Australian Government

Australian Accounting Standards Board

AASB RESEARCH REPORT 21

Auditors' Perspectives: The Impacts of IFRS Practice Statement 2 *Making Materiality Judgements*

October 2023

Australian Government
Australian Accounting Standards Board

Principal Authors

Tom Frick – University of Melbourne
Associate Professor Brad Potter – University of Melbourne
Professor Michael Davern – University of Melbourne

Disclaimer

The views expressed in this research report are those of the author(s) and those views do not necessarily coincide with the views of the Australian Accounting Standards Board. Any errors or omissions remain the responsibility of the principal authors.

Acknowledgement

The authors express their gratitude to members of the IASB and staff of the AASB for their assistance in sourcing auditors to participate in this research.

AASB Research Reports and Suggested Citation

The AASB Research Centre publishes research reports to promote thought leadership in accounting and reporting through rigorous analysis and research, aimed at informing stakeholders and advancing the quality of corporate reporting.

The suggested citation for the complete report is:

T. Frick, B. Potter and M. Davern (2023), Auditors' Perspectives: The Impacts of IFRS Practice Statement 2 *Making Materiality Judgements.* AASB Research Report 21 (October 2023).

Enquiries

Australian Accounting Standards Board
PO Box 204
Collins Street West,
Victoria, 8007
Australia
Tel: +61 3 9617 7637
Email: standard@aasb.gov.au
Website: http://www.aasb.gov.au

Copyright

Australian Government
Australian Accounting Standards Board

Contents

Foreword

The International Accounting Standards Board (IASB) issued a call for research on the subject of materiality that is crucial in financial reporting. We extend our heartfelt thanks to the authors who responded to this call, providing valuable insights into the gaps that exist in our understanding and application of materiality. We would be remiss not to thank the participants whose inputs form the backbone of this study. Without such participation, the insights gained from this research would not be possible.

This research shows that the IFRS Practice Statement 2 *Making Materiality Judgements* is helpful as it clarifies the concept of materiality. However, there is a significant need for enhanced educational programs targeting key stakeholders, including auditors. The concept of materiality, despite its importance, is not as well understood as it should be, and this has implications for the quality of financial reporting. Educational gaps exist, and there is an urgent need to fill these gaps to ensure that financial statements relevant are to users. The findings not only urge standard-setters to recognise the importance of education but also serve as a reminder to other key stakeholders—such as educators and practitioners—of the need to focus on educational efforts.

The AASB remains committed to ensuring that accounting and reporting standards are well-suited to the Australian economy and meet user needs. The business environment is continually evolving, as are the needs of the users of financial reports. This research serves as a vital step in that ongoing journey to ensure that accounting and reporting standards remain current and relevant.

Keith Kendall
Chair, Australian Accounting Standards Board

1. Introduction

1.1 The Current State of Materiality

Materiality is widely considered to be a fundamental financial reporting concept, facilitating the preparation of general-purpose financial statements which meet their intended objective of providing useful information for users of general-purpose financial reports. By serving as a judgement filter on all disclosures, materiality plays a crucial role in the financial reporting process. Materiality judgments made by report preparers and auditors significantly impact decisions made by report users as they seek to make efficient capital allocation decisions.

Even though materiality has been embedded in the conceptual framework and accounting standards for decades, standard setters continue to grapple with how best to define and apply materiality in practice (Edgley, 2014). Consistent with this, anecdotal evidence from audit partners, and academic research, reveal the concept to be applied by report preparers and auditors largely in a mechanical fashion, without the sufficient nuance or systemic context required to appropriately make materiality judgements that provide decision-useful information to report users.

Existing research into report preparer and auditor materiality judgements has settled around the application of percentage-based heuristics to make materiality judgements based on the quantitative properties of information (Brennan & Gray, 2005; Messier Jr et al., 2005). Typically this is applied by comparing the dollar value of a financial statement line item relative to a base figure such as total assets or revenue.[1] Throughout recent decades, these heuristics have become embedded into accounting textbooks (see Loftus et al. (2020) and Moroney et al. (2017) for examples), and even some accounting standards, such as the now withdrawn the Australian accounting standard AASB 1031 *Materiality*.

While percentage-based heuristics may simplify the application of materiality, such a process for making materiality judgements is not consistent with the materiality judgements and decisions made by investors and other report users (Choudhary et al., 2021). While auditors and report preparers may make materiality judgements primarily based on the quantitative properties of information, report users are likely to take into account a range of quantitative and qualitative information factors, making materiality judgments in a more holistic manner, and in light of the relevant organisational context (Cho & Patten, 2007; Hutton et al., 2003). Regulators, such as the Chief Accountant for the SEC, have also recommended that auditors more actively adopt an investor perspective when making materiality judgements, to help drive alignment with the materiality judgements of report users (Bricker, 2016).

