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The Effects of Materiality Concept on Auditing Practices and Decision Making

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Abstract
This study aimed at investigating the effects of materiality concept on auditing practices and decision making, a case study of Cross River State, Nigeria. The purpose of the study was to examine the effects of the types of materiality, component and performance materiality on auditing practices and decision making. To be able to examine the relationship, two research hypotheses were posed and tested at 0.05 level of significant. The statistical tool used for the analysis was ordinary least square (OLS) method with the aid of SPSS 20 due to its versatility. The results obtained from the study showed that component materiality has a positive relationship with auditing practices and decision making in organizations. The result further showed that performance materiality does not significantly affect audit practices and decision making. Based on these findings recommendations were made to support auditing practices and decision making as a whole.

1. Introduction
The application of materiality concept is not a new issue of discussion. The materiality concept plays a major role in any decision making related to management, accounting and auditing fields. The concept of materiality states that: "Information is material if omitting it or misstating it could influence decisions that users make on the basis of financial information about a specific reporting entity."(International Accounting Standard Board, 2010:84). In other words, materiality depends on stakeholders and what they find will influence the decisions they make on the basis of financial information.

The concept of materiality may be perceived simple but it is central in applying Generally Accepted Auditing standards (GAAS). Standard setters, regulation enforcers and legislators find the concept of materiality interesting as they are concerned about different views that exist on materiality concept, particularly expressing concern about apparently heterogeneous materiality assessments made by auditors resulting in different information in financial statements and thus different decision bases for users. (European Securities and Markets Authority,2013). Standard setters at both the national and international level, are conducting projects that aim to improve audit reporting on financial statements, recommending more information in the auditor's report about materiality.

This work will examine the effect of component and performance materiality concept in line with general audit practices and decision making. The analysis will enable auditors to make more homogeneous decisions.

1.1 Statement of the problem
The materiality threshold should be based upon what will affect financial statement user's decisions and not upon preparers' arbitrary assessments. These decisions should be based both on quantitative as well as qualitative factors because both have effects on materiality.

For many years now auditors have used quantitative method to help them identify potentially material transactions. Working materiality levels on quantitative estimates of 5% rule of thumb, which holds that reasonable financial statement users would not be influenced in their investment decisions by a fluctuation in net income of 5% or less. Nor would the investor be swayed by a fluctuation or series of fluctuations of less than 5% in income statement line items, as long as the net change was less than 5%.

The use of these quantitative thresholds, such as 5 percent of some income statement number, to assess materiality does not serve the users interests, other qualitative factors of assessing materiality in auditing practices should not be ignored. The researcher using the concept of component and performance materiality seeks to explain that materiality assessments should be based on a standard of whether the item would make a difference to an informed financial statement user for decision making.

1.2 Objectives of the study
The main objective of this study is to examine the effects of materiality concept on auditing practices and

decision making. This will be achieved with the specific objectives as listed below:

(i) To precise the concept of materiality and explain the relationship that exist between component materiality and auditing practice,

(ii) To examine the relationship that exist between performance materiality and auditing practices as it relates to decision making

1.3 Research hypotheses

H_0: Component Materiality has no significant effect on auditing practices and decision making

H_0: Performance materiality has no significant effect on auditing practices and decision making

2. Literature review

2.1 Materiality concept

The concept of materiality is essentially an accounting term that has been defined by the International Accounting Standards Board (IASB) (2010) as:

"Information is material if omitting it or misstating it could influence decisions that users make on the basis of financial information about a specific reporting entity. In other words, materiality is an entity-specific aspect of relevance based on the nature or magnitude, or both, of the items to which the information relates in the context of an individual entity's financial report".

Auditing adopted this definition of materiality. In auditing, the materiality concept is used to design and perform an audit that provides reasonable assurance of detecting misstatements that are of a sufficient magnitude to affect the judgment of reasonable financial statement users, as it is not the goal to perform an audit that catches every misstatement no matter how small (Eilifsen et al. 2014). Auditors assess materiality for the financial statements as a whole and decide on performance materiality for significant accounts or disclosures.

