

Materiality of misstatements from the perspective of the users of the financial statements - Narrowing the expectation gap between users and auditors

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Executive Summary

Misstatements or omissions in the financial statements are considered material if they could influence the economic decisions of users based on the financial statements. This research presents an empirical research, which provides evidence that a relevant expectation gap regarding materiality of misstatements exists between users of the financial statements and auditors. This gap can mainly be explained by lack of communication.

According to the respondents, the expectation gap can be narrowed by introducing a uniform guideline, which incorporates quantitative rules, and especially by disclosing the materiality threshold used by the auditor in the audit report.

1. Introduction and research questions

Introduction

‘Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements.’
(NIVRA 2007, NV COS 320.3).

As long as misstatements do not violate the true and fair view the financial statements give of the financial position of a company, they are considered immaterial. It is the responsibility of the auditor of the financial statements to be reasonably sure that the financial statements are free from material misstatement.

Because the user is the one, who makes decisions based on the annual financial statements, in theory it should be the user of the financial statements, who decides what is material and what is not material. However, users of the financial statements are not a homogenous group. Shareholders, creditors and clients have different information needs and preferences and therefore consider other things as being material to their decisions.

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Therefore, in practice the auditor decides on materiality thresholds for the audit of the financial statements. The auditor is the confidant of the financial statement users who audits the financial statements of a company on behalf of the users.

The auditor assesses the level of misstatement above which economic decisions of users of the financial statements will be affected. Next to his professional judgment of the perceived threshold of users, rules and guidelines support the auditor executing his materiality decisions. Real consultation of the user of the financial statements is unusual.

Although the definition of the term explicitly addresses users' economic decision-making, in practice, users are not involved in the concept at all.

This gives reason to suspect that the implications of the concept of materiality are not known, or not fully known to users of the financial statements.

Economic scientific literature refers to the existence of an expectation gap between auditors and users of the financial statements, if what the users perceive the auditor does is not in line with what the users expect the auditor does (Porter 1993, 49). This gap can also exist where it regards materiality.

Research question

A suitable way to discover what users need regarding materiality and how to narrow the possible expectation gap is to consult the users themselves.

Therefore, the main question in this research is:

'Does a relevant expectation gap exist between users of the financial statements and auditors concerning materiality of misstatements, and if so, in which way do the users want to narrow this gap?'

In order to arrive at an answer to this main research question, several sub topics will be outlined in this paper.

In this chapter, the concept of materiality of misstatements and its relevance were introduced.

Chapter 2 explains the relation between users and auditors by describing the origination of the audit of the financial statements from the point of view of the agency theory and by describing in which way materiality levels are determined.

The expectation gap is introduced in chapter 3.

In chapter 4, the issues concerning materiality that might contribute to an expectation gap are structured into possible measure to improve the concept of materiality to users. Based on an instrument that is specially designed for this research, hypotheses are derived that forecast what measures users want to introduce to narrow the expectation gap.

Chapter 5 outlines the design of the empirical part of the research that is executed among users of the financial statements.

Chapter 6 presents and analyses the results of this empirical research, which contain information regarding the knowledge and opinion of users regarding materiality and the measures they would like to introduce in order to improve the concept of materiality. The last chapter - chapter 7 - presents the answer to the main research question. Finally, recommendations for future research and for audit practice are presented.

This scientific research aims at providing insight in the composition of the expectation gap regarding materiality. At the same time, measures that might narrow the expectation gap are presented to the users of the financial statements. Recommendations result from this, which might contribute to the narrowing of the possible expectation gap regarding materiality.

2. The user of the financial statements, the auditor and materiality

The Framework of the IASB

It is commonly accepted that well-functioning capital markets are a key to economic development and growth. The financial statements of a company are a valuable economic decision-making tool for users of the financial statements and therefore, the financial statements contribute to the well functioning of the capital markets (Hoogendoorn and Mertens 2001, 3/10). This is one of the reasons, why companies need to prepare financial statements. According to the Framework for the Preparation and Presentation of Financial Statements (Framework) of the International Accounting Standards Board (IASB), is 'the objective of financial statements to provide information about the financial position, performance and changes in financial position of an entity that is useful to a wide range of users in making economic decisions' (IASB 2005, Framework, paragraph 12).

The Framework also describes what qualitative characteristics information should possess in order to be useful. These are: Understandability, relevance, reliability and comparability (Framework, paragraph 24). When preparing the financial statements, the management of the company should at all times keep these qualitative characteristics in mind. These elements of useful information are also used in assessing the usefulness of the measures for improving the concept of materiality (see chapter 4).

The agency theory and the audit of the financial statements

Financial statements have to be put up for company-stakeholders. However, management of the preparing company can have goals that deviate from the goals of the users of the financial statements, or unintentional mistakes can be made when preparing the financial statements. Users cannot just rely on the financial statements to present a true and fair view of the company's income and assets and liabilities. This is an agency problem (Jensen and Meckling 1976).

A solution to solve or diminish the agency problem of potentially unreliable financial statements presented by the management of the company, is the introduction of a monitor. This is the auditor. The auditor assesses on behalf of the principal (the

shareholder) whether the agent prepared financial statements that are in line with the applicable rules and regulations and present a true and fair view of the company.

In the Netherlands, the auditor is the legally required external monitor that represents the interests of all the users of the financial statements (Santen et al. 2006, 48).

Audit rules

The audit of the financial statements originates from the need to have an independent party assessing the reliability of the financial statements. Materiality is a concept that relates to the audit of the financial statements. The choices of the auditor regarding the materiality thresholds have influence on the financial statements and subsequently on users' decision-making. Therefore, in which way to handle the concept of the materiality of misstatements has been a matter of continuous discussion.

Rules and guidelines are available in audit standards, in audit literature and in audit manuals of audit firms. In the Netherlands, the rules for auditors regarding the audit engagement are incorporated in the so-called Nadere voorschriften Controle- en overige standaarden (NV COS), which are drawn up by the NIVRA.

Most of the applicable rules regarding materiality are included in NV COS 320 - Audit Materiality (NIVRA 2007). Paragraph 4 of this audit standard states that 'the objective of an audit of financial statements is to enable the auditor to express an opinion whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework' (NIVRA 2007, NV COS 320.4). In the Netherlands this is the framework of the IASB.

