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Materiality & The Audit Report

It's Time for Disclosure

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Abstract

The concept of materiality has received a lot of attention in recent years as high profile accounting scandals have plagued financial reporting. Auditing Standards from the PCAOB and the AICPA require that early in an audit engagement the auditor establish a preliminary level of materiality. This preliminary level of materiality, a dollar value, is used to determine the extent of audit testing that is performed. It can be changed as the audit progresses and key financial statement numbers change. Under current standards neither the preliminary nor final materiality number is disclosed. They are known only to the auditor. This paper examines the reasons why the materiality level is so carefully concealed. It also suggests the benefits that would accrue to users of the financial statements if the auditor's materiality level were disclosed in the auditor's report.

I. Introduction

Every time an audit is performed, careful planning is required to assure that during the execution of the audit sufficient, competent evidential matter is gathered to support the auditor's ultimate opinion on the financial statements. Risk assessment consumes a great deal of the auditor's planning time as the auditor understands the business of the client, the environment in which the client operates, and the structure of controls put in place by the client. The auditor reviews the financial statements and identifies key client assertions for which evidence is required. The assertions of existence, completeness, rights and obligations, valuation and allocation, presentation and disclosure must be evaluated for risk. The assessment of risk drives how the auditor allocates time during an audit. "Audit Risk" is the term used to capture the danger of audit failure.

Audit risk is defined by the profession to be the likelihood that the auditor will give an unqualified opinion on financial statements that are materially misstated. With that definition, the terms "Audit Risk" and "Materiality" become inextricably linked. You cannot talk of audit risk unless you speak of the level of Materiality.

This role of materiality related to risk can be easily demonstrated with the following example. Consider your checking account. Let's define materiality as a \$1,000,000 error. What is the likelihood that at the moment you are reading this paper your checkbook has an error of at least

\$1,000,000 in it? That is, your checkbook says your balance is \$1500, when in reality your balance is actually \$1,001,500. The likelihood of that error (for most of us) is minimal. We can say the RISK that your checkbook has at least a million dollar error is very LOW. That is, for a high level of materiality, the audit risk is very low. But what if we define materiality at one cent (\$.01)? What is the likelihood that the moment you are reading this paper, your checkbook has an error of at least \$.01 in it? For example your checkbook says the balance is \$1500 but in reality it is actually only \$1499.99. We can say the RISK that your checkbook has at least a penny error in it is quite HIGH.

So risk is inversely related to materiality. All other things being equal, as materiality goes up, audit risk goes down, and vice versa. The point is this: materiality plays a key role in the assessment of audit risk.

II. Materiality in Professional and Academic Literature.

Professional Literature

Because of its centrality, materiality gets a lot of attention from accounting standard setters, regulators, the auditing community, international standard setters, and the PCAOB. Consider the role of materiality as it comes from each of these five sources:

A. Accounting Standard Setters – Materiality as interpreted today is driven by the Conceptual Framework Project of the FASB. Statement of Financial Accounting

Concepts #2 “Qualitative Characteristics of Accounting Information” (FASB, para 123 ff), where it states the concept as a question:

“...is this item large enough for users of the information to be influenced by it? ...the answer to that question will usually be affected by the nature of the item”. So there are qualitative as well as quantitative aspects to materiality that need to be considered. The statement gets quite specific in Appendix C as it references court cases. It also has a chart “Examples of Materiality Guidelines” which summarizes seven instances where GAAP (at that time) gave specific guidance on materiality.

B. Regulators – The SEC issued “SEC - Staff Accounting Bulletin: No. 99 – Materiality” in August, 1999. It is directed at those in the accounting and auditing professions who were relying exclusively on quantitative benchmarks as they exercised judgment on materiality in financial statements. Its theme is to shift attention back to the qualitative aspects of materiality as well. Controllers and auditors must assess materiality within the context of “surrounding circumstances” and not just narrowly with formulas or quantitative reference points. It then develops specific illustrations where an item must be considered material even though the item fails the normal quantitative materiality test used by the company or auditing firm. Some of these situations which must be considered material are:

*small misstatements that mask a change in earnings or other trends.

*small misstatements that hide a failure to meet analysts' consensus expectations for the enterprise

*small misstatements that change a loss into an income or vice versa.

*small misstatements that conceal an unlawful transaction.

*small misstatement that affects the registrant's compliance with loan covenants.

*small misstatements that have the effect of increasing management's compensation.

(from SEC, Section 1. Assessing Materiality)

It is clear the SEC wanted to get materiality issues back on the main burner for registrants and their auditors.

