California Public Employees' Retirement System
Investment Office
P.O. Box 2749
Sacramento, CA 95812-2749
TTY: (916) 795-3240
(916) 795-3400 phone • (916) 795-2842 fax
www.calpers.ca.gov

December 8, 2015 Via E-Mail: director@fasb.org

Susan M. Cosper
Technical Director
Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk, CT 06856-5116

Dear Ms. Cosper:

RE: FILE NO. 2015-310 – PROPOSED ACCOUNTING STANDARDS UPDATE NOTES TO FINANCIAL STATEMENTS (TOPIC 235) ASSESSING WHETHER DISCLOSURES ARE MATERIAL

On behalf of the California Public Employees' Retirement System (CalPERS), thank you for the opportunity to provide our comments on the Financial Accounting Standards Board's (FASB, Board) Exposure Draft (ED) dated September 24, 2015, titled *Accounting Standards Update Notes to Financial Statements (Topic 235) Assessing Whether Disclosures are Material.*

CalPERS is the largest public defined benefit pension fund in the United States with approximately $300 billion in global assets. CalPERS' Investment Office mission is to manage its assets in a cost effective, transparent and risk –aware manner in order to generate returns to pay benefits. We manage these assets on behalf of more than 1.72 million public employees, retirees, and beneficiaries. [1]

CalPERS adopted a set of ten Investment Beliefs intended to provide a basis for strategic management of CalPERS investment portfolio in its fiduciary role as an asset owner and manager. Investment belief 4 states, "Long-term value creation requires effective management of three forms of capital – financial, physical and human."[2]

---

[1] CalPERS Facts at a Glance, November 2015 https://www.calpers.ca.gov/docs/forms-publications/facts-at-a-glance.pdf

[2] Investment Committee, Agenda Item 6a, Adoption of CalPERS Investment Beliefs, September 16, 2013. https://www.calpers.ca.gov/docs/forms-publications/calpers-beliefs.pdf

Accordingly, we are strong advocates of reform that ensures the continual improvement and integrity of financial reporting.[3]

The ED raises many questions. It appears to tackle the problem of information overload to benefit investors, although investors have not complained about information overload. We believe it is important to discuss the EDs three main provisions and answer some of the specific questions. The following is a summary of our concerns:

- The ED generally reduces disclosure. It was initially unclear how adding that "materiality is applied to quantitative and qualitative disclosures individually and in the aggregate" fits with the ED as a whole until one reads the Final Report of the Advisory Committee on Improvements to Financial reporting to the United States Securities and Exchange Commission.[4] The report notes that one reason to highlight qualitative measures is to further reduce disclosures;
- Materiality is more than a legal concept as shown by FASB defining materiality four years after the seminal case on materiality, as well as investors looking to FASB to continuously define materiality in the accounting context for more than 35 years;
- It is not clear that an omission of immaterial information is not an accounting error, and in any event, the audit committee of a company's board should review all misstatements and omissions;
- Assessing materiality becomes more difficult given the varying guidance and the inconsistent application of the materiality definition by the courts since *Mills v. Electric Auto-Lite Co* in 1970;[5]
- From an investor perspective, there would be significant issues raised if a company uses its discretion to omit specific information some years and then reports such items in other years;
- The Board should not eliminate any minimum requirements from the Accounting Standards at this time;
- We strongly disagree with the proposed amendment to the definition of materiality that would explicitly state that the omission of an immaterial disclosure is not an accounting error given SAB 99[6] provides clear examples where such omissions would be material and the change would mean that such omissions would not be brought to the attention of the audit committee; and

[3] CalPERS Global Governance Principles, California Public Employees' Retirement System, Section 4. Integrity of Financial Reporting, Updated March 16, 2015. https://www.calpers.ca.gov/docs/forms-publications/global-principles-corporate-governance.pdf

[4] Final Report of the Advisory Committee on Improvements to Financial Reporting to the SEC, August 1, 2008. http://www.sec.gov/about/offices/oca/acifr/acifr-finalreport.pdf

[5] *Mills v. Electric Auto-Lie Co.,* 396 U.S. 375 (1970), January 20, 1970. https://supreme.justia.com/cases/federal/us/396/375/

[6] SEC Staff Accounting Bulletin No. 99 Materiality (SAB 99), August 12, 1999. http://www.sec.gov/interps/account/sab99.htm

- We do not believe that the proposed amendments should be effective upon issuance given that we strongly disagree with the amendments.