To achieve the goal of an audit the auditor successively plans and designs an audit approach, executes the audit procedures based on the audit plan and evaluates the results of the audit (Arens et al. 2007, 160).

Evaluation materiality

Throughout the audit process, the auditor uses different materiality levels for different purposes. The most relevant materiality level to the user is the materiality level that is set by the auditor at the end of the audit and on which he bases his opinion whether the financial statements represent a true and fair view or not. This is the so-called *evaluation materiality*. The determination of this materiality level consists of selecting a materiality benchmark and a percentage to quantify the materiality level (Arens et al. 2007, 250). Net income before taxes is frequently considered the most sensitive predictor of future cash flow for a company and a critical item of information for users. That is why auditors often choose income as a benchmark (Arens et al. 2007, 250; Zuber et al. 1983, 43). The determination of a percentage depends on among other factors on the benchmark chosen. When the audit is fully executed, the auditor has to evaluate, based on the evidence gathered, whether the financial statements present a true and fair view of the financial position of a company. Financial statements may be materially misstated (or: alter users' economic decision-making) due to the effect of an individual omission or misstatement, or

due to the aggregate effect of a number of omissions or misstatements that are not individually considered material.

3. The expectation gap

The expectation gap

If what the users perceive the auditor does is not in line with what the users expect the auditor does, an expectation gap exists between users and auditors (Porter 1993, 49). In the first place, this expectation gap exists there were society (or the user of the financial statements) has unreasonable expectations of the auditor (unreasonable expectations gap). An auditor cannot fulfil all of society's needs because of limited control methods and control techniques and because a cost-benefit analysis needs to be taken into account. Secondly, sometimes the auditor does not live up to society's expectations, because he is limited or not required to do so by certain regulation (deficient standards gap). These two parts of the expectation gap together are also called the communication gap (Pheijffer 2005, 44).

A third cause of the expectation gap is a deficient performance by the auditor (deficient performance gap). The auditor does not always seem to be able to recognize what the reasonable expectations of society about the auditor's performance are, or he simply fails in doing his job.

Porter (1993) modelled the expectation gap as follows:

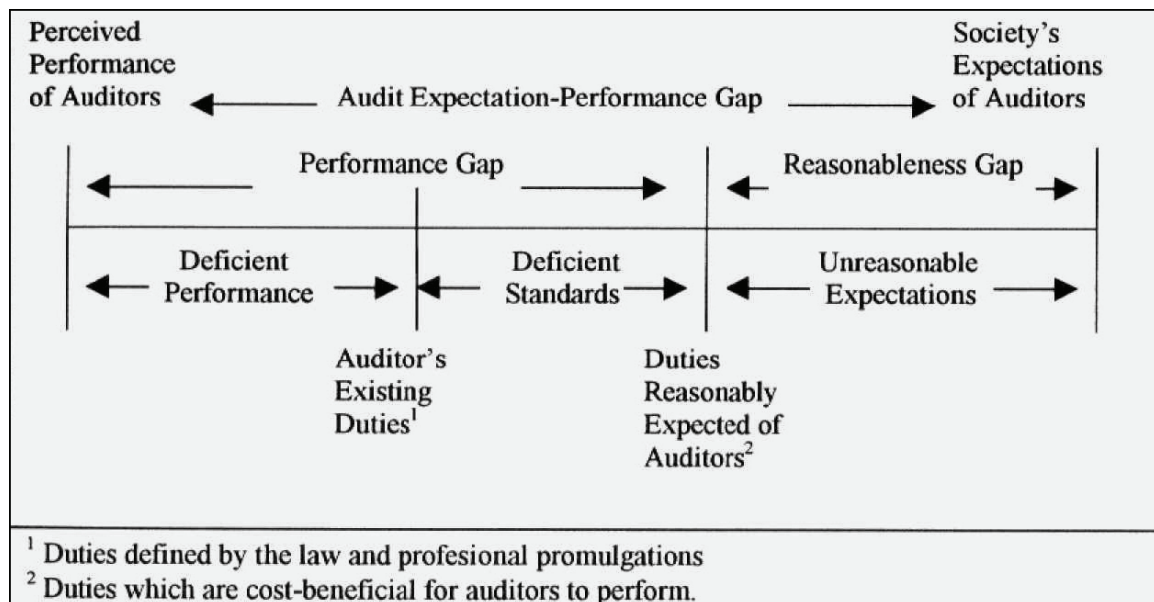


Figure 3.1 - The Audit Expectation-Performance Gap

An expectation gap regarding materiality seems to exist. Several studies indicate that users demonstrate lower materiality thresholds than auditors (deficient performance gap) (Cho et al. 2003, 75; Holstrum and Messier 1982, 58; Højskov 1998, 6). Many users expect that an unqualified audit report implies that an auditor has performed a hundred percent

check and guarantees the preciseness of the financial statements (unreasonable expectations gap) (Den Dekker 2005, 25; Gowthorpe and Porter 2002). The gap that is caused by unreasonable expectations of users is also referred to as the 'knowledge gap', because it results from users having not enough knowledge with respect to the auditors' existing responsibilities (Gowthorpe and Porter 2002).

In her research, Brakenhoff states that one third of the users of the financial statements are not informed about the concept of materiality (Brakenhoff 2002, 37).

The existence of an expectation gap regarding materiality, might contribute to a reduction of the perceived value of the auditor's opinion as regards to the true and fair view of the financial statements of a company. This is not in the interest of users and auditors of the financial statements. Therefore, it is important to know whether a relevant expectation gap regarding materiality exists and if so, how to narrow it.

4. Solutions to narrow the possible expectation gap

Introduction

In this chapter, based on issues commented in audit literature and scientific economic literature that might contribute to the existence of a gap regarding materiality, measures (or: 'solutions') are presented that might solve materiality issues.

In the second part of this chapter, an instrument is presented, based on which the solutions can be weighed in terms of desirability for the user of the financial statements. From this, hypotheses regarding the desirability of the measures are derived, which will be investigated empirically. This will contribute to getting insight in what needs regarding materiality the user might have and what measures need to be taken in order to reduce the expectation gap.

