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Materiality in the context of audit: the real expectations gap

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Abstract

Purpose – This paper seeks to focus on the issue of materiality judgements and the need for public disclosure of materiality levels. Insights about the concept of materiality are drawn from the words of users of audited financial reports, auditee managements, suppliers to the market for audit services and auditing standard setters and regulators.

Design/methodology/approach – This paper reports findings arising from face-to-face office interviews with individuals representing identified groups of stakeholders in the market for audit services about the issue of “materiality” as this concept is applied in auditing. The interviews canvassed many issues related to audit as part of a larger project entitled “The future of audit”.

Findings – In general, stakeholders perceive that the concepts involved in audit materiality are not well understood and they point to the difficulty in providing educative materiality about it, especially in relation to qualitative materiality, to retail investors in particular. There are mixed views as to whether the actual level of tolerable error, as per one of the meanings of materiality in the audit space, should be disclosed, with some feeling that it might be detrimental or dangerous.

Practical implications – If incremental information about materiality is to be disclosed, the issue of where, what to whom, by whom and when arise. Various suggestions are made by stakeholders in respect of these questions.

Originality/value – The paper concludes by drawing from the insights gained by the authors through the comments of participant stakeholders to make recommendations that deal with the issue of audit materiality.

Keywords Materiality, Accounting firms, Audit process, Auditing

Paper type Research paper

1. Introduction

The issue of materiality is central to the concepts of “sampling”, “tolerable error” and “reasonable assurance”. This study examines the perceptions of individuals representative of key stakeholder groups in the audit process; auditee management, suppliers of audit services, users of audit reports, those who set auditing standards and regulators of the market for audit services. This paper is one part of a much wider Australian study into the “future of audit”[1].

This current paper argues that there is an absence of shared understanding of a crucial term between relevant stakeholder groups. Differences exist in perceptions

of the meaning, application, importance and consequences of the concept of audit materiality and the level of understanding held about its relevance to the audit function (Houghton *et al.*, 2010). This paper aims to shed light on any misunderstandings of materiality as a concept and to investigate any need for public disclosure of materiality threshold levels.

In addition to giving voice to the stakeholders who participated, this study contributes to our understanding of a previously little noticed aspect of the audit expectations gap; the concept of audit materiality. Monroe and Woodliff (1993) defined the audit expectation gap as the difference in beliefs between auditors and the public about the duties and responsibilities assumed by auditors and the messages conveyed by audit reports. By providing insights and public policy recommendations to achieve wider comprehension of the concept, so crucial to the audit function, one aim is to reduce the level of opacity in the eyes of some about the role that materiality plays in the context of auditing (Houghton *et al.*, 2010).

2. How “materiality” is used in audits

The purpose of this section is to convey how the term “materiality” is used in two contexts in auditing. The first relates to the more widely known notion of “bigness” and relates to large items that are “material” to the financial statements. The other, probably less well-understood context, at least on the part of non-suppliers, is the notion of the aggregated or cumulative materiality level to which the audit work is conducted, with various account balances being assigned separate levels according to their risk and the cost to audit (depending on the auditor’s judgement). Under this context, it is the case that the lower the materiality level(s) set, the more conservative and the more costly the audit.

In Australia, Auditing Standard ASA 315 “Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement” (AUASB, 2006b), based on the International Auditing and Assurance Standards Board’s International Standard on Auditing of the same name, is relevant. In particular, paragraph 8 of ASA 315 states:

Obtaining an understanding of the entity and its environment is an essential aspect of performing an audit in accordance with Auditing Standards. In particular, that understanding establishes a frame of reference within which the auditor plans the audit and exercises professional judgement about assessing risks of material misstatement of the financial report and responding to those risks throughout the audit, for example when: *(amongst other points)* establishing materiality and evaluating whether the judgement about materiality remains appropriate as the audit progresses.

Australia also has an accounting standard dealing with materiality and has retained it, despite there being no International Accounting Standards Board equivalent. AASB (2004) paragraph 9 states that:

Information is material if its omission, misstatement or non-disclosure has the potential, individually or collectively, to: (a) influence the economic decisions of users taken on the basis of the financial report; or (b) affect the discharge of accountability by the management or governing body of the entity.

Auditing standard ASA 240 “The Auditor’s Responsibility to Consider Fraud in an Audit of a Financial Report” is relevant also in that it requires the auditor to:

- identify and assess the risks of material misstatement due to fraud at the financial report level and the assertion level;
- evaluate the design of the entity's related controls to determine whether they have been implemented;
- determine overall responses to address the risks of material misstatement due to fraud at the financial report level; and
- design and perform audit procedures to respond to the risk of management override of controls; amongst other things.

Also, ASA 320 "Materiality and Audit Adjustments" (AUASB, 2006c) is relevant as it provides explanatory guidance regarding the auditor's consideration of materiality and its relationship with audit risk in planning an audit and evaluating audit evidence.

3. Literature review

There has been a renewed interest in the concept of materiality (Messier *et al.*, 2005), partly motivated by the issuance of new International Auditing and Assurance Standards, and the major corporate collapses of the early part of the last decade involving audit failure. Messier *et al.* (2005) conduct a review of the substantial body of materiality research since 1982. Although much of this research has contributed to our understanding of materiality, Messier *et al.* (2005) conclude that many questions still remain, and identify a number of areas where future research should proceed. These include more research on planning materiality (Chen *et al.*, 2008, Blokdijs *et al.*, 2003), evaluation of materiality decisions (Pinsker *et al.*, 2009), materiality of internal control deficiencies (Chandra and Calderon, 2008) and materiality in attest engagements (DeZoort *et al.*, 2003).

