THE CONCEPT OF AUDIT MATERIALITY AND ATTITUDES TOWARDS MATERIALITY THRESHOLD DISCLOSURE AMONG MALTESE AUDIT PRACTITIONERS

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Abstract. Materiality permeates the audit process and is a term often used to describe the scope of the auditor's responsibility to the general public. This paper attempts to evaluate the Maltese auditing profession's perceptions and use of the concept of materiality in the performance of an audit as well as attitudes towards disclosure of materiality thresholds. Results from personal in-depth interviews with twenty-four practitioners show that although considerable importance is attached to qualitative aspects of materiality, professional judgment is applied to establish quantitative materiality thresholds. Practitioners in Malta do not seem to treat materiality uniformly, with various materiality thresholds applied in practice. Nevertheless, prescriptive guidelines are not advisable. The proposal of disclosing materiality thresholds to reduce the omnipresent expectations gap was strongly rejected. It is the authors' view that such disclosures, need to be adequately regulated and users would need a proper understanding of materiality and audit methodologies.

Introduction

At present, the Malta Companies Act (1995) imposes a statutory audit requirement for the financial statements of all companies irrespective of size, capital structure or business activity. The audit profession has increasingly become the subject of critical analyses over the years. While the focus may at times be the profession as a whole, this paper, which is based on a dissertation by Azzopardi (2007), narrows the scope of the analysis to an evaluation of the auditing profession's perceptions and use of the concept

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of materiality in the performance of an audit as well as attitudes towards disclosure of materiality thresholds among Maltese audit professionals.

The target interviewers were identified as Maltese audit professionals based on a sample of twenty four such practitioners. This restricted sample, common in qualitative research, permitted in-depth interviews to ensure an adequately comprehensive analysis of the subject matter.

In order to produce reliable results, the composition of the sample was specifically chosen to provide a balanced cross-sectional analysis of the population. Hence equal numbers of respondents from big four firms, non-big-four firms and sole practitioners made up the sample.

Materiality Defined

Materiality is a term often used to describe the scope of the auditor's responsibility towards the general public. It is a significant determinant of audit effort and relates to the level of precision considered tolerable in the preparation of financial statements to ensure that they give a true and fair view of an entity's financial situation. The recent financial turmoil has cast doubt upon the integrity of the auditing profession. Such precedents as well as increasing complexities inherent to the auditing profession are leading to a redefinition of the importance of materiality. A significant need is being felt to define the concept in a way that satisfies all stakeholders who are increasingly demanding of assurance provided by the auditor.

The interview's first section aspired to understand respondents' perceptions of materiality. When presented with statements related to the concept of materiality, respondents gave most importance to a statement which asserted that materiality judgments should take into account surrounding circumstances, both qualitative and quantitative; this was followed by the affirmation that materiality relates to the magnitude of items likely to affect users' decisions.

It emerged from the replies of respondents that although considered crucial to financial statement users, materiality is nevertheless deemed vague and liable to misinterpretation. There is also the conviction that there is no consistency of application among practitioners. Most respondents appear to distinguish between materiality and relevance, but there were mixed reactions as to whether relevance must be established prior to assessing materiality. A respondent aptly stated that "an item which is factually correct to the pound need not necessarily be relevant". Almost all respondents also believe that materiality is crucial in achieving the objectives of an audit of financial statements.

ISA 320 (IAASB, 2009a) indicates that the auditor uses the concept of materiality both in planning and performing the audit and in evaluating the effect of identified misstatements on the financial statements. Candidates were encouraged to expand on their personal definition of materiality and unsurprisingly a good number associated materiality with the magnitude of an omission or misstatement that would affect reasonable users' decisions. Hence, as argued by Brady Vorhies, (2005) materiality is not simply a calculation, but a consideration of what will versus what will not affect the decisions of knowledgeable investors.

