



Agenda Item 2C

Table 2: Responses to 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.

Responses to Question 1

Inconsistent

01 - John Keyser

I agree with the ASB's approach to converge U.S. standards for audits of private companies with the standards of the IAASB, while remaining closely aligned with the standards issued by the PCAOB. Difficulty arises with this approach when there are conflicts between IAASB standards and PCAOB standards. The ASB must then decide whether to align its standards with those of the IAASB or the PCAOB. In the proposed standard, the board is proposing to align with the PCAOB, rather than the IAASB. I am not convinced it is necessary, in this case, to choose a side.

I suggest the ASB refrain from defining materiality within the auditing standards and instead make reference to the definition and description of the applicable financial reporting framework. This approach would be consistent with the Board's recent decision in SAS No. 132 where it declined to define substantial doubt, but instead references the applicable financial reporting framework. Paragraph .A3 of AU-C 570 references FASB's definition of substantial doubt. This approach would align the definition of materiality with those of the FASB when the applicable financial reporting framework is U.S. GAAP, but also provide flexibility for an alternative definition of materiality for audits involving other financial reporting framework such as IFRS. When the applicable financial reporting framework fails to define materiality, the Board could provide guidance such as is given in AU-C 800.17 for fair presentation.

03 VA Auditor of Public Accounts

We believe the wording of the amendment is consistent with the definition of materiality used by the U.S. judicial system and other U.S. standard setters and regulators, excluding FASB. FASB does not include the phrase "substantial likelihood", which we believe has a significant impact on the interpretation of the definition, implying a different degree of certainty when compared to the term "probable." Historically, the AICPA has tended to remain in alignment with FASB, however including "substantial likelihood" introduces an inconsistency in the definitions.

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Description of Materiality, Responses to Question 1 of the ED

Responses to Question 1

Inconsistent

11 NSAA

We believe the proposed 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, excluding FASB. FASB does not include the term “substantial likelihood,” which we believe has a significant impact on the interpretation of the definition, implying a different degree of certainty when compared to the term “probable” (used by FASB). Historically the AICPA has tended to remain in alignment with FASB, however including “substantial likelihood” introduces an inconsistency in the definitions. If the ASB proceeds with use of the term “substantial likelihood” we suggest it define the term in the standard. The auditing standards currently define the terms “reasonably possible” and “probable” when referring to internal control deficiencies and the likelihood of a material misstatement or noncompliance occurring that will not be prevented, or detected and corrected, on a timely basis (AU-C 265.07 and 935.11). “Probable” is also defined and used in AU-C 501. Specifically, probable is defined as a future event or events that are likely to occur. However, the term *substantial likelihood* is not defined in either the auditing standards or attestation standards. Therefore, it is unclear whether the ASB intended for this term to mean more likely than probable (i.e., highly probably) or whether it should align with the current definition of probable, the term used by FASB. This should be clarified.

18 Robert Waxman

No, the wording of the revised definition is not consistent with the (1) U.S. Supreme Court’s decision in *TSC Industries, Inc. v. Northway, Inc.*, (2) PCAOB definition in paragraph 2 of AS 2105, (3) SEC’s guidance in SAB Topic 1.M. (Financial Statements: Materiality), and (4) FASB definition in paragraph QC11 of Concepts Statement No. 8.

The definitions of materiality used by the U.S. Supreme Court, the U.S. standard setters and regulator show that they all have one crucial element of the definition in common - which is missing in the Proposal’s definition - namely, the concept that [the misstatement or disclosure of the omitted information] significantly alters the “total mix” of information.

Concepts Statement No. 8 (as amended (2018)) observes –

“Materiality, QC11. ... The omission or misstatement of an item in a financial report is material if, in light of surrounding circumstances, the magnitude of the item is such that it is probable that the judgment of a reasonable person relying upon the report would have been changed or influenced by the inclusion or correction of the item” (emphasis added).

The phrases “under all circumstances” (as used in *TSC v. Northway*), and “in light of surrounding circumstances” (used by the FASB) are essentially equivalent to and subsumed in the phrase “total mix of information.” Therefore, I suggest the proposed definition be revised along the following lines to track more closely with *TSC v. Northway*:

“Misstatements, including omissions, are considered to be material if there is a substantial likelihood that, individually or in the aggregate, they [the misstatement or disclosure of the omitted information] would influence the judgment of a reasonable user as having significantly altered the total mix of information made available, ~~made~~ based on the financial statements.”

