Another question is: ‘Do they actually understand that they don’t understand what materiality is?’ Because if it’s never actually mentioned to them, they may not be aware that they don’t understand this term…So…rather than just the concept of materiality, if you…start disclosing what your materiality level is…in simple terms…if your materiality’s 10 million, that means that the auditors will want accounts restated if they find errors that total that sort of money, for example.

— Purchaser

1.0 Key issues

The contribution to the audit expectations gap of the issue of the level of understanding of the concept of materiality in an auditing context might be one of the most important findings from this study. The issue presents many challenges for the profession and for regulators, including:

• how can the role of auditor judgment surrounding the auditors’ use of materiality in the conduct of the audit be best explained
• what are the mechanisms used for auditors to determine the level of materiality (tolerable error) and when and to whom is this information communicated
• can information about materiality be articulated effectively to users of the audit product of varying levels of sophistication
• is developing deeper understanding of quantitative materiality alone sufficient, or must it be accompanied by developing deeper understanding of qualitative materiality
• should the real levels of materiality used in conducting the audit be disclosed publicly or could this be ‘dangerous’ to the audit product
is developing greater understanding about materiality of a higher priority than developing understanding of other aspects of audit
is board and/or audit committee member understanding of materiality sufficiently well developed
if educative material about audit materiality is to be made available, which party/parties should take responsibility for it and where should it be located?

2.0 Introduction: shareholders and materiality

The notion of materiality arose frequently in interviews and, to a somewhat lesser extent, in focus groups. Its importance to the debate after the interviews seems to be unquestioned and indeed might be one of the more underdeveloped issues in the whole audit expectations gap debate.

2.1 Users

Most users favour auditor provision of more information around the issue of materiality in the context of audit conduct, as the following comments illustrate. The first user foresees a day when disclosing materiality thresholds is required:

They [users] probably don’t understand the materiality and [for]… large organisations, the materiality threshold can be quite large. So maybe a bit more work can be done there to inform about the material. And I could even see a day when you have to disclose your materiality thresholds.

The difficulty of explaining to those earning modest incomes the size and application of materiality thresholds for the audit of a very large company is the subject of this next user’s quotation:

[I]s it just materiality that drives the level of work, or is it risk…it’s very hard to explain to a schoolteacher that a $200 000 difference is irrelevant, because to a schoolteacher, to a taxi driver, $200 000 is a vast sum of money, and for someone to say: ‘Well, in the scope of the BHP accounts, it’s totally irrelevant’—it’s a very hard concept for them to grasp. But…I would question how many retail shareholders even know the
word exists. Yes, there is an audit function in there, that’s in [their]
checking, and they probably think they are doing far more checking
than they really are, but they do take comfort from the fact that the
auditors are in there. Well, at least the big firms, they have a chance
of recognising the name when the auditor has any issues.

The same user continues, highlighting his or her understanding of the
personal responsibility involved when an audit partner signs an audit
report:

When all’s well…I don’t think anyone’s concerned. But the auditor
of [a recently collapsed company] must have had worries. It didn’t
just all happen overnight and go down the gurgler. And I’m not
sure how you would do it…I don’t have an answer, but the audit
partner who signs off on [one of the largest blue-chip companies] is
a lot more relaxed than the audit partner who signed off the last set
of accounts for [a recently collapsed company].

The need to explain the concept of materiality in layman’s terms is
articulated by this user:

[M]aybe [materiality] just needs to be explained in layman’s terms,
or less accounting type of terms, because…from experience, it’s
something that if you don’t understand, you just go over it and it
could be quite crucial in the scheme of things.

This next user believes that auditors should bring material issues to the
attention of investors before issues cause problems; otherwise people tend
not to identify problems until they have emerged.

[Auditors] should [explain materiality]…investors understand it intuitively in the sense that if you’ve
got something major in accounts and it has the…potential to impact a company’s performance, then
they understand it. But…people don’t identify the problem until, typically, it’s already emerged. So
that’s why…while [accountants] understand the concept…the auditors should be striving to identify
those issues, so [as to] at least to bring those issues to the attention of people prior to them causing problems…people have an intuitive understanding of that without understanding the technicalities of
the accounting, if you like.
Lack of understanding of the auditor’s use of materiality by retail investors is one thing, but if boards of directors are struggling with the concept, it could be of greater concern.

Yeah, it is a concern [that potentially many shareholders do not understand the concept of materiality]…it’s even not well understood by a lot of boards either. There’s always a bit of…an explanation required to the board as well.

The interviewer then asks whether that communication to the board is effective and the response given is negative, with the claim that the audit profession should take action to create better understanding:

Not necessarily, no. I’d say with issues like that…the audit industry could probably go a long way in trying to clarify some of those things a lot better to everybody. I don’t think they’re well understood.

The interviewer then asks whether this issue is a major driver of expectations gaps between suppliers and purchasers and this user does not seem to think so, but it is difficult to see how it would not be, given the full context of his or her response:

[A]t the end of the day, when you get the outcome, it leads to either a better or a confused understanding of the situation. So, you can be in meetings where you’ll be going through something and these issues come up and…it’s news to people how that is actually defined or how it’s clarified.

2.1.1 Summary

Users, when asked whether auditors should explain more about their implementation of the concept of materiality in the conduct of the audit, feel that this would be a positive, but somewhat difficult, thing to do in layman’s terms. Comment was received about the likely incomprehensibility to some of the large threshold dollar amounts of audit materiality used in the conduct of audits of the largest companies. The need to explain the concept in layman’s terms, if it is to be explained, and the foreseeability of required public disclosure of materiality thresholds are raised also.
2.2 Purchasers

Remembering that in a past life, purchasers had sometimes been auditors, two purchasers expressed a perception that there was not a problem with the understanding of the concept of materiality as used by auditors.

[T]o me, it’s...not an issue at all...I can’t speak...for retail shareholders, but...I used to be an auditor myself [and] I don’t think there is an issue with materiality at all.

[A]s a concept, no, I don’t think so. Because... the auditor’s approach of applying materiality I don’t think has led to any of the significant audit failures...it’s a valid approach that says we can’t look at every single transaction that the company has undertaken in the past 12 months. We have to determine where to focus the audit effort, and we’re going to make that determination on considering the risk associated with any particular aspect of the client’s business and, providing we’re satisfied that an error that we miss in our audit is not going to have a significant effect on the financial statements, then that’s acceptable, and that probably should be acceptable...the big audit failures have not really been materiality driven. They’ve been driven by either incompetence or just a lack of understanding of the client’s business and/or the clients themselves not properly disclosing what’s happening in their business—and the nature of risks that they’re undertaking.

Another purchaser feels that developing deep understanding of the concept of audit materiality is not high on investors’ agendas and that what is more important is having faith in the professionalism of the auditor. He or she alludes to disclosures around subjective judgments as raising concerns:

‘[T]he auditor’s approach of applying materiality I don’t think has led to any of the significant audit failures.’
‘[T]hose subjectivity-type areas on what you disclose and what you don’t, and more around the nature of what’s material would possibly raise a concern [as to] where it’s headed.’

As far as the wider community is concerned, it’s important to have more education and have that information out there so that people are well informed...if you’re well informed of materiality and what auditors are actually doing and how they’re going about it...you’ll have more comfort in the work they’re performing...otherwise...a couple of those subjectivity-type areas on what you disclose and what you don’t, and more around the nature of what’s material would possibly raise a concern [as to] where it’s headed.

The same purchaser continues with the theme of the importance of confidence in the professionalism of the auditor:

‘[Q]uite often, I’m sitting there explaining to people what an auditor actually does and how they review things.’

At the end of the day...materiality is just...a mechanism, of how auditors go about their work...and do investors want to know that or do they just want to know that they’re doing a good job and they’re doing what they should be doing? I can see how it plays a role internally, but...for investors, as long as they have confidence in the auditing profession—the professionalism—then...that’s probably more of just another mechanism of how they go about their work, which they should have confidence in.

The remaining purchasers, however, constituting the majority, did feel that there was a problem with understanding materiality and that greater disclosure by auditors of the level of materiality to which they worked and/or around the concept of materiality more generally was desirable. Some, as in the next three quotations, want more detail of materiality as it pertains to the conduct of specific audits.

‘[W]here they might be signing something off...tell us a bit more about the issues you do have a material issue with and what you [have] done around it and how you’ve satisfied yourself. Just doing a more generic statement in terms of ‘this is a process we’ve undertaken to review these accounts’. [What I would want] from the generic statement would be...to try and explain to people what the account is doing if you haven’t been an expert, haven’t been
familiar with the process of what they do…quite often I’m sitting there explaining to people what an auditor actually does and how they review things…it just gives the reader of the accounts a bit more feeling as to…materiality and does it actually get explained in the accounts, what materiality thresholds are, et cetera…even the standards are a bit broad in terms of ‘is this material?’…if it’s going to impact on users’ economic decisions…I haven’t looked at the statement in detail for a while but…the [auditor’s] sign-off…does it refer to materiality or not…it’s not really a high order of priority-type issue that we’ve got.

That different risk tolerances exist among key stakeholders to the audit is articulated by this next purchaser as a reason for disclosure by the auditor of the materiality level used.

[M]ateriality affects everything external auditors do in many ways. How they disclose, how they make a decision, determine whether certain adjustment needs to be made or need[s] to be disclosed, so materiality is definitely going to affect the way that certain financial information’s being interpreted…there is some need to actually incline towards disclosing some more information on that particular part because materiality is basically…a risk-tolerance level, and therefore slightly different shareholders or key stakeholders would have a different level of risk appetite, so they need to be able to make an informed decision. They need to understand what materiality the auditors use. I work in a company and…I therefore understand what materiality our external auditors use in respect of my own company. But, obviously…the general public perhaps may not be aware of that. There will be a need for them to understand it.

