THE IMPLICATIONS OF MATERIALITY CONCEPT ON ACCOUNTING PRACTICES AND DECISION MAKING

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The materiality concept is crucial for economical decision making. In accounting practices, accountants are still need to develop more specific materiality guidelines to avoid judgmental decisions. It seems that the accountant practices and judgments are the dominants in considering the materiality of an economical event.

Keywords: materiality, accounting practices, accountants’ judgments, International GAAP, US GAAP.

Introduction

The application of materiality is not a new issue. The materiality is applied for most decisions involving economical activities. Since 1800’s, the United Kingdom courts had emphasized the importance of the disclosures to the users of financial statements. In the United States, the discussion about the importance and implications of materiality increased after The Security Act of 1933. The materiality concept is important for all decision making topics. Also the implication of materiality is essential to understand and apply the generally accepted accounting principles (GAAP) and to prepare and analyze the financial statements.

The materiality concept plays a central role in any decision making related to all management fields and in accounting field in particular. Items, transactions or events that
are considered immaterial are not reported separately in the financial statements, and therefore, information considered immaterial by accountants is not reported to investors, creditors, and other users of financial statements. This leads stakeholders to be aware of all public information (mandatory or non-mandatory information). According to Watts and Zimmerman (1986), in some instances investors give more attention to the released no-mandatory information.

According to Bernstein (1967) the concept of materiality is simple but it is central in applying GAAP and this makes it a problematic issue for accountants. In analyzing the materiality importance in decision making, this article is organized in the following sections presents some definitions of materiality, the third sections deals with materiality classification, the fourth section presents final remarks.

**Definition of Materiality**

Authoritative accounting bodies in the USA such as Financial Accounting Standard Board (FASB), Securities and Exchange Commission (SEC), General Accounting Office (GAO), American Institute of Certified Public Accountants (AICPA) and in the international arena, The International Accounting Standards Committee (IASC) have contributed to clarify the materiality concept. FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information* (1980) defines materiality as follows:

“The magnitude of an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement” (Para. 132).
This definition is quoted by Statement on Auditing Standards (SAS) No. 47, Audit Risk and Materiality in Conducting an Audit (AICPA 1983, AU 312) without providing computational measures or guideline. SAS No. 47 discusses audit risk and materiality in planning and audit, stating that

“As a result of the interaction of quantitative and qualitative considerations in materiality judgments, misstatements of relatively small amounts that come to the auditor’s attention could have a material effect on the financial statements”

Based on Regulation S-X, Rule 1-02 (1940), the SEC (1995) defines materiality as follows:

“The term “material” when used to qualify a requirement for furnishing of information as to any subject, limits the information required to those matters as to which an average prudent investor ought to reasonably be informed before purchasing the security registered”.

According to SAB 99 qualitative factors should be considered on the basis of the aggregate items not only on the base of a single item. The SAB 99 states that:

“The omission or misstatement of an item in a financial report is material if, in the light of surrounding circumstances, the magnitude of the item is such that it is probable that the judgment of a reasonable person relying upon the report would have been changed or influenced by the inclusion or correction of the item ...Magnitude by itself, without regard to the nature of the item and the circumstances in which the judgment has to be made, will not generally be a sufficient basis for a materiality judgment. ... Qualitative factors may cause misstatements of quantitatively small amounts to be material”
The GAO establishes in Government Auditing Standards that auditors may set lower materiality level and states that:

“In an audit of the financial statements of a government entity or an entity that receives government assistance, auditors may set lower materiality levels than in audits in the private sector because of the public accountability of the entity, the various legal and regulatory requirements, and the visibility and sensitivity of governmental programs, activities, and functions (GAS, 1994; 34)

The International Accounting Standards Committee (IASC) (1989) defines the information as materiality as follows:

“Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements. Materiality depends on the size of the item or error judged in the particular circumstances of its omission or misstatement. Thus, materiality provides a threshold or cut-off point rather than being a primary qualitative characteristic which information must have if it is to be useful”.

International Auditing Standards (IAS) No. 11 defines materiality in the following way:

“Materiality refers to the magnitude or nature of a misstatement (including an omission of financial information) either individually or in the aggregate that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been influenced or his decision affected, as a result of the misstatement” (IAS No. 25, Para. 5).

These definitions leave accountants with no practical guideline to indicate how accountants should apply materiality threshold, but recognize that the judgment of
accountants is fundamental in all decision making. This implies that accountants should adopt convincing and logical form of judgment with respect to the level of materiality.

**Classification of materiality**

One of the limitations on decision making is how much information is needed to disclose on the face of a company’s financial statements or as a note. If accountants want to be comprehensive and include all economic events, financial statements will contain huge unnecessary information and this will mislead the readers of financial statements. On the other hand, if accountants fail to disclose an economic event or to choose the adequate method to present economic information would mislead the users of financial statements. This means that the perceptions or judgments of materiality by accountants may differ from the perceptions of materiality of the users of financial statements.

