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## COMMENTARY

### **Comments of the Auditing Standards Committee of the Auditing Section of the American Accounting Association on Proposed Statement on Standards for Attestation Engagements, *Amendments to the Description of the Concept of Materiality***

#### **Participating Committee Members:**

Sean Dennis, Denise Dickins (Chair), Christine Earley, Julia Higgs

**SUMMARY:** In June 2019, the Auditing Standards Board (the Board) of the American Institute of Certified Public Accountants issued a request for comment on its Proposed Statement on Standards for Attestation Engagements, *Amendments to the Description of the Concept of Materiality* (the Proposal), which 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. The comment period ends August 5, 2019. This commentary summarizes the participating committee members' views on feedback requested by the Board.

**Data Availability:** The Proposal, including questions for respondents, is available at:  
<https://www.aicpa.org/content/dam/aicpa/research/exposedrafts/accountingandauditing/downloadabledocuments/20190605a/20190605a-ed-sas-ssae-materiality.pdf>.

The views expressed in this letter are those of the contributing members of the Committee and do not reflect an official position of the American Accounting Association. Although the comments reflect the consensus view of the Committee, they do not necessarily reflect the views of every member.

## COMMENTARY

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.

The Board solicited feedback on two issues: (1) 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, and (2) whether the proposed amendments will change how auditors determine materiality in an audit or attestation engagement?

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. 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. 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.

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.

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