

EFFECT OF AUDIT MATERIALITY THRESHOLDS ON AUDIT REPORT IN NIGERIA

¹Bassey Eyo Bassey, ²Peter Kekung Bessong, ³Charles Effiong, ⁴Kalada Ekperi

ABSTRACT

The role of materiality on audit report nature and quality cannot be overemphasized in the field of auditing. Yet a general consensus on the applicable threshold has been elusive to practitioners and researchers. With this in mind this paper seeks to empirically investigate the effect of audit materiality on audit reports in Nigeria. Three auditing firms were chosen and annual financial data for their clients in the banking industry were collected. The Panel OLS and Granger Causality tests were used to test for materiality threshold effects and variations on audit reports. Three benchmarks were used to calculate audit report quality namely accurateness, two hypotheses were constructed and tested at 0.05 percent level of significance. Both results from the empirical tests shows that materiality thresholds significantly affect audit report in the country. The study concluded that since materiality thresholds are important in influencing the nature of audit report, audit firms should do more to study the financial information of their clients that brought about their conclusions on thresholds used.

***Keywords:** Audit Materiality, Audit Materiality Thresholds, Audit Report, Overall Materiality, Performance Materiality*

I. INTRODUCTION

It is a standard accounting practice for organizations to present a report of their business dealings at the end of an accounting year. This report when presented will demystify the financial state of the organization to investors. Financial statements as presented by management are sadly not without distortions, overly dramatized and as such conveying a wrong impression of the organization's financial affairs to the public, Adeniyi (2012, p:509). It therefore behooves auditors to holistically inspect the record to ascertain if the financial statement is consistent with reality. The concept of materiality rests greatly on the true and fair principle of reporting. It is expedient that auditors plan for materiality in line with the requirements of this principle (Tapang, Bessong & Ujah, 2015).

¹ Department of Accounting, Faculty of Management Sciences, University of Calabar, P.M.B. 1115, Calabar, Cross River State – Nigeria

² Department of Accounting, Faculty of Management Sciences, University of Calabar, P.M.B. 1115, Calabar, Cross River State – Nigeria

³ Department of Accounting, Faculty of Management Sciences, University of Calabar, P.M.B. 1115, Calabar, Cross River State – Nigeria

⁴ Department of Accounting, Faculty of Management Sciences, University of Calabar, P.M.B. 1115, Calabar, Cross River State – Nigeria

Materiality is defined as any financial information by its omission and misstatement can influence the economic decisions of the users of the report, Bassey, Dada and Adejompe (2018), and Vaclovas and Andrius, (2017). This means that the true and fair principle does not guarantee the flawlessness of financial reports rather there is an accepted threshold that accounting errors and inaccuracies should fall. Any error outside this threshold makes the financial information to be material (Effiok, Tapang, & Eton, 2012; 2013).

The accepted threshold is dependent on auditors' judgments as such what is material for one auditor might be immaterial to another. There is lack of consensus among auditors and preparers when they assign their value on materiality even among homogenous firms. It follows therefore that though the concept of materiality is well defined, its application among auditors presents a major problem, Hamed (1973). In view to finding a solution to this problem this paper identifies the materiality thresholds of three out of the big four multinational auditing firms and how it influences their report on the financial statements of their clients in the Nigerian banking industry. Therefore, the general objective of this paper is to investigate the effect of audit materiality thresholds on auditing reports in Nigeria. This will be achieved in line with the specific objectives listed below

1. To review holistically the concept, types and thresholds of materiality.
2. To carry out an empirical investigation on the role played by overall materiality thresholds on the report of selected auditing firms in Nigeria.
3. To envisage the influence of performance materiality thresholds on the report of selected auditing firms in Nigeria.
4. To proffer policy recommendations based on findings

II. LITERATURE REVIEW

Information is material if its misstatements or omissions individually or aggregate could influence the economic decisions of users on the basis of the financial information provided, FRC (2017). As elucidated by Financial Reporting Council

- Judgements about materiality are made in light of surrounding circumstances and are affected by the size and nature of misstatements or a combination of both.
- Judgements that are material to the users of the financial statements are based on a consideration of the common financial information of users as a group.
- Auditor determination of materiality is a matter of professional judgement and is influenced by their perception of the financial information needs of users.