Responses to Question 1

Consistent

02 TN State Audit

Description of Materiality, Responses to Question 1 of the ED

Responses to Question 1

Consistent

We generally agree with the proposed language.

04 AAA

Proposed Statement on Standards for Attestation Engagements, *Amendments to the Description of the Concept of Materiality* (the Proposal), seeks to change the criteria for determining whether omissions or misstatements rise to the level of materially misstating financial statements from those that *could reasonably be expected to influence economic decisions* of a user, to those where there is a *substantial likelihood that they would influence the judgment* of a reasonable user. As research supports the notion that the concept of materiality is not well understood by stakeholders (Houghton, Jubb, and Kend 2011), standardization of wording that encourages consistency in its application by auditors is encouraged.

We believe the amended wording is consistent with the definition of materiality used by the U.S. judicial system and other U.S. standard setters and regulators (Question 1 of the Proposal).

There is at least one additional consideration. As described in the Proposal, the change will make the definition of materiality different from that prescribed by auditing standards of the International Auditing and Assurance Standards Board. Although recently in a retrenchment phase, substantial resources were previously invested to improve the comparability of accounting and auditing standards across international geographies (Gnanarajah 2017, p. 22-25; Dickins and Cooper 2010). While the Proposal appears to be a reversal of these efforts, there may be legitimate reasons for differences in auditing standards among countries. Simunic, Ye and Zhang (2017) propose a country's optimal auditing standards (degree of toughness and vagueness) is dependent upon its legal regime and mandatory rotation policies.

07 NASBA

We believe that 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.

The description of the concept of materiality is of particular importance to U.S. Boards of Accountancy. When considering a disciplinary issue involving the concept of materiality, the Board of Accountancy must determine the appropriate definition of materiality based on the nature and scope of the professional services. Alignment of the descriptions of materiality used by the U.S. judicial system and other U.S. standard setters will benefit Boards of Accountancy to allow for more consistency in addressing disciplinary issues involving materiality.

To minimize the differences in the concepts of materiality between the U.S. judicial system and U.S. standard setters and regulators is in the public interest and we support the Amendments.

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08 CLA We believe 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.

09 GT

We believe 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.

10 MI Auditor General

We consider the proposed definition as consistent with the legal and regulatory definitions. We consider it beneficial to the auditing profession to adopt the widely accepted and legal definition of this term incorporating the word "would" instead of "could" and the phrase "substantial likelihood" instead of "reasonably be expected."

12 Illinois CPA Society

The Committee agrees that the proposed wording of the amendment is consistent and provides more definitive guidance as to materiality thresholds.

13 EY

Overall, we support the ASB's proposal to change the description of the concept of materiality to be used as a frame of reference by auditors to determine materiality when planning and performing an audit of financial statements, if the applicable financial reporting framework does not include such a discussion about materiality. We believe that the proposed amendments are consistent with the definition of materiality used by the US Supreme Court and US standard setters and regulators. However, we believe the following changes to the ASB's proposed amendments would help clarify application of the concept of materiality and avoid unintended consequences.

14 Robert Richter

The proposed definition of materiality in the amendments is not fully consistent with but is better than the definition promulgated by the Supreme Court in *TSC Industries v. Northway*. The Supreme Court held that an "omitted fact" is material if there is "a substantial likelihood that the ... fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."

The proposed definition change from "could" to "would" is consistent with the Supreme Court definition. The word "substantial" in the proposed definition also is consistent with the Supreme Court definition, but the term is not well defined.

The Supreme Court definition does not clearly relate to the consequence of the use of the information. The proposed definition also does not clearly state the consequences, but it is an improvement. However, simply stating that the matter would affect the "judgment" of the user is not sufficient. It should link the judgment ultimately to the user's decision, as in "... a reasonable user's decision based on the financial statements." The proposal addresses that matter somewhat where it states "judgments about matters that

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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.”