The same person goes on to articulate a dilemma in explaining the materiality concept in an auditing context. Could it raise more issues than it solves?
Having said that, materiality itself is not...simple. A lot of the time we’re not talking about just 5 per cent, 10 per cent of P&L [profit and loss] items because obviously external auditors also make their own judgment based on materiality...so there will be some judgment call required [about] how to actually disclose it without...misleading the audience because [there's] nothing worse [than] when we just give information and it’s actually misleading...So, rather than just give...figures—because probably a certain number of figures may not actually apply in most situations...people would therefore need to understand when they read the financial statement, they need to be a bit more informed in what they actually read. It may not be, for example, 100 per cent correct [which] is probably one of the main things they need to be aware of and...is probably important. But then, obviously, we don’t want to suddenly ring the alarm bells; not 100 per cent correct—what does it mean? Is it only 50 per cent correct...that’s probably not what we are trying to drive...people need to understand perhaps what we’re talking about [with] materiality is anything maybe under a certain level or something which is a little bit more important to the readers.

The next purchaser’s comments reveal that he or she sees more explanation around materiality as useful not for retail investors, but for professionals who can use that information more effectively.

[You need to maybe spell out what percentage or what level of due diligence or materiality have been put into it, as against just a standard statement that ‘we’ve done audits based on section something that says [what] materiality is’...that needs to be further clarified...as a note as to what you’ve really done and what you haven’t done. If you’re looking at a normal, common shareholder...they’re pretty sceptical anyway overall, so it’s not going to help to that extent. If you’re looking at professionals using the information...you can ask the question and it’s just that much easier if it was disclosed: what have we looked at, what haven’t we looked at, et cetera? And then, say somebody is looking at that or analysing the balance sheet, whether...
it’s a fund manager or a banker, maybe the questions have been answered in those notes, or if they haven’t then they could [drill in] to a particular aspect.

In the following comments, purchasers make clear the way in which misunderstanding or miscommunication of auditors’ use of materiality (otherwise thought of as the level of ‘tolerable error or omission’) in the conduct of the audit can feed into the expectations gap.

[T]here is quite a big expectations gap on the materiality threshold, which is, in a very big company…a very big number, and I don’t think that number is really stated clearly enough…most people in the [name of a major ASX-listed company] issue didn’t realise that that very big number—was it [a] $120 or $140 million…hole in the foreign exchange—might’ve ended up being higher in the end, but that it was under the auditor’s threshold of what they actually said they would catch. So I wonder if that number should be stated. Obviously, that number…[is] approved by the audit committee each year, and obviously also that number is very sensitive for the audit fee…if they bring down the threshold, there’s the implied assumption that there’ll be an increase in the fee, which obviously the auditee never wants.

The same purchaser continues, concluding with a positive affirmation of just how much the insider knowledge that the auditor possesses is appreciated and valued:

[T]he auditor may be seen as a warrior for the P&L as well as the capital…on the balance sheet, and…that is an expectations gap and probably could be better communicated…the reason I say that is, talking to…people in the market, whether they’re on the buy or sell side…the market has a very lively knowledge of just how deeply the auditor understands the operations and risks of the company.

Constantly reiterating the cost consequences of failing to set a materiality level to which the auditor works is the suggestion of this next purchaser as a means to educate the public about the materiality issue.
‘[T]here’s an expectation in some people’s minds that auditors would review every single transaction and I don’t think they understand what that would cost.’

[Y]ou’ve got to do it at a material level and I absolutely understand [that] the concern...[goes] back to the fact that [there] is an anticipation... there’s an expectation in some people’s minds that auditors would review every single transaction and I don’t think they understand what that would cost and I don’t know how...you educate them because when you look at [Sarbanes-Oxley] and all the rest of it...[the] general public was wildly enthusiastic and it plugged a political gap at that stage and it’s now turning out to be one of the worst interventions that I can think of...it’s just caused billions of dollars of impost with virtually no return and it would be the same with materiality...I know this business about letting the people regulate themselves is a tricky one politically, but...you’ve just got to drive to a materiality level and I don’t know how you do that except at every instance suggest what the consequences of not doing it [are]. So...if our audits...are costing over a million dollars, well, if we did it to a materiality level of zero, we probably wouldn’t make a profit. And what would be achieved? I don’t know how you do get that whole management-of-risk concept across.

That it is not feasible to expect that retail investors can be educated about the role of audit or audit materiality comes through in this next purchaser’s quotation:

The ordinary person cannot in any genuine sense understand the auditing framework, so when we talk about this issue of materiality or any other issue, you really have to segment the audits. Let’s abandon the mum and dad because, frankly, an annual report is beyond their comprehension...So let’s move to the sophisticated end. The problem is that an audit is limited assurance— we all know that—so what’s the problem? It is not a thorough investigation of every transaction. It is effectively looking at the control posture of a company, looking at the risks and seeing if those risks and the

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6 An audit provides ‘reasonable’ assurance and reviews provide ‘limited’ assurance in the language of the auditing standards; however, it is, in the authors’ opinion, reasonable to presume that this purchaser uses the word ‘limited’ here to signal less than absolute assurance, given the context of the remainder of this quotation.
controls are properly reflected in the financial statements and in the narrative that’s given to the shareholders—that’s what an annual report is about.

The same person goes on to allege that auditing firms are ‘captured’ and he or she asserts that the regulatory model under which they work is flawed in that the contract effectively becomes one between directors and auditors rather than between shareholders and auditors, as is the legislative intent. It is therefore not regulatory capture that is being spoken of here, which is the way in which the word ‘capture’ is often used in the research literature. Rather, it is capture of auditors by the auditee that is alluded to.

[T]here’s a sense that, frankly, audit firms are captured. There are four big ones and they deal with the top-200 companies…The auditors are—it’s almost a rote that they go through…the appointment and the contractual model is…flawed in today’s world. It’s a contract with the directors—understand [that] it used to be a contract with the shareholders—it’s no longer a contract with the shareholders even though the words say it is…I don’t have a problem with that, but don’t try and create any link between auditor and shareholder when in fact the auditor directs literally 99 per cent of their attention to the management and the directors and 1 per cent of their time to the shareholders when they now, for the first time in years, turn up to an AGM and can be subject to questions…this question of materiality—how many top-200 audits have been qualified in the last 10 years? It’s not even a fat tail on a normal distribution curve. It’s such a low number…So then when you get down to materiality it is only the sophisticated end that understand what the materiality concept is. There is no mum and dad shareholder who has read the relevant accounting standard on materiality or the relevant auditing standard, so how can they possibly understand it?

This next purchaser implies that even when the concept of audit materiality is understood, it is conveniently overlooked when something goes wrong and a scapegoat is sought—often the auditor.
Yes, [the audit concept is] easy to explain. There are certain things that are too small to worry about. But...there’s almost a selective amnesia about it. If something goes wrong and the managing director is being hauled over the coals because of problems in his organisation, the default response is to look for someone to blame. And generally the person to blame is the auditor, on the assumption that they’re checking 100 per cent every process, every account balance, every whatever, and they miss the fact...[of] what the auditors are trying to achieve in an audit.

Another purchaser alludes to the same tendency of management to selectively ignore the application of audit materiality levels if something goes wrong. This purchaser also indicates that non-accounting or finance-specific management personnel need education with regard to materiality as auditors apply it.

Not being a listed business and not having to think too much about shareholders, I guess I’m changing the word ‘shareholders’ for ‘general management’ and use them as my reference. Outside of the accounting and finance people, the general management, in this business at least, doesn’t understand the concept of materiality. They know about it, but they seem to selectively forget about it if ever issues arise. And there’s a general presumption that the auditors are actually checking that we’re 100 per cent right. And if anything goes wrong, the default position is to blame the auditors—be that even not just external auditors but internal auditors for missing something. I don’t know if that’s indicative of the fact that they don’t understand materiality or selectively they choose to ignore it when it suits their own ends...addressing the issue of materiality...as the customers of the audit firm, purchasing their service...if they were to provide more information about how they conduct the audit in terms of the process, and their proprietary method, that would probably
address materiality at that point. So...that would be useful as an educator for management in the purchase of these audit services as to what materiality is and how it fits into the whole process.

Several other purchasers also differentiated between sophisticated and retail users of financial reports in terms of their level of understanding of the auditor’s use of the materiality concept.

I did a quick search on our annual report from last year...just on the word ‘materiality’, and the only place it was really mentioned was in the corporate governance disclosures. So, you’d have to...[ask whether] materiality really [is] discussed out there in the public forum, being through annual reports or whatever. You’d probably say no. Does that mean people don’t understand what it is...if you’re an experienced or a sophisticated shareholder then you would understand these types of concepts, especially since those corporate governance principles have come in and three or four of them specifically mention material misstatement, or words to that effect. So if you were...a sophisticated shareholder...and you didn’t understand something, you should research it and find that out yourself. The ones...[who] maybe...don’t really understand the concept...[are] some of your mum and dad investors...or maybe ones who have just become investors through demutualisations or things like that.

One apparently knowledgeable purchaser observes the profoundly different attitude of the regulatory regime in the United States. He or she points to the more conservative approach in the United States, where all errors are treated as material because a user might be affected if they are not corrected.