Another definition worthy of note here is the International Standards on Auditing 320 which states that: The auditor's consideration of materiality is a matter of professional judgment and is influenced by the auditor's perception of the needs of users of financial statements. The perceived needs of users are recognized in the discussion of materiality in Financial Accounting Standards Board (FASB) Statement of Financial Accounting Concepts No. 2, Qualitative Characteristics of Accounting Information, which defines materiality as "the magnitude of an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement." This discussion recognizes that materiality judgments are made in light of surrounding circumstances and necessarily involve both quantitative and qualitative considerations.

2.2 Audit Objective and Materiality

The primary objective of an audit of financial statements, prepared within a framework of recognised accounting policies and practices and relevant statutory requirements, if any, is to enable an auditor to express an opinion on such financial statements. Such opinion as expressed by the auditor helps in the determination of the true and fair view of the financial affairs of an enterprise. The objective of the auditor according to NSA 10 is to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels, through understanding the entity and its environment, including the entity's internal control, thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement. The users are not in position to assume that the auditor's opinion is an assurance as to the future viability of the company or the efficiency or effectiveness with which management has conducted the affairs of the company. CAMA 1990 requires that the profit and loss account should disclose every material features. The concept of materiality recognises that some matters, either individually

or in the aggregate, are relatively important for true and fair presentation of the financial information in conformity with recognised accounting policies and practices. The auditor should consider materiality at both the overall financial information level and in relation to individual account balances and classes of transactions. It is necessary for the auditor to obtain sufficient appropriate audit evidence which may be influenced by the materiality of the item, before making an opinion on the financial statements.

2.3 Audit practice and the determination of materiality

Determining materiality level involves the use of professional judgment. A percentage is often applied to a chosen benchmark as a starting point in determining materiality for the financial statements as a whole. Factors that may affect the identification of an appropriate benchmark include the following:

• The elements of the financial statements (which includes, assets, liabilities, equity, revenue, expenses);

• Whether there are items or components on which the attention of the users of the particular entity's financial statements tends to be focused (for example, for the purpose of evaluating financial performance users may tend

to focus on profit, revenue or net assets);
• The nature of the entity, in other words the stage where the entity is in its life cycle and the industry and economic environment in which the entity operates;
• The entity's ownership structure and capital structure (for example, if an entity is financed solely by debt rather than equity, users may put more emphasis on assets and claims on them, than on the entity's earnings); and
• The relative volatility of the benchmark.

Examples of benchmarks that may be appropriate, depending on the circumstances of the entity, include (Azzopardi,2012):

1. Pre-tax income	5-10%
2. Net (or after-tax) income	5-10%
3. Gross revenue	0.5-1%
4. Equity	5-10%
5. Total assets	0.5-1%

The main outcome of a survey carried out by Azzopardi (2012) shows that materiality thresholds based on the income statement are the most favoured for the financial statements as a whole; typically 5-10% of pre-tax income. The various elements of the financial statement are considered when arriving at this benchmark with materiality typically been established by the partner with the engagement team. Non-big four firms sometimes leave this to the auditor on the job. Whereas big four firms assign different materiality levels to different clients.

However, there are no sets of rules or procedures that may be applied consistently for determining audit materiality. What may be material in one circumstance may not be material in another. CAMA 1990, requires that the profit and loss account should disclose every material features. The users of the financial statements expect that the financial statements should be reliable and should disclose accurately all the material information in respect of financial matters and otherwise of the entity. While conducting an audit the auditor should adopt appropriate audit procedures and measures to identify material misstatements and to assess them to make an opinion on the financial statements. Whenever the auditor faces a difficult situation to decide whether a particular misstatement is material or not, its impact, either individually or when aggregated with other misstatements, on the financial statements of current period, or its expected impact, either individually or when aggregated with other misstatements, on the financial statements of later periods, should be considered

2.4 Component materiaity and auditing practices

The auditor should determine the amount or amounts of tolerable misstatement for purposes of assessing risks of material misstatement and planning and performing audit procedures at the account or disclosure level. The auditor should determine tolerable misstatement at an amount or amounts that reduce to an appropriately low level the probability that the total of uncorrected and undetected misstatements would result in material misstatement of the financial statements as a whole. Accordingly, tolerable misstatement for the different components and class of transactions should be less than the materiality level for the financial statements as a whole and, if applicable, the materiality level or levels for particular accounts or disclosures.