The concept of materiality is important throughout the audit process, from planning the audit to the evaluating the results of audit testing. Professional judgment determines what is regarded as being material at each of these phases of the audit process. The notion of the aggregated or cumulative materiality level to which the audit work is conducted, with various account balances being assigned separate levels according to their risk and the cost to audit also depends on the auditor's judgement. Determining overall materiality and materiality for individual components is becoming more of a hot-button issue as the number and complexity of large international audits increases (Glover *et al.*, 2008). More recently, there was commentary related to the PCAOB's rulemaking related to auditors' assessments of and their response to risks (Bierstaker *et al.*, 2010). Concerns raised related to capping the aggregation of tolerable misstatements to financial statement materiality as this may result in over auditing. Unfortunately, auditing standards and other professional guidance releases offer little practical guidance on the topic (Glover *et al.*, 2008). Yet, some issues that an auditor deems to be immaterial may be very material to investors and others. And, despite accounting regulators' attempts to avoid bright-line rules and develop principles-based accounting standards, many auditors consistently seek "definitions" and "examples" when it comes to materiality (Kranacher, 2007).

Early studies did not find evidence for requiring specific materiality guidance like many auditors have been seeking. For example, Bernardi and Pincus (1996) examined 152 Big 6 managers and their evaluation of materiality and risk in an audit simulation based on an actual case where material fraud was undetected. Their empirical evidence did not support the need for specific quantitative guidance in accounting standards related to materiality.

However, with the dramatic increase in the number of restatements filed over the past years that have been attributed to numerous causes, including changes in materiality thresholds, and the overly conservative nature of auditors, this lack of specific guidance needs to be reconsidered. Recently, Plumlee and Yohn (2010) analyzed disclosures surrounding restatements filed from 2003 to 2006 to provide empirical evidence of the restating companies' explanations of the underlying cause of restatements. Overall, the results are inconsistent with claims that the underlying complexity of the accounting is the primary driver of restatements. They find some evidence that the proportion of restatements with signed net income effects that exceed 5 per cent of total assets, a commonly used materiality threshold, decreased over the four-year period. In summary, they document that internal company error is the primary cause to which company disclosures attribute restatements, although a significant portion of restatements are attributed to accounting standards.

Some countries do have professional guidance on materiality including Australia, Canada and South Africa (De Martinis and Burrowes, 1996), but even in these countries the disclosure of materiality thresholds and criteria in the financial reports is not required. The non-disclosure of these concepts, and lack of explanation regarding what, and why information is disclosed makes such reports less understandable and less useful for users' decision making (De Martinis and Burrowes, 1996). It is also argued that the non-disclosure of these thresholds may cause users to have unreasonable audit expectations, particularly in relation to the extent of the auditors responsibility for detecting and reporting material fraud. Several studies have looked at individual countries such as The Netherlands (Blokdijs *et al.*, 2003) and Spain (Del Corte *et al.*, 2010) and the impact the effective use of qualitative materiality guidance have on auditors and the other potential consequences on materiality planning, etc. The findings of these papers have significant practical implications for auditors, as well as for policy makers, although limited to that specific country's context. For instance, Blokdijs *et al.* (2003) contend that given the vagueness of the guidance and the importance of the materiality judgment, studying actual materiality judgements by auditors in practice can provide useful insights into the audit process and audit quality. However, due to limited data availability, there have been few archival data studies of this aspect of auditor decision making, thus making the current study, providing some quantitative data as useful in adding to the literature on auditor materiality planning and judgements.

So in summary, although many rules of thumb for calculating materiality exist (Pany and Wheeler, 1989), sizable differences can occur depending upon the method and the industry, thus placing auditors in a difficult situation. The fundamental meaning of materiality continues to haunt regulators and practitioners (Kranacher, 2007). Therefore, it is understandable that both these stakeholder groups, and financial statement users struggle with the concept of materiality.

4. Theoretical framework

Past research has generally explained the demand for quality-differentiated audits in terms of agency/contracting costs (Watts and Zimmerman, 1986; Simunic and Stein, 1987). Agency theory attempts to explain the auditor monitoring functions and infer that auditors will report on behalf of shareholders (Deegan, 2007). Agency theory "which focuses on the needs and welfare of a diverse group of individual investors who entrust their wealth to the control of managers" is widely used in current mainstream

accounting and auditing research (Bricker and Chandar, 1998, p. 487). Agency theory which underpins this research attempts to explain the demand for auditing and was used to develop the expectations of auditors' opinion reporting.

"This principal-agent model has also been implicitly adopted in the regulation of accountancy" (Bricker and Chandar, 1998, p. 487). These regulation requirements and the associated threat of liability impact on the actions of both directors and auditors. The collusion of accountants and external auditors with companies' directors raises questions on the role of auditors as a monitoring mechanism and of audit quality. The theory explains that differing motivations and information asymmetries between directors and shareholders lead to the need for auditors to act as a mechanism to reinforce the trust regarding the reliability of information. Auditors are entitled to report at various risk levels by virtue of the different types of audit modifications. Whilst agency theory testifies to the commitment of auditors' independence in reporting, literature has questioned this by suggesting that auditors would compromise their reporting level (De Fond, 1992; Francis and Wilson, 1988). While literature highlights that collusion of two agents could result in significant harm to shareholders, further examination is encouraged to prevent such problems. This current research fuels debate on whether auditors should convey materiality thresholds. It is also argued that the non-disclosure of these thresholds may cause users to have unreasonable audit expectations, thus adding to the audit expectations gap debate (De Martinis and Burrowes, 1996).