We’re talking about someone making an assessment. So people make assessments for a variety of reasons—and not all of them are financial. So, if we just stick with financial analysts and funds...the big end of town have a good handle on the concept of materiality. So, I would suggest you have to stratify your shareholder base to answer this question. And then [ask] should this be a concern? Well, yes...it should, because...what you do get is
the situation in the US where everything’s material in the view of the regulator. If it’s a mistake, it’s not appropriate not to correct it, because you don’t know if that would change someone’s view. And so you err on the side of caution and say that everything’s material…I’m not sure how you address the concern around materiality…the only way that you cannot backslide further is to maintain a substance-over-form framework.

One purchaser felt that information about materiality should be available, but only for those interested and on an ‘opt-in’ basis.

[S]hareholders have to have an avenue that’s made clear where they can find [information about materiality]…what I’m saying is…that, effectively…1 per cent should actually opt in to…be able to have a very efficient way through an information market to be able to find out their answer to their question, as opposed to working [to] a scheme that sends the information to all 100 per cent [of] them—for 99 [per cent] not to read it.

As is the case with some of the above quotations, several purchasers’ comments, illustrated explicitly by the next two quotations, go to the desirability of providing educative material around the issue of materiality.

[M]aybe it’s more an education and disclosure issue than actually changing the way an audit is done, or changing the use of the concept of materiality. Maybe you do have to educate people to say we undertake our audit under the umbrella of materiality, and this is what that means. It means that we will miss things, or we may miss things, that are not appropriate, but the implication of that is not going to have a significant effect on the wellbeing of the company or the share price or other aspects to do with the audit.

There is a group of shareholders that do understand materiality, but…there still needs to be materiality thresholds…Rather than try and address materiality, let’s try and address the education of the shareholder, [provide] an explanation to the shareholder, without just standing up at an AGM…[or] a shareholder meeting and just saying ‘it wasn’t material’, [which goes] straight over the head. So just explain what we mean by that…it’s a fine CFO trick to say ‘it wasn’t material’. It’s not a trick, but it’s true. You don’t help a shareholder by not explaining what you mean. So if you
actually say, ‘The impact of that court case was only $3 million on this company and you all know the cost of it, you all know our expenses are $12 billion’—sorry, that’s why it’s not addressed...So, my point is this: the way to address the question is to explain it better to the shareholders.

The difficulty of providing effective educative material alluded to in some of the preceding quotations is, however, explicitly pointed out in this next quotation:

[I]f you’d never ever bumped into any of this before but you had a whole series of shares and companies and things, I really do think there’d be an expectation out there that you wouldn’t have a clue that it’s been done to a materiality level, although it’s put in this statement. I don’t know how you do educate people that way, I really don’t.

The same person, when pressed by the interviewer about whose responsibility it was to educate about materiality, saw that squarely in the remit of auditors, but pointed out that the concept needed to be placed within a risk framework and there was also the danger of it being seen as an attempt to absolve the auditor from responsibility.

Auditors collectively...probably [have] a responsibility [to educate on materiality]. But...what you don’t want...is...a perception with everybody saying, ‘Oh well, they’re just absolving themselves from everything’, and then they lose confidence in it. So there’s the balance of perception that, yes, we are detailed, we are following it up, because...having that mindset out there probably has a governance role in itself. But...maybe it’s trying to drive the fact that they’re managing risk, which is what they’re all doing now...they’re auditing to risk...and...that’s—certainly at our board meetings—all well understood...But I wouldn’t anticipate it to be [understood] at the...general shareholder level.

The next purchaser points to a wider perspective of materiality and how it needs to be applied to many engagements to maintain cost parameters and obtain meaningful information.
[Y]ou’ve got to put it into a context. If you say, ‘Do people understand the issue of materiality?’, it’s like all things in the literature and the auditing and accounting standards. I don’t think many readers would understand most of the accounting standards or the auditing standards in detail. So the fact that…they might not understand the materiality issue in great detail, that’s not surprising. But you’ve got to have a notion of materiality just to be able to do a job within a reasonable boundary of economics and the cost of doing it, and a reasonable exercise as to what does the information mean.

The next purchaser raises the subjectivity of the more qualitative aspects of materiality judgments. This purchaser, unlike an earlier one, feels that there will be more confidence in the audit process if the wider community is well informed about this issue:

[T]he main area of materiality that would probably cause some concern is that area where there’s subjectivity…there’s not as much subjectivity if we’re just talking pure numbers—if you find an issue worth X amount. But when we talk about perhaps the nature of some items, or disclosure…and what’s material and what’s not, and where subjectivity creeps into that decision, there could be some concern there as to what’s disclosed and what’s not and should it be…as far as the wider community [is concerned,] it’s important to have more education and have that information out there so that people are well informed…if you’re well informed of materiality and what auditors are actually doing and how they’re going about it…you’ll have more comfort in the work they’re performing.

Purchasers were also asked explicitly about audit committees and boards’ understanding of materiality. Their responses indicate perceptions of a much deeper understanding of materiality by the members of these bodies compared with retail investors and even average sophisticated investors.

[E]verybody who sits on an audit and risk committee should understand the concept at the very least, if not the board…from a shareholder’s point of view, do they need to know what materiality is…It’s probably questionable because if the auditors have signed off the accounts then they’re saying everything…is true and correct…Does a shareholder need to know that it’s true and correct to a certain level of materiality? For example, that’s why the audit firms have materiality. It’s because anything below that would generally
mean that it’s not going to affect the financial performance of the company. So does the shareholder need to know about it? You’d probably question that and maybe say no. But certainly management and the audit risk committee should definitely know what that is. Although I don’t think they have a lot of input in setting the level of materiality, they should understand why it’s set at that level and how it’s set at that level. At least ask the questions.

The next purchaser provides a suggestion that it be within the charter of the audit committee that committee members become educated about audit materiality.

[T]hey do [understand materiality]…because audit committees generally are made up of people who’ve been around the traps for a long time…they’ve been involved in a lot of discussions on financial statements. They understand and also they’re seeing the unders and overs and things that haven’t been adjusted…again, it comes down to how does the audit risk committee function? What does it see? And that’s all around governance and what is…best practice in terms of [the] audit committee as to whether directors are really on top of the game—and that, to me, is best addressed through that avenue…But the ones I’ve been involved with…I don’t think there’s any issue about people understanding what materiality is and at what levels it’s applied because it’s very transparently advised by the auditors to the audit committee…Perhaps…there ought to be an obligation on the external auditors to be educating members of the audit committee and likewise the audit committee should have on their charter that they should get education…from the external auditors on their process and what materiality is.

The next purchaser points out that audit committee members who do not understand audit materiality are in peril:

Certainly in respect of the way that auditors report to audit committees now, I’d be surprised by [a lack of understanding of materiality] because of the fact that—and I’m not sure if this is
a requirement of the auditing standards—but certainly the whole reporting of audit differences is pretty much standard now, and that’s been driven largely out of the US. Tell us if you’ve got an audit difference, and we want to know the audit differences that were there and [were] adjusted as much as anything. So if you’re dealing with audit committees…that’s a ‘horses for courses’ issue…if you’re a director and you’re not understanding the financial report and you’re on the audit committee, well, you’ve got bigger problems than the auditor does.

Explicit in this next quotation is the fact that in some circumstances audit committees demand to know and are aware of the level of audit materiality to which the auditor is working:

I don’t understand why it’s a concern because when the issue comes up of materiality, on the audit committee, we’re very specific about…what level of materiality they’re working towards…for example, recently I was in a board meeting and they said they were working to a broad materiality—hundreds of thousands. And that was in theory, but in practice they were working to a much stricter [level]. And we said we want it spelled out—what you’re working to—because it’s important for us to know exactly, so we can present to shareholders what materiality means. And that point of it’s so broad that you could have a major problem and it wouldn’t be…covered in the sense of having been considered to be material under their much broader guidelines.

[T]hat can sometimes happen because you get to a situation…typically it arises where you get something that’s gone wrong, and let’s just say there’s been an error or a defalcation or something of that description and if someone says, ‘Well, gee, that’s material’, in their mind it’s a material number because it’s more than a certain dollar impact. And…in my own mind when I’m looking at accounts, I say forget about the 5 per cent test…tell me the items that are over $1 million. Now…$1 million might only represent 1 per cent, but I still want to know about it because…it’s not so much that it’s material as such in final accounts, but it
becomes significant to me in managing the process by which those accounts are prepared. So the context in which people can raise it is different.

The same purchaser continues, explaining that in his or her experience, even among audit committee members, differential levels of understanding of the concept of audit materiality exist:

[A]n audit partner might say to me, as a chairman of an audit committee, ‘But that’s not material’, and I say, ‘I don’t care.’ I want to know about it because it is important [to] me understanding the process of what’s happened. He might then turn around and say, ‘Well, you’re trying to put too fine an interpretation on something.’ Well, so be it, but that’s something you agree with the audit engagement team up front about what’s a reportable item. You’ll get different people on audit committees that have different levels of knowledge and expertise. And on the audit committees I chair, I have people who have a very high level of financial sophistication and knowledge and others that are more business oriented and not so much into financial issues. And the ways they approach things, and the questions they ask, and the way they get to their comfort, [are] entirely different. So you can get differences in terms of people understanding it or not.

2.2.1 Summary

With the exception of an ex-auditor purchaser, there is general agreement among purchasers that the concept of materiality as used by auditors is not well understood by retail users of financial reports and even, as some observe, by some auditee managements and even audit committee members. Some purchasers in their comments, however, make it clear that the situation is complex, with the more sophisticated readers of financial reports much more able to grasp and understand the concept and its utilisation in the conduct of an audit. Directors and audit committee members create another level of sophistication and accountability again and are seen generally by purchasers as competent in their understanding of auditing concepts surrounding materiality.

