Statement of Federal Financial Accounting Concepts 9: Materiality: Amending Statement of Federal Financial Accounting Concepts (SFFAC) 1, Objectives of Federal Financial Reporting, And SFFAC 3, Management's Discussion and Analysis

Status

Issued	May 4, 2020
Interpretations and Technical Releases	None.
Affects	• SFFAC 1, amends paragraph 164 and inserts a chapter titled Materiality between the current chapters 6 and 7. • SFFAC 3, amends paragraph 26 footnote 10.
Affected by	None.

See pages 6-7 for the preamble to Statements of Federal Financial Accounting Concepts (www.fasab.gov/pdffiles/handbook_preamble.gov).

Summary

This concepts statement updates concepts related to the application of materiality in the federal financial reporting environment. Through amendments to SFFAC 1, Objectives of Federal Financial Reporting, and SFFAC 3, Management's Discussion and Analysis, this SFFAC clarifies implementation of materiality concepts in the issuance of federal financial statements.

A reporting entity considers materiality in the application of specific requirements to information contained in its general purpose federal financial reports. This Statement clarifies the materiality guidance. It identifies the users, scope, and factors to consider when applying materiality in the federal environment. This Statement will also enhance preparers' and auditors' understanding of materiality concepts in federal financial reporting.

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Concepts

Amendments to SFFAC 1, Objectives of Federal Financial Reporting

This paragraph *amends Statement of Federal Financial Accounting Concepts (Statement or SFFAC) 1, Objectives of Federal Financial Reporting, by inserting a chapter titled Materiality between the current chapter 6: Qualitative Characteristics of Information in Financial Reports and chapter 7*: *How Accounting Supports Federal Financial Reporting.* The new *Materiality* chapter is as follows:[1]

164a. A reporting entity considers materiality in the application of accounting and reporting requirements. The Federal Accounting Standards Advisory Board (FASAB or "the Board") intends that information presented in accordance with generally accepted accounting principles (GAAP)[12.1] will not contain misstatements, including omissions of information, considered material. Such omissions include information that is necessary for a reasonable financial report user (reasonable user)[12.2] to understand the effect of particular material transactions, events, and conditions on the entity's financial statements, notes to the financial statements, and required supplementary information. Footnote (FN) [12.1] Such information would include financial statements, notes to the financial statements, and required supplementary information.[2]

FN 12.2. A reasonable financial report user has appropriate knowledge of the federal government's activities and reviews and analyzes the information diligently.

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164b. A misstatement, including omission of information, is material if, in light of surrounding facts and circumstances, it could reasonably be expected that the judgment of a reasonable user relying on the information would change or be influenced by the correction or inclusion of the information.

[1] The inserted chapter will become chapter 7: Materiality and the existing chapters following chapter 6 in SFFAC 1 will be renumbered to accommodate the insertion.

[2] Statement of Federal Financial Accounting Standards 57, Omnibus Amendments 2019, eliminates required supplementary stewardship information (RSSI) in the general purpose federal financial report.

164c. 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, after quantitative and qualitative factors are considered, materiality may vary by financial statement, line item, or group of line items within an entity.

164d. Misstatements should be considered individually and in the aggregate. Materiality determinations regarding such misstatements should include consideration of both qualitative and quantitative factors. Information that is not considered quantitatively material may be considered qualitatively material if it can reasonably be expected to change or influence the judgment of a reasonable user. Qualitative considerations include the public accountability[12.3] of the reporting entity; 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 judgment about the information.

FN 12.3. SFFAC 1, par. 73 and 74 identify different kinds of accountability. These may be relevant qualitative considerations in determining materiality.

164e. Materiality concepts and related factors should be considered when making materiality judgments. While specific qualitative and quantitative thresholds for materiality are not provided in this Statement, illustrative factors are discussed in paragraphs 164c and 164d.

164f. In applying materiality concepts, the specific needs of a reasonable 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, the needs of federal government financial report users extend to having the ability to assess the allocation and use of resources in the federal government. Compliance with laws, regulations, contracts, and grant agreements is also a significant consideration of the user.12.4

FN 12.4 Information requiring protection from unauthorized disclosure is referred to as "classified national security information." The application of federal financial accounting standards needs to support the legal requirements to protect classified national security information.

164g. To emphasize that materiality should be considered in applying the accounting standards, the Board will place the following notice at the end of each Statement of Federal Financial Accounting Standards (SFFAS):

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 Statement of Federal Financial Accounting Concepts 1, *Objectives of Federal Financial Reporting,* chapter 7, titled *Materiality*, for a detailed discussion of the materiality concepts.