In recent years, the International Accounting Standards Board (IASB) has undertaken a series of actions in an attempt to improve the understanding and application of materiality. Information is currently defined as material by the IASB if it "could reasonably be expected to influence

1 For example, Bernardi & Pincus (1996) find that up to 75% of auditors make materiality judgements consistent with some kind of established quantitative rule, with a threshold of 5% of pre-tax income the most common.

decisions," made by "primary users of general-purpose financial reports".[2] This requires those who apply materiality in the preparation and presentation of financial statements, namely report preparers and auditors, to essentially proxy for the materiality judgements of the users of those financial statements to understand whether information should be deemed material.

In 2017, the IASB issued IFRS Practice Statement 2 *Making Materiality Judgements*, which provides reporting entities with non-mandatory guidance on a four-step process to make materiality judgements. In 2018 the *IFRS Conceptual Framework for Financial Reporting* (*Conceptual Framework*), IAS 1 *Presentation of Financial Statements*, and IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* were each updated to include a revised definition of materiality. The IASB's intention was to "make it easier for companies to make materiality judgements," (IFRS Foundation, 2018) and see entities disclosing more relevant and decision-useful information, alongside less irrelevant information.

While the guidance contained within IFRS Practice Statement 2 is geared towards report preparers, it is also important to consider materiality judgements made by auditors. The key role of an auditor is to assess whether a set of financial statements are free from material error or misstatement. If an auditor judges information that has not been disclosed within a set of financial statements to be material, they may judge that those statements are not free from material error or misstatement. This would prompt the preparer to disclose the information in the financial statements, or potentially face a qualified or adverse audit opinion. In this sense, auditor materiality judgements interact with report preparer materiality judgements to arrive at decisions of what information is disclosed within financial statements.

In practice, a large number of report preparers are also ex-auditors, meaning that the materiality judgements and processes followed by auditors are likely to show considerable overlap to those followed by report preparers (Messier Jr et al., 2005). The *Basis for Conclusions on the IFRS Practice Statement 2* also notes that some public feedback to the Practice Statement Exposure Draft notes that "preparers and auditors of financial statements assess materiality using a comparable approach" to each other.

Despite the importance of auditor materiality judgements to information disclosure decisions, the authors of this report are unaware of any existing studies providing evidence as to how auditor materiality judgements, and the way in which auditors make materiality judgements, may be influenced by IFRS Practice Statement 2. As such, this study focuses on materiality judgements made by auditors.

1.2 IFRS Practice Statement 2

IFRS Practice Statement 2 provides a four-step process for reporting entities to make materiality judgements, as briefly detailed below.

---

2 The IASB *Conceptual Framework* identifies the primary users of general-purpose financial reports as "potential investors, lenders and other creditors" (para. 1.2). This study will focus primarily on investors, and use the terms "users" and "investors" interchangeably, in line with prior academic research into materiality (Messier Jr et al., 2005), and to avoid the complexities of the materiality judgements of different user groups.

- Step 1 – identify – An entity should identify a set of potentially material information by identifying information about its transactions, other events and conditions that users might need to understand to make decisions relating to the entity
- Step 2 – assess – An entity should assess whether the set of potentially material information is material by considering a range of quantitative factors, qualitative factors, and any interactions between those factors
- Step 3 – organise – An entity should classify, characterise, and present material information clearly and concisely to make it understandable for users
- Step 4 – review – An entity should assess whether information is material individually and in combination with other information in the context of its financial statements as a whole

There are two broad channels through which IFRS Practice Statement 2 attempts to improve the decision-usefulness of materiality judgements made by an entity.

Firstly, in Step 2–assess, the practice statement guides those making materiality judgements for reporting entities to consider quantitative factors, qualitative factors, and interactions of qualitative and quantitative factors, to make materiality judgements. Evidence shows that investors and other report users make use of a variety of information sources to make decisions relating to an entity, including qualitative information sources, such as management commentary and sustainability-focused disclosures (Cho & Patten, 2007; Hutton et al., 2003). In order to make materiality judgements which can effectively proxy for those of report users, those making materiality judgements for reporting entities should also consider a wide variety of factors, rather than relying solely on quantitative factors such as percentage-based heuristics.