Given purchasers’ comments about the concept of materiality and the perceived potential of a failure to fully understand it to exacerbate the expectations gap, several advocate the need for education of users
about the audit product. The use of materiality in terms of ‘tolerable error’ emerges from purchasers’ comments as particularly misunderstood, although two comment that this could be a deliberately selective, self-interested misunderstanding.

2.3 Suppliers

Suppliers’ comments about their application of the materiality concept and their perceptions of users’ understanding of that concept range from those asserting that materiality is of little interest to shareholders to those who believe it is crucial that understanding of the concept becomes more widespread.

The first two quotations below express suppliers’ perceptions that there is little need for shareholder concern or interest in the concept of materiality as it is used in the conduct of audits, although education about the issue is desirable.

[P]robably all shareholders wouldn’t care about materiality; all they care about is the value of their shares and whether or not their investment is going to be returned to them at some stage with a reasonable interest or capital improvement. So they probably don’t even care or know about the concept of materiality. But from the audit point of view, we still have to recognise materiality and we still have to recognise risk assessments and so on, and I don’t think the auditor should change. But the educational process to the end user should be beefed up so that if materiality should be an issue to the reader of the financial reports, or the stakeholders, or the shareholders or whoever they are, they should be educated more about the concept of materiality, or whether they should even concern themselves with materiality. Materiality should be a tool of part of the audit; it shouldn’t necessarily concern the end user. But…there must be much more education [of] the end user of financial reports than exists at the moment about the whole concept of financial reporting in the disclosure [area].

I don’t see [materiality] as a major concern. Occasionally, you do get questions, but if they are answered…I haven’t seen it as a major issue, no. Yes, it can be explained to [mum and dad investors]. I don’t think it’s a difficult concept…I would’ve thought a lot of people do understand it. I don’t see it as a major issue…the people
that I see are quite accepting of the concept. Once you explain it to them, they can understand.

The potential for lack of understanding of materiality to exacerbate the audit expectations gap is, however, acknowledged by the next supplier:

[I]t is part of the expectation gap, because…there would be very few shareholders who would understand materiality as applied by an auditor. And…some of them would be quite staggered to learn…if you take [one of the top-100 listed companies], the materiality on that job might be 20 million [dollars]—I’m just picking a figure—and therefore the numbers are sort of right, plus or minus the 20 million. Well…the shareholders would absolutely be staggered at that. And they wouldn’t understand the correlation between that materiality level and…the cost of the audit—that if you were going to be dropping that down to just, say, five million then you’re going to have to be doing four times the amount of work that you presently do. And I think therefore that concept hasn’t been well put out there because, again, it’s started to get into the audit report.

Another two suppliers agree that the concept of materiality is not well understood, but they express the belief that articulation of more information about the concept is likely to be of limited usefulness because of its technical nature.

[Ordinary shareholders] don’t understand the concept of materiality. Materiality doesn’t just come in numerical form…which is largely the way we would do it, but there are other non-numerical concepts which apply to materiality. If it was on a just non-numerical form, it probably wouldn’t be difficult to communicate as to what our materiality [is]—whether you call it materiality, whether you call it tolerance, whatever you like to call [it]. Quite possibly, that could give them some level of comfort…I don’t know…How we communicate it…where we have, let’s say, non-numerical materiality. And what I mean by non-numerical [is] it’s really where something is just absolutely material by nature regardless of what the amount is. So how you articulate that might be a little bit difficult. Would
it give them any more comfort…it might give them some comfort…to know what the tolerance level is, but I’m not sure how much comfort that would give the users on those financial reports.

[I]t’s such a technical issue, I don’t think that we necessarily expect the public to understand it…materiality always comes down to commonsense. If you’ve got a million-dollar profit and there might be $10 000 of dubious revenues, well, why would you spend any time at all looking at that? You would just simply say, ‘Well, look, I’ll accept that because it makes sense to me, because I expected them to make some money on that particular little venture’, or whatever it was. It might be donations or it might be reimbursements or something like that. But…that’s an easy commonsense-type thing. It gets a little bit harder when, obviously, the numbers get bigger. And the auditor does in fact need to have empathy…[he or she] needs to put themselves…pretty much in the shoes of the investor, or the member of the company…or prospective investor even, and just say, ‘Well, if I was going to be investing here would I be concerned about whether the profit was X or X plus 100 or X less 100?’ Does that make a difference? We can come up with all the statistical analysis in the world but it doesn’t necessarily give us the answer as to whether something’s material or not. And of course one of the age-old problems with the materiality is that something might be material for the profit and loss statement, but not material for the balance sheet…that’s a technical issue, which I don’t think most people necessarily get.

The perceived difficulty of articulating understandable explanations of the auditor’s use of materiality and its association with the degree of auditor judgment is demonstrated in the next few quotations.

Both within the accounting standards and within the auditing standards there are standards of what is materiality and guidelines to materiality, so if you really are concerned [about] getting people to understand it, I don’t think that those standards are overly complex. What they do outline is that materiality is a particularly complex issue that is made up both of quantitative and qualitative factors. There are some broad guidelines, but…it comes down to individual judgment around
something as material and…you could probably start to address the broad concepts of materiality with users of the financial statements, and with shareholders if you did that through some form of education marketing campaign. But is that really a concern for the accounting profession? Even within the accounting profession…you could speak to four different people and you’d get four different interpretations of what materiality is in a particular context…it’s a very complex issue, it requires judgment that is particular to an individual circumstance, and therefore…you can give some broad guidelines, but…you’ve got to leave it…to individual practitioners to exercise their judgment.

[I]t’s a huge area, materiality. And we all struggle with it as professional accountants. So how the hell people who are not accountants can look at materiality and properly understand it, I don’t know.

[T]he issue of materiality is no more a concern than shareholders understanding what an audit does and doesn’t do…the materiality effectively drives that and how you apply things…Whether…and quite how you’re able to articulate a materiality…it’s quite difficult for me to stand up in an AGM in front of 700 people and try and explain the principles of materiality. If they ask me, that’s what I’ll do, but…you’ll lose people after a while, and…you’ll get into a philosophical debate about well ‘gosh, shouldn’t you do more to give the comfort’, which comes back [to] the heart of what an audit is and what an audit isn’t.

[I]t’s a difficult question because if I say yes, [auditors] should [explain materiality], the way in which you would do that then becomes awfully complex…Obviously, professional judgment is a strong part of what we do and if you then try and explain…everyone’s going to have a different view about what an audit should be…I’ve had experiences where I’ve just worked through materiality with boards of listed entities and while they might agree

‘[I]t’s quite difficult for me to stand up in an AGM in front of 700 people and try and explain the principles of materiality.’

‘[W]hile they might agree with what the materiality is in regards to the financials as a whole, when we then try and apply that and talk them through how we apply that to different line items or captions in accounts…that discussion…becomes quite a heated debate and people have different views.’
with what the materiality is in regards to the financials as a whole, when we then try and apply that and talk them through how we apply that to different line items or captions in accounts, even that discussion with board members who are well educated, often with a finance background, becomes quite a heated debate and people have different views.

The same supplier continues, expanding on the complexity of explaining not just ‘materiality’, but ‘sampling’ to a broad user base:

If we put this question and applied it purely in regards to materiality, to try and take that debate into a forum and a broader group...maybe the institutional investors could get that, but the mum and dad investor I don’t think will have the ability to do that. So, if you then say, ‘Well, okay what about the audit as a whole and forget materiality, tell us what you do and when you do it, sampling and how that might work’, I cannot imagine how you could possibly explain that to an average [investor]...and professional judgment is the main reason. As long as we’re able to apply our professional judgment while working within the accounting standards and the relevant regulations, I can’t imagine how you could properly explain that to a broad user base.

The same supplier goes on to explain the nexus between the audit materiality concept and the audit expectations gap:

The audit opinion, although it’s distinct...explains the materialities at play and there’s sampling, and if someone read that carefully, they should get a sense of maybe what an audit is not. The thing [that]...is well and truly misunderstood is the concept of materiality...across a lot of users, not just mums and dads. For big...multinational groups, that obviously can be a very big figure and...a lot of shareholders would struggle if you said to them we can still sign a clean audit opinion but the audit error might be X many tens of millions...that would stun them...so there is still this expectation gap between what an auditor knows an audit opinion actually is versus what a reader of accounts might expect an audit to be.
The divide between retail investors and more sophisticated players among users of financial reports is apparent in several of the preceding suppliers’ comments and is made explicit in the next quotation:

[I]f you ask most…mums and dads…who knows what they know? But if you were to ask most analysts, most brokers, most lawyers…what’s…material, they’ll say 5 per cent…[so] that kind of quantitative threshold is capable of being reasonably well explained…whether…you mandated putting some extra disclosure about that in the audit report so everyone understood it, I don’t know. Where it gets harder of course is…[where] in the auditing standard it talks about the quantitative and then the qualitative threshold and the qualitative threshold will always make you lower your materiality. It will never say ignore the quantitative, go higher. And so there’s always judgment around that…[but] I’m not a big fan of making things more prescribed, so I don’t know how big an issue this is…most people other than mums and dads would say 5 per cent is material in anyone who deals in financials…whether you’d want to go to the next step of highlighting that, I don’t know.