Different terminologies are used to identify the likelihood implied in materiality guidance. These include remote, extremely unlikely, possible, reasonable possible, would reasonable influence, would be likely to influence, and probable (Price and Wallace, 2001, 2002). The judgment of an accountant is very important in considering the materiality of an event. The consideration of an accountant depends on a variety of quantitative and qualitative measurements such the circumstances, type, size, the aggregate base etc.

**Practical guides of materiality**

Materiality is a disclosure matter. Accountants are to judge all events or transactions and to decide whether to disclose the information or not. In identifying factors affecting the judgment process of materiality by financial executive and certified
public accountants, Pattillo and Siebel (1974) classified the factors into financial (quantitative and qualitative) and non-financial (quantitative and qualitative). These factors include dollar amount or percentage of the item compared with other items, nature of the item, effects on accounting or reporting requirements, effect on the overall appearance of the financial statements, characteristics of the firm or industry, general economic environment, management ability, and desires and wishes of top management, accounting officials, or external auditors.

**Quantitative and qualitative measures**

According to Thompson, Hodge and Worthington (1990) accounting authorities do not offer specific guide of materiality and only 10% of the pronouncements offer specific measurements of materiality. Examples of USGAAP that include some measures of materiality include: FAS-85 (2/3 % comparison of effective yield to current average Aa corporate bond yield); FAS 13 (75% comparison of lease term to economic life of leased property; 90% present value of minimum lease payments to fair value of leased property); FAS 28 (10% present value of rental for lease back to value of assets sold);

Based on literature review on accounting field, Thompson (1993) classify materiality with respect to quantitative measures into three aspects, namely: 1) arbitrary (stated in relevant literature as arbitrary; e.g. FAS 28: test for transfer of rights 10%), 2) empiric (specific study is cited in the literature; e.g. FAS 14: industry revenue 10%), and 3) inherent (a logical extension of another materiality guideline; e.g. FAS 14: disclosed dominant segment 90%).

To examine the bases that determine materiality used by audit firms, Woolsey (1954) used a questionnaire survey. He found that the materiality decision of an event is
based on the percentage of the event on current income suggesting that the materiality thresholds to be between the 5% to the 15% of income before tax. Also, he found that national CPAs have higher materiality thresholds than local and regional CPA’s. Dyer (1975) verified Woolsey’s (1954) works and found that the basis of judgment remains the current income before tax, but the percentage had reduced and found the difference between national and local CPA’s had reduced with respect to the materiality thresholds.

Other researchers (see for example, Pattillo, 1976; Moriarity and Barron 1976; Jennings et al, 1987; Carpenter et al 1994; and Chewing et al 1989, 1998) confirmed these findings using survey, archival studies and experimental studies.

The economic factors are considered to determine the materiality of any issue. A rough criterion of 5% to 10% of net income is an example of an adapted guideline of materiality by some CPAs (Patterson, 1967). Other basis of measures such as income trend or income growth has been used. Auditors usually use three quantitative measurements, namely percentage effect on net income, percentage effect on total sales or total revenues, and percentage effect on total assets (Kinney, 1986).

Chewing et al (1998) found that the commonly-held view that an item’s income effect is a primary factor considered in auditors’ materiality judgments. Boatsman and Robertson (1974) conclude that a simple percent of net income was computed that appeared to distinguish material from immaterial cases. That percent was computed to be 4% of the current year net income, but this simple rule was found to be inferior to the multivariate policy-capturing model. Moriarity and Barron (1976) summarize the opinion and research on the variables which affect materiality judgments as effect on gross profit, relative size of item to its proper account, earning per share, earning trend, current ratio,
net income before tax, absolute size of the item, working capital, average net income, total assets, net worth, other.

In the absence of authoritative materiality guideline to support accountants’ works, accountants often use rules of thumb taking in consideration the nature of the item and the size of the entity. Examples of rules of thumb suggested by the literature include:

1) 10% to 15% of average net income after taxes for the three to five most recent years.
2) 5% to 10% of the current years’ income from continuing operation before taxes.
3) 0.5 to 2% of total revenue or total assets.
4) 1% to 2% of owners’ equity.

The rules of thumb for profit oriented enterprises as the least of

1) 5% of normal pre-tax income for companies with income exceeding $2 million.
2) 5% to 10% of normal pre-tax income for companies with income less than $2 million or where the public ownership is not widespread.
3) 1% of gross revenue.

Range versus a percentage of income as a measure of materiality. Range of 5% to 10% indicate that an error more than 10% of net income is material while less than 5% is immaterial and in between merits more consideration. More than one base should be considered. Seeking opinion from an outsider or an expert is another tool to determine the materiality of an event.

In the theoretical discussions, there are no agreements on the components of total monetary error, how they should be combined, and how the total should be allocated. SAS No. 22 states that the auditor should consider “preliminary estimates of materiality
levels for audit purposes”. This does not require an advance determination of total monetary error. It states that materiality affects the scope of the examination.

Uniformity (Woolsey 1954) and consistency (Bersntein 1967) are important factors in considering materiality in decision making. Uniformity is important for comparison and quality. Relative importance is also an important issue to consider materiality in decision making.