The concept of an audit expectation gap suggests that the public expects auditors to act in ways which are different from what auditors themselves would expect to act (Koh and Woo, 1998). Responses to a potentially widening expectation gap have come from both researchers and the accounting profession. Researchers are concerned with investigating the factors contributing to the expectation gap and proposing solutions to narrow the gap (Humphrey *et al.*, 1993). One might argue that the disclosure of materiality thresholds might help with the audit expectations gap problem, and better assist stakeholders understand the concept of materiality (De Martinis and Burrowes, 1996). There might be some stakeholders that perceive financial statement audits by an external independent auditor to be some type of guarantee on the fairness and accuracy of the financial statements. There was a view that providing disclosure of the existence of a materiality threshold represents a key ingredient in advising the market that the audit is not a 100 per cent guarantee. Thus, this is seen as a mechanism in narrowing the audit expectations gap.

Agency theory predicts certain behaviours related to directors (agents) and this raises concerns related to the risks associated with disclosing materiality levels. If directors knew the materiality threshold there is the risk they might measure items in a manner that means they are set just below the threshold and thus are considered immaterial. In other words, disclosure of materiality thresholds could lead to misleading practices, manipulation and potentially financial statement fraud. Agency theory suggests directors who are motivated to act in their best interest would only report certain items when there is not high likelihood of failure which could affect their likelihood of being sued. Agency theory dictates that directors (agents) are only motivated to report difficulty of paying debts as and when they fall due when it is in their best interest. So, if given the chance to have a material debt not on the face of the financial statements, and thus deemed immaterial, agency theory predicts that directors (agents) would most likely do so, under certain circumstances, and therefore this is a risk associated with disclosing the materiality thresholds to client management (auditees).

5. Approach

Face-to-face office interviews with stakeholders in the market for audit services were conducted as part of a wide ranging project exploring "the future of audit"[2]. During preliminary focus groups of stakeholders that helped focus the wider study, the issue of audit materiality was raised as a problematic issue worthy of further investigation.

Focus groups are particularly useful to explore and generate ideas and issues through group interactions. However, the nature of the focus groups presents limited opportunity to probe issues. In-depth interviews, on the other hand, provide a source of data richness as the researcher is able to enquire further into the complexity of issues. The personal interaction that is required, however, restricts the number of interviews that can be conducted within a reasonable timeframe.

To reflect as wide a range of opinions as possible, this project sought the participation of representatives of key stakeholder groups from both the supply and demand sides of the market for audit services, encompassing: users of audit reports; purchasers of audit and assurance services; and suppliers, representing both Big4 and non-Big4 firms. Opinions were also sought and received from auditing standard setters and regulators of the market.

Participants were drawn primarily from the following sources: nominees from the professional accounting bodies and accounting firms, purchased databases, data collected from the Connect 4 database and professional association membership lists[3]. In total, 7,296 records were purchased from the Fairfax and Accountable List Brokers' databases, covering finance professionals, chief executive officers and directors. An additional 2,530 records on directors and audit committee members of listed companies were collected by the researchers using Connect 4. We also approached relevant professional associations for their assistance in securing the participation of their membership.

5.1 Research design

Data for this project were collected using a multiple-method approach, using both focus groups and in-depth interviews. These techniques were conducted in two phases, using the strengths of each technique to build an understanding of the issues. This initially involved focus groups to map out the issues and in some cases questions to be asked, followed by several dozen in-depth interviews with stakeholders many of whom were key and even iconic participants in the market for audit services within the jurisdiction of this enquiry; Australia.

The following outlines the type of participants in the focus groups and in-depth interviews.

5.2 Type of participants

As discussed previously, views were canvassed from a wide cross-section of key stakeholders from both the supply and demand sides of the market for audit services as well as standard setters and regulators within that market. This ensures a sample that is representative of the Australian market for audit and non-audit services. Specifically, the project sought participation from the following major stakeholder groups:

- users of audit reports, including users with accounting expertise (e.g. accounting professionals), professional (e.g. financial advisors, financial planners, lenders, analysts, investment managers and stockbrokers) and private investors;

- purchasers of audit and assurance services, including directors and audit committee members and management (CEOs and CFOs);
- suppliers of audit and assurance services (Big4 and non-Big4);
- auditing standard setters; and
- regulators of audit services.

5.3 Focus groups

Focus group participants were asked to consider three broad questions relating to:

- (1) audit services;
- (2) the audit expectations gap; and
- (3) the risks faced by suppliers and users.

These broad question areas were identified in the pilot testing phases of the future of audit project. The specific questions used as a starting point for discussion were:

- (1) "What types of audit or audit-related services are wanted by shareholders and management to enhance the credibility of financial statements?"
- (2) "Are there other audit or audit-related services that are wanted by shareholders and management?"
- (3) "Do you believe a gap in expectations still exists? If so, in what areas and among which groups?"
- (4) "Can the gap be closed? Does it need to be closed? What are the mechanisms that can help to manage expectations or narrow the gap?"
- (5) "What are the major risks faced by:
 - audit suppliers; and
 - other participants in the market for audit services (e.g. users and preparers)?"