Secondly, paragraph 13 of the practice statement prompts those making materiality judgements for reporting entities to directly "consider the impact information could reasonably be expected to have on the primary users of its financial statements". This concept is reinforced throughout each of the four steps and examples given throughout the practice statement. This aligns with the definitions of material and relevant information in the Conceptual Framework. If those making materiality judgements for reporting entities specifically consider users in their materiality judgement processes, the information disclosed in financial statements should be more likely to meet the objective of general-purpose financial reports of providing useful information to report users.

The guidance provided in IFRS Practice Statement 2 prompts auditors to adopt a process to make materiality judgements that is less reliant on percentage-based heuristics, and instead better reflects the more holistic materiality judgement process typically employed by financial report users. This research therefore aims to investigate the following question, which is broken down to investigate two specific elements of IFRS Practice Statement 2:

How has IFRS Practice Statement 2 influenced the decision-usefulness of auditor materiality judgements for financial report users?

a) *How has IFRS Practice Statements 2 influenced the consideration of quantitative factors, qualitative factors, and the interaction of these factors, in auditor materiality judgement processes?*
b) *How has IFRS Practice Statement 2 influenced the consideration of report users in auditor materiality judgement processes?*

To gain insight into this research question, an experiment was designed which captured the processes and outcomes of experienced auditors making a materiality judgement relating to a financial statement line item of a fictitious firm. These auditors also provided information on their familiarity, knowledge, and alignment with IFRS Practice Statement 2. The following sections of this report detail the methodology used, and perform analysis on the auditors' responses to understand how their materiality judgements may have been influenced by IFRS Practice Statement 2.

2. Method

2.1 Respondents

Data for this research study was collected across late 2022 and early 2023. 42 auditors responded to the study. All respondents were experienced auditors, with the majority holding senior positions within their audit firm, such as partner or director. Experienced auditors were used to ensure that respondents had substantial experience in making materiality judgement as part of an audit. Materiality judgements, particularly those relating to disclosure decisions in financial statements, are usually made by auditors that hold senior positions and regularly interact and liaise with clients. Prior studies into auditor materiality judgements have typically used audit partners to collect data (e.g. Boatsman & Robertson, 1974; Moriarity & Barron, 1976).

Respondents were sourced from three continents, being Oceania, Asia, and South America. All respondents were sourced from jurisdictions that adopt or align with IFRS Accounting Standards, meaning that reporting entities and auditors in these countries adopt a consistent definition of materiality, and may use, or refer to, the non-mandatory guidance within IFRS Practice Statement 2 to aid in making materiality judgements.

2.2 Task Design

The study was designed as an online task that asked respondents to make a simple materiality judgement. Respondents received information relating to a restatement in a particular line item in the financial statements of a fictitious company, and judged whether that information was, from their perspective, material.

To inform their decisions, respondents were provided with a set of financial statements (containing a Statement of Financial Position, a Statement of Profit and Loss, and a Cash Flow Statement), and a set of nine facts relating to the firm's background.[3] The financial statements contained only two years of data, and were presented without notes, to minimise the complexity of the task and increase the chance that respondents paid attention to the presented information.

The fictitious firm respondents were required to analyse was a coffee machine and small household appliance manufacturer, named 'Presto Coffee Machines' (referred to as 'Presto').

3 A full copy of the materials and post-task questionnaire are available by contacting the authors.

The materials were adapted from real data for coffee machine manufacturer DeLonghi.[4] Two years of financial statements were presented to respondents, based on the 2017 and 2018 financial reports of DeLonghi. Several line items were consolidated or omitted to reduce the size of the financial reports. Overall, the financial reports showed a relatively stable business experiencing moderate growth over the time period shown.

To investigate the research question, respondents were required to make a materiality judgement on a restatement to the Employee Wages & Benefits[5] (EWB) line item contained within the Statement of Profit and Loss. Respondents were provided with information that the restatement was due to a one-off administrative configuration error in Presto's accounting systems, which had since been rectified by the firm.

The 2018 and 2019 figures for the EWB expense were $254.0 million and $257.3 million respectively. The restated 2019 figure was $252.4 million. The restated figure represents a 0.6% and 1.9% decrease from the 2018 and original 2019 figures respectively. These numbers were deliberately chosen to exhibit a small quantitative change, below a typical percentage-based heuristic such as a 5% in the value of the line item. However, the change in the trend of the figure from increasing to decreasing year-on-year may indicate the restatement is qualitatively material.[6] In this sense, the restatement to EWB is intended to be ambiguous, creating scope for variation in the materiality judgements different auditors may make.