The Auditor's Responsibility and Materiality in Practice

The 8th Directive of the EU emphasizes the importance of ensuring consistently high quality statutory audits which have to be "carried out on the basis of international auditing standards." Article 179 (2) of the Malta Companies Act, 1995 (Chap. 386) states that an auditor's report should be drawn up "in accordance with International Standards on Auditing". ISA 700 (IFAC, 2007b) limits auditor responsibility to obtaining "reasonable assurance" as to whether financial statements are free from material misstatement. This indicates an element of risk of having financial statements not fairly stated, albeit an unqualified audit report. SAS No. 107 (AICPA, 2006) similarly states that:

> "In planning the audit, the auditor is concerned with matters that could be material to the financial statements. The auditor has no responsibility to plan and perform an audit to obtain reasonable assurance that misstatements, whether caused by error or fraud, that are not material to the financial statements are detected." (AU section 312.05).

ISA 320 emphasises that materiality judgments affect the nature, timing and extent of audit procedures. Hence the lower the materiality levels set, the greater the scope of the audit. Materiality is used to plan the audit such that errors of a relevant size or nature are identified to provide reasonable assurance that the financial statements are free from material misstatement. This level of materiality, which is often difficult to determine in practice, is determined by considering the size, nature, circumstances and cost versus benefit of auditing the item.

Respondents were presented with a series of statements relating to factors affected by or affecting materiality judgments. It was observed that among Maltese practitioners the extent and nature of audit procedures are most affected by materiality judgments, whereas the timing of audit procedures is least affected. Conversely, materiality judgments are most affected by the size and type of operations of the client.

The replies of respondents indicated that the most common consideration when assessing materiality is monetary value considered in relative rather than absolute terms since materiality can only be assessed for items which are quantifiable in monetary terms. The respondents indicated that qualitative factors must also be considered, especially when it is not possible to quantify a materiality decision. Items deemed quantitatively immaterial become material when, due to their nature, they affect the financial statements, consequently having an impact on users' decisions. Hence, ISA 450 (IFAC, 2009a) encourages the auditor to consider what gave rise to the misstatement, the legality and sensitivity of the transaction, the parties involved and the effect the transaction has on the financial statements.

ISA 320 explains that benchmarks on which to estimate materiality vary depending on the operations of the entity, where the entity is in its lifecycle and the economic environment in which it operates. Furthermore the auditor needs to consider whether there are any items on which the attention of the users tends to be focused, the entity's ownership structure, the way it is financed as well as the relative volatility of the benchmark.

The predominant primary base is net income before taxes. However, when a company is near break-even, average net income over a number of years is more appropriate. Moreover, the auditor may decide to use a more stable base or sliding-scales, should net income be fluctuating from year to year. Other benchmarks suggested by ISA 320 include total revenue, gross profit, total expenses and total equity. The methodology for establishing the percentage applied to the benchmark should take into account financial results of the prior period and of the period-to-date, plus any budgets adjusted for changes in circumstances. The percentage applied to profit before tax is customarily higher than that applied to total revenue.

Since international standards give no absolute guidance, in practice audit firms have developed 'rules of thumb.' However, these can only be used as an initial step in assessing materiality, since qualitative factors must also be taken into consideration. Hair *et al. (2005*) observe that rules of thumb commonly used in practice are the following:

- 5-10% of net income before taxes
- 5-10% of current assets
- 5-10% of current liabilities
- 0.5-2% of total assets
- 0.5-2% of total revenues
- 1-5% of total equity

There were similar replies by those interviewees with the most commonly cited benchmarks being net income before taxes, total revenues and total assets. When probed further as to the percentage rates applied to the favoured benchmark, most of the respondents use 5% to 10% of profit before taxes (often choosing the lower end of the range). It was also pointed out that often each case must be considered on its own merit and hence a significant portion of the remaining respondents did not set a materiality threshold consistently from one engagement to another. Typically a blanket rate is applied to all clients and when asked whether Sliding Scale techniques are ever utilised, few practitioners were aware of the technique and even fewer applied it.

