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## **A review on the evolution of the definitions of materiality**

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**Abstract:** This paper reviews the accounting and auditing definitions on materiality. The International Standard of Auditing (ISA) 320 'Materiality in planning and performing an audit' defines performance materiality as "the amount or amounts set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole. If applicable, performance materiality also refers to the amount or amounts set by the auditor at less than the materiality level or levels for particular classes of transactions, account balances or disclosures" (paragraph 9). The definition is vague and does not address the extent of omissions and misstatement that leads to materiality. This paper supplements by reviewing the evolution of the definitions from accounting literature, regulatory bodies, court cases, non-profit organisations. Results of this mega review have provided ramifications to the accounting professions, practitioners and policy makers.

**Keywords:** materiality; definition; evolution; accounting; auditing.

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**Biographical notes:** H. Gin Chong is the Director of EMBA programme and Professor of Accounting at Prairie View A&M University (Texas), and is best known for his research work on materiality and audit risk, fraud, performance measurements, journal ranking, and governance and ethics. He delivered keynote speeches at national and international conferences, published over 100 scholarly papers and a recipient of several external research funds. He teaches accounting and auditing, oil and gas accounting, and international accounting, holds visiting positions at universities in China and Europe, and has received many teaching, research and service awards.

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### **1 Introduction**

There are many worldwide definitions on materiality in accounting due to intrinsic nature of the items and events. There is no known systematic review on the evolution of materiality and the reasons for the evolution. This paper fills the gap by reviewing and synthesising the definitions based on literature from accounting bodies, legal cases, empirical research, and regulatory documents including the SEC rules and London Stock

Exchange Handbook. The definitions have undergone many changes intending for business and legal environments.

The International Federation of Accounting Commission (IFAC) (2009) revised its ISA 320 'Materiality in planning and performing an audit' by defining performance materiality as

“the amount or amounts set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole. If applicable, performance materiality also refers to the amount or amounts set by the auditor at less than the materiality level or levels for particular classes of transactions, account balances or disclosures” (paragraph 9).

This definition fails to state expressly the extent or context of misstatements or omissions of items that would constitute material.

A standardised definition does not mean it is a tool that fits all situations. Sectors and auditors may modify and adapt the definition for their needs. A clear definition does not absolve the responsibilities of preparers and auditors, but helps shield users and judges in case of litigations. A clear definition helps set appropriate thresholds, quantitative measures, qualitative indicators and the extent of professional judgments. This review helps accounting and auditing professions, regulators and policy makers to understand the ramifications and challenges of determining materiality thresholds.

I organise remaining of the paper as follows: in the next section, I evaluate the theoretical frameworks of financial reporting, and assess the applications of materiality in the reporting and auditing processes. In Section 3, I map the evolution of the definitions, while in Section 4, I put forward recommendations on how the definitions could be made clear, and in the concluding section, I suggest the ways forward for the accounting and auditing professions, policy makers and regulators.

## **2 Theoretical background**

Preparers of the financial information are responsible for disclosing adequate, timely, accurate, material and quality information to the external stakeholders for decision making purposes. The stakeholder theory defines the constituency of a corporation as “a person or group that can affect or is affected by the achievement of the organization’s objectives” [Freeman, (1984), p.46]. A stakeholder is an individual or party who deals with the firm and relies on its published information. The individual or party includes customers, suppliers, lenders, government agencies, employees, communities and general public. The theory broadens the management’s vision on its roles and responsibilities beyond the profit maximisation functions to include interests, claims (Mitchell et al. 1997), care, concerns, well beings and social responsibilities toward all groups. Long-term survival and success of a firm depend on the continuing supports, both financial of and relationships between, stakeholders and stakeholders. The stakeholders need to provide all the material information while the auditors, as watchdogs, are responsible for verifying the information. Both the stakeholders and auditors need to strike a balanced level of disclosing information. Too much information may distract stockholders from focusing on significant items, while too little may blur them from zooming on the firm’s actual financial performance. Materiality is the benchmark to help set this level. To do so,

the profession needs a clear and concise definition and identifies the elements that impact upon materiality.

For stakeholders, they are the legitimate parties seeking for needed information. Suchman (1995, p.574) defines legitimacy as a “generalized perception or assumption that the actions of an entity are desirable, proper; or appropriate within some socially constructed system of norms, values beliefs, and definitions”. Stakeholders can achieve the intended level of legitimacy or exercise their rights if there exists little, or no, undue hindrance or fear, and has a legitimate standing in a society or a legitimate rights of claims on a firm and its agents. Legitimacy theory includes failures to embrace underlying legal and accounting requirements. This exposes preparers and auditors to potential litigations and stoppage in resource supports. In the case of reporting and audits, stockholders enjoy the legitimate rights of aware material items that have undergone verifications. Material omission or misrepresentation of items reflects failures on both preparers and auditors fulfilling the needed level of obligations, duties of care and accountability. All these lead to litigations, lost trust and further resource constraints. Lack of a standardised definition gives the accounting and auditing professions to interpret what is material and what is not, and to apply individuals’ professional judgments. Inconsistency in deciding the definitions and benchmarks further the gap between.

