Audit materiality: a comparative analysis between normative principles and professional standards[1]

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ABSTRACT

Audit materiality is a fundamental concept of the external audit process. Guidelines issued by professional standard-setting bodies generally state that the determination of audit materiality is primarily a matter of professional judgement. Overemphasizing professional judgement as predominate guideline might be an attempt to advance and maintain so-called uncertain professional knowledge. This paper examines the proposition that in respect of determining materiality during the audit of company annual financial statements, professional auditing standards suggest the preference of standard-setting bodies not to provide concrete guidelines to the extent it is possible. It does so by means of a comparative analysis between normative principles regarding the determination of audit materiality and the corresponding professional standards. The results provide sufficient evidence to support the research proposition. Audit materiality standards presently have two major shortcomings, namely: overemphasizing the exercise of professional judgement and providing for various alternatives, while normative principles favour a specific approach.

Key words:

audit materiality, auditing standards, standard-setting process, normative principles, professional judgement, external audit, audit process

1 BACKGROUND

The directors of a company, in their capacity as the managing agents of the owners (shareholders) of the company, adhere to their accountability duty by, among others, preparing and publishing annual financial statements that are used for decision making purposes by the shareholders and various other users (compare Kohler 1975:6; Anderson 1988:3-4; Willmott 1990:315; Koen, *et al.* 1994:1,6,7; Knechel 1998:10,11).

It is acknowledged that, for the following reasons, there is a need for an external audit function which will enhance the credibility of the annual financial statements to the various users thereof: the possible conflict of interest between the prepares and the users of the statements, the consequences of incorrect (unreliable) information, the complexity of the process whereby financial information is gathered, recorded, analysed and summarised, and the isolation of the user from the company and these processes (Holmes and Burns 1979:4-5; Defliese, *et al.* 1987:10-14; Anderson 1988:5-6; Gloeck and De Jager 1993:2).

1 Based on a paper presented at the second biennial IAAER international accounting research conference and the thirty third CIERA international accounting conference. The original paper was presented at DePaul University, Chicago on 3 October 1998.

With regard to the audit of financial statements in particular, the audit process is generally applied using a risk-based approach (refer Cushing, *et al.* 1995:11; Konrath 1996:14-19; Arens and Loebbecke 1997:157-160; Knechel 1998:51-53). Cushing, *et al.* defines the risk-based approach as follows (1995:11):

> ... a systematic approach in which the nature, timing and extent of testing are determined by assessing and evaluating the risk that financial statement assertions are materiality misstated.

The concepts of *audit risk* and *audit materiality* underlie this approach and influence the whole audit process, from the planning of the audit to the evaluation of the audit findings and the issuance of an audit report (compare Mautz and Sharaf 1961:53-67; Taylor 1985:94; Konrath 1996:134-140; Arens and Loebbecke 1997:248,255,256; Knechel 1998:200-207). A standard unqualified audit report on company annual financial statements communicates the *materiality* concept when it states that the financial statements *fairly present* the company's financial position, results of operations and cash flow information ─ the auditor is in actual fact confirming, with a high degree of assurance, that the financial statements are free of *material* misrepresentations, taking cognisance of the fact that the financial statements are presented in accordance with a specified set(s) of criteria (compare Mautz & Sharaf 1961:85,158-200; Defliese, *et al.* 1984:29; Lee 1984:10; Leslie 1985:8; Low & Koh 1997:199-201).

Notwithstanding the obvious importance of *audit materiality* and, in particular, audit materiality judgements that need to be made throughout the audit process and that will ultimately influence auditor/shareholder communication, profes-sional standards tend to suffice with the following primary guideline: determining what is material and what is not is primarily a matter of professional judgement (Lee 1984:18,19; Anderson 1988:146,289; Bamber, *et al.* 1995:55-59; Arens and Loebbecke 1997:248,249; Botha and Gloeck 1998:49,50; Knechel 1998:31,205; Martinov and Roebuck 1998:105). In light of extensive research that has been conducted since the 1950's with regard to the *materiality* concept (references made by Holstrum and Messier 1982; Botha and Gloeck 1998; Martinov and Roebuck 1998), the lack of formal standards providing concrete and specific guidance is somewhat surprising. Already in 1967 L.A. Bernstein aptly indicated that a comprehensive process described as "judgement" does not inspire confidence, it poses educating and training problems and it is conducive to practices that would most likely discredit the profession (1967:90).

The purpose of this study is to provide insight into the normative principles that underlie the concept of *audit materiality* and the extent to which these principles have been included in professional standards on audit materiality. This will have value in that:

- the information obtained may be used as a basis to reevaluate current professional standards and the desirability of the *status quo*;
- awareness would be created amongst auditors and the users of auditing services with regard to the availability (and necessity) of normative principles to describe a historically ill-defined concept ─ the concept of audit materiality;
- the description and understanding of the role and functions of the external auditor would be enhanced.

The remainder of this paper is organised as follows: The next section provides a brief discussion on the standard-setting process and how it relates to audit materiality. Against this background the research proposition is formulated. The third section discusses the methodology that was followed to investigate the research proposition. Section four reports on the results and the interpretation of the results. The paper ends with relevant conclusions and suggestions for future research.