Respondents were also asked to give their opinion as to the extent to which particular misstatements would be deemed material even though their value falls below materiality thresholds. Responses show that misstatements relating to possible fraud are deemed most material by all categories of respondents. Further questioning as to whether a materiality level is established below which misstatements are deemed clearly inconsequential revealed that some respondents do establish such a materiality level, typically set at 2% of planning materiality.

ISA 320 requires the auditor to document materiality levels and how they were determined for the financial statements as a whole and for classes of transactions, account balances or disclosures. The auditor should also record the amount below which misstatements are deemed "clearly trivial" and any changes made to materiality levels throughout the audit. Documentation is to be compiled such that the auditor may evaluate whether misstatements exceed materiality levels, as well as the aggregate effect of uncorrected misstatements on ratios, trends and the financial statements themselves. ISA 450 states that on this basis, the auditor should then document conclusions reached as to whether financial statements as a whole can be considered free from material misstatement. When asked in what way materiality issues are documented, nearly half the respondents document material issues in their audit working papers.

A number of interviewers stated that they also noted that although material issues are documented, materiality thresholds are not.

The audit practitioners were also asked for feedback with respect to standards on materiality. The prevalent view was that standards should contain more concrete examples illustrating approaches to be taken in different situations. Respondents from Big-four firms supported this possibility more fervently than the others. By and large, respondents agreed that existent standards provide enough guidance on materiality. When asked about the development of prescriptive guidelines, respondents from Big-four audit firms opposed the possibility more strongly than their counterparts.

Upon enquiry as to the extent to which respondents consult standards, the majority appear to do so. Respondents from audit firms, especially those from the Big-four, pointed out that consultation is also done indirectly through the use of audit software packages constantly updated to reflect changes in standards. A few sole practitioners did however indicate that reference to standards is made only on rare occasions.

Disclosure of Materiality Thresholds

The end result of an audit of financial statements is the auditor's report. Materiality assessments are essential for the auditor to form an appropriate opinion on whether the financial statements give a true and fair view of the financial position of the entity. Aarens *et al.* (2006), state that three levels of materiality affect the type of opinion to issue:

Level 1: Amounts are immaterial. If misstatements uncovered are not expected to affect the decisions of a reasonable user, then they are considered to be immaterial and an unqualified opinion is appropriate.

Level 2: Amounts are material but do not affect financial statements as a whole In such a case, misstatements are material enough to affect users' decisions; however the overall financial statements still give a true and fair view. Such a situation requires a departure from an unqualified report and hence the auditor must ensure that all effects of the misstatements on the financial statements have been evaluated. In these circumstances it is suitable to issue a qualified 'except for' opinion.

Level 3: Amounts are highly material and pervasive. This is the highest level of materiality, where the misstatement is so material that financial statements can no longer be said to give a true and fair view. As a result users may take wrong decisions if they rely on the financial statements. Depending on existing circumstances, the auditor must issue a disclaimer of opinion or an adverse opinion subject to the pervasiveness of the misstatements.

Although the theory behind the effect of materiality on the type of report to issue is clear-cut, in practice it is very complex and depends entirely on professional judgment since there are no definitive rules on which type of report to issue in every situation.

A material matter is one about which the average prudent investor should be informed. An expectations gap arises when auditor materiality levels do not correspond with those of the users of financial statements. On the one hand there is a quest for efficiency; on the other, a quest for credibility. Respondents believe that lenders and investors have allegedly similar perceptions of the concept. With respect to the Inland Revenue Department, disagreement was due to the belief that, for taxation purposes, figures should be precise and hence materiality is inapplicable.

