

The Determination of Materiality Thresholds in Maltese Private Sector Audits

by

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Abstract

TITLE: The Determination of Materiality Thresholds in Maltese Private Sector Audits

PURPOSE: This study sets out (i) to ascertain the major quantitative and qualitative factors influencing the determination of materiality thresholds in the private sector external audits performed by large and medium-sized Maltese audit firms, (ii) to assess the effectiveness of ISA 320 in the determination of such materiality thresholds, as well as the impact of introducing more prescriptive guidelines within the Standard, and (iii) to assess the current level of professional judgement and its effectiveness in determining materiality thresholds, as well as to ascertain the typical challenges involved in exercising such judgement.

DESIGN: A predominantly qualitative mixed-methods approach was adopted. Semi-structured interviews were carried out with twelve audit partners from large and medium-sized Maltese audit firms.

FINDINGS: The findings indicated that the major quantitative factors influencing overall materiality are 5-10% of profit before tax and 1-3% of total revenue. The major quantitative factor influencing performance materiality and the clearly trivial threshold is 75% and 5% of overall materiality, respectively. Additionally, the major qualitative factors influencing materiality thresholds are fraud and litigation risk, quality of client internal controls, auditor critical thinking skills, client complexity, the client's sector and a change in auditor. Furthermore, the findings indicated that, overall, ISA 320 provides sufficient guidance on the determination of materiality thresholds. Moreover, the most cited benefit of introducing more prescriptive guidelines within the Standard was greater consistency among auditors, while the most cited drawback was the limitation on professional judgement. The findings also revealed that professional judgement is crucial and generally effective in determining materiality thresholds. However, auditors typically face a few challenges when exercising such judgement, of which time pressure and the setting of appropriate thresholds are particularly significant.

CONCLUSIONS: The study concludes that a clear understanding of the various quantitative and qualitative factors influencing materiality thresholds will enable auditors to set such thresholds appropriately. Furthermore, it is evident that the determination of materiality thresholds requires a balance between following the guidance provided by ISA 320 and exercising professional judgement.

IMPLICATIONS: This study attempts to raise awareness of how large and medium-sized Maltese audit firms determine materiality thresholds. The proposed recommendations may aid ISA 320 and the Maltese Accountancy Board to provide clearer and additional guidance in order to ensure that auditors set appropriate materiality thresholds.

KEYWORDS: Materiality Thresholds, ISA 320, Prescriptive Guidelines, Professional Judgement

Dedication

*To my parents
for their unwavering support
and encouragement*

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List of Abbreviations

EBITDA	Earnings Before Interest, Taxes, Depreciation, and Amortisation
IAASB	International Auditing and Assurance Standards Board
ICAEW	Institute of Chartered Accountants in England and Wales
ISA	International Standard on Auditing
KPI(s)	Key Performance Indicator(s)
PIE(s)	Public Interest Entity(ies)
RoMM	Risk of Material Misstatement

Chapter 1

Introduction

1.1 Introduction

This introductory chapter lays the foundation of the study. As portrayed in Figure 1.1, Section 1.2 provides a brief background to the study. Subsequently, Section 1.3 explains the rationale for the study. Section 1.4 identifies the research objectives, while Section 1.5 establishes the scope and limitations of the study. Finally, Section 1.6 outlines the structure of the dissertation.

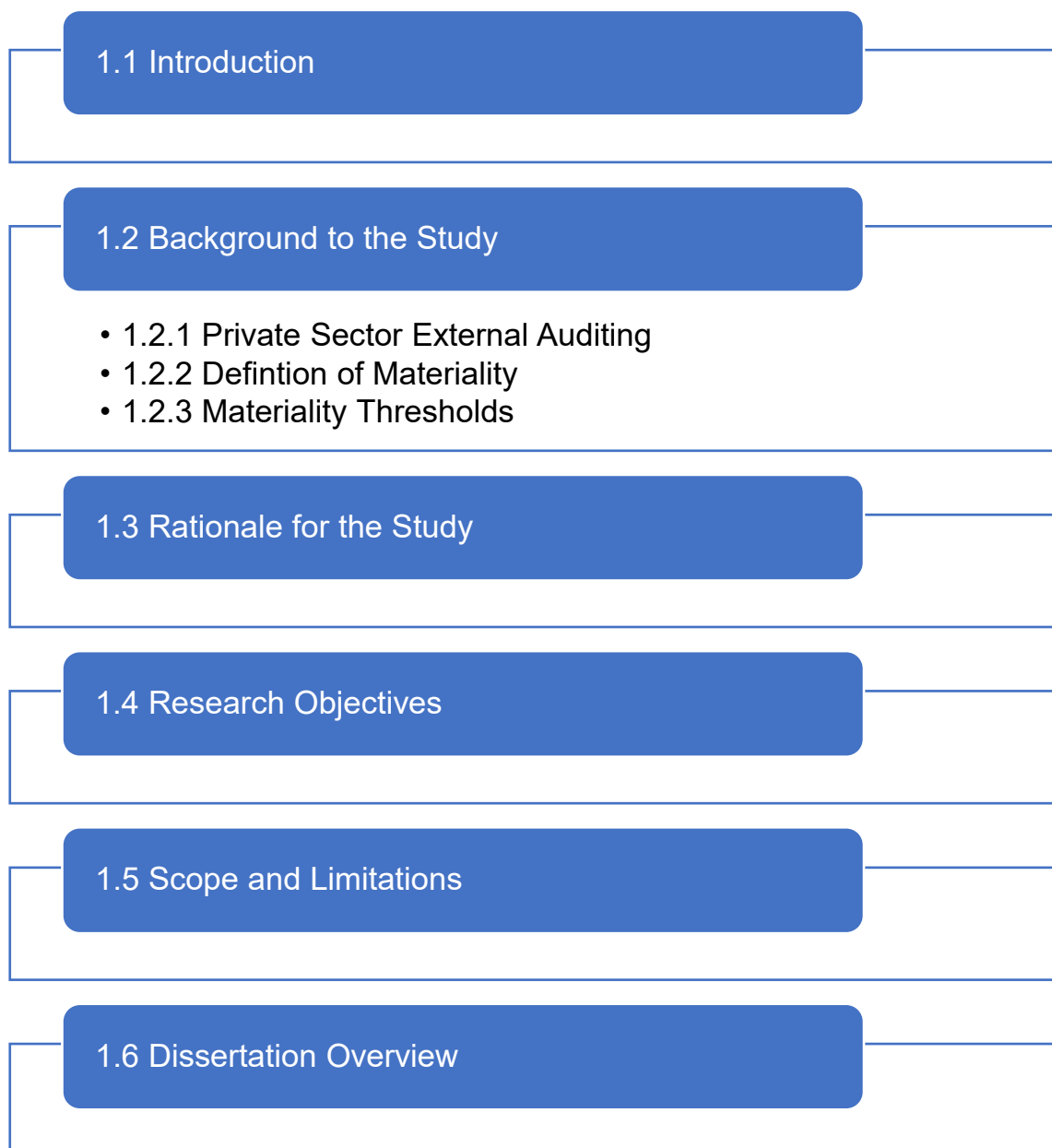


Figure 1.1: Outline of Chapter 1

1.2 Background to the Study

1.2.1 Private Sector External Auditing

In compliance with the statutory requirement laid down by the Companies Act (1995), all companies registered in Malta must appoint an auditor in possession of a practicing certificate in auditing to carry out an audit of their annual financial statements. When carrying out an external audit, the auditor shall obtain reasonable assurance, by collecting sufficient appropriate audit evidence, about whether the financial statements as a whole are free from material misstatements (International Auditing and Assurance Standards Board (IAASB) 2009a). This will enable

“...the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework”.

(IAASB 2009a, Para. 11a)

In doing so, the auditor ensures that the audit achieves its intended purpose, which is that of enhancing the degree of confidence of the intended users (IAASB 2009a).

Furthermore, since the auditor's opinion is expressed in relation to the financial statements as a whole, the auditor is not responsible to detect misstatements which are immaterial to such financial statements (IAASB 2016). Therefore, materiality is viewed as a fundamental concept when carrying out external audits. In fact, a study by Azzopardi and Baldacchino (2009) found that the majority of Maltese audit practitioners believe that materiality plays an important role in achieving the objectives of an external audit.

1.2.2 Definition of Materiality

An indirect definition of materiality is found in International Standard on Auditing (ISA) 320 *'Materiality in Planning and Performing an Audit'* as follows:

“Misstatements, including omissions, are considered to be material if they, individually or in aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements”.

(IAASB 2009b, Para. 2)

A key part of the definition is the phrase *“could reasonably be expected to influence the economic decisions of users”*. This suggests that the auditor must determine whether a misstatement or omission is likely to have a significant influence on the economic decisions taken by the users of the financial statements. This is not a simple task, rather it involves a lot of subjectivity. Therefore, the auditor is required to exercise professional judgement. This refers to:

“The application of relevant training, knowledge and experience, within the context provided by auditing, accounting and ethical standards, in making informed decisions about the courses of action that are appropriate in the circumstances of the audit engagement”

(IAASB 2009a, Para. 13k)

Furthermore, this also suggests that materiality is not only a matter of quantitative considerations but also a matter of qualitative considerations (Vorhies 2005). This is also substantiated locally, whereby Maltese audit practitioners emphasised that materiality judgements should be made in light of both qualitative and quantitative considerations (Azzopardi, Baldacchino 2009).

1.2.3 Materiality Thresholds

Materiality thresholds refer to numeric thresholds which are used by the auditor throughout the audit in order to detect material misstatements. Since ISA 320 requires the auditor to apply the concept of materiality *“in planning and performing an audit of financial statements”* (IAASB 2009b, Para. 1), a number of materiality thresholds must be determined.