C. The Auditing Community – The AICPA first and now the PCAOB as well address the concept of materiality as critical to the auditor's work. The foundation of the auditing process is the Audit Risk Model. (AICPA, SAS#47) It follows a very simple to write, hard to implement formula:

$$\text{Audit Risk} = \text{Inherent Risk} \times \text{Control Risk} \times \text{Detection Risk}$$

Looking at the basic idea behind each of these terms, we find:

Audit Risk = the risk of a material error flowing through to the financial statements undetected by the auditors.

Inherent Risk = the risk of a material error arising in the environment in which the business entity exists.

Control Risk = the risk of a material error flowing through the internal controls of the company undetected.

Detection Risk = the risk of a material error flowing through all the substantive tests performed by the auditors undetected.

So we see that EVERY component of the model which drives the auditor in the examination of financial statements embraces materiality as part of its core definition.

But when does this materiality number get established? The answer is that the auditor must set this number during the planning phase of the audit discussed earlier. It is given the name “Preliminary Materiality,” meaning that it is based on the client’s unaudited numbers, but it can be altered if audit adjustments booked during the conduct of the audit result in updated financial statement numbers. In the end a “final materiality” number is established which may or may not be the same as the preliminary level of materiality.

D. International Standard Setters – Most recently the International Federation of Accountants has jumped into the fray regarding materiality. It has issued an exposure draft, “Materiality in the Identification and Evaluation of Misstatements” (International Federation of Accountants, 2004). A final statement will be issued in 2006 or later. The driving directive of this document reaffirms the prominence of materiality:

“The auditor should consider materiality when planning and performing the audit to reduce audit risk to an acceptably low level that is consistent with the objective of an audit.” (IFAC, p. 7)

E. Public Company Accounting Oversight Board – In Auditing Standard No. 2 of the PCAOB the issue of materiality is discussed (PCAOB, 2004, para. 22 & 23). The focus in this context is on the audit of internal controls and the ability of an internal control weakness to cause material misstatement at both the account balance and financial statement level. The result could be a finding of a significant deficiency or material weakness in internal controls.

Academic Literature

In the academic literature the issue of materiality has also received a lot of attention. The literature can be parsed into four major areas.

A. Determining materiality for an audit engagement – This research stream focuses on the way in which an auditor arrives at a quantitative materiality figure for an audit engagement. This may involve use of an algorithm-based measure which is applied at the assertion level (Waller, 1993); the effect of audit firm structure and unique audit firm judgment consensus (Morris & Nichols, 1988), the cumulative approach versus the current-period approach (Nelson, Smith, Palmrose, 2005), and the use of differing materiality levels (lower) on recognition issues than is used on disclosure issues (Iselin & Iskandar, 2000).

B. Auditing theory – This research stream takes a theoretical approach to the problem of materiality, developing a model that can be used to assess the appropriate level of materiality in a given situation. Examples would be the use of an expert system which sets the preliminary level of materiality and then observes the effect of the rule under changing circumstances (Steinbart, 1987), and development of a game-theoretic which can build in uncertainty regarding materiality and explains possible interactions between the auditor and the manager (Patterson & Smith, 2003).

C. Laboratory experiments – This research stream sets up artificial situations to imitate real life. Typically a group of individuals are thrust into a carefully constructed artificial environment and then asked to react to stimuli or information provided to them. The investigator observes the behavior. An example of such experiments related to materiality used the Myers-Briggs instrument and people

from accounting firms to study how materiality levels are determined (Vaassen, Baker, and Hayes, 1993). Another study looked at policy factors in materiality judgment formation using 30 hypothetical cases (Boatsman, 1974). Yet another used 19 partners of CPA firms to make materiality decisions under varying degrees of uncertainty and risk (Newton, 1977).

D. Field tests – In this research stream the concept of materiality is applied to a set of issued financial statements in a particular area of GAAP. For example, a study of the application of materiality to the reporting of contingent tax liabilities by 100 large industrial companies indicates that often firms fail to disclose in the notes to the financial statements IRS claims for material tax deficiencies (Gleason and Mills, 2002). Another example is a study of disclosures related to retiree health care costs under SFAS No. 81, where actual disclosures were found to be consistent with author estimates of plan materiality (Liu & Mittelstaedt, 2002).

One of the consistent themes that permeates all of these research efforts is the lack of information on actual materiality levels used by auditors. Realistic estimates of what would be a reasonable level of materiality have to be assumed, given the lack of any hard facts on the level of materiality chosen by the auditor.

III. Arguments in Favor of Materiality Disclosure

There are many reasons why the materiality level used by the independent auditor should be disclosed. Among them are:

A. Disclosure Highlights the Concept of Earnings as a Range. It helps the user of the financial statements think of earnings as a range rather than an exact amount. There is so much emphasis in the market on hitting analyst forecasts. The market punishes a company if it misses analyst expectations by \$.01 per share. Now missing earnings per share by \$.01 would not be a big deal as that one cent difference is easily contained in the range of earnings defined by the materiality figure.

