# A normative reference framework for determining audit materiality

WJJ Botha & JD Gloeck

School of Accountancy
University of Pretoria

**ABSTRACT**

Materiality is a central concept in the process which is applied during the external audit of company annual financial statements. Guidelines issued by professional standard-setting bodies generally state that the determination of audit materiality is primarily a matter of *professional judgement*. A normative analysis and description of the materiality concept in auditing led to the formulation of specific normative principles in respect of determining audit materiality which are presented in this article. These normative principles are summarised and discussed in a normative reference framework for determining audit materiality. The normative reference framework represents the factors which should influence the external auditor's decisions in respect of determining audit materiality and, therefore, provides external auditors with specific guidance in this regard. The application of normatively based decision making processes serves to enhance the accountability of the duties and functions of the external auditor.

**Key words:** audit materiality, external audit, professional judgement, audit planning, postulates, evaluation of audit procedures, materiality studies, reference framework.

## A NORMATIVE[1] REFERENCE FRAMEWORK FOR DETERMINING AUDIT MATERIALITY

### 1 BACKGROUND

Materiality is central to the audit process in respect of the external audit of company annual financial statements - it is an important variable in the planning of the audit procedures, performing the planned audit procedures, evaluating the results of the audit procedures and issuing an audit report (compare CICA 1980:43; De Jager 1982:322; Leslie 1985:57-62; Anderson 1988:143-154; Kiger & Scheiner 1994:202-231; IFAC 1995:113-116; SAICA 1996:1-5; Arens & Loebbecke 1997:248-271). In an auditing context, materiality influences the planning, nature, extent and timing of the audit procedures, as well as the evaluation of the results of the planned audit procedures in order to determine whether any differences or deviations identified are material or not. The auditor only reports on *material* differences and/or deviations, and the decision of whether an item (representation, fact or amount) is material or not, is therefore decisive as far as auditor/shareholder communication is concerned (SAICA 1996:3,4; Arens & Loebbecke 1997:733-735; SAICA 1997:4,8-10).

The general principle applied is that determining what is material and what is not, is primarily a matter of professional judgement (compare Lee 1984:18,19; Robinson 1985:1; Anderson 1988:146; Bamber, *et al.* 1995:55-59; IFAC 1995:114; SAICA 1996:1; Arens & Loebbecke 1997:249). Persisting with this narrow principle as the main guideline will leave a decades long problem in auditing unresolved. The following authors have aptly summarised this problem decades ago, but it is as relevant today as it was then:

> Judgment is, of course, a vital part of any professional's work. ... But that does not mean that it is a mysterious process, undefinable and inexplicable. ... Let us first see why the analysis and description of judgment processes are important and

[1] Inductively establishing a norm by means of analysis and description, using the theory of auditing as the point of departure.

> necessary. There are three main reasons: (1) An undefined and all-embracing process described as "judgment" does not inspire the confidence of thinking men. (2) The mere assertion that a vital professional process depends on "judgment" is of no help in educating and training entrants to the profession. (3) Such an undefined approach is conducive to the kind of practice most likely to discredit the profession. (Bernstein 1967:90.)

> The continued use of an undefined concept of materiality has the potential of undermining the financial community's confidence in published accounting data. ... the accounting profession must earnestly seek a solution to the materiality problem - the problem of subjective determination of materiality. (Dyer 1973:341.)

The objective of this article is consequently to describe *materiality* normatively and to present a reference framework which external auditors should use as a theoretical basis from which to determine materiality during the audit of company annual financial statements.

## 2 DEFINING MATERIALITY IN AN AUDITING CONTEXT

In order to describe materiality *normatively* it is important to establish that materiality is indeed a concept of auditing. In pursuing a scientifically accountable approach, the materiality concept has to be deducted from within the postulates of auditing and consequently defined as a concept thereof (Mautz & Sharaf 1961; Krogstad 1975; Schandl 1978 and Loots 1989, among others, support this approach).

In sections 2.1 and 2.2 that follow, we present a number of definitions which do not necessarily agree with similar definitions included in various professional statements and standards. This is done deliberately because the creation of professional institutional pronouncements are, as stated by the institutional standard-setters, more a product of negotiation of various competing constituencies represented on the standard-setting bodies than normatively derived arguments supported by logical and researchable sources.