A uniform guideline

An often-heard shortcoming of the audit standards concerning materiality, is that they do not provide an unambiguous basis for the quantification of materiality (Majoor 2006, 50). The only information concerning materiality that users can derive from the audit report is the phrase 'the financial statements are prepared, in all material respects'. This does not contribute to much clarity and does not provide much information (Koopmans 2003, 15; Majoor 2006, 50).

If it is possible to formalize materiality practice into one uniform standard for the whole audit profession, the user has something to hold on to in determining the amount of immaterial misstatements or omissions that might be left in any financial statement.

Therefore, in the empirical research, the subsequent statement regarding a uniform audit standard is presented to the respondents of the survey:

A uniform guideline should be developed based on which all auditors are obliged to determine the materiality threshold.

Currently, no rules or guidelines exist in which a method for the quantification of the materiality threshold is incorporated and on which the auditor needs to base his materiality decision. It is possible for the auditor to use for example existing quantitative rules of thumb or the audit firms' audit manuals.

When developing a uniform guideline, the quantitative materiality level will be determined. The auditor is only allowed to deviate from this level if he motivates this. In any way, the auditor should apply his professional judgment, especially regarding qualitative elements. In the audit report will be reported in which audit standard of the NIVRA the condition is incorporated.

Abolish materiality

Many users of the financial statements have the supposition that the audited financial statements contain no omissions or misstatements. They assume and expect that during the audit, the auditor checks every item accurate to the euro (Den Dekker 2005, 25; Gowthorpe and Porter 2002). An unqualified opinion does only state that a user can reasonably rely on the information presented in the financial statements, not that it does not contain any errors or omissions of immaterial importance. On this point, an expectation gap seems to exist.

Although the auditor cannot give full insurance on the financial statements being fully correct, there exists discussion on to what extent the auditor should audit the financial statements. The cost aspect is of importance, but next to that the opinion exists that reputation damage could harm a company a lot more, if material errors become known after the issuance of the financial statements.

In the empirical research, the subsequent statement regarding abolishing materiality is presented to the respondents of the survey:

Materiality of misstatements should be abolished.

An example of a rule of thumb that is currently applied by auditors is a materiality threshold of 5% of pre-tax income. The auditor uses the established materiality level in planning the audit work that needs to be executed. The audit procedures to verify the financial statements are partial. They contain sampling of the segments.

A materiality of zero implies the auditor checks every item of the financial administration of the company that is contained in the financial statements (a full audit). All the identified misstatements need to be adjusted in the financial statements. In this situation, the financial statements might still contain misstatements that the auditor is not capable to detect, neither by means of a full audit. As a result of this measure, the audit would become much more expensive.

Correct all discovered misstatements

Many users of the financial statements are in the supposition that the financial statements contain no omissions or misstatements (Den Dekker 2005, 25; Gowthorpe and Porter 2002). This implicates they expect that all the detected misstatements are corrected. What is even less known, is that the auditor often advises management to correct immaterial

misstatements discovered during the audit, but that it is up to the management to decide whether they want to do that or not.

In the empirical research, the subsequent statement regarding the correction of discovered misstatements is presented to the respondents of the survey:

All detected misstatements should be corrected, whether material or not.

This measure requires that all the misstatements the auditor has identified during the audit, need to be corrected in the financial statements by the management, whether they are material or not (an exception holds for very small misstatements of for example < 1% of the materiality level). The audit is not aimed at identifying all the misstatements in the financial statements, as is the case with abolishing materiality.

Disclosure

The materiality of errors chosen by the auditor affects the annual financial statements. Depending on the choices, the financial statements may differ. The user has to execute his economic decisions based on the financial statements, but no information is presented in the audit report or any other place in the financial statements about the materiality level the auditor has determined (Koopmans 2003, 15; Majoor 2006, 51). The consequence is that the user cannot simply compare the financial statements of companies, especially not when different audit firms have audited them. Moreover, the user is not informed about the possible magnitude of deviation.

In the empirical research, the subsequent statement regarding the disclosure of materiality thresholds is presented to the respondents of the survey:

The materiality level that is applied by the auditor should be reported in the audit report.

In the audit report accompanying the audited financial statements, the auditor reports the applied materiality level and communicates a short explanation of the way in which the threshold is determined.

Shareholder input

As has become clear from chapter 2, during his audit the auditor determines the different materiality levels. When executing this, the auditor should base his decisions on the possible effect of a certain materiality level on the economic decision-making of users of the financial statements. Because the auditor is allowed to use professional judgment, no real obligation for the auditor exists to consult the user. It seems paradoxical that the users, for who the financial statements are prepared and audited, cannot influence the materiality deliberations made by auditors.

Therefore, in the empirical research, the subsequent statement regarding the input of the shareholder is presented to the respondents of the survey:

The shareholder should have a voice in the materiality level the auditor needs to apply.

Shareholders (possibly assisted by their financial advisors) should have the opportunity to yearly anonymously express the magnitude of the materiality level that is desired to the company's auditor, based on which the auditor should determine an average desired materiality level. Based on qualitative factors and his professional judgment, the auditor may adjust the materiality threshold downwards. Adjusting the materiality level upwards is not allowed.

No relevant expectation gap

Does materiality really matter to the user? There might be a gap, but the gap might not be relevant. Solutions that provide the user more insight in materiality all come at a cost (e.g. cost of working out the details) and are a hassle to implement.

In the empirical research, the subsequent statement regarding not changing the concept of materiality is presented to the respondents of the survey:

The way materiality of misstatements currently is designed, is good as it is.

As a user of the financial statements, you are satisfied about the way materiality is handled in practice by the auditor and of the degree to which you are informed about the concept. According to you, considering the possibilities presented before and your opinion regarding materiality of misstatements, no measures are needed.

