



Agenda Item 2

Materiality Definition — Cover Letter and Issues Paper

Objective

To review a draft of 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
- Victoria Pitkin (ARSC)
- Dan Voogt

Background

In August 2018, the FASB amended its definition¹ of “materiality” in order to align with the definition of materiality used by the United States judicial system, the auditing standards of the Public Company Accounting Oversight Board (PCAOB), the Government Accounting Standards Board (GASB), and the U.S. Securities and Exchange Commission (SEC). The amendment mistakenly stated that the FASB’s revised definition of materiality is in substance identical to the definition used by the ASB; however, the ASB’s current definition, consistent with the definition of materiality that had been adopted by the FASB in 2010, is that used by the International Accounting Standards Board (IASB) and the International Audit and Assurance Board (IAASB).

The ASB believes it is in the public interest to eliminate inconsistencies between the AICPA *Professional Standards* and the definition of materiality used by other standard setters, regulators, and other participants in the financial reporting system in the United States. Accordingly, the Task Force was charged with developing amendments to align the materiality concepts discussed in *Professional Standards* with the definition of materiality used by the United States judicial system, the auditing standards of the Public Company Accounting

¹ The term *definition* in this document means the words used to explain the concept of materiality and is not intended to mean a statement of the exact meaning of the term *materiality*.

Oversight Board (PCAOB), the Financial Accounting Standards Board (FASB), the Government Accounting Standards Board, and the U.S. Securities and Exchange Commission (SEC).

Definitions

The primary difference between the definitions held by other standard setters, regulators, and the United States judicial system and the definitions held by the ASB, IASB and IAASB relate to whether a misstatement “*would* influence the judgment of a reasonable investor” or “*could* reasonably be expected to influence the decisions of users.” In essence, the United States Supreme Court, the SEC, and the PCAOB define an omission or misstatement as material if there is a substantial likelihood that a reasonable person *would* consider it important. The IASB, IAASB and ASB definition define an omission or misstatement as material if it *could* reasonably be expected to influence the economic decision of users taken on the basis of the financial statements.

The definition of materiality in existing GAAS is as follows:

Misstatements, including omissions, are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users made on the basis of the financial statements.²

The SSAEs have a comparable definition.

Issues for Task Force Consideration

Issue 1: Whether to amend the definition of materiality using the words of the PCAOB or of the FASB.

The PCAOB and the FASB are aligned in the concept of materiality but use slightly different words. The PCAOB, in AS 2105, *Consideration of Materiality in Planning and Performing an Audit*, does not define materiality but describes it, in paragraph 2, by quoting *TSC Industries vs. Northway, Inc.*, as follows:

.02 In interpreting the federal securities laws, the Supreme Court of the United States has held that a 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."

Paragraph 7 of AS 2105 states that

The auditor should evaluate whether, in light of the surrounding circumstances, there are particular accounts or disclosures for which *there is a substantial likelihood* that

² Paragraph .02 of AU-C section 320, *Materiality in Planning and Performing the Audit*

misstatements of lesser amounts than the materiality level established for the financial statements as a whole *would influence the judgment of a reasonable investor*. If so, the auditor should establish separate materiality levels for those accounts or disclosures.

The FASB's amended definition of materiality is as follows:

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 FASB states in Concept Statement No. 8 issued in August 2018 that

The definition of materiality that is in Concepts Statement 2 is quoted in SEC Staff Accounting Bulletin No. 99, *Materiality*. SAB 99 notes that the definition that is in Concepts Statement 2 is in substance identical to the definition of the U.S. Supreme Court, which in turn results in the definition in this chapter being in substance identical to the definition in the auditing standards of the AICPA and the PCAOB.

If based on PCAOB wording, the proposed change to GAAS³ definition based on PCAOB wording would be

Misstatements, including omissions, are considered to be material if ***there is substantial likelihood that they***, individually or in the aggregate, ~~could reasonably be expected to~~ ***they would*** influence the ***judgment of a reasonable user*** economic decisions of users made on the basis of the financial statements.

If based on FASB wording, the proposed change to GAAS definition using FASB wording would be

Misstatements, including omissions, are considered to be material if ~~they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of~~ ***in light of surrounding circumstances, it is probable that the judgment of a reasonable person relying on users made on the basis of the financial statements would be influenced or changed by the misstatements, individually or in the aggregate***

The Task Force recommends that the wording of the proposed amendment be based on PCAOB wording for the following reasons:

- The PCAOB wording is closest to the Supreme Court wording.
- Paragraph .02 and .03 of AU-C section 320 state, in part, that financial reporting frameworks often discuss the concept of materiality in the context of the preparation and fair presentation of financial statements, and that such a discussion about materiality

³ Similar changes are being proposed to the AT-C sections but for purposes of discussion only GAAS is shown.

provides a frame of reference to the auditor in determining materiality for the audit. Accordingly, the auditor considers the FASB definition in audits of financial statements prepared in accordance with GAAP.