The auditor shall start by determining a materiality threshold for the financial statements as a whole, often referred to as *‘Overall Materiality’* (Institute of Chartered Accountants in England and Wales (ICAEW) 2017). In line with the

definition of materiality provided earlier, overall materiality refers to a threshold above which misstatements, including omissions, *“could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements”* (IAASB 2009b, Para. 2). This materiality threshold is determined by applying a percentage to a selected benchmark. Some examples of benchmarks include profit before tax, total revenue, gross profit and total assets. Furthermore, if there is a significant change in circumstances of the entity, the auditor is required to normalise the benchmark (IAASB 2009b). Typically, overall materiality is set between 5% and 10% of profit before tax (Eilifsen, Messier Jr 2015).

Once materiality for the financial statements as a whole has been established, the auditor shall then determine *‘Performance Materiality’*, which is also referred to as *‘Working Materiality’*. This materiality threshold is set below overall materiality

“...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”

(IAASB 2009b, Para. 9).

Performance materiality is typically expressed as a percentage of overall materiality and is used during the planning stage to identify areas of risk which require audit procedures to be performed, as well as to determine the nature, timing and extent of such audit procedures. This materiality threshold is also used during the early fieldwork stage to precisely identify the items which need to be audited, including the determination of the sample and the sample size (ICAEW 2017). Additionally, it is clear that the determination of performance materiality is dependent on the assessed level of risk and therefore, the higher the assessed risk, the lower such materiality. The percentage typically applied by the auditor varies between 50% and 75% (ICAEW 2017, Eilifsen, Messier Jr 2015).

Furthermore, in accordance with ISA 450 *‘Evaluation of Misstatements Identified during the Audit’*, the auditor is required to determine a *‘Clearly Trivial Threshold’*.

This threshold is

“...an amount below which misstatements would be clearly trivial and would not need to be accumulated because the auditor expects that the accumulation of such amounts clearly would not have a material effect on the financial statements”

(IAASB 2009c, Para. A2)

The clearly trivial threshold is also expressed as a percentage of overall materiality and it typically varies between 2% and 5% (Quick, Zaman et al. 2023).

1.3 Rationale for the Study

The determination of materiality thresholds is a crucial process that significantly influences the auditor’s judgement regarding what constitutes a material misstatement. This subsequently affects the auditor’s opinion and the users’ degree of confidence in the financial statements. Therefore, ultimately, establishing appropriate materiality thresholds is vital for maintaining the integrity and reliability of financial statements.

Despite the crucial role of materiality in audits, there is limited research on how materiality thresholds are established in Maltese private sector audits. A study by Azzopardi and Baldacchino (2009) focused on the perceptions and use of the concept of materiality as well as the attitudes towards materiality threshold disclosures. Furthermore, a study by Bruno (2012) focused on materiality thresholds within the Maltese public sector rather than the private sector. Meanwhile, a study by Demanuele (2016) focused solely on materiality disclosures.

Therefore, this study should contribute towards filling the gap in the existing literature. It seeks to provide valuable insights into the procedures followed by large and medium-sized Maltese audit firms in determining materiality thresholds, including the major factors taken into consideration. Furthermore, it aims to

identify any areas within ISA 320 which have room for improvement. Finally, this study also seeks to provide insights into the current level of professional judgement exercised and whether such judgement leads to appropriate materiality thresholds.

1.4 Research Objectives

The objectives of this study are:

- To ascertain the major quantitative and qualitative factors influencing the determination of materiality thresholds in the private sector external audits performed by large and medium-sized Maltese audit firms.
- To assess the effectiveness of ISA 320 in the determination of such materiality thresholds, as well as the impact of introducing more prescriptive guidelines within the Standard.
- To assess the current level of professional judgement and its effectiveness in determining materiality thresholds, as well as to ascertain the typical challenges involved in exercising such judgement.

1.5 Scope and Limitations

This study focuses solely on materiality thresholds, excluding any considerations on materiality disclosures. Furthermore, this study does not delve into the concept of performance materiality insofar as this relates to specific classes of transactions, balances or disclosures.

Moreover, this study excludes an analysis of materiality thresholds within group audits, focusing exclusively on their application within audits of individual entities. Finally, this study reflects relevant studies and developments from local and foreign sources up to 31st March 2025.

1.6 Dissertation Overview

Chapter 1 provides a brief background to the study. This chapter also identifies the need for the study and outlines the research objectives.

Chapter 2 reviews various local and foreign literature on materiality thresholds and related aspects.

Chapter 3 describes the research methodology selected for this study.

Chapter 4 presents the research findings obtained from the interviews.

Chapter 5 discusses the research findings presented in Chapter Four, in light of the literature reviewed in Chapter Two.

Finally, **Chapter 6** concludes the study by summarising the key findings, providing recommendations and suggesting areas for further research. Figure 1.2 outlines the structure of the study.

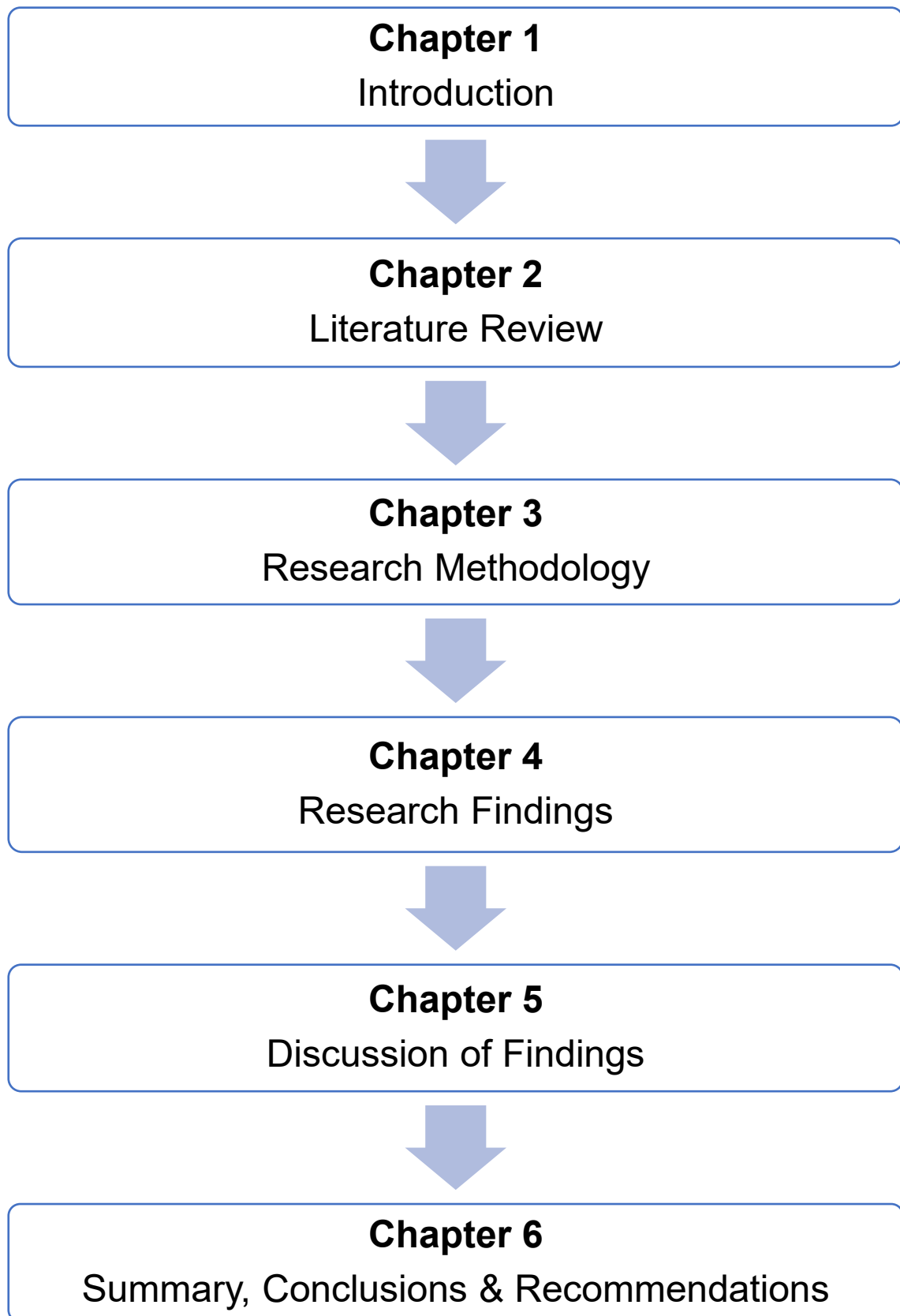


Figure 1.2: Structure of the Study

Chapter 2

Literature Review

2.1 Introduction

This chapter provides an analysis of the existing literature on the research area. Figure 2.1 illustrates the structure of this chapter. Section 2.2 delves into the major factors influencing the determination of materiality thresholds. Thereafter, Section 2.3 overviews the literature relating to the effectiveness of ISA 320 as a guidance tool and the impact of introducing more prescriptive guidelines within the Standard. Section 2.4 then provides insights into the role of professional judgement in determining materiality thresholds, as well as the typical challenges involved in exercising such judgement. Finally, Section 2.5 concludes the chapter.