### **3 Definitions of materiality**

#### *3.1 Accounting bodies*

In 1954, the Committee on Concepts and Standards of the American Accounting Association issued the first definition as “an item should be regarded as material if there is a reason to believe that knowledge of it would influence the decisions or attitude of informed investor.” The definition emphasizes on the extent an item could influence the decisions of an informed investor. Presumably, an informed investor includes both existing and potential investor. The definition implies stakeholdees and auditors could be held responsible for known and unknown and unforeseeable investors. The definition has gone beyond the boundary of known and current stockholders. A decade later, the Institute of Chartered Accountants in England and Wales (1968) issued ‘The interpretation of ‘material’ in relation to accounts’ (Accounting Recommendation 2.206; Statement no. V10) that defines materiality as “a matter is material if its non-disclosure, misstatement or omission would be likely to distort the view given by the accounts” (para 6). The focus has changed from meeting the needs of investors to measuring the extent of disclosing or omitting of an item. The recommendation, though not mandatory to preparers, fails to moot the idea of extending the impact on users of the financial statements. Instead, it requires preparers to assess the impact of the matters on ‘views given by the accounts’. The accounting profession has retained the ‘views given by the accounts’ concept until 1974 when the Australian Accounting Research Foundation (1974) issued an accounting standard that defined materiality as “an item must be regarded as material if its omission, non-disclosure or misstatement would result in distortion of, or some other shortcoming in, the information being presented in the financial statements, and thereby influence users of the statements when making evaluations or decisions” (para 6). The Statement reversed the definition to the

American Accounting Association Committee on Concepts and Standards (1954) definition that is, emphasising on the impact of individuals, but replaced the word ‘investors’ by ‘users’. ‘Users’ of a financial statement in a sense include a wide range of stakeholders, whether they relate to or have any dealing with the stakeholders. The boundary of care and duties of responsibilities becomes wide and unlimited, so as stakeholders’ liabilities and possible exposure to litigations.

So far, the definitions have focused on the impact of an item on either a ‘user’ or a ‘stakeholder of the financial statements’. Nonetheless, the definition remains status quo until 1980 when the Financial Accounting Standards Board takes a stance on requesting the profession evaluating the magnitude of omissions and misstatements of accounting information to the users:

“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.” [Financial Accounting Standards Board, (1980), p.xv]

Though the magnitude of materiality depends on its impacts on the users, FASB has introduced new words and phrases like ‘probable’, ‘reasonable person’ and ‘changed or influenced by the omission or misstatement’ to the definition. The 1980 definition becomes the capstone to help shape the landscape and dimension of defining materiality by accounting professional bodies worldwide. For example, South African Institute of Chartered Accountants (1984), Australian Accounting Research Foundation (1985), New Zealand Society of Accountants (1985), Canadian Institute of Chartered Accountants (1987, 1992)<sup>1</sup>, Chartered Institute of Management Accountants, UK (1988), and Accounting Standards Board (1995) and Auditing Practices Board (1995) and Auditing and Assurance Board (2004) in the UK have a similar emphasis on the impact of an item due to its omissions or misstatements to the third parties (Table 1).

**Table 1** Definitions of materiality

<i>Accounting bodies</i>	<i>Definitions of materiality</i>
American Accounting Association Committee on Concepts and Standards (1954)	An item should be regarded as material if there is reason to believe that knowledge of it would influence the decisions or attitude of informed investor.
Institute of Chartered Accountants in England and Wales, UK (1968)	A matter is material if its non-disclosure, mis-statement or omission would be likely to distort the view given by the accounts.
Australian Accounting Research Foundation (1974)	An item must be regarded as material if its omission, non-disclosure or misstatement would result in distortion of, or some other shortcoming in, the information being presented in the financial statements, and thereby influence users of the statements when making evaluations or decisions (para. 6).
Financial Accounting Standards Board (1980)	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 mis-statement (p.xv).

