Accounting and Auditing

Auditors' Assessments of Materiality Between Professional Judgment and Subjectivity

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Abstract: Materiality has been and continues to be a topic of importance for auditors. It is considered as a significant factor in the planning of the audit procedures, performing the planned audit procedures, evaluating the results of the audit procedures and issuing an audit report. Recently, there has been a renewed interest in the concept of materiality motivated by concerns at the Sarbanes-Oxley Act, Securities and Exchange Commission and International Auditing and Assurance Standards Board issuance of proposed standards on materiality. The objective of this paper is to discuss and analyze comprehensively the concept of audit materiality including how materiality threshold is determined by auditors. Auditing standards settings bodies pointed out that auditor's determination of materiality threshold is a matter of professional judjment. As a judgmental concept, however, materiality is susceptible to subjectivity. Furthermore, the absence of audting standards on how materiality is determined has highlighted the significance of this issue and indicated that guidance for materiality professional judgments must come from other non-authoritative sources such as empirical researches. A number of new and important areas of materiality are in need of further investigation.

Keywords: materiality threshold; quantitative and qualitative materiality factors; expectation gap

JEL Classification: M40; M42

1. Introduction

Materiality is considered as a key concept in the theory and practice of accounting and auditing. It is a significant factor in the planning of the audit procedures, performing the planned audit procedures, evaluating the results of the audit procedures and issuing an audit report **(**International Standards on Auditing, ISA 320, Statement of Auditing Standards, SAS 107; AU 312).

The American Institute of Certifies Public Accountants (AICPA) and the International Auditing and Assurance Standards Board (IAASB) pointed out that the auditor's determination of materiality is a matter of professional judgment (ISA

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320, 4, SAS No. 108; AU No. 312, 4). This indicates that the guidance for individual materiality professional judgments must come from other non-authoritative sources such as empirical researches. The absence of uniform standards or set of standards for materiality has highlighted the significance of this issue and encouraged many of the researchers to conduct studies in this area.

Holstrum and Messier indicated that three main problems with a user approach to materiality (Holstrum & Messier, 1982, p. 48). First, very little is known about the ways the financial Statement are used by users in making their credit and investment decisions. Second, materiality decisions are made by prepares auditors, and users; these heterogeneous groups are likely to have dissimilar view concerning materiality. Third, limited knowledge is available on how materiality judgments made by preparers and auditors affect users' decision making. These same problems regarding users prospective continue to be relevant after two decades (Messier et al. 2005).

Empirical studies in materiality area started in the early 1950s. However, materiality continues to be a topic of significance for researchers. The objective of this paper is to discuss and analyze comprehensively the concept of audit materiality. The remainder of this paper is organized as follows. The second section introduces accounting and auditing concepts of materiality. Section three presents the application of materiality in the audit process. The fourth section discusses quantitative and qualitative factors that are used in order to make materiality judgments. Section five presents the expectation gap regarding materiality and the last section concludes.

2. Accounting and Auditing Concepts of Materiality

The concept of materiality is directly linked to the decision-making requirements of financial statement users. Materiality has been defined by the Financial Accounting Standards Board (FASB, 1980) in Statement of Accounting Concepts No. 2, "Qualitative Characteristics of Accounting Information" as follows **(**Messier et al. 2005, p. 155**)**:

" The omission or misstatement of an item is material in a financial report, if, in 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 an item".

Thus, the accounting concept of materiality addresses decision usefulness of the financial statements users. The financial statements – which are the responsibilities of the management – are prepared using accounting estimates and the management has to make those estimates accurately. Therefore, the accounting concept of materiality is related to the minimum amount of omission or misstatement that

would influence the judgment of the reasonable user depending on the financial statements prepared by the management as pointed out by the FASB.

To define materiality in an auditing concept we need to define auditing first. Auditing is defined as follows (Botha & Gloeck, 1998):

"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".