Materiality is of two forms – quantitative and qualitative materiality. Materiality is quantitative when related to its monetary value or size and qualitative when related to its nature. Quantitative materiality involves information that are financial and physical metrics related. Many auditors favour the application of this form in their reports because it is easier to compute and the ability to unveil the potential effect on the liquidity of the

organization. Information are qualitative when they answer questions that relates to the firm specifics and characteristics, Thus qualitative materiality considers qualitative factors that range from enterprise specifics cases of compliance and business ethics to operating environment factors such as market and regulations, to broader societal factors such as economic trends, political realities and social license to operate. The application of materiality is carried out at all stages of auditing which includes audit planning, auditing performance/testing and account analysis (Adeniyi, 2012; Tapang, Kankpang, Inah, Bessong, & Uklala, 2020).

Determining Materiality

In order to determine materiality, the auditor when planning has to choose a benchmark that is appropriate and realistic after which a percentage of the benchmark is chosen after which an explanation is given for the choice of benchmark. When these steps are taken the auditor arrives at a final figure that is proper for the financial statement which is known as overall materiality. According to Daoud (2016); Tapang, Bessong and Ujah (2015), once the appropriate benchmark has been selected and the amount of the benchmark has been determined, overall materiality can be computed using the following ranges

Table 2.1: Overall Materiality

| Benchmark | Lower Limit | Upper Limit |
|--------------------------|--------------------|--------------------|
| Profit Before Tax(Net) | 3 percent | 10 percent |
| Total Revenue | 0.5 percent | 2 percent |
| Equity | 2 percent | 5 percent |
| Total Assets/Liabilities | 1 percent | 2 percent |
| Total expenses | 3 percent | 10 percent |

Source: Daoud (2016)

Following the arrival of a value for overall materiality, it is necessary for auditors to determine the working or performance materiality. Performance materiality is the amount(s) set by the auditor at less than planning materiality to reduce to an appropriate low level the probability that the aggregate of the uncorrected and undetected misstatements exceeds planning materiality, ISA 320 (2009). If the overall materiality is applied during the planning and testing stages then there is a higher chance that the auditor risk not detecting certain material misstatements. The application of performance material is expedient because it guarantees that auditors are able to carry out more work in assessing the risks, nature, timing and the extent of misstatement identified in the audits previously done in relation to the present audit opinion, ICAEW(2017).

The next step of materiality determination is “Clearly Trivial” or “Audit Misstatement Posting Threshold”. Clearly trivial are misstatements that are inconsequential to the performance of the company and users of financial statements. Matters that are clearly trivial will be of a wholly different (smaller) order of magnitude than the

materiality determined in accordance with ISA 320 and will be a matter that are clearly inconsequential whether taken individually or in aggregate and whether judged by any criteria, size, nature and circumstance, ISA 450(2009).

Table 2.2: Comparative Analyses on Selected Multinational Auditing Firms Materiality Thresholds

| Measure | Benchmark | Firm A | Firm B | Firm C |
|--------------------------------|---------------------------------|------------------------------------------------------------------------------|------------------------------------------------------------------------------|------------------------------|
| Overall Materiality | Profit/loss before tax(PIE) | 5 – 8% | 5-10% | 5-10% |
| | Profit/loss before tax(Non PIE) | 5-10% | 5-10% | 5-10% |
| | Total Revenue/expenses(PIE) | 0.5-1% | 0.5-2% | 0.5-2% |
| | Total Revenue/expenses(Non PIE) | 0.5-2% | 0.5-2% | 0.5-2% |
| | Net Asset/Equity (PIE) | 1-2% | 1-5% | 3-5% |
| | Net Asset/Equity (Non PIE) | 1-2% | 1-5% | 3-5% |
| Performance Materiality | | 50 or 75% | 50-80% | 40-75% |
| Clearly Trivial | | 0-5% | 0-5% | 0-5% |
| Component Materiality | | Based on the percentage of the overall threshold that the component makes up | Based on the percentage of the overall threshold that the component makes up | Professional Judgement based |

