



## Agenda Item 2

### Materiality Definition — Cover Memo, Summary of Responses, and Issues Paper

#### Objective

To vote to ballot for issuance as final standards a proposed SAS and a proposed SSAE, both titled *Amendments to the Description of the Concept of Materiality*

#### Task Force

The Materiality Definition Task Force (Task Force) members are:

- Jan Herringer (Chair)
- Joe Cascio
- Marcia Marien
- ~~Richard Miller~~ [Lawrence Gill](#)
- Victoria Pitkin (ARSC)
- Dan Voogt

#### Background

In June 2019, the ASB issued an exposure draft of a proposed SAS and a proposed SSAE, both titled *Amendments to the Description of the Concept of Materiality*. The proposed standards would amend the description of materiality.

Materiality is described in existing AU-C section 320 as follows: “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 proposed amendments would change that description to the following: “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.”

#### I. Summary of Responses

23-24 responses were received to the ED.

**FIRMS (78)**

08	Clifton Larson Allen	CLA
09	Grant Thornton	GT
13	EY	EY
16	BDO	BDO
19	PwC	PwC
21	KPMG	KPMG
23	DT	DT
<u>24</u>	<u>RSM</u>	<u>RSM</u>

**Government Auditors (6)**

02	Tennessee State Auditor	TN
03	VA Auditor of Public Accounts	VA
10	MI Auditor General	MI
11	National State Auditors Association	NSAA
22	Association of Local Government Auditors	ALGA
15	GAO	GAO

**Other Groups (5)**

07	NASBA	NASBA
04	AAA Auditing Committee	AAA
12	Illinois CPA Society	IL
17	TX State Society	TX
20	Center for Capital Markets Competitiveness	CCMC

**Individuals (5)**

01	John Keyser	JK
05	Alonzo Neese	AN
06	Frank Van Hoy	FVH
14	Robert Richter	RR
18	Robert Waxman	RW

**Overall**

The respondents were overwhelming positive, with 92~~1~~% expressing support for the project. (See Agenda Item 2B: Table 1: General Comments)

Supportive	<u>2</u> <del>1</del>	
Not supportive	1	AN
Unclear	1	RW

The exposure draft stated that the changes are proposed to eliminate inconsistencies between the definition of materiality in AICPA *Professional Standards* and the definition of materiality used by the United States (U.S.) judicial system, the auditing standards of the PCAOB, the U.S. Securities and Exchange Commission (SEC), and the Financial Accounting Standards Board

(FASB) (hereinafter referred to as “U.S. judicial system and other U.S. standard setters and regulators), and that the ASB believes that the proposed amendments would not result in significant impact on the extent of work performed in those engagements. Nonetheless, two respondents (AAA, TN) requested that the ASB issue guidance that describes the Board’s intent in terms of the expected impact of the Proposal on the determination of materiality and what practice issue(s) the proposed wording changes are intended to address or solve (other than consistency).

The Task Force recommends that messaging accompany the issuance of the final standards indicating that

- the changes are being made to better align the definition of materiality in AICPA *Professional Standards* and the definition of materiality used by the U.S. judicial system and other U.S. standard setters and regulators, including the FASB.
- Firms who responded to the exposure draft indicated that because the revised definition is aligned with the FASB, it is substantially consistent with current firm practices with respect to determining and applying materiality in an audit or attest engagement.
- The amendments are not intended to, and the ASB believes that the amendments will not, result in significant impact on the extent of work performed in an audit or attest engagement.

**Question 1**

1. Please provide your views on whether the wording of the amendments is consistent with the definition of materiality used by the U.S. judicial system and other U.S. standard setters and regulators. If the wording is not consistent, please identify the areas of inconsistency and suggest alternate wording.

See Agenda Item 2C, Table 2: Question 1.

Consistent	<del>18</del> 19	
Inconsistent	4	JK, VA, RW, NSAA
Did not state	1	AN

The majority of respondents stated that the description of materiality was consistent with that of other standard-setters and regulators in the U.S.

Two respondents (VA, NSAA) noted that FASB does not include the phrase “substantial likelihood [and that..] the AICPA has tended to remain in alignment with FASB, however including ‘substantial likelihood’ introduces an inconsistency in the definitions.” See Question 2 below, for further discussion of “substantial likelihood”.

