Subject: PCAOB Docket 026: Comment

Docket 026: Re-Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk; Proposed Conforming Amendments to PCAOB Standards

Comment: William Kinney, Professor, University of Texas at Austin

I appreciate the opportunity to comment on three specific aspects of Appendix 3 regarding "Consideration of Materiality in Planning and Performing an Audit" that I believe are not in the public interest.

Paragraphs 2: To guide the auditor in determining materiality for the financial statements as a whole, the proposal's only source is a 1976 U.S. Supreme Court decision that defines when "a fact" is material (rather than defining the *amount* of misstatement that would cause the financial statements as a whole to be materially misstated). The 1976 decision acknowledges that determining a material amount requires "delicate assessments of the inferences a 'reasonable shareholder' would draw," but neither the Court nor the proposal provides guidance or criteria for how such "delicate assessments" should be made.

Adoption of this paragraph would replace the lengthy history of development of the concept of a material amount in professional accounting and auditing standards (as well as numerous other court decisions) with a *single* court decision made under case-specific circumstances more than a quarter of a century ago and under vastly different circumstances and technologies.

If the Board wishes to make such a change, then it seems to me that the Board should provide guidance as to how the single definition would be applied in 2010 and beyond. Frankly, I'm skeptical of the viability of such a path. I base this judgment, in part, on stock price analyses related to the SEC's SAB 99 materiality criteria reported in a 2002 *Journal of Accounting Research* article by Kinney, Burgstahler, and Martin.

Paragraph 10: This paragraph states that "materiality at an individual location cannot exceed, *and generally should be less than*, materiality for the financial statements as a whole" (emphasis added). This guidance may be correct, but under what conditions is it acceptable for an auditor to audit Subsidiary A, Subsidiary B, . . ., Subsidiary Z to the same materiality amount, say $100,000, and yet conclude that the Consolidated statements are free of misstatements of no more than $100,000? If the Board has valid exceptions in mind, then list them or describe their contexts so that auditors will reduce the extent of auditing *only* when the Board exceptions are met. If there are no known exceptions, then "generally" should be deleted.

Paragraphs 11 and 12: I may have misinterpreted paragraph 11, but it seems to suggest the following example: "Suppose that the auditor plans the audit in September based on expected net income for the calendar year of $1,000,000 and determines that planning materiality is, say 5% of $1,000,000 or $50,000. At the December year end, the auditor finds that net income for the year is $1,000." My reading of paragraph 11 is that the auditor is obligated to reduce planning materiality – perhaps to $50 – and to greatly modify the auditing procedures necessary to obtain sufficient audit evidence per paragraph 12?

Does the proposal presume that a "reasonable investor" would expect that the auditor would change planning materiality to $50? I hope not and believe that such an obligation would not be in the interests of the "reasonable shareholder" or the public interest.