Respondents were also presented with background information, in a series of nine dot points that detailed the nature of the company's operations, brief details on the global coffee machine market, the company's dividend policy, brief details on company plans for global expansion, and results of a recent customer satisfaction survey. This provided respondents with the necessary background information to understand the context of the firm, and draw on any qualitative factors they may find relevant, as well as the information contained within the financial statements, to make a materiality judgement.

As some data was collected at a time when some countries were still experiencing substantial economic impacts from the Covid-19 pandemic, respondents were instructed to assume the Covid-19 pandemic had not occurred for the purposes of the task. This was to avoid any respondent basing their decision-making processes on implications of Covid-19, which would likely add noise to their responses.

---

4 A coffee machine manufacturer was chosen as it is a fairly niche discretionary goods manufacturer, creating a low chance that respondents would have previous experience auditing or investing in the industry. This was a deliberate choices to ensure that respondent decision-making processes were not dominated by their previous auditing or investing experiences. However, the coffee machine product should have been familiar to most respondents, enabling them to easily understand the operations of the business and the basic market in which it operates.

5 Some financial statement line items would be expected to be material in almost all cases due to their nature, such as Sales or Net Profit. Employee Wages & Benefits was chosen for this study as it is a common line item expected to be found in a typical set of financial statements, but is not necessarily always material by nature.

6 An unexpected change in a trend is listed in Practice Statement 2 (para. 48(c)) as an example of an entity-specific qualitative factor that may make information more likely to influence the decisions of financial report users.

2.3 Variable Measurement

Familiarity with IFRS Practice Statement 2

While all respondents were auditors within jurisdictions that adopt or align with IASB Accounting Standards, IFRS Practice Statement 2 provides non-mandatory guidance only. It is therefore expected that only some auditors would be familiar with the content, and apply the principles, of IFRS Practice Statement 2. To understand whether IFRS Practice Statement 2 has improved the decision-usefulness of auditor materiality judgements, it is important to understand if respondents are familiar with the content of the practice statement. This was measured in two ways.

Firstly, respondents were asked to rate their familiarity with IFRS Practice Statement 2 on a 1 to 5 scale, where 1 is 'Completely unfamiliar' and 5 is 'Completely familiar' (*Self PS2*).

To avoid any potential bias in respondents' self-reporting of their familiarity with IFRS Practice Statement 2, respondents were also asked to briefly explain how they applied materiality judgements in their work as an auditor. The research team manually coded these free text responses according to whether they were broadly consistent with the four-step process for judging materiality set out in IFRS Practice Statement 2, to determine whether respondents were sufficiently familiar with the practice statement to apply its principles (*PS2 Familiarity*). The responses were coded as 1 if the response was consistent with IFRS Practice Statement 2, and 0 if it was not.

Materiality Judgements

Respondents' materiality judgements were captured to determine if familiarity with IFRS Practice Statement 2 leads to more decision-useful materiality judgements. Respondents were firstly asked whether they found the restatement in EWB material in the context of the financial statements and background information presented to them. This judgement was made on a 1 to 7 scale (where 1 is 'Not at all' and 7 is 'A great extent').

Respondents were then asked to explain their materiality judgement, using a free text response. The research team coded these responses along two dimensions to understand if the materiality judgement would be decision-useful for report users, with the variable coded as 1 if the attribute was present, and 0 if it was absent. Firstly, responses were coded based on whether the responses indicated that respondents holistically considered both quantitative and qualitative factors, rather than just one set of factors alone, when making the required materiality judgement (*Factors*). Secondly, responses were coded based on whether they indicated that respondents specifically considered the information needs of report users when making the required materiality judgement (*Users*).

Respondents were also asked to indicate to what extent quantitative factors, qualitative factors, and interaction of these factors, influenced their materiality judgement. These judgements were all made on a 1 to 7 scale (where 1 is 'Not at all' and 7 is 'A great extent').

Demographic Information

Respondents completed the experiment by providing demographic data, including information relating to their audit experience, gender, and country. Respondents also provided information indicating what sources of guidance they use to inform their understanding of materiality.