Source: IFR Audit Quality Thematic Review (2017)

The table above is a simple but comprehensive materiality guidance for three of the big four auditing firms in the world. These firms are Ernst and Young, KPMG and PWC auditing firms and are proxy by firms A, B and C respectively. The representation makes evidenced that there is a similitude in benchmark thresholds for overall materiality, and also for audit misstatement posting (clearly trivial). It is important to note that even if it were possible for these firms to arrive at the materiality threshold their audit report would not be identical due variations in the nature, timing and extent of audit work performed, IFR (2017).

Items of similar nature or function are aggregated and each material class of similar items is presented separately. If a line item in the accounts is immaterial, it need not be presented but is aggregated with other items; however, separate presentation may be necessary in the notes to the accounts. When applying this FRS an entity shall decide, taking into consideration all relevant facts and circumstances, how it aggregates information in the financial statements, which includes the notes. An entity shall not reduce the understandability of its financial statements by obscuring material information with immaterial information or by aggregating material items that have different natures or functions.' FRS 102

III. METHODOLOGY

This section intends to give a clear description of the method and procedures involved in carrying out this study and ways by which information on the subject matter of this research study are collected and organized for proper analysis. This study will employ the regression method of analyzing using secondary data which will be interpreted using the classical linear regression model with` the aid of economics views (E-views 9) statistical software. The regression result will form the basis for final conclusion based on findings.

In order to empirically investigate the effect of audit materiality thresholds on auditors report I will utilize the panel ordinary least square regression method. With the above in mind, I present the functional form as

Model 1:

$$AR = f(OMV_1, OMV_2, \text{ and } OMV_3)$$

From the equation above I derived the econometric form

$$AR = b_0 + b_1 OMV_1 + b_2 OMV_2 + b_3 OMV_3 + Ut \dots \dots \dots (1)$$

Where *AR* is the audit report *OMV₁* is the Overall Materiality Variable 1 which is represented by the Profit and Loss before Tax Threshold 1, *OMV₂* is the Overall Materiality Variable 2 as represented by Total Revenue Threshold 1 and *OMV₃* is the Overall Materiality Variable 3 and the proxy for Net asset/Equity Threshold 1, and *Ut* is the stochastic error term

Model 2

$$AR = f(PMV_1, PMV_2, \text{ and } PMV_3)$$

The econometric form is given below as

$$AR = b_0 + b_1 PMV_1 + b_2 PMV_2 + b_3 PMV_3 + Ut \dots \dots \dots (2)$$

Where *PMV 1* is the Performance Materiality Variable 1 which is represented by Profit before Tax Threshold 2, *PMV 2* is Performance Materiality Variable 2 and is represented by Total Revenue Threshold 2, *PMV3* is Performance Materiality 3 and proxy by Net Asset/Equity Threshold 2, and *Ut* is the stochastic error term.

b_0 is the constant term while b_1, b_2, b_3 are the coefficients.

IV. PRESENTATION OF DATA AND ANALYSIS

This section deals with the presentation and interpretation of results obtained via statistical and econometrical methods. Econometric and statistical theory requires one to test if the data used is normally distributed to arrive at a valid result. The rule of the thumb requirement posits that $n = 30$, where n is the sample size. Since the sample size of this panel regression is 54, therefore I conclude that the data is normally distributed, and the panel OLS result is valid.

Table 4.1

Reliability Tests

| Cronbach's Alpha | N of Items |
|------------------|------------|
| 0.723 | 3 |

Source: SPSS 16

The table above shows the reliability test presentation using Cronbach's Alpha. It measures how consistent a set of data is to judge its suitability for statistical inference. This test requires that its coefficient fall between 0.70 and 0.80 which is the respectable range for one to reach a conclusion on data reliability. From the table the coefficient is 0.723, therefore the data is internally consistent and reliable.

Panel OLS Diagnostic Tests

The Panel OLS requires that the researcher carry out some pre regression tests to identify the most appropriate model to use. These tests include Hausman test and Breusch Pagan (LM) test.