**Table 1** Definitions of materiality (continued)

<i>Accounting bodies</i>	<i>Definitions of materiality</i>
South African Institute of Chartered Accountants (1984)	Materiality may be defined as the magnitude of an omission or misstatement of financial statements that, in the light of surrounding circumstances, makes it likely that the judgment of a reasonable person relying on those statements would have been changed or influenced by the omission or misstatement (para. 89).
Australian Accounting Research Foundation (1985)	Information shall be deemed material if its omission, non-disclosure or misstatement would cause the financial statements to mislead users of the statement when making evaluations or decisions. Information may be material having regard to its nature, the amount involved, or both (para. 15).
New Zealand Society of Accountants (1985)	A statement, fact, or item is material if, given full consideration of the surrounding circumstances at the time of completion of the financial statements, it is of such, a nature that its disclosure, or the method of treating it, would be likely to influence the making decisions by the users of the financial statements (para 3.1).
Australian Accounting Research Foundation (1985)	Materiality refers to the magnitude of an omission or misstatement of accounting information either individually or in the aggregate that, in the light of surrounding circumstances, makes it probable that as a result of the misstatement the judgment of a reasonable person relying on the information would have been changed or influenced or his decision affected (para. 5).
Chartered Institute of Management Accountants, UK (1988)	The principle that financial statements should separately disclose items which are significant enough to affect evaluation or decisions. The level of significance is a matter for individual judgment. Thus, an entity may decide to treat all fixed assets which cost less than, say, £500 as revenue expenditure because the amounts are not material to the entity's financial statements as a whole, the balance sheet, the profit and loss account, or individual items within the financial statements. In addition, depending upon the nature of the matter, materiality may be considered in relative or absolute terms (pp.5–6).
Canadian Institute of Chartered Accountants (1992)	Materiality is determined by "reference to what he or she (auditor) believe will probably change or influence the decision of a person who is relying on the financial statements and who has a reasonable knowledge of business and economic activities" (para 2).
Auditing Practices Board, UK (1995)	Materiality is an expression of the relative significance or importance of a particular matter in the context of financial statement as a whole. A matter is material if its omission would reasonably influence the decisions of an addressee of the auditors' report; likewise a misstatement is material if it would have a similar influence. Materiality may also be considered in the context of any individual primary statement within the financial statements or of individual items included in them. Materiality is not capable of general mathematical definition as it has both qualitative and quantitative aspects (para 3)

**Table 1** Definitions of materiality (continued)

<i>Accounting bodies</i>	<i>Definitions of materiality</i>
Accounting Standards Board (1995)	An item of information is material to the financial statements if its misstatement or omission might reasonably be expected to influence the economic decisions of users of those financial statements, including their assessments of management's stewardship (para 3.30)
International Federation of Accountants, Glossary of terms (2004)	Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements. Materiality depends on the size of the item or error judged in the particular circumstances of its omission or misstatement. Thus, materiality provides a threshold or cut-off point rather than being a primary qualitative characteristic which information must have if it is to be useful.
<i>Academics</i>	
Gordon (1933)	A material fact is a fact the untrue statement or omission of which would be likely to affect the conduct of a reasonable man with reference to the acquisition, holding or disposal of the security in question.
Dohr (1950)	A statement, fact, or item is material, if giving full consideration to the surrounding circumstances, as they exist at the time, it is of such a nature that its disclosure, or the method of treating it, would be likely to influence or to 'make a difference' in the judgment and conduct of a reasonable person (p. 56).
Chetkovich (1955)	considered materiality as a concept which is useful for "... separating those important from unimportant items"
Hick (1964)	The materiality of an item entering into financial statements lies in its impact on the user. The question to be answered is: is it likely that an average prudent investor or a reasonable person would be influenced in his investment decisions if the matter at issue were disclosed or if net income or some other significant statement item were increased or decreased by the amount under consideration.
Study Group on Audit Techniques (1965)	an accounting error is material if the distortion affects or should affect the decisions of an intelligent reader of the financial statements (p.3).
Frishkoff (1970)	The relative quantitative importance of some piece of financial information, to a user, in the context of a decision to be made.
Brandt and Houle (1982)	Materiality in accounting is the concept under which choices relating to financial information are made in a way that will meet the objectives of financial statements.
Ghatalia (1984)	"... what is important and what matters to the financial statements and users".