2 THE STANDARD-SETTING PROCESS AND AUDIT MATERIALITY

The auditing standard-setting process is one of the instruments used in the self-regulation of the auditing profession ─ an instrument various authors have argued is being misused by the standard-setting bodies to exclude certain roleplayers in the accountability framework and thereby furthering agendas reflecting the rationality of certain groupings (compare Parry and Parry 1977; Willmott 1986; Booth and Cocks 1990; Mitchell, *et al.* 1993; Wilmott, *et al.* 1993; Gloeck and De Jager 1995 and 1997).

Considering auditing a principle of social, political and economic organisation, focuses the issues around the standard-setting process on the public interest. This entails including all the roleplayers in the accountability framework so that democratically chosen representatives of the various constituencies affected by the work of auditors may define, through a process of negotiation and re-negotiation, the audit objectives and related auditing standards (Gloeck and De Jager 1995:21-23; 1997:21-24). Persisting with an exclusive standard-setting process would lead to auditing standards not being generally accepted by the users of auditing services and thereby undermining the existence of the auditing profession (Tandy and Wilburn 1996:92,93; Gloeck and De Jager 1997:25).

One strategy used to establish and maintain the exclusive standard-setting approach referred to above, is the advancement of uncertain professional knowledge by, among others, overemphasizing and elevating the exercise of *professional judgement* to the status of predominate principle in deciding technical and practical accounting and auditing issues (compare Nilson 1979:571; Harding and McKinnon 1997:56-58). The principle of *professional judgement* however poses a problem for auditors who daily have to deal with real practical situations. This has led to a wide range of audit judgement research in an attempt to develop structured approaches providing concrete guidelines which can be applied to specific situations (refer Bamber, *et al.* 1995:55-76).

Audit materiality has been no exception to the above phenomenon (compare Leslie 1985:11-19) — balancing the standard-setting bodies' agenda of maintaining uncertain professional knowledge, and the practical problems of applying the concept to real audit situations. Using professional judgement as the principal determinant of audit materiality in the context of the audit of company annual financial statements, has serious disadvantages, including (Dyer 1973:21-24; Leslie 1985:11):

- a lack of comparability and diverse results in similar circumstances;
- bias towards the auditor's own data needs and personal perspective, thereby widening the audit expectation gap;
- overestimating the unknown user's knowledge of a particular situation;
- a loss of public confidence in the external audit because of the subjective justification of judgement processes;
- undermining the status of the auditor and the value of auditing services to the users of financial statements;
- reducing the auditor's accountability and obscuring his/her duties and functions.

Academics in particular are in a unique position, through research, to contribute to the standard-setting process and, more specifically, in developing and testing structured approaches/normative models that will provide concrete guidance in respect of specific auditing issues or concepts, in this case *audit materiality*. This unique position is mainly attributable to academics' independence from special interest groupings and economic interests and consequences, as well as their theoretical understanding of issues in the context of a conceptual framework (compare Tandy and Wilburn 1996:93).

Tandy and Wilburn (1996:92-111) examined academics' participation in the standard-setting process of the Financial Accounting Standards Board, by focusing on factors that may affect the extent of participation and whether participation has changed over time. They conclude as follows (1996:111):

> Conversely, survey responses from both participants and nonparticipants indicate that participation is deterred by *low expectations of affecting FASB decisions*, lack of time or resources, inadequate rewards for this activity at their universities, and narrow scope of some issues. [Own emphasis.]

Although Tandy and Wilburn's study does not specifically focus on participation in the auditing standard-setting process, similar tendencies in respect of participation are visible with specific reference to the South African situation (refer Gloeck and De Jager 1995:21-23,48-50; 1997:21-25,35-38). These results warrant, amongst other things, the conclusion that the standard-setting process is being misused to maintain an exclusive process and uncertain professional knowledge, as was discussed above. The phenomenon of maintaining uncertain professional knowledge could be applied to any specific auditing concept under discussion, including *audit materiality* which is at issue in this paper.

3 RESEARCH PROPOSITION

Based on the results of the literature study regarding professional standard-setting, and the results of a normative study on the determination of audit materiality during the audit of company annual financial statements (refer Botha 1997; Botha and Gloeck 1998), the following research proposition is presented:

> *In respect of determining materiality during the audit of company annual financial statements, professional auditing standards suggest the preference of standard-setting bodies not to provide concrete guidelines to the extent it is possible*.

4 METHODOLOGY

It was decided to test the research proposition by means of a comparative analysis between normative principles in respect of determining audit materiality and their corresponding professional standards. The comparative analysis has been done in the context of the external audit of company annual financial statements.

4.1 Normative principles that should apply when determining audit materiality

These normative principles have been identified in a separate study with which the author was involved (Botha 1997; Botha and Gloeck 1998) and are summarised in Appendix 1, together with explanatory notes as necessary.

The aforementioned study had as its objective to identify which factors influence or should influence the external auditor's decisions in respect of determining materiality during the audit of company annual financial statements in a South African context. The normative principles identified and presented in a normative reference framework are representative of these factors and have a wider application than the South African situation alone. The South African context merely pertains to a section of the study where current South African auditing practice was evaluated against the normative principles identified.