Table 4.2.1

Hausman Test

| Chi sq. d.f | Prob. |
|-------------|-------|
| 3 | 1.00 |

Source: Authors' own computation, 2019

There are two models in Panel OLS – fixed and random effect models. The Hausman test enables the researcher to make the right choice between both models. The decision criterion states that reject the null hypothesis if probability value is less than 0.05 percent significance level. The table above show that Hausman probability value is 1.00 which is greater than 0.05 percent significance level. Therefore, we accept the null hypothesis that the random effect model as the appropriate model to use.

Table 4.2.2 Langrange Multiplier Tests

| Test Method | Test Hypothesis | | |
|----------------------|-----------------|---------|---------|
| | Cross-section | Time | Both |
| Breusch-Pagan | 3.38 | 135.00 | 138.38 |
| | 0.07* | 0.00*** | 0.00*** |
| Honda | -1.84 | 11.62 | 6.92 |
| | -- | 0.00*** | 0.00*** |
| King-Wu | -1.84 | 11.62 | 5.76 |
| | -- | 0.00*** | 0.00*** |
| Standardized Honda | -1.69 | 15.29 | 5.61 |
| | -- | 0.00*** | 0.00*** |
| Standardized King-Wu | -1.69 | 15.29 | 4.15 |
| | -- | 0.00*** | 0.00*** |
| Gourierioux, et al. | -- | -- | 135.00 |
| | -- | -- | < 0.01 |

Note: *** denotes 1% significance level and * denotes 10% significance level

Source: Authors' own computation, 2019

The Langrange Multiplier tests helps one to decide between random effect model and common effect model (simple OLS). The decision criterion states that if the significance value is less than 0.05, we reject the null hypothesis that the common effect model is the appropriate one to utilize, otherwise accept. Table 4.2.2 shows that Breusch Pagan prob. Value is less than 0.05 percent significance level. Therefore, the null hypothesis is rejected which means that random effect model should be employed.

Table 4.2.3 Panel Regression for Model 1

| Variable | Coefficient | t-Statistic | Prob. |
|----------|-------------|-------------|-------|
| OMV1 | 3.19 | 0.32 | 0.75 |

| | | | |
|-------------------------|-------|--------------------|---------|
| OMV2 | -8.75 | -2.83 | 0.01** |
| OMV3 | 2.11 | 2.60 | 0.01** |
| C | 3.21 | 9.37 | 0.00*** |
| Weighted Stat. | | | |
| R-squared | 0.34 | Mean dependent var | 3.92 |
| Adjusted R-squared | 0.30 | S.D. dependent var | 0.57 |
| S.E. of regression | 0.48 | Sum squared resid | 11.45 |
| F-statistic | 8.61 | Durbin-Watson stat | 2.50 |
| Prob(F-statistic) | 0.00 | | |
| Unweighted Stat. | | | |
| R-squared | 0.34 | Mean dependent var | 3.92 |
| Sum squared resid | 11.45 | Durbin-Watson stat | 2.50 |

Note: *** denotes 1% significance level and *, ** denotes 5% significance level and *denotes 10% significance level

Source: Authors' own computation, 2019

The result above shows that Overall Materiality Variable 1 (OVM1) prob. Value is 0.75 and therefore insignificant at 1 percent, 5 percent and 10 percent significant levels. The prob. Value for Overall Materiality Variable 2 (OVM2) and Overall Materiality Variable 3 (OVM3) were found to be significant at 5 percent significant level. The adjusted R squared which is a better goodness of fit criterion to R squared shows that the independent variables explains 30% variations in the dependent variables. The F statistics which is used to test the overall significance of the regression has a prob. value of 0.00 which significant at 1 % level. The Durbin Watson (DW) test is used to investigate the presence of autocorrelation among the t values of the random variables in the model. DW thumb rule suggest that values from 1.5 to 2.5 are free from autocorrelation. The DW for the regression is 2.5 and is acceptable since it falls within the acceptable threshold.