Focus group participants were primarily drawn from the nominees provided by the industry partners and the databases. Five focus group sessions were held in Sydney (2 sessions), Melbourne (2 sessions) and Brisbane (1 session). In total, there were 23 participants, though the numbers of participants in each session varied. Each session was approximately 1.5 hours in duration, and different approaches were used to elicit responses from participants, including individual assessment and group discussion. These procedures facilitated the identification of relevant issues which were then developed and pursued further during the interviews.

5.4 Interviews and coding

The interviews provided an opportunity to probe issues in more depth. In total, 58 interviews with 15 users, 18 auditee management representatives, 15 suppliers, 10 standard setters and regulators were conducted (Table I), providing "richness" to the data that could not be accomplished solely through other data collection mechanisms such as survey questionnaires and focus groups. Each interview lasted typically between one and two hours in duration. Given the volume of interviews to be covered, the interviews were staggered across two broad time periods primarily through 2007[4].

The primary prompting question asked in the interviews about materiality consisted of the following:

Materiality drives the level of work external auditors have to do and affects the assessments they make. Given that potentially many shareholders do not understand the concept of materiality, should this be a concern for the accounting profession? Can you suggest ways to address this concern?

However, it was common for there to be follow-up questions and interactive discussions between the interviewer and the interviewee. Where relevant, the specific follow-up question is quoted in the sections that follow.

Although there are several qualitative methods, such as the constant comparative method in analyzing qualitative interviews (Boeije, 2002), thematic analysis (Boyatzis, 1998) is used for code development in our analysis of the interview research findings. The process of coding the qualitative information involved listing themes and identifying patterns that casually relate themes and help describe and organise the interview observations. Transcribed audio recordings are coded into themes and using ATLAS.ti qualitative data analysis software, textual patterns are identified from the voluminous set of interview transcriptions to enable conclusions to be drawn from the trends and themes in the data.

6. Findings

The issue of materiality in the audit was discussed during the interviews both as a consequence of specific questioning and more broadly. Table II summaries some of the key findings of this research.

6.1 A misunderstood concept?

That, some stakeholders in the audited financial reporting process do not have a good understanding of audit materiality comes through in some of their comments, where the tendency is to think in terms of material (large) items rather than the superiority in terms of rigour of auditing to a low level of materiality:

User: Look I think they [auditors] should [explain materiality]. I guess investors understand it intuitively in the sense that if you've got something major in accounts and it has the [...]. potential to impact a company's performance, then they understand it. But [...] people don't identify the problem until typically it's already emerged. So that's why I think – while they'd understand the concept – certainly I think accountants – the auditors should be striving to identify those issues, so at least to bring those issues to the attention of people prior to them causing problems.

However, there was distinction between retail and sophisticated investors in terms of a capability to understand:

Auditee Management: The ordinary person cannot in any genuine sense understand the auditing framework, so when we talk about this issue of materiality or any other issue,

Users	Stakeholder groups				Total
	Auditee management representatives	Suppliers	Standard setters	Regulators	
15	18	15	4	6	58

Table I.
Interview participants
by groupings

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Table II.
Responses from
interviewees

		%
<i>Capability of understanding materiality: retail vs more sophisticated users</i>		
The retail investors struggle to understand materiality	26	45
The more sophisticated users better understand it	23	40
<i>Capability of understanding materiality: directors and audit committee members</i>		
Suppliers confident that directors and audit committee members understand the concept	12	21
Other stakeholder groups confident that directors and audit committee members understand the concept	7	12
<i>How materiality adds to audit expectations gap</i>		
The concepts related to materiality are difficult to explain	21	36
<i>Disclosure of materiality levels – will this make a difference?</i>		
Suppliers do not support more disclosure	9	16
May help narrow gap; removes notion of 100 per cent guarantee	2	3
Would not be required if there was more confidence in existing audit procedures	1	2
<i>The need for more education</i>		
Educate users of financial reports	11	19
Educate preparers of financial reports	8	14
Tolerable error most misunderstood	7	12

Note: Total number of participants = 58

you really have to segment the audits. Let's abandon the Mum and Dad because frankly an annual report is beyond their comprehension [...] So let's move to the sophisticated end.

Supplier: I think it's such a technical issue, I don't think that we necessarily expect the public to understand it [...] I think materiality always comes down to common sense.

User: Well, in the scope of the [*a large company by global standards*] [...], it's totally irrelevant' – it's a very hard concept for them to grasp. But again, I would question how many retail shareholders even know the word exists.

Standard Setter: [...] who are the, if you like, the core users of these reports? And you go back to analysts, brokers, they understand materiality because they look at the risk. Your average punter on the street, probably not, but then again, research would show they don't read audit reports – so you ask the question "well, would they even understand what the basis of an audit was before you get to materiality?"

A comment from one of the auditee management interviewees expresses a belief that some managements do not have a good understanding of audit materiality:

Auditee Management: Actually not being a listed business and not having to think too much about shareholders, I guess I'm changing the word "shareholders", for "general management" and use them as my reference. Outside of the accounting and finance people, the general management, in this business at least doesn't understand the concept of materiality. They know about it, but they seem to selectively forget about it if ever issues arise.

One supplier comments that even board members sometimes lack real understanding of the concept:

Supplier: I mean I've had experiences where I've just worked through materiality with boards of listed entities and while they might agree with what the materiality is in regards to the financials as a whole, when we then try and apply that and talk them through how we apply that to different line items or captions in accounts, even that discussion with board members

who are well educated often with a finance background, becomes quite a heated debate and people have different views.