The ED generally reduces disclosure. It was initially unclear how adding that "materiality is applied to quantitative and qualitative disclosures individually and in the aggregate" fits with the ED as a whole until one reads the Final Report of the Advisory Committee on Improvements to Financial reporting to the United States Securities and Exchange Commission. The report notes that one reason to highlight qualitative measures is to further reduce disclosures.

At first glance, there appears to be nothing controversial about adding that "materiality is applied to quantitative and qualitative disclosures individually and in the aggregate." We agree with the concept, but the overall tenor of the combined Exposure Drafts makes one contemplate the reason for explicit addition given qualitative disclosures have been considered following SAB 99 guidance. Upon reviewing historical materials to understand the initiation of the current changes, we came across the Final Report of the Advisory Committee on Improvements to Financial reporting to the United States Securities and Exchange Commission dated 2008 (ACIFR Report). The ACIFR report is the oldest and most significant work we found promoting the alignment of materiality with existing case law involving securities fraud. Interestingly, on page 81 of the ACIFR Report, the committee makes clear that qualitative factors are not one directional. The committee further explains with examples that certain qualitative factors can be used to make otherwise material errors not material. It is therefore important for us to better understand the intent in adding a greater focus on qualitative disclosures in the ED. We would like the focus to trend toward additional and better disclosures.

Materiality is more than a legal concept as shown by FASB defining materiality four years after the seminal case on materiality, as well as investors looking to FASB to continuously define materiality in the accounting context for more than 35 years;

In *Northway, Inc. v. TSC Industries, Inc.,* the Supreme Court stated the following:

> The general standard of materiality that we think best comports with the policies of Rule 14a-9 is as follows: **An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote. (emphasis added)** This standard is fully consistent with Mills' general description of materiality as a requirement that "the defect have a significant propensity to affect the voting process." The standard does not require proof of a substantial likelihood that disclosure of the omitted fact would have caused the reasonable investor to change his vote. What the standard does contemplate is a showing of a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in

> the deliberations of the reasonable shareholder. 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. [7]

Interestingly, FASB has chosen to highlight the second sub-part of the holding rather than the actual holding which reads, “An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important when deciding to vote.”

In *Basic Inc. et al. v Levinson et al* (1988), the court extended the definition of materiality to a second context by stating the following:

> The Court also explicitly has defined a standard of materiality under the securities laws, see TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 96 S.Ct. 2126, 48 L.Ed.2d 757 (1976), **concluding in the proxy-solicitation context** that "**an omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote**." Id., at 449, 96 S.Ct., at 2132. 7 Acknowledging that certain information concerning corporate developments could well be of "dubious significance," id., at 448, 96 S.Ct., at 2132, the Court was careful not to set too low a standard of materiality; it was concerned that a minimal standard might bring an overabundance of information within its reach, and lead management "simply to bury the shareholders in an avalanche of trivial information—a result that is hardly conducive to informed decision making." Id., at 448-449, 96 S.Ct., at 2132. The court further explained that to fulfill the materiality requirement "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." Id., at 449, 96 S.Ct., at 2132. **We now expressly adopt the TSC Industries standard of materiality for the § 10(b) and Rule 10b-5 context.** [8]

As highlighted, the Supreme Court made clear that it was defining materiality in particular contexts, proxy solicitation and the § 10(b) and Rule 10b-5. It does not appear that a definition has been adopted in any other context, including the FASB context. Consequently, FASB is simply using its power to define materiality by choosing to apply the Supreme Court definition that was used in the securities fraud context. The Supreme Court has never opined on a FASB definition of materiality, but lower courts

---

[7] *TSC Industries, Inc. v. Northway, Inc.* 426 U.S. 438 (1976)., June 14, 1976. https://supreme.justia.com/cases/federal/us/426/438/case.html

[8] Basic, Inc. V. Levinson, 485 U.S. 224, March 7, 1988. https://supreme.justia.com/cases/federal/us/485/224/case.html

have referenced the FASB definition.[9] Given that FASB is free to choose a definition, we would prefer that FASB maintain the definition that it adopted after the 2008 financial crisis. The existing definition is better because it applies to the full range of stakeholders rather than just voting shareholders as in the Supreme Court cases that FASB references. The existing definition also applies to a fuller range of activities, including obtaining the information necessary to provide oversight of company operations.