No suppliers are explicitly in favour of disclosure of the real level of materiality used in the audit and one voices his or her express wish that this not be done since it could be detrimental:

W]hat we need to do is get a better understanding out there of how the audit works and what does it mean, because I still think that generally people think that we are there to stop fraud. And…they don’t understand materiality…I’m not sure how you get to the average shareholder…I don’t think you’d be smart to be [saying] this is our materiality on this job…you need an educational process of somehow putting information out there which allows the people to get a feel for materiality, and then you can be starting to maybe allude a bit more to that in the audit report…But I doubt that they’d ever get to the point of actually putting a dollar figure [on it].
If people actually sit back and think about things, they ought to understand materiality and that that 5 per cent threshold’s not a big concern. So, now the audit report as it currently stands talks about things being material…whether you’d actually want to go [to] the next level and prescribe the amounts—I don’t know. I think that would be unwise and probably detrimental.

Several of the suppliers’ comments—some prompted by a specific interviewer question—turned their attention to directors and audit committee members’ understanding of materiality in the context of an audit.

Generally, suppliers are positive about board understanding of the concept, as is revealed in the next few quotations. The first comment also reinforces doubt that the materiality level should be publicly disclosed:

[There are] often some significant items that are left on our unadjusted schedule that the board concurs with or is happy to lean with—unadjusted—but [which] never see the light of day either in value or in the quantum of errors…I [would] like to put those on the table now, or I have an obligation to anyway, but…not in terms of just the value, but the fact that if you’ve got pages and pages of unadjusted differences it also goes to show that there are other deficiencies—potentially control deficiencies. So from that point of view, I know that you come back to the question of materiality…I would never get to the point…of necessarily disclosing that to shareholders because it’s not just quantitative, it is a qualitative assessment and…if you start talking quantitative, it does take away the qualitative. But…in terms of the amount of…the profile materiality…has now maybe to what it did five–10 years ago, I can certainly say the board is more conscious of it now, management is certainly more conscious of it now. Sometimes they use it as a bit of a tool themselves as to what they can and can’t do.

The same supplier continues, explaining his or her perception that, increasingly, management is using the materiality concept to say to the auditor ‘don’t worry about that, that’s not material’:

[O]ne thing that I would hate to think would happen is that companies start to think materiality in their own right. I’ve seen that creep in a little bit more over the recent years where management will say,
‘Don’t worry about that, that’s not material.’ And our view is well, that’s your objectives, you should really get it right; materialities has [sic] just become more of an audit function rather than for in the first instance not to address something because you don’t believe it’s material. So as long as there’s not a disconnect there as well.

Generally, suppliers are also positive about the skills of audit committee members in understanding the concept of materiality as pertaining to audit. The next quotation, however, makes the point that understanding it does not mean approving of its use:

I don’t know if [audit committees] don’t understand [materiality]; they just don’t like it. So they will understand that the audit’s done to materiality, but nevertheless they expect you to know everything. So if there’s a million-dollar fraud, then why didn’t you pick it up? If there’s something like the wheat board type of thing, with all those facilitation payments…would they necessarily have come to the auditor’s attention based on materiality? No.

The next supplier’s comment points out that even audit committee members can be surprised by the numbers involved in audit materiality:

[W]hen you deal with audit committees and things like that, when you start talking about materiality and you put [out] ballpark figures, you still get a bit of a reaction from people. ‘What does that mean—that’s a big number?’ And it’s the complexity of the systems…which requires you to do testing of a representative sample. But because of the volume of transactions, that’s why we end up with materiality. Yes, it is a concern…because that’s part of that. I don’t think they understand that.

The next supplier explains what he or she sees as one of the reasons for the level of audit committee understanding of materiality:
[The audit committee has certainly elevated their understanding or the level of inquiry that they make beyond just the normal reporting mechanism—being the kind of board reports. Probably what's given them a greater appreciation as well, just in the context of materiality, is the kind of factors that we as the auditors are grappling with as well—whether something might be material from a disclosure-deficiency point of view...that’s certainly something and we’ve moved down that path in the last couple of years...We're not just reporting financial statement errors in terms of [the] quantitative, but we’re also reporting disclosure deficiencies...We won’t qualify because of that deficiency, but it’s certainly not preferred practice. It’s not enough for us to give a qualified opinion, but certainly a preferred position would be to have more disclosure and therefore...even there, you’re starting to see boards in particular start to think...[about asking] the question of management: ‘Well, why not? Why haven’t you gone down that path?’ And if there’s not a reasonable explanation there then...that’s where we think you should take it. You should move towards the preferred position...there’s a general view that more disclosure is better than less.

Not all suppliers, however, are complimentary about the knowledge levels of management, boards and audit committees, as the next few interview quotations show.

Now, the shareholder doesn’t have any idea on a particular entity whether we’re working to $1 million [or] $10 million. Right, so a shareholder—a big perception—may think that we’re auditing everything and even though we say an audit can’t test everything, they may still [think] that. Would it help to say that we’ve used a materiality of $10 million? The only issue with that is, do they really understand the concepts around materiality and how that drives it? So you get caught either way. But
if there is one area...[where there is] still...confusion between even boards and audit committees, and something that we’ve got to decide, [it] is making them abundantly aware of the standard on materiality and what that means and how it’s been set. Because often a board will say, ‘Well, how come you didn’t spot that 200-grand adjustment?’ Well, you’re never going to spot the 200-grand adjustment if you’re working with a materiality of 10 million. It’s just not how an audit will work...[that area is] still fraught with danger as to how you explain that to the general public.

The next supplier has experience with a board that understands that to lower the materiality level below that set by the auditor will increase the cost, with a preparedness to pay that incremental cost to acquire the requisite level of assurance.

[Q]uite often management and the board don’t have a good appreciation of materiality and how it works and how it fits in. And I’m very keen to set out my materiality to the board so they understand exactly where it is, how we’ve applied the...standard on materiality. But firstly...it actually helps me when you’re selecting the benchmark to confirm that’s where they view it. I recently had an example where we had a good discussion with a very major listed company, and I’d set the materiality absolutely in accordance with the standard and judgment and so on. And they accepted that that was the benchmark, it was a right benchmark, or a benchmark. But they actually had another benchmark that was important to [them] and [they wanted to know] could we reduce our materiality to come to that benchmark? And I said, ‘Yeah, absolutely’, because that’s an extension of the scope of the audit. There’s a cost element to it, which the board understood and were comfortable with. So we varied that. And both materialities in fact are acceptable under the standard, which actually shows that the standard itself can lead you down to different answers. So...the first point I have is that I want to make sure that the board understands the concept of materiality and therefore what is or isn’t going to get picked up in an audit. And that leads us into another one, which is extending the audit and so on.
2.3.1 Summary

Several suppliers position the understanding of audit materiality within the context of other understandability challenges presented in the form of complex financial reports more generally, the issue of audit sampling and what it is that can and cannot be expected of an audit. Suppliers are eloquent in expressing the qualitative as well as quantitative nature of materiality and the role of their judgment in applying materiality, leading to the difficulty they perceive in articulating to unsophisticated users of the audit product their use of materiality in their audit conduct. Most suppliers are positive in their comments about the level of understanding of the materiality concept displayed by directors and audit committee members; however, this is not a universally held view. While there is little dispute that retail investors do not understand adequately the concepts involved, there is not agreement that this situation can be resolved, even with more disclosure. There is no support by suppliers for public disclosure of the real level of audit materiality employed, but it is evident that there are many instances—although not universally so—where the materiality level is disclosed to clients, either auditee management or audit committees. Suppliers are particularly knowledgeable that the level of materiality and the related use of sampling have consequences for the cost of the audit.

2.4 Standard setters

Like the comments of suppliers, those of standard setters range from conveying no discomfort with existing levels of understanding of audit materiality to those who see further education being required.

One standard setter reminds us that there are many aspects of audit that are not well understood and uses an analogy to convey the point that not all the intricacies of a product or service need to be known before use can be made of that product or service.

I challenge what is it that they need to know. I don’t want to get too off the track here, but we can joke about using inappropriate analogies around brain surgery and nuclear physics or whatever, but if I went to a doctor and needed to be fixed, how much do I need to know about the process and how he goes about fixing me? Does a brain surgeon need to explain to me

‘Does a brain surgeon need to explain to me every intricacy, or do I just need to know that he knows what he’s doing and he’s going to fix me up?’
every intricacy, or do I just need to know that he knows what he’s doing and he’s going to fix me up? So I could equally talk about shareholders not understanding the difference between controls testing and substantive testing, understanding what we report to audit committees or those charged with governance. I could pick up lots of individual aspects of an audit in addition to materiality and say ‘people don’t understand’.

One standard setter claims that it would be ‘dangerous’ to disclose the materiality level itself, and believes that the auditing standards should be the source of information about materiality, with education about where the standards can be found as a potential solution.

[The disclosure of the materiality level itself is] probably dangerous and you don’t really want to dig those kind of holes for yourself because it’s subject to interpretation and you get a dollar above or a dollar below. Who knows what kind of impact that’s going to have in the minds of some investors…the auditing standards do set out materiality pretty well and…maybe there’s scope for increased awareness of the auditing standards to some extent. So we say that we have conducted this audit in accordance with Australian Auditing Standards and maybe some reference to key elements of auditing standards…[with] materiality—probably the risk standards around assessing the risks of an organisation, the risk of material misstatement and procedures designed to address those risks. That’s a general [statement], which you could include and then refer to the main body of standards and where they might be found…It makes them aware that the information’s available but now they’d probably just read the word in accordance with the Australian Auditing Standards without any concept of what that actually is…So if you can increase their awareness of what the Australian Auditing Standards actually are and where they can be found then…that’s probably a good thing.