In order to justify the validity of these normative principles it is appropriate to briefly refer to the process through which they were isolated and identified.

Firstly, *materiality* was defined as a concept of auditing, as deducted from the postulates of auditing. In this regard the following definition of *audit materiality* applies:

> An item (representation, fact or amount) included in the financial statements will be material if that item, based on its size or nature, will probably influence the decisions or actions of a reasonable user of the annual financial statements.

An analysis and discussion of the elements of the above definition of *audit materiality* led to the identification of twelve general normative principles that should apply when determining audit materiality. Previous studies on materiality provided further important sources for identifying basic principles with regard to determining audit materiality and broadened the base from which specific normative principles were developed. In all, 27 representative materiality studies conducted between 1960 and 1998 were selected. The selected studies, each with its own objectives, methodology, decision tasks, decision items, etcetera, exhibit an average to high degree of correspondence in respect of the principles identified and therefore provide persuasive evidence regarding the basic principles applicable to determining audit materiality. All the normative and basic principles identified and isolated were finally integrated into a normative reference framework for determining audit materiality.

4.2 Professional standards with regard to determining audit materiality

Pronouncements containing professional standards on *audit materiality* were selected for analysis based on availability in the library of the South African Institute of Chartered Accountants. Care was taken to include the latest available pronouncements of various accounting and auditing bodies. This approach is considered acceptable in light of the fact that the most recent pronouncement on a particular topic is representative of all the developments that topic has undergone. Where applicable, and dependant on availability, pronouncements preceding the latest pronouncement were also included in the selection. This would make observations with regard to the developments that have taken place possible.

As shown in Table 1, a total of thirteen pronouncements from six accounting and auditing bodies were selected. Seven pronouncements represent the latest (available) standards from the various bodies, while the other pronouncements preceded these.

Table 1: Audit materiality pronouncements selected

Accounting & Auditing Bodies	Pronouncements selected	
International Federation of Accountants (IFAC)	IAG 25 ISA 320	Materiality and audit risk (*October 1987*) Audit materiality** (*July 1994*)
South African Institute of Chartered Accountants (SAICA)	DP 6 AU 210 AU 290 AU 291 SAAS 320	Audit risk and materiality (*July 1984*) Audit planning (*July 1986*) Evaluating and concluding (*April 1987*) Audit differences (*April 1987*) Audit materiality** (*July 1996*)
American Institute of Certified Public Accountants (AICPA)	SAS 47 SAS 82	Audit risk and materiality in conducting an audit (*December 1983*) Consideration of Fraud in a financial statement audit** (*February 1997*)
Canadian Institute of Chartered Accountants (CICA)	Section 5130 of Member's Handbook AuG-7	Materiality and audit risk in conducting an audit** (*1988 – 1996*) Applying materiality and audit risk concepts in conducting an audit** (*1990 – 1992*)
Institute of Chartered Accountants in England and Wales (ICAEW)	SAS 220	Materiality and the audit** (*March 1995*)
Institute of Chartered Accountants in Australia (ICAA)	AUS 306	Materiality** (*October 1995*)

** The latest (available) pronouncement/statement from the particular body.

The pronouncements selected were examined in order to identify principles or standards pertaining to the *audit materiality* concept. It should be noted that because the normative principles discussed earlier, are the result of a study that focused on the *determination* of audit materiality alone, only such principles included in the pronouncements have been included for purposes of comparison - principles dealing with the *application* of audit materiality (for example using audit materiality as a variable in determining sample size) have been excluded. Applicable standards included in the pronouncements selected, were identified under the following headings:

- the audit materiality concept in general;

- audit materiality during the planning of an audit;
- audit materiality during the evaluation of the results of substantive procedures.

For examination and evaluation purposes the following pronouncements have been grouped together (*refer Table 1*):

- AU 210, AU 290 and AU 291: These pronouncements all follow from DP 6 and merely address different topics or stages of the audit process.
- Section 5130 of the Member's Handbook and AuG-7: AuG-7 follows on, and supports section 5130 by providing additional guidance and emphasising certain aspects.

Appendix 2 provides a summary of the professional audit materiality standards identified from the professional pronouncements selected.

4.3 Comparative analysis

The last stage of the methodology involved a comparative analysis between the *normative principles* identified and their corresponding *professional standards*. This analysis was done by means of informal observation and evaluation by the author. The next section reports on the results of the comparative analysis.

5 RESULTS AND DISCUSSION

With reference to the definition of *audit materiality* provided earlier, it is important to note that all of the professional pronouncements examined, contain a definition of audit materiality. Each institute (accounting and auditing body) provides its own wording, but inessence all the definitions, with two exceptions, contain all of the elements of the definition provided earlier. Only the definitions of IFAC and SAICA correspond exactly. The two exceptions mentioned, are:

- The ICAEW: This definition does not recognise that an item's materiality relates to the probable influencing of the decisions or actions of a *reasonable user*, but rather to the influencing of the decisions of an *addressee* of the audit report. In the author's opinion this is incorrect.
- The ICAA: This definition does not state that an item can be material based on its size or nature. The relevant pronouncement (*AUS 306*) does however mention elsewhere that an item's materiality involves both quantitative and qualitative considerations (ICAA 1995, para.05). This aspect should rather be addressed in the definition itself.