Predictive instrument and hypotheses

While the importance of the different components of the expectation gap to users is not known, it is hard to predict how users perceive the concept of materiality as it is and what measures users might want to introduce in order to improve the concept, thereby narrowing the expectation gap. An instrument is developed to guide in predicting the users' preferences. The qualitative characteristics of information (see chapter 2) and a cost-benefit consideration are incorporated in this instrument. Next to that, another variable 'influence on users' perception' is added. Each component represents a characteristic that a measure might, or might not have.

This table indicates the relative preferences of each of the measures by the users. From this table, the hypotheses are derived that state whether the measure is valued by the user. These predictions can be helpful in interpreting the results of the empirical research and if they align with respondents' opinion, strengthen the conclusions of the empirical research.

Table 4.1 - Relative contribution of solutions to several characteristics of information²⁹

	Understan- dability	Relevance	Reliability	Compara- bility	Influence on users	Sub-total
Uniform guideline	1,4	0	0,6	1,4	0,6	4
Abolish materiality	0,4	-0,2	1,1	0,8	1	3,1
Correct all misstatements	0	0	1	0,4	0,6	2
Disclosure	0,6	0,4	0,6	1,2	1,6	4,4
Shareholder input	1	0,8	-0,4	-0,6	1,2	2
No change	-0,4	0,2	-0,2	-0,4	0,1	-0,7

Table 4.1 - Continued

	Easy	Cheap	Total
Uniform guideline	1,6	1,6	7,2
Abolish materiality	-0,6	-2	0,5
Correct all misstatements	1	-0,6	2,4
Disclosure	0,4	0,4	5,2
Shareholder input	-1,6	-1	-0,6
No change	0,8	0,8	0,9

The hypotheses that are derived from this table read:

- H1:** Users want the uniform guideline measure to be implemented.
- H2:** Users want the disclosure measure to be implemented.
- H3:** Users do not want the ‘correct all discovered misstatements’ measure to be implemented.
- H4:** Users do not want the abolish materiality measure to be implemented.
- H5:** Users do not want the shareholder input measure to be implemented.
- H6:** Users do at least want one measure to be implemented in order to narrow (part of) the expectation gap regarding materiality.

5. Design of the Empirical Research

Units of analysis

The research is executed amongst a variety of users of financial statements of listed companies. The biggest share of these users (83%) consists of shareholders and creditors.

²⁹ The table is compiled as follows: 5 independent auditors provided each of the characteristics of each of the measures a value of -2, -1, 0, 1, or 2, dependent on the relative contribution or reduction of each of the measures to the specific characteristics. The averages of these scores are included in the table. The auditors had to reason from the point of view of users when assessing the values of each measure.

Professional representatives of creditors and shareholders are equated with creditors and shareholders, while they represent the interests of shareholders and creditors.

The remaining respondents are persons that use the financial statements for a variety of purposes that do not contain considering, taking, keeping, or abandoning a financial interest in a company.

Questionnaires

The instrument that is suitable to conduct the research is a questionnaire, which can provide information about both knowledge and attitude (Baarda and De Goede 1995, 144). Two questionnaires (part one and part two) are developed. The first part consists of a questionnaire with questions about the respondent and his position and general open-ended questions about his knowledge and his perception of materiality of misstatements. From part one, the aptitude of the respondent, his or her knowledge of the subject materiality of misstatements and qualitative information will be derived. The purpose of this is to express an opinion on the existence of an expectation gap together with the results of the second part of the research. The biggest part of the second questionnaire consists of closed-ended questions (statements) about the desirability of the different materiality measures. The measures are briefly described and the respondent needs to assess the lacking details himself. The respondent needed to choose the desirability of a certain measure out of five response categories often referred to as a Likert scale (Babbie 2007, 170). Before conducting the actual research, the draft questionnaires were submitted to a pilot study.

Data collection

From the database of Company.info several lists of Dutch companies were derived in which professional representatives of financial statement users might work. These companies included among others banks, investment companies and pension funds. This method is called random availability sampling.

Approximately 85 companies have been approached personally by telephone. Thirty subjects agreed to cooperate. Personal questionnaires by mail or e-mail were sent to them.

Next to the personal approach by telephone, thirty companies and/or persons have been sent an e-mail unannounced in which the request was made to fill out the survey or to pass the survey to a suitable person.

Finally, an important part of the respondents (N=27) were reached via the network of the author. This part contained first line respondents and next to that, the author was introduced or the research of the author was introduced to network contacts of people directly linked to the author. This sampling method is called snowball sampling (Baarda and De Goede 1995, 127; Babbie 2007, 184). The respondents were distributed questionnaires via mail or e-mail.

Response

In the end, 46 qualifying persons (N=46) took part in the whole survey, from which 38 qualify as investor, creditor or professional representative and eight as other users of the financial statements.

Table 5.1 - Response per category of respondents that was sent part one of the survey

	Amount sent	Valuable response	Response rate
Telephone acquisition	30	16	53%
Mail acquisition	30	3	10%
Snowball acquisition	NA	27	NA
Total		46	

Qualitative and quantitative analysis of results

The results of the research are assessed in two different ways.

All the information that is obtained from the open-ended questions is assessed qualitatively. Next to that, also the information from the closed-ended questions is assessed qualitatively. A thorough analysis of the possible deeper meanings of the information is executed.

In addition, the quantitative information from the statements containing the materiality measures are analyzed using a quantitative statistic program (SPSS, version 15.0). The answers of the respondents on the statements are coded as follows:

- Strongly agree = 1
- Agree = 2
- Neutral = 3
- Disagree = 4
- Strongly disagree = 5

The ordinal scale variables are subjected to non-parametric tests. From this, the hypotheses that have been formulated which reflect the expectations of users' opinion in which way to narrow the gap, can be confirmed, or rejected with a higher reliability. For all the statistical tests in this research, the results are considered statistically significant if the p-value is less than 5% ($p < .05$).

Limitations

As can be deduced from the approach just described, the population sample that is taken is not a random sample of the population, for a large part nonprobability sampling is used instead, because it is practically impossible to determine the size of the whole population of users of the financial statements. Consequently, it is not possible to access a random sample of the whole population.

The attempt is made to include 'randomly chosen' respondents by phoning to the companies that were included in the lists from the Company.info database. Obviously, in case of snowball sampling, a random sample is out of the question.