The proposed definition is not inconsistent with the legal requirements because if the existing definition of materiality is used the legal requirements will be met. In fact, the existing materiality definition reduces the probability to a more appropriate level that a company would fail to provide material information in the aggregate.

It is not clear that an omission of immaterial information is not an accounting error, and in any event, the audit committee of a company's board should review all misstatements and omissions.

In the Summary and Questions for Respondents in the ED, FASB explains that a 2013 field study was conducted by FASB staff indicating a focus on "reducing or eliminating **irrelevant** disclosures." It appears that in the ED irrelevant has been substituted for immaterial. The concepts are very different. The proposed change would not only prevent investors from being made aware of certain omissions, but the proposal would result in the information being hidden from the company board as well. There are a number of instances where such omissions should be disclosed, including if the omission, (1) masks a change in earnings, (2) changes a loss to income, (3) hides a failure to meet analysts' consensus expectations, or (4) increases management compensation. [10]

Stakeholders need the information necessary to properly oversee the operation of companies. Withholding this information from stakeholders and the board is inconsistent with Concept Statement 8 and the FASB mission. SAB 99 highlights one important example in which a series of misstatements that were individually not material actually concealed management incompetence.[11] FASB is proposing a change that would make it harder to assess management competence and properly influence management action.

[9] *Ganino v. Citizens Utilities Company* (2000), 228 F. 3d 154, September 6, 2000. http://scholar.google.com/scholar_case?case=13652608653559035365&q=GANINO+v.+CITIZENS+UTILITIES+COMPANy&hl=en&as_sdt=2006&as_vis=1

[10] See SAB 99, August 12, 1999.

[11] See In re Kidder Peabody Sec. Litig., 10 F. Supp. 2d 398 (S.D.N.Y. 1998). July 6, 1998. http://law.justia.com/cases/federal/district-courts/FSupp2/10/398/2465934

Assessing materiality becomes more difficult given the varying guidance and the inconsistent application of the materiality concept by courts since Mills v. Electric Auto-Lite Co in 1970.

The descriptive words have not been changed since the TSC case in 1976, but court application of those words has varied. The Supreme Court addressed materiality as recently as last year in *Halliburton Co. v. Erica P. John Fund Inc*.,[12] and the court itself remains divided on certain materiality related issues such as reliance. The details matter. The proposed changes make unclear which party will bear the burden of proof. In our view, the registrant should bear the burden given that it has access to the greatest amount of information and that it provides disclosures for the benefit of investors. This issue becomes garbled in the proposed changes and should be made clear that FASB does not intend to shift the legal burden.

As early as 1977, legal commenters highlighted the complexity of applying the judicial materiality standard.[13] It is unclear how the defining process would work without more specific guidance in the Accounting Standards Codification. TSC, the seminal court case is not clear on a definition. In fact, FASB, in the ED to Concept Statement 8, opted to use the second sub-test of the holding rather than the holding in defining materiality.

For investors, using the holding in TSC, that "An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote," may work if such votes extend to say on pay votes and other votes that involve great precision and result in more robust disclosures, like FASB, registrants would likely prefer to use the second sub-test as a definition which would reduce the disclosure requirement. The proposed change creates uncertainty that was likely recognized by FASB in 1980 when it adopted its own definition of materiality rather than relying on "a legal concept."

From an investor perspective, there would be significant issues raised if a company uses its discretion to omit specific information some years and then reports such items in other years.