### 2.1 Materiality as a concept of auditing

Auditing is defined as follows, taking cognisance of the definitions of the American Accounting Association Committee on Basic Auditing Concepts (1973:2), Holmes & Burns (1979:1), Kiger & Scheiner (1994:6) and Arens & Loebbecke (1997:2):

> An audit is performed in reaction to an assignment given by a person or a group who has delegated certain responsibilities to others. The audit is performed by an independent third party (who is professionally competent to perform the assignment) on the results of an entity or an event, which results have to be in conformity with an identified set of criteria. The objective of an audit is to gather audit evidence by performing a structured process and forming an opinion on the degree to which the relevant results compare to the stated set of criteria.

Postulates are the generally accepted prerequisites that serve as a basis for making deductions and drawing conclusions in order to describe an intellectual discipline, such as auditing. An evaluation of various authors' postulates (Mautz & Sharaf 1961:37-52, Krogstad 1975:132-156, Schandl 1978:69-92 and Loots 1989:81-116) results in the identification and formulation of *seven* postulates of auditing:

1 Information which is subjected to audit, is verifiable.

2 The information which is subjected to audit, is compiled or prepared in accordance with an identified set of criteria (e.g. an identified reporting framework).

3 When the auditor examines information with the objective of expressing an independent opinion, he/she is acting solely in his/her capacity as auditor.

4 An audit must be conducted by a person who is independent from the entity being audited and who is able to objectively take decisions, make deductions and draw conclusions.

5 The process of opinion forming consists of collecting convincing audit evidence in

accordance with a risk based approach.

6 The auditor's opinion is expressed in the form of a report on the audited information.

7 Auditors accept professional obligations in exchange for the professional status of their occupation.

All concepts which are generally accepted in the subject literature as the concepts of auditing can be deduced from the seven postulates identified above (refer to the following authors of auditing text books: Holmes en Burns 1979; Defliese, *et al.* 1984; Kell, *et al.* 1986; Anderson 1988; Ricchiute 1992; Kiger & Scheiner 1994; Arens & Loebbecke 1997). *Materiality* as such is a concept of auditing and is specifically associated with postulate 5. The risk based approach referred to in postulate 5 proposes an audit process whereby the audit is planned and audit evidence is gathered and evaluated in such a way to support an opinion that the annual financial statements are not *materiality* misstated (refer Cushing, *et al.* 1995:11; Konrath 1996:14-19; Arens & Loebbecke 1997:157-160).

Materiality is also implied by, and communicated in the concept of “present fairly” as it appears in the standard unqualified audit report on annual financial statements. The concept “present fairly” relates to postulate 6 and is defined as follows (as deduced from the definitions of Mautz & Sharaf 1961:85,158-200; Defliese, *et al.* 1984:29; Lee 1984:10; Leslie 1985:8; Low & Koh 1997:199-201):

> When an auditor expresses an opinion that the annual financial statements of a company *fairly present* the financial position, the results of operations and cash flow information of that company, he is in actual fact confirming, with a high degree of assurance, that the annual financial statements are free from *material* misrepresentations, taking account of the fact that the annual financial statements are presented in accordance with an identified set of criteria.

### 2.2 Definition of materiality

The following authors and institutions, among others, have all (formally) defined materiality, whether it be in a study on materiality and related subjects, or in describing the audit process, or in standard-setting for the audit process: Dohr (1950:56), Committee on Accounting Concepts and Standards as quoted by Mautz & Sharaf (1961:105), Rose, *et al.* (1970:139), FASB (1980:xv), the Institute of Chartered Accountants of Australia as quoted by Robinson (1985:8), the High Court of the USA as quoted by Remmele (1985:63,64), Leslie (1985:10), Kiger & Scheiner (1994:106), the Institute of Chartered Accountants in England and Wales as quoted by Dunn (1996:105) and the SAICA (1996:1). The FASB's definition is particularly important because of its wide use as a formal definition of materiality in auditing textbooks (refer among others Kell, *et al.* 1986:82; Ricchiute 1992:40; Kiger & Scheiner 1994:202; Arens & Loebbecke 1997:248).

An analysis of the above mentioned definitions leads to the identification of a sufficient number of common elements in order to present the following definition of materiality in the context of auditing (compare Botha 1997:57-62): In the context of the audit of a company's annual financial statements, an item (representation, fact or amount) 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.

This definition formalises *materiality* as a concept of auditing and can therefore be used as a basis for normatively describing the determination of materiality during the audit of company annual financial statements.

## 3 IDENTIFYING NORMATIVE PRINCIPLES

### 3.1 Using the definition of materiality

Using various deductions from the definition of materiality as a starting point, it is now possible to identify certain *general normative principles* that should apply when determining audit materiality.