The representativeness of the samples using snowball sampling is questionable (Babbie 2007, 185). However, snowball respondents were not informed about the research in advance and did not have more information in advance than any arbitrary respondent did.

Therefore, it is deliberated that the respondents approached via the snowball-method constitute an as valuable contribution to the survey as any other respondent with no ties to the author does.

6. The results of the empirical research

Introduction

In this chapter, the results of the empirical part of this research will be presented. In the next paragraph, the knowledge of respondents regarding the concept of materiality is assessed. After that, the vision of respondents regarding materiality and their opinions on whether to improve the concept of materiality or not, are presented.

Knowledge regarding the concept of materiality

The first objective of the research is to determine whether an expectation gap concerning materiality exists. An important element of the answer to this question is to know whether respondents of financial statements are aware and informed of the concept.

In the first part of the survey, questions are posed whereof the answers provide insight about the knowledge and attitude of respondents concerning materiality.

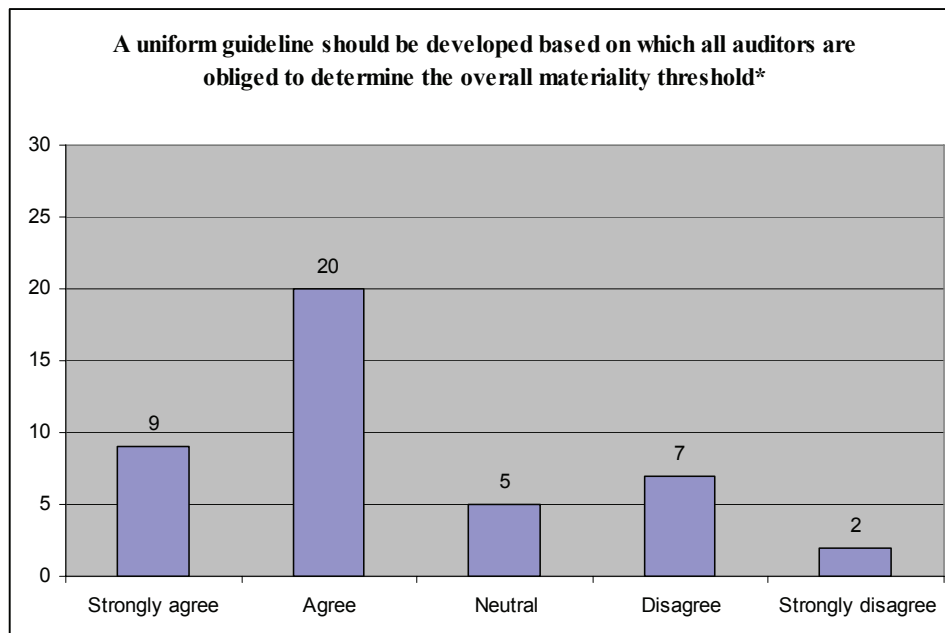
The results whether respondents of the financial statements are informed and aware of the existence and the implications of the concept of materiality are mixed, but it can be concluded that for at least one third of the respondents (35%) a lack of knowledge exists.

Ways in which the respondents want to improve the concept of materiality

All the respondents had to express their opinion on six different statements that represented the different possible measures regarding materiality as introduced in chapter 4 of this research.

A uniform guideline should be developed based on which all auditors are obliged to determine the materiality threshold

Bar chart 6.1



* Two respondents answered ‘Don’t know’.

In the audit standards that currently exist, no prescriptions of in what way to determine the quantitative materiality threshold exist. The figures show that the majority of respondents would like to end this situation by introducing a new uniform standard with quantitative thresholds included.³⁰ The auditor should refer to this guideline in the audit report.

Several reasons exist why respondents are attracted to this measure:

- Clearness and transparency; many respondents indicated they would support a clear standard to which is referred to in the audit report, because this would make the concept more clear to users as well as to auditors.
- The increase of uniformity among auditors in determining materiality, would increase the uniformity of financial statements and with that the comparability.
- The standard would introduce more objectivity, based on which users can more easily rely on the reliability of the financial statements.

Opponents argue:

- The auditor is best capable of judging materiality.
- Some matters are just impossible to capture in rules. For example, in which way can be dealt with differences in branches and in size of companies?

³⁰ In this statement, the term uniform guideline is used and not audit standard. This can be considered as a flaw in the design of the research. The uniform guideline measure is intended as a uniform audit standard. Based on the answers, it could be determined that most respondents of the empirical research considered the guideline to be a prescriptive audit standard. Therefore, the term ‘uniform guideline’ and ‘uniform standard’ are used interchangeably.

- Despite of the uniformity in the quantitative assessment of materiality, this guideline would still leave room for professional judgment.

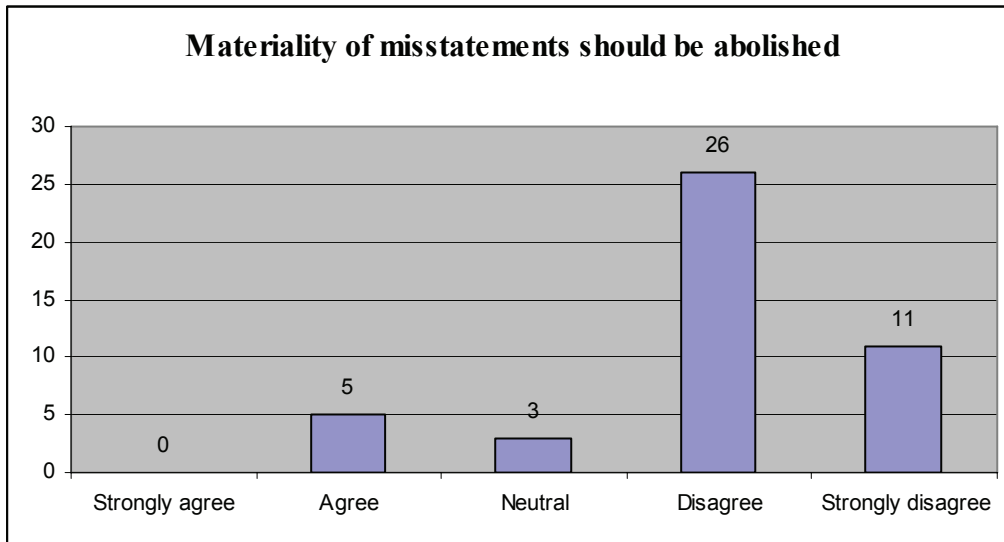
Both the proponents and opponents have valid reasons for being in favor or against this measure, but the tendency is unarguably that the majority of the respondents is in favor of this measure. The results of the Wilcoxon Signed-Ranks test significantly show that respondents would have no objection against introducing this measure for improving the concept of materiality. That is why hypothesis 1, ‘Users want the uniform guideline measure to be implemented’, seems tenable.

