Materiality, Earnings Management, and Earnings Quality

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Abstract

The purpose of this article is to examine the relationship between materiality, earnings management, and earnings quality; and how managers' judgments on materiality can lead to opportunistic behavior to manage reported earnings. Materiality is usually defined as the magnitude of error in a company's financial statements that would influence the judgment of informed users of those statements (SEC, 1999). Incorrect application of materiality can have serious negative repercussions on accurate financial reporting and might indicate hiding a possible fraud.

Keywords: Earnings Management, Quality, Fraud, Manipulation, Materiality

Introduction

The concept of materiality is one of the most critical in accounting, both in terms of how items are accounted for and how financial statements are audited; even so, the concept does not appear to be well understood, nor do the implications of its application in practice (Brennan & Gray, 2005; Juma'h, 2006). Auditing standards direct that all material adjustments should be reflected either in the financial statements or in a modification to the auditor's report (SAS No. 47, AICPA [1984]). The concept of materiality recognizes that some adjustments are important for a fair presentation of the financial statements, whereas immaterial adjustments are not and, consequently, may be waived. Immaterial adjustments may, however, be reported. (Wright & Wright, 1997). Materiality has been and continues to be a topic of importance for auditors (Messier, Martinov-Bennie, & Eilifsen, 2005; Juma'h, 2009, 2014, 2019a, 2019b). Without a doubt, materiality is the mystery concept of accounting. It is rarely discussed in the accounting classroom, little understood by consumers of accounting information, and rarely written about in the accounting literature (Rose, Beaver, Becker, & Sorter, 1970).

Shafer (2002) argued that studies of ethical attitudes toward earnings management have generally neglected the issue of materiality, while studies of ethical perceptions usually make a distinction between two basic types of earnings management: (1) operating decisions, (use of discretion in establishing the structure or timing of financial transactions); (2) accounting decisions, which involve judgment in the selection among alternative accounting methods or revisions of accounting assumptions or estimates.

Accounting standards allow for managerial discretion in the application of accounting methods used to report firm performance. When this discretion is used with the intent to manipulate reported results, it is called earnings management (Richardson, 2000). Incorrect application of materiality can have serious negative repercussions on accurate financial reporting. For example, hiding a fraud might cause litigations from stakeholders.
The different ways of applying the concept of materiality in practice, different judgments, and beliefs can misinform investors and manipulate numbers for management's benefit.

The purpose of this paper is to examine the relation between materiality and earnings management, and how managers' judgments in materiality can lead to opportunistic behavior to manage reported earnings.

The remaining sections of the paper are organized as follows: the next section presents a literature review of materiality, second, the relation of materiality and earnings management, follows by materiality and earnings quality and final remarks closes.

Literature Review

A significant amount of research was conducted in the 1970s that address different aspects of the materiality concept (Messier et al., 2005). Before 1982, materiality literature can be summarized into four categories: the nature of the item, the structural form of the decision model, the relative importance of factors used to determine materiality, and materiality thresholds. Messier et al. (2005) reviewed and integrated the empirical research on materiality since 1982 and suggests some implications for audit practice and research. They argued that while many issues have been addressed by prior research, several new and important areas require further examination. Chewning, Pany, & Wheeler (1989) used audit reports of companies that have changed accounting principles to provide evidence on how auditors interpret the materiality concept and provided evidence that the income effect of an accounting change appears to be the primary factor considered by auditors in making accounting change opinion modification judgments. Bernardi and Pincus (1996) evaluated materiality and risk for an audit simulation based on an actual case where material fraud was undetected and found that while auditors materiality judgments differ, these differences were not statistically significantly related to either fraud risk judgments or the amount of evidence the auditors chose to examine rendering their judgments. Their evidence does not support the need for specific quantitative guidance in accounting standards related to materiality.

Wright and Wright (1997) utilized archival data gathered from actual audit engagements to examine variables that may explain the decision to waive an audit adjustment. Their findings revealed that in addition to materiality, some factors appear to be considered, including directional impact on income, the nature of the adjustment (objective versus subjective), and the size of the client. Libby and Kinney (2000) reported two experiments in which Big 5 audit managers estimate reported (audited) earnings conditional on analysts' consensus forecast, auditing standards, and auditor discovery of a quantitatively immaterial earnings overstatement. They found that auditors judge overstatement correction less likely if it would cause a missed forecast, even for objectively measured misstatements. This behavior shows opportunistic corrections to manage earnings to forecast favoring managers' interests.