Several standard setters make it clear that in their view there are more important audit issues than materiality for which understanding needs to be clarified, as the quotations below demonstrate.
[C]ertainly, wherever I’ve worked, yes, [materiality is understood by boards of directors]. And it’s now absolutely the norm for the auditors to disclose their level of materiality in terms of the work they’re doing. That seems to me now to be standard practice at audit committees and then [there is] potentially a robust discussion around whether that is an appropriate level. In terms of shareholders…it’s just another facet of the difficulties of understanding the complexity of the work that auditors are expected to do. So yes, I’m sure that’s not well understood, although it’s not a difficult concept to grasp if you can engage someone and have a discussion. But how do you do that with the shareholders?

Education about the fact that a financial report audit does not give absolute assurance, which is a corollary of the application of audit materiality, is seen as the way to tackle the issue, according to the next two standard setters.

[T]he profession would benefit…by having a greater understanding in the marketplace about the fact that an audit isn’t absolute assurance, so I would perhaps focus more on not so much defining materiality, but defining just what an audit is…So an audit provides reasonable but not absolute assurance. What does that mean…more discussion and disclosure [are needed] about the fact that it’s not a 100 per cent review, but…the message to convey there is more one of concept than the fact that it isn’t absolute assurance, rather than getting into the detail of describing materiality and what your thresholds are and the technical concepts…[it should be] the reinforcement that it’s not absolute assurance.

In discussing the materiality issue, this standard setter also comments on the issue of probability and the lack of desirability of disclosure of the dollar value of materiality:

[A]s long as people understand that the opinion an auditor gives is not an absolute opinion, but [that] really it is done within a range and you’re up in that 94 [per cent range]…If they understand it’s in that area that the opinion is given…that would be of benefit. I don’t know how you’d go around better educating the user base out there…it’s a task which you will never get a satisfactory answer [or] outcome on. In other words, there will always be someone who believes you’re giving absolute assurance, which is clearly not the case, and
I notice that in the review opinions where you’re giving the negative opinion…there is the level of confidence which is being expressed…that is probably even less well known. And so [for] the materiality level, my preference would be that…we give a general recognition to it, but I wouldn’t like to see the number being flagged or disclosed because…the materiality does vary. In other words, you might have one materiality for an area but in terms of, say, the related parties and the materiality in terms of that may in fact be less than what you’ve used for receivables and payables because of the…qualitative nature of the materiality, and materiality is based on both quantitative and qualitative…so therefore it’s just not one figure.

The same standard setter continues, affirming the need for greater understanding of the concept of audit materiality:

[While I would support…a greater recognition, it would be interesting to see how that is done in terms of the…general or whether in fact it should be [in] the audit report…[in] my opinion…the audit report [doesn’t need] to give any more than what it’s currently got on it, but…the general kind of awareness in terms of what an audit is about and the role of materiality…would be good and…that goes generally without saying. We’ve got to increase users’ understanding of those concepts. Whether it’s achievable or not, it’s probably hard to say, but…we have to certainly devote more in that area.

The same person goes on to infer, as with certain other comments cited in this chapter, that there could be negative consequences for the public’s views on auditing if there is universal understanding of materiality and its implications for ‘reasonable’ assurance.

[From a public interest point of view, it probably would be helpful for the retail investors to understand more about materiality. And I’m trying to think of the wording of the audit report…in terms of whether it helps investors understand that we’re not saying the accounts are correct to the dollar—within reasonable limits…there are statements about reasonable assurance. But…the retail investor probably doesn’t understand what reasonable assurance
actually is…it could be helpful if something was said that this audit report is not a cast iron guarantee. But there’s always a pro and a con and the other side of that coin is that it may lead to a negative view of the audit opinion in the invested community. It’s a doubled-edged sword really. How much do people need to know…Having said that, if you make these disclosures, you make them across the board…an audit report is what it is, so…one firm’s audit report’s going to be the same as another firm’s audit report. So if investors are not happy that they don’t get [a] cast-iron guarantee down to the dollar, they’re still not going to find that anywhere. Even if they want it, they’re not going to get it. So…awareness is always a good thing… I always believe in being transparent about things…that’s a good principle in itself, but you’ve always got to do things with caution and think about whether you’re achieving the right objectives, because [what you’re trying to do is] objectives driven.

The next standard setter expresses the difficulty of dealing with tiers of sophistication among users of the audit product and having all tiers understand materiality:

‘[A]nalysts [and] brokers… understand materiality because they look at the risk. Your average punter on the street probably [does] not, but then again, research would show they don’t read audit reports.’

[W]ho are the…core users of these reports? And you go back to analysts [and] brokers—they understand materiality because they look at the risk. Your average punter on the street probably [does] not, but then again, research would show they don’t read audit reports, so you ask the question, ‘Well, would they even understand what the basis of an audit was before you get to materiality?’ And the fact that the audit scope actually discusses the concept of materiality and the risk of material error and the risk of collusion and breakdowns in controls and all sorts of things that can lead to problems…materiality is one element of variance that could result. I actually query…whether materiality is the real issue or whether what we’re looking at here is in terms of the assessments people make. My concern would be that…businesses are projecting, forecasting, communicating their outcomes and it’s achieving those outcomes that then becomes the focus and…the audit becomes the verification of whether they did achieve that forecast, and does materiality come into that?
The same standard setter goes on to argue that it is qualitative materiality that could end up having a more important consequence than quantitative materiality:

Materiality has two elements—qualitative and quantitative—so you’ve got your two branches. You’re probably dealing with the qualitative aspect…more than the quantitative in a lot of these types of situations, because you can get some fairly significant variances of earnings over a period…[about which] arguably no-one would have done anything different even if they’d known about it. But let’s just say you’ve got a new start-up in your business, [a] new segment, et cetera. The qualitative aspect there is, is that segment delivering what you said it would deliver based on a forecast basis? And, that segment in its own right may not necessarily be material today in terms of its relevance to the business, but going forward, it may be what everyone’s betting on. And qualitatively that information is far more important than anything else you would read in the accounts or want to know about and…that’s probably where materiality is of greater importance than [whether]…earnings per share [were] 11 cents or…10 cents or nine cents.

Among the standard setters, there is confirmation that board and audit committee members are conversant with the concept of materiality as used by auditors and that there have been improving levels of understanding among these parties in recent years.

We [auditors] have probably driven that discussion in the sense of…[having] consciously put it fairly and squarely on the table, going back a little bit, and built a discussion around what that means in that framework, and that has then engendered, in some cases, an ongoing discussion around materiality and what does it mean. What does this issue mean in the context of materiality? So, yes, absolutely. It’s been a bit of push/pull…The auditors have pushed that issue more front and centre into the board at some places…[but] what’s happened is…you get these cross networks of directors…it actually filters through the director network over a period.

‘[T]hat segment in its own right may not necessarily be material today in terms of its relevance to the business, but going forward, it may be what everyone’s betting on.’
Materiality does not cause confusion in their minds...not within the audit committee environment...We give them the audit plan at the start of the year and we explain our process and...the auditing standards make it fairly clear these days. Not that audit committees are familiar with them but...you’ve got to aggregate a number of issues. On the other hand, you’ve got qualitative aspects of issues to be addressed by management and by others charged with governance as well. So we have a professional obligation to report a number of things that we would never deem to be individually or in aggregate material. But now under the standards we must still make those charged with governance aware of these issues. So...over the last three to four years, between ourselves and our clients, everyone’s become quite educated on that.

2.4.1 Summary

Standard setters, many of whom are suppliers also, tend to position the issue of understanding of materiality within a broader perspective of other aspects of audit that need to be understood just as much, if not more. Addressing these understandings among an audience comprising varying levels of sophistication is perceived as a difficult issue to overcome. Several standard setters are not convinced the issue needs to be given high priority, even though it might be contributing to the expectations gap. Confirmation that directors and audit committee members, on the whole, have appropriate levels of understanding is forthcoming from interviewed standard setters.

2.5 Regulators

Not unexpectedly, regulators’ comments focus on the application of auditors’ judgment around materiality considerations.

If you see the review-level reports...that the big firms produce today—and this is closely related to materiality—you’re very limited in terms of what they’ve done, and the audit profession uses materiality all the time. The thing with materiality is, where do you...draw the line...I don’t expect an auditor per se to detect every error. I expect an auditor to pick up all the big-ticket items...And there’s a commonsense test...let me [give] a simple example...If you’ve got a balance sheet with assets of 100 million and you find a $10 or $20 million asset...is misstated—that’s material. It gets tricky
when it’s five…[which is] in the grey area…When you’re in the five to 10 area…the auditor needs to actually justify quite clearly in their work papers at least why they’ve reached that conclusion and how they’ve made that conclusion.

This regulator goes on to advocate more information being provided in the audit report if further testing does not resolve an issue that is in the ‘grey’ 5–10 per cent quantitative materiality range. Adding content to the audit report over this type of issue is currently not encouraged by the auditing standards.

[T]he idea of prudence with professional judgment seems to be lost on an auditor sometimes…if you’re dealing with an issue, and there’s a material issue and it’s in the grey space. If you adopt a very prudent approach—let’s put aside the cost considerations of the audit—in a perfect world, the auditor will do further testing and satisfy themselves that that’s not going to cause me concern going forward. So that grey area will become either black or white. So you’ll do either more procedures or whatever, in the 5–10 per cent [range]. If you can’t reach that conclusion and you believe in aggregate they’re material…you should state it in the audit report. If you’ve got three errors, on its own it’s not material, but in aggregate if the three of them are material, you should…communicate that.

When asked whether it would help just to disclose the quantitative side, this regulator’s response is:

No…you need to disclose both.