However, this lack of understanding by boards is not the general experience as the next quotation demonstrate:

Supplier: But if there is one area [...] that still is a confusion between even boards and audit committees, and something that we've got to decide, is making them abundantly aware of the standard on materiality and what that means and how it's been set. Because often a board will say well, how come you didn't spot that 200 grand adjustment? Well you're never going to spot the 200 grand adjustment if you're working with a materiality of 10 million. It's just not how an audit will work. So that's the one area – but like I said, it's still fraught with danger as to how you explain that to the general public.

In summary, there is agreement that sophisticated investors or users of audited financial statements have a better capacity to understand the concept of materiality than retail investors, however there is mixed views as to whether board members lack a real understanding of the concept. The concept of differential reporting may find support given the above findings, as retail investors need financial statements that they are capable of extracting more meaning from, and that are less technical in nature. While accounting research has focused on differential reporting for small to medium enterprises, or private versus public entities, more research should investigate the needs of retail investors also.

6.2 Can we explain the concept better?

Many interviewees agreed that more education was needed before an understanding of materiality could be said to be widespread[5]:

Auditee Management: There is a group of shareholders that do understand materiality, but generally [*they do not understand*]. I think there still needs to be materiality thresholds [...] Rather than try and address materiality, let's try and address the education of the shareholder, an explanation to the shareholder, without just standing up at an AGM and saying whatever – a shareholder meeting and just saying “it wasn't material” [*which goes*] straight over the head.

Auditee Management: Well [...] I did a quick search on our annual report from last year [...] just on the word “materiality”, and the only place it was really mentioned was in the corporate governance disclosures. So, you'd have to say that is materiality really discussed, out there in the public forum, being through annual reports or whatever? You'd probably say no.

That the auditing standards should be turned to for an understanding of materiality is the suggestion of one supplier.

Supplier: Both within the accounting standards and within the auditing standards there are standards of what is materiality and guidelines to materiality, so if you really are concerned around getting people to understand it, I don't think that those standards are overly complex.

However, as one of the audit management comments point out, it is questionable how many amongst the public would understand the standards:

Auditee Management: Well I think you've got to put it into a context. If you say “do people understand the issue of materiality?”, it's like all things in the literature and the auditing and accounting standards. I don't think many readers would understand most of the accounting standards or the auditing standards in detail.

The judgement involved in evaluating not just quantitative but also qualitative materiality and the difficulty in explaining these concepts is raised in these next few quotations:

Auditee Management: I guess the main area of materiality that would probably cause some concern is that area where there's subjectivity. So obviously there's not as much subjectivity if we're just talking pure numbers – if you find an issue worth X amount. But when we talk about perhaps the nature of some items, or disclosure and these sort of things, and what's material and what's not, and where subjectivity creeps into that decision, there could be some concern there as to what's disclosed and what's not and should it be.

Supplier: I think they [ordinary shareholders] don't understand the concept of materiality. Materiality doesn't just come in numerical form. If it just came in numerical form, which is largely the way we would do it, but there are other non-numerical concepts which apply to materiality.

In summary, there is agreement that more education is needed before the understanding of the concept of materiality could become more widespread, and some suggest turning to the auditing standards for this education process. Our findings lead us also to make some observations about undergraduate auditing education and its placement within the curricula and the perspective with which it is taught. Conventionally, because of the perceived need to have a fulsome education on financial accounting, generally auditing is taught towards the end of a business degree. A non-conventional alternative would be the earlier introduction of a unit on auditing so that a student's exposure to financial accounting issues can be informed from an audit point of view. An even more controversial alternative would be that auditing education is interwoven throughout the teaching of financial and corporate accounting rather than as a discrete and separate subject in the business degree. This may give the student a more subtle and insightful perspective on their education in financial accounting. Furthermore, the authors suggest that the concept of materiality be brought to the early stages of the course outline, so up front students are confronted with the concept. Many auditing courses tend to have the concept imbedded in the course somewhere after week four or five of a semester, same with some financial accounting courses.

6.3 Would benefit flow from the disclosure of the materiality level?

Those who favour disclosures of the concept of materiality make a compelling argument that the qualitative characteristics are a key aspect to the determination of materiality. For example, materiality levels over related party transactions might be very different to materiality levels over accounts receivable. The nature of these two items is different, which drives dissimilar relevant materiality levels. The notion of having disclosure of the level(s) of materiality applied in the conduct of the audit was raised in several of the comments:

User: They probably don't understand the materiality and [for] [...] large organisations, the materiality threshold can be quite large. So maybe a bit more work can be done there to inform about the material. And I could even see a day when you have to disclose your materiality thresholds.

Auditee Management: I think you need to maybe spell out what percentage or what level of due diligence or materiality have been put into it, as against just a standard statement that "we've done audits based on section something that says materiality is". So I think that needs to be further clarified [...] as a note as to what you've really done and what you haven't done.

Auditee Management: I certainly think that there is quite a big expectations gap on the materiality threshold, which is, in a very big company, [...] a very big number, and I don't think that number is really stated clearly enough.

User: So an audit partner might say to me as a chairman of an audit committee, "but that's not material" and I say "I don't care". I want to know about it because it is important in me understanding the process of what's happened. He might then turn around and say "well, you're trying to put too fine an interpretation on something". Well, so be it, but that's something you agree with the audit engagement team up front about what's a reportable item. You'll get different people on audit committees that have different levels of knowledge and expertise.

