November 18, 2008

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, DC 20006-2803

PCAOB Rulemaking Docket Matter No. 2008-026
Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk and Conforming Amendments to PCAOB Standards

Dear Members and Staff of the Public Company Accounting Oversight Board:

I appreciate the opportunity to comment on the proposed standards, “Evaluating Audit Results” and “Consideration of Materiality in Planning and Performing an Audit.” In that regard, I believe the PCAOB is failing to act on an opportunity to improve the quality of financial reporting for public companies. While materiality is an important issue in every independent audit, the proposed standards offer no substantive change to aid either the auditor or the user in regard to the underlying precision of audited financial statements. Instead, the proposed statements merely perpetuate the lack of needed guidance inherent in standards and regulations previously published. Accordingly, I would like to propose a more specific decision rule as to whether uncorrected misstatements should be considered material, i.e., important enough to influence the decisions of financial statement users.

In general, the auditor makes choices regarding the precision of account balances at two different phases of an audit: (1) when considering the necessary precision of audit tests (referred to in the proposed standards as “tolerable misstatement” and (2) when deciding whether known and likely uncorrected misstatements should be recorded to prevent the financial statements from being misleading. While both decisions are important, for the remainder of my discussion I focus on a decision rule related to waiving or requiring recording of uncorrected misstatements.

Why Is A Specific Decision Rule Needed?

As with existing standards, under the proposed standards the concept of consistency likely will be violated. In a set of comparative financial statements for example, three years of Statements of Income are presented, each prepared with a level of materiality relative to that specific year. The differing levels of precision make horizontal analysis, i.e., comparisons over time, problematic as there is no consistency between the balances being compared. Such differences in precision either may hide or may overemphasize differences between periods. Similarly, as I demonstrate in a refereed journal article, “The Impact of Materiality Decisions on Financial Ratios—A Computer Simulation,” immaterial misstatements can combine to adversely impact
vertical analysis as well. In a second refereed journal article, “Aligning Auditor Materiality Choice and the Needs of a Reasonable Person,” I also demonstrate that misstatements considered immaterial by the heuristics commonly used by auditors can have significant impacts on earnings per share. As this clearly is an important metric used by investors, significant variations resulting from inconsistent auditor judgments are not helpful and do not meet the needs of financial statement users.

In addition to problems of consistency, neither current nor the proposed standards address continuing calls for increased transparency in financial reporting. Auditors do not publicly disclose decisions about materiality, thus there is no way for financial statement users to reliably analyze comparative or even single-year statements. It can be argued reasonably that lack of knowledge regarding financial statement precision is contrary to the need for transparency.

What Would Be a Useful Decision Rule?

It is clear that existing audit standards and regulations, accounting principles promulgated by the FASB, and findings by the courts all are consistent in requiring that the needs of reasonable financial statement users be the factor used to determine an appropriate level of materiality. It also is clear that auditors have a tremendous degree of flexibility in determining what an appropriate level should be. A substantial body of research, however, points to a serious disconnect between levels considered material by auditors and levels considered important by financial statement users. A study commissioned by the Big Five Audit Materiality Task Force, for example, finds “statistically significant price responses to earnings surprises of as little as 0.03 percent of assets and price, amounts far below conventional rules of thumb for materiality in accounting and auditing.” Numerous other studies have reached similar conclusions.

To be consistent, a decision rule for determining reporting materiality levels should have certain characteristics. First, materiality should reflect a primary measure common to all financial statements and known to be important to users. Second, both producers and users of financial statements should understand the basis on which materiality is established. Third, for comparability the same basis should be used for all financial statements.

A logical solution is to define materiality based on the effect on earnings per share rather than as an absolute dollar magnitude as presently done. An earnings per-share metric satisfies all three characteristics identified above and reflects a measure known to be important to financial market responses. It is easily understood and provides a uniform measure across entities and industries.

Given substantial anecdotal and empirical evidence that one cent per share is viewed as important by the markets and to comply with the professional and legal definitions of materiality, the acceptable precision of financial statements should be established to be relative to that amount. This would require recording of every uncorrected misstatement that either would increase or decrease primary earnings per share by one cent or more and could be stated as:
“An uncorrected misstatement in a financial report is material if the magnitude of the item, either individually or in aggregate with other uncorrected misstatements, is such that, if corrected, the result would be a change in primary earnings per share of one cent or more.”

Implementation of this new definition of materiality would provide financial statement users with greater confidence in the reliability of the financial statements as the issue of auditors allowing identified large omissions or likely misstatements to remain uncorrected should no longer be relevant. Additionally, if auditors adhere to this policy, questions about auditor independence should be greatly reduced.

Conclusion

With issuance of new standards, the PCAOB has the opportunity to make audited financial statements more reliable, more transparent, and more useful. To achieve this objective and to improve reporting transparency, however, financial statement reporting materiality needs a more precise definition. A substantial body of anecdotal evidence and rigorous research points to earnings per share as being one of the most valuable metrics for valuation and comparison available to financial statement users. I recommend that the proposed standards be revised to define an uncorrected misstatement as being material if correction of that misstatement would change earnings per share by one cent. This simple definition would result in a much greater degree of confidence in the reliability of audited financial statements.

I would be pleased to discuss my comments with members of the Public Company Accounting Oversight Board or its staff. If you have any questions or would like to discuss these issues, please feel free to contact me at 901-678-3507.

Very truly yours,

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Professor of Accountancy