According to Gleason and Mills (2002) firms infrequently disclose the existence of IRS claims, and argue that the majority of disclosures do not contain the detailed information required by SFAS No. 5, showing how companies can manage earnings through contingent liabilities.

The purpose of the financial statements is to facilitate users to comprehend the business operation and support the credit policy decision making (Huang, et. al. 2011). Liu and Mittelstaedt (2002) examined factors underlying materiality judgments regarding financial statement disclosures. In addition to examining the magnitude of the financial statement effect, they explored whether the judgments are influenced by factors identified in the voluntary disclosure literature. They found that the potential interaction of materiality judgments and voluntary disclosure incentives suggests that more specific authoritative guidance may be needed for evaluating disclosure materiality.

Shafer (2002) examined fraudulent financial reporting within the context of Jones' (1991) ethical decision-making model. It was hypothesized that quantitative materiality would influence judgments of the ethical acceptability of fraud and that both materiality and financial risk would affect the likelihood of committing fraud. His results show that financial executives continue to be influenced by quantitative materiality when misstatements are material on the qualitative ground and view intentional earnings manipulations as highly unethical, even when the amounts involved fall below traditional materiality thresholds. In examining the context in which materiality is relevant, and the problems arising from applying the concept in practice, Brennan and Gray (2005) calls on regulators to extend disclosure requirements to include information about materiality levels to enhance the transparency of accounting and auditing. Their research shows that the different ways of applying the concept of materiality in practice, different judgments, and beliefs can misinform investors and numbers can be manipulated for management's benefit. Legoria et al. (2013) hypothesize that after controlling for the distance between pre-managed earnings and analysts' consensus forecasts, firms with earnings before tax expense management that miss analysts' forecasts by an amount less than quantitative materiality are more likely to decrease their effective tax rate in the fourth quarter. They found that over 19 % of the observations with pre-managed earnings less than the forecast were able to attain the forecasted earnings through tax expense management, showing evidence that materiality estimates rely on quantitative computations rather than qualitative characteristics.

Materiality and Earnings Management

Those who make accounting decisions and those who make judgments as auditors continually confront the need to make judgments about materiality (Nelson et al., 2005). Materiality judgments are “primarily quantitative in nature” (FASB Statement No. 2, p. 123). FASB Concept Statement No. 2 (paragraph 132) defines materiality as follows:

“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 hanged or influenced by the inclusion or correction of the item.”

Despite regulatory and professional guidance, anecdotal evidence suggests auditors rely mainly on quantitative materiality estimates (Legoria et al., 2013). Those quantitative estimates arise from several rules of thumb commonly used in practice as the 5 to 10 percent of pretax income. Some auditors apply this rule of thumb so that items less than 5 percent of normal pretax income are considered immaterial, whereas items that are more than 10 percent are material (Brody et al., 2003). Another common rule of thumb is 1 to 1.5 percent of the larger total assets or revenues. These rules of thumb are based on the manager’s or auditor’s judgments. Under a quantitative standard, a financial misstatement under 5 percent can still be material if it meets certain qualitative criteria, such as allowing the company to meet earnings targets or affecting management compensation (Park, 2009).

Leslie (1985) reviewed literature from U.S. and Canada and interviewed accountants in both countries and found that four rules of thumb prevailed in determining quantitative materiality: (1) 5% of pre-tax net income; (2) .5% of total assets; (3) 1% of total equity; and (4) .5% of total revenues. Leslie also noted that the Canadian Institute of Chartered Accountants (CICA) had recommended a fifth potential rule of thumb (Bernardi, 1996) as follows:

(1) 2% to 5 % of gross profit if gross profit in no more than $20,000

(2) 1% to 2% of gross profit if gross profit is between $20,000 and $1,000,000

(3) .55 to 1% of gross profit if gross profit is between $1,000,000 and $100,000,000

(4) .5 % of gross profit if gross profit exceeds $100,000,000

In the absence of quantitative guidance in auditing standards, many accounting firms have provided specific guidance for setting materiality thresholds for their audit clients (Bernardi, 1996). This initiative can help auditors and firms be more consistent in their materiality approach resulting in a more transparent financial statement. DeAngelo (1981) argued that the value of an audit to consumers of audit services depends on the auditor's perceived ability to (1) discover errors or breaches in the accounting system, and (2) withstand client pressures to disclose selectively in the event a breach is discovered. The incentive to waive an adjustment(s) would be linked to the potential size of future income (Wright and Wright, 1997), since auditors may allow some earnings management in order to keep the client and future aggregated services.