3. Results & Discussion

3.1 Demographics / Descriptive Statistics

Table 1 – Descriptive Statistics

Variable	n	min	max	mean
Firm	42	0	1	0.215
Region (Oceania)	42	0	1	0.190
Region (Asia)	42	0	1	0.238
Region (South America)	42	0	1	0.571
Years of experience	42	3	40	20.619
Factors	42	0	1	0.310
Users	42	0	1	0.119
PS2 Familiarity	42	0	1	0.381

Table 1 presents descriptive statistics for the sample. Usable responses were collected from 42 respondents. Table 1 shows that:

- The majority of respondents represented Big-4 audit firms, with 78.5% (21.5%) currently working at a Big-4 (non-Big-4) firm.
- Most of the respondents are based in South America (57.1%), 23.8% of the respondents are based in Asia and 19% are based in Oceania.
- Respondents were generally highly experienced in audit roles, with a mean of 20.619 years, and median of 21.0 years of experience in audit.

3.2 Materiality Judgement Process

If IFRS Practice Statement 2 is effective in prompting auditors to make more decision-useful materiality judgements, then those that have a materiality process aligned with IFRS Practice Statement 2 should follow a process to make materiality judgements that firstly considers a range of relevant quantitative and qualitative factors, and secondly specifically considers the information needs of report users.

Table 2 – Logistic Regressions on Usefulness of Materiality Judgements

Dependent Variable	(1) *Factors*	(2) *Users*
Intercept	-1.259	-19.912
	(0.877)	(3755.999)
PS2 Familiarity	1.797*	0.786
	(0.799)	(1.041)
Firm	1.451	0.479
	(0.958)	(1.064)
Region (South America)	-1.140	18.004
	(1.038)	(3755.999)
Region (Asia)	-0.192	0.102
	(1.105)	(5045.162)
No. observations	42	42

Standard errors are reported in parentheses.
*, **, *** indicates significance at the 95%, 99%, and 99.9% level respectively.

Table 2 presents logistic regressions showing whether a respondent who adopts a materiality judgement process aligned with IFRS Practice Statement 2 (*PS2 Familiarity*) considered both quantitative and qualitative factors (*Factors*), and if they considered the information needs of users (*Users*) in making their materiality judgements. Firm type (Big-4 or non-Big-4) and region were included as control variables.

Results show a significant effect for *PS2 Familiarity* ($p < 0.05$) on *Factors*, but no significant effect on *Users*. This shows that respondents who adopt a materiality process aligned with IFRS Practice Statement 2 were more likely to demonstrate their materiality judgement process included consideration of a range of quantitative and qualitative, but were not more likely to demonstrate a consideration of the information needs of report users.

The result for *Factors* provides strong evidence that IFRS Practice Statement 2 leads to more decision-useful materiality judgements by auditors, through the use of a range of quantitative and qualitative information cues. The experiment materials created ambiguity over the materiality of the EWB restatement based on a range of relevant quantitative and qualitative factors. While some respondents may have used their professional judgement to deem certain factors as irrelevant to their final materiality judgement, these factors should still be considered as part of the materiality process to align with the materiality judgement processes that users often employ. This type of thinking can be seen in the below example explanations given by respondents on how they made their materiality judgement[7]:

"*We note we've hired new executives, stated expansion activities and hired new op staff. As a result, it appears unusual to see employee wages & benefits decrease YoY and to decrease as a result of a late adjustment increases our sensitivity to the balance.*" (Respondent 39)

"*The error itself does not seem to be quantitatively important. However, as it is related to an operation of Asia, a newly expanded area, we should be careful if similar error has occurred in Asian operation.*" (Respondent 4)

Responses from both Respondents 39 and 4 clearly consider quantitative factors from the financial statements (the restatement in EWB), and qualitative factors from the contextual background information, (increase in staff numbers due to expanding operations in Asia). They also consider the interaction of these factors by noting that an increase in staff numbers is inconsistent with a decrease in EWB expense. In completing the experiment, the respondents exercised their professional judgement differently, with Respondent 39 indicating they found the restatement to EWB to be material, whereas respondent 4 was uncertain whether the restatement was material. By following such a materiality judgement process, these respondents were able to make a materiality judgement drawing on the context of the firm, without relying solely on quantitative information cues.

The result for *Users* does not provide any evidence that IFRS Practice Statement 2 leads to auditors being more likely to specifically consider report users when making materiality judgements. Such a small proportion of respondents outlined a consideration of users in their materiality judgement process (11.9% of the sample), that it appears that auditors in general continue to neglect the information needs of report users when making materiality judgements.