All the institutes concerned state in their pronouncements, whether directly or by implication, that the *materiality concept* is communicated in the auditor's report through the phrase “present fairly”, which implicitly indicates the auditor's belief that the financial statements taken as a whole are not materially misstated.

Tables 2 and 3 indicate significant variance in the congruence between standards included in the professional pronouncements examined. Nine (38%) of the standards identified occur in five or six of the current pronouncements, and 15 (62%) of the standards occur in one to four of the current pronouncements — nine of the 15 standards occurring in one pronouncement only. Important deductions are possible when one further examines the nature of these standards. It is however more appropriate to discuss these deductions together with Tables 4 and 5.

Table 2: Professional standards' frequency of occurrence

Standards[1]	Fr.[2]	Standards[1]	Fr.[2]
1 Planning and evaluating	6	15 Finan. Statements as a whole	—[3]
2 Quantitative and qualitative	6	16 Should relate to entity's size	—[3]
3 Small errors: qualitative effect	2	17 Latest available information	1
4 A materiality interval	1	18 Could use other information	1
5 Professional judgement	6	19 Relationship with audit risk	6
6 Auditor's perception	2	20 Illustrates quantification	1
7 Overall level and individual	4	21 In the auditee's context	1
8 Should be documented	1	22 Planning lower than final	3
9 Communicating materiality	1	23 Final will probably differ	5
10 Errors: indiv. and aggregate	5	24 Defines "audit differences"	—[3]
11 Quantify planning materiality	2	25 Consider amount and nature	5
12 May or may not be quantified	1	26 Quantitative effect	6
13 No general mathematical def.	1	27 Errors approach materiality	5
14 Smallest aggregate level	2		

Key to Table 2:

1 The standards represent those included in the pronouncements/statements examined (refer Table 1). A short name is provided for each standard — refer Appendix 2 for a detailed description of the standards.

2 Fr.: Frequency of occurrence. The number of *current* professional pronouncements in which each standard is included (6 pronouncements represent *current* professional pronouncements, while the others precede these — also refer to Table 1).

3 These standards are only included in statements preceding the current statements, and have therefore been excluded for purposes of analysis.

Table 3: Congruence between the standards included in the professional pronouncements examined

Professional standards pertaining to ...	Total	Number of institutes which include the standards in their pronouncements			
		All 6	5	2-4	1 only
Audit materiality in general	9	3	—	3	3
Audit materiality during the planning of an audit	11	1	1	3	6
Audit materiality during the evaluation of the results of substantive procedures	4	1	3	—	—
	24	5	4	6	9

Table 4: Comparison between normative principles and professional standards

Normative principles[1]	A	B	C	Normative principles[1]	A	B	C
1 Planning and evaluating	1	●	6	13 List of quantitative factors	6	❍	2
2 Quantitative & qualitative	2	●	6		20	❍	1
3 Calculate materiality limit	—	—	—	14 Available — appropriate	—	—	—
4 Consider qualitative factors	—	—	—	15 Even scale / sliding scale	—	—	—
5 M.limit: initial indicator	3	❍	2	16 Percentage intervals	21	❍	1
	14	❍	2	17 Single percentage/figure	—	—	—
	27	❍	5	18 Influence: risk assessment	19	●	6
6 Combination of factors	3	❍	2	19 Conservative evaluation	22	❍	3
7 Single materiality limit	—	—	—	20 Differences/uncertainties	—	—	—
8 Conservative approach	14	❍	2	21 For monetary errors	25	❍	5
	22	❍	3	22 For uncertainties	—	—	—
9 Professional judgement	5	●	6	23 Final materiality limit	23	●	5
10 Persons involved	8	❍	1	24 Identify qualitative factors	—	—	—
	9	❍	1	25 List of qualitative factors	6	❍	2
11 Quantified during planning	11	●	2	26 Assess qualitative factors	—	—	—
12 Relative to size of balances	—	—	—				

Key to Table 4:

1 A short name is provided for each normative principle - refer Appendix 1 for a detailed description of the normative principles.

A Number assigned to the professional standard(s) which relates to the particular normative principle (also refer Table 2 and Appendix 2).

B Status of relationship:
- ● The normative principle and the related professional standard correspond in essence.
- ❍ The normative principle is more or less implied by the related professional standard.

C The number of current professional pronouncements/statements in which each standard is included (also refer Table 2).

Table 5: Extent of correspondence between the normative principles and the professional standards

Normative principles pertaining to ...	Total	Status of relationship — correspondence between normative principle and related professional standard(s)		
		Included in essence	More or less implied	Not included in standards
Audit materiality in general	10	3	4	3
Audit materiality during the planning of an audit	9	2	3	4
Audit materiality during the evaluation of the results of substantive procedures	7	1	2	4
Total number of normative principles	26	6	9	11
Percentage	100%	23%	35%	42%

Tables 4 and 5 contain the results of the comparative analysis between the normative principles with regard to determining audit materiality and the concomitant professional standards. The following summary will be used as a basis for the discussion of the results:

- The professional standards correspond in essence with six (23%) of the normative principles.
- Nine (35%) normative principles are implied (to a greater or lesser extent) by the professional standards.
- 11 (42%) normative principles are not included in the professional pronouncements/statements examined.