**Table 1** Definitions of materiality (continued)

<i>Accounting bodies</i>	<i>Definitions of materiality</i>
Lee (1984)	Materiality is a matter of judgment...Materiality criteria would require to be specified for each judgment...Criteria reduce the latter (i.e., holding accountants accountable for their actions) to mere adherence to predetermined guidelines which may or may not suit the individual circumstances. Thus, in answer to the question of whether or not materiality criteria would be desirable, the answer is in the negative because of the danger that they would be regarded as rules capable of subsuming the professional judgments of accountants, and auditors. Further in answer to the question of whether or not materiality criteria would be feasible, the answer is in the negative so long as user needs are relatively unknown and the concept of true and fair view is undefined... Warnings that specified criteria ought not to supersede expert judgment (which are usually given in audit manuals) are inadequate counter-measures to the dangers of a rigid adherence to rules (p.23).
Accountants International Study Group (1974)	One need be concerned only with what is important or with what matters (para. 4).
<i>Government</i>	
National Audit Office (1983)	In general terms, a matter should be judged to be material if knowledge of the matter would be likely to influence the general impression of the authority's financial position formed by the user of the statement. Materiality should be considered in the context of the statement as a whole, the balance sheets, revenue accounts and individual items within the statement.
National Audit Office (1992)	A matter would be material if knowledge of it would be likely to influence the user of the financial statements (para 20).

Since 1980, the evolution process comes to a halt. The increasing volume of litigation compelled the accounting and auditing bodies to revisit the definition. The call for review could be due to lacking of a concise and clear definition (Nolan, 2005, 2006). In 2004, the IFAC issued its Glossary of Terms defining materiality as an:

“Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements. Materiality depends on the size of the item or error judged in the particular circumstances of its omission or misstatement. Thus, materiality provides a threshold or cut-off point rather than being a primary qualitative characteristic which information must have if it is to be useful.”

IFAC has standardised the definition by removing words like ‘magnitude’ initiated by the Financial Accounting Standards Board (1980), ‘matters’ by the American Accounting Association Committee on Concepts and Standards (1954) and ‘items’ by Institute of Chartered Accountants in England and Wales (1968) by ‘information’. Information covers not only matters and items, but also facts and issues that surround and affect a firm. With this stakeholders need to pay attentions on whether an information or fact deems important and has any implications to users’ decision-making processes. This extends an auditor’s responsibilities with events or situations that may have potential or actual impact on the stakeholders. In response, the Auditing and Assurance Board (2004)

issued the International Standard on Auditing (ISA) on ‘Materiality in the Identification and Evaluation of Measurements’ that defines materiality as:

“Omissions or misstatements of items are material if they could, individually or collectively, influence the economic decisions of users taken on the basis of the financial statements. Materiality depends on the size and nature of the omission or misstatement judged in the surrounding circumstances. The size or nature of the item, or a combination of both, could be the determining factor” (para 6).

Though this is an auditing standard, AASB adopts the accounting definition of IAS 1 (Presentation of Financial Statements). The definition is vague and ambiguous, and focuses on the accounting instead of auditing perspective. The AASB should provide a definition that could apply in the auditing context rather than based on the existing accounting perspective. Both auditors and preparers have different sets of stakeholders and responsibilities. Preparers rely on materiality to disclose information while auditors on selecting the appropriate level of audit samples.

In 2009, IFAC issued the ISA 320 ‘Materiality in Planning and Performing an Audit’, in it, performance materiality is defined as

“the amount or amounts set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole. If applicable, performance materiality also refers to the amount or amounts set by the auditor at less than the materiality level or levels for particular classes of transactions, account balances or disclosures” (paragraph 9).

The standard does not specify the audiences that it intends for. Paragraph 2 of the Standard spells out materiality should be taken in the context of

- a misstatements, including omissions, are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements
- b judgments are made in the light of surrounding circumstances, size or nature of a misstatement, or a combination of both
- c judgments about matters to users of the financial statements<sup>2</sup>, and possible effects of misstatements on specific individual users, whose needs may vary widely, but not considered in the Standard.

In fact, the Standard should provide a concise definition, if not a guideline, on materiality for preparers and auditors. A concise definition on audit materiality will help set the benchmarks and eventually protect the reputation of the profession<sup>3</sup> (Porter et al., 1996), serve as a shield of defence for negligence, a mechanism for teaching and educating the stakeholders, and standardise the approach to the accounting and auditing procedures (Chong, 1992), but not for absolving the responsibilities and liabilities of preparers and auditors. Materiality guidelines should include both the quantitative and qualitative variables. Examples of the qualitative variables are risk, nature of the item, nature of the client’s business, strength (or weaknesses) of client’s internal control system, and environment in which the client operates (Chong, 1996). Modern organisations are facing the constant pressure on compliance with ethical moral and reasoning, and expanding their social responsibilities. The definition should extend beyond the traditional

accounting and auditing approaches to issues relating to social responsibilities. The definition should evolve the codes of conducts, honesty and moderation on business ethics, strategies and approaches.