According to Botha and Gloeck, there are seven postulates for auditing that considered as 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. These postulates are as follows:

1. Information which is subjected to audit, is verifiable;
2. The information which is subjected to audit, is compiled or prepared inaccordance with an identified set of criteria (e.g. an identified reporting framework) ;
3. When the auditors examines information with the objective of expressingan independent opinion, they are acting solely in thier capacity as auditors;
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.

Materiality is a concept of auditing and is specifically associated with postulate five that adopts the risk based approach in conducting the audit. The concept of materiality is important through out auditing process. In conducting the audit the auditor should apply materiality both in planning and performing the audit, and in evaluating the results of audit testing **(**ISA No. 320 P. 5**)**. During the audit planning process, audit evidence is gathered and evaluated in such a way to support an opinion that the annual financial statements are not materiality misstated.

When an auditor expresses his opinion about the annual financial statements of a specific company, audit materiality represents the maximum amount of

misstatements the auditor believes in the financial statements and still fairly represents - with a high degree of assurance - the firm's results of operations, financial positions and cash flows information in conformity with applicable financial reporting framework.

3. The Use of Materiality in the Audit Process

The concept of materiality is important throughout the audit process, but is particularly relevant to planning the audit and in evaluating the results of audit testing. The assessment of what is material at each of these phases of the audit is a matter of professional judgment.

In planning the engagment, an auditor decides early in the audit the combined amount of misstatements in the financial statments that would be considered material. SAS No.107, AU 312 defines the amount as preliminary judgment about materiality. This judgment need not be quantified but often is. It is called preliminary judgment about materiality because it is a proffesional judgment and may change the engagment if circumustances change. The preliminary judgment about materiality is thus the maximum amount by which the auditor believes the statments could be misstated and still not effect the decision of reasonable users. SAS 107, AU 312 called it tolreable misstatments. (conceptually, this could be the amount that is $1 less than materiality as defined by th FASB. Preliminary materiality is difined in this manner as a convenience in application). This judgment is one of the most important decisions the auditior make and it requires considerable professional judgment.

The reason for setting a preliminary judgment about materiality is to help the auditor plan the appropriate evidence to accumulate becuase there is an inverse. relationship between the amounts in the financial statements that the auditors consider to be material and the amount of audit work necessary to provide and opinion about the fairness of the financial statements. For example if the auditor sets low level of materiality, more evidence is required rather than for a high amount.

The auditor will often change the preliminary judgment about materiality during the audit. When that is done the new judgment is called a revised judgment about materiality as stated in SAS 107 and ISA 320. The reason why the auditor may revise his judgment about materiality is due to a change in one of the factors used to determine preliminary judgment about materiality or the auditor may decide that the preliminary judgment was too small or too large. For example, the preliminary judgment about materiality is often determined before year end, therefore this preliminary judgment must be set based on prior years' financial statements or interim financial statement information.

In planning the audit auditors must give careful consideration to the setting of preliminary judgment about materiality because if the amount materiality is judged too low unnecessary audit work will be expended. On the other hand if the amount of materiality is set too high, the auditors might overlook a significant misstatements and express openion about financial statements that are materially misstated.

Generally, auditors ‘‘allocate’’ a portion of the planning materiality to account balances or classes of transactions. This allocated amount is referred to as ‘‘tolerable misstatement,’’ and represents the amount by which the account or class of transactions can be misstated and not be considered material. The allocation of preliminary judgment about materiality to accounts (segments) is necessary because auditors accumulate evidence based on balances rather than for the financial statements as a whole. Therefore, if the auditor has a preliminary judgment about materiality for each balance account, it helps him/her decide the appropriate audit evidence to accumulate. For instance if an auditor is auditing an account receivable balance of $1.000.000 he is likely to accumulate more evidence when a misstatements of $45,000 in the account is considered material rather than if $ 450,000 were material. The auditor can allocate materiality to either income statement or balance sheet accounts. However, in practice most auditors allocate materiality to balance sheet rather than income statement accounts because most income statement misstatements.

have an equal effect on the balance sheet due to the double-entry accounting system. Besides, there are fewer balance sheets than income statement accounts in most audits. Since most audit procedures focus on balance sheet accounts, allocating materiality to balance sheet accounts is considered most appropriate alternative.