Each of four of the six professional standards that correspond in essence with the normative principles, appear in all six of the current professional statements examined. Furthermore, it is important to note that all four relate to normative principles that describe the general nature of the audit materiality concept, including audit materiality's relationship with audit risk. Two of these standards warrant specific mention:

- Professional standard 5, in context, suggests that the exercise of professional judgement is the predominate factor which influences the determination of audit materiality. While the related normative principle (9) acknowledges that professional judgement will always play an important role in the decision process, the other normative principles provide concrete guidelines that provide a framework within which professional judgement should be exercised.

- Professional standard 19 (related to normative principle 18) describes the relationship between audit materiality and audit risk in principle, but fails to explain how this relationship will be applied during the actual determination of audit materiality.

The other two professional standards (11 and 23) that correspond with the normative principles, appear in two and five respectively of the current professional statements examined. The following comments apply:

- Professional standard 11, in line with normative principle 11, requires the quantification of materiality during the planning of the audit — calculating a materiality limit. This principle is normatively correct in light of the fact that an item can only be judged material because of its size, if it is compared to some measure of size — the materiality limit. This already needs to be considered during the planning of the audit, because the audit is planned and performed in such a way that there is a high probability that material misstatements would be identified (compare Lee 1984:6-8; Anderson 1988:146,289-294; Arens and Loebbecke 1997:248-250). Two related professional standards (12 and 13), although only appearing in one professional statement each, are therefore normatively incorrect and unacceptable.

- Professional standard 23 correctly recognises that there should be a distinction between audit materiality during the planning phase of an audit and audit materiality during the conclusion/evaluation phase. Unlike its related normative principle (23), professional standard 23 fails to mention specifically that the auditor should also calculate a final materiality limit.

The following deductions and observations relate to the nine normative principles which are more or less implied by the professional standards:

- The fact that the professional standards concerned do not clearly and decisively mention the particular normative principles is alarming. Recognising the implication of the relevant normative principles and judging the standards in proper context require a clear understanding and insight into the normative principles and the underlying theory. The average practising auditor would probably have difficulty in identifying the connection, not to mention other less informed readers of the pronouncements concerned. In short, the professional standards lack content and are not clear and precise to the extent possible.

- With regard to two of the nine normative principles concerned (5 and 21), the related professional standards each appear in at least five of the professional pronouncements examined. These standards again relate to general principles describing the audit materiality concept, as opposed to standards which provide specific guidelines regarding the determination of audit materiality, either quantitative materiality or qualitative materiality.

- The professional standards that relate to the remaining seven normative principles each appear in three or fewer of the professional pronouncements, indicating that some of the accounting and auditing bodies do not even by implication address the normative principles concerned.

- The following professional standards, in particular, illustrate the characteristic of professional statements to be vague and indecisive:

  Standard 9: The standard incorrectly states that communicating the materiality levels to the client is a matter of professional judgement. Normatively the materiality levels should be submitted to, and approved by the audit committee.

  Standards 6 and 20: Normatively it is possible to identify specific quantitative and qualitative factors which influence materiality decisions (refer normative principles 13 and 25), and therefore represent available factors for consideration in a particular audit situation. The professional standards however merely provide *examples* of some factors.

With regard to the eleven normative principles that are not included in the professional statements at all, cognisance should be taken of their underlying nature. Five of these normative principles discuss the distinction between quantitative and qualitative materiality in detail, including describing how quantitative and qualitative materiality should be determined with regard to certain decision items. The other six normative principles provide specific guidance on how to determine audit materiality, both quantitatively and qualitatively — four principles relate to the calculation of the materiality limit, while two relate to the consideration of qualitative factors. This again confirms that the professional standards lack content and are not clear and precise to the extent possible.

A number of final observations with regard to the results of the analysis:

- A few of the professional standards (10, 17, 18 and 26) do not relate to any of the normative principles. As the process through which the normative principles were identified and formulated did not address the topics concerned, namely whether to use the current year's or other financial information for purposes of calculating a materiality limit, as well as the aggregation of individual errors, no deductions can be made with regard to these professional standards.

- In light of normative principle 7, which requires the calculation of a single materiality limit in respect of the annual financial statements taken as a whole, professional standard 4 is incorrect. Professional standard 7 also needs further clarification because it also can be misinterpreted in this context.

The results of the comparative analysis provide sufficient evidence to support the research proposition presented. Although it may be argued that there are valid reasons why accounting and auditing bodies do not include certain principles in their professional pronouncements, the current *exclusive* standard-setting process to a large extent disqualifies such arguments.

It should be recognised that the normative principles used for purposes of the comparative analysis are open for evaluation, discussion, refinement and addition. The practical application of these normative principles, in particular, is an empirical issue (compare Bamber, *et al.* 1995:59).

6 SUMMARY AND CONCLUSIONS

It cannot be denied that *audit materiality* is a fundamental concept of the external audit process. Yet, an investigation of the professional pronouncements of various accounting and auditing bodies reveals a lack of concrete guidelines with regard to the determination and application of audit materiality during the audit of company annual financial statements. A normative analysis of the relevant auditing theory, in addition to the principles identified from previous materiality studies, enables the identification and formulation of specific normative principles that should apply when determining audit materiality. Concrete, normatively based, guidelines are therefore available in this regard.