### *3.2 Legal cases*

Jennings et al. (1985), Jeffries (1981), and Chong and Vinten (1994) review various legal cases on how judges determine and define materiality. They conclude courts have yet to develop a concise definition on materiality. This could be due to the accounting and auditing professions themselves have failed to develop a consensus definition, and judges need to consider each case on its merits and interpretations. The Securities Exchange Acts initiate the judicial definitions to protect investors against possible losses due to omissions and misstatements of material facts. The Securities Exchange Acts (1933 and 1934) define materiality as:

“The term ‘material’ when used to qualify a requirement for the furnishing of information as to any subject, limits the information required to those matters which an average prudent investor ought reasonably to be informed before purchasing the security purchased” (17 CFR, 230.404(1) and 240.12b-2, 1933)

The definition is vague as it merely suggests extent of offences involving misleading and omission of information<sup>4</sup>. Due to vagueness, US courts failed to interpret materiality precisely but required reporting parties to incorporate all material financial and non-financial information (Chong and Vinten, 1994). In the UK, the Handbook of the London Stock Exchange<sup>5</sup> (1997), equivalent to the US Securities Acts, has faced a similar failure on defining materiality<sup>6</sup>. Without a clear and precise definition, stakeholders and stake seekers remain in the dark on what constitute materiality and how it should be measured.

### *3.3 Government agencies*

The government accounting and auditing manuals do not provide a concise definition of materiality and guideline (Tomkins and Barker, 1985, Rahman and Daniker, 1992, and Ramamoorti, 1998). Both Tomkins and Barker (1985), and Rahman and Daniker (1992) review and conclude the literature from government agencies do not provide a precise definition on materiality but asking preparers and auditors to exercise their professional decisions. Ramamoorti (1998) suggests that government auditors need a clear definition on materiality that embraces benchmarks that include both the qualitative and quantitative factors (p.45). As far as internal audits are concerned, the UK Central Government’s Internal Audit Manual (Her Majesty’s Stationery Office, 1988) defines materiality as “the significance of undesirable events occurring, applied to systems if it reflects the significance of a failure to achieve management’s objectives” (Glossary D1) and

“materiality is a reflection of the significance to the department as a whole of a failure to achieve management’s objectives. In considering materiality, the internal auditor should take into account (a) possible direct and indirect financial consequences, (b) importance of particular management objectives in the context of the department’s overall objectives; and (c) potential for embarrassment to either Ministers or the Accounting Officer” (Section C2.3, para 6).

The Manual further provides that

“in considering the materiality of what is at risk, the internal auditor should take into account the cost of reacting to a failure as well as the effects of the failure itself. Such costs may include, for example, the resources to be applied to investigation, taking corrective actions and supplying appropriate explanations to Parliament and the public” (para 7).

The definition includes both quantitative aspect and qualitative perspective of materiality such as department’s overall objectives, and embarrassment that may cause to either Ministers or Accounting Officer. To what extent an event or situation that considers defiance to a department’s overall objectives and brings embarrassment to the Minister or Accounting Officer remains vague. These qualitative variables cause more confusions than clarifications to preparers and stakeholders. In 1983, the UK National Audit Office, responsible for audits of the federal and local government departments, issued the Audit Commission Code of Local Government Audit Practice for England and Wales. It defines materiality as

“In general terms, a matter should be judged to be material if knowledge of the matter would be likely to influence the general impression of the authority’s financial position formed by the user of the statement. Materiality should be considered in the context of the statement as a whole, the balance sheets, revenue accounts and individual items within the statement” (para 5).

The definition seems similar to the Audit Manual for the Government Internal Auditors (1992). The Manual is meant for guiding auditors in local and regional governments, and defines materiality as “a matter would be material if knowledge of it would be likely to influence the user of the financial statements” (para 20). Though shorter than the Audit Commission Code (1983), both audit manual emphasise on requiring civil servants to assess and separately disclose all material matters that could influence decisions of the users.

### *3.4 Academics*

Academics have expressed the need for a well-defined concept of materiality. In 1933, Gordon defines materiality as “a fact that the untrue statement of omission of which would be likely to affect the conduct of a reasonable man with reference to the acquisition, holding or disposal of the security in question.” The definition provides a guide to preparers and auditors to perform the necessary tasks for meeting the needs and expectations of investors. The emphasis is much in line with the SEC’s 1933 and 1934 Acts whereby preparers are expected to restore the minimum level of trust and confidence to investors, and avoid omissions and misstatements. The emphasis of the definition remains the same for next two decades until 1950 when Dohr defines materiality as:

“A statement, fact, or item is material, if giving full consideration to the surrounding circumstances, as they exist at the time, it is of such a nature that its disclosure, or the method of treating it, would be likely to influence or to ‘make a difference’ in the judgment and conduct of a reasonable person” (p.56).