Suggestions from the other respondents who stated that the description was inconsistent were to

- refrain from defining materiality within the auditing standards and instead make reference to the definition and description of the applicable financial reporting framework, consistent with how the term “substantial doubt” is treated in AU-C section 570 (JK), and
- include the term “total mix of information” (RW). However, another respondent (RR) stated that the term [total mix of information] “is vague and not defined in a useful way. The proposed definition does not use that term, which is good.”

The Task Force believes that omitting the description of materiality from extant is not viable or appropriate. Because the two respondents who commented on the phrase “total mix of information” have contradictory views, the Task Force is not proposing any change.

**Question 2**

2. Please provide your views on whether the proposed amendments will change how auditors determine materiality in an audit or attestation engagement. If the amendments would result in a change, how would the change affect those engagements?

See Agenda Item 2D, Table 3: Question 2.

Don't expect change, without qualification	<del>12</del> 13	BDO, CLA, DT, EY, GT, KPMG, PwC, RSM, MI, IL, GAO, RW, ALGA
Don't expect change, qualified that it's possible	3	VA, TN, TX
Possibility of change	4	JK, AAA, NASBA, NSAA,
Did not state	4	AN, FVH, RR, CCMC

Of the ~~19~~20 respondents who addressed this question, ~~15~~16 respondents, including all the public accounting firms that responded to the Exposure Draft, do not believe or expect that how auditors determine materiality will change. Of these ~~15~~16 respondents, three respondents qualified that expectation by also expressing that the possibility of change exists. Another four respondents believe that there is a possibility that it might change, without stating an expectation of that occurring.

Two respondents (AAA, NASBA) believed the use of “would” may result in higher materiality levels. Five respondents also cited the use of “substantial likelihood” as a driver of potential change in auditor behavior:

VA: “We do not believe there will be a significant change in how auditors determine materiality in an audit or attest engagement based on the proposed amendments. However, we do believe the inclusion of “substantial likelihood” within the definition could result in auditors concluding more needs to be identified as being omitted or misstated to be considered materially incorrect, causing materiality thresholds to increase.”

JK: “For example, should *substantial likelihood* be read to mean that it is probable that the misstatement would influence the judgment of a reasonable investor? If so, this seems to be a higher threshold than “could reasonably be expected”, which seems like a lower threshold than probable (perhaps *more-likely-than-not*). I think the Board should clarify its expectation regarding whether auditors will audit at lower levels of precision under the proposed revision.”

AAA: “*Reasonably be expected*” versus “*substantial likelihood*” – Research suggests auditors perceive 67 percent as the level of uncertainty required to issue a going concern opinion modification using the “substantial doubt” terminology of AU 341 (Daugherty et al. 2016), while the level of confidence associated with “reasonable assurance” is “high, but not absolute” (AU-C Section 200.06; AS 1015.10) which has been interpreted by some as 90 to 95 percent confidence (Christensen, Glover, and Wood 2012). It is therefore possible that the revised terminology may be interpreted as requiring a lower degree of certainty than the current terminology.

NSAA: Auditors could interpret the description of the concept of materiality as proposed in this exposure draft as requiring more of a likelihood that a user would be influenced with the use of the term ‘substantial likelihood’ than other terms (i.e., reasonably possible and probable) currently defined and used in the auditing and attestation standards. This could result in auditors concluding more needs to be identified as being omitted or misstated to be considered materially incorrect, causing materiality thresholds to increase.

ALGA: However, please consider providing guidance, or examples, for determining when there is a “substantial likelihood”.

The U.S. Supreme Court uses “substantial likelihood”, as does the PCAOB. The Task Force noted that SEC Staff Accounting Bulletin: No. 99 — Materiality (SAB 99) quotes the description of materiality used by FASB (at the time, in Concepts Statement No. 2) and states that “[T]his formulation in the accounting literature is in substance identical to the formulation used by the courts in interpreting the federal securities law.” Accordingly, the Task Force is not recommending any revisions to the exposure draft with regard to “substantial likelihood”.

One respondent (AAA) had the following observations:

- The Proposal modifies the focus of the definition of materiality from user decisions (observable actions) to user judgments (unobservable beliefs). Information can impact users’ judgments without changing their investment decisions. For example, if a company enters a new line of business, stakeholders may believe risk has increased which may or may not result in modifying their investment decisions. *Ergo*, the requirement to take into consideration investors’ beliefs, not merely actions, could be interpreted as increasing auditors’ responsibility for errors and omissions.
- We also caution that at least one study provides evidence that more than half of restatements involve income levels less than the auditor’s planning materiality level using the current definition (i.e., Chen, Zhang, and Pany 2008). Accordingly, if the

Board intends the revised definition to permit higher thresholds of materiality, doing so may have the unintended effect of increasing financial statement restatements of U.S. non-issuers.