In determining tolerable misstatement and planning and performing audit procedures, the auditor should take into account the nature, cause (if known), and amount of misstatements that were accumulated in audits of the financial statements of prior periods.

2.5 Performance materiaity and auditing practices

Performance materiality *is the materiality established for a particular component inside financial statement for example an assertion level* i.e. materiality established while performing audit procedures on certain account balances and/or transactions etc. This is deliberately settled lower than the materiality level for the financial statements as a whole so that overall misstatements are kept under the materiality level for the financial statement as a whole.

Financial statements are made up of different accounts which are connected with each other. Every account is interdependent and error in one can pose problems in other areas of accounting. It should be noted that in a financial statement as a whole some accounts are more crucial than others and slightest misstatements in them can be material in nature which can cause whole financial statements to be useless or meaningless. This is why in auditing practice, the auditor ignores some misstatements in certain accounts and for certain accounts he asks management to correct the misstatements promptly.

Auditors have different level of materiality for different accounts so that no material misstatement either individually or collectively render financial statements useless for users of financial statements.

2.6 Materiality and Users

In the audit of financial statements, the auditor's judgment as to matters that are material to users of financial statements is based on consideration of the needs of users as a group rather than individually; the auditor does not consider the possible effect of misstatements on specific individual users, whose needs may vary widely. The evaluation of whether a misstatement could influence decisions of users, and therefore be material, involves consideration of the characteristics of those users. Users are assumed to:

a. Have an adequate understanding of business and economic activities and accounting and a willingness to study the information in the financial statements with an appropriate diligence;

b. Understand that financial statements are prepared and audited to certain levels of materiality;

c. Recognize the uncertainties inherent in the measurement of amounts based on the use of estimates, judgments, and the consideration of future events; and

d. Make appropriate economic decisions on the basis of the information in the financial statements.

The determination of materiality, therefore, takes into account how users with such characteristics as identified above could reasonably be expected to be influenced in making economic decisions.

2.7 Materiality and Disclosure

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

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

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

3. Method

This paper used a survey research design to obtain data from primary sources through the use of questionnaires. The questionnaire was designed and a Test retest Method was carried out to check for data instrument reliability. The correlations between both responses were high hence confirming reliability of the instrument. The population comprise of all audit firms in Calabar, Cross River state. Judgemental Sampling was employed to select sample size to collate data for the purpose of analyses.

3.1Model specification

This study specified a simple regression equation model to analyse the relationship between the types of materiality and audit practice and decision making. The relationship between the variables is represented by the model:

$APD = \beta_0 + \beta_1 CPM + \beta_2 PFM + \mu_1$

Where:

β_0 = Constant
APD = Audit practices and decision making
CPM = Component Materiality
PFM = Performance Materiality
μ_1 = error

3.2Data presentation and analysis

The data were analysed using the Ordinary Least Square (OLS) method with the aid of SPSS 20 because of its versatility. The results obtained from the regression are presented and interpreted below.

Table 1: Regression Results
Dependent Variable: APD
Method: Least Squares
Date: 08/14/17 Time: 12:34
Sample: 46
Included observations: 46

Variable	Unstandardized Coefficients		Standardized Coefficient	t-Statistic	Prob.
	Coefficient	Std. Error			
(Constant)	8.251	4.203		1.963	0.056
CPM	0.213	0.164	0.193	1.298	0.201
PFM	0.360	0.186	0.288	1.934	0.060

R-squared	0.157	Durbin-Watson stat	2.323
Adjusted R-squared	0.118		
F-statistic	4.019		
Prob. (F-statistic)	0.025		

Source: SPSS 20

The regression result shows the systematic relationship between Auditing practice and Decision making, and Component materiality and Performance materiality. The coefficient of determination (R-squared) shows the explanatory power of the model. This is the squared correlation coefficient, it generally predicts relationship and variability caused by the model. We use the adjusted component of the coefficient of determination to explain this because it accounts for degrees of freedom. It is only influenced by variables that causes variability in the dependent variable. The adjusted R-squared value of 0.118 shows that the independent variables, component materiality and performance materiality explain about 11.8% of the systematic variations in Auditing Practice and Decision making of the sample studied. Auditing practice and decision making in organisation are influenced by several variable including firm size and transaction volume, location and dispersion of branches, complexity and weakness of control systems. However, the entire audit opinion hinges upon the materiality level chosen for the audit, hence the results obtained from the model.