The definition of materiality (refer to section 2.2 above) consists of the following six elements: (1) the audit of a company's annual financial statements, (2) an item in the annual financial statements (or an item that should be included in the financial statements), (3) the size of an item, (4) the nature of an item, (5) the probable influencing of decisions or actions and (6) the reasonable users of the annual financial statements. An analysis of these elements leads to various deductions that serve to describe the concept of materiality and are summarised in 12 general normative principles. The importance of the general normative principles lies in the fact that any description of the factors that should influence the auditor's decisions in respect of determining materiality must conform to these principles.

The general normative principles are (refer to Appendix 1 for a brief description of each of the principles):

i Audit materiality is determined for purposes of evaluating the materiality of audit differences and audit uncertainties.
ii Audit materiality is determined by the auditor, based on his perception of what will influence the decisions or actions of a reasonable user of the annual financial statements.
iii The auditor must be mindful of information which indicates that specific users want to place specific reliance on the audit report.
iv Except in the case of evidence to the contrary, all items that have to be disclosed in the annual financial statements of a company in accordance with generally accepted accounting practices and/or other specified requirements (e.g. requirements of legislation) will probably influence the decisions or actions of a reasonable user of those statements.
v Audit materiality must initially be considered during the planning of the audit.
vi Audit materiality must also be considered during the completion of the audit when the results of the audit procedures are being evaluated.
vii Materiality is determined in terms of the annual financial statements taken as a whole.
viii A materiality limit must be calculated to serve as a measure of size.
ix The materiality limit will be calculated relative to the size of the balances and financial totals included in the annual financial statements.
x The materiality limit is calculated for purposes of considering the materiality of audit differences.
xi The materiality of all audit differences and audit uncertainties must be considered in terms of their underlying nature, which implies various qualitative characteristics.
xii When determining a measure of materiality the auditor must consider the effect of audit differences and audit uncertainties on specific amounts in the annual financial statements, the effect on ratios between amounts and the effect on trends over a period of time.

The above general normative principles are subsequently incorporated into the normative reference framework for determining audit materiality, dealt with later in this article.

### 3.2 Using the results of previous studies on materiality

The results of previous empirical studies on materiality provide additional sources which support the existence and relevance of most of the general normative principles. Such studies were identified by doing a word search on the *SABINET* library system, using both the *PADB* database and the *PADI* database, as well as on the *ABI* indexing system. Certain studies identified, had to be eliminated for one or a combination of the following reasons:

- some studies were duplicated;
- the titles of certain studies indicated that they did not relate to the current research objective;
- some studies were not reasonably available, because of practical, logistic and/or cost considerations.

Furthermore, five of the studies identified, namely Dyer (1973), Drumming (1982), Robinson (1985), Remmele (1985) and Dow (1989), also refer to other materiality studies in reasonable detail. Keeping in mind the reasons listed above, it was decided to include some of these other studies to which the above mentioned authors refer. This process resulted in the selection of 24 materiality studies. In the course of examining the selected studies, a further three materiality studies were identified and included, to bring the final selection to 27. The following 27 studies were subsequently examined, analysed and summarised (listed by date):

| | |
|---|---|
| Hylton (1961) | - |
| Bernstein (1967) | Holstrum & Messier (1982) |
| Neumann (1968) | Remmele (1985) |
| Frishkoff (1970) | Robinson (1985) |
| Rose, *et al.* (1970) | Jennings, *et al.* (1987) |
| Dyer (1973) | Dow (1989) |
| Woolsey (1973) | Carpenter & Dirsmith (1992) |
| O'Connor & Collins (1974) | Wheeler, *et al.* (1993) |
| Moriarity & Barron (1976) | Carpenter, *et al.* (1994) |
| Pattillo (1976) | Raman & Van Daniker (1994) |
| Hofstedt & Hughes (1977) | Jordan, *et al.* (1995) |
| Firth (1979) | Roberts & Giorgione (1995) |
| Moriarity & Barron (1979) | Turner (1997) |
| Drumming (1982) | Chewning, *et al.* (1998) |

The selected studies differ from each other in respect of their objectives, methods used to gather the study data, the decision tasks examined, decision items included in the decision tasks, the elements in the financial statements on which were focused, respondents, sample sizes, statistical techniques applied (if any) and the evaluation of results. Notwithstanding these differences, the results of the selected studies and the deductions made from the results provide convincing evidence in respect of basic principles that are applicable when determining audit materiality. The degree of consensus that exists with regard to these basic principles supports a decision to include them in a discussion and description of the normative principles that influence the determination of audit materiality.