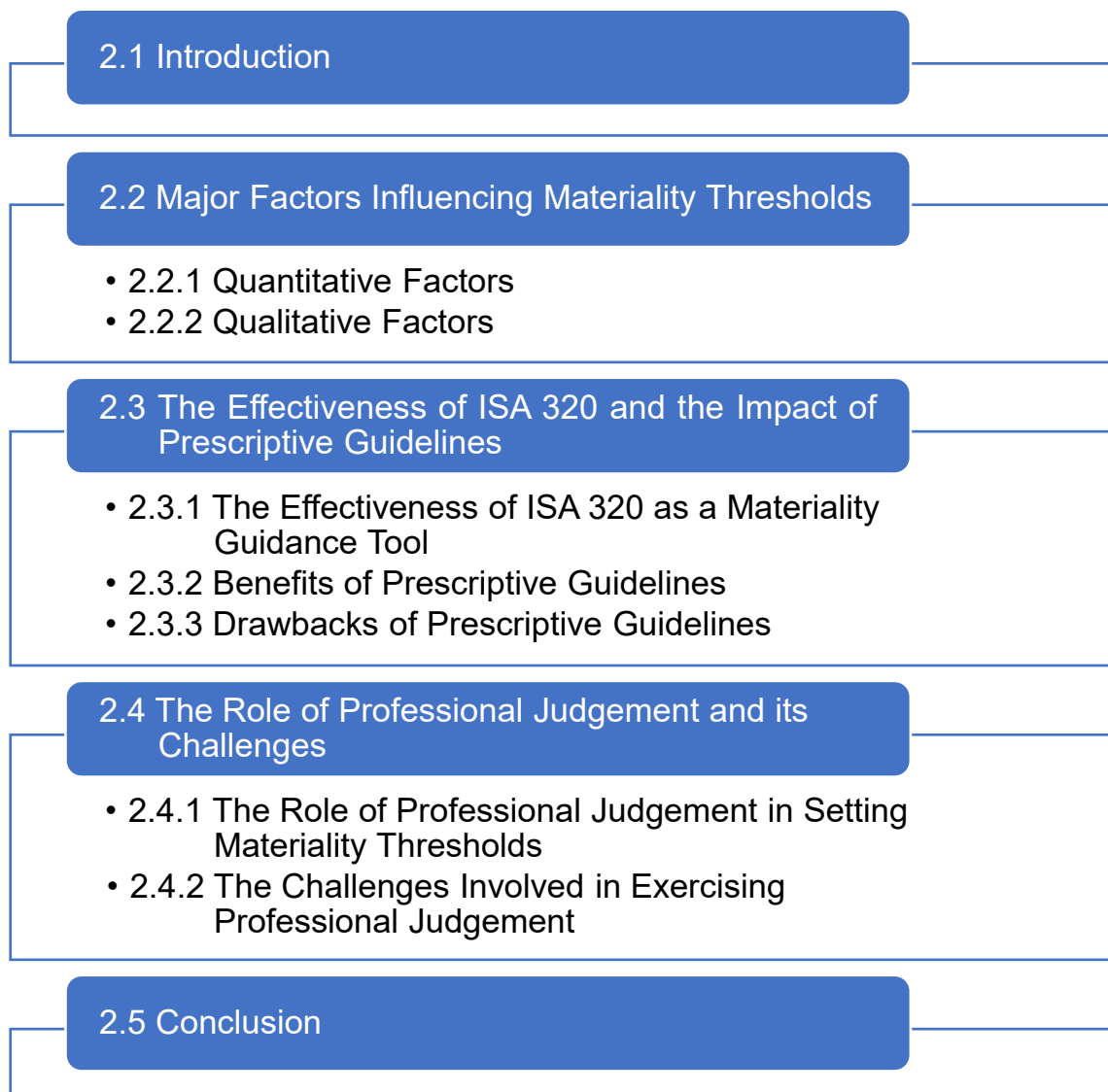


Figure 2.1: Outline of Chapter 2

2.2 Major Factors Influencing Materiality Thresholds

2.2.1 Quantitative Factors

The concept of materiality plays a crucial role in financial reporting and auditing. It is particularly important in audit engagements as it helps to shape the entire audit process, from planning to reporting, ensuring that audit focus is directed towards areas where potential misstatements could influence the decision-making of users of the financial statements. To this end, by establishing materiality thresholds, auditors can determine the nature, timing and extent of audit procedures to be performed. Ultimately, materiality ensures that audit effort is aligned with the needs of users, thereby enhancing the reliability of financial statements (Amiram, Chircop et al. 2017).

When determining materiality thresholds, auditors should take into account both quantitative and qualitative factors. Initially, quantitative factors refer to percentages applied to selected benchmarks, such as profit before tax, total assets and total revenue, which are used to calculate overall materiality. These factors then take the form of percentages applied to overall materiality, since performance materiality and the clearly trivial threshold are derived from such threshold. Furthermore, the selection of an appropriate benchmark and the percentages to be applied in determining the respective materiality thresholds, are influenced by certain qualitative considerations, which will be discussed later in this section. Once a preliminary amount has been established for all materiality thresholds, auditors should consider a number of qualitative factors, as will be discussed in Section 2.2.2, to assess whether these thresholds are appropriate and thus, whether they need to be adjusted accordingly. Additionally, ISA 320 requires the auditor to revise materiality thresholds if there is a change in the circumstances of the audit, new information affecting materiality comes to the attention of the auditor or if the auditor's understanding of the entity changes owing to further audit procedures performed (IAASB 2009b).

Overall Materiality

The first step in calculating overall materiality involves selecting an appropriate benchmark. Quick, Zaman et al. (2023) and Costa (2023) found that the most commonly used benchmark is *profit before tax*. This finding is consistent with prior research (Choudhary, Merkley et al. 2019, Eilifsen, Messier Jr 2015). Furthermore, the second most commonly used benchmark is *total assets*, as found by Quick, Zaman et al. (2023) and Costa (2023). Other frequently used benchmarks include *total revenue* and *total equity*, while *total expenses* are the least used (Goh, Lee et al. 2023, Quick, Zaman et al. 2023, Choudhary, Merkley et al. 2019, Eilifsen, Messier Jr 2015). Similarly, Azzopardi and Baldacchino (2009) found that the most commonly used benchmarks in Malta are *profit before tax*, *total revenue* and *total assets*.

One important factor influencing the selection of an appropriate benchmark is *the entity's financial performance*. If an entity is usually profitable, then it is recommended that profit before tax is selected (Choudhary, Merkley et al. 2019, IAASB 2009b). However, if an entity which is usually profitable is experiencing a loss in the current period or if an entity's profitability is volatile, then in such cases it is recommended that other benchmarks, such as gross profit or total revenue, are selected (Eilifsen, Messier Jr 2015, IAASB, 2009b). Similarly, if an entity is operating close to or at the break-even point, it is also recommended that other benchmarks, such as gross profit or total revenue, are selected (ICAEW 2017, Eilifsen, Messier Jr 2015).

Another key factor is *the primary focus of users*. When selecting a benchmark, it is important to consider whether there are any specific items which users of the financial statements primarily focus on. For instance, users may focus on profit, total revenue or total equity when evaluating an entity's financial performance (Bellandi 2017, IAASB 2009b). Additionally, the selection of an appropriate benchmark is influenced by *the nature of the entity, its stage of development* and *its financing structure* (Bellandi 2017, IAASB 2009b). *The industry in which the entity operates* is another important factor influencing the selection of a

benchmark since a specific benchmark may be selected to align with industry practices (Quick, Zaman et al. 2023, IAASB 2009b).

Furthermore, *the volatility of financial statement measures* may also influence the selection of a benchmark. For example, if an entity reports volatile profits, adjusted profit before tax would be more appropriate to reduce the impact of volatility (Quick, Zaman et al. 2023, IAASB 2009b). Finally, the selection of a benchmark may also be influenced by *the entity's key drivers or Key Performance Indicators (KPIs)*. For instance, if profit before tax is a KPI, the most appropriate benchmark would be profit before tax (Quick, Zaman et al. 2023, Abilova 2022).

Once a benchmark has been selected, a percentage must be applied to it. Rules of thumb commonly used include *5–10% of profit before tax* and *0.5-2% of total assets or total revenue*. More specifically, *5% of profit before tax* is the most widely applied (Abilova 2022, Eilifsen, Messier Jr 2015). Azzopardi and Baldacchino (2009) observed that these rules of thumb are also frequently used in Malta, with *5-10% of profit before tax* being the most commonly applied. Additionally, some key factors influencing the percentage to be applied include *the level of risk associated with the client, whether the client is a publicly listed entity, the industry in which the client operates and whether the client has restrictive debt covenants* (Abilova 2022). A few other factors include *the intended use of the client's financial statements and prior experience with the client* (Steinbart 1987).

Goh, Lee et al. (2023) found that the *mean percentage applied to profit before tax is 5.2%*, which is reasonably consistent with the percentage of 5% commonly applied by major public accounting firms (Eilifsen, Messier Jr 2015). Similarly, Choudhary, Merkley et al. (2019) reported a mean percentage of 5.3%, while Costa (2023) observed a slightly lower figure of approximately 4.8%. Furthermore, Goh, Lee et al. (2023) found that the *mean percentages applied to total revenue and total assets are 1% and 0.8%, respectively*. Costa (2023) revealed that the *mean percentage applied to total assets is 1.1%*, while Choudhary, Merkley et al. (2019) observed that the *mean percentages applied to total revenue and total assets are 0.62% and 0.57%, respectively*. Overall, these

findings are somewhat consistent with the percentages applied by major public accounting firms, which range from 0.5% to 2% (Eilifsen, Messier Jr 2015).

Performance Materiality

With respect to performance materiality, this threshold typically ranges from 50% to 75% of overall materiality (Quick, Zaman et al. 2023, Abilova 2022, Eilifsen, Messier Jr 2015). However, depending on the specific circumstances, the percentage can increase to as much as 90% (Eilifsen, Messier Jr 2015, Bagshaw, Selwood 2014). Furthermore, Abilova (2022) and Choudhary, Merkley et al. (2022) noted that the specific percentage most commonly applied is 75%. ISA 320 outlines some key factors influencing the percentage to be applied, including *the auditor's understanding of the client, the level of misstatements identified in prior audits and the expected level of detected misstatements for the current period* (IAASB 2009b). Additionally, *the auditor's expectation regarding the amount of undetected misstatements* must also be considered (Millichamp, Taylor 2022). A few other factors which must be considered include *audit risk, fraud risk, the number of accounting issues requiring significant judgement, the level of turnover among senior management or key financial reporting staff, and the effectiveness of internal controls* (Eilifsen, Messier Jr 2015).