The Durbin Watson statistic of 2.323 hovers around 2 which is the conventional level and indicates the absence of autocorrelation in the independent variables.

The F-statistic of 4.019 with a probability of 0.025 shows that the independent variables are jointly significant. The p – value of 0.025 is less than 0.05 hence we reject the null hypothesis and accept the alternate hypothesis. Hence the null hypothesis that states that the model does not have predictive variables is rejected. Therefore it is concluded that the model predicts the relationship between the variables.

Hypothesis Testing

Hypothesis 1

- H_0: Component materiality has no significant effect on Auditing practices and decision making.

The results obtained shows that with a t-statistic of 1.298 and a probability of 0.201, the P-value is higher than the 5% (0.05) significance level threshold, hence we accept the null hypothesis and reject the alternate hypothesis. The decision rule is also checked by confirm that t-statistics calculated of 1.298 is greater that t-statistics critical value of -1.681. We therefore accept the null hypothesis that says Component materiality has no significant effect on Auditing practices and decision making

Hypothesis 2

- H_0: Performance materiality has no significant effect on Auditing practices and decision making.

With a t-statistic of 1.934 and probability 0.060, the P-value is higher than the 5% (0.05) significance level threshold, hence we accept the null hypothesis and reject the alternate hypothesis. The decision rule is also confirmed by checking that t-statistics calculated of 1.934 is greater that t-statistics critical value of -1.681. We therefore accept the null hypothesis that says Performance materiality has no significant effect on Auditing practices and decision making.

3.3Discussion of Findings

Generally, the auditor as well as managers set threshold level at which non-inclusion or incorrect disclosure of transactions either in component or aggregate makes the financial statement wrong. This materiality levels are found to be jointly significant. However, the individual types of materiality used in organisations as discovered in this study were found not to be significant.

The results obtained showed that component materiality has a positive relationship with Auditing practices and decision making in organisations, although this relationship is not significant. This result is plausible in real life scenario because a group audit will comprise of different individual audit at different companies which makes up one single entity. Auditors over time have learnt and planned audits methodically to hover around transactions which fall below the materiality level as there is tendency for high frauds at that point. Different companies within the group will exhibit different characteristics which will impact heavily on the auditor's procedures if different materiality levels are observed. Component materiality is very useful where the audit firm has the capacity to handle the individual companies within the group, but this consideration may not be the sole determinant for the general audit procedures.

The results also showed that performance materiality does not significantly affect audit practices and decision making. The overall threshold at which all misstatements become material only impacts on decisions when this phenomenon occurs in organisations. The auditor most concentrates on the general materiality level during an engagement. Audit planning and execution is mostly based on the transaction levels at chosen materiality levels, the minor misstatements are only called into consideration where the frequency of such are consistently high. The auditor makes a plan action for the cases where performance materiality reaches the threshold but does not focus completely on this level rather he does on the general materiality level.

3.4Conclusion

Based on the result of the findings, the following conclusions were made;

i. Component materiality has a positive impact on auditing practices and decision making,
ii. Auditors must concentrate on the determination of the materiality level both at the class of transaction level and the financial statements as a whole.

3.5Recommendations

1. To implement the method of materiality, audit managers should keep in mind that the content and preparation of working documents requires the engagement of auditors with:
   - High degree of qualification for the engaged auditors,
   - Experience in auditing the financial statements,
   - Good knowledge on accounting standards and operation of this system
2. The audit team should apply with caution and intelligence:
   - Coefficients applied to calculations
   - Determining materiality of the transactions that will be tested to argue conclusions both in component and aggregate.
3. In all cases, the audit team (auditor) should:
   - Provide support for the findings,
   - Provide complete and accurate evidence for the findings, and
   - Provide conclusions and recommendations
4. Auditors at the end of the audit should prepare a detailed report, which should include: the realization of the objectives, scope and methodology of the audit, audit results, findings, conclusions and recommendations.

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