Agenda Item 2D

Table 3: Responses to 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?

Response
Don't expect change, without qualification
08 CLA We do not believe the proposed amendments will change how auditors determine materiality in an audit or attestation engagement.
09 GT We do not believe the proposed amendments will change how auditors determine materiality in an audit or attestation engagement.
10 MI Auditor General We do not expect this will significantly change how auditors determine materiality in an audit or attestation engagement.
12 Illinois CPA Society In practice auditors generally tend to be conservative in assessing materiality and already predominately operate under the materiality thresholds of the U.S. judicial system and other U.S standard setters and regulators. Therefore, we believe the proposed amendments would not substantially change how auditors determine materiality in an audit or attestation engagement.
13 EY We wouldn't expect the proposed amendments to significantly change our firm's practices and guidance with respect to determining and applying materiality in an audit or attestation engagement. We observe that most financial statements audited in the US are prepared in accordance with US GAAP and that financial reporting framework already contains a similar concept of materiality, which auditors should use as a frame of reference when planning and performing the audit in accordance with AU-C 320.03.

15 GAO We agree that the proposed definition of materiality and related conforming amendments are substantially consistent with current practice in determining and applying materiality during an audit or attestation engagement. We also agree that the proposed amendments would not significantly affect the extent of audit or attestation work performed.
16 BDO We do not expect the proposed amendments to change how auditors currently determine materiality in practice on audit or attestation engagements. We expect that materiality determinations will continue to be framed in the context of the financial reporting framework and influenced by other legislative and regulatory requirements. Consequently, materiality determinations will continue to be based on auditor judgements, various qualitative and quantitative considerations, and perceptions of what is relevant to the users of the financial statements.
21 KPMG We do not believe the proposed amendments would change how auditors determine materiality in an audit or attestation engagement. Although financial reporting frameworks or other subject matter may discuss materiality in different terms, professionals apply judgment and consider the needs of intended users in determining whether materiality is appropriate for each engagement.
19 PwC We agree with the ASB's view that the proposed amendments would not have a significant impact on the extent of work performed in audits or attestation engagements.
22 ALGA Generally, no. The proposed amendments still include the concept that misstatements be considered material when they can "influence" decisions/judgement a "reasonable" user. Auditors would continue identify the users of the financial statements under audit/attestation in setting the materiality levels.
23 DT D&T does not believe that the proposed amendments will change how auditors determine materiality, nor result in a significant impact on the extent of work performed.
18 Robert Waxman **GAAP and GAAS** This change in verbs, from could to would, while important in the abstract, will have little or no impact on how auditors will determine materiality. As the Background section of the Proposal outlines, the word "would" has been in use in the authoritative literature for over 40 years, and over all those years it had been "baked" into both GAAP and GAAS. At the time, auditors had concluded that convergence was not a sufficient reason for the FASB (in 2010) and the ASB (in 2011) to have rejected TSC v. Northway and adopt the definition of materiality found in ISA 320 (IAASB), and in the conceptual framework of the IASB. In addition, there is no evidence that auditors suddenly switched from "would" to "could" in their thinking about and use of "materiality" measures in audits.

SEC In 1999, SAB 99 Topic 1.M. (among other considerations) reinforced the "would" formulation as it applied to registrants and their auditors. As this SAB was the most thorough and extensive guidance on materiality when is it was issued, auditors of both public and private entities focused on this SAB and were very shortly "on board" with the "would" formulation. As mentioned, I know of no study or other evidence that auditors, beginning in 2010 gradually or promptly changed their audits to fully incorporate a "could" concept into the audit process.

Other Reasons Why the Change Will Likely Have No Impact

In addition to the four-decade use of the "would" formulation, it is likely this change ("could" to "would") will have no (or little) impact for the simple reason that it was near impossible to apply either the would or could construction (without more guidance) in a coherent way. The definition in the Proposal has cascading subjective terms and no two auditors will agree on just how to think about and then consistently apply its terms:

(a) substantial likelihood

How should auditors determine this? Can this be expressed as a range of probabilities, say from 70% to 95%?