Actually, allocating preliminary judgment about materiality to account balances is a difficult task. It is often difficult to expect which accounts are most likely to be misstated and whether any misstatement will lead to overstatements or understatements of certain accounts. In addition to that, relative costs of auditing different accounts usually can’t be determined. In practice, several auditing firms have developed rigorous guidelines and sophisticated statistical methods for allocating materiality to individual account balances.

After allocating preliminary judgment about materiality to individual accounts balances, the auditor will estimate the total misstatement in each account or" projection” as referred to in SAS 111, AU 350 (Audit Sampling). That is because only a sample rather than the whole populated was audited. The misstatements which are found in the sample will be used in estimating the total misstatements in each account. One technique to calculate this estimate of misstatements is to make a direct projection from the sample to the population and add an estimate for

sampling error. In addition to that the auditor will estimate sampling error using an appropriate approach because the auditor has sampled only a proportion of the population. The estimate sampling error and the direct projection estimate of misstatement form total estimated misstatement. In the next step the projected misstatments amounts for each accounts are combined on worksheet. Finally total estimated misstatement will be cpmpared with the amount of preliminary judgment about materiality (tolerable misstatements) that was determined before. If the total estimated misstatements are below the tolerable misstatements, the auditor probably would not need to expand audit tests. However, If the total estimated misstatement is significantly greater than preliminary judgment about materiality the auditor ask the client to make adjustments to the estimatrd misstatments or perform additional audit proceures to make sure that total estimated misstatement exceeds tolerable misstatements.

Although applying audit materiality is important in both planning and evaluation processes, the practice issues related to materiality, for the most part, involved evaluation materiality and not planning materiality as concluded by the Big Five Audit Materiality Task Force. The task force beliveed that problem is not related to the level of materiality used to plan the scope of audits. The problem comes with the application of appropriate audit judgment to the evaluation of the significance of detected misstatements. A good example of this issueis the $51 million adjustment that was waived by Arthur Andersen on Enron's 1997 audit case. Andersen argued that this amount was not material, using an average of annual reported earnings. While various government sources were critical of this materiality judgment and show that much of the professional materiality guidanc supports Andersen's decision to waive the adjustment as immaterial (Messier et al. 2005, p. 156).

4. Determining Materiality Threshold

The ISA No. 320 "Materiality in Planning and Performing an Audit" and SAS No. 107, AU 312 "Audit Risk and Materiality in Conducting an Audit" pointed out that the auditor's consideration of materiality is a matter of professional judgment and is influenced by the auditor's perception of the needs of users of financial statements. Therefore, the standard setting bodies have not set definite authoritative guidance concerning making judgment about materiality. The reason behind that is an amount that is material to the financial statements of one entity may not necessarily be material to the financial statements of another entity of a different size or nature. Further, what is material to the financial statements of a particular entity might change from one period to another (Vadivel, 2004, p. 725).

The decision of materiality involves both quantitative and qualitative factors as stated in SAS 107 and ISA 320. In response to this fact, a number of materiality

calculations methods "rule of thumb" have emerged within both practice and academic research. In this section a number of quantitative materiality measures suggested by prior researches and emerged from the practice will be presented. Moreover, qualitative considerations of materiality will be discussed.

4.1. Quantitative Materiality Measures

Previos research that investigated the significance of various factors in the materiality judgment indicated that the percentage effect of the item on income was the most important quantitative factor (Messier et al. 2005; Iskandar & Iselin, 1999; Holstrum and Messier, 1982). A distant second in importance was the effect of the item on earnings trend that explained small amount of judgment variance. However, the effect of the working capital (or the current ratio) and effect on total assets (or net assets) were the least significant (Holstrum & Messier, 1982).

Different methods, however, for determining materiality have emerged from prior researches and practices. In this paper these methods are summarized as follows:

1. Absolute size of the item;
2. Constant percentage method;
3. Canadian Institute of Chartered Accountants method;
4. Blend method.