Respondents' materiality judgement processes instead often focused on considering the needs of the reporting entity, and concerns over fraud, governance, and internal controls, as shown by the below examples:

"*As the restatement is related to employee benefits, I would further analyse for any potential fraud implications.*" (Respondent 22)

"*Despite the fact that the adjustment seems to be not material, the company should review the potential controls impact and corresponding inputs.*" (Respondent 12)

While the role of an auditor often includes judgements over potential frauds, and a consideration of a reporting entity's governance and internal controls, the fact that the information needs of financial report users are seemingly not considered at any stage of the materiality judgement process means that IFRS Practice Statement 2 has had a limited influence on this aspect of auditor materiality judgements.

7 Respondent explanations are presented verbatim.

3.3 Materiality Judgements – Qualitative and Quantitative Factors

Table 3 – Anova Models on Materiality Judgements Made

	(1) Material		(2) Quantitative		(3) Qualitative		(4) Interaction	
	F-value	p-value	F-value	p-value	F-value	p-value	F-value	p-value
PS2 Familiarity	0.645	0.427	0.343	0.562	0.376	0.544	1.541	0.222
Firm	0.094	0.760	6.903	.013*	0.740	0.395	0.131	0.719
Country	0.817	0.449	3.704	.034*	1.837	0.173	2.571	0.090
No. observations	42		42		42		42	

*, **, *** indicates significance at the 95% ,99%, and 99.9% level respectively.

To provide further evidence on whether IFRS Practice Statement 2 leads to more decision-useful materiality judgements, responses on the various factors which influenced respondents' materiality judgements are also analysed.

Table 3 presents ANOVA tests on whether respondents' self-reported responses on whether they found the EWB restatement to be material, and what factors they considered important to make those materiality judgements, vary based on familiarity with IFRS Practice Statement 2. The results show no significant differences for the materiality judgements made (model 1), or how the quantitative factors (model 2), qualitative factors (model 3), or interaction of these factors (model 4) were considered, based on whether a respondent demonstrated familiarity with IFRS Practice Statement 2.

It is important to consider that the specific materiality judgements made, and the factors considered to make those materiality judgements, are highly specific on the information and context presented in the experiment. While the experiment was framed in a way to induce variation in respondents' use of quantitative and qualitative factors, it is possible that in this setting, the quantitative and qualitative factors were salient enough for respondents to consider no matter their degree of alignment with IFRS Practice Statement 2. In this sense, while the results in Table 3 do not provide any support for IFRS Practice Statement 2 improving the decision usefulness of auditor materiality judgements, this study would need to be carried out in the context of many different materiality judgements and reporting entities to show IFRS Practice Statement 2 has no effect on the decision usefulness of auditor materiality judgements.

The results in model 2 of Table 3 do provide an interesting insight that respondents reported they were influenced by quantitative factors differently if they work at a Big-4 audit firm ($p < 0.05$). Untabulated analysis shows that auditors working at a Big-4 firm had an increased likelihood of being influenced by quantitative factors to make their materiality judgement, as compared to auditors working at non-Big-4 firms.

Prior research has shown that auditors that rely on quantitative factors to judge materiality are likely to make use of percentage-based heuristics, such as 5-10% of the value of key line items, such as sales or net profit (Boatsman & Robertson, 1974; Messier Jr et al., 2005). Some respondents detailed that they judged materiality in the experiment purely by using percentage-based heuristics, such as the below response:

"*The error represents almost 40% of overall materiality (5% of profit before taxes). It should be recorded for further analysis.*" (Respondent 9)

While the use of such heuristics may provide a useful shortcut for auditors to make materiality judgements, they do not reflect the decision-making processes that report users are likely to undertake when analysing a set of financial statements (Cho & Patten, 2007; Hutton et al., 2003). This means disclose decisions made by auditors relying solely on quantitative factors, including percentage-based heuristics, are unlikely to consistently provide decision-useful information for users.

Other respondents did not indicate a use of percentage-based heuristics, but did focus primarily on quantitative factors to make their decision:

"*This error is small relative to the profit.*" (Respondent 35)

While Respondent 35's brief explanation does not indicate the use of a percentage-based heuristic, the materiality judgement appears to be made solely on quantitative factors. Even if an auditor were to, in their judgement on the case provided, find that qualitative factors were not material, it is important they are still considered in the materiality judgement process.

An overreliance on quantitative factors to make materiality judgements will likely become an issue of increasing prevalence as the scope of corporate reporting increases to consider sustainability-related financial information. Such information is often qualitative by nature, and can have limited quantitative dimensions, meaning percentage-based heuristics cannot be used to judge its materiality. It is important that auditors are able to judge materiality using a more holistic process, such as that outlined in IFRS Practice Statement 2, to ensure that the information disclosed in financial statements is useful for users.