The basic principles identified from the selected materiality studies are summarised as follows (refer to Appendix 2 for a brief description of each of the principles):

a Specific quantitative factors and qualitative factors have shown to significantly influence respondents' decisions with regard to determining the materiality of various decision items.

b The materiality decision is influenced by a *combination* of appropriate quantitative and qualitative factors considered in the circumstances.

c Although certain studies present specific objective materiality norms (heuristics) for calculating a materiality limit, these results are essentially inconclusive.

d Qualitative factors influence the materiality decision in a particular direction, based on the decision maker's perception of whether these factors are favourable or unfavourable.

e In general, quantitative factors are used as initial indicators of materiality and qualitative factors are used to finalize the materiality decision.

f Materiality is a relative concept and the materiality measure will be determined relative to certain indicators of size and nature.

g When calculating a materiality limit an even scale or sliding scale of percentages, presented in the form of intervals, should be applied to appropriate quantitative bases.

h Users of financial statements exhibit a low self-insight into their materiality decisions, but in general expect the auditor to be conservative in making materiality decisions.

i The optimum materiality decision is the result of consensus between two or more interested parties.

The above principles broaden the base from which the normative reference framework is developed

## 4 A normative reference framework

The integration of the 12 general normative principles in respect of determining audit materiality, in addition to the basic principles identified from previous materiality studies, now results in the identification and formulation of *specific* normative principles that should apply when determining audit materiality. The specific normative principles are finally used to develop the following normative reference framework:

### 4.1 Background and perspective

This normative reference framework identifies the factors that should influence the decisions of the external auditor of company annual financial statements regarding the determination of audit materiality. In the main it is a summary of the interpretations of, and the deductions from the normative principles identified, based on a discussion of the definition of materiality in auditing and an analysis of 27 previous studies on materiality in auditing and accounting. Auditors should use this reference framework as a point of departure in order to evaluate whether their determination of audit materiality is normatively justifiable.

Certain aspects to keep in mind:

- The reference framework does not represent a decision model for the use of the materiality measure during the audit.
- The reference framework identifies specific quantitative and qualitative factors that should be considered in determining audit materiality - future research could identify other suitable factors.
- The reference framework does not provide for specific percentages to be used in respect of calculating materiality figures.
- The reference framework does not provide for normative principles in respect of aggregating individual audit differences and audit uncertainties in order to consider their combined effect on the annual financial statements taken as a whole.

### 4.2 Determining a materiality measure during the planning of an audit

**a** Exercising professional judgement is an important part of the process of determining a materiality measure. The auditor has to apply professional judgement in (1) considering the specific circumstances, (2) deciding between available alternatives, and (3) doing specific evaluations. It is however vital that the auditor must take cognisance of the underlying principles presented in this reference framework and must exercise his professional judgement within the boundaries provided by these principles.

**b** Determine a quantitative measure in the form of a materiality limit.

**c** The materiality limit is a single amount that serves as a measure of size in respect of the company as a whole and is used as an initial indicator of materiality during the planning of the audit procedures.

**d** The materiality limit is not allocated to individual line items in the annual financial statements, but serves as a quantitative materiality measure in respect of the financial statements taken as a whole. Individual line items and components of individual line items have to be considered qualitatively in terms of their underlying nature and inherent characteristics.

**e** The materiality limit = a *conservative evaluation* of the materiality figures calculated by using *appropriate quantitative bases*.

- A *conservative evaluation* involves evaluating a series of appropriate materiality figures and deciding on a single amount as the materiality limit. The auditor's decision in this regard should be representative of his inclination to take relatively strict materiality decisions (a conservative approach). A strict materiality decision requires choosing the lowest materiality limit that is practical in the circumstances.

- *Appropriate quantitative bases*: In respect of a specific auditee, the auditor has to decide which of the following quantitative bases can reasonably be seen as reliable indicators of the company's size and therefore be appropriate for use in calculating the materiality limit:

| Net income factors: | Financial position factors: |
|---|---|
| Current year's net income after taxation | Total assets |
| | Shareholders' equity |
| Current year's net income before taxation | Total liabilities |
| | Market capitalization |
| Average net income | Cash flow from operating activities |
| Growth in net income | Total current assets |

Earnings per share:
An amount which results in a certain percentage change in earnings per share.

**f** A *materiality figure* has to be calculated in respect of each appropriate quantitative basis in order to provide a series of materiality figures from which the materiality limit will be chosen.

- An individual materiality figure = quantitative basis x *percentage*.