Clearly Trivial Threshold

Quick, Zaman et al. (2023) and Abilova (2022) found that the clearly trivial threshold commonly ranges from 2% to 5% of overall materiality. Similarly, Eilifsen and Messier Jr (2015) observed that the most commonly applied percentage varies between 3% and 5%, this indicating a reasonable degree of consistency. Furthermore, Quick, Zaman et al. (2023) and Abilova (2022) found that the specific percentage most commonly applied is 5%, while Azzopardi and Baldacchino (2009) noted that, in Malta, this is typically 2%. One key factor influencing the selection of the percentage to be applied is *the history of misstatements identified in prior audits*. For example, if a significant number of misstatements have been previously identified, it would be more appropriate to

select a percentage closer to the lower end of the range. This approach helps lower the risk that small misstatements could accumulate to a level that should be communicated to management (ICAEW 2017, Eilifsen, Messier Jr 2015).

2.2.2 Qualitative Factors



Figure 2.2: Major qualitative factors influencing materiality thresholds

Source: Author

As highlighted earlier, it is crucial that auditors do not simply rely on quantitative factors when determining materiality thresholds, as these should only serve as a starting point. Rather, they must also consider qualitative factors and adjust such thresholds accordingly. In this regard, a review of the existing literature on such major qualitative factors, as shown in Figure 2.2, now follows.

Blokdijk, Drieenhuizen et al. (2003) found that *client complexity* and *the quality of the client's system of internal control* influence materiality thresholds. Specifically, the more complex the client, the lower the materiality thresholds set. Conversely, the more robust the system of internal control, the higher the materiality thresholds set.

Messier, Martinov-Bennie et al. (2005) observed that *the size of the audit firm* influences materiality thresholds. Large audit firms typically set higher materiality thresholds than smaller audit firms, as they often use a comprehensive range of procedures, this leading to higher quality samples obtained (Pop, Fulop et al. 2010).

DeZoort, Harrison et al. (2006) established that *accountability pressure* influences materiality thresholds. As accountability pressure increases, auditors tend to become more cautious and sensitive to the risks involved in the specific circumstances of the audit, this leading to more conservative materiality judgements and consequently, lower materiality thresholds. Additionally, as accountability pressure increases, auditors tend to become more motivated to take account of qualitative factors, rather than simply relying on quantitative measures, which may lead to more appropriate materiality thresholds.

Popa, Span et al. (2013) identified a positive relationship between *the auditor's experience in the sector in which the client operates* and materiality thresholds. As auditors gain experience in a particular sector, they tend to set higher materiality thresholds, reflecting an increase in their level of confidence. Essentially, those who have a sufficient degree of knowledge of a particular sector are better equipped to identify and address sensitive areas, enabling them to set higher materiality thresholds. On the other hand, auditors who lack such

knowledge tend to adopt a more sceptical approach, which often results in lower materiality thresholds.

Similarly, materiality thresholds are also influenced by *the sector in which the client operates*. Auditors typically set lower materiality thresholds for the industrial sector and higher thresholds for the commercial and service sectors (Popa, Span et al. 2013). Additionally, auditors often establish lower materiality thresholds for the financial sector in view of the heightened risk of assets diversion (Iselin, Iskandar 2000). *The longevity of the auditor's relationship with the client* also influences materiality thresholds. Typically, as the longevity of the auditor-client relationship increases, the auditor gains a deeper understanding of the client's operations and the risks involved, while also building greater trust with the client. This increased level of understanding and trust allows the auditor to use higher materiality thresholds (Popa, Span et al. 2013).

Choudhary, Merkley et al. (2019) established that *client performance* influences materiality thresholds. If auditors expect investors to be less sensitive when analysing financial reports of clients reporting a strong financial performance, they are likely to set higher materiality thresholds for such profitable clients. They also found that auditors often set lower materiality thresholds when *fraud and litigation risk* is high since this increases the Risk of Material Misstatement (RoMM). Furthermore, the *quality of the financial reporting system* may also influence the determination of materiality thresholds. When such quality is high, auditors tend to set higher materiality thresholds as the *ex ante* RoMM is lower (Choudhary, Merkley et al. 2019).

Hasan, Chand et al. (2021) noted that the *auditor's level of experience* influences the determination of materiality thresholds. Auditors with vast experience tend to set more precise materiality thresholds than their less experienced counterparts since they are more likely to consider both quantitative and qualitative aspects. Another factor influencing materiality thresholds is the *auditor's rule observance attitude*. Auditors with a high rule observance attitude tend to place more emphasis on quantitative aspects, thereby overlooking qualitative considerations when determining materiality thresholds. This often results in less accurate

thresholds than those set by their counterparts with a low rule observance attitude (Hasan, Chand et al. 2021). Additionally, the determination of materiality thresholds is influenced by *the auditor's critical thinking skills*. Auditors with strong critical thinking skills tend to consider both quantitative and qualitative information when establishing materiality thresholds, thereby leading to more accurate thresholds than those set by their counterparts with weaker critical thinking skills (Hasan, Chand et al. 2021).

Abilova (2022) found that *audit committee independence* also influences materiality thresholds, whereby the more independent the audit committee, the higher the materiality thresholds. The reason for this is that an independent audit committee reduces the perceived audit risk (Stewart, Munro 2007).

One might expect that a *change in auditor* will lead to lower materiality thresholds owing to the additional risk associated with a first-year audit. This is because the new auditor may lack a thorough understanding of certain key aspects of the client, such as the nature of the activities, the internal controls in place and any potential weaknesses. However, Costa (2023) revealed that many new auditors tend to set higher materiality thresholds. In this regard, Costa (2023) explained that one possible reason is that, since more work is required to obtain an understanding of the key aspects of the client, it may be challenging to meet reporting deadlines. As a result, new auditors may set higher materiality thresholds in order to reduce their workload and subsequently ensure that they are able to meet such deadlines.

2.3 The Effectiveness of ISA 320 and the Impact of Prescriptive Guidelines

2.3.1 The Effectiveness of ISA 320 as a Materiality Guidance Tool

Regulations and standards play a crucial role in providing guidance and ensuring consistency across various industries and professions. These are particularly important in the field of auditing as they help establish a uniform framework that auditors can rely on to maintain the integrity, accuracy and reliability of financial

reporting (Costa 2023). Within the context of materiality, an important Standard is ISA 320 '*Materiality in Planning and Performing an Audit*', issued by the IAASB in 2009. This Standard provides guidance on materiality, assisting auditors in setting materiality thresholds when planning and performing an audit (IAASB 2009b). However, there are concerns regarding whether the guidance provided by this Standard is sufficient to enable auditors to determine appropriate materiality thresholds.

Popa, Span et al. (2013) and Aqel (2011) noted that, since ISA 320 states that determining materiality thresholds is a "*matter of professional judgement, and is affected by the auditor's perception of the financial information needs of users of the financial statements*" (IAASB 2009b, Para. 4), the Standard lacks definite authoritative guidance. Abilova (2022) concurred with this view, observing that, aside from stating that materiality judgements should be made "*in light of surrounding circumstances*", and that such judgements "*are affected by the size or nature of a misstatement, or a combination of both*" (IAASB 2009b, Para. 2), ISA 320 does not provide specific guidance on how to determine materiality thresholds. This is also substantiated in Malta, whereby Azzopardi and Baldacchino (2009) found that Maltese audit practitioners perceive materiality to be vague and subsequently, liable to misinterpretation. Their study also revealed that materiality is not consistently applied amongst Maltese auditors, which could possibly be the result of a lack of proper authoritative guidance.

2.3.2 Benefits of Prescriptive Guidelines

In view of the above, there is an ongoing debate regarding the need for more prescriptive guidelines within ISA 320. One argument in favour of clearly set guidelines is that they may enhance the comparability and consistency of a firm's financial statements, this enabling users to easily compare financial statements both over time and across different firms, thereby helping them make better informed decisions (Azad, Salehi et al. 2022, de Rooij 2009). This is also substantiated by a study conducted by Hegazy and Salama (2022), which found that there would likely be greater consistency among auditors with the

establishment of explicit materiality guidelines. Another argument in favour of prescriptive guidelines is their attention-directing property, as they may require auditors to take into consideration specific qualitative factors that might otherwise be overlooked (Bu-Peow NG, Tan 2007).

Furthermore, explicit authoritative guidelines may enhance clarity and transparency, thereby rendering the concept of materiality more understandable to both auditors and users. Such guidelines may also enhance objectivity in the assessment of material misstatements, thus allowing users to place greater reliance on the accuracy and reliability of the financial statements (de Rooij 2009). Moreover, in Malta, non-Big-Four audit firms strongly favoured the development of prescriptive guidelines, possibly because they tend to rely on professional judgement rather than sophisticated audit software commonly used by Big-Four firms (Azzopardi, Baldacchino 2009).

2.3.3 Drawbacks of Prescriptive Guidelines

Despite the perceived benefits of explicit authoritative guidelines, concerns have been raised about potential drawbacks. One of the main drawbacks is that, owing to the complex nature of businesses and transactions, it would be difficult for prescriptive guidelines to address all possible situations (Abilova 2022, Azzopardi, Baldacchino 2009). Closely related to this issue is the fact that materiality applies to entities of varying sizes and nature, thereby making it challenging for such guidelines to cater for all types of entities (Vadivel 2004, p.725 cited in Aqel 2011).

Furthermore, it is argued that prescriptive guidelines should not be developed since auditors are best positioned to make materiality judgements based on their experience and knowledge of the specific circumstances surrounding the financial statements. Additionally, even though these guidelines may enhance uniformity and comparability, the inherently subjective nature of auditing means that there will likely remain room for professional judgment, as auditors must rely on their expertise to assess the specific circumstances of each audit (de Rooij 2009).

Another drawback is that authoritative guidelines could foster a compliance mentality, which may subsequently reduce auditors' motivation to improve their competence. Moreover, such guidelines could undermine the auditor's discretion to exercise professional judgement, this potentially leading to a mechanical process that may overlook the specific circumstances of each audit (Gao, Zhang 2019). Similarly, the Big-Four audit firms in Malta strongly opposed the development of prescriptive guidelines, possibly due to concerns that such guidelines could undermine professional judgement and thus lead to a mechanical exercise (Azzopardi, Baldacchino 2009).