The emphasis has now moved from evaluating the impact of omissions or misstatements of items on an investor to the impact on a reasonable person. The evolution cycle

continues. For example, Hick (1964) defines materiality as “if the matter at issue were disclosed or if net income or some other significant statement items were increased or decreased by the amount under consideration”, while Brandt and Houle (1982) defines it as “choices (of accounting treatment or items) relating to financial information are made in a way that will meet the objectives of the financial statements”. In 1984, Ghatalia simplifies the definition as “what is important and matters to the financial statements”. In 1992, Chong expands the definition incorporating impact of these items on the truth and fair presentations of the financial information. In the surveys of audit manuals of major firms including all the then Big Eight, Turley and Cooper (1991) conclude firms emphasising materiality threshold needs to meet truth and fairness of the financial statements. Materiality becomes one of the elements that compliment toward the notion of truth and fairness. The notion of true and fair becomes a norm for ensuring disclosure of all material facts and information. Despite this, Chong (1996) contends that the definition seems too narrowly focused, does not include reports on any fraudulent acts, fails to define the benchmarks for materiality, lacks emphasis on firms’ ethical and social responsibilities issues, and shorts of identifying reasoning in the whole reporting and disclosure processes.

### *3.5 True and fair view*

The notion of ‘true and fair’ view originated from the 1947 Companies Act. It has undergone little change from the original version of ‘full and fair’ view (Joint Stock Companies Act, 1844) to ‘true and correct’ view (Joint Stock Companies Act, 1856, Companies Acts 1856, 1879, 1990) and eventually ‘true and fair’ view (Companies Act, 1947 onwards)<sup>7</sup>. Chong (2008) remarks these changes as no collection of perceptions to give unequivocal meaning to the phrase. The change from ‘true and correct’ to ‘true and fair’ was made without offering the reasons (Walton, 1991), and too rigid (Rutherford, 1988, 2005), while the word ‘fair’ conveys the same kind of general impression as ‘correct’. Courts seem to arrive at the conclusion that a set of financial statements is deemed ‘true and fair’ view [for example, re. Press Caps Limited (1949), Lloyd Cheyham & Co. v. Littlejohn & Co (1987) BCLC 303] as long as they were “drawn up under currently accepted practice” [Walton, (1993), p.51]. In its separate statements, the ICAEW defines ‘true and fair’ as:

“A true and fair view implies appropriate classification and grouping of items and therefore the balance sheet needs to show in summary form the amounts of the share capital, reserves and liabilities as on the balance sheet date and the amounts of the assets representing them, together with sufficient information to indicate the general nature of the item.” (Statement N18, 1958), and

“Financial statements are required to give a true and fair view. This includes the provision of sufficient information, properly displayed, to enable a reader to assess the overall performance of a business, the full extent of its liabilities (actual and contingent) and its exposure to risks.” (TR603, 1985)

The first statement indicates that compliance with the GAAP would assume firms have satisfied the needs of a true and fair view, while the second requires preparers and auditors not only to comply with GAAP, but also apply the qualitative tests in determining the accounting treatment<sup>8</sup>. In this instance, both statements require firms need to adhere with the quality of disclosure. No one seems to know exactly whether the true meaning of ‘true and fair’ is correctly and appropriately transpired as McGee (1991)

observes that even “...relatively few lawyers have much understanding of the principle of accounting, while.. the accountants themselves have not succeeded in developing a satisfactory conceptual framework for the subject (‘true and fair’)” (p.874). The confusions continue when the ICAEW published its Audit Brief on Special Reports of Accountants (September, 1984) states that “because the information on which the accountant is reporting does not constitute a complete set of financial statements prepared on a comprehensive basis of accounting, it will not be possible for the accountant to report in ‘*true and fair view*’ terms” (para 38) (emphasis added). It is difficult to establish whether a set of financial statements have been prepared on ‘a comprehensive basis of accounting’. Presumably ‘a comprehensive basis of accounting’ includes compliance to the current GAAP and regulatory requirements. This may not be true. Different commentators offer different views on the definitions of true and fair. Walton (1991) argues a ‘true and fair’ view notion include

- a disclosure of financial information should comply not only with the requirements of the Companies Act but also to ensure such compliance would not mislead sets of figures, and to disclose further information or even departure from the rules (set out by the Companies Act),
- b an independent concept which may be referred to in order to resolve conflicts in setting standards or making decisions in individual cases, that is independent of the accounting rules
- c compliance with the generally accepted accounting principles (GAAP).

Both Mckee and Elifsen (2000) and Rosner et al. (2006) comment that a true and fair view may be distorted due to

- a the figures given in the accounts may be over or under stated by a material amount
- b the description of the figures in the accounts may not disclose their true nature or be misleading or ambiguous
- c the accounts may not be prepared on a basis consistent with previous periods or conformity to GAAP
- d some of the relevant information may not be given
- e the presentation of the figures in the accounts may be so obscure or complicated that they are difficult to interpret.