- Aligning with the auditing standards of the PCAOB will eliminate a difference between those standards and GAAS; using FASB wording would create a difference between GAAS and both PCAOB standards and the ISAs.

1. Does the ASB agree with the wording of the proposed amendment?

Issue 2: The definition of completeness of criteria

AT-C section 105, *Concepts Common to All Attestation Engagements*, provides application guidance on suitable criteria. Suitable criteria exhibit four characteristics, including completeness. Completeness is described as follows:

- Completeness. Criteria are complete when subject matter prepared in accordance with them does not omit relevant factors that could reasonably be expected to affect decisions of the intended users made on the basis of that subject matter.⁴

AU-C section 940, *An Audit of Internal Control Over Financial Reporting That Is Integrated With an Audit of Financial Statements*, has essentially the same guidance.

The words in this description are similar to the words used to describe materiality:

- Materiality: "...could reasonably be expected to influence the economic decisions of users..."
- Completeness: "...could reasonably be expected to affect decisions of the intended user..."

Because the words are similar, the question was raised of whether it might be appropriate to propose amending the description of completeness to be consistent with the definition of materiality, given that the purpose of this project is to eliminate inconsistencies in the definition of materiality.

The original description of completeness in SSAE 10 said: "Criteria should be sufficiently complete so that those relevant factors that would alter a conclusion about subject matter are not omitted."⁵ SSAE 10 also defined materiality as "a reasonable person would be influenced by the omission or the misstatement."⁶

⁴ Paragraph .A42 of AT-C section 105, *Concepts Common to All Engagements*

⁵ Paragraph 24 of AT-101.

⁶ Paragraph 67 of AT-101.

The ASB has never discussed whether “materiality in a financial statement audit” is the equivalent to “completeness of criteria” in an attestation engagement. Criteria are concerned with *completeness*; materiality is concerned with *misstatements*, including omissions. Misstatements occur when the subject matter is not prepared in accordance with the criteria; the criteria themselves cannot be materially misstated. The wording in the attestation standards is the exact same wording as in ISAE 3000, and any change would create a difference between two converged standards. The implications of making this change on the development of criteria for attestation engagements are not known. For these reasons, the Task Force has concluded not to propose any amendment to the description of completeness as part of this materiality project.

Question for ASB consideration:

2. Does the ASB agree that no amendment be proposed to the description of completeness?
3. Does the ASB believe that the Explanatory Memorandum should include a discussion of this issue and a question as to whether the description of completeness be amended?

Issue 3: Effective date

The Task Force recommends that the amendments be effective for audits of financial statements for periods ending on or after December 15, 2020. This aligns with the effective date of the auditor reporting suite of standards and the omnibus SAS. Early implementation will not be precluded; as described in paragraph A59 of AU-C section 200, the auditor is permitted to apply an AU-C section before the effective date specified therein unless otherwise stated in the AU-C section.

Question for ASB consideration:

4. Does the ASB agree with the proposed effective date, and that early implementation should not be precluded?

Issue 4: The definition of materiality in an auditor’s report when the audit is performed in accordance with GAAS and the ISAs.

The existing auditor’s report does not include a definition of materiality, and there are no proposed amendments to existing AU-C section 700. However, the revised auditor’s report under soon-to-be-issued SAS No. 134, *Auditor Reporting and Amendments Addressing Disclosures in an Audit of Financial Statements*, includes a definition of materiality. This definition is being proposed to be amended, and, if adopted, a conforming change would be made to all the illustrative reports in exhibits in SAS No. 134 (changes to exhibits do not require exposure).

However, this amendment will result in the auditor’s report under GAAS not being fully converged with the ISA auditor’s report. Both the ISAs and SAS No. 134 require a sentence in the auditor’s report defining materiality; however, the wording of that sentence would differ between the two sets of standards. This creates the question of which wording to use when reporting on an audit conducted in accordance with both GAAS and the ISAs.

Paragraph 50 of ISA 700 sets out the minimum elements that are required to be included in the auditor’s report, if applicable, when reporting in accordance with the ISAs and another set of auditing standards. These elements include a description of the auditor’s responsibility for an audit of the financial statements that *addresses, and is not inconsistent with*, the requirements of paragraphs 37-40 of the ISA. Paragraph 38(c)ii of ISA 700 states that the auditor’s responsibilities section shall provide a definition or description of materiality in accordance with the applicable financial reporting framework. Accordingly, using the GAAS definition of materiality, which is consistent with the GAAP definition, in the auditor’s report would be consistent with the requirements of the ISAs.

The PCAOB auditor’s report does not include a definition of materiality, so the amendment to describe materiality will not have any effect on the differences between the GAAS auditor’s report and the PCAOB auditor’s report.

Question for ASB consideration:

5. Does the ASB agree with the conclusion that the auditor’s report in accordance with both the ISAs and GAAS should include the GAAS definition of materiality?

Items Presented

Agenda Item 2– Issues Paper

Agenda Item 2A – Proposed exposure draft, *Proposed SAS* and *Proposed SSAE* – wording based on PCAOB