- The *percentages* that should be used in respect of each appropriate quantitative basis should be presented in the form of an *even scale* and/or a *sliding scale*. To support the requirement that materiality decisions should be taken conservatively, it is important to compensate for the relative size of the auditee, otherwise there is the danger of using a too big/high materiality limit for large companies. When the percentages are presented in the form of an *even scale*, it must be stated clearly that the relative size of the auditee is discounted qualitatively in deciding on a single percentage for calculation purposes. When the percentages are presented in the form of a *sliding scale*, the scale itself compensates quantitatively for the relative size of the auditee - notes on how this is achieved should be documented together with the sliding scale.

- Regardless of the type of scale being used, the recommended percentages should be presented in the form of intervals (e.g. 5% to 10% of average net income) to provide for differing and changing circumstances in respect of the company as a whole, as well as different interpretations of the circumstances by different people. The percentages should be established in each auditee's circumstances by referring to, among others, financial ratios and trend analysis. The use of standard materiality heuristics is problematic, and should be avoided.

- The percentage within the relevant interval that is chosen for purposes of calculating a materiality figure is the result of an evaluation of the risk factors in respect of the company as a whole. These risk factors, in total, should be evaluated as:

(1) unfavourable: choose a percentage on the lower end of the interval; or
(2) favourable: choose a percentage on the higher end of the interval; or
(3) neutral: choose a percentage near the middle of the interval.

**g** Members of the audit team, under supervision of the audit manager, should calculate and document the materiality limit, together with appropriate notes explaining the decision process. The audit partner must review and approve the materiality limit.

**h** At a planning meeting, the materiality limit should be presented to, and discussed with the audit committee, which has to give its final approval.

### 4.3 Determining a materiality measure for purposes of evaluating the results of substantive audit procedures

**a** Refer point (a) under 4.2 above in respect of the role and application of professional judgement in determining audit materiality. This principle is equally applicable during the evaluation of the results of the audit procedures.

**b** A distinction should be made between determining the materiality of *audit differences* and *audit uncertainties*.

- *Audit differences* are monetary errors which are the result of differences between amounts included in the annual financial statements and amounts supported by the audit evidence.
- *Audit uncertainties* are representative of situations where the auditor is unable to form an opinion on specific assertions included in the annual financial statements. The nature of audit uncertainties implies that they are, in the main, not reasonably quantifiable.

**c** A materiality measure is determined for purposes of evaluating each individual audit difference and each individual audit uncertainty.

**d** A materiality limit (quantitative measure) serves as an initial indicator of the materiality of an *individual audit difference*. The materiality limit used is the same materiality limit which was calculated during the planning of the audit, adapted, if necessary, for 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 can change from the planning stage to the conclusion stage of the audit.

**e** The materiality limit provides the following cut-off point in determining the materiality of an individual audit difference:

(1) If the audit difference is greater than the materiality limit, it will be judged material (the materiality limit represents the maximum acceptable deviation for audit purposes).

(2) If the audit difference is smaller than or equal to the materialitylimit, its materiality will finally be judged in terms of a *qualitative* materiality measure.

**f** The materiality of an *individual audit uncertainty* will be judged in terms of a *qualitative* materiality measure.

**g** Determining a qualitative materiality measure involves firstly identifying *appropriate qualitative factors* that probably influence the materiality of the particular audit difference or audit uncertainty under consideration.

- The auditor identifies *appropriate* qualitative factors by considering a list of *available* qualitative factors and deciding which of these factors are relevant in indicating the materiality or non-materiality of the specific decision item.

- The available qualitative factors are:

<u>Item factors</u>:
Inherent characteristics of the decision item**
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 practices 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 toward 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, whether it pertains to the company as a whole or to a specific line item that is of importance to the particular user.

****** Inherent characteristics 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 audit difference and the materiality limit.

**h** The final materiality decision is based on a *conservative evaluation* of the appropriate qualitative factors. A *conservative evaluation* involves considering and applying the following principles:

(1) each appropriate qualitative factor should be evaluated in the circumstances as favourable or unfavourable or neutral;
(2) the total effect of all the appropriate qualitative factors should be evaluated as favourable or unfavourable or neutral;
(3) the more unfavourable the evaluation, the more inclined the auditor will be to judge the decision item material;
(4) during the evaluation the auditor should be more sensitive to unfavourable factors than favourable factors (conservative approach).

**i** All materiality measures (quantitative and qualitative) used for purposes of evaluating the results of substantive audit procedures must be documented by the members of the audit team, under supervision of the audit manager. The audit partner must review and approve these materiality measures.