Understandability of the audit is one of the key issues that has arisen in the audit expectation gap debate (Houghton *et al.*, 2010). Understandability can be very much in the eye of the beholder and it can be argued that self-evaluation of understandability is fraught with measurement error about the quality of that self-insight. Materiality as that term is used in an auditing concept is another area that emerges as commonly misunderstood. However, there is also some doubt that disclosure of the materiality level will itself be understood:

Auditee Management: But [...] I think another question is: "Do they actually understand that they don't understand what materiality is?" Because if it's never actually mentioned to them, they may not be aware that they don't understand this term [...] So [...] I think [...] rather than just the concept of materiality, if you [...] start disclosing what your materiality level is, and once again, in simple terms, what does that mean – if your materiality's ten mil, that means that the auditors will want accounts restated if they find errors that total that sort of money, for example [...].

And, not all are in favour of such disclosure. One supplier points to the various levels of materiality applied to different areas as an impediment to disclosure:

Supplier: I would never get to the point I think of necessarily disclosing that to shareholders because it's not just quantitative it is a qualitative assessment and I think if you start talking quantitative, it does take away the qualitative. But I think in terms of the amount of profile, the profile materiality that it has now maybe to what it did 5-10 years ago, I can certainly say the board is more conscious of it now, management is certainly more conscious of it now. Sometimes they use it as a bit of a tool themselves as to what they can and can't do.

One standard setter claims that it would be "dangerous" to disclose the materiality level (tolerable error) itself, and believes that the auditing standards should be the source of information about materiality, with education as to where and how the standards can be used for a potential solution. Agency theory predicts potential manipulative behaviours related to directors (agents) and this raises concerns related to the risks associated with disclosing materiality levels. If directors knew the materiality threshold there is the risk they might attempt to step into the auditors shoes and make materiality judgements, or try to pressure auditors to adjust their materiality judgements. This is a domain that should be preserved for auditors, otherwise there is a risk that directors will have too much influence in the work performed by an independent external auditor:

Standard Setter: I think that's [disclosure of the materiality level itself] probably dangerous and you don't really want to dig those kind of holes for yourself because it's subject to interpretation and you get a dollar above or a dollar below. Who knows what kind of impact that's going to have in the minds of some investors?

Another supplier similarly sees disclosure as “detrimental”:

Supplier: I think if people actually sit back and think about things, they ought to understand materiality and that that 5% threshold's not a big concern. So, now the audit report as it currently stands talks about things being material [...] so whether you'd actually want to go the next level and prescribe the amounts – I don't know. I think that would be unwise and probably detrimental.

One supplier voices disquiet that management might overstep the mark and attempt to make materiality judgements that should be the preserve of auditors:

Supplier: But one thing that I would hate to think would happen is that companies start to think materiality in their own right. I've seen that creep in a little bit more over the recent years where management will say don't worry about that, that's not material. And our view is well, that's your objectives, you should really get it right, materialities has just become more of an audit function rather than for in the first instance not to address something because you don't believe its material. So as long as there's not a disconnect there as well.

There was a view that providing disclosure of the existence of a materiality threshold influencing the audit represents a key aspect in advising the market that the audit is not a 100 per cent guarantee that the representations made in the financial statements are entirely accurate. That is, if the market is informed that there is a materiality threshold, the notion of a 100 per cent guarantee is immediately removed. This would then naturally help in narrowing the audit expectations gap. So, the notion of disclosing materiality thresholds has its benefits and risks:

Standard Setter: [...] So an audit provides reasonable but not absolute assurance. What does that mean? And so I think more discussion and disclosure about the fact that it's not a 100 per cent review – but I think the message to convey there is more one of concept than the fact that it isn't absolute assurance, rather than getting into the detail of describing materiality and what your thresholds are and the technical concepts – I think more the reinforcement that it's not absolute assurance.

Regulator: I think if you see the review level reports that the big firms produce today, and this is closely related to materiality, you're very limited in terms of what they've done, and the audit profession uses materiality all the time. The thing with materiality is, where do you believe you draw the line, right? I don't expect an auditor *per se* to detect every error.

Some, who were negative about further disclosures in this area, made the observation that the real thrust of what is needed is more confidence in the existing process and framework; for with this comes a reduced need for further disclosures:

Auditee Management: I think as far as the wider community [is concerned] it's important to have more education and have that information out there so that people are well informed. I mean if you're well informed of materiality and what auditors are actually doing and how they're going about it, I think you'll have more comfort in the work they're performing. But otherwise I think a couple of those subjectivity type areas on what you disclose and what you don't, and more around the nature of what's material I think would possibly raise a concern [as to] where it's headed [...].

While the above argument is held with some degree of passion, particularly by suppliers, it runs the risk of being interpreted as patronising. By this statement, the authors mean that the supply side within the profession might be viewed as only providing information and therefore accountability where they believe it is in their interests to do so and those people expert in the market know enough to be able to protect all market interests.

7. Summary

Users, when asked whether auditors should explain more about their implementation of the concept of materiality in the conduct of the audit, feel that this would be a positive, but somewhat difficult, thing to do in layman's terms. Comment about the likely incomprehensibility to some of the large threshold dollar amounts of audit materiality used in the conduct of audits of the largest companies was received. The need to explain the concept in layman's terms, if it is to be explained, and the foreseeability of required public disclosure of materiality thresholds is raised also.