2.4 The Role of Professional Judgement and its Challenges

2.4.1 The Role of Professional Judgement in Setting Materiality Thresholds

Professional judgement plays a crucial role in determining materiality thresholds, partly because, as has been pointed out earlier, it is argued that there is currently limited authoritative guidance on how such thresholds should be determined (Abilova 2022, Chewning Jr, Higgs 2002). It also plays such a role because, as mentioned earlier, ISA 320 highlights the importance of such judgement, stating that the *“auditor’s determination of materiality is a matter of professional judgment”* (IAASB 2009b, Para. 4). ISA 320 further emphasises that professional judgement is necessary to assess the needs of users of the financial statements, taking into account how any piece of information may influence their decision-making process (Abilova 2022, IAASB 2009b, Pinsker, Pitre et al. 2006). To this end, Kranacher (2007) suggests that auditors should identify who the users are and understand the types of decisions they may make on the basis of the information presented in the financial statements. This ensures that auditors apply materiality appropriately, this ultimately resulting in financial statements providing the respective users with all the relevant information that would influence their decision-making process (Pinsker, Pitre et al. 2006).

One key area wherein auditors must exercise their professional judgement is the determination of overall materiality. Auditors must start by selecting a benchmark,

and, in doing so, they must exercise their professional judgement to ensure that the selected benchmark is appropriate in the circumstances of the audit (Bagshaw, Selwood 2014, Popa, Span et al. 2013). Furthermore, the selected benchmark must be justifiable and therefore, the rationale behind its selection must be documented (ICAEW 2017). Auditors must then exercise their professional judgement in order to determine the percentage to be applied to the selected benchmark. In practice, there are both common guidelines and firm-specific policies outlining the appropriate percentage range for various types of benchmarks. These are used to guide auditors in determining the appropriate percentage to be applied. However, the final decision depends on their professional judgement (Abilova 2022).

Another key area is the determination of performance materiality. Specifically, the percentage to be applied is not derived from a simple formula, but rather it requires the exercise of professional judgement (Bellandi 2017, IAASB 2009b). A further key area wherein auditors must exercise their professional judgement is the determination of the clearly trivial threshold, particularly when determining the percentage to be applied (ICAEW 2017). Finally, auditors must exercise their professional judgement in order to account for the qualitative factors noted earlier and subsequently assess whether the respective materiality thresholds need to be adjusted (Popa, Span et al. 2013, Aqel 2011).

2.4.2 The Challenges Involved in Exercising Professional Judgement

It is important that auditors exercise sound professional judgement in order to determine appropriate materiality thresholds. However, this may be a challenging task since the quality of professional judgement is influenced by various environmental factors, including both external and internal factors. One example of an external factor, which Costa (2023) also indirectly referred to earlier¹, is time pressure, whereby significant time constraints may lower the quality of judgements made by auditors (Ranzilla, Chevalier et al. 2011, Maule, Edland 2002). Another external factor is limited resources, which may include limited

¹ Vide S.2.2.2

access to information. This limitation may hinder auditors from obtaining sufficient knowledge and thus, adversely affect the quality of their judgements (Goldberg, Bettinghaus 2015, Ranzilla, Chevalier et al. 2011).

Moving onto internal factors, one example is a judgement trap known as '*the rush to solve*'. This occurs when auditors feel pressured to make quick judgements in order to solve problems immediately and, as a result, they invest less time in the important steps of the judgement process, thereby leading to suboptimal judgements (Bettinghaus, Goldberg et al. 2014, Ranzilla, Chevalier et al. 2011). Another important internal factor is judgement shortcuts. Such shortcuts are often efficient and effective. However, in certain situations, they can lead to lower-quality judgements owing to their inherent bias (Fay, Montague 2015, Ranzilla, Chevalier et al. 2011). Therefore, in light of the above challenges in exercising professional judgement, an ongoing question lingers as to whether the current level of such judgement is sufficient to determine appropriate materiality thresholds.

2.5 Conclusion

This chapter provided a review of the relevant literature on the major factors influencing materiality thresholds, and the guidance provided by ISA 320. Furthermore, it explored the role of professional judgement in determining such thresholds. The following chapter will present the research methodology adopted for this study.

Chapter 3

Research Methodology

3.1 Introduction

This chapter outlines the research methodology adopted for this study, as illustrated in Figure 3.1. Section 3.2 describes the preliminary research carried out at the commencement of the study. This is followed by Section 3.3, which presents the theoretical framework and research design, while Sections 3.4 and 3.5 describe the research tool and participants, respectively. Section 3.6 explains the data collection process, while Section 3.7 delineates its analysis. Subsequently, Section 3.8 identifies the research limitations. Finally, Section 3.9 concludes the chapter.



Figure 3.1: Outline of Chapter 3

3.2 Preliminary Research

At the commencement of the study, an analysis of the existing literature was carried out to gain familiarity with the research area. This primarily involved reviewing past local dissertations to identify gaps in the literature, along with relevant foreign dissertations to obtain further ideas. Furthermore, an evaluation of peer-reviewed articles, academic journals and books was conducted, most of which were foreign-sourced due to the limited availability of local literature on the research area. Discussions were also held with lecturers to get preliminary feedback on the feasibility of the proposed study.

3.3 Theoretical Framework and Research Design

The theoretical framework of this dissertation is the Agency Theory. Owing to potential conflicts of interest between the Board (*agents*) and the shareholders (*principals*), the latter appoint external auditors to carry out the process of monitoring the activities of the former. With such a process, the principals become more confident that the information reported to them by the agents through the financial statements is fairly presented and free from material misstatements. The audit process hinges on the determination of materiality thresholds, which establish whether a misstatement or omission by the agents is significant enough to affect the stakeholders' decisions, particularly those of the principals.

There are three main research design methodologies, namely, quantitative, qualitative and mixed-methods. Selecting the most appropriate research design depends on several factors, including the research objectives, the research strategy, the data collection and analysis methods, the researcher's expertise and experience, and the study's intended audience (Creswell, Creswell 2023).

Quantitative research collects numerical data from a large pool of individuals, which is analysed using statistical procedures, while qualitative research gathers non-numeric data from a small pool of individuals to understand the meaning they assign to a particular phenomenon (Leavy 2023, Creswell, Guetterman 2019). In quantitative research, the researcher employs predefined questions to collect

data (Saunders, Lewis et al. 2023), while in qualitative research, the researcher observes participants' actions and opinions (Busetto, Wick et al. 2020), as this approach seeks to gather exploratory and open-ended data to obtain the participants' views and experiences (Creswell, Guetterman 2019).

The use of a quantitative approach allows the researcher to generalise the findings, but it also limits the ability to gain insights into the interviewees' opinions and perspectives (Scalcău, Ana 2021, Leavy 2023). On the other hand, the use of a qualitative approach allows the researcher to obtain a deeper understanding of a phenomenon, although the research findings cannot be extrapolated to a larger population (Creswell, Creswell 2023).

A mixed-methods approach is often considered to be the most suitable research design since it capitalises on the benefits of both quantitative and qualitative research, whilst also overcoming their respective limitations (Plano Clark 2017, Creswell, Plano Clark 2018). After a thorough assessment of which methodology to adopt for this study, it was determined that a predominantly qualitative mixed-methods approach would be most appropriate given the study's objectives. By combining quantitative and qualitative research, this approach enabled the researcher to conduct a thorough and broad investigation of the research problem (Dawadi, Shrestha et al. 2021).

3.4 Research Tool

Semi-structured interviews, including both open-ended and closed-ended questions, were deemed to be the most appropriate research tool for achieving the research objectives of this study. Such interviews were conducted by following a detailed interview schedule² in order to ensure that these objectives are attained (Adams 2015). The semi-structured design of the interviews provided the participants with flexibility to answer questions freely, which allowed them to provide detailed insights (McIntosh, Morse 2015). The researcher also used prompts and follow-up questions to encourage participants to engage in further

² Vide Appendix 3.1

discussion or to elaborate on their responses (Roulston, Choi 2018). Furthermore, the use of standardised questions facilitated the comparison and statistical analysis of the data collected (McIntosh, Morse 2015).

The interview schedule developed for this study was applicable to audit partners from large and medium-sized Maltese audit firms. As shown in Table 3.1, it was organised into three main sections in line with the research objectives. Furthermore, two supplementary sections were included, namely, Section A1, which provided some key definitions, and Section A2, which outlined the Likert scale used for the closed-ended questions.

Section Heading	Question Number
Section 1: Major Factors Influencing Materiality Thresholds	1 – 9
Section 2: The Effectiveness of ISA 320 and the Impact of Prescriptive Guidelines	10 – 18
Section 3: The Role of Professional Judgement and its Challenges	19 – 23
Section A1 – Definitions	/
Section A2 – Likert Scale	/

Table 3.1: Structure of the interview schedule

The interview schedule comprised a combination of both open-ended and closed-ended questions, as illustrated in Table 3.2. Thereafter, Table 3.3 depicts the five-point Likert scale employed for the closed-ended questions.

Question Type	Question Number
Open-ended	1 – 3, 5 – 23
Closed-ended	4

Table 3.2: Grouping of open-ended and closed-ended questions

Response	Strongly disagree	Disagree	Neutral	Agree	Strongly agree
Scale	0	1	2	3	4

Table 3.3: Likert scale used for question 4

3.5 Research Participants

The research participants of this study consisted of audit partners from Maltese audit firms. The list of such firms was obtained from the Accountancy Board website. As at 26th April 2025, there were 145 registered audit firms. The sampling technique used in this study was purposive sampling, whereby audit firms were purposively selected to be interviewed. For the purpose of this study, all the Big-Four firms as well as other large and medium-sized audit firms were selected. Subsequently, the email addresses of the respective audit partners were obtained from the firms' websites to contact them. Where the email addresses were not available on the websites, the respective audit firms were contacted by telephone to provide such information.