**j** The materiality measures used should be presented to, and discussed with the audit committee, which has to give its approval in this regard.

## 5 CONCLUSIONS

The normative reference framework for determining audit materiality, as presented in this article, provides a basis for a theoretical description of the concept of materiality in auditing. The elucidation of the materiality concept and the application of the normative reference framework provide valuable contributions on four levels:

(i) The normative reference framework can, and should be used as a common point of departure for future research into the materiality concept in auditing. Using a common point of departure will lead to research findings that complement each other and that contribute to a better and more precise description of the concepts of auditing.

(ii) The normative reference framework focuses on the audit of company financial statements. It, however, also has application possibilities in other auditing areas such as government auditing, auditing of entities other than companies and the audit of information other than that contained in annual financial statements. Although certain adjustments and the consideration of specific factors might be necessary in other areas, the normative reference framework provides a common point of departure, as explained in (i) above.

(iii) The current practice and guidelines of regulating bodies that the determination audit materiality is *primarily* a matter of professional judgement is no longer acceptable. Although professional judgement will always be part of the auditor's decision processes, the normative reference framework clearly indicates that in respect of determining audit materiality, specific normative guidance is possible and appropriate. Controlling bodies should recognise opportunities to provide their members with clear guidelines, especially in situations where these guidelines are normatively justifiable.

(iv) The audit profession can, and should use the normative reference framework as a basis to evaluate current standards, guidelines and policies in respect of determining audit materiality. This may either lead to adjustments to current standards and practices, or further inputs regarding the interpretation of the normative reference framework, which in turn will stimulate future research in this regard.

Taking into account the auditor's responsibilities discharged through his reporting of *material* aspects to shareholders and users of auditing services in general, the application of a normative reference framework will contribute towards confirming that auditors acknowledge their responsibility to act in the public interest.

The general use of the normative reference framework by external auditors will in time improve the visible consensus in respect of audit materiality decisions and thereby enhance the accountability of the duties and functions of the external auditor.

Appendix 1: refer next page

## APPENDIX 1

### Descriptive information in respect of the general normative principles for determining audit materiality

| No.[1] | Description and substantiation |
|---|---|
| i | The annual financial statements are representative of a number of assertions made by the directors of the company to the users of the statements. The auditor gathers audit evidence to obtain assurance that these assertions are not materially misstated. Audit evidence can identify *differences* between management's assertion(s) with regard to a balance or financial total, or a lack of evidence can create *uncertainty* so that the auditor can not draw a conclusion in this regard. The auditor must evaluate existing differences and/or uncertainties to determine whether they lead to the financial statements being materially misstated.<br><br><u>Compare the following sources for substantiation</u>:<br><br>Leslie 1985:82; Anderson 1988:146,289-294; Kiger & Scheiner 1994: 71-79,782-284; SAICA 1997:6-10; Arens & Loebbecke 1997:44-48, 150-157. |
| ii | Although the auditor's report is addressed to the shareholders of the company, the auditor must consider the potential decisions and actions of a much wider range of potential users of the financial statements. This is because of the auditor's potential liability to third parties and the so-called social contract between the auditing profession and society as a whole. Practically the auditor therefore bases his/her materiality decisions on realistic perceptions of what might influence the decisions or actions of a reasonable user of the company annual financial statements.<br><br><u>Compare the following sources for substantiation</u>:<br><br>Flint 1982:16; Defliese, *et al.* 1984:249; Leslie 1985:30; Anderson 1988:3; Gaa 1991:90; Singleton-Green (1995:94). |
| iii | Information can be material only if it is relevant to the decisions or actions of the users of the financial statements. The auditor must therefore be mindful of situations where specific users indicate specific needs in terms of the audited financial statements. These known needs serve to form the auditor's perception of what might influence the decisions or actions of users of the company annual financial statements.<br><br><u>Compare the following sources for substantiation</u>:<br><br>Lee 1984:3-10, in conjunction with the discussion under principle ii above. |
| iv | The argument is that defined reporting frameworks, e.g. generally accepted accounting principles, statutory requirements, etc., aim to provide potential users with information that is relevant to their decision making needs. Whether this in fact the case, is a question for further research.<br><br><u>Compare the following sources for substantiation</u>:<br><br>Lee 1984:3-10, in conjunction with the discussions under principles ii and iii above. |
| v<br>vi | Materiality is a variable in planning the nature and extent of the audit procedures, and must also be considered during the evaluation of the results of the audit procedures. The audit procedures are planned, performed and evaluated i such a way to confirm with a high degree of assurance whether or not the financial statements are free from material misrepresentations.<br><br><u>Compare the following sources for substantiation</u>:<br><br>Defliese, *et al.* 1984:249-252; Anderson 1988:146,289-294; Kiger and Scheiner 1994:202-204; SAICA 1996, para. .06-.16; AICPA 1997, appendix C, para. 5-40; Arens and Loebbecke 1997:248-250,254-255. |