Pushing the boundary on what exactly constitutes a true and fair view continues when Jayalakshmy et al. (2005) suggest that a true and fair is designed to meet the users’ expectations and needs rather than being looked at the perspective of the company or of the auditors. In an attempt to pin down the definition of true and fair view, Livne and McNichols (2009) conclude that the concept allows firms to depart from the letter of the law and promulgated accounting standards in certain circumstances, while provides flexibilities to firms on disclosing material items using the principles-based rather than rigid accounting rules. Countries that subscribe to the International Accounting Standards including Japan require firms to ‘present fairly’ their financial position, financial performance and cash flows (paragraph 13). In the UK, the Financial Reporting Council (the UK regulator overseeing the ASB) has confirmed that following the

adoption of IAS and ‘fair presentation’ in the EU, the concept of ‘true and fair view’ remains a cornerstone of financial reporting and auditing in the UK.

Results of above review show there is a wide definition on the true and fair notion. What constitutes a truth and fairness depends on many variables including materiality, reliability and relevance of information to be disclosed in the financial statements (Chong 2008). Failure to establish a concise definition on materiality could adversely affect and allow users to misinterpret the financial position of a reporting entity. There exists a close relationship between true and fair and materiality (Chong 1992; Turley and Cooper, 1991).

### *3.6 Summary*

The above analysis shows that preparers, auditors, regulators and judges could derive their own definitions on materiality. This gives a principle-rule approach with added flexibility toward the process of preparing and auditing the financial information. Liberty could mean the surrounding facts, matters and issues are given equal, if not more, attentions than the quantitative measurements. Present fairly is recommended in the course of assessing material facts and information. In this regard, materiality could be defined as:

“matters which would influence the decision making of a prudent stockholder, after considering the qualitative and quantitative variables, and fairness on presenting in the financial statements”.

## **4 Conclusions and ways forward**

The above analysis attempts to derive a general definition on materiality of items, matters or facts that could influence the decision of an average prudent investor in the course of evaluating and making decisions. Omissions and misstatements of such an item, either on an individual or on an aggregate basis, could affect the decisions due to its significance. The definition on materiality needs to be clear, concise and principle-based to meet the needs and expectations of the users. The definition should be firm and fair, but gives opportunities for preparers and auditors to incorporate significant surrounding facts and information that may affect users’ decisions.

A clear definition is important to all stakeholders and stakeholders in helping them to understand the implications of the concept. For preparers, they should be able to defend themselves in case of any deviations from the boundary of the definition, in particular when called upon by the courts for expert witness<sup>9</sup>. For the judges, instead of relying on the past judgments and case laws, or the accounting and auditing professions, a standardised definition will help determine the gravity of the cases. For the auditors, the definition will serve as a defence mechanism in case of litigations or misunderstanding.

Due to its intrinsic nature, when deciding the threshold, individuals need both qualitative and quantitative variables in the evaluation process. The thresholds could be in the format of a range consisting of various variables rather than a strict percentage. For example, 5%–10% of net profit, 2%–5% of turnover and 1%–2% of total assets. Apart from a clear definition, the professions should consider having the bases of measurements disclosed in the footnotes. This could serve as part of the accounting policies, and state the reasons for and effects of departure from the recommended thresholds. It is

understandable that professional judgments may apply in the course of determining the thresholds, these additional disclosures could help users to understand the processes of determining materiality. In the initial stage, users may find these additional disclosures complicated, confusing and disturbing, but in a long run, they will appreciate and wean to these information. For the practitioners, these could mean additional resources needed to ensure accuracy and appropriateness in the disclosure processes, but would become a useful defence mechanism where they face the legal challenges in a future stage.

There is an urgent need to educate the stakeholders, in particular the courts, on how the accounting and auditing professions define materiality and determine the thresholds. A clear definition will help courts to determine the impact of material facts and consider the surroundings and gravity of the cases in the legal decision processes. Undoubtedly, courts will apply a qualitative standard and ready to squash any evaluation put forward by the accounting and auditing professions if they do not think fit or comprehensible. For example, in the *US v Simon* [425 F.2d 796, 807 (Cir.2, 1969)], the judges conclude that:

“We do not think the jury was also required to accept the accountants’ evaluation whether a given fact was material, at least not when the accountants’ testimony was not based on specific rules or prohibitions to which they could point, but only on the need for the auditor to make an honest judgment.”