Amendment to SFFAC 3, Management's Discussion and Analysis

This paragraph amends SFFAC 3, Management's Discussion and Analysis, footnote 10 at paragraph 26 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 note disclosures project to its agenda in October 2017 with the objective of improving the relevance, clarity, consistency, and comparability of disclosures among federal entities. Staff formed a task force to assist the Board with the related research. The Board also conducted a survey on disclosures in which a majority of respondents indicated that materiality-based judgment can assist in eliminating redundant and unnecessary disclosures by providing only relevant information.

A2. Currently, materiality concepts are discussed in three Statements: SFFAC 3; SFFAS 1, *Accounting for Selected Assets and Liabilities*; and SFFAS 3, *Accounting for Inventory and Related Property*. The Board concluded that the clarity, detail, and organization of that guidance could be improved. As such, the Board agreed to update the materiality guidance to assist preparers' and auditors' understanding of the Board's intention with respect to making materiality judgments and improving disclosures.

A3. In February 2018, staff provided draft materiality concepts to the note disclosures task force. The task force included federal financial report preparers, auditors, and consultants. Task force members agreed the draft was not significantly different from their understanding of the application of materiality in practice, but it would help in applying materiality concepts in the federal environment by providing more clear, detailed, and organized guidance.

Materiality Concepts

A4. This Statement does not include substantive changes to underlying materiality concepts. Rather, to provide better guidance, this Statement clarifies the materiality concepts by discussing the needs of reasonable users, clarifying the concept of misstatement, and identifying specific federal environment considerations. This Statement is also intended to enhance preparers' and auditors' understanding of the materiality concepts in federal financial reporting.

A5. In developing this Statement, several sources were considered, including the materiality discussion in the current *FASAB Handbook*, other accounting standards boards' publications, relevant audit standards, and Securities and Exchange Commission (SEC) guidance.

A6. The Board considered the guidance in the Government Accountability Office (GAO)'s *Government Auditing Standards* (GAS)[3] when assessing the materiality concepts for the federal environment. Similar to what is stated in GAS section 6.03 and noted in paragraph 164f, the needs of the federal government report user generally differ from those of the commercial entity financial report user. The Board considered the users identified in SFFAC 1 (citizens, Congress, federal executives, and federal program managers) in developing this *Materiality* Statement. In addition, paragraph164f also highlights some important elements related to the visibility and sensitivity of government programs.

A7. This Statement clarifies that materiality should be assessed using both quantitative and qualitative considerations. Quantitative considerations (for example, magnitude of the misstatement), without considering the nature of the misstatement and the circumstances in which the judgment about it has to be made, generally do not provide a sufficient basis for a materiality judgment. Thus, misstatements should also be assessed using qualitative considerations to determine if those qualitative considerations can reasonably be expected to change or influence the judgment of a reasonable user.

A8. The SEC Staff Accounting Bulletin Topic 1.M.1 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."[4] The Board has a similar view. Misstatements should be considered individually and in the aggregate.

A9. Financial statements presented fairly in accordance with GAAP could contain misstatements as long as those misstatements are not material. Additionally, the Board concluded materiality-based judgment in federal financial reporting can assist in eliminating redundant and unnecessary disclosures.

A10. This Statement defines materiality in terms of the likelihood that a misstatement, including the omission of information, could reasonably be expected to affect the judgment of a reasonable user relying on the information. The Board ultimately concluded that "could

[3] GAO, *Government Auditing Standards 2018 Revision*, GAO-18-568G (Washington, D.C.: July 17, 2018), 109-110.

[4] "Codification of Staff Accounting Bulletins, Topic 1: Financial Statements," Securities and Exchange Commission, accessed April 30, 2020, https://www.sec.gov/interps/account/sabcodet1.htm#M.

reasonably be expected" conveyed the appropriate level of certainty to use in determining whether a misstatement would affect the judgment of a reasonable user. The Board noted that the meaning of "can reasonably be expected" in paragraph 33 of SFFAS 5, *Accounting for Liabilities of the Federal Government*, may be ambiguous. SFFAS 5, paragraph 33 states, "'Probable' refers to that which can reasonably be expected or is believed to be more likely than not on the basis of available evidence or logic…" The Board concluded that "can reasonably be expected" or "is believed" represent alternatives, both qualifying "to be more likely than not" and is not intended to equate "reasonably be expected" with "more likely than not."