| No.[1] | Description and substantiation |
|---|---|
| vii | It is the concept "fairly present" in the auditor's report that communicates the materiality concept in terms of the audited annual financial statements. Therefore, when the auditor plans and performs the audit in order to form an opinion on the fair presentation in the annual financial statements, audit materiality should be considered in terms of the annual financial statements as a whole.<br><br><u>Compare the following sources for substantiation</u>:<br><br>Refer to the discussion under section 2.1 of the article. |
| viii | Monetary errors identified during the audit process should be evaluated in the context of the point at which these errors are large enough to influence the decisions of a reasonable user of the annual financial statements. To do this necessarily implies comparing the size of the error(s) with a measure of size, namely the materiality limit.<br><br><u>Compare the following sources for substantiation</u>:<br><br>Lee 1984:6-8; Jennings, *et al.* 1987:104-114; Roberts & Giorgione 1995:85,86; Turner 1997:126. |
| ix | Considering materiality in *absolute* terms implies determining an amount that will always, in all possible circumstances, be material - an unrealistic alternative. The auditor therefore calculates a materiality limit *relative* to the size of the balances and totals included in the financial statements.<br><br><u>Compare the following sources for substantiation</u>:<br><br>Leslie 1985:11-28; Anderson 1988:145,146; Arens & Loebbecke 1997: 250-252; Turner 1997:130,131. |
| x<br>xi | An item can be material because of its size or because its nature, implying that the determination of materiality has both a quantitative and a qualitative perspective. The materiality of monetary errors (audit differences) should be considered both quantitatively and qualitatively, whereas uncertainties, which can not reasonably be quantified, would only be considered qualitatively.<br><br><u>Compare the following sources for substantiation</u>:<br><br>Lee 1984:12,13; Kiger & Scheiner 1994:204; SAICA 1996, para.08; AICPA 1997, para.10; Arens & Loebbecke 1997:250. |
| xii | For purposes of decision making, users of financial statements do not evaluate the financial information in absolute terms alone, but also consider the relation between different totals and balances, as well as the effect of certain items on financial trends. This aspect of user decision making should therefore also be an important consideration in determining audit materiality.<br><br><u>Compare the following sources for substantiation</u>:<br><br>Lee 1984:15,16; Koen, *et al.* 1994:32,33,70; Turner 1997:126,129. |

<u>Note</u>:

1 The numbers of the general normative principles that correspond with the summary on page 52 of the article.

## APPENDIX 2

### Descriptive information in respect of basic principles identified from selected materiality studies

| No.[1] | Description and substantiation |
|---|---|
| a | The quantitative and qualitative factors have been ranked based on a distinction between empirical results that were evaluated statistically and those that were not. The ranking itself was not done statistically, but is the result of an informal analysis of the empirical results based on occurrence rate in general, as well as the number of times each factor obtained a certain position of importance relative to the other factors. Practically only *audit specific* factors can be included in a discussion of normative principles that influence the determination of audit materiality (also refer to Botha 1997:171-179,299-308).<br><br><u>Quantitative factors</u><br>Current year's net income after taxation<br>Total assets<br>Shareholders' equity<br>Combinations of, or interactions between various factors<br>Current year's net income before taxation<br>Relevant line item in the statements<br>Total liabilities<br>Market capitalization<br>Cash flow from operating activities<br>Average net income<br>Effect on earnings per share<br>Growth in net income<br>Total current assets<br><br><u>Qualitative factors</u><br>Changes in income or earnings trends<br>Management's objectives/intensions/actions<br>Inherent characteristics of the decision item<br>The company's solvency<br>Combinations of, or interactions between various factors<br>Relative size of the company<br>Control or changes in the control of the company<br>Objective verifiability of the decision item<br>Descriptive or factual information provided<br>Management's credibility<br>Management's attitude toward corrections in the financial statements<br>Information already known outside the company<br>Deviations from set criteria<br>Weak systems of internal control<br>Number of unissued ordinary shares |
| b | The importance of the quantitative and qualitative factor "combinations of, or interactions between various factors" is due to the observed phenomenon that materiality decisions are influenced by a *combination* of factors. It is an over simplification to suggest that a single factor determines the materiality of a decision item.<br><br>*Refer to*[2]: Dyer (1973); Hofstedt & Hughes (1977); Drumming (1982); Robinson (1985); Carpenter & Dirsmith (1992); Chewning, *et al.* (1998). |
| c | The objective materiality norms presented are not appropriate for inclusion in a normative reference framework, because of a lack of consensus, the fact that some of the norms have a statistical basis while others merely represent the authors' opinions and preferences, and the suggestion that each set of norms can only be applied if certain conditions are met.<br><br>*Refer to:* Hylton (1961); Bernstein (1967); Rose, *et al.* (1970); Dyer (1973); Robinson (1985); Jordan, *et al.* (1995); Chewning, *et al.* (1998). |
| d | The auditor's evaluation of relevant qualitative factors as predominantly unfavourable will result in stricter materiality decisions. In other words, the more unfavourable the evaluation the more likely that the specific decision item will be judged material. Materiality decisions in general are more sensitive to unfavourable factors than favourable factors.<br><br>*Refer to:* Bernstein (1967); Frishkoff (1970); Dyer (1973); Woolsey (1973); Pattillo (1976); Drumming (1982); Remmele (1985); Robinson (1985); Wheeler, *et al.* (1993); Carpenter, *et al.* (1994); Jordan, *et al.* (1995). |