4.1.1. Absolute Size Criteria

This measure dictates that the amount potential misstatement can be important regardless of any other considerations. This measure is not widely used by auditors because it might not be convenient for many situations. For example a given amount, say $50000 may be appropriate in one case but too large or too small in another. Yet, some auditors have been known to say “1 million (or more other large number) is material, no matter what” (Robertson, 1996, p.155).

4.1.2. Constant Percentage Methods

In this measure the relation of potential misstatement to a relevant base number is often used. But the question is about the most appropriate base for making materiality decisions. Holstrum and Messier (1982) in their thorough review of the findings of empirical research on materiality indicate that that the percentage influences of an item on income is the most important factor to materiality judgments as stated before. They also conclude that items become material at some point between approximately five percent and ten percent of income. Similarly, Leslie 1985 proposed a level of five percent for "larger incomes," and ten percent for "smaller incomes." He also presents methods related to gross profit, total assets, equity and revenues. Quantitative materiality measures suggested by Leslie 1985 are as follows **(**Pany & Wheeler, 1989, p. 72**)**:

- 5% of pre-tax income;
- 1/2% of total assets;
- 1% of total equity;
- 1/2% of total revenues.

4.1.3. Canadian Institute of Chartered Accountants Method

The Canadian Institute of Chartered Accountants (CICA) recommended a method that uses a changing percentage of gross profit as follows **(**Pany and Wheeler, 1989 p. 72**)**:

- 2%-5% of gross profit if between $0 and $20,000;
- l%-2% of gross profit if between $20,000 and $1.000.000;
- l/2%-l% of gross profit if between $1.000.000 and $100.000.000;
- 1/2% of gross profit if over $100.000.000.

This provides basis for a new measure for calculating materiality. However, there is drawback for this measure. That is when using discrete category rule such as this it is it is possible for a given company to calculate a higher materiality threshold than another company in the next largest category. For example, an auditing firm using the second scale (l%-2% if between $20,000 and $1.000.000) for materiality judgment decision for a company with gross profit of $99.999.999 would calculate materiality at $1.000.000, but using a 1/2% rate for a company with a gross profit of $1.000.000.001 would calculate materiality at $500,000. This may result for large differences of judged materiality for approximately equal values.

4.1.4. Blend Method

This method "blend" that was suggested by Leslie 1985 provides other measures of materiality. In this approach materiality is calculated based on more stable amounts such as assets or equity. Although available researches indicate that that the percentage effect of the items on income is the most important factor to materiality judgments, income tends to fluctuate more than assets or equity. Therefore, in the absence of authoritative guidance on materiality determination, using Blend method provides a more stable, as well as defensible judgment of materiality **(**Pany & Wheeler, 1989 p. 77**)**. This method typically take four or five individual rules of thumb and then either weight each rule according to some proportion or average them. An example of averaging method would be to take the previosly four single rules and average them.

Hypothetical Case Illustration:

In order to illustrate the previous materiality methods. The following summary financial statments of Z company are given:

Table 1 Summary financial statments of Z company

Balance Sheet		**Income Statement**	
Assets	4.500.000	Total Revenu	13.500000
Liabilities	13.000.000	Cost of Goods Sold	7.500.000
Owners Equity	1.500.000	Selling& Other Expenses	4.800.000
		Gross Profit	6.000.000
		Net Income Before Tax	1.200.000
		Net Income	450.000
		Net Income After Tax	750000

The preliminary materiality judjment is determined according to the above methods as follows:

- **Constant Percentage Method:**

Table 2 Determining materiality judjment using constant percentage method

Scale	**Computation**	**Materiality Amount**
5% of pre-tax income	5% * 1.200.000	60.000
½% of total assets	½%* 4.500.000	22.500
1% of total equity	1% * 1.500.000	15.000
½% of total revenues	½%* 13.500.000	67.500

- **Canadian Institute of Chartered Accountants Method:**

Table 3 Determining materiality judjment using Canadian Institute of Chartered Accountants method