There is a need for comparability and consistency which helps manage expectations and evaluate management. There would be major problems if a company began to selectively disclose particular information. Investors would have to use the only means available to address the problem which would be through votes in board of directors' elections or through litigation. Using the

[12] *Halliburton Co. v. Erica P. John Fund Inc.,* 573 U.S., June 23, 2014. https://supreme.justia.com/cases/federal/us/573/13-317/

[13] See, James O. Hewitt. *Developing Concepts of Materiality and Disclosure*. The Business Lawyer; Vol. 32 pg. 887-956. http://connection.ebscohost.com/c/articles/5964108/developing-concepts-materiality-disclosure

existing FASB definition of materiality would more likely correct this problem. Jack Ciesielski, CPA, CFA, highlights a related problem in his recent article, *Materiality Matters,* by focusing on the current issues surrounding Valeant Pharmaceuticals (Valeant).[14] An investor alleged disclosure improprieties related to Philidor Rx (Philidor) which Valeant had consolidated in its financial statements. Apparently, Philidor was not significant enough to require individual disclosure about its operations, and even with the current guidance in place regarding materiality, Valeant, using its discretion, did not disclose the existence of Philidor in its 2014 10-K, neither did it disclose particulars about Philidor in either of its first two 10-Qs in 2015. Assorted abuses were alleged to have occurred at Philidor, and Valeant added information about the subsidiary in its third 10-Q. Appropriately, Ciesielski posits:

> The Valeant case would argue well for revamping materiality criteria – but not in the direction of increasing discretion, which is the direction FASB is taking it. In this case, discretion may have kept information out of quarterly reporting for half a year – and Valeant's management paid dearly for not making robust disclosures.

Valeant provides a real life example that argues against the proposed changes.

The Board should not eliminate any minimum requirements from the Accounting Standards at this time.

Many other commenters have focused on the appropriateness of changes to the materiality standard. The elimination of the minimum requirements is equally problematic. We are asked to comment on changes to 66 sub-topics and over 120 total changes by reviewing changes to one sub-topic. We do not agree with the concept changes and even if we did agree with the concept, we would need to view and consider the individual changes.

It appears that at least one prominent corporation thought "the Board should continue to set minimum disclosure requirements," in its response to File Reference No. 2014-200, but FASB did not include that input in the Summary. Some companies would prefer to have the safe harbor, but the Summary assumes all companies would favor the eliminating the minimum requirements.

The ED envisions a change in the materiality standard which would result in reduced disclosures and less transparency. It also eliminates minimum requirements in reporting which would further reduce transparency. At CalPERS, we actively support enhanced disclosures from the current baseline. Taken together the changes make investors worse off regarding financial disclosures

---

[14] Jack T. Ciesielski, CPA, CFA, "Materiality Matters," *The Analyst's Accounting Observer,* Vol. 24, No. 12, Nov. 30, 2015.

than we were immediately before the financial crisis. We are strongly against eliminating the minimum requirements.

We strongly disagree with the proposed amendment that would explicitly state that the omission of an immaterial required disclosure is not an accounting error given SAB 99 provides clear examples where such omissions would be material, and the change would mean that such omissions would not be brought to the attention of the audit committee.

SAB 99 highlights numerous areas that would be material to long-term shareowners that would not be reported to shareowners if the proposed change is made. The omission would not be reported to the board's audit committee. An immaterial item may raise concerns because the misstatement or omission masks a change in earnings, changes a loss to a gain, hides a failure to meet analysts' expectations or leads to executives being unjustly enriched. Hiding such omissions is very problematic.

The disclosures are required for a reason. From an investor perspective, we would like to be made aware of the issue, at minimum, the board should be made aware of such omissions.

We do not believe that the proposed amendments should be effective upon issuance given that we strongly disagree with the amendments.

As we have expressed throughout this comment letter, we do not approve of the proposed changes. We would prefer that the proposed amendments do not become effective.

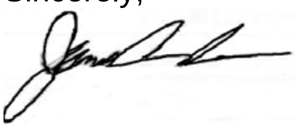
Next Steps

Given the disclosure effectiveness projects underway, we have been looking forward to developing more effective disclosures to enhance transparency. Each issue addressed in the ED goes the other way. We are strongly against diluting required disclosures because we do not believe that immaterial equals irrelevant.

It is our hope that FASB takes time to reflect on the Exposure Drafts, develops a plan to bring investors to the table to find out their actual needs, and includes such input in a final decision while acknowledging the need for the focus on stewardship and prudence included in the current Concept Statement 8.

Thank you for the opportunity to provide our comments. If you have any questions, please do not hesitate to contact me at (916) 795-9058 or James.Andrus@calpers.ca.gov.

Sincerely,



JAMES ANDRUS
Investment Manager
Global Governance