HOW IMMATERIAL IS IMMATERIAL?

A PILOT STUDY

Gregory P. Cermignano
Widener University
and
Joseph M. Hargadon
Widener University
and
David Contarino
Widener University 2003 Graduate

ABSTRACT

Attempting to define and evaluate "materiality" is not a new concept. Regularly accountants and auditors need to arrive at a working definition to determine the nature and extent of audit tests to be performed and to assess the degree of disclosure needed in the financial statements.

The recent wave of accounting scandals has brought the materiality concept to the forefront once again. Is it possible that companies like Enron, WorldCom, ICN, Global Crossings, and Mirant hid behind some nebulous definition of materiality?

The purpose of this paper is to first review the accounting literature to determine common approaches found in practice for assessing materiality. This analysis includes an examination of quantitative considerations found in official pronouncements such as SAS 47, SAS 99 and SEC regulations. We also address some qualitative considerations pertaining to materiality. Secondly, we report the results of a survey conducted in January 2003 where CPAs in Pennsylvania were asked to identify the specific factors they used to evaluate materiality.

It is our hope that the descriptive results of this survey will allow us to better understand the key factors associated with materiality determination in financial reporting and identify the warning signals that the users of financial statements should look for.

INTRODUCTION

The beginning of the 21st century has taught society many lessons about corporate and auditing ethics. Accounting scandals such as Enron, Adelphia, WorldCom, and the subsequent involvement of Arthur Andersen have impacted many innocent investors causing some to lose a majority of their 401k retirement savings, their jobs and other aspects of their financial security. An adverse impact on the capital markets was felt as investors lost confidence in the credibility of the financial reporting process and in the role of the external auditor. As these scandals were investigated and analyzed, the activities of the auditors came under a great deal of scrutiny.

Some experts say the SEC, AICPA, and FASB have rules and mechanisms that already exist to sufficiently to address the reporting and auditing issues found in these scandals. They just need to be better enforced. Others say legislation like Sarbanes-Oxley was just waiting to happen. One thing is certain--the effects of these accounting scandals were heavily felt as markets plunged. Our research is designed to analyze one of the issues that has been raised by these scandals. Specifically, we attempt to examine the concept of "materiality" and its effect on the ultimate financial statements and on financial decision-makers. The idea is to try and determine how auditors determine and apply the measurement of materiality. When they say something is immaterial, what do they mean?

The first section of the paper briefly discusses two of the major accounting scandals, when materiality may have come into question. We are not suggesting that these are the only two cases impacted by the problem of materiality. We are merely saying that these are probably the most publicized and famous. This is not a paper on accounting scandals. Our reason for presenting this information is to provide background and framework for you to consider the question - "How immaterial is `immaterial'?"

ENRON AND WORLDCOM – THE BIG TWO

Enron/Arthur Andersen

The facts of the Enron case (at lease those that we know) have been highly documented in the press and in the literature. In short, Enron went from a natural-gas company to a utility "wheeler-dealer" in a very short time. To avoid the appearance of losses, Enron, with the help of its auditor, Arthur Andersen, created thousands of offbalance-sheet entities (i.e., special purpose entities – SPEs) where losses were hidden. These SPEs probably should have been consolidated, but were not due to a questionable application of the rules. Among other things, Enron secured stock acquisition of outsiders in some of these entities with guarantees of their own stock; they hid debt and poor investments in some of these off-balance-sheet entities; they engaged in the production of financial statements that were in part the result of at least questionable entries; they treated their investments in derivatives in a highly unorthodox manner; and the executives engaged in almost illegal stock transactions.

Arthur Andersen, although not technically accused, basically looked the other way. Prompted by their clear lack of independence, they also engaged in document shredding as a form of cover up that eventually brought this "Big Five" firm down.

Although many of the individual accounting treatments may not have been material by themselves, when taken as a whole that changed. Our concern is whether the apparent attempt to avoid material disclosures may have been misleading to financial statement users, and thus were, in part, responsible for job loss as well as loss of financial security. How immaterial was immaterial?

WorldCom

According to a July, 2002 article in Global Agenda, WorldCom, which was audited by Arthur Andersen, capitalized close to $4 billion dollars of what were actually operating expenses. Whether by mistake or done intentionally, this accounting misclassification turned what would have been an operating loss into a profit. The method of handling these costs was a definite violation of GAAP and was allowed in part by Andersen's audit in which it stated that the statements were fairly presented "in all material aspects." How immaterial was immaterial?