The 'Letter of Introduction and Invitation to Participate in Research', which provided a brief overview of the study and which was also signed by the dissertation supervisor, was attached to the email inviting the selected audit partners to participate in the study. This allowed them to familiarise themselves with the study, while it also enhanced the email's credibility. Where no reply was received from potential interviewees within two weeks, a follow-up email was sent. Furthermore, if a response was still not received, they were contacted by telephone. Nonetheless, some individuals failed to reply, while others stated that they were unable to participate in the study due to time constraints.

A total of twelve interviews were conducted. After the final interview took place, it became evident that qualitative saturation had been reached. This saturation was established by concluding the interview process at the point where the data collected was no longer providing additional insights or revealing new themes, indicating that further interviews would be unnecessary.

3.6 Data Collection

Accurate data collection serves as the foundation of any research study since it helps to ensure that reliable research findings are obtained (Mwita 2022). Therefore, the selected data collection method should align with the study's

research objectives (Guest, Namey et al. 2013). In conducting this study, both secondary and primary data were collected.

3.6.1 Secondary Data Collection

Secondary data was gathered from various literature sources analysed in Chapter Two of this study. This data served as the basis for formulating the interview schedule. A pilot interview was also conducted with a senior member of a Big-Four audit firm to assess the reliability and validity of the research tool (Saunders, Lewis et al. 2023). Thereafter, the interview schedule was amended, taking into consideration the recommendations provided.

3.6.2 Primary Data Collection

Interviews were conducted between the 7th of November and the 19th of December 2024. They were scheduled on a date and time which was most convenient for the research participants. The interviews were held either in-person at the interviewees' workplace or online using Zoom or Microsoft Teams, according to their preferences. The interview schedule was sent to all participants beforehand to give them sufficient time to familiarise themselves with the questions. This was also presented as a hard copy during the in-person interviews and as a soft copy via screen sharing during the online interviews. Prior to each interview, participants were requested to sign the Interviewee Consent Form to obtain their consent to participate in the study. Furthermore, to facilitate the data analysis process, they also gave their permission for the interviews to be audio-recorded.

3.7 Data Analysis

Audio recordings were promptly transcribed following each interview to maximise the effectiveness of the interviews conducted. These transcripts, along with the notes taken during the interviews, enhanced the data analysis.

3.7.1 Quantitative Data Analysis

Quantitative data was obtained from the closed-ended questions, primarily through the use of the Likert scale ratings. This data was analysed using IBM SPSS Statistics.

The Friedman Test³ was used to compare the mean rating scores assigned to the materiality thresholds factors, and to determine whether such scores varied significantly.

3.7.2 Qualitative Data Analysis

Qualitative data was obtained from the open-ended questions and the comments added by respondents when providing their ratings in the Likert scale questions. In order to facilitate thematic analysis, a summary for each transcript was prepared and mapped out in a spreadsheet. This enabled the comparison of the different responses and the identification of the emerging themes (Braun, Clarke 2012).

3.8 Research Limitations

One of the limitations encountered in this study was that most of the audit firms interviewed use their own methodology to determine materiality thresholds, rather than following the guidance provided by ISA 320. Although these firm-specific methodologies are based on this Standard, the fact that such respondents do not directly refer to it somewhat limits their knowledge of ISA 320. Therefore, their responses on the effectiveness of ISA 320 may not have been entirely accurate.

In mitigation of this issue, half such respondents stated explicitly that they had revisited ISA 320 prior to answering the relevant part (Section 2) of the interview schedule. However, the other respondents may have been vague in their responses. Furthermore, one such respondent did not provide any answers to Section 2 of the interview schedule, citing limited knowledge of ISA 320, this

³ Vide Appendix 3.2

further highlighting the challenges posed by practitioner reliance on firm-specific methodologies.

A further limitation of this study was the small sample size. This is because such a sample size reduces the study's statistical power, which makes it more challenging to identify meaningful effects and increases the likelihood that the results could be influenced by random variation. This limitation also impacts the findings' generalisability, since a smaller sample may not truly represent the larger population. As a result, although the findings provide insightful information, they should be interpreted cautiously since they may not be relevant in all contexts. Moreover, the participants' responses inevitably reflected a degree of subjectivity.

3.9 Conclusion

This chapter explained the research methodology adopted for this study. The following chapter will present the research findings obtained from the interviews.

Chapter 4

Research Findings

4.1 Introduction

This chapter presents the findings that emerged from the interviews conducted. As shown in Figure 4.1, Section 4.2 outlines the major factors influencing the determination of materiality thresholds, while Section 4.3 delves into the effectiveness of ISA 320 and the impact of prescriptive guidelines. Subsequently, Section 4.4 deals with the role of professional judgement and its challenges. Finally, Section 4.5 concludes the chapter.

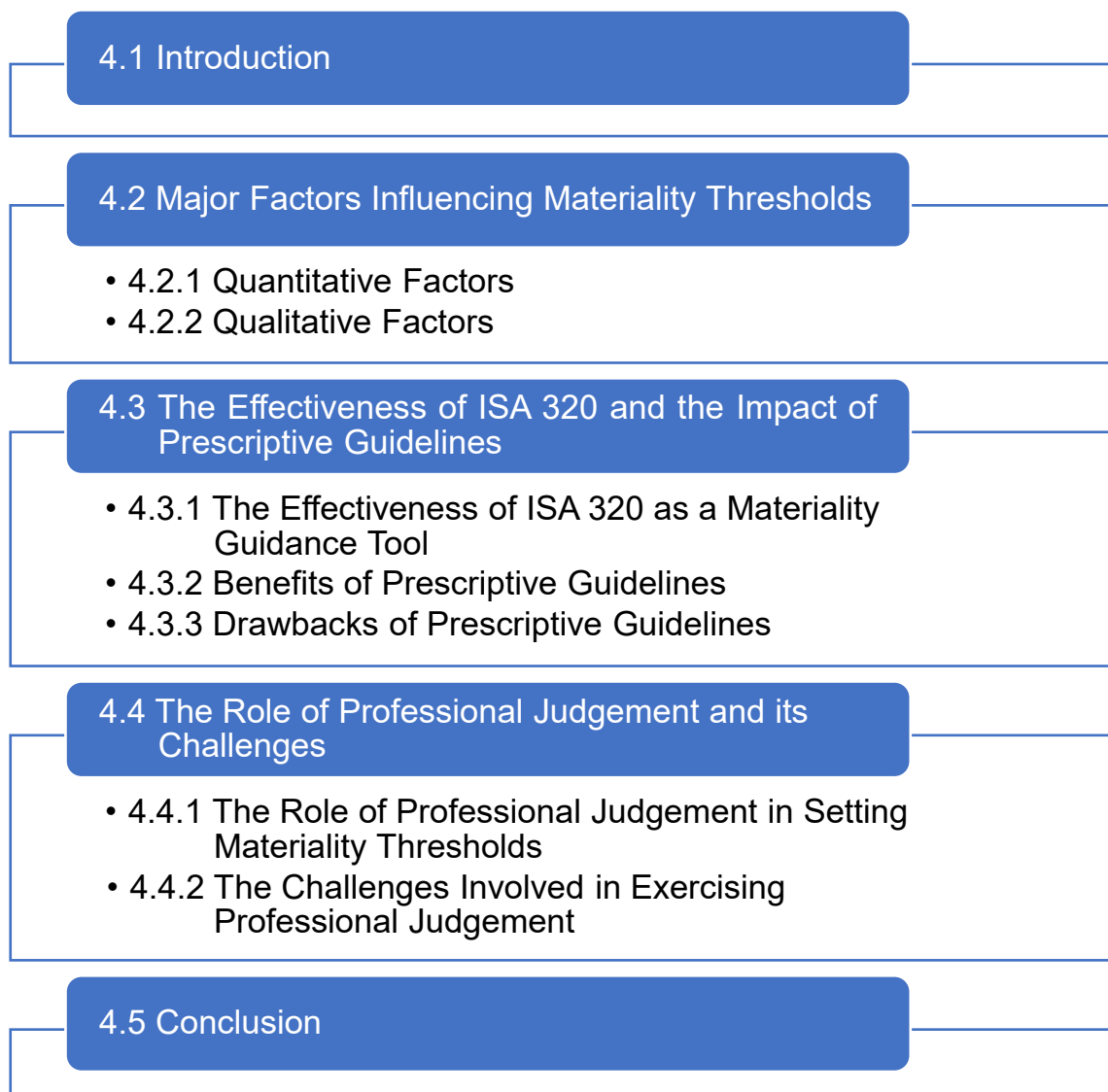


Figure 4.1: Outline of Chapter 4

4.2 Major Factors Influencing Materiality Thresholds

The first section of the interview schedule consisted of nine questions (Q.1-9) relating to major factors influencing materiality thresholds.

4.2.1 Quantitative Factors

Overall Materiality

The first question⁴ was divided into five parts and related to overall materiality, which is determined by the application of a percentage to a selected benchmark.

Examples of commonly used benchmarks. In the first part of the question⁵, respondents were asked to provide some examples of commonly used benchmarks and specify the circumstances in which they apply. In line with the findings of Azzopardi and Baldacchino (2009)⁶, they provided the following three benchmarks:

a) Profit before tax: One commonly used benchmark is profit before tax. Consistent with Choudhary, Merkley et al. (2019) and IAASB (2009b)⁷, respondents_(12/12) agreed that this benchmark is typically used for profit-oriented operating entities. Furthermore, some respondents_(4/12) noted that it is also used for entities where the users of the financial statements focus on earnings. One respondent_(1/12) also mentioned that profit before tax is commonly used for Public Interest Entities (PIEs), “*especially those with listed shares*”, since earnings per share is a key metric for such entities.

b) Total revenue: Another frequently used benchmark is total revenue. Respondents_(12/12) agreed that this benchmark is often used for revenue-driven operating entities. Additionally, a few respondents_(2/12) remarked that it is also used for entities where the users focus on revenue. Two respondents_(2/12) added that total revenue is also commonly used for ‘*break-even companies*’ since profit

⁴ Vide Q.1 p.A3.1-2

⁵ Vide Q.1a p.A3.1-2

⁶ Vide Overall Materiality in S.2.2.1

⁷ Vide Overall Materiality in S.2.2.1

before tax is not an appropriate benchmark in such cases. Furthermore, one respondent_(1/12) stated that it could also be used for entities with volatile profits, as well as for entities where “*management compensation is tied to revenue*”.

c) Total assets: A further widely used benchmark is total assets. Respondents_(12/12) agreed that this benchmark is often used for asset-driven entities, such as investment companies, holding companies and real estate companies. However, some respondents_(5/12) noted that the net assets benchmark is also commonly used for such entities. Moreover, one respondent_(1/12) pointed out that total assets is also used for entities which are not profitable, and where “*revenue is intra-group or with related parties*”.