Given auditee management representatives' comments about the concept of materiality and the perceived potential of a failure to fully understand it to exacerbate the audit expectations gap, several advocate the need for education of users of the audit product. Only a relatively small proportion of the interviewees believed there was no audit expectations gap and the vast majority of those believed there was an audit expectations gap and indeed many argued there were multiple gaps depending on different stakeholders within the market for audit services (Houghton *et al.*, 2010). The concerns over the auditing profession have arisen out of false expectations, which may in part be due to the need to the attempt to gain some economic recompense from one who can afford it. There was also critical comment in respect of the media reaction to business failure and the role of auditors (Houghton *et al.*, 2010). With the exception of an ex-auditor auditee management representative, there is general agreement amongst auditee management representatives that the concept of materiality as used by auditors is not well understood by retail users of financial reports and even, as some observe, by some auditee managements and even audit committee members. However, some auditee management representatives in their comments make it clear that the situation is complex, with the more sophisticated readers of financial reports much more able to grasp and understand the concept and its utilisation in the conduct of an audit. Directors and audit committee members create another level of sophistication and accountability again and are seen generally by auditee management representatives as competent in their understanding of auditing concepts surrounding materiality. The use of materiality in terms of "tolerable error" emerges from auditee management representative's comments as particularly misunderstood, although two comment that this may be a deliberately selective self-interested misunderstanding.

Suppliers' comments about their application of the materiality concept and their perceptions of users' understanding of that concept range from those conveying assertions that materiality is of little interest to shareholders, to those who convey their belief as to how crucial it is that understanding of the concept becomes more widespread. Several suppliers position the understanding of audit materiality in the context of other understandability challenges presented in the form of complex financial reports more generally, the issue of audit sampling and what it is that can and cannot be expected of an audit to be achieved. Suppliers are eloquent in expressing the qualitative as well as quantitative nature of materiality and the role of their judgement in applying materiality, leading to the difficulty they perceive in articulating to unsophisticated users of the audit product their use of materiality in their audit conduct. Most suppliers are positive in their comments about the level of understanding of the materiality concept displayed by directors and audit committee members, however this is not a universally held view. Whilst there is little dispute that retail investors do not understand adequately the concepts involved, there is not agreement that this situation can be resolved,

even with more disclosure. There is no support by suppliers for public disclosure of the actual level of audit materiality employed but it is evident that there are many instances, but not universally so, where the materiality level is disclosed to clients; either auditee management or audit committees. Suppliers are particularly knowledgeable that the level of materiality and the related use of sampling have consequences for the cost of the audit.

Like the comments of suppliers, those of standard setters range from conveying no discomfort with existing levels of understanding of audit materiality to those who see further education as required. Confirmation that directors and audit committee members, on the whole, have appropriate levels of understanding is forthcoming from interviewed standard setters. The grey area of quantitative materiality where the item at issue is found to be between 5 and 10 per cent of the relative base preoccupies the regulator's comments, with a call for more disclosure in the audit report where such issues cannot be definitively resolved with more testing.

8. Concluding remarks

Despite the efficiencies that would flow to the capital market, we find little if any empirical evidence of the public disclosure of materiality[6]. We also find significant diversity of practice amongst audit committees in asking for or being provided with materiality information. There is little direct guidance available for audit committees on this issue. Some, perhaps many, audit committees seek direct and substantial information on materiality from their auditor. One or two may seek to avoid that knowledge because of real or perceived legal consequences. Others may not know of its availability and its role within decision making on the quality of the audit; hence, our observation about diversity in practice. This variability seems troubling from a public policy setting. An implication is that guidance and perhaps even requirements for boards and/or audit committees could be enhanced to make express reference to the desirability of having a conversation with their auditor about materiality, if not their right to ask for disclosure to them of the level or levels used. In the same vein, it may be mandated that board and audit committees be educated as to the role of and responsibilities in respect of the use of materiality in auditing.

Who could be responsible for providing this guidance? Clearly, the AUASB could be a vehicle, as could be the Australian Securities Exchange and/or the AICD. Each would have varying attributes and bring varying qualities in the provision of such guidance.

Clear communication with management, as opposed to boards and audit committees, in respect of the materiality level may be seen as desirable but also has some potentially disadvantageous effects. It is the case that some managements might use knowledge of materiality level as "pushback" on the auditors and it may be used to dissuade auditors from pursuing a line of enquiry if the matter in question is under a pre-specified materiality level. Similarly, if materiality levels and auditor judgements became known to an auditee, those who may wish to commit fraud or engage in other opportunistic behaviour may have valuable information with which to work that would not be available in the circumstance of uncommunicated materiality levels. Agency theory suggests that such auditees, who are motivated to act in their own best interest, would only report certain reportable items, conceal misstatements or fraud and engage in opportunistic or misleading behaviour.

Despite the fact that the capital market is a global one, any specific guidance on materiality would have to recognise that there is a sharp difference between the US regulatory style, to which some Australian (and other non-US) companies are exposed,

and the common experience in the Australian capital market. It would seem that in the US system, if there is error, the tolerable materiality level is zero[7]. This comes about because of accounting standards that are interpreted to mean that any error might affect the decision making of users including one individual user and hence needs to be corrected. This is not the application in Australia unless it is material and, as we understand it, is uncommon in other parts of the world. One consequence of this is that there is a higher proportion of modified audit reports in the Australian jurisdiction than in the USA and it would seem that there are more restated accounts in the US system. Some might argue that the Australian system is more tolerant of imprecision.