3.4 The Need for Materiality Education

Table 4 – Familiarity with PS2 and Auditor Comfort in Making Materiality Judgements

	n	Completely unfamiliar / uncomfortable	Somewhat unfamiliar / uncomfortable	Neither unfamiliar / uncomfortable	Somewhat familiar / comfortable	Completely familiar / comfortable	Average / 5
Self PS2	36	6 (16.7%)	5 (13.9%)	7 (19.4%)	11 (30.6%)	7 (19.4%)	3.22
Materiality Comfort	37	4 (10.8%)	4 (10.8%)	7 (18.9%)	9 (24.3%)	13 (35.1%)	3.62

Figures in Table 4 show that only 50.0% (18/36) of respondents reported being at least somewhat familiar with the content of IFRS Practice Statement 2, and only 27.8% (10/36) of respondents were able to accurately describe at least a portion of the guidance contained with

IFRS Practice Statement 2.[8] While these figures are taken from a small sample of auditors, they indicate that a large portion of the audit community have little to no understanding of the guidance contained within IFRS Practice Statement 2.

Rather surprisingly, only 59.5% (22/37) of respondents indicated that they were at least somewhat comfortable in making materiality judgements as part of an audit.[9] Amongst a cohort of auditors with an average of over 22 years of experience in the audit industry, 40.5% stated they were uncomfortable in making materiality judgements. This statistic should be a cause for concern for standard setters and regulators in the audit industry. Making materiality judgements is a key part of an auditor's role, especially in senior roles such as directors and partners who liaise with clients, and are directly involved in discussions with clients around disclosure decisions in financial statements. If an auditor lacks the relevant skills or expertise to make a materiality judgement, they are unable to fulfil their professional duties in carrying out an audit engagement.

Table 5 – Sources of Guidance for Auditor Materiality Judgements

	n	Extremely small extent / Not at all	Very small extent	Small extent	Moderate extent	Large extent	Very large extent	Extremely large extent	Average /7
Audit firm's guidance	37	0 (0.0%)	1 (2.7%)	0 (0.0%)	5 (13.5%)	2 (5.4%)	6 (16.2%)	23 (62.1%)	6.19
Past audit work papers	37	4 (10.8%)	3 (8.1%)	4 (10.8%)	6 (16.2%)	8 (21.6%)	6 (16.2%)	6 (16.2%)	4.43
Relevant accounting standards (including PS2)	37	2 (5.4%)	2 (5.4%)	4 (10.8%)	6 (16.2%)	8 (21.6%)	7 (18.9%)	8 (21.6%)	4.86
The accounting conceptual framework	37	5 (13.5%)	2 (5.4%)	4 (10.8%)	6 (16.2%)	10 (27.0%)	5 (13.5%)	5 (13.5%)	4.32

Furthermore, statistics in Table 5 show respondents' understanding of materiality was most heavily informed by guidance from their audit firm (average rating of 6.19/7 on a 7-point scale), ahead of relevant accounting and auditing standards (4.86/7), past audit workpapers (4.43/7), and the accounting conceptual framework (4.32/7). These statistics indicate that the guidance an audit firm provides to its auditors may be critical in informing how an auditor understands, and therefore applies, the concept of materiality. At the same time, accounting and auditing

8 Untabulated analysis shows no significant differences in these statistics based on continent of origin, firm type, or years of audit experience.

9 Untabulated analysis shows no significant differences in this statistic based on continent of origin, firm type, or years of audit experience.

standards (including IFRS Practice Statement 2), and the accounting conceptual framework, appear to have had a limited influence on how an auditor understands and applies materiality.

These findings show that education is needed for the audit community at large around the content of IFRS Practice Statement 2 and its 4-step process to judge materiality. Given that the results in section 3.2 indicate that IFRS Practice Statement 2 may be effective in improving the decision-usefulness of an auditor's materiality judgements, there is an opportunity to increase awareness and familiarity with IFRS Practice Statement 2 within the audit profession to see more useful materiality judgements made by auditors. Standard setters and regulators should pursue this as a key priority to help achieve the objective of general purpose financial reports of providing useful information to report users.

An effective route to educate auditors about IFRS Practice Statement 2 may be through communicating directly with large audit firms to update the guidance that is provided to their auditors, as Table 5 indicates that auditors are heavily influenced by their firm's guidance. In particular, education efforts may be most effectively focused at more senior auditors at senior levels to ensure that those auditors who regularly liaise with clients, and have ultimate responsibility for the findings and outcomes of audits, are able to make well-informed and decision-useful materiality judgements.