The Top Benchmarks. In the second part of the question⁸, respondents were requested to rank in descending order the benchmarks most commonly used. One respondent_(1/12) argued that the selected benchmark depends on the entity being audited and was therefore unable to rank the benchmarks used. Most of the other respondents_(6/11) reported *profit before tax* as the most commonly used benchmark, this being in line with the literature⁹, while a few of them cited total revenue_(3/11) and total assets_(2/11). Furthermore, most respondents_(7/11) stated that *total revenue* is the second most commonly used benchmark, while some of them indicated this to be total assets_(3/11) and net assets_(1/11). This contrasts with the findings of Quick, Zaman et al. (2023) and Costa (2023)¹⁰, who found that the second most commonly used benchmark is total assets. With respect to the third most commonly used benchmark, there was no clear favourite among respondents, with some citing total assets_(3/11), profit before tax_(3/11) and net assets_(3/11), while a few referred to total expenses_(1/11) and Earnings Before Interest, Taxes, Depreciation, and Amortisation (EBITDA)_(1/11). Similar to the literature¹¹, some respondents_(7/11) added that total assets_(3/7), net assets_(2/7) and total expenses_(2/7) are also used, though less frequently. Three of these

⁸ Vide Q.1b p.A3.1-2

⁹ Vide Overall Materiality in S.2.2.1 e.g. Quick, Zaman et al. (2023) and Costa (2023)

¹⁰ Vide Overall Materiality in S.2.2.1

¹¹ Vide Overall Materiality in S.2.2.1 e.g. Goh, Lee et al. (2023) and Quick, Zaman et al. (2023)

respondents^(3/7) also stated that EBITDA can also be used, but this is rarely the case.

Factors Influencing the Selection of a Benchmark. The third part of the question¹² asked respondents to outline the factors they consider in selecting an appropriate benchmark. In line with Bellandi (2017), Quick, Zaman et al. (2023) and IAASB (2009b)¹³, one predominant factor is *the nature of the entity*, including *the industry in which the entity operates*^(12/12). Closely linked to this factor, some respondents^(5/12) mentioned that *the entity's main driver*^(3/5) and *its KPIs*^(2/5) also influence the benchmark selection, this being in line with Quick, Zaman et al. (2023) and Abilova (2022)¹⁴. For example, if the entity is revenue-driven or if revenue is a KPI, the most appropriate benchmark would be total revenue. In conformance with Bellandi (2017) and IAASB (2009b)¹⁵, another important factor is *the primary area of focus for the users of the financial statements*^(7/12). Therefore, say, if the users are mainly interested in profit, the most appropriate benchmark would be profit before tax.

Furthermore, two respondents^(2/12) noted that *the volatility of financial statement measures* influences the benchmark selection, this being in line with Quick, Zaman et al. (2023) and IAASB (2009b)¹⁶. For instance, if profits are volatile, the average profit before tax would be more appropriate since it “*smoothens the volatility*”. Similar to Eilifsen and Messier Jr (2015) and IAASB (2009b)¹⁷, one respondent^(1/12) stated that *the entity's profitability* is also taken into consideration in selecting an appropriate benchmark. For example, if a typically profitable entity is experiencing a loss in a particular year, total revenue or total assets would be more appropriate than profit before tax.

Commonly Used Rules of Thumb. In the fourth part of the question¹⁸, respondents were requested to provide a few examples of rules of thumb typically

¹² Vide Q.1c p.A3.1-2

¹³ Vide Overall Materiality in S.2.2.1

¹⁴ Vide Overall Materiality in S.2.2.1

¹⁵ Vide Overall Materiality in S.2.2.1

¹⁶ Vide Overall Materiality in S.2.2.1

¹⁷ Vide Overall Materiality in S.2.2.1

¹⁸ Vide Q.1d p.A3.1-2

used and indicate which one is the most commonly applied. With respect to *profit before tax*, the majority_(8/12) agreed on a range of 5-10%, this being in line with the findings of Abilova (2022), Eilifsen and Messier Jr (2015), and Azzopardi and Baldacchino (2009)¹⁹, while others cited 3-10%_(3/12) and 8-10%_(1/12). As for *total revenue*, almost half of the respondents_(5/12) reported a range of 1-3%, while others indicated 0.5-2%_(2/12), 0.5-3%_(2/12), 1-5%_(1/12), 0.8-2%_(1/12) and 0-3%_(1/12). In terms of *total assets*, two notable ranges emerged from the responses, specifically 1-3%_(4/12) and 1-2%_(4/12), while a few respondents cited 0.5-3%_(2/12), 0.5-2%_(1/12) and 0-2%_(1/12). The reported ranges for both total revenue and total assets are somewhat consistent with the findings of Abilova (2022), Eilifsen and Messier Jr (2015), and Azzopardi and Baldacchino (2009)²⁰, who found that the typical range applied to both benchmarks is 0.5-2%.

With regard to the most commonly applied rule of thumb, one respondent_(1/12) argued that it depends on the circumstances of the audit and was therefore unable to specify a particular rule of thumb. However, in line with Azzopardi and Baldacchino (2009)²¹, most of the other respondents_(6/11) indicated that the rule of thumb most commonly applied is that of *profit before tax*, while some of them mentioned *total revenue*_(3/11) and *total assets*_(2/11). Furthermore, when probed further about the specific percentages applied to these benchmarks, respondents_(12/12) stated that they were unable to do so since the percentage is determined on a case-by-case basis, taking into account the factors discussed in the next part of the question.

Factors Influencing the Determination of a Percentage. In the last part of the question²², respondents were asked to outline the factors they consider in determining the specific percentage to be applied to the selected benchmark. One respondent_(1/12) did not provide any factors since the respective audit firm's methodology establishes the specific percentage, depending on the entity being

¹⁹ Vide Overall Materiality in S.2.2.1

²⁰ Vide Overall Materiality in S.2.2.1

²¹ Vide Overall Materiality in S.2.2.1

²² Vide Q.1e p.A3.1-2

audited. However, the other respondents_(11/12) provided the following seven factors:

a) Assessed risk: Consistent with Abilova (2022)²³, one important factor is the assessed risk of the entity_(6/11), whereby if an entity is considered to be of high risk, a percentage closer to the lower end of the range would be more appropriate.

b) PIE client: In line with Abilova (2022)²⁴, another important factor is whether the client is a PIE_(6/11). In such cases, a lower percentage would be applied since the financial statements of PIEs are made available to “a wider range of people” and therefore, the impact on society would be more significant compared to non-PIEs.

c) Number of users: Closely linked to the previous factor is the number of users of the entity’s financial statements_(4/11), whereby if multiple users are interested in the entity’s financial statements, the impact of potential misstatements would be more significant and therefore, a lower percentage would be more appropriate in such case.

d) History with the client: In conformance with Steinbart (1987)²⁵, another key factor is the history with the client_(4/11), whereby if it is a first-year audit, a lower percentage would be more appropriate. This is because, typically, the auditor would not have a full understanding of the client, and therefore, a more conservative approach is often adopted in the first year to obtain an understanding of the client and mitigate any potentially high risks.

e) External financing: Similar to Abilova (2022)²⁶, a further factor is the entity’s level of external financing, including the extent and complexity of its debt obligations_(4/11). If an entity has a significant level of external financing, including several restrictive and complex debt arrangements, the RoMM would be higher owing to factors such as incorrect accounting of debt, misinterpretation of terms

²³ Vide Overall Materiality in S.2.2.1

²⁴ Vide Overall Materiality in S.2.2.1

²⁵ Vide Overall Materiality in S.2.2.1

²⁶ Vide Overall Materiality in S.2.2.1

and conditions, and improper classification of debt and equity. Therefore, a lower percentage would be more appropriate in this case.

f) Client's industry: In line with Abilova (2022)²⁷, the percentage to be applied is also influenced by the industry in which the entity operates^(3/11), whereby the more complex and risky the industry, the lower the percentage applied.

g) Expected level of misstatements: According to two respondents^(2/11), the expected level of misstatements identified during the audit also influences the percentage to be applied, whereby if it is expected that a significant number of misstatements will be identified during the audit, it would be more appropriate to apply a lower percentage.

Performance Materiality

The next question²⁸ was divided into two parts and focused on performance materiality, which is expressed as a percentage of overall materiality.

Commonly Applied Percentages. In the first part of the question²⁹, respondents were requested to indicate the percentage range typically applied to determine this threshold, as well as the specific percentage most commonly used. One respondent^(1/12) did not provide a percentage range as the respective audit firm's methodology establishes the specific percentage to be applied, depending on the circumstances of the audit. As for the other respondents, the reported percentage ranges varied, thereby indicating that a commonly applied range does not exist. In fact, the variations in ranges were as follows: 50-75%^(2/11), 50-90%^(2/11), 65-85%^(2/11), 50-80%^(1/11), 50%-85%^(1/11), 60-90%^(1/11), 65-80%^(1/11), and 70-90%^(1/11). These ranges are somewhat consistent with those found in previous international studies³⁰. With regard to the specific percentage most commonly applied, almost all respondents^(11/12) cited 75%, this being in line with the findings

²⁷ Vide Overall Materiality in S.2.2.1

²⁸ Vide Q.2 p.A3.1-2

²⁹ Vide Q.2a p.A3.1-2

³⁰ Vide Performance Materiality in S.2.2.1 e.g. Quick, Zaman et al. (2023) and Abilova (2022)

of Abilova (2022) and Choudhary, Merkley et al. (2022)³¹, while one respondent_(1/12) indicated this to be around 70%.

