

Understanding Materiality

By BNET Editorial

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Materiality is a term used in accounting and the law, in relation to information disclosed in financial statements that affects decisions made by the people who read them.

Deciding whether something is a material item involves making a judgment about it, in both quantitative and qualitative terms. Such evaluation is for a professional to make, who needs to be aware of practice in a particular sector in relation to material disclosures. When the materiality concept is applied according to such well-considered principles, investors can feel confident in the integrity of a company's financial reporting.

What You Need to Know

How is materiality defined?

The materiality concept is based on the premise that a company's financial statements must be both relevant and reliable. However, it could be disproportionately expensive and even unhelpful to provide everything that could be relevant or reliable in a financial statement. So the Financial Accounting Standards Board (FASB) came up with the concept of a "material item" to apply some constraints—defining it as: "an omission or misstatement of accounting information that in light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the inclusion or correction of the item." The SEC's definition is an item "about which an average prudent investor ought reasonably to be informed."

When is an item considered material?

If the presence of an item might influence or change the decisions of investors or financiers, it is significant and should be disclosed in financial statements, no matter how small. Examples might be an item that tips profit into loss (or vice-versa), or diverts a particular trends from its course. Similarly, any business dealings that could compromise existing agreements or contravene statutory regulations should appear in a statement's footnotes.

Who can help managers decide whether information is material and should be disclosed in a financial report?

The best people to consult in the first instance are a company's public accountant, or members of its audit committee.

Are there any other restrictions that apply to compiling, summarizing and distributing financial information?

Managers will need to consider the cost of providing information in relation to the benefits it brings to decision-makers. Sometimes, the costs may be small—for example, to reinstate something that was left out, or to make a correction. But if it is very expensive to compile, summarize and distribute the information, a judgment should be made about whether the high cost outweighs the benefit—while bearing in mind that financial statements should ideally contain information of the highest caliber and greatest relevance.

Have any authorities issued guidance about the materiality concept?

In 1993, the Securities and Exchange Commission (SEC) commissioner Richard Y. Roberts drew attention to an informal rule of thumb used to determine materiality from a quantitative perspective. Using bases like gross profit, net income, stockholders' equity, a numerical value of 10% above the base is considered material; less than 10%—possibly material; and under 5%—not generally material.

What to Do

Know the Background

The concept of materiality is not that new—back in 1867, a judge in England (in the case of *Central Railway of Venezuela v. Kisch*) voiced the idea by ruling that a prospectus should not contain any misstatements or conceal any “material fact.” In the United States, the concept was taken up towards the end of the 19th century, and since then has been a basic component of financial disclosure.

Consider Quantitative Measures

In the most straightforward cases, decisions about materiality depend on the relative size of the item. The basic rule of thumb used for such judgments is that adjustments, misstatements or omissions should be considered material items if they are equal or greater than:

- five percent (5%) of pre-tax profit
- one-half percent (.5%) of total assets or total revenues
- one percent (1%) of book equity

Accountants will generally discount any less significant items. Because the rule of thumb is relative rather than absolute, an error that would be considered material for one company may not be for another. For example, a company with \$20 million in assets might filter out misstatements involving less than \$100,000, while a company with assets worth \$10 million would not.

Be Aware of Degrees of Precision

When assessing materiality, it's important to understand how precise estimated figures can be expected to get. The degree of precision will depend on the specific context. For instance, the value of a company portfolio should not be seriously adrift, given the exactness of the processes involved in valuing securities. But in the case of contingent liabilities, there is greater room for error because estimating their value is inherently imprecise.

Exercise Judgment

The SEC makes it clear that judgments about materiality should take into account both quantitative and qualitative measures. It also expresses concern about the misuse of the materiality concept to mask a company's true financial position. For example, auditors who interpret "materiality" too loosely could disguise a downturn in performance; an error which could be compounded by failing to include a qualified opinion as part of the company statements. This illustrates the difficulty that even with guidelines provided by bodies such as the FASB or the SEC, the concept of materiality is a slippery one, which often comes down to the professional judgment of individual accountants and auditors. The key question to ask is "is this item sufficiently influential to make a difference to the decisions made by people reading this report?". If the answer is "yes," then it needs to be disclosed.

What to Avoid

You Omit Qualitative Information on Quantitative Grounds

If an item appears insignificant on qualitative grounds, it's tempting to filter it out—but it should also be considered on its qualitative merits first. The SEC gives examples of instances where a qualitative issue could be of material significance, which provides a useful checklist for managers assessing materiality in qualitative terms. These include errors that:

- disguise an aberration from a trend;
- mask a failure to achieve targets;
- turn losses into profits (or the reverse);
- undermine previous agreements, contracts or statutory obligations;
- inflate the performance-based earnings of managers;
- hide any unlawful dealings or actions.

You Become Confused By Multiple Misstatements

It's tempting to assess the impact of misstatements collectively, because together they may reduce the effect of one. However, it's essential to judge them individually, and to make any disclosures accordingly.

Where to Learn More

Web Site:

U.S. Securities and Exchange Commission: www.sec.gov