| No.[1] | Description and substantiation |
|---|---|
| e | The materiality limit serves as an initial indicator of the materiality of a decision item by providing a cut-off point between monetary items that are material and those that are not. The final materiality decision is however reached by also considering relevant qualitative factors in the circumstances.<br><br>*Refer to:* Bernstein (1967); Neumann (1968); Frishkoff (1970); Dyer (1973); Woolsey (1973); Moriarity & Barron (1976 and 1979); Pattillo (1976); Hofstedt & Hughes (1977); Firth (1979); Drumming (1982); Remmele (1985); Robinson (1985); Carpenter & Dirsmith (1992); Wheeler, *et al.* (1993); Carpenter, *et al.* (1994); Raman & Van Daniker (1994); Jordan, *et al.* (1995). |
| f | Although only two studies [Hylton (1961) and Raman & Van Daniker (1994)] explicitly state that materiality is a relative concept, the list of quantitative and qualitative factors under (a) above, as well as principle (g) confirm the relative nature of the concept. |
| g | An *even scale* of percentages would be presented as x% to y% of a particular base amount. If a *sliding scale* is to be used, the interval of percentages will gradually decrease as the base amount increases. The difference between these two scales lies in the way in which the auditor chooses to compensate for the size of the company - in order to apply a conservative approach (refer to principle h) the auditor wants to prevent the use of a too large materiality limit for a very large auditee. A sliding scale compensates quantitatively for the size of the auditee. In the case of an even scale the size of the auditee is considered as a qualitative factor.<br><br>Furthermore, it is important to present the percentages in the form of interval (x% to y%) in order to provide for differing and changing circumstances in respect of the company as a whole, as well as different interpretations of the circumstances by different people. The percentages used should be determined in each auditee's circumstances and the use of standard materiality heuristics should be avoided as far as possible.<br><br>*Refer to:* Dyer (1973); Raman & Van Daniker (1994); Turner (1997). |
| h | There is a lack of consensus between different interest groups, individuals within a specific interest group and between different decision tasks in respect of the “weight” assigned to each appropriate quantitative and qualitative factor. The degree of conservatism expressed in the materiality decisions of different interest groups is related to each group's objectives, responsibilities and duties. Empirical results however indicate that various user groups expect the auditor to take conservative materiality decisions, and that it seems as if auditors' decisions in this regard are more conservative than those of most other interest groups.<br><br>*Refer to:* Bernstein (1967); Woolsey (1973); Pattillo (1976); Firth (1979); Jennings, *et al.* (1987); Dow (1989); Jordan, *et al.* (1995); Chewning (1998). |
| i | Different interested parties, each evaluating and interpreting the situation in the context of their own background and experience, should agree on the determination of materiality for a specific auditee. Interested parties refer to audit personnel, personnel of the auditee and the shareholders of the company, or representatives of the shareholders (e.g. the audit committee).<br><br>*Refer to:* Moriarity & Barron (1976 and 1979); Jennings, *et al.* (1987); Roberts & Giorgione (1995). |

Note:

1 The numbers of the basic principles that correspond with the summary on page 53 of the article.

2 Listed each time under the heading “*refer to*” are those studies whose results specifically support the principle under discussion. General support for the principle can also be found in some of the other studies not listed.

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