In the eyes of retail investors and possibly even some more sophisticated users and auditee management representatives, as well as accounting students who might be useful surrogates for some of the above, there is the possibility of materiality being misconceived because some of the dynamics of materiality may be counterintuitive. In common language, the convention is that the "more material the better". In its application to auditing, however, the higher the level of materiality the "weaker the audit". That is to say, where materiality levels are higher, the screen through which the auditor puts the transactions and balances is more coarse. Put more directly, more gets through the screening device undetected. As noted above, the alternative expression to materiality is "tolerable error". The authors would speculate that usage of the term "tolerable error" in guidance or elsewhere may be received with more clarity than the term "materiality".

The evidence we gathered, either expressly or impliedly refers to quantitative materiality thresholds, but there is also reference, particularly from suppliers, to qualitative materiality. This introduces a level of subtlety and complexity that is hard for even sophisticated stakeholders in the capital market to get a good handle on. While the authors accept that there is validity with this qualitative notion of materiality, there is a question as to whether it leads to the audit being opaque, less understandable and even more mysterious. In terms of public policy, the valid existence of qualitative materiality is, one might argue, not sufficient to invalidate the possibility of disclosure of quantitative levels of materiality.

In conclusion, there are other aspects of audit that are not well understood and it may be that materiality is not the highest need priority for attention. However, some of the more experienced and sophisticated interviewees were strongly of the view that better communication of materiality is an area where action can and should be taken. The authors note that successive Australian Governments have encouraged retail shareholders to participate in the capital market but this encouragement has not been matched by equivalent public support mechanisms to assist them into this capital market participation. There has been an implicit assumption that the free market behaviour of Australia's capital market will ensure their rights and interests are protected. Disclosures, including that of materiality, may be a key factor in effective participation in the capital market. Not informing participants is a public policy issue. Put more directly, some widespread understanding that materiality levels exist within the audit poses a significant benefit in reducing the audit expectations gap if, by virtue of its disclosure, it removes the notion that the audit is somehow comprehensive and is a guarantee that the transactions and financial representations made are 100 per cent guaranteed by the auditor. One limitation of the study is that the sample of interviewees consists mainly of top 500 listed clients, and therefore their views on materiality levels, and disclosures may differ from very small listed companies.

Notes

1. This project referred to as "The future of audit" has a full title of "The Future of Audit: Keeping Capital Markets Efficient: Towards a National Strategy on the Future of Auditing" (Houghton *et al.*, 2010) and is a Linkage Grant funded by the Australian Research Council, in partnership with the Institute of Chartered Accountants in Australia, CPA Australia, Deloitte, Ernst & Young, KPMG and PriceWaterhouseCoopers.
2. In addition to the face-to-face interviews conducted by one or more of the authors, the observations made have benefited from the input of approximately 40 participants in a symposium held at the Australian Parliament House, Canberra, in late 2007.
3. The various bodies included both accounting and non-accounting professional bodies. Because of the requirements of the Privacy Act in Australia, it was necessary that the professional bodies were the conduit for the initial interaction with potential participants. Participating professional associations were: The Institute of Chartered Accountants in Australia, CPA Australia, Australian Shareholders' Association, Financial Planners Association of Australia Ltd, Securities and Derivatives Industry Association, The Association of Financial Advisors Ltd, Australian Bankers' Association, Group 100, Australian Securities Exchange and the Financial Services Institute of Australasia.
4. The particular questioning on materiality was undertaken from December 2006 until August 2007 and therefore was after the major regulatory changes that affected the market for audit services in Australia, but before the impact of the global financial crisis.
5. Square brackets inserted into quotations are included by the authors to assist in clarifying meaning or the context from the question asked.
6. While this is a question that could be asked and answered by examining a population of financial statements, but of the financial statements reviewed by the authors, we can find no quantitative estimation of level or levels of materiality being provided to the users of financial statements. In our discussions with interviewees, it was evident that there were some instances where audit committees did seem to be appraised of audit materiality.
7. The relevant auditing standard in the US is SAS No. 99 "Consideration of Fraud in a Financial Statement Audit" (AICPA, 2002), however it is more the way application of standards is administered and enforced by the General Accounting Office (GAO) that prompts this observation. There are, however, some differences in wording between the US and Australian standards. For instance, the US Auditing Standard again provides more specific detail than the corresponding Australian Standard. In the USA, SAS No. 99 states specifically that financial reporting fraud results in the financial reports not being presented in conformity with GAAP (AICPA, 2002, Para. 6). The definition provided by ASA 240 (AUASB, 2006a, Para. 11), on the other hand, does not explicitly describe compliance with GAAP when defining financial reporting fraud. ASA 240 does, however, explain that the preparation of financial reports in compliance with GAAP is one aspect of management's responsibilities (AUASB, 2006a, Para. 19), and that this is consistent with the objective of an audit, that is, to assess whether the financial reports are prepared in accordance with the relevant reporting framework (AUASB, 2006a, Para. 20). The notion that financial reporting fraud causes the reports not to be in conformity with GAAP, therefore, appears to be implied elsewhere in ASA 240, rather than being stated explicitly within the definition of fraud (refer Powell (2009), for a fuller analysis of the differences between the standards).

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Aumueller, D. (2005), "Semantic authoring and retrieval within a wiki", paper presented at the European Semantic Web Conference (ESWC), Heraklion, Crete, 29 May-1 June, available at: <http://dbs.unileipzig.de/file/aumueller05wiksar.pdf> (accessed 20 February 2007).
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