Granger Causality Test

Granger Causality as defined by Granger (1969), is when the lagged values of a variable have explanatory power in a regression of another variable. Thus, X is said to Granger Cause Y if the forecast of Y is improved by using the past values of X together with the past values of Y, Granger (1969). Granger Causality distinguishes between Uni-direction and bi-direction causalities. The Uni-direction causality is a causality with no feedback while the bi-direction causality is a causality with a feedback.

Table 4.3.1 Panel Granger Causality Test

| Independent Variables | | | | |
|-----------------------|--------------------------|----------|------|---------|
| | AR | PMV 1 | PMV2 | PMV3 |
| Dependent Variables | F statistics Prob. Value | | | |
| AR | - | 0.02** | 0.36 | 0.00*** |
| PMV1 | 1.43 | - | 4.58 | 1.43 |
| PMV2 | 9.49 | 2.04 | - | 0.01** |
| PMV3 | 2.55 | 6.59 | 1.68 | - |

*Note: *** denotes 1% significance level and *, ** denotes 5% significance level and *denotes 10% significance level*

Source: Authors' own computation, 2019

The granger causality table shows that the F probabilities values of PMV1 and PMV3 are significant at 5% and 1% respectively.

Discussion of Findings

H0₁. There is no significant effect of overall materiality thresholds on audit firms report in Nigeria.

Decision Rule: If the (χ^2) probability value is less than 0.05 significance level, we reject H₀. Otherwise we accept.

The panel regression table 4.2.3 shows that two of the three independent variables are significant at 5% significant level. Furthermore the joint significance (F stat prob. Value) of the independent variables is 0.00 which is less than 0.05 decision rule criterion. There the null hypothesis is rejected and the conclusion is made that overall materiality has a significant effect on audit report of firms in Nigeria. A careful investigation on the result shows that there is a negative relationship between Audit Report and OMV2 (Total Revenue). The reason being that TR benchmark is closely related to factors such as company performance and earning quality which are direct measures that affects audit report quality. As such an increase in these variables can reduce the quality of audit report. This is similar to the findings of Marsel and Ali, (2015). One can conclude the reason why the overall materiality of these auditing firms significantly affects its audit report quality is due to the low threshold appropriated to all benchmarks. A low threshold has the ability to detect better accounting errors which can be material if not identified and corrected. This concurs with the findings of Beng, Jimmy, Dan and et al (2017).

H0₂. Performance Materiality thresholds do not significantly explain the variations in audit report in Nigeria.

Decision Rule: If the (χ^2) probability value is less than 0.05 significance level, we reject H₀. Otherwise we accept.

From table 4.3.1 it is seen that two of the three performance material threshold variables are highly significant at 1% and 5% level respectively. With the following in mind the null hypothesis that performance materiality thresholds do not significantly explain the variations in audit report is rejected, and the alternative is accepted. It follows that the auditing firms have a good understanding of their clients and therefore factors in misstatements discovered in previous audits. This acts as safety buffer and mitigates risks associated with uncorrected and undetected misstatements during audit process. In summary the lagged values of performance materiality thresholds can be used to forecast the quality of audit report in Nigerian banks.

V. CONCLUSION AND RECOMMENDATIONS

This paper seeks to investigate the effect of audit materiality thresholds on audit report in Nigeria. Some statistical/econometrical tests were employed to reach a scientifically accepted conclusion. From the findings this paper concludes that both overall and performance materiality thresholds play important roles in influencing the quality and nature of audit report in Nigeria.

With these in mind, the following recommendations are made.

1. Staff of these firms should be educated periodically about the constant changes applicable to audit profession.

2. Since performance materiality thresholds are dependent on conclusions on overall materiality, audit firms should holistically examine their guideline on materiality in line with standard international guidance calculation.

3. Conservative material thresholds have the ability to reduce audit risks. Several researches have shown that experience auditors are more conservative when making judgements on materiality threshold. As such organizations should seek to employ the services of more experienced audit firms.

4. Information and data are key in audit process. It is therefore pertinent for the senior auditors to do more work in carefully studying the financial information of their clients. This is because of the unavailability of the current year result during audit planning. If audit firms get their financial information right, then their judgement on materiality thresholds would be precise in line with what is obtainable from the organization and industry.

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