Scale	Computation	Materiality Amount
½%	½% * 6.000.000	30.000
to		to
1% of gross profit	1% * 6.000.000	60.000

- **Blend Method:**

Table 4 Determining materiality judjment using Blend Method

Scale	Computation	Materiality Amount
5% of pre-tax income	5% * 1.200.000	60.000
½% of total assets	½%* 4.500.000	22.500
1% of total equity	1% * 1.500.000	15.000
½% of total revenues	½%* 13.500.000	67.500
		165000/ 4 = 41250

The previous determination of materiality amount indicates that differnt auditors may make differnt materiality judgments given the same set of facts and conditions when using Constant Percentage Method and the Canadian Institute of Chartered Accountants Method. The reason for setting a preliminary judgment about materiality is to help the auditor plan the appropriate evidence to accumulate in order necessary to provide and opinion about the fairness of the financial statements. Therefore, the variability in determining the amount of materiality using the previous two methods could result for auditors doing widly differnt amount of work for the same client. In order to eliminate the variability resulting by these two methods the auditing firm might decide to adopt the Blend method.

4.2. Qualitative Materiality Measures

The concept of materiality as defined by FASB (SFAC No.2, 1980) is directly linked to the decision-making usefulness of the financial statement users. Certain types of qualitative misstatements are likely to be more important to users than others even though their values are the same. In his famous speech ‘‘Numbers

Game'', the Chairman of Securities and Exchange Commission (SEC) Arthur Levitt addressed this issue when he argued that companies and their auditors were abusing the concept of materiality in order to ''manage'' earnings. Commissioner Levitt stated that:

''Some companies misuse the concept of materiality. They intentionally record errors within a defined percentage ceiling. They then try to excuse that fib by arguing that the effect on the bottom line is too small to matter. If that's the case, why do they work so hard to create these errors? May be because the effect can matter, especially if it picks up that last penny of the consensus estimate. When either management or the outside auditors are questioned about these clear violations of GAAP, they answer sheepishly... ''it doesn't matter. It's immaterial. In markets where missing an earnings projection by a penny can result in a loss of millions of dollars in market capitalization, I have a hard time accepting that some of these so-called non-events simply don't matter.'' (Messier et al. 2005, p. 153):

In response to Commissioner Levitt speech, the SEC (1999) issued Staff Accounting Bulletin (SAB) No. 99, Materiality which states that strict reliance on quantitative measures to assess materiality is inappropriate practice and required auditors to consider qualitative factors in determining materiality (Messier et al. 2005 p. 154). The Overreliance on quantitative materiality thresholds (such as 5 percent of net income) may cause auditors to waive quantitatively immaterial but qualitatively material audit differences (or detected misstatements), thus undermining the quality of audited financial reports. Such concerns have led to the issuance of more explicit guidance on materiality-in addition to SAB No. 99- Such as SAS No. 107 (AICPA) in the United States, and a review of the international auditing standard on materiality by the (IAASB) **(**Bn-Peow & Hun-Tong, 2007, p. 1171**)**.

On the other hand it is not practical to design procedures to detect misstatements that could be qualitatively material. For instance, the famous Enron collapse case that has occurred recently has revealed that exclusive reliance on quantitative criteria for assessing materiality is inappropriate. Materiality amounts derived using quantitative approaches may be increased or decreased on the auditor's professional judgment about the possible effect of qualitative factors. Therefore, key component of overall materiality judgments is consideration of qualitative materiality.

Examples for qualitative factors that may affect materiality include the followings (Elder et al. 2010, p. 253):

- Amounts involved fraud is usually considered more important than unintentional errors of the same amounts because fraud reflects on the honesty and reliability of the management or other personnel involved. For instance,

most users would consider an intentional misstatement of inventory as being more important than clerical errors in inventory of the same amount.