Likelihood is increasingly linked to materiality (Price and Wallace, 2001). SFAS 5, Accounting for Contingencies, assumes the following for the recognition of liabilities:

- Probable and estimable liabilities are to appear on the face of the financial statements,
- Possible and estimable liabilities are to appear on the notes to the financial statements
- Remote and estimable liabilities are neither reported nor disclosed

Risk is seen as the probability of an event to be different than expected. Also, risk is viewed as a measure of uncertainty and materiality to measure an amount of a given size. Quantitative materiality measurements are part of the risk measurements and in some cases do not capture the real risk surrounding the enterprise. Qualitative materiality is difficult to measure and consists of intangibles. The lack of clarity and specificity regarding the interpretation and application of probability in both the financial reporting and auditing literature is a problem of global propositions. Practitioners and standard setters should direct attention to this area in order to enhance the convergence effort as well as the comparability of financial and non-financial disclosures (Price and Wallace, 2001).
Qualitative measures

In August 12, 1999, SEC published the Staff Accounting Bulletin (SAB) 99, in which auditors should not assume that errors are immaterial. SAB 99 remember auditors that qualitative factors should be considered in addition to quantitative factors. Several works (Krogstad et al, 1984; Carpenter and Dismith, 1992; Carpenter et al, 1994) examined the effect of non financial factors on materiality judgments. Krogstad et al (1984) identify five non-financial (contextual) factors that influence the auditors’ materiality judgments. These factors are industry trends, management cooperativeness, the state of internal control, expected users of financial reports and management accounting policies.

The experimental studies (Messier 1983; Krogstad et al 1984; Carpenter et al 1994) state that experience influence the materiality judgments. In analyzing various characteristics of disclosure judgments in less frequent and less structured situations, Messier (1983) states that in addition to the financial characteristics (income, earnings trend, total assets, total inventories, and current ratio), non financial characteristics are important in materiality judgments, in particular experience, and type of firms.

According to Carpenter et al (1994), the personal characteristics are important in materiality judgments. Attention must be paid as well to the manner in which individual practitioners relate such factors to their individual perceptions about the uncertain economic consequences of materiality judgments. SAB 99, Materiality, discusses the importance of qualitative factors in considering and determining materiality by accountants and auditors. This effectively encourages accountants to broaden their
perspective. SAB 99 requires further evaluation of any misstatements that are intentional or illegal. Intentional errors could reflect weakness in internal control.

SAS 89, Audit Adjustment, issued December 1999 and effective for audits after December 15, 1999, aims to make management acknowledge responsibility for uncorrected misstatements, and to ensure that audit committees are influenced of these uncorrected adjustments. SAS 89 requires that auditors add the summary of uncorrected misstatements to their list of items discussed with the audit committee.

Where to start from the qualitative or quantitative factors to measure an issue such as to outsource or to keep in-house IT department is an important consideration taken by managers. There are three possibilities, the first qualitative possibility alone, the second quantitative possibility alone, and the third to conjoint both possibilities to consider in decision making. To avoid misleading information and to minimize the possibility of lawsuits, auditors identify the areas that are vulnerable to materiality decision, identify the applicability of any existing rules or guidelines such as pronouncements or standards of FASB, SEC, or any other authoritative body, determine the materiality guidelines for areas not covered by materiality standards, encourage implementation of policies related to materiality decisions, and determine the implications of the materiality decisions to employees, managers, etc.

After the guideline of general and specific materiality issues are determined and discussed internally by managers, accountants, and internal auditors, the company should seek suggestions and recommendations from the external auditor. Also, the company should compare its own guideline to the guidelines adopted by similar companies or any other available information in the market.
SAB No. 99 states that in a variety of considerations small misstatement of a financial statement may have a material effect. These considerations include: the precise mature of measurement or estimation; changing in earnings or other trends; hiding a failure to meet analysts’ consensus expectations for the enterprise; changing a loss into income or vice versa; relating to a segment or other portion of the registrant’s business that has been identified as playing a significant role in the registrant’s operations or profitability; affecting the registrant’s compliance with regulatory requirements and or with loan covenants or other contractual requirements; increasing management’s compensation; involves concealment of an unlawful transaction.

Final Remarks

FASB has removed the materiality topic from its agenda (see Newton 1987) based on the logic that the materiality should be considered by those accountants involved in the situation. FASB considers not publishing standard to cover the applications of materiality. The absence of standards and guides to cover materiality in most situations implies that accountants were applied a variety of decisions and there is no consensus in many cases.

In absence of normative guidelines for materiality applications for decision making, qualitative and quantitative methods are used to determine the accountants’ position on the materiality of a decision making. Qualitative methods include accountants own judgment based on their experience and quantitative based on historical data of financial and nonfinancial variables.
Despite there are ample statistical methods that can be used in accounting decision making, accountants are still using qualitative methods in their routine practices and based their judgments on the actual accounting practices and they rarely make innovative processes applied to materiality. Most new accounting practices rise after an issue or problem that affected accounting rules and guides. Therefore, it is recommended that accountants and auditors should be more innovative and try to apply nontraditional methods.

References