Conclusions regarding the expectation gap

- The existence of a deficient standards gap appeared. In order to achieve transparency and uniformity, the existing audit standards need to be adapted.
- The existence of an unreasonable expectations gap appeared. Respondents indicated the concept of materiality is not clear to them and therefore they need to be informed about it by means of a guideline that is known to them.
- A modest deficient performance gap can be discerned. Some respondents indicate the guideline would introduce more objectivity, which indicates they are concerned about the subjective assessment of materiality, as it currently exists.
- On the other hand, also proponents of professional judgment exist. This category would be of the opinion that the performance of the auditor becomes deficient if his professional judgment is suppressed.

Materiality of misstatements should be abolished

Bar chart 6.2



This measure implicates a full audit. Most respondents recognized this as a very expensive option, with limited benefit. Practically half (49%) of the respondents rank this measure as least favorable measure.

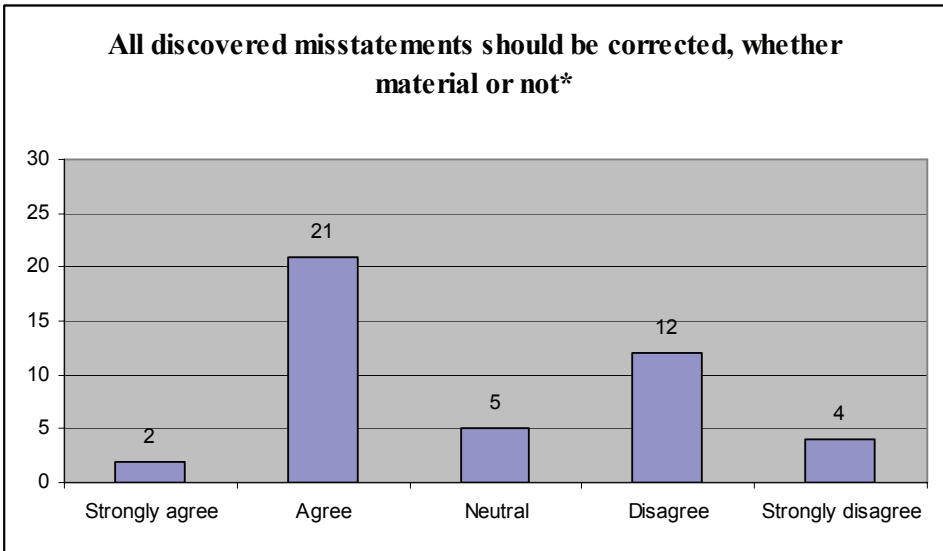
The results of this statement support hypothesis 5, 'Users do not want the abolish materiality measure to be implemented'. This conclusion is also statistically supported in the Wilcoxon Signed-Ranks test.

Conclusions regarding the expectation gap

- Earlier results presented a lack of knowledge of 35% of the respondents regarding the concept. These respondents might not have been aware of the existence of a materiality threshold. Some comments support this assumption. Therefore, a reasonableness gap is subscribed to the results of this measure.
- No deficient performance gap is encountered and neither a deficient standards gap.

All discovered misstatements should be corrected, whether material or not

Bar chart 6.3



* One respondent answered 'Don't know'.

The opinions on this measure are much dispersed. Proponents present the following arguments:

- An error should be redeemed at all times.
- Discovered misstatements should be corrected to safeguard the reliability of the financial statements.

The measure seems to have a strong subjective appeal on respondents, for them correcting mistakes is a matter of principle.

The opponents argue:

- From a cost-benefit perspective, it is not desirable to correct immaterial misstatements.
- Because they do not influence the view of the company in the financial statements, correcting misstatements that are not relevant is senseless.

These comments seem to appeal more to the relevance aspect of the measure and the costs of the measure and are more rational than emotional arguments.

The results of the Wilcoxon Signed-Ranks test, do not provide a decisive answer to the question whether respondents would like to introduce the ‘correcting all misstatements’ measure. The result for this statement slightly bends in favor of introducing the measure, but this is not statistically significant so it cannot be concluded that respondents agree with this measure.

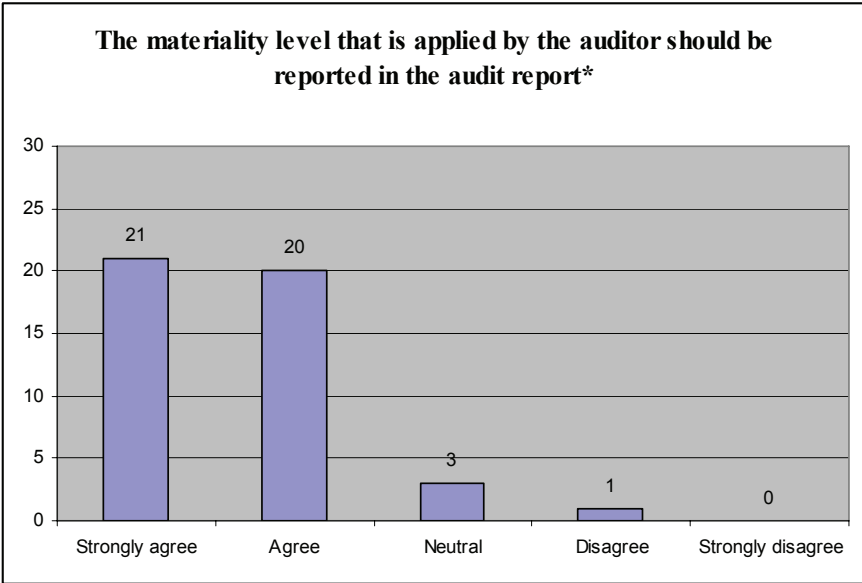
Splitting the sample group in respondents that use the financial statements to base decisions on to buy, hold or sell stock and respondents that do not, does show a significant result. Respondents that use the financial statements for stock related decisions seem to be proponents of the statement and the others are opponents. An explanation for this result might be that (indirect) shareholders want the financial statements to be more precise, because stock prices can react unpredictable to the discovery of misstatements (even when they are perceived immaterial by the auditor) and small changes in stock prices might have huge consequences for (short term) shareholders. However, from the comments presented with this statement this reasoning cannot be extracted. Provisionally, hypothesis 3, ‘Users do not want the ‘correct all discovered misstatements’ measure to be implemented’, is accepted.