A literature study in respect of the standards-setting process reveals that standard-setting bodies tend not to provide concrete, detailed guidelines, because of a perceived strategy to advance uncertain (esoteric) professional knowledge by, amongst other things, overemphasizing the exercise of professional judgement as the predominate principle in deciding technical and practical auditing issues.

A comparative analysis between normative principles and professional standards provides evidence that supports the research proposition that in respect of determining materiality during the audit of company annual financial statements, professional auditing standards suggest the preference of standard-setting bodies not to provide concrete guidelines to the extent it is possible. This despite judgement research indicating a need to clarify the exercise of professional judgement by developing structured approaches. Bamber, *et al.* summarises the situation as follows (1995:74):

> The view expressed by many academics and practitioners is that structured approaches supplement rather than replace audit judgment. It is sometimes argued that structured approaches clarify what judgments are needed, the possible choices, and the implications of each choice - but they leave the auditor responsible for reaching appropriate decisions.

There exists reasonable consensus between the normative principles and the professional standards in respect of the definition of audit materiality, the communication of the materiality concept in the audit report and the general description of audit materiality as a concept of the external audit process. The professional standards however lack content when it comes to providing specific, concrete guidelines with regard to determining quantitative materiality and qualitative materiality, either during the planning or conclusion phases of the audit. Only six of the twenty six normative principles are clearly reflected in the professional standards, nine are implied to a greater or a lesser extent and eleven (42%) are not reflected in the professional standards at all.

Observed developments in the various professional pronouncements seem to pertain to general, basic principles that have been included all along, with no shift towards providing more concrete, specific guidelines.

Professional standards with regard to determining audit materiality presently have two major shortcomings, namely: (1) overemphasizing the exercise of professional judgement, while concrete, normatively based guidelines are available and desirable, and (2) providing for various alternatives, while normative principles favour a specific approach.

Future research is needed of both the normative principles identified and the professional standard-setting process. Regarding the *normative principles*, future research should focus on testing the principles empirically, clarifying uncertain and unresolved aspects inherent in the normative principles, (for example determining appropriate percentage intervals in a specific auditee's circumstances), and providing support for and/or identifying additional quantitative and qualitative factors that should influence the external auditor's decisions in respect of determining audit materiality. Regarding the *standard-setting process*, future research should focus on revealing current strategies and policies inherent in the standard-setting process, identifying and implementing strategies to establish an inclusive democratic process, and reevaluating the current professional standards which are the results of a process perceived to be defective.

APPENDIX 1

Normative principles with regard to determining audit materiality

Audit materiality in general:

1 During the audit of company annual financial statements materiality is determined in respect of an individual auditee for purposes of: (1) planning the nature, extent and timing of the audit procedures in order to limit audit risk to an acceptable level, and (2) evaluating the results of the audit procedures in order to determine whether the financial statements are free from material misrepresentations.

2 When determining and considering audit materiality, it is necessary to distinguish between quantitative materiality and qualitative materiality.

3 Quantitative materiality requires the calculation of a materiality limit to serve as a measure of size.

A decision item is quantitatively material when it is large enough to probably influence the decisions or actions of a reasonable user of the financial statements. To determine this, one needs a measure of size.

4 Qualitative materiality requires the consideration of applicable qualitative factors that serve to describe the nature of, and circumstances in which the decision item occurred.

5 The materiality limit will serve as an initial indicator of the materiality of a specific monetary item during audit planning and during the evaluation of the results of the audit procedures.

6 The final materiality decision is however influenced by a combination of appropriate quantitative and qualitative factors considered in the circumstances.

Principles 5 and 6 are supported further by the principle that a decision item can be judged to be material based on its nature (qualitative considerations) alone, irrespective of its size.

7 A single materiality limit will be calculated in respect of the annual financial statements taken as a whole.

> *This is opposed to a materiality limit being presented in the form of an interval — having a lower limit and a higher limit. Because the calculated materiality limit serves as an initial indicator of the materiality of a decision item only, it will be misleading to present this limit as an interval — an interval can be misinterpreted to imply that items larger than the upper limit are definitely material and items smaller than the lower limit are definitely not material.*

6 In general a conservative approach will be applied in determining audit materiality.

> *Quantitatively a conservative approach implies choosing the lowest practical materiality figure in the circumstances. Qualitatively it implies being more sensitive to unfavourable qualitative factors than favourable qualitative factors.*

9 Exercising professional judgement is an important part of the process of determining audit materiality. The auditor has to apply professional judgement in considering and assessing the specific circumstances, deciding between available alternatives, and doing specific evaluations.

10 The determination of audit materiality should be the responsibility of a senior member(s) of the audit team. The audit partner will review and approve the documented materiality decisions, which will be submitted to the audit committee for final approval.

<u>Audit materiality during the planning of an audit</u>:

11 During audit planning, materiality will be quantified by calculating a materiality limit.

12 The materiality limit will be calculated relative to the size of the balances and financial totals included in the annual financial statements.