The Task Force notes that this amendment is consistent with other standard-setters in the US; however, the Task Force recognizes that changes in terminology have the potential to result in changes in behavior. While, as noted above, neither the firms responding to the Exposure Draft nor the Task Force believe that the proposed changes will have significant impact, the Task Force would welcome post implementation research on the topic.

## II. Proposed Edits

### A. Proposed edits to description of materiality

#### 1. AU-C 320, paragraph 2, 1<sup>st</sup> bullet

Respondents proposed the following specific edits to the first bullet of paragraph 2, which contains the description of materiality:

GAO	misstatements <u>of the financial statements</u> , including omissions, are considered to be material if there is a substantial likelihood that, individually or in the aggregate, they would influence the judgment <u>made by a</u> reasonable user <del>made based on the financial statements</del> <u>based on the financial statements</u> .
DT	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 <del>made based on the financial statements</del> .
PwC	misstatements <u>of the financial statements</u> , 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 <del>made based on the financial statements</del> .
GT	misstatements, including omissions, are considered to be material <u>to the financial statements</u> if there is a substantial likelihood that, individually or in the aggregate, they would influence the judgment of a reasonable user <del>made based on the financial statements</del> .

The Task Force believes that the phrase “based on the financial statements” is necessary because the judgement made by the user needs to be based on something – in this case, the financial statements. The FASB definition includes “the report” (i.e. the financial statement) as the basis for the judgment, as does the extant definition in GAAS and in the ISAs. The Task Force also believes that it is clear from the context of the lead-in that the misstatements being discussed are misstatements of the financial statements. Accordingly, the Task Force recommends the following revision:

- 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 made by a reasonable user ~~made based on the financial statements based on the financial statements~~.

In addition, all uses of the phrase “judgment of a reasonable user made based on the financial statements” would be revised to “judgment of made by a reasonable user ~~made based on the financial statements~~”. (Paragraph .07 of AU-C section 200; paragraphs 32 and .A63 of AU-C section 600; paragraphs .35 and .A14 of AU-C section 700; and paragraphs 74, 115, and A69 of AU-C section 703)

**Question for ASB Consideration:**

Does the ASB agree with the proposed edit?

**2. AU-C 320, paragraph 2, all but the first bullet**

Respondents proposed the following specific edits to paragraph 2 (not including the first bullet):

DT	<p><del>.02 Financial reporting frameworks often discuss</del> <b><u>T</u></b>he concept of materiality <b><u>is often discussed</u></b> in the context of the preparation and fair presentation of financial statements, which provides a frame of reference to the auditor in determining materiality for the audit. Although <del>financial reporting frameworks may discuss materiality</del> <b><u>as it relates to the financial statements may be discussed</u></b> in different terms, <del>they</del> generally <b><u>the discussion</u></b> explains that</p> <ul style="list-style-type: none"> <li>• [see #1 above].</li> <li>• judgments about materiality are made in light of surrounding circumstances and are affected by the size or nature of a misstatement, or a combination of both.</li> <li>• <b><u>judgments involve both qualitative and quantitative considerations.</u></b></li> <li>• judgments about matters that are material to users <del>of the financial statements</del> are based on a consideration of the common financial information needs of users as a group. The possible effect of misstatements on specific individual users, whose needs may vary widely, is not considered.</li> </ul>
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PwC	<p>.02 Financial reporting frameworks <del>may often</del> discuss the concept of materiality in the context of the preparation and fair presentation of the financial statements, which <u>may</u> provides a frame of reference to the auditor in determining materiality for the audit. Although <del>financial reporting frameworks may discuss materiality in the context of the financial statements may be discussed</del> in different terms, <del>they</del> generally <u>the discussion</u> explains that</p> <ul style="list-style-type: none"><li>• [see #1 above].</li><li>• judgments about materiality are made in light of surrounding circumstances, <u>involve both qualitative and quantitative considerations</u>, and are affected by the size or nature of a misstatement, or a combination of both.</li><li>• judgments about matters that are material to users <del>of the financial statements</del> are based on a consideration of the common financial information needs of users as a group. The possible effect of misstatements on specific individual users, whose needs may vary widely, is not considered</li></ul>
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The Task Force agrees with including a reference to both qualitative and quantitative considerations but did not believe that the other edits were necessary.