(b) would

Is there a bright line to distinguish terms such as "may" v. "might" v. "likely" v. "could" v. "would"? Again, can these terms be expressed as ranges of probabilities?

(c) influence the judgment

What audit steps should be undertaken to test for a change in the behavior of a financial statement user? How will auditors know what will influence a reasonable users judgment?

(d) reasonable user

Who is the user – a lender, shareholder, vendor or other interested party? Exactly how should the auditor find this reasonable user? Can the auditor, or the audit firm, ever be considered a reasonable user and thus supplant the actual user?

In addition, adding the "total mix" of information to the definition (as suggested above) only stacks another subjective concept on top of all the other subjective concepts.

Also, of interest is the auditor's application of the various types of materiality, for example: accounting materiality, audit materiality, legal materiality, component materiality, planning materiality, performance materiality, etc.

I know I left out many other questions, but this short exercise is only meant to show that the definition of materiality in the Proposal is of no practical use. The definition is merely a placeholder until a more useable (by auditors) one is found.

Don't expect change - qualified

02 TN State Audit

At this time, we do not believe the proposed amendments will change how we determine materiality for our engagements. However, this assumes the purpose, intent, or objective of the proposed changes does not substantively change the intent of the current conceptual definition of materiality.

3 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.

17 TX Society

The committee thinks that the concept of materiality has always been subjective by nature and always has a function of professional skepticism. The committee believes that the proposed amendments should pose no challenge to current audit practices. Auditors have always considered the end users and readers of the financial statements when performing an audit and determining the appropriate levels of materiality. The only concern expressed by the committee was that the amendments may affect certain disclosures, such as related party transactions and subsequent events, by lowering the threshold considered to be material. From a litigation standpoint, the proposed amendments would place a higher burden of proof on plaintiffs, which the committee thinks will be beneficial to the profession.

Possibility of change

01 - John Keyser

If the Board concludes that it is necessary to describe materiality as proposed, it would be helpful for the Board to explain how the two concepts differ in terms of the likelihood threshold. 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.

04 AAA

Further, as the results of extant research suggest slight differences in the wording of auditing standards are associated with differing auditor judgments (Daugherty, Dee, Dickins, and Higgs 2016), increasing standardization should result in more consistent judgments and decisions – at least among U.S. companies and their auditors (Question 2 of the Proposal). Importantly, the Proposal may signal that a change in auditor behavior is justified or necessary and may impact the judgments of third parties when evaluating *ex post* audit quality. Three proposed changes to the definition of materiality are noteworthy.

"Could" versus "would" – As noted in the Proposal, the U.S. Supreme Court's interpretation of materiality (i.e., a "would" threshold) reflects its belief that the Seventh Circuit Court of Appeals' interpretation (i.e., a "might" or "could" threshold) imposed too low a threshold to impose auditor liability. It is therefore possible that auditors will view the revised definition of materiality as permitting higher scopes and less work.

"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.

"Decisions" versus "judgments" –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.
Considering the potential for variation in practice when adopting the new definition, we recommend guidance be included that describes the Board's intent in terms of the expected impact of the Proposal on the determination of materiality. 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.
07 NASBA It would be difficult to determine or assess if the proposed Amendments will change how auditors determine materiality in an audit or attestation engagement and the impact on audit performance and the extent of work performed in engagements. We believe that the change in the description of materiality from "could reasonably be expected" to "would" may raise the threshold for considering a matter "material" and may thus have an impact on practice. That said, we support the Amendments because harmonization of the concepts of materiality between the U.S. judicial system and U.S. standard setters and regulators justifies making the change.
11 NSAA_ 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. Rather it could change how it is applied at the end of an audit. 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. In addition, the term 'reasonable user' may be interpreted as having a broader meaning than the intended user, which may result in auditors changing how they determine and apply materiality. Specifically, it may be more difficult for auditors to judge a misstatement's effect on a reasonable user's decision-making versus an intended user's decision-making, the latter of which implies some degree of knowledge about the financial statements.