13 The following quantitative factors influence materiality decisions and are representative of available financial totals/bases in the annual financial statements that can be used to calculate a materiality limit:

<u>Net income factors</u>
- Current year's net income after taxation
- Current year's net income before taxation
- Average net income
- Growth in net income

<u>Financial position factors</u>
- Total assets
- Shareholder's equity
- Total liabilities
- Market capitalisation
- Cash flow from operating activities
- Total current assets

<u>Earnings per share</u>
- An amount which results in a certain percentage change in earnings per share.

In the absence of evidence to the contrary, these quantitative bases are representative of the auditor's perception of what would influence the decisions or actions of a reasonable user of the annual financial statements.

14 In a particular auditee's circumstances, the auditor must decide which of the *available* quantitative basis are *appropriate* for use during the calculation of the materiality limit.

This decision should be made in the context that all appropriate bases should reasonably be seen as reliable indicators of the size of the auditee's organisation and business.

15 An even scale or sliding scale of percentages, presented in the form of an interval, should be applied to each of the appropriate quantitative bases.

Presenting the relevant percentages in the form of intervals provides for differing and changing circumstances in respect of the company as a whole, as well as different interpretations of the circumstances by different people.

An example of an ***even scale*** *would be: 5% to 10% of net income after taxation. If a* ***sliding scale*** *is to be used, the interval of percentages will gradually decrease as the base amount (net income after taxation) increases.*

16 The percentage intervals for the appropriate quantitative bases should be determined in each auditee's circumstances by considering financial ratios and trend analysis.

Turner's study (1997), which examined the impact of immaterial errors on nine common financial ratios, implies that the use of general, standardised materiality heuristics could be problematic and should therefore be considered with caution (and ideally be rejected). Prior materiality studies indicate a lack of consensus in establishing objective materiality norms (standard heuristics) and were essentially inconclusive (Botha 1997:177,178,240,241) — indirectly supporting the above principle.

17 Because the objective is to calculate a *single* materiality limit, the auditor should decide on, for each appropriate quantitative base, a single percentage/figure within the interval mentioned.

18 The above decision is influenced by the auditor's assessment of inherent risk and control risk at the financial statements level — the more unfavourable the risk assessment, the closer the chosen percentage/figure will be to the lower end of the materiality interval, and vice versa.

19 The final decision regarding the *Materiality limit* for planning purposes, involves a conservative evaluation of the materiality figures calculated using the appropriate quantitative bases (refer principle 8 above).

<u>Audit materiality during the evaluation of the results of substantive procedures</u>:

20 Substantive procedures can lead to the identification of audit differences (monetary errors) and/or audit uncertainties. The auditor has to decide whether these items, if left uncorrected/untreated, lead to the financial statements being *materiality* misstated.

21 The materiality of monetary errors identified should be determined by considering quantitative and qualitative factors — quantitative factors being the initial indicators of materiality and qualitative factors to reach a final decision (refer principles 5 and 6 above).

The materiality limit, as the initial indicator of materiality, provides the following cut-off point: If the monetary error identified is greater than the materiality limit, it will be judged material. If smaller than or equal to the materiality limit, its materiality will finally be judged in terms of appropriate qualitative factors.

22 The materiality of uncertainties, which are normally not reasonably quantifiable, should be determined by considering appropriate qualitative factors.

23 During the evaluation phase with regard to the financial statements as a whole, a final materiality limit has to be calculated in the same manner as the planning materiality limit, taking cognisance of new information, or existing information which was confirmed, refuted or extended during the audit process.

In light of the fact that the audit process, in essence, involves systematically gathering audit evidence, it is understandable that the auditor's information about the auditee would change from the planning stage to the conclusion stage of the audit.

24 Determining qualitative materiality firstly involves identifying *appropriate* qualitative factors from a list of *available* factors that probably influence the materiality of the particular item being considered.

25 The following qualitative factors influence materiality decisions and are representative of *available* factors in this regard:

<u>Item factors</u>

- Inherent characteristics of the decision item, which include, but are not limited to, (1) the decision item as a component of a specific line item in the annual financial statements, and (2) the extent of the difference between the amount of the monetary error and the materiality limit.
- Objective verifiability of the decision item.
- The degree to which the decision item has been described factually.
- The degree to which the decision item is already known outside the company.
- Deviations from generally accepted accounting principles and/or other specified requirements.

<u>Financial factors</u>

- Changes in income or earnings trends.
- The company's solvency.

<u>Management factors</u>

- Objectives/intentions/actions of management.
- Management's credibility.
- Management's attitude towards corrections in the annual financial statements.

<u>General company factors</u>

- Relative size of the company in terms of either total assets or shareholder's equity.
- Control or changes in the control of the company.
- Effectiveness of the systems of internal control.
- Number of unissued ordinary shares.
- Knowledge that a specific user wants to place specific reliance on the annual financial statements.

In the absence of evidence to the contrary, these qualitative factors are representative of the auditor's perception of what would influence the decisions or actions of a reasonable user of the annual financial statements.

26 The qualitative determination of materiality finally involves a conservative evaluation of each

appropriate qualitative factor, as well as the effect of all the appropriate qualitative factors, as favourable or unfavourable or neutral.

The more unfavourable the evaluation, the more likely it is that the decision item will be judged material (also refer principle 8 above).