B. Disclosure Improves the Transparency of the Auditor's Decision Process. Financial accounting standard setters are continually working toward transparency in the financial statements. Transparency in financial reporting is defined to mean "the extent to which financial information about a company is visible and understandable to investors and other market participants" (Herdman, 2002). Similarly we need to improve the transparency of the auditor's decisions on materiality. The calculation of the materiality level for the audit process is a critical calculation. It determines the amount of testing that is being performed by the auditor in various phases of the audit. As long as auditors perform the materiality calculation inside a black box, there is no outside check as to the reasonableness of the calculation. The sun needs to shine in so the decision process used by

auditors is visible and understandable to investors and other market participants. At the present time we only learn of that process when a failure has occurred and a lawsuit arises. Disclosure puts pressure on the auditor to get it right every time. It deters use of upper-biased materiality calculations as justification for fewer audit procedures performed.

C. Disclosure Improves Evaluation of Earnings Restatements. We are in a world where earnings restatements are becoming more common. If the auditor has provided the level of materiality upfront, in real time, at the time the audit report is released, it gives a context with which to evaluate later earnings restatements. A restatement that lowers income of \$50 million when the materiality level was \$20 is an audit failure with possible repercussions for the auditor and the client. But a restatement of \$3 million when the materiality level was \$20 million can be greeted with a yawn.

D. Disclosure Improves Understanding of Qualitative Factors in the Materiality Computation. The SEC is clear that qualitative factors as well as quantitative factors must be considered when determining materiality. If an auditor's calculation of materiality was affected by critical qualitative factors, the auditor can identify these qualitative factors and explain how they entered into the final determination of materiality.

E. Disclosure helps Refine and Improve the Materiality Calculation for the Auditing Profession. With each auditor

implementing a method of materiality estimation in secret, auditors cannot learn from one another. As auditors share through the Audit Report the ways in which the materiality calculations are made, best practices will emerge that will improve the quality of all audits.

IV. Arguments against Disclosure of Materiality

There can be some red flags raised against the idea of auditor disclosure of materiality levels. Among them are:

A. Disclosure will confuse the User of the Financial Statements. When the materiality figure is made public, a range of earnings emerges, replacing the comfortable single earnings number of old. Some users of the financial statements may be confused by this new format.

B. Disclosure will increase the Liability Exposure of the Auditor. When materiality is disclosed, it provides a clear measurement standard against which to measure the severity of earnings misstatements and other adverse financial reporting developments. Opportunities for litigation to hold the auditors accountable for failing to find the misstatements or other adverse financial reporting developments will increase.

In assessing the issue of materiality disclosure, I believe that the arguments in favor of disclosure far outweigh those against it. If materiality were disclosed, how would it be done?

V. Examples of the Materiality Disclosure

Two possible ways to disclose materiality are: a new phrase in the current standard audit report and a new paragraph in the current standard audit report.

A. A New Phrase in the Standard Audit Report. The phrase “in all material respects” would be deleted and a new phrase would take its place. The opinion paragraph would read:

In our opinion, the consolidated financial statements referred to above present fairly, **at a materiality level of \$20 million**, the financial position of the Company as of December 31, 2005 and 2004, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2005, in conformity with U.S. generally accepted accounting principles.

This approach would convey the amount in a succinct direct way to the reader of the financial statements.

B. A New Paragraph in the Standard Audit Report. An alternative way for disclosure of materiality would add a new paragraph to the auditor’s report between the second and third paragraphs. This new materiality paragraph of the Auditor’s Report could read as follows:

The preliminary level of materiality established at the start of the audit was \$20 million. This amount was

arrived at primarily by taking 4% times the preliminary net income of \$500 million. Other considerations of percentage of preliminary total assets and a percentage of preliminary total stockholders equity yielded bigger numbers and were not used. There was no significant development during the audit that caused us to change our level of materiality during the audit.

This approach shares with the reader the actual way in which the materiality level was computed. It shares more information to the auditing community as it continues to refine and hone its estimates of materiality and bring some homogeneity to the process. It would also allow for qualitative considerations of the materiality calculation to be mentioned if they were present.

VI. Conclusion

The time has come to require the disclosure of materiality calculations by the independent auditors. The benefits to the users of the financial statements and to the auditing profession as a whole clearly outweigh the disadvantages. As with any change in a long established protocol, it will feel uncomfortable to all involved at first. But one can envision a time in the future when one might be amazed at the fact there was an earlier day in the history of auditing when auditors used to keep the level of materiality locked up for no one to see.

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