A concise definition is clearly needed in particular, in today’s litigious society. If an accountant’s judgment becomes questionable, the ultimate determination of a proper treatment will be made by the courts. To avoid legal liability, it seems that the accountants need to comply with the common law definition of materiality. However, cautious accountants may wish to compel to adopt the judicial definition of materiality, though it may not always agree with the profession’s conceptual framework of accounting. The differences in the definition and approach will cause another contention between the professions and additional confusions to the stakeholders.

Though the IFAC (2009) has revised its ISA 320 ‘Materiality in Planning and Performing an Audit’ by defining performance materiality as

“the amount or amounts set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole. If applicable, performance materiality also refers to the amount or amounts set by the auditor at less than the materiality level or levels for particular classes of transactions, account balances or disclosures” (paragraph 9).

The emphasis remains on the auditing rather than accounting perspective.

The IFAC has now issued a revised version of ISA 320. It would be interesting to conduct further research on how materiality definitions are being accepted or adopted among the various industries and sectors. The results will then be measured against the types and numbers of legal cases pertaining to materiality. Rather than based solely on reviews of literature, future research could embark upon soliciting views and comments from the professions and stakeholders. A clear and concise definition will greatly help the professions surviving in a litigious environment. When interpreting the definition, the profession should not use the definition solely on the rule-based basis, instead should use the common sense approach of principle-based basis when considering the absolute amount and relative amount of the items involved. The definition and measuring of materiality should go hand in hand, and the quest for guidance continues.

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## Notes

- 1 The Auditing Standards Steering Committee (1975) initially has serious doubt as to whether to publish a guideline on materiality. After rounds of consultations with their members, the Committee concludes that  
“... those advocate the publication of such (materiality) guidelines believe that they will reduce the number of inappropriate materiality judgments, provide a greater degree of consistency in such judgments, create a greater awareness of the limitations of the audit process and establish a basis for discussing materiality with client. Those who oppose the publication of such guidelines contend that they may create the impression that the determination of materiality is a mechanical exercise, tend to become ‘cast in stone’ thus seriously down playing the importance of professional judgment and the qualitative aspects of materiality, and be open to misinterpretation or misapplication. After carefully considering these arguments, the Auditing Standards Steering Committee has concluded that the advantages of including some quantitative materiality guidelines outweigh the disadvantages” (para 3).
- 2 For example, the ‘Framework for the Preparation and Presentation of Financial Statements’, adopted by the International Accounting Standards Board in April 2001, indicates that, for a profit-oriented entity, as investors are providers of risk capital to the enterprise, the provision of financial statements that meet their needs will also meet most of the needs of other users that financial statements can satisfy.
- 3 In its Scope and Authority of APB Pronouncements (Auditing Practices Board, 1995), the APB explains that “statements of auditing standards contain basic principles and essential procedures... with which auditors are required to comply... in the conduct of any audit of financial statements” (para 4).
- 4 Section 11(a) of the Securities Exchange Act 1933 specifically stipulates the civil liabilities on the auditors as follows: “In case any part of the registration statement contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein not misleading, any person acquiring such securities may sue every accountant who has with his consent been named as having certified any part of the registration statement with respect to the statement in such registration statement which purports to have been certified by him.”

- 5 This is also called the Yellow Handbook of The London Stock Exchange.
- 6 In its Yellow Handbook, The London Stock Exchange requires ‘substantial’ shareholders to be disclosed in the directors’ reports. Substantial shareholders are those owning 3% or more equity shares (Chapter 12, para 43, 1997). This is the closest word used in lieu of materiality in the Handbook.
- 7 The requirement of a true and fair first entered English Law in Section 13(1) of the Companies Act 1947. This then became Section 149(1) of the Companies Act 1948. After the UK joined the EEC in 1973, harmonisation of company law began, and the Fourth Directive on Company Law in 1978 also adopted the concept of a true and fair view.

The process of implementing the Fourth Directive began in 1981, when the Companies Act of that year introduced for the first time detailed rules as to the format and content of company accounts. The true and fair view requirement, which had been retained in the Fourth Directive at the insistence of the United Kingdom, then became Section 228 of the Companies Act 1985. Further amendments were made by the Companies Act 1989, and the true and fair view requirement is now to be found in Section 226 of the 1985 Act (as amended). Section 226(2) of the Companies Act 1985 provides:

“The balance sheet shall give a true and fair view of the state of affairs of the company as at the end of the financial year, and the profit and loss account shall give a true and fair view of the profit or loss of the company for the financial year.”
- 8 See Alexander and Jermakowicz (2006) for a detailed discussion on principles versus rules based approach on truth and fairness on presenting financial statements.
- 9 For example, Ashton (1987) cites Argyll Food as an example of accountants were called upon by the courts to provide decisions and clarifications on the effects of SSAP 16 (current cost accounting) on performance measurements of companies.