- Misstatements that are otherwise minor may be material if there are possible consequences arising from contractual obligations. An example is when net working capital included in the financial statements is a little bit greater than the required minimum in a loan agreement. If the correct net working capital were less than the required minimum, putting the loan in default, the current and noncurrent liability classifications would be materially affected.
- Misstatements that are otherwise immaterial may be material if they affect the trend in earnings. For example, if reported income has increased 3 percent annually for the past five years but income for the current year has declined 1 percent, that change of trend may be material. Similarly, a misstatement that would cause a loss to be reported as profit would be of concern.

5. Expectation Gap Concerning Materiality

The financial statements preparation is the responsibility of the management that should report these statements for stakeholders such as shareholders, boards of directors, regulators and other third parties who depend on the financial statements for making relevant decisions. However, management can have goals that differ from the goals of the shareholders. The management (agent) may be motivated by factors such as financial rewards, labor market opportunities and relationship with other parties that are not directly relevant to shareholders (principal). This is referred to as agency theory (Jensen & Meckling, 1976).

Because of this conflict of interests between agents and principals, users of the financial statements can not just rely on the financial statements prepared by the management without being verified by an independent third party who is the auditor. The auditor's task is to assess on behalf of the principal whether the agent prepares the financial statements in conformity with applicable financial reporting framework by expressing opinion about the fairness of the financial statements.

However, the widespread litigation against auditors indicates that there is a gap between society's expectations of auditors and auditors' performance, as perceived by society. This gap is defined as expectation gap (Porter, 1993, p. 49). As defined by Porter the expectation gap has two main components:

1. **The reasonableness gap** that exists because the society has unresonable expectations of auditors. However, the auditor cannot fulfil all of society's needs because of limited control methods and control techniques and because a cost-benefit analysis needs to be taken into account.

2. **The performance gap** that is the gap between what society can reasonably expect of auditors and what it perceives they deliver. This may be subdivided into:
   - **A.** **Deficient standards gap** which is the gap between the duties which **can reasonably be expected of auditors and auditors' existing duties as** defined by the law and Professional promulgations.
   - **B.** **Deficient performance gap** a gap between the expected standard of performance of auditors' existing duties and auditors perceived performance, as expected and perceived by society. In other word, the auditor does not always seem to be able to recognize what thereasonable expectations of society about the auditor's performance are, or he simply fails in doing his job.

Expectation gap regarding materiality seems to exist. Little information is known on how materiality judgment made by prepares and auditors will affect the users' decision making because limited knowledge is available on how financial statements are utilized by users in investment and credit decision making (Holstrum and Messier, 1982, p. 48). However, some studies have observed that investors' materiality threshold based on their reactions to new earnings announcements. Cho et al., 2003 for example investigated empirically investors' perceptions of materiality in the context of several materiality criteria that include percentage of pretax earnings, percentage of sales, and percentage of total assets by observing stock price reactions when unexpected information is revealed to stock market participants. The study pointed out that users demonstrate lower materiality thresholds than auditors (Cho et al. 2003, p. 63). This indicates the existence of expectation gap regarding materiality.

In addition to that many users expect that auditors guarantee that audited financial statements were completely accurate and that the auditor has performed one hundred percent check for auditees whose financial statements received an unqualified audit report. This is due to society's lack of knowledge about auditor's responsibilities which is referred to as "knowledge gap" by (Gowthorpe & Porter, 2002).

The FASB definition of materiality explicitly addresses decision usefulness of the financial statements users. However, in practice users are not involved in the concept at all. Users don't have enough knowledge about auditors' responsibilities (Gowthorpe & Porter, 2002). Furthermore the auditor's report does not include detailed information related to materiality. What is more, the role of the auditor in verifying financial statements and providing an opinion in relation to those statements is one which relies on too much judgment, is too subjective and creates greater possibilities of widening the expectations gap (Ojo, Marianne, 2006).