A11. When developing the materiality definition in paragraph 164b, the Board considered the terms "probable" and "more likely than not," currently used in existing FASAB pronouncements, as alternatives to "could reasonably be expected." The Board noted that the inconsistencies throughout FASAB guidance in the meaning of "probable" may cause confusion. The Board also concluded that "more likely than not" (more than a 50 percent chance of occurrence) is not appropriate in assessing the overall application of materiality because it conveys a lower degree of likelihood compared to "can reasonably be expected." Therefore, the Board concluded that both "probable" and "more likely than not" were not appropriate to be used in the materiality definition.

A12. Prior to the exposure of the proposed materiality concepts, the Board also discussed whether to use "substantial likelihood" or "could reasonably be expected" in its materiality definition. The Board noted that "substantial likelihood" had not been previously used by FASAB and would require a specific definition that could inhibit the preparer's judgment when applying materiality.

A13. Because of the public accountability of government entities, various legal and regulatory requirements, and the visibility and sensitivity of government programs, the materiality thresholds in federal practice may be different from those in the commercial practice. Each standards-setter sets its standards for the unique characteristics of its constituency. The Board concluded that, for purposes of this Statement, "could reasonably be expected" is based on whether a reasonable person would expect that a misstatement would affect the judgment of a reasonable user, and, therefore, "could reasonably be expected" allows appropriate flexibility and judgment in considering the specific facts, circumstances, size, and nature of the misstatement when assessing whether a misstatement is material. It also accommodates the distinguishing characteristics of the federal environment. Ultimately, the Board proposed "could reasonably be expected" in its exposure draft (ED) and received positive feedback on it from the respondents.

A14. In arriving at the materiality definition in paragraph 164b, the Board also observed that materiality definitions vary among other standards-setters' current and proposed guidance. Some of the materiality definitions include:

a. The International Accounting Standards Board (IASB) uses "*could reasonably be expected to influence the decisions that the primary users of general purpose financial statements make.*"[5] [Emphasis added]

b. The Financial Accounting Standards Board (FASB) uses "*probable that the judgment of a reasonable person relying upon the report would have been changed or influenced.*"[6] [Emphasis added]

c. The Public Company Accounting Oversight Board (PCAOB) uses substantial likelihood in the following context: "…there are certain accounts or disclosures for which there is *a substantial likelihood that misstatements of lesser amounts than the materiality level established for the financial statements as a whole would influence the judgment of a reasonable investor.*"[7] [Emphasis added]

d. In addition, the Audit Standards Board (ASB) currently uses, "Misstatements, including omissions, are considered to be material if, individually or in the aggregate, they *could reasonably be expected to influence economic decisions of users that are taken based on the financial statements*." The ASB has proposed to use, "Misstatements, including omissions, are considered to be material if there is *a substantial likelihood that, individually or in the aggregate, they would influence the judgment of a reasonable user made based on the financial statements*."[8] [Emphasis added]

A15. The Board recognizes the differences in terms used by different standards-setters to define materiality. The Board also recognizes the possibility that the definitions of materiality may be applied differently by preparers and auditors. The Board considered the merits of convergence with the audit literature but concluded that aligning the materiality definitions was not essential because materiality in terms of financial statement reporting is different from the financial statement audit perspective.

A16. The Board does not provide specific quantitative or qualitative considerations in this Statement. Both quantitative and qualitative considerations are typically entity specific. Other existing literature already provides detailed guidance on materiality considerations. Materiality considerations could vary depending on whether the reporting entity is a sub-component, component, or the government-wide reporting entity.

[5] IASB, *Definition of Material (Amendments to IAS 1 and IAS 8)*, October 2018.

[6] FASB, Concepts Statement No. 8 *Qualitative Characteristics of Useful Financial Information*, August 2018.

[7] PCAOB, Auditing Standard No.11 *Consideration of Materiality in Planning and Performing an Audit*, August 2010.

[8] In June 2019, the ASB issued an exposure draft of a proposed Statement on Auditing Standards, *Amendments to the Description of the Concept of Materiality.*

A17. In certain situations, an entity may have a quantitatively significant balance or activity that would lead to a quantitatively high entity-wide materiality threshold. If applied to the entity's other balances or activities, such elevated materiality amounts could influence a reasonable user's judgment regarding the rest of the entity's activities. In such cases, qualitative factors should be considered to determine whether separate materiality considerations are warranted. Materiality may vary by financial statement, line item, or group of line items within that entity.