Conclusions regarding the expectation gap

- The results are inconclusive, but a deficient standards gap is looming.
- No deficient performance or reasonableness gap is derived from these results.

The materiality level that is applied by the auditor should be reported in the audit report.

Bar chart 6.4



* One respondent answered ‘Don’t know’.

This measure requires the auditor to report the applied materiality level in the audit report and to present a short clarification of the establishment. It was the most agreed upon statement in the research. It was the only measure with an extreme answer ('strongly agree') as the mode answer.

Proponents state:

- Having this knowledge has value to the user. It provides knowledge about the reservedness with which the financial statements should be assessed.
- Transparency is important.
- The measure provides users the possibility to assess the reliability of financial statements themselves.
- It will bring more uniformity in materiality thresholds, which will make financial statements of companies more comparable.
- If materiality levels become public, this might stimulate auditors to perform better.

Some respondents point at difficulties reporting the materiality in the audit report. The materiality figure alone is not sufficient to derive valuable information from. The auditor needs to provide an adequate explanation of the realization of this figure, but an overkill of information is not desirable either.

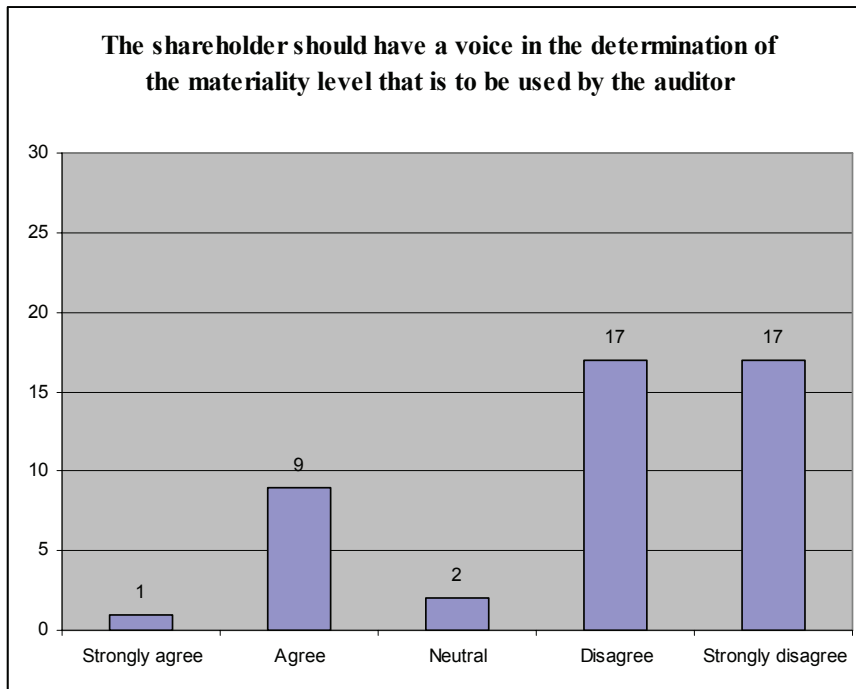
The results of the Wilcoxon Signed-Ranks test are significant. Together the results lead to the conclusion that hypothesis 2, 'Users want the disclosure measure to be implemented', is valid.

Conclusions regarding the expectation gap

- Respondents indicate they want to be informed of the materiality threshold, which implicates they currently lack information that might be valuable for decision-making. This constitutes a communication gap. The deficient standards should be adjusted (require disclosure) which subsequently diminishes the reasonableness gap.
- A deficient performance gap is not likely, but the need for information can possibly be interpreted as a need of the respondent to monitor the performance of the monitor.

The shareholder should have a voice in the materiality level the auditor needs to apply.

Bar chart 6.5



This measure is the only measure that implicates direct involvement of users of the financial statements (more specific: shareholders) in the determination of materiality thresholds.

Respondents are not of the opinion that shareholders should have more influence. Reasons for this are:

- Because auditors are the experts and most shareholders would not be able to make sensitive materiality valuations, this is a task of the auditor.
- If shareholders can judge materiality, it will become an expensive and complex affair.
- The auditor should operate independently and therefore should not be influenced by shareholders.
- Shareholders are not the only stakeholders. The interests of other stakeholders are neglected by a measure like this.

In the end, 74% of the respondents disagreed with the measure. This result is only slightly better than the result of the 'abolish materiality' measure.