4. Conclusion

The findings in this study indicate that IFRS Practice Statement 2 *Making Materiality Judgements* has improved the decision-usefulness of auditor materiality judgements to financial report users. Specifically, auditors who demonstrate knowledge of, and familiarity with, the four-step process of IFRS Practice Statement 2 are more likely to consider quantitative factors, qualitative factors, and interactions of these factors, when making materiality judgements, more closely reflecting a typical user's materiality judgement process. There is little evidence to support that IFRS Practice Statement 2 has prompted auditors to more actively consider report users when making materiality judgements.

Responses collected for this study indicate that a substantial proportion of auditors are unaware of, or cannot adequately explain, the content of IFRS Practice Statement 2. Instead, audit materiality judgements appear to be primarily driven by guidance provided by audit firms. An alarmingly high number of senior auditors, with decades of experience, report being uncomfortable in making materiality judgements in audits. These findings question whether auditor materiality judgements are providing useful inputs into reporting entities' disclosure decisions.

Overall, these findings indicate that IFRS Practice Statement 2 can be an effective tool to improve the decision-usefulness of auditor materiality judgements to users of financial reports. The authors recommend the IASB, national standard-setters, and professional accreditation bodies consider undertaking education campaigns to increase awareness and application of the practice statement across the audit profession.

The findings of this study should be considered in light of the small sample size of respondents. While the respondents were senior auditors with an average of over 20 years of experience in the audit profession, these findings may not be typical of the broader audit profession.

Further research into materiality judgements, made by both report preparers and auditors, is essential in the future, to ensure that disclosure decisions result in financial statements that provide useful information to users. This need is made more pressing by the publication of the International Sustainability Standards Board's initial financial-related sustainability reporting standards, and the broader expansion of corporate reporting practices to include sustainability-related information. In this area in particular, a range of information sources will be relevant to user decision-making, and an IFRS Practice Statement 2-like process of judging materiality will be vital for report preparers and auditors to adopt to ensure the disclosure of decision-useful information.

References

Bernardi, R. A., & Pincus, K. V. (1996). The relationship between materiality thresholds and judgments of fraud risk. *Managerial Finance, 22*(9), 1-15.

Boatsman, J. R., & Robertson, J. C. (1974). Policy-capturing on selected materiality judgments. *The Accounting Review, 49*(2), 342-352.

Brennan, N. M., & Gray, S. J. (2005). The impact of materiality: accounting's best kept secret. *Asian Academy of Management Journal of Accounting and Finance, 1*, 1-31.

Bricker, W. (2016). *Working together to advance high quality information in the capital markets*. Keynote address before the 2016 AICPA conference on current SEC and PCAOB developments. December 5, Washington, DC, https://www.sec.gov/news/speech/keynote-address-2016-aicpa-conference-working-together.html

Cho, C. H., & Patten, D. M. (2007). The role of environmental disclosures as tools of legitimacy: A research note. *Accounting, organizations and society, 32*(7-8), 639-647.

Choudhary, P., Merkley, K., & Schipper, K. (2021). Immaterial error corrections and financial reporting reliability. *Contemporary Accounting Research, 38*(4), 2423-2460.

Edgley, C. (2014). A genealogy of accounting materiality. *Critical Perspectives on Accounting, 25*(3), 255-271.

Hutton, A. P., Miller, G. S., & Skinner, D. J. (2003). The role of supplementary statements with management earnings forecasts. *Journal of accounting research, 41*(5), 867-890.

IFRS Foundation. (2018). Amendment issued: IASB clarifies its definition of 'material'. Retrieved from https://www.ifrs.org/news-and-events/news/2018/10/iasb-clarifies-its-definition-of-material/

Loftus, J., Leo, K., Daniliuc, S., Boys, N., Luke, B., Ang, H. N., & Byrnes, K. (2020). *Financial reporting*: John Wiley & Sons.

Messier Jr, W. F., Martinov-Bennie, N., & Eilifsen, A. (2005). A review and integration of empirical research on materiality: Two decades later. *Auditing: A Journal of Practice & Theory, 24*(2), 153-187.

Moriarity, S., & Barron, F. H. (1976). Modeling the materiality judgements of audit partners. *Journal of accounting research*, 320-341.

Moroney, R., Campbell, F. M., & Hamilton, J. M. (2017). *Auditing: A Practical Approach*: John Wiley & Sons Australia, Limited.