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APPENDIX 2

Professional standards with regard to determining audit materiality

Summary of standards[*]	**Pronouncements examined**[**]									
	I25	I320[!]	S6	SAU	S320[!]	A47	A82[!]	CICA[!]	E220[!]	A306[!]
Audit materiality in general:										
1 Materiality needs to be considered in determining the nature, timing and extent of auditing procedures (planning and designing) and in evaluating the results of those procedures.	√	√	√	√	√	√	√	√	√	√
2 Materiality judgements involve both quantitative and qualitative considerations.	√	√	√	√	√	√	√	√	√	√
3 Because of the interaction between quantitative and qualitative considerations, errors of relatively small amounts detected could have a material effect on the financial statements.			√			√	√	√		
4 Quantitative materiality represents a grey area between what is very likely material and what is very likely not material (*therefore an interval*).								√		
5 The consideration of materiality by the auditor is a matter of professional judgement.	√	√	√		√	√	√	√	√	√
6 The consideration of materiality by the auditor is influenced by the auditor's perception of the known (information) needs of a reasonable user of the financial statements.			√			√	√	√		
7 Materiality is considered at both the overall financial statements level and in relation to individual account balances/items. This can result in different materiality levels depending on the aspect being considered.		√			√				√	√
8 Because of materiality's importance, it should be documented together with other important considerations for the audit process.									√	
9 Communicating materiality and risk levels to the client is a matter for the professional judgement of the auditor.									√	

Audit materiality during the planning of an audit:										
10 The audit is primarily planned to detect errors (quantitative items) that could be material to the financial statements taken as a whole, either individually or in aggregate.	√	√	√	√	√	√	√	√		√
11 During the planning of the audit the auditor makes a preliminary judgement about materiality that is referred to as planning materiality and that is quantified.			√	√				√		√
12 The auditor's judgement about materiality during the planning phase may or may not be quantified.						√	√			
13 Materiality is not capable of general mathematical definition.									√	
14 Materiality for planning purposes is considered in terms of the smallest aggregate level of error that could be considered material to the financial statements.			√			√	√	√		
15 The auditor's judgement of planning materiality should relate to the financial statements taken as a whole, rather than individual elements of the financial statements.			√	√						
16 The auditor's judgement about planning materiality should relate to the size of the entity and in this regard use can be made of elements in the financial statements that are considered to be reliable (consistent) indicators of the entity's size.			√	√						
17 The auditor's assessment of planning materiality should be based on the latest available, reliable financial information.									√	
18 Situations could occur where it might be necessary to base the preliminary judgement about materiality on annualized interim financial statements or the financial statements of one or more prior annual periods, recognising any major changes in the entity's circumstances, the economy or in the industry.			√	√		√	√			

19 There is an inverse relationship between audit risk and materiality. The components of audit risk and the inverse relationship with materiality should be considered during the planning of the audit.	√	√	√	√	√	√	√	√	√	√
20 Illustrates how to quantify planning materiality, but emphasizes that the guidelines and examples are for illustration purposes alone, and do not substitute for the auditor's professional judgement.			√					√		
21 Guidelines in the form of percentage ranges always need to be considered in the context of each particular audit.								√		
22 The planning materiality figure will normally be lower than the final materiality figure, because of considerations in respect of the inherent limitations of the audit process — this provides a margin of safety.	√	√	√	√	√					√
<u>Audit materiality during the evaluation of the results of substantive procedures</u>										
23 The auditor's consideration of final materiality and planning materiality will probably differ, because when planning the audit it is difficult to anticipate all of the circumstances that will ultimately influence his judgement about materiality in evaluating audit findings at the completion phase.	√	√	√	√	√	√	√		√	√
24 Defines the term "audit differences" — the materiality of audit differences must be evaluated.			√	√						
25 When determining whether errors or irregularities are material or not, the auditor should consider their amount (quantitative materiality) and nature (qualitative materiality) in relation to the items in the financial statements under examination.	√		√	√	√	√	√	√	√	√
26 When determining whether errors or irregularities are material or not, their (quantitative) effect on the financial statements taken as a whole should be considered individually and in the aggregate.	√	√	√	√	√	√	√	√	√	√

27	When aggregated uncorrected misstatements approach the materiality level there is an increased risk that together with undetected misstatements, the materiality level may be exceeded. This risk should be reduced by performing additional audit procedures or requesting adjustments by management.	√	√	√		√	√	√	√		√

Key:

* The standards set out above are not quotations from the particular pronouncements, but represent the author's interpretation of the standards as contained in the relevant pronouncements.

The standards relate to the *determination* of audit materiality alone and do not represent all the standards and principles included in the pronouncements concerned.

** The following codes apply to the pronouncements examined:

I25:	IFAC, IAG 25	A47:	AICPA, SAS 47
I320:	IFAC, ISA 320	A82:	AICPA, SAS 82
S6:	SAICA, DP 6	CICA:	CICA, Section 5130 of the Member's Handbook & AuG-7
SAU:	SAICA, AU 210, 290 & 291	E220:	ICAEW, SAS 220
S320:	SAICA, SAAS 320	A306:	ICAA, AUS 306

! These pronouncements represent the latest available statements on audit materiality of the accounting and auditing bodies concerned (a total of six).