Various studies have been carried out to identify differences between auditors' and users' judgments regarding materiality. According to Shaikh and Talha (2003), disclosure of materiality thresholds would allow users to build realistic expectations rather than expect auditors to be "public watchdogs." Davis (2005) sought to identify whether disclosure of audit materiality thresholds affects market behaviour and investor perceptions of the audit report. Her study showed that upon disclosure, investor overconfidence decreased as they price-protected themselves more completely and more accurate perceptions of the audit report were made.

Auditors have to use professional judgment to translate complex qualitative information into a quantitative measure; hence, varying perceptions of materiality arise (Turner, 2003; Kaplan and Reckers, 1995). Messier *et al.* (2005) observe that auditors from larger firms tend to have higher materiality thresholds than those from smaller firms.

Disclosure of materiality thresholds provides significant insight regarding auditors' judgment and the scope of audit testing. It carries the advantage that the auditor cannot be held responsible for unknown misstatements within the materiality level disclosed. The lack of consensus about materiality levels would however mean that they become subject of controversy. Another consequence would be that all known errors, except for trivial errors, have to be corrected otherwise there will be uncertainty among users that misstatements close to the materiality level still exist. This can be enforced through regulation (Shaikh and Talha, 2003).

The respondents to the interviews carried out for the purpose of the study were asked to explain which disclosures are currently made with respect to materiality issues. From the replies it emerged that save for material events or as required by the standards, no materiality disclosures are made in the financial statements. The mentality of disclosing as little information as possible to the general public still prevails in the Maltese scenario. Hence when presented with the prospect of disclosing further information and possibly materiality thresholds, this was treated with adamant aversion by the majority of respondents.

Turner (2003) sustains that although transparency, comparability and consistency are increasingly important, "auditors appear to violate these concepts in the conduct of every audit in regards to materiality choice." Since materiality is re-evaluated every year based on circumstances and no disclosure of thresholds is made, it impinges on consistency, comparability and transparency. Turner suggested that a measure called Materiality per Share (MPS) be disclosed in the auditor's report or financial statements or both, asserting that being a "common-size metric," MPS is more objective and aligns users' needs with those of auditors since the market can demand materiality levels in line with its needs. The majority of respondents opined that the expectations gap would not be reduced by disclosing materiality thresholds or MPS. One of the big-four respondent even stressed that "when you attempt to explain what is and what is not material, you are opening the door to risk."

When asked what would be the effect of disclosures of materiality information in the Maltese scenario, many respondents were convinced that users of the financial statements would not understand the meaning of such information and hence there would not be much of an effect. Almost an equivalent number of respondents were positive that such disclosures would bring about confusion especially since users might start questioning why different materiality levels are being used for different clients.

Respondents pointed out that although to a certain extent such disclosures may provide the auditor with 'insurance' against litigation, it would seem as if the auditor would have provided absolute assurance up to the materiality level stated. This is bound to give users of financial statements a false sense of security, since the nature of audit methodology does not permit absolute assurance to be achieved.

Further Considerations

The Concept of Materiality

Responses to the questions posed show that considerable importance is attached by Maltese practitioners to the qualitative aspects of materiality. Nevertheless, it emerged that quantitative aspects are also taken into account and quantitative materiality thresholds are customarily established. Since materiality decisions are strongly related to audit risk and its components, especially detection risk, these affect the nature, timing and extent of audit procedures. Nonetheless, an auditor never has all available information about a client, and hence judgment is made in view of surrounding circumstances.

The auditor must bear in mind that not all information is relevant to the user before assessing materiality. Moreover, although materiality is deemed crucial for financial statement users, their needs are not taken into high regard when taking materiality decisions since a statutory audit is an audit of general purpose financial statements "designed to meet the common information needs of a wide range of users" (IFAC, 2009c). Consequently, it is impossible to consider the needs of all possible users. Hence materiality decisions are influenced by the auditor's *perceived* needs of reasonable, knowledgeable users.

The perceived vagueness of materiality seems to result in the conviction held by Maltese practitioners that materiality is not applied consistently. This is sustained by the divergencies in the responses obtained when enquiring about typical benchmarks and the variety of materiality thresholds applied in practice.