Others

The brief description of Enron and WoldCom, two of the more famous accounting scandals, shows their pseudo-relationship to materiality. A short list of others might include a discussion of Dynegy, Global Crossings, Adelphia and Waste Management. In many of these situations, parties also hid behind the materiality veil. In any of these cases, whether the definition being used by the companies and their auditors was appropriate is questionable. One thing, however, is clear — the meaning of materiality and how it is operationalized is definitely unclear. So how immaterial is immaterial? We don't know. However, in the next section we attempt to catalog approaches to "defining" and assessing materiality cited in the accounting literature.

CURRENT APPROACHES IN DETERMINING MATERIALITY

The method most frequently used in determining a definition of materiality includes a concept often referred to as the "User Perspective". Looking at the effects on the financial information user has been an established principle of the FASB, the SEC and the AICPA. Even with the user orientation, these sources make constant reference to a "magnitude" of materiality coupled with the use of professional judgment. Clearly this process, should incorporate two distinctive approaches — one qualitative and the other quantitative. Obviously the quantitative approaches involve the setting and application of numerical benchmarks. There are many of these such benchmarks found in practice as well as organizations involved in recommending them. This section will review just a few of the approaches typically cited.

SAB 99 was the ultimate product of Arthur Levitt according to Fang and Jacobs (May, 2000). Levitt believed that "defined percentages" were needed for management to be able to keep earnings and the amount of recorded errors under control. Levitt apparently thought that the old "rule of thumb" method was outdated and that materiality should be a product of both quantitative and qualitative factors. In proposing SAB 99, however, the SEC staff made it clear that they thought the definition should move away from numerical thresholds. By doing so, however, they indirectly promoted earnings as a part of the definition.

Fang and Jacobs also cited one court case, Kidder Peabody SEC Litig., 10 E. Supp. 2d 398 (S.D.N.Y. 1998), This case made reference to a "low" earnings materiality misstatement threshold as resulting in large errors. While chastising the method, they seemed to reinforce the base used -- percentage of earnings.

According to a July 2002 article in *Investor Relations Business*, the SEC, with the issuance of its new disclosure rule (Regulation FD) has listed "new triggers" for materiality analysis. They include "an unusual material agreement; loss of business with a significant customer; new or accelerated debt; write-offs; changes in ratings, listing arrangements; employee benefit plans; and audit report withdrawal." While shifting the focus slightly away from totally quantitative considerations, one can see a few additional benchmarks for typical high risk transactions such as debt, write-offs and business losses.

In a piece describing the non-quantitative requirement of SAS No. 47, "Audit Risk and Materiality in Conducting an Audit", Carmichael, et al., suggest that common benchmarks for materiality determination have been: "5% - 10% of income before tax, or owners equity" and ".5% - 1% of total revenue or total assets."

Tuttle, et al., in *Auditing: A Journal of Practice and Theory* (March, 2002) cite a number of sources that identify and describe various benchmarks. They include Friedberg (1989) who prescribes income before taxes, income from continuing operations and total assets. Cerman and Hollison (1991), Boatsmen and Robertson (1991), Ward (1976), Firth (1979), Bates et al., (1982), Messier (1983). Fugstad, et al. (1984), and Carpenter and Dirsmith (1992) also point primarily to income measures. Michael and Ricketts (1992), Pany and Wheeler (1992) and Pevess (1986), suggest using assets or revenues when income is close to zero.

In a brief article in *Mergers and Acquisition Journal* (Jan. 2000), the editors indicate that whenever a benchmark is used, 10% or more seems to be treated as material. In a March 1999 note in *Financial Modernization Report*, the editors state that "the idea of what is material to shareholders has been loosely understood as anything that would affect earnings between 3% and 5%."

According to Price and Wallace in *Accounting Today* (Dec. 1996), materiality criteria "established by management and operationalized by CPA's" ... "could include income, normal pretax income, gross revenues, sales revenues, income before extraordinary items, balance sheet categories including percentage of current assets, working capital, total assets, total liabilities and owners' equity." They state that as many as 52 factors have been mentioned.