Materiality and Earnings Quality

The financial press suggests that a company has an earnings-quality problem if earnings contain unusual items or lack transparency, even if reported earnings and the related disclosures are following generally accepted accounting principles (GAAP), (Dechow & Schrand, 2004). Earnings quality has different means to different people, depending on the decision maker’s objective. Regulators generally view earnings to be of high quality when they conform to GAAP, creditors in how easy these earnings are convertible to cash flows and compensation committees when earnings reflect manager's real performance and have little influence by factors beyond the manager's control, (Dechow & Schrand, 2004). Schipper and Vincent (2003) define earnings quality as the extent to which reported earnings faithfully represent Hicksian income, which is the maximum amount that can be consumed in a given period while keeping real wealth unchanged. Earnings quality and, more generally, financial reporting quality is of interest to those who use financial reports for contracting purposes and investment decision making (Schipper & Vincent, 2003). The usefulness of information must be evaluated about the purposes to be served, and the objectives of financial reporting are focused on the use of accounting information in decision making. The central role assigned to decision-making leads straight to the overriding criterion by which all accounting choices must be judged. (FASB Concept Statement No. 2).

Relevance and reliability are the two primary qualities that make accounting information useful for decision making, (FASB Concept Statement No. 2). Subject to constraints imposed by cost and materiality, increased relevance and increased reliability are the characteristics that make information a more desirable commodity—that is, one useful in making decisions. If either of those qualities is completely missing, the information will not be useful. Though the choice of an accounting alternative should produce information that is both more reliable and more relevant, it may be necessary to sacrifice some of one quality for again in another. (FASB Concept Statement No. 2, paragraph 132). For auditors, a reliable number should be verifiable and reasonably free of error or bias. A reliable number involves little estimation or judgment. Also, a relevant number should be presented on a timely basis and has predictive value for valuation (Dechow & Schrand, 2004). In the real world, the information asymmetry between managers and potential investors provides managers with incentives to influence investor estimates of firm value by managing reported earnings (Richardson, 2000), the financial statements of a company might have accounting estimates made by managers to accomplish certain numbers that can be misleading to users. Some of those adjustments can involve materiality issues waived by auditors to keep the client. Wright and Wright (1997) provided evidence that materiality appears to be an important factor considered by auditors in deciding whether to waive a detected adjustment. Also, high audit quality certified public accountant firms based on long-term brand and reputation might not be inclined to earnings management manipulation (Huang, et. al. 2011). Such variations in auditor beliefs may result in inconsistent treatment of proposed adjustments across engagements.

From the investment perspective, low-quality earnings are undesirable because they provide a defective resource allocation signal (Schipper & Vincent, 2003). Low-quality earnings can be related to low-quality accruals. Firms with low-quality accruals have more accruals unrelated to cash flow realizations, and so have more noise and less persistence in their earnings (Dechow & Dichev, 2002). The higher the quality of current earnings, the more useful the earnings data as a forecasting metric and the more accurate the valuation (Dechow & Schrand, 2004).

Final remarks

Materiality has been and continues to be a topic of importance for auditors (Messier et al. 2005). This concept recognizes that some adjustments are important to present a fair picture of the company's financial position. A misuse or misunderstanding of the proper application of materiality can lead to intentional or unintentional earnings management or earnings manipulation, misinforming investors and users of financial statements. Although there is not a quantitative rule for assessing materiality, some rules of thumb have become common in the preparation of financial statements, empowering managers to use their discretion to make accounting choices potentially resulting in opportunistic behavior that benefits themselves and not the shareholders. This opportunistic behavior and accounting choices can also affect the quality of earnings and widen the information asymmetry between managers and financial statements users.

Materiality and its different rules of thumb, in the absence of qualitative rules, can lead managers and auditors to interpret the same item in different ways causing dissimilar results with the same financial information.

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