.02 Financial reporting frameworks often discuss the concept of materiality in the context of the preparation and fair presentation of the financial statements, which provides a frame of reference to the auditor in determining materiality for the audit. Although financial reporting frameworks may discuss materiality in different terms, they generally explain that

- [see A1, above].
- judgments about materiality are made in light of surrounding circumstances and are affected by the size or nature of a misstatement, or a combination of both.
- ***judgments involve both qualitative and quantitative considerations.***
- judgments about matters that are material to users of the financial statements are based on a consideration of the common financial information needs of users as a group. The possible effect of misstatements on specific individual users, whose needs may vary widely, is not considered.

**Question for ASB Consideration:**

Does the ASB agree with the proposed edit?

**B. Economic decisions**

One respondent noted that when aligning the materiality concepts with the definition of materiality used by the U.S. judicial system and other U.S. standard setters and regulators, the concept of “economic decisions of users” was necessarily deleted. Conforming amendments to paragraph .04 of AU-C section 320 are therefore recommended, as well as a detailed search of the professional standards be undertaken in order to identify instances where the phrase *economic decisions* has been used in order to determine whether the wording should be amended

to align with the proposed amendments in AU-C section 320; for example paragraph .A23 (11th bullet) of AU-C section 450, *Evaluation of Misstatements Identified During the Audit*, references misstatements “that may reasonably be expected to influence the economic decisions of the users of the financial statements.”

Instances in AU-C sections of “economic decisions” not already revised in the exposure draft are paragraphs .04 (addressed below) and .A3 of AU-C 320 and paragraph A23 of AU-C 450. These are shown below with recommendations for revisions.

AU-C 450 par. A23

**.A23** The circumstances related to some misstatements may cause the auditor to evaluate them as material, individually or when considered together with other misstatements accumulated during the audit, even if they are lower than materiality for the financial statements as a whole. Circumstances that may affect the evaluation include the extent to which the misstatement

...

- affects other information that will be communicated in documents containing the audited financial statements (for example, information to be included in a "Management Discussion and Analysis" or an "Operating and Financial Review") ~~that may reasonably be expected to influence the economic decisions of the users of the financial statements~~ **when there is substantial likelihood that the other information would influence the judgments of a reasonable user made based on the financial statements.** Section 720A, *Other Information in Documents Containing Audited Financial Statements*, addresses the auditor’s consideration of other information, on which the auditor has no obligation to report, in documents containing audited financial statements.

### AU-C 320

**.A3** In the case of a governmental entity, legislators and regulators are often the primary users of its financial statements. ~~Furthermore, the financial statements may be used to make decisions other than economic decisions.~~ The determination of materiality for the financial statements as a whole (and, if applicable, materiality level or levels for particular classes of transactions, account balances, or disclosures) in an audit of the financial statements of a governmental entity, therefore, may be influenced by law or regulation.

**Question for ASB Consideration:**

Does the ASB agree with the proposed edits?

**C. AU-C section 320, par. 4: reasonable user/economic decisions/other**

Issues raised that affect paragraph 4 include (i) explaining the term “reasonable user”, (ii) considering the use of “economic decisions”, and (iii) other suggested edits.

Four respondents (EY, DT, TN, NSAA) expressed concern about how the terms “reasonable user,” “intended user,” and “user(s) of the financial statements” are used in both the auditing and attestation standards. The ASB was asked to determine whether additional guidance is necessary to explain the interrelationships between these concepts. Two respondents suggested adding language similar to that in ¶A17 of AT-C 205 regarding the characteristics of the reasonable user. That language is already in paragraph 4 of AU-C 320.

One respondent stated that the ASB should consider whether conforming edits to need to be made to other instances of “users of the financial statements” in paragraphs .02, .04, .A4, .A5, and .A12 of AU-C section 320 in order to align the use of terminology, the unintended consequences of doing so, and the related impact throughout the SASs.

Specific wording suggestions were as follows:

EY	.04 The auditor’s determination of materiality is a matter of professional judgment and is affected by the auditor’s perception of the financial information needs of users of the financial statements. <b><u>When determining materiality for purposes of planning and performing the audit, the auditor should consider what would be material to reasonable users.</u></b> In this context <b><u>of this section</u></b> , it is <b><u>the term</u></b> reasonable for the auditor to assume that users <b><u>refers to users of the financial statements that:</u></b> [No suggested edits to bullets]
DT	<b>.04</b> The auditor’s determination of materiality is a matter of professional judgment and is affected by the auditor’s perception of the <b>common</b> financial information needs of users of the financial statements. In this context, it is reasonable for the auditor to assume that users  ...  <i>d.</i> make <del>reasonable economic decisions on the basis of</del> <b>judgments based on</b> the information in the financial statements.