The Supreme Court definition uses the term “significantly.” The term does not aid in the meaning of material. A matter may be significant, but not necessarily material if it does not change the user’s decision, which is then tied to the potential consequences. In other words, it becomes material if it increases the consequences of its use in a manner that causes the user’s decision to change.

The Supreme Court decision refers to the “total mix of information.” That term is vague and not defined in a useful way. The proposed definition does not use that term, which is good.

The Securities and Exchange Commission’s Regulation S-X contains a definition of material in Rule 1-02(o): “The term material, when used to qualify a requirement for the furnishing of information as to any subject, limits the information required to those matters about which an average prudent investor ought reasonably to be informed.” The proposed wording is different but not inconsistent with that definition and has the same objective.

15 GAO

We believe that the proposed wording reduces the inconsistencies between the definition of materiality in AICPA *Professional Standards* and those that the U.S. judicial system and other U.S. standard setters and regulators use.

16 BDO

We find the wording of the amendments to be consistent with the definition of materiality used by the U.S. judicial system and other U.S. standard setters and regulators.

17 TX Society

The committee thinks that the wording of the amendments is consistent with the definition of materiality currently used by the U.S. judicial system and other standard setters, other than the International Accounting Standards Board (IASB). It appears that the Auditing Standards Board is adopting a U.S. approach to defining materiality rather than continue to use the IASB and International Auditing and Assurance Standards Board definition. It is unclear whether or not this direction was intentional, but it’s not necessarily a negative presumption. Use of the word “would” instead of “might” as it relates to understanding of materiality narrows the field of consideration by the readers of the financial statements. The proposed amendments conform to generally accepted accounting principles currently in practice. The committee expressed overall support of the amendments.

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19 PwC

We believe the wording of the amendments is generally consistent with how the PCAOB explains the term “materiality” in the context of a financial statement audit. We support using a similar articulation of materiality in GAAS. We note the language in the proposed amendments that indicates that financial reporting frameworks “often” discuss materiality. The two most prevalent frameworks in the US are governed by the GASB and FASB. GASB standards do not explicitly discuss the concept of materiality. Although concept statements do not establish generally accepted accounting standards, the FASB’s Statement of Financial Accounting Concepts No. 8—Conceptual Framework for Financial Reporting—Chapter 3, *Qualitative Characteristics of Useful Financial Information* (CON 8), may provide a useful frame of reference.

The PCAOB’s adopting release when AS 2105 was finalized explicitly acknowledged how CON 8 is positioned and recognized the legal concept of materiality, noting “although the discussion of materiality in the accounting literature might help auditors understand how accounting standards-setters view materiality in the context of preparation and presentation of financial statements, the concept of materiality that is relevant for audits to which PCAOB standards apply is the concept used by the courts in interpreting the federal securities laws.”

As noted in the ASB’s Explanatory Memorandum, AS 2105 expressly relies on *TSC v. Northway* as the basis for its discussion of materiality. This federal definition and the federal securities laws applying it, however, may not be incorporated directly or indirectly in financial reporting frameworks discussed in state law. Accordingly, we believe the guidance in AU-C section 320 and other standards should be principles-based.

21 KPMG

We believe that the proposed amendment to the definition of materiality from “*could reasonably be expected* to influence the judgment of a reasonable person” to “*would* influence the judgment of a reasonable investor” would result in consistency with the definition of materiality used by the US judicial system and other US standard setters and regulators. Further, the proposed amendments to the *AICPA Professional Standards* have used the new definition consistently.

22 ALGA

Generally, yes. The proposed amendments to the description of materiality is, in substance, consistent with the definition of materiality used by other regulators.

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

23 DT

D&T believes that the wording of the amendments in the exposure draft are broadly consistent with the definition of materiality used by the U.S. judicial system and other U.S. standard setters and regulators. We also believe that the ASB’s approach as outlined in the exposure draft is appropriate and consistent with the ASB’s goals of considering the standards of other standard-setters and striving to mitigate any unnecessary differences between the auditing standards applicable to issuers and nonissuers. Similarly, it is reasonable for the ASB to adopt an analogous approach to ensure conformity as it pertains to the underlying materiality concepts between the SASs and the SSAEs.