In a study published in *The CPA Journal* (March, 1993) Thompson and Fowler identify a number of rules-of-thumb that had been proposed. They include 5% of normal pre-tax income if less than $2 million; 5% to 10% of normal pre-tax in excess of $2 million; and 1% of gross revenue. They also describe a study by the FASB which identifies a number of quantitative guidelines noted in a variety of official pronouncements. For example, there are specific materiality percentages with respect to stock dividends percentages, EPS dilution tests, voting stock ownership, the pension expense corridor, lease term, segment reporting requirements and others.

Thompson, Hodge and Worthington (July 1990) in an article in *The CPA Journal*, mention that comparative benchmarks could include income before extraordinary items, net income or trends of earnings. They suggest that "a majority of materiality percentages are investment-related". The rest "relate to specialized accounting practices".

Finally in *Accounting, Organizations and Society*, (1992) Carpenter and Dirsmith indicate "that most of the predictive power of the isolated modes is produced by a single, dominate cue – the size of the item relative to current year net income – while such other quantitative size measures as percent of net assets or total assets play secondary roles".

After reviewing the literature, it seems that so-called predictive benchmarks could include anything from income to assets, to debt to owners' equity, all with varied percentages. However, as noted in the discussion by Fang and Jacobs (2000) of SAB 99, many seem to feel that **qualitative** considerations would be a better approach to handle potential problems. Proponents of a qualitative approach constantly refer to the necessity to know when something matters to the ultimate financial information user. The SEC, through a discussion of the shortcomings of quantitative considerations, implies a few qualitative concepts. They could include earnings trends, compliance with regulations, contractual covenants, concealment of unlawful actions and management compensation. Harvey Pitt in a July 2002 article in *Investors Relations Business*, indicated that companies should decide materiality based on their knowledge of their own business.

Price and Wallace (1996), reported that the Accounting Standards Executive Committee asks for disclosures of items such as nature of operations, health of cash flows, vulnerabilities of the industry or business and use of estimates.

In the July 1995 *Journal of Accountancy*, Jordan, Clark and Pate as well as Carpenter and Dirsmith in the 1992 *Accountings, Organizations and Society* indicated that the size and nature of a company transaction might affect materiality. They stress that professional judgment and overall client knowledge have been deemed as important measures. Thompson and Fowler (March 1963) and Pany and Wheeler (June 1992) also identify the need for professional judgment. Pany and Wheeler (June 1989) indicated that the FASB needed to develop improved quantitative guidelines. They implied that there is an inherent weakness in the use of certain quantitative considerations. While reviewing such measures as 5% of average pre-tax income, gross profit, '/2 % of total assets, 1% of total equity and '/2 % of total revenues, they present an implied need for non-quantitative measures. They also identify specific knowledge of industry, client and firm as major non-quantitative inputs in the determination of materiality.

Another major qualitative consideration in determining materiality focuses on the user of the materiality definition. Audit experience is a major factor in determining materiality as explained by Messier in a 1983 article in the *Journal of Accounting Research*. Coupling years of experience with the type of experience seems to indicate a level of stability which can be used in the process of determining a materiality definition.

One major area of qualitative measurement involves a study of the economic environment. Ward in a 1976 article in the *Journal of Accounting Research* refers to its importance in the determination of materiality. The economic environment that the company operates in along with the nature of its contractual relationships affects the overall level of business risk for the organization. Materiality and risk assessment are intertwined.

In this section we have superficially identified several factors of a qualitative nature that could be used by an auditor in the determination of materiality. They could include company size, professional judgment, (which is inherent in all of the approaches to some degree) industry knowledge, client/firm knowledge, audit experience, economic environment and the level of business risk. Adding these items to the list of quantitative approaches makes it a daunting task to determine the "best" approach to assessing materiality. This section has been an attempt to identify the materiality determination process as described by the literature. In the following section we identify the specific approaches used by CPAs based on their responses to a 2003 survey.

The Survey – Background

The purpose of the survey was to attempt to gather some empirical evidence as to how CPAs assess and evaluate materiality decision in practice. Specifically, we wanted to determine (1) if some of the approaches cited in the literature were actually being used, (2) if other quantitative and/or qualitative techniques not commonly found in the literature were being used, and (3) how comfortable the CPA respondent was in assessing materiality during an audit. We also requested certain limited demographic information from the respondents to gain a better understanding of their business experience – both audit and non-audit related.

