

Aligning Auditor Materiality Choice and the Needs of a Reasonable Person

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Materiality choice impacts the transparency, consistency and comparability of financial statements. Lack of prescriptive guidance, however, results in auditors often using a subjective heuristic to determine whether to waive or require correction of identified omissions or likely misstatements. This paper shows that if the auditor actually adheres to any one of the commonly-used heuristics, earnings per share may be misstated by potentially unacceptable amounts. As capital markets research indicates that the markets react to changes in earnings per share as small as one cent, it is recommended that a policy be promulgated defining an identified omission or likely misstatement to be material when, if corrected, primary earnings per share would change by one cent. Implementation of this policy will make financial statements more transparent, comparable and reliable by applying a uniform metric across industries, across entities of different sizes, and across time and will reduce the possibility of impaired auditor independence.

I. INTRODUCTION

“We don’t need no stinkin’ Congressional hearings. This whole accounting mess can be cleared up by simply defining the word materiality” (Kessler 2002). While there are, of course, existing definitions of materiality, this statement reflects a view that current financial statement materiality guidelines are too vague and rely too heavily on the professional judgment of the auditor.

Several recent audit failures emphasize the view that auditors may be making inappropriate judgments about materiality. By accepting aggressive accounting choices by Enron, for example, Arthur Andersen allowed large errors to remain uncorrected by declaring the errors to be immaterial. This is detailed in, “Could \$51 Million be Immaterial When Enron Reports Income of \$105 Million?” (Brody et al. 2003). Brody et al. conclude that “...using