2.5.1 Summary

The grey area of quantitative materiality where the item at issue is found to be between 5–10 per cent of the relative base preoccupies this regulator’s comments, with a call for more disclosure in the audit report when such issues cannot be definitively resolved with more testing.
3.0 Materiality: responsibility for and location of disclosures

In making comments about the level of understanding of the auditor’s use of the materiality concept, several stakeholders made suggestions as to where incremental disclosures or educative material might be positioned and who might be made responsible for provision of this information. Some content relevant to this section appears in the comments in the previous section too, but below are stakeholders’ comments dedicated to this issue of responsibility and positioning.

3.1 Users

Only one user makes a comment with respect to responsibility for provision of information on audit materiality:

[W]hen you have a concept like that, that auditors rely so much on…the education needs to come out there. The Auditing Standards Board [is the body to provide it]. Impose that consistently across the profession…the problem is that it’s not just quantitative it’s also qualitative judgment…and also can be cumulative.

3.1.1 Summary

One user comments that it is the role of the Auditing and Assurance Standards Board to provide educative information about the role of audit materiality.

3.2 Purchasers

One purchaser is wary of any more disclosures made in the financial report:

[T]he way to educate shareholders is not through more disclosure in financial statements. That’s not the place to do it…that has to be just clear, simple, to-the-point opinions…that’s the right way to go, and where it is at the moment, I’m happy with that as a general statement. But…there needs to be the ability for shareholders very easily to be given explanations of materiality and how it operates.

Another purchaser would like to see a general educative statement that explains materiality, presumably in the financial report, although this is not made entirely clear:
A] general statement in terms of educating shareholders or [the] general public especially, who are not familiar with the term materiality, is probably...important—as to what is materiality in the first place and what does it actually mean...when the reader’s reading the financial statement...that is probably [more] important than anything else...[It shouldn’t be just] a figure, because probably a certain number of figures may not actually apply in most situations...people would therefore need to understand when they read the financial statement, they need to be a bit more informed in what they actually read. It may not be, for example, 100 per cent correct is probably one of the main things they need to be aware of and...that is...important.

One purchaser wanted disclosures to be made by the auditor, presumably in the auditor’s report, tailored to the audit. This same type of comment also featured in purchasers’ quotations detailed previously in this chapter.

When there is a material number, we’d rather have more disclosure on material numbers rather than [less.] And...it comes back to material in terms of...signing this off, but it might be worth saying, ‘Well, it’s a very generic statement that the sign-off is well’...and it might just be a bit more detail as to this is the process that we’ve undertaken to review the account.

3.2.1 Summary

From purchasers’ comments, it is clear they want auditors to have responsibility for disclosing more about materiality. The content of the disclosure ranges from a wish to have audit engagement-specific information in the auditor’s report to a wish to have educative material made available somewhere other than in the financial report.

3.3 Suppliers

Few suppliers made suggestions about which party should take responsibility for provision of more information about materiality in an audit context. One who did suggested the location should be within the financial statements:

Maybe the solution to this is...[and this is] where certainly the International Accounting Standards Board has been going, and I know the PCAOB in the US has been going...and this is why financial
statements are blowing out, but more disclosure about some of the judgments, more disclosure about the estimates, more disclosure about some of the qualitative factors behind the financials and behind the actual companies you’re putting to that is…as important as the quantitative numbers themselves.

The other supplier making a comment in the context of which party might be responsible for incremental information surrounding auditors’ use of materiality suggested the professional accounting bodies or the Australian Institute of Company Directors, but acknowledged the difficulty in making it highly readable.

‘How you make that interesting so people will read it I have no idea, because that would be the hardest thing.’

[I]t’s the professional accounting bodies and the directors’ association, [the] Institute of Company Directors…[who are responsible] so that people understand a bit more about what auditing is and how it works. How you make that interesting so people will read it I have no idea, because that would be the hardest thing. And that’s why you then come back to a simplistic way of saying…if you know materiality, mention [it]. And there’s mention of it already in the audit report, but there [are] no parameters or context…Mr Joe Average…might think anything over 100 000 is quite material without relating it to the company. So that’s the problem at the moment, because everyone has their own concept of materiality. And…there is an issue there and how you overcome that I’m not actually too sure. But…there needs to be more information out there, more articles and a variety of things. And maybe a bit more prescriptive description of what an audit is and what it can achieve.

3.3.1 Summary

Suppliers suggest the professional accounting bodies and/or the Australian Institute of Company Directors (AICD) as appropriate parties to take responsibility for generalised provision of incremental materiality information. A suggestion for location of the material is in the financial report disclosures.
3.4 Standard setters

One standard setter believes the audit report or the publications of the accounting firms would be the best locations for incremental materiality information:

[There are] two options…One is in the body of the audit report, which is in the auditor’s responsibilities…if it was reasonably brief and, in terms of managing the expectation gap, there’s obviously a cost associated with everything and the cost of more than reasonable assurance is increased costs [to] the organisation. So it’s assurance at a reasonable cost as well as reasonable assurance. The…only other place to basically educate the community…is in the publications of the accounting firms…or somewhere in the financial statements. But it’s not a client entity’s issue…for them to disclose. So the only places auditors can disclose things really are in their own reports and in their own web sites…You don’t want to make the audit report too long.

Another standard setter believes the profession—presumably through the accounting bodies—would be best to take responsibility:

[The accounting profession] could do [it], but they tend to communicate more with their own constituency than anything else. The accounting profession communicates with accountants around the place. They don’t really put pronouncements out to the public. The public probably would never look at them or read them or be interested in them.

Another standard setter suggests the incremental materiality information be placed within reports by regulators, or through forums such as those held by the Shareholders’ Association or the professional accounting bodies. The Auditing and Assurance Standards Board is mentioned also as playing a potential role.

I don’t have a simple answer for that because…we do it in the audit opinions at the moment, but that’s really a statement that it’s not absolute assurance…when we’re providing a statement of the scope of the audit opinion…How would I demystify the process a little bit
more…[and say] it’s appropriate? Perhaps through reports from the regulators around how they assess whether an appropriate piece of work is done or not, but…if it’s shareholders generally, how do you [do it?]…the retail people are difficult. Institutional investors and larger interest groups are…more easily touched…forums through the Shareholders’ Association and obviously bodies that represent assurance practitioners are forums [where] we can do this, but only if we touch the people who are interested in the message…how do you get a message out…it’s more about confidence in the process and that it’s applied appropriately rather than having to understand the process in detail. But perhaps there’s a role here for the Auditing and Assurance Standards Board as well.

3.4.1 Summary

Standard setters vary in their suggestions as to which party might be given responsibility for providing incremental disclosures surrounding the auditor’s use of the materiality concept and where such disclosures might be located. Suggestions for responsibility range from auditors themselves and audit firms to the AUASB, professional accounting bodies and the Australian Shareholders’ Association. Suggestions for positioning range from the audit report and forums held by the above-mentioned bodies to the publications of the audit firms.

4.0 Issues and implications

The issue of materiality in the audit was discussed during the interviews both as a consequence of specific questioning and more broadly. The notion of having some form of disclosure of the level(s) of materiality was common among users and purchasers and was mixed among suppliers, standard setters and regulators. Those who did not support some form of disclosure of materiality included those who believed that participants in the capital market did not read financial statements and therefore would be disinclined to inform themselves about issues of materiality or that the majority of the participants in the capital market would find the concept confusing and it would contribute to the audit expectations gap rather than assist in closing it.

Those who played a standard setter’s or regulator’s role also observed that while there had been audit failures in Australian corporate history and
UNdERSTANdINg oF MATERIALITY

elsewhere, none related directly to a misinterpretation, misunderstanding or miscommunication on the matter of materiality, but went to more fundamental issues. There were some responses to these more negative positions, including the notion that while not all those who participated in the market would necessarily understand the concept of materiality, even if disclosed or discussed in some form, there would be more informed users who represented the price makers in the capital market and even if that small minority was informed it would assist in making the market more efficient.

Some who were negative about further disclosures in this area made the observation that the real thrust of what was needed was more confidence in the existing process and framework—for with this came a reduced need for further disclosures.

While this argument is held with some degree of passion, particularly by suppliers, it runs the risk of being interpreted as patronising. By this statement, the authors mean that the supply side within the profession might be viewed as providing information and therefore accountability only when they believe it is in their interests to do so and those people expert in the market know enough to be able to protect all market interests. The parallel might be a distinguished surgeon who has such great knowledge of surgery that he or she makes all decisions with respect to the surgery, doing away with informing the patient of key aspects of the procedure. Of course, the parallel here is the issue of informed consent. If those participating in a capital market know key issues about an audit that would more fully inform the capital market then why is this not provided? It might represent the equivalent of informed consent in surgery.

A large majority of all interviewees suggested that some form of disclosure would be useful, however, suggestions about the nature of that disclosure, to whom the disclosure was made, where the disclosure was made and what form the disclosure would take were quite varied. There were various innovative ideas as to what could be achieved. There are, however, some important caveats that need to be considered before any final decision is taken.

Among suppliers, purchasers and some users, there was a view that providing disclosure of the existence of a materiality threshold influencing the audit represented a key ingredient in advising the market that the audit was not a 100 per cent guarantee that the representations made in
the financial statements were entirely accurate. That is to say, if the market is informed that there is a materiality threshold, the notion of a 100 per cent guarantee is immediately removed.