This study was **not** intended to test any hypotheses. It was purely an attempt to gather some **descriptive** information on how a select group of CPAs evaluate and assess materiality. In effect, it represents a **pilot study** which we hope will lead to a more comprehensive survey and a more extensive sample population in the future.

The Survey – Who was Sampled?

In order to expedite the survey process, we elected to do the following:

(1) Select a convenience sample of CPAs listed in the Pennsylvania Institute of CPAs (PICPA) data base of Career Recruiting and Opportunities Program (CROP).
(2) Limit the survey to eight key, but basic, questions (Tables 1-8).

We recognized that the timing of this study (i.e., January) coincided with the start of the "traditional" busy season for CPAs, thus we wanted the survey to require very little time to complete. The survey was also part of an independent research study requirement for an undergraduate senior business student.

The Survey – Results

A total of 135 surveys were mailed to Pennsylvania CPAs and we received 41 responses, yielding a 30% response rate.

Table 1 indicates the vast majority (76%) of the respondents were at the partner level in their firms. Consistent with partner status, Table 2 shows that 90% of the respondents have over 10 years of auditing experience. Table 3 reports that the majority of the respondents (76%) also have over 10 years of non-auditing accounting experience. Consequently, it is clear that the participants in this study have a substantial amount of accounting and auditing work experience and thus are knowledgeable about business issues.

Based on the experience level of the CPAs in this study, it is not surprising that Table 4 shows over 65% indicated that they were very comfortable with assessing materiality during the audit and 29% stated they were somewhat comfortable. Finally, all 41 respondents reported that they were directly involved in materiality decisions. (Table 5)

From the responses received and information reported in Tables 1 through 5, the overwhelming majority of the CPAs in this study have over 10 years of auditing and non-auditing accounting experience, they are all directly involved in materiality decisions and are either very comfortable or somewhat comfortable in assessing materiality during the audit. With this established, we feel more confident about the approaches they indicate they use to assess materiality.

Table 6 reports the authoritative references and/or factors the CPAs used to determine materiality. Most of the respondents selected multiple approaches with official pronouncements (e.g. AICPA, FASB), industry practices and internal policies being the most heavily cited.

Table 7 also indicates that the majority of the CPAs in the study selected multiple financial statement items as quantitative materiality benchmarks, with sales, net income and total assets being the most common. This finding is consistent with the benchmarks cited in the literature.

Finally, Table 8 reports other elements that affect the materiality decision. Although this question was intended to identify qualitative (non-quantitative) factors, some of the respondents indicated factors that are quantitative in nature. The nature of the industry (39%) and years the company was their audit client (15%) were cited as factors. Surprisingly, however, the risk of audit failure (5%) and professional judgment were very low in their consideration (4%). The CPAs also identified company size (58%) and the magnitude of accounts (59%) as the other key elements that influence their materiality decisions.

SUMMARY AND CONCLUSION

Recent accounting scandals such as Enron and WorldCom have heightened the public's concern about the role of the external audit in the financial reporting process. One of the issues that has always caused great concern for auditors and financial statement users is the concept of materiality. There has been an extensive body of recommended authoritative and academic literature citing approaches to assessing financial statement materiality.

The purpose of this study was to survey CPAs to determine what, if any, of the recommended approaches they are actually using to evaluate materiality, to identify other approaches (both quantitative and qualitative) they incorporate into their materiality assessment during an audit, and to ascertain how comfortable they were in determining materiality thresholds.

The pilot study reveals that 41 practicing CPAs in Pennsylvania with substantial audit and other accounting related experience, are generally comfortable making a materiality determination for their clients. The vast majority use the traditional sources for assessing materiality cited in the literature (e.g. official pronouncement guidelines and industry practice) and the recommended benchmarks (e.g. sales, net income and total assets). They also identify company size, magnitude of the accounts and the years the client has been an audit client as factors that influence materiality decisions.

Based on our findings in this survey, it appears that CPAs are comfortable with this somewhat nebulous concept of materiality. They currently use the benchmarks commonly cited and they factor in selected qualitative measures as well. However, if financial reporting problems result and "material" disclosures are the underlying cause, perhaps what is being done needs to be re-examined.

Although this was a convenience sample and very limited in geographic scope, the results warrant a more exhaustive evaluation of the materiality concept and how this determination should be disclosed to financial statement users.

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