcomes your comments on other aspects of the proposed Statement. Because FASAB may modify the proposals before a final Statement is issued, it is important that you comment on proposals that you favor as well as any that you do not favor. Comments that include the reasons for your views are especially appreciated.

The Board believes that this proposal would improve federal financial reporting and contribute to the federal financial reporting objectives. The Board has considered the perceived costs associated with this proposal. In responding, please consider the expected benefits and perceived costs and communicate any concerns that you may have in regard to implementing this proposal.

The questions in this section are available in a Microsoft Word file for your use at http://www.fasab.gov/documents-for-comment/. Your responses should be sent to fasab@fasab.gov. If you are unable to respond by email, please fax your responses to 202-512-7366. Alternatively, you may mail your responses to:

Wendy M. Payne, Executive Director
Federal Accounting Standards Advisory Board
441 G Street, NW
Suite 1155
Washington, D.C. 20548

All responses are requested by [insert date].

Q1. The Board proposes materiality concepts providing an in-depth discussion of users, scope, and factors to consider in the federal government environment. Refer to paragraph 1.

**a. Do you agree or disagree with the proposed materiality section? Please provide the rationale for your answer.**

**b. Do you have any suggestions that would enhance the section?**

*Q2.* The Board proposes placing the materiality concepts in Statement of Federal Financial Accounting Concepts 1, *Objectives of Federal Financial Reporting.* Refer to paragraph 1.

**Do you agree or disagree with the placement? Please provide the rationale for your answer.**

# PROPOSED CONCEPTS

## AMENDMENTS TO SFFAC 1, *OBJECTIVES OF FEDERAL FINANCIAL REPORTING*

1. This paragraph amends Statement of Federal Financial Accounting Concepts (SFFAC) 1, *Objectives of Federal Financial Reporting,* by inserting a header titled *Materiality* immediately after paragraph 190 along with text that reads as follows*:*

Materiality

191a. A reporting entity considers materiality in the application of accounting and reporting requirements. The Board intends that information presented in accordance with generally accepted accounting principles (GAAP) will not contain misstatements, including omissions of information, considered material. Such omissions include information that is necessary for a user to understand the impact of particular material transactions, other events, and conditions on the entity's financial statements.

191b. The misstatement, including omission of information, is material if, in light of surrounding facts and circumstances, ~~there is substantial likelihood~~it can be reasonably expected that the judgment of a reasonable financial report user relying on the information would change or be influenced by the correction or inclusion of the information. A reasonable financial report user has knowledge of the entity's and/or the federal government's activities and is willing to study the information with due diligence.

191c. Materiality should be evaluated in the context of the specific reporting entity. Determining materiality requires appropriate and reasonable judgment in considering the specific facts, circumstances, size, and nature of the misstatement. Consequently, the materiality considerations may change as financial information is consolidated from sub-component to component to government-wide reporting entities. [Refer to the memo – question 1 – for options.]

191d. Misstatements should be considered individually and in the aggregate and materiality determinations regarding such misstatements should include both qualitative and quantitative considerations. Information that is not considered material from a quantitative standpoint may be considered qualitatively material if a substantial likelihood exists that it changes or influences the judgment of a reasonable user. Qualitative considerations include the public accountability of the entity issuing the financial report; applicable legal and regulatory requirements; the visibility and sensitivity of government programs, activities, and functions; as well as other factors that may affect a reasonable user's judgments about the information.

191e. The Board establishes materiality concepts and related factors to consider in making judgments. Due to the factors discussed in paragraphs 191.c and 191.d,

the Board does not provide specific qualitative or quantitative thresholds for materiality.

191f. In applying materiality concepts, the specific needs of a reasonable financial report user should be considered. In the federal government environment, such needs generally differ from those of the commercial entity financial report user. For example, due to the visibility and sensitivity of government programs, federal government financial report user needs extend to having the ability to assess the allocation and use of resources in the federal government. Further, compliance with laws, regulations, contracts, and grant agreements is also a significant consideration of the user.[15.1]

FN 15.1 Information requiring protection from unauthorized disclosure is referred to as "classified national security information." The application of financial accounting standards needs to support the ~~mandate~~ legal requirements to protect classified national security information.

191g. Material misstatements may occur with any information included in the financial report. A reporting entity should disclose relevant information and also be mindful that inclusion of significant amounts of irrelevant information could, in some circumstances, affect the judgment of a reasonable user. (Refer to the memo – question 2 – for options)

191h. To emphasize that materiality should be considered in applying all FASAB financial accounting standards, the Board will place the following notice at the end of each Statement:

*The provisions of this Statement need not be applied to information if the effect of applying the provision(s) is immaterial.*[FN]

FN – Refer to SFFAC 1, *Objectives of Federal Financial Reporting,* chapter 7, titled *How Accounting Supports Federal Financial Reporting* for a detailed discussion of the materiality concepts.

## AMENDMENT TO SFFAC 3, *MANAGEMENT'S DISCUSSION AND ANALYSIS*

2. This paragraph amends SFFAC 3, *Management's Discussion and Analysis*, footnote 10 at paragraph 26. Footnote 10 is amended as follows:

FN 10 Materiality of effects to be discussed should be evaluated in the context of the specific reporting entity~~, not the Government as a whole~~.

# APPENDIX A: BASIS FOR CONCLUSIONS

This appendix discusses some factors considered significant by Board members in reaching the conclusions in this Statement. It includes the reasons for accepting certain approaches and rejecting others. Individual members gave greater weight to some factors than to others. The concepts enunciated in this Statement—not the material in this appendix—should guide the development of standards for specific transactions, events, or conditions.