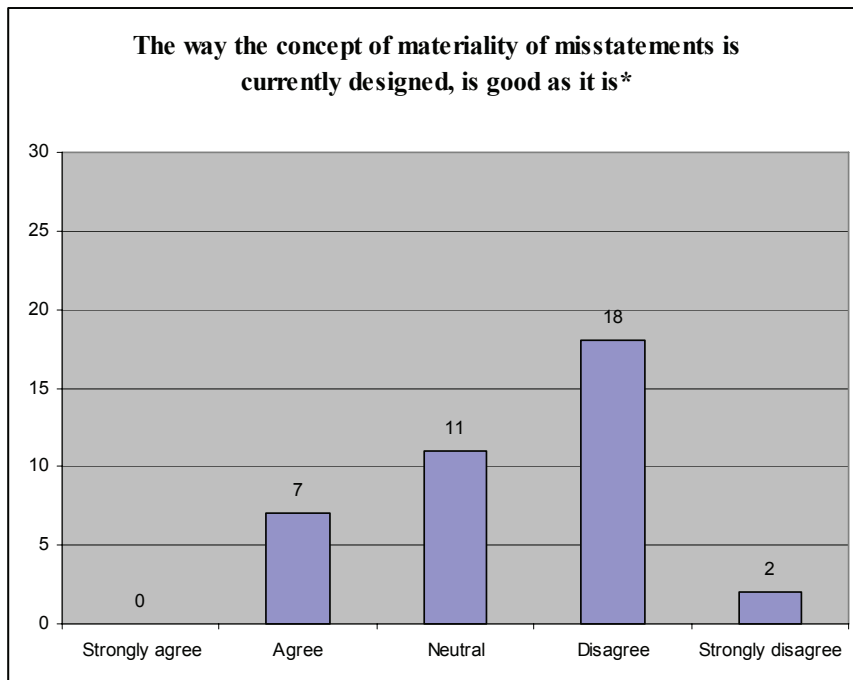
All together the hypothesis 'Users do not want the shareholder input measure to be implemented' (hypothesis 5), is considered accepted. This supposition is also statistically substantiated by means of a Wilcoxon Signed-Ranks test.

Conclusions regarding the expectation gap

- No real expectation gap can be distinguished from the results of this measure. However, some suggestions are presented to monitor the auditor, which indicates the respondents are not completely confident the auditor executes the materiality decisions eminently (and which might indicate a small deficient performance gap).

The way materiality of misstatements currently is designed, is good as it is.

Bar chart 6.6



* Eight respondents answered 'Don't know'.

A good score on this measure would implicate no relevant expectation gap regarding materiality exists. However, the Wilcoxon Signed-Ranks test indicates respondents do not favor the 'no change' measure and are therefore not satisfied and of the opinion that one or more measures should be introduced.

Conclusions regarding the expectation gap

- The concept of materiality should be changed, so hypothesis 7 ('Users do at least want one measure to be implemented in order to narrow (part of) the expectation gap on materiality') is accepted. The acceptance of the hypothesis implies a relevant expectation gap exists.

7. Conclusions and Recommendations

The goal of this research was to provide an answer to the main research question:

‘Does a relevant expectation gap exist between users of the financial statements and auditors concerning materiality of misstatements, and if so, in which way do the users want to narrow this gap?’

In the first part of the survey, more than half of the respondents who claimed to have (some) insight in which way the auditor applies materiality in practice, indicated that in order to judge financial statements well it is important to have knowledge about materiality. It appeared that a considerable number (at least 35%) of respondents was not informed about the concept of materiality.

In the second part of the survey, it turned out that many of the respondents, the ones that were knowledgeable of the concept beforehand as well as the ones that were not, are of the opinion the concept of materiality can be improved by introducing one or more measures. The statement ‘The way the concept of materiality of misstatements is currently designed, is good as it is’ is significantly rejected by the respondents, 43% of the respondents indicated to agree or strongly agree with changes regarding the concept. These results indicate that a relevant expectation gap regarding materiality exists between the respondents and auditors.

Therefore, the first part of the main research question is answered affirmative: a relevant expectation gap between users of the financial statements and auditors concerning materiality of misstatements does exist.

The elements that constituted the gap between respondents and auditors in this empirical research are also derived.

The performance of the auditor regarding the determination of materiality thresholds did not bother the respondents, becoming clear from the rejection of the ‘abolish materiality’ and ‘shareholder input’ measure. In general, respondents seem to trust the materiality assessment the auditor executes. Therefore, it is concluded that the expectation gap regarding materiality is not significantly present on the deficient performance part of the gap. However, indirectly a small deficient performance gap exists, while respondents indicate the need to be able to judge auditor performance via a uniform guideline and disclosure of materiality levels.

The materiality bottleneck turned out to concentrate on the deficient standards gap and on the reasonableness gap. Together these two parts of the gap are also known as the communication gap.

A lack of communication being a considerable cause of the expectation gap is the most prevalent conclusion that can be derived from the results of the survey. Because they now do not know what materiality of misstatements is, or do not fully understand the concept, many respondents indicated they wanted to be better informed about the concept. The two measures presented in the survey that will provide the user with information regarding materiality, a uniform guideline and disclosure, turned out to be popular measures.

A uniform guideline, to which the auditor refers in the audit report, would contribute to clearness and transparency regarding materiality according to the respondents. Disclosing the materiality levels applied by auditors accompanied by a short explanation, would be even a better solution for providing information and transparency about the subject.

Introducing a uniform guideline and/or the obligation to disclose materiality levels, would contribute in narrowing the deficient standards gap. Introduction of these measures would also narrow the reasonableness gap.

While a broad range of users participated in the survey and the results are quite convincing, the final answer on the second part of the research question is: users of the financial statements in general want to introduce a uniform guideline and a disclosure requirement in the audit report. To this, the comment is added that the results of the disclosure measure were more convincing than the results of the uniform guideline measure.

Recommendations for research

This research pointed out that respondents want the concept of materiality to be improved. It is recommended to further investigate the measures that were preferred by the respondents in terms of disadvantages and benefits to users in general (also for the long term) and in terms of design.

Next to that, it is essential that every measure will be researched from the point of view of all the different stakeholders related to the measure (preparers, auditors, users). This research was limited to the users' point of view regarding the different measures.

Recommendations for practice

The respondents provided many reasons for their opinion to introduce the two measures that, according to their point of view, will improve the concept of materiality for users of the financial statements. The message of these respondents (that can be regarded as representatives of all users) should be heard and not ignored.

A recommendation to the IFAC/IAASB (and the NIVRA) is to fuel the debate about the audit standards that might be interesting for users by actively approaching the user of the financial statements and assess their needs and opinion. Regarding materiality, the financial statement users of today do not seem to be a part of the concept of materiality anymore, despite the users being explicitly incorporated in the definition of materiality of misstatements of the IAASB.

Clarifying the concept of materiality to users has the potential to improve the confidence of users of the financial statements in the audit profession and that should sound attractive in these days of reduced confidence because of several scandals.

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