The Task Force discussed whether to omit the word “reasonable” and concluded that would be inconsistent with the description of materiality used by the U.S. judicial system and other U.S. standard setters and regulators. The Task Force agreed with the need to clarify that the concept of “reasonable user” is intended to be for the purposes of determining materiality.

The following revisions are suggested:

.04 The auditor’s determination of materiality is a matter of professional judgment and is affected by the auditor’s perception of the financial information needs of **reasonable** users of the financial statements. ***For purposes of determining materiality, In this context, it is reasonable for the auditor to may assume that reasonable users, at a minimum,***

- a. have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information in the financial statements with reasonable diligence;
- b. understand that financial statements are prepared, presented, and audited to levels of materiality;
- c. recognize the uncertainties inherent in the measurement of amounts based on the use of estimates, judgment, and the consideration of future events; and
- d. make reasonable ~~economic decisions on the basis of~~ **judgments based on** the information in the financial statements.

Conforming changes will be made to paragraph .A17 of AT-C section 205 and paragraph .A16 of AT-C section 210, as shown in section II.D of this paper, below.

**Question for ASB Consideration:**

Does the ASB agree with the proposed edits?

**D. Intended User vs Reasonable User – Attestation Standards** (See Agenda Item 2E, Table 4)

Several respondents pointed out that the proposed amendments to the attestation standards did not include amending all instances of “intended user”, and the introduction of the term “reasonable user” into the attestation standards created confusion about the difference between the two terms. Because the attestation standards already use “intended user” in relation to determining materiality, continuing to use that term instead of revising to “reasonable user” is recommended. In addition, revisions are proposed for consistency with proposed revisions to paragraph .04 of AU-C section 320 as shown in section II.C. of this paper.

Proposed revision:

**205.A17** In general, misstatements, including omissions, are considered to be material if *there is a substantial likelihood that*, individually or in the aggregate, they ~~could~~ reasonably be expected to *would* influence *the judgment of* ~~relevant decisions of~~ *reasonable* intended users that are made based on the subject matter. The practitioner’s consideration of materiality is a matter of professional judgment and is affected by the practitioner’s perception of the common information needs of intended users as a group. *For purposes of determining materiality, In this context, it is reasonable for the practitioner to* ~~may~~ assume that intended users, *at a minimum* ...

**210.A16** In general, misstatements, including omissions, are considered to be material if *there is a substantial likelihood that*, individually or in the aggregate, they

could ~~reasonably be expected to~~ **would** influence **the judgment of** relevant decisions of ~~reasonable~~ intended users that are made based on the subject matter. The practitioner's consideration of materiality is a matter of professional judgment and is affected by the practitioner's perception of the common information needs of intended users as a group. **For purposes of determining materiality, In this context, it is reasonable for the practitioner to** ~~may~~ assume that intended users, **at a minimum** ...

**Question for ASB Consideration:**

Does the ASB agree with the proposed edits?

**E. Materiality Level and Other Edits** (See Agenda Item 2E, Table 4)

Two respondents (PwC, DT) raised a concern about use of the phrase “materiality level or levels” as stated in paragraph 10 of AU-C section 320, *Materiality in Planning and Performing an Audit*. Confusion exists as to whether this phrase refers to the testing that is intended to be performed, or whether the materiality level(s) are intended to address the evaluation of misstatements for those particular classes of transactions, account balances, or disclosures. One respondent believes the intention of this sentence relates to the evaluation of misstatements, and requests that the ASB amend the last sentence of paragraph 10 of AU-C section 320 to address this practice issue as follows; “... materiality level or levels to be applied to those particular classes of transactions, account balances, or disclosures **when evaluating whether the financial statements are materially misstated.**”

In addition, one respondent (PwC) suggested several edits “to align more closely with AS 2105”.

The Task Force believes that these edits are outside the scope of this project and is not recommending changes.

**Question for ASB Consideration:**

Does the ASB agree that the edits discussed above are outside the scope of the project and should not be addressed?

**Agenda Materials**

**2A** Proposed SAS and Proposed SSAE, marked

**2B** Table 1: General Comments

**2C** Table 2: Responses to Question 1

**2D** Table 3: Responses to Question 2

**2E** Table 4: Edits Proposed by Respondents