Summary of Outreach Efforts and Responses

A18. The Board issued the ED on October 15, 2018, with comments originally requested by January 23, 2019. In light of the partial government shutdown during the comment period, some departments and agencies may not have been able to respond by the deadline; therefore, FASAB extended the comment deadline to March 11, 2019.

A19. Upon release of the ED, FASAB provided notices and press releases to the FASAB subscription email list, the *Federal Register*, FASAB News, the Journal of Accountancy, Association of Government Accountants Topics, the CPA Journal, Government Executive, the CPA Letter, the Financial Statement Audit Network, and committees of professional associations generally commenting on EDs in the past (for example, the Greater Washington Society of CPAs and the Association of Government Accountants Financial Management Standards Board).

A20. The Board did not rely on the number of respondents in favor of or opposed to a given position. Information about the respondents' majority view is provided only as a means of summarizing the comments. The Board considered each response and weighed the merits of the points raised. The respondents' comments are summarized below.

A21. FASAB received 19 responses from preparers, users of federal financial information, and professional associations. Nearly all respondents agreed with the proposed materiality concepts and their placement in a concepts statement. The placement in a concepts statement provides broad flexibility when exercising materiality judgments, while also providing consistency across standards without overriding existing materiality guidance. In addition, respondents also agreed that this guidance is not significantly different from their current application of materiality in practice.

A22. Some respondents suggested creating a separate chapter in SFFAC 1 regarding materiality due to its importance. After carefully considering the comments received and the fact that materiality concepts may affect a reporting entity at various levels and areas of responsibility, accountability, and mission, the Board decided to place the materiality guidance in SFFAC 1 by creating a new chapter 7 titled *Materiality*.

A23. Based on several respondents' suggestions, the Board modified the following guidance originally proposed in the ED:

a. The Board eliminated the following wording from paragraph164c: "Therefore, misstatements of relatively small amounts could have a material effect on the financial statements. For example, an amount that is not quantitatively material with respect to a very large line item may be material with respect to a smaller line item." This avoids the misinterpretation that each line would have its own unique quantitative materiality value.

b. The Board defined the term "reasonable financial report user (reasonable user)" in footnote 12.2 to ensure consistency and clarity of its use throughout the guidance.

A24. Some respondents suggested providing detailed quantitative and qualitative guidance or references to other existing literature for materiality considerations. The Board concluded that its emphasis on the importance of evaluating both quantitative and qualitative factors in the determination of materiality, without providing specifics, allows entities broader flexibility in exercising materiality judgments. References to existing literature would not be valuable, as it is not the Board's intent to endorse or prioritize these sources. As such, no specific reference to other existing literature is provided.

A25. Several respondents asked about the effect of this guidance on the existing non-authoritative sections of other Statements and the *FASAB Handbook*, where materiality is also discussed. For example, there is a materiality discussion in the Introduction sections of SFFAS 1 and SFFAS 3 and in the Foreword section of the *FASAB Handbook*. These sections are considered non-authoritative guidance and will be updated with a reference to this Statement.

A26. Additionally, the Board observed that existing concepts and standards discuss materiality in the context of management's discussion and analysis (MD&A). SFFAC 3's Figure 1: Schematic Diagram of a Sample General Purpose Federal Financial Report states:

> The assertions and report on control called for by the Federal Managers Financial Integrity Act (FMFIA or Integrity Act) would not be stated in full in MD&A. They would be reported in a discrete section of the GPFFR or incorporated in the GPFFR by reference. They are within the scope of MD&A because highly important aspects of systems, compliance, and internal controls should be discussed in MD&A. "Highly important" in this context may imply a higher threshold than "materiality" for the financial statements.

SFFAS 15, *Management's Discussions and Analysis*, paragraph 5 states:

Because MD&A must be concise if it is to be useful, management must select the most important matters to discuss. This means that some items that are material to the financial statements, notes, and other sections of the GPFFR may not be discussed in MD&A.

The issuance of this Statement does not affect the materiality considerations applied to MD&A as stated in SFFAC 3 and SFFAS 15.

Board Approval

A27. This Statement was approved unanimously. The written ballots are available for public inspection at FASAB's office.

Appendix B: Abbreviations

ED	Exposure Draft
FASAB	Federal Accounting Standards Advisory Board
FN	Footnote
GAAP	Generally Accepted Accounting Principles
GAO	Government Accountability Office
GAS	Government Auditing Standards
GPFFR	General Purpose Federal Financial Report
MD&A	Management’s Discussion and Analysis
SEC	Securities and Exchange Commission
SFFAC	Statement of Federal Financial Accounting Concepts
SFFAS	Statement of Federal Financial Accounting Standard