The audit expectation gap is a detrimental issue to the auditing profession as "the greater the gap of expectations, the lower is the credibility, earning potential and prestige associated with the auditors' work". They also claim that the audit expectation gap is harmful to the public, investors and politicians because in a capitalist economy, the process of wealth creation and political stability depend heavily upon the confidence in the processes of accountability (Lee et al. 2009, p. 8). Therefore, the existence of an expectation gap regarding materiality, might contribute to a reduction of the perceived value of the auditor's opinion as regards to the true and fair view of the financial statements of a company which is not in the interest of users and auditors. Hence, it is important to know whether a relevant expectation gap regarding materiality exists and if so, how to narrow it.

According to Sikka et al. the nature of the components of the expectations gap makes it difficult to eliminate (Ojo & Marianne, 2006). However, the gap could be bridged by the adoption of the long-form audit report, augmentation of the auditing framework, strengthening of the auditor's integrity, and educating users on the nature and functions of audit (Dixon et al. 2006, Lee et al., 2009). Moreover the gap could be narrowed by asking shareholders to decide the level of assurance they are willing to pay for each year. This would serve not only to educate investors to an audit's inherent limitations but also o enlighten them to the relative costs for audit work that would lead to increased levels of assurance (Epstein and Geiger, 1994). Another recommendation is the expansion of auditors' responsibilities and enhancement of auditors' performance. For example, The Institute of Chartered Accountants in Australia (ICAA), in their report 'Financial Report Audit: Meeting the Market Expectation' (2003) recommended that the auditing profession should expand the scope of audit so that the services provided by the auditors are able to meet the demands of the public (Lee et al. 2009, p. 28).

6. Conclusion

The most significant point regarding materiality is determining materiality threshold. The review of the materiality studies shows that the dominant factor in making materiality decision is percentage effect of an item on net income since 1950s. However, qualitative factors such as the effect of the item on meeting consensus forecasted earnings; trend in earnings is found to be important in making materiality judgment.

Furthermore, prior researches pointed out that there is a lack of consensus in materiality thresholds between auditors, preparers and users. In general, users demonstrated lower materiality thresholds than prepares and auditors. In addition to that many users expect that auditors guarantee that audited financial statements were completely accurate. Based on this belief, the concept of materiality should be

totally abolished. This in turn indicates the existence of the expectation gap concerning materiality between financial statements users and auditors.

However, some may argue that "why don't the profession set materiality standards that include quantitative and consider qualitative factors, in addition to disclose information about materiality determinations in the auditors report in order to solve this problem radically?" Actually, the issue is not so straightforward like that. Setting materiality standards is difficult since qualitative, as will as quantitative, characteristics may be relevant in an ideal conceptualization of materiality (Jennings et al. 1987, p. 114). An amount that is material to the financial statements of a small service firm may not necessarily be material to the financial statements of a huge manufacturing one. Further, what is material to the financial statements of a particular firm might change from one period to another.

Furthermore, disclosing of materiality thresholds in the auditor's report would improve the interface of users and prepares and capital markets could more easily assess the information presented **(**Jennings et al., 1987, p. 114**)**. However, auditing professions refuse to disclose information about materiality judgment in the auditors report and satisfied by the terms "material respects" and "reasonable assurance". This is referred to by Roberts and Dwyer, 1998 as "unjustified professional paternalism" because the professional's refusal to disclose information about key audit inputs arises from a self-interested need to maintain secrecy about the amount of audit work performed. In other words, the profession refuses to reform practice in these areas because the profession benefits (at the cost of client and the public) by mystifying these practices. This interpretation is obviously contradicts the alleged public interest orientation of the profession (Roberts & Dwyer, 1998, p. 576).

The earlier discussion in this paper argues strongly for the significance of materiality issue and the importance of its resolution. However, a straightforward resolution such as formalizing materiality practice into one uniform standard is not expected to come from the profession as stated earlier. Moreover, the auditing profession refuses to disclose materiality threshold in the auditors report because of its benefits by mystifying these practices at the cost of client and the public. Therefore, the entire issue of the use of materiality concept in auditing should subject to research. The future research in this area should proceed in testing factors influencing materiality judgments especially significant qualitative factors. Furthermore, future research should examine expectation gap regarding materiality and try to provide recommendations to bridge this gap.

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