## PROJECT HISTORY

A1. The Board added the disclosure project to its agenda in October 2017 with the objective of improving the relevance, clarity, consistency, and comparability of disclosures among federal entities. FASAB formed a task force to conduct related research. FASAB also conducted a survey on disclosures in which a majority of respondents indicated that materiality-based judgment can assist in eliminating redundancy and unnecessary disclosure by providing only relevant information.

A2. Currently, materiality is discussed in several Statements: SFFAC 3, *Management's Discussion and Analysis*; Statement of Federal Financial Accounting Standards (SFFAS) 1, *Accounting for Selected Assets and Liabilities;* and SFFAS 3, *Accounting for Inventory and Related Property*. The guidance, however, lacks clarity, detail, and logical organization. As such, the Board agreed to update the materiality guidance to assist preparers in making materiality judgments and improving disclosures.

A3. In February 2018, staff presented a draft materiality section to the disclosure task force. The disclosure task force includes federal financial report preparers, auditors, and consultants. Task force members agreed that this proposed materiality section is not significantly different from their understanding of the concepts, but it would help in applying materiality concepts in the federal environment as a result of its improved clarity, detail, and organization.

## PROPOSED MATERIALITY SECTION

A4. The proposed materiality section does not include substantive changes to underlying concepts. Rather, to provide better guidance, it adds important elements, such as a discussion of users, a clearer concept of misstatement, and specific federal environment considerations.

A5. In an effort to improve the proposed section, several sources were considered, including existing standards and other regulatory bodies~~ and boards~~. The Board considered the materiality discussion in the current FASAB Handbook, other accounting standards boards' publications, relevant audit standards, and Securities and Exchange Commission (SEC) guidance.

A6. Federal financial report users have different ~~focuses and~~ needs compared to users of commercial entity financial reports. The users identified in SFFAC 1 (citizens, Congress, federal executives, and federal program managers) are the users FASAB considered in developing the proposed materiality section.

A7. FASAB considered guidance from the Government Accountability Office's 2018~~7 exposure draft~~, *Government Auditing Standards*, for the materiality section's federal environment related discussion. This guidance, commonly referred to as the *Yellow Book*, states the following:

> **6.03** *Standards used in conjunction with GAGAS require the auditors to apply the concept of materiality appropriately in planning and performing the audit. Additional considerations may apply to GAGAS engagements that concern government entities or entities that receive government awards. For example, for engagements conducted in accordance with GAGAS, auditors may find it appropriate to use lower materiality levels than those used in non-GAGAS audits because of the public accountability of government entities and entities receiving government funding, various legal and regulatory requirements, and the visibility and sensitivity of government programs.*

A8. Misstatements are often easier to assess using quantitative considerations. However, they should be assessed using qualitative considerations as well. Therefore, this proposed section clarifies that materiality should be assessed using both quantitative and qualitative considerations.

A9. The SEC Staff Accounting Bulletin Topic 1.M states, "*Even though a misstatement of an individual amount may not cause the financial statements taken as a whole to be materially misstated, it may nonetheless, when aggregated with other misstatements, render the financial statements taken as a whole to be materially misleading."* The Board has a similar view. Misstatements should be considered individually and in the aggregate.

A10. Standards do not require perfection; instead, the standards allow for misstatements as long as they are not material. The Board believes that financial reporting should emphasize disclosing material information, not immaterial or irrelevant information.

A11. The proposed concepts define materiality in terms of the likelihood that a reasonable user's judgment would be affected by the misstatement. The Board proposes to be consistent with current practice regarding the degree of likelihood. In SFFAS 5, *Accounting for Liabilities of The Federal Government*, "probable" means more likely than not. The Board does not believe "more likely than not" is appropriate in assessing materiality because it would be a lower degree of likelihood. Such a change could lead to unreasonable expectations regarding precision. The Board believes "~~substantial likelihood~~reasonably expected" is more consistent with current practice and is appropriate in the federal government environment.

A12. The proposed concepts focus on the effect of misstatements on a reasonable user's judgment, but the Board recognizes that other aspects of a financial report may also affect a reasonable user's judgment. Specifically, a poorly written or unnecessarily verbose financial report may affect a reasonable user's judgment. Nevertheless, in response to a need expressed by the financial reporting community, this Statement focuses on guidance for the community in applying the concept of materiality.

A13. The Board does not provide specific quantitative or qualitative considerations in the proposed section. Both quantitative and qualitative considerations are typically entity specific. Existing audit and regulatory literature already provides detailed guidance on the quantitative considerations. Qualitative considerations will likely vary depending on

whether the reporting entity is a sub-component, component, or the government-wide reporting entity. The entity-specific nature of the quantitative and qualitative considerations will likely require sub-components to consider different factors than components.

A14. Disclosure task force members held different views regarding the placement of the proposed materiality concepts since they could be placed in an SFFAC or an SFFAS. The task force discussed advantages and disadvantages of placement during the meetings. The Board agreed that this proposed section should be placed in a concepts statement after considering the following factors:

- This would provide broader flexibility in the exercise of materiality judgments.
- This would be consistent with other accounting standards boards' positions.
- This would provide consistency across the standards since it would be guidance for the Board to consider.
- This would not override other authoritative guidance on materiality.
- This would be classified as other literature in the GAAP hierarchy.

# APPENDIX B: ABBREVIATIONS

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|---|---|
| FASAB | Federal Accounting Standards Advisory Board |
| GAAP | Generally Accepted Accounting Principles |
| GAGAS | Generally Accepted Government Auditing Standards |
| SEC | Securities and Exchange Commission |
| SFFAC | Statement of Federal Financial Accounting Concepts |
| SFFAS | Statement of Federal Financial Accounting Standards |

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