Materiality in Practice

The main outcome of the survey carried out by Azzopardi (2007) results show that materiality thresholds based on the income statement are the most favoured for the financial statements as a whole; typically 5-10% of profit before tax. The various elements of the financial statements are considered when arriving at this benchmark with materiality typically being established by the partner with the engagement team. non-big-four firms sometimes leave this to the auditor on the job. In some firms, the engagement partner initially reviews client management accounts to set a preliminary materiality level based solely on professional judgment.

Whereas big-four firms assign different materiality levels to different clients, sole practitioners especially, apply a blanket rate (adjusted only if deemed necessary) to all audit clients. Although not applied in practice, sliding scales which cater for different-sized entities would possibly be more appropriate. Since their clients are characteristically very small, many sole practitioners carry out 100% substantive testing and do away with materiality. Such clients generally have few transactions and omissions or misstatements are easily adjusted.

Provided they are set with due care, materiality thresholds are changed only due to factors beyond the auditor's control, such as when information surfaces that was unknown when setting materiality or actual financial results differ significantly from those anticipated. This rigidity ensures audit quality as it leaves little opportunity for manipulation.

Most Maltese firms calculate materiality with audit software and to avoid mechanising the decision, adjustments to materiality thresholds based on professional judgment are consented. Sole practitioners tend not to avail themselves of such software, possibly since related costs are unjustified considering their client portfolio. Indeed, the Small Practitioners Association encourages audit software utilisation and eventually perhaps the Malta Institute of Accountants may be willing to negotiate with software providers. While audit firms document materiality thresholds within planning documentation, sole practitioners tend to document only material issues or events. This violates ISA 320 which requires such thresholds to be documented. The sporadic reference made to the standards indicates that sole practitioners are possibly unaware of such an obligation and hence such requirements should be highlighted in CPE (Continued Professional Education) programmes.

Both the nature and monetary size of a misstatement are considered when establishing its materiality. The nature of a misstatement may be sufficient to make it material, albeit falling below materiality thresholds. This is especially so where fraud and contractual requirements are concerned. Not to be undermined are the misstatements' effects on management compensation, masking a change in earnings or regulatory compliance.

Commonly, big-four firms, establish another materiality level below which misstatements are deemed 'clearly trivial' – generally 2-5% of planning materiality. While misstatements below this threshold are disregarded, misstatements above it are documented in a Statement of Unadjusted Audit Differences for management representation. Material misstatements are communicated to management for adjustment on a timely basis with failure resulting in a modified audit report, qualification on this basis not being atypical.

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The International Auditing and Assurance Standards Board (IAASB) programme to improve the clarity of standards aimed to encourage harmonised application of ISAs. John Kellas, IAASB Chairman, declared that "redrafted ISAs are clearer and the expectation of consistent application by professional accountants worldwide has been strengthened," (IAASB, 2009a). The relevance of ISAs 320 and 450 provide has been enhanced with considerations for small entities, which, in Malta, are the predominant type of audit client. ISAs' approach has remained principle-based, asserting that materiality is a matter of professional judgment. Sole practitioners and respondents from non-big-four firms strongly favour prescriptive guidelines; possibly since most of them do not apply audit software but rely on professional judgement. The relative nature of materiality is such that no standard can adequately cater for all possible situations. Hence it is unlikely and inadvisable that prescriptive materiality standards be developed.

Materiality Disclosed

The general public tends to expect absolute assurance from auditors, who however can only provide *reasonable* assurance. Materiality threshold disclosures may reduce this expectations gap, but this is a very controversial issue, with various supporting and opposing arguments.

The success or otherwise of disclosing materiality information can be tied to a proper understanding of materiality and audit methodologies by users of the financial statements. Without such an understanding, the results of disclosure are likely to be twofold. On the one hand, the disclosures would not be comprehended and would therefore not have much of an effect. On the other hand, users could read more into disclosures than they actually represent or start questioning audit methodologies, resulting in misunderstandings. It is clear from the findings of the survey that practitioners think that users' perceptions of materiality do not coincide with theirs.