There is a key set of issues around what type of disclosures are necessary or useful with respect to materiality. Users and purchasers focus on the quantitative aspects of materiality. When discussing this issue with suppliers, there was considerable debate surrounding the fact that materiality involved both quantitative and qualitative characteristics and hence the complexity of materiality judgments could not be underestimated. This gives rise to an important choice in terms of disclosures between some aggregated, quantitative, estimative materiality or a more simple conceptual disclosure of the presence of materiality. Further, some suppliers argued that at audit committee level, it was common to have a discussion about materiality at an aggregate level, but when one discussed line items in the financial statements on the basis of materiality, occasionally the discussion could become ‘heated’. Another factor to bear in mind with respect to disclosure of quantitative estimates of materiality—although not brought out in the interviews—is that this might present a useful piece of information (that could have damaging consequences for the auditee) for those who might seek to commit fraud to a level below the materiality threshold against the auditee.

Those who favour disclosures of the concept of materiality make a compelling argument that the qualitative characteristics are a key aspect to the determination of materiality. For example, materiality levels over related-party transactions might be very different to materiality levels over accounts receivable. The nature of these two items is different, which drives dissimilar relevant materiality levels.

There is also active debate about to whom and when the materiality disclosures should be revealed. On the one hand, there is strong argument that boards of directors/audit committees are the appropriate audience for this information and the appropriate time is at the audit planning stage. In this circumstance, both qualitative and quantitative issues could be discussed at considerable length. There is a strong argument that the existing best-practice guidance, including the ASX corporate governance guidelines, could explicitly make reference to the fact that audit committees have a responsibility to be informed on matters of materiality and that audit committee charters should reflect this.
The more controversial disclosure would be to shareholders and therein lies the debate about the level of understanding and potential confusion these disclosures could cause. There were, however, persuasive comments that more complete discussion about general aspects of materiality could be included on an auditee’s web site or on the web sites of the audit firms, the AUASB or professional associations.

Some of the more experienced and sophisticated interviewees were strongly of the view that better communication of materiality was an area where action could and should be taken. The authors of this report note that successive governments have encouraged retail shareholders to participate in the capital market but this encouragement has not been matched by equivalent public support mechanisms to assist them into this participation. There has been an implicit assumption that the free market behaviour of Australia’s capital market will ensure their rights and interests are protected. Disclosures, including that of materiality, might be a key factor in effective participation in the capital market. Not informing participants is a public policy issue. Put more directly, some widespread understanding that materiality levels exist within the audit poses a significant benefit in reducing the audit expectations gap if, by virtue of its disclosure, it removes the notion that the audit is somehow comprehensive and is a guarantee that the transactions and financial representations made are 100 per cent guaranteed by the auditor.

5.0 Concluding remarks

If the capital market had information about materiality then it seems certain that it would use it to enhance market efficiency. This can be illustrated by reference to two examples. The first example is a hypothetical one, in which we have two absolutely economically identical companies trading on the stock market with assets, profitability and prospects as well as risk, which are identical. One company, however, is audited with a materiality level of $2 million and the other with a $6 million threshold. In an efficient market, investors would gravitate to the first mentioned company because of the prospect that its financial statements are likely to be more ‘finely tuned’ than the second company’s. A second example is more realistic in a sense that one might have two companies that have different asset structures and different prospects for the future. One company, however, has a governance structure that ensures it has a very low level of materiality.
as part of the audit process and the other company is more aggressive in its behaviour and has agreed with its auditor to a much higher level of materiality. The second company represents for an investor a higher level of information risk, which would need to be incorporated into the investor’s decision making. If investors have a large appetite for risk then they are more attracted to the second of the two potential investments. These examples imply that the absence of information about materiality results in a cost being borne by the capital market.

Despite the efficiencies that would flow to the capital market, we find little if any empirical evidence of the public disclosure of materiality. We also find significant diversity of practice among audit committees in asking for or being provided with materiality information. There is little direct guidance available for audit committees on this issue. Some—perhaps many—audit committees seek direct and substantial information on materiality from their auditor. One or two might seek to avoid that knowledge. Others might not know of its availability and its role within decision making on the quality of the audit—hence, our observation about diversity in practice. This variability is troubling from a public policy setting. An implication is that guidance or even requirements for boards and/or audit committees could be enhanced to make express reference to the desirability of having a conversation with their auditor about materiality, if not their right to ask for disclosure to them of the level or levels used. In the same vein, board and audit committee educative processes could mandate the inclusion of a discussion of materiality.

Who could be responsible for providing this guidance? Clearly, the AUASB could be a vehicle for providing this guidance, as could be the ASX and/or the AICD. Each would have varying attributes and bring varying qualities to the provision of such guidance.

Clear communication with management—as opposed to boards and audit committees—with respect to the materiality level has some potentially disadvantageous effects. It is the case that some managers might use knowledge of the materiality level as ‘pushback’ on the auditors and it might be used to dissuade auditors from pursuing a line of inquiry if the matter in question is under a pre-specified materiality level. In other words, management might use this knowledge to dissuade auditors from following their own preferred line of inquiry. Similarly, if materiality levels become known within an auditee, those who wish to commit fraud or engage in other opportunistic behaviour could have valuable information
with which to work that would not be available in the circumstance of uncommunicated materiality levels.

Despite the fact that the capital market is a global one, any specific guidance on materiality has to recognise that there is a sharp difference between the US regulatory style—to which some of Australia’s companies are exposed—and the common experience in the Australian capital market. It would seem that in the US system, if there is error, the tolerable materiality level is zero. This comes about because of accounting standards that are interpreted to mean that any error might affect the decision making of users and hence needs to be corrected. This is not the application in Australia. One consequence of this is that there is a higher proportion of modified audit reports in the Australian jurisdiction than in the United States and it would seem that there are more restated accounts in the US system. Some might argue that the Australian system is more tolerant of imprecision.

In the eyes of retail investors and possibly even some more sophisticated users and purchasers of audit services, as well as accounting students who might be useful surrogates for some of the above, there is the possibility of materiality being misconceived because some of the dynamics of materiality are counterintuitive. In common language, the convention is that the ‘more material, the better’. In its application to auditing, however, the higher the level of materiality, the ‘weaker is the audit’. That is, where materiality levels are higher, the screen through which the auditor puts the transactions and balances is coarser. Put more directly, more gets through the screening device undetected. As noted above, the alternative expression to materiality is ‘tolerable error’. The authors would speculate that usage of the term ‘tolerable error’ in guidance or elsewhere might be received with more clarity than the term ‘materiality’.

Some respondents made the suggestion that the key to understanding materiality was to turn to the auditing standards. These standards, even in the hands of experts, are insufficient in order to calibrate levels of materiality for any given engagement. The rationale that all can be found in the auditing standards is, in the view of the authors, false because so much rests on the proprietary audit models of the audit suppliers. This further supports the necessity for clear guidance.

The evidence we have gathered, either expressly or impliedly, refers to quantitative materiality thresholds, but there is also reference, particularly from suppliers, to qualitative materiality. This introduces a level of
subtlety and complexity that is hard for even sophisticated stakeholders in the capital market to get a good handle on. Further, it makes the audit more opaque, less understandable and more mysterious.

In addition to the complexities introduced by qualitative aspects to materiality, it is the case that there are multiple levels of materiality that apply in any given audit and so a conversation that talks about a (singular) materiality level is in many instances overly simplistic and makes the difficulties of communication to relevant stakeholders on materiality more complex than might be represented.

Among the unforeseen consequences of this project have been some observations about undergraduate auditing education and its placement within the curricula and the perspective with which it is taught. Conventionally, because of the perceived need to have a fulsome education in financial accounting, auditing is taught towards the very end of a commerce degree. A non-conventional alternative would be the early introduction of auditing so that a student’s exposure to financial accounting issues can be informed from an audit point of view. This could give the student a more subtle and insightful perspective on their education in financial accounting.

It is also possible that with auditing being taught earlier in the curriculum, it might be less technically focused and more conceptual. This being the case, the use of case studies could lend itself more positively to the educational experience of the student. The consequence of this would be lower levels of technical knowledge of auditing standards; however, one might speculate that those students who go on to auditing are re-educated on these through their professional training.

From our discussions, it would seem that materiality is crucial to the quality of the audit, is never expressly referred to in the audit report and is less than universally discussed even among audit committees. This being the case, we would argue that materiality has a significant role in the existence and extent of the audit expectations gap. It is the case that auditors use materiality as a crucial screening device for the conduct of their professional work. Closely related to this is their use of sampling. Sampling and materiality are keys to audit quality and to cost. This, together with the quality of the staff undertaking the audit, the methodology employed, the wider availability of expertise and
mechanisms for ensuring independence are keys to the completion of a satisfactory audit.

As conventionally worded, the audit report makes no explicit reference either to the level of materiality or to sampling. Materiality can be represented by reference to the aggregate absolute dollar value that applies generally to the engagement. Sampling has direct consequences on the probability that misstatement will occur. Note particularly that current conventional wording to ‘test’. ‘Test’ could mean that 100 per cent of transactions are tested or that some smaller proportion is examined. It gives no hint that it is a proportion or sample that is tested or that there is existence of a probability around that test.

One wonders if an audit report that, among other things, states that ‘this audit is a certification of the X percentage probability of the absence of misstatement in the financial report above an absolute aggregate dollar value of Y’, would be subject to the same level of misinterpretation that has been attributed to the current wording in the audit expectations gap literature.

The fact that materiality levels and the cost of an audit are so inexorably linked is known by a number of purchasers, and probably every supplier in the market for audit services. The fact that it is not seen as an express part of the negotiation over the quality of the audit (and as an opportunity for an added assurance service) is, however, an important oversight in the market for audit services. We found little evidence that there were negotiations over materiality levels and that this aspect of quality and price appeared to be treated as independent from each other in all but a handful of cases. Surely, as part of an efficient market for audit services, this should be more explicit.