Upon disclosure, auditors must justify the materiality levels chosen, especially since different thresholds may be applied to different clients. This may increase the workload and push up audit fees. Nevertheless, threshold disclosures can provide insurance against litigation. The enhanced transparency means the auditor can no longer be held liable for unknown errors below materiality levels disclosed.

Practitioners seemed to be intrigued by the concept of Materiality Per Share (MPS). The measure allows the market to determine the level of precision it requires and hence users may be provided with more relevant information. However, it can be argued that one may perhaps find more acceptable the use of market value as a denominator, as this is thought to provide more relevant information.

Although studies have shown that the disclosure of materiality information helps to reduce overconfident behaviour in investors, practitioners were unsure whether this would be the case in Malta. The introduction of regulation compelling disclosure of any sort of materiality information would stir up discontent in a culture where entities are resiliently unwilling to disclose information. Such a development may be possible if adequate regulation is developed.

The Quality Assurance Directive came into force in February 2006, establishing an independent Quality Assurance Oversight Committee (QAOC) in line with the 8th EU Council Directive. While currently practitioners, in particular sole ones, were found lacking with respect to the determination and documentation of materiality, monitoring visits which commenced in Malta in 2007, should improve audit quality and documentation. This monitoring by the Quality Assurance Oversight Committee should encourage more rigour in the performance of statutory audits and simultaneously increase public and client confidence in the audit profession.

Concluding Remarks

This study described in the paper revealed that materiality treatment is inconsistent among practitioners in Malta do not treat materiality uniformly, with various materiality thresholds applied in practice. Since materiality standards can never cover all possible circumstances, prescriptive guidelines are not advisable. However, reference to materiality standards needs to be encouraged. Various difficulties could be resolved by introducing audit software which is within financial reach of practitioners.

Studies have shown that disclosure of materiality information may reduce the expectations gap, although respondents interviewed expressed themselves against this possibility. The proposition may be successful if accompanied by adequate regulation and if users have the proper understanding of materiality and audit methodologies. Materiality thresholds applied in practice are various, hence the IAASB Clarity Programme attempts to improve the comprehensibility of standards to harmonise their application. Currently no materiality disclosures are made and such a possibility is likely to meet resistance in Malta.

The following recommendations, based on the findings derived from the survey are being put forward:

Encourage utilisation of audit software. Audit software facilitates compliance and at the same time retains flexibility in the auditing process in a cost effective manner. Audit software packages generally include formulae for the calculation of materiality based on client risk assessment. Since they tend to be considered too costly for small practitioners, the Malta Institute of Accountancy should endeavour to negotiate an affordable price with software providers. Liaising with a software house to produce audit software targeted specifically to SMEs may possibly be less costly. A software package to SMEs would be sufficient for small practitioners.

Allow disclosure at a price. Disclosure of materiality information is beneficial only in the hands of informed users. Consequently, materiality disclosures should possibly be made only in a report submitted to the Registrar of Companies, making materiality information available to all those who really wish to refer to it, thereby improving transparency and avoiding unnecessary misunderstanding.

Ensure that materiality is fully understood. Directors, knowledgeable as they may be, may not be fully conversant with audit methodologies. Therefore, in their preliminary meetings with the directors, audit practitioners need to explain the application of materiality in auditing. However, it is probably not advisable to establish materiality thresholds with the client, since bias could be introduced. As a result disclosure of the materiality thresholds can be made subsequently in a letter addressed to the directors.

Organise specialised workshops. Maltese practitioners use a variety of thresholds in the application of materiality. The MIA could organise specialised workshops where materiality standards' application is discussed; in particular the different scenarios to identify appropriate materiality treatment. This could also help to harmonise materiality application in the Maltese context.

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