Factors Influencing the Determination of a Percentage. In the second part of the question³², respondents were asked to indicate the factors they consider in determining the percentage to be applied. The respondent_(1/12) identified in the first part of this question did not provide any factors for the same reason mentioned earlier. However, in line with IAASB (2009b)³³, the other respondents_(11/12) indicated that three factors outlined earlier in relation to overall materiality, namely *the assessed risk of the entity*_(6/11), *the expected level of misstatements identified during the audit*_(4/11) and *the history with the client*_(4/11), are influential with respect to performance materiality. In addition to these factors, such respondents_(11/12) provided the following six factors:

a) History of misstatements: In line with IAASB (2009b)³⁴, one predominant factor is the entity's history of misstatements_(9/11), whereby if an entity has a history of a significant number of misstatements identified in previous audits, it would be more appropriate to apply a percentage closer to the lower end of the range.

b) Internal control environment: Similar to Eilifsen and Messier Jr (2015)³⁵, the percentage to be applied is also influenced by the internal control environment of the entity_(4/11), whereby the more robust the control environment and the more effective the internal controls, the lower the risk and therefore, a higher percentage may be applied.

c) Competency of the finance team: According to two respondents_(2/11), another factor is the competency of the finance team, whereby if an entity has a "*highly experienced and competent finance team*", the RoMM would be lower, and therefore, a higher percentage may be applied.

³¹ Vide Performance Materiality in S.2.2.1

³² Vide Q.2b p.A3.1-2

³³ Vide Performance Materiality in S.2.2.1

³⁴ Vide Performance Materiality in S.2.2.1

³⁵ Vide Performance Materiality in S.2.2.1

d) Complexity of the entity: Two further respondents^(2/11) highlighted that the complexity of the entity also influences the percentage to be applied, whereby the more complex the structure, operations or transactions of the client, the higher the RoMM, and therefore, a lower percentage would be more appropriate.

e) Management's attitude towards identified misstatements: According to one respondent^(1/11), management's attitude towards identified misstatements also influences the percentage to be applied. If management "*takes identified misstatements seriously*", for example, by cooperating and booking the necessary adjustments, the RoMM would be lower and therefore, a higher percentage may be applied.

f) Level of turnover among senior management: Echoing Eilifsen and Messier Jr (2015)³⁶, one respondent^(1/11) noted that the level of turnover among senior management influences the percentage to be applied. For instance, if a significant number of senior management personnel leave the entity during the year, "*this would raise concerns*". Therefore, in this case, a lower percentage would be more appropriate.

Clearly Trivial Threshold

The following question³⁷ was divided into two parts and related to the clearly trivial threshold, which is expressed as a percentage of overall materiality.

Commonly Applied Percentages. In the first part of the question³⁸, respondents were asked to indicate the percentage range typically applied to determine this threshold, as well as the specific percentage most commonly used. Most respondents^(8/12) did not provide a range since they simply apply *5% of overall materiality* as the clearly trivial threshold. Each of the remaining respondents^(4/12) provided a different range, specifically 2-3%^(1/4), 3-5%^(1/4), 3-10%^(1/4) and 5-10%^(1/4). These ranges somewhat contrast with those found in previous

³⁶ Vide Performance Materiality in S.2.2.1

³⁷ Vide Q.3 p.A3.1-2

³⁸ Vide Q.3a p.A3.1-2

international studies³⁹. As for the specific percentage most commonly applied, the majority_(10/12) cited 5%, this being in line with the findings of Quick, Zaman et al. (2023) and Abilova (2022)⁴⁰, while two respondents_(2/12) reported 3%_(1/2) and 5% or 10%_(1/2), respectively. The most commonly applied percentage of 5% indicates an increase on the 2% threshold typically applied in Malta in 2009, as found by Azzopardi and Baldacchino (2009)⁴¹.

Factors Influencing the Determination of a Percentage. The second part of the question⁴² enquired about the factors considered in determining the percentage to be applied. All the respondents who did not provide a range_(8/12) emphasised that there are no factors because their respective firm's methodology requires them to apply a standard 5%. Three respondents_(3/8) added that any potential factors would have already been considered in determining performance materiality. One respondent_(1/8) also emphasised that the "*test of reasonability*" is applied, whereby, on a case-by-case basis, the auditor exercises professional judgement to assess the reasonableness of the percentage applied. If the standard 5% clearly trivial threshold is deemed to be unreasonable, the auditor has the discretion to apply a different percentage.

The other respondents_(4/12) who provided a range outlined a number of factors influencing the percentage to be applied. One factor mentioned earlier in relation to overall materiality and performance materiality, namely *the assessed risk of the entity*_(3/4), was also highlighted as a key factor with respect to the clearly trivial threshold. Similarly, one factor mentioned earlier in relation to performance materiality, namely *the entity's history of misstatements*_(1/4), was also identified with respect to the clearly trivial threshold. This is line with ICAEW (2017) and Eilifsen and Messier Jr (2015)⁴³. *The entity's average transaction size*_(1/4) also influences the percentage to be applied, whereby if an entity has a low average transaction size, it would be more appropriate to apply a lower percentage since

³⁹ Vide Clearly Trivial Threshold in S.2.2.1 e.g. Quick, Zaman et al. (2023) and Abilova (2022)

⁴⁰ Vide Clearly Trivial Threshold in S.2.2.1

⁴¹ Vide Clearly Trivial Threshold in S.2.2.1

⁴² Vide Q.3b p.A3.1-2

⁴³ Vide Clearly Trivial Threshold in S.2.2.1

if a higher clearly trivial threshold is used, certain misstatements will not be captured.

4.2.2 Qualitative Factors

The next question⁴⁴ presented respondents with ten statements relating to qualitative factors influencing materiality thresholds. They were asked to rate their level of agreement and add their comments, if any. Table 4.1 displays the mean rating scores obtained, in descending order of agreement. Significant differences were observed among the mean rating scores ($p < 0.001$).

		Mean	Std. Dev.
j.	Fraud and litigation risk: The higher the fraud and litigation risk, the lower the materiality thresholds.	3.25	0.452
b.	Quality of client internal controls: The more robust the system of internal control, the higher the materiality thresholds set.	3.08	0.669
i.	Auditor critical thinking skills: Auditors with strong critical thinking skills tend to consider both quantitative and qualitative information. This results in the setting of more accurate thresholds.	3.08	0.793
a.	Client complexity: The more complex the client, the lower the materiality thresholds set.	3.00	1.279
d.	Accountability pressure: As accountability pressure increases, auditors tend to become more cautious and sensitive to the risks involved in the specific circumstances of the audit. This leads to lower materiality thresholds.	2.58	1.084
h.	Auditor rule observance attitude: Auditors with a high rule observance attitude tend to place more emphasis on quantitative rather than qualitative aspects. This leads to the setting of less accurate materiality thresholds.	2.58	0.669
g.	Auditor experience: Auditors with extensive experience tend to set more precise materiality thresholds.	2.50	1.000

⁴⁴ Vide Q.4 p.A3.1-3 and p.A3.1-4

e.	Auditor experience in the client's sector: As auditors gain experience in a particular sector, they become better equipped to identify and address sensitive areas. This enables them to set higher materiality thresholds.	1.67	0.888
f.	Longevity of relationship with client: As the longevity of the auditor-client relationship increases, auditors set higher materiality thresholds.	1.58	0.996
c.	Audit firm size: Large audit firms typically set higher materiality thresholds than smaller audit firms.	0.83	1.030
Scale from 0 (Strongly disagree) to 4 (Strongly agree) Number of respondents = 12		$\chi^2(9) = 50.261, p < 0.001$	

Table 4.1: Major qualitative factors influencing materiality thresholds

As portrayed in Table 4.1, the qualitative factor most agreed ($\bar{x}=3.25$) to by respondents was fraud and litigation risk, whereby the higher the fraud and litigation risk, the lower the materiality thresholds set. Some respondents_(4/12) emphasised that a higher fraud and litigation risk would increase the “*risk associated with the client*” and that, as a result, a more conservative approach should be adopted in this case to mitigate the heightened risk.

Another factor agreed ($\bar{x}=3.08$) to was the quality of client internal controls, whereby the more robust the system of internal control, the higher the materiality thresholds set. A few respondents_(3/12) remarked that stronger internal controls operating effectively would reduce the likelihood of misstatements and that, as a result, higher thresholds would typically be set.

Respondents also agreed ($\bar{x}=3.08$) to the factor of auditor critical thinking skills, whereby auditors with strong critical thinking skills often consider both quantitative and qualitative information, which results in more accurate thresholds. Some respondents_(4/12) asserted that materiality thresholds should be determined by taking into consideration both quantitative and qualitative factors. One respondent_(1/12) also added that this is linked with professional judgement since “*having a critical mind*” is one of the ways of applying professional judgement.

Furthermore, respondents agreed ($\bar{x}=3.00$) to the factor of client complexity, in that the more complex the client, the lower the materiality thresholds set. A few

respondents_(3/12) emphasised that if there are complex and highly judgemental areas, the RoMM would increase, which would require *“more testing to be performed”*.

One factor which respondents marginally agreed_($\bar{x}=2.58$) to was accountability pressure, whereby as accountability pressure increases, auditors tend to become more cautious and sensitive to the risks involved in the audit, which leads to lower materiality thresholds. Two respondents_(2/12) argued that auditors should always be accountable and therefore, there should not be any change in accountability. Furthermore, one respondent_(1/12) noted that, rather than lowering materiality thresholds, documenting the procedures performed is crucial to *“prove that audits are carried out correctly”*.

Respondents also marginally agreed_($\bar{x}=2.58$) to the factor of auditor rule observance attitude, whereby auditors with a high rule observance attitude tend to place more emphasis on quantitative rather than qualitative aspects, which leads to less accurate materiality thresholds. Similar to the comments provided in relation to auditor critical thinking skills, a few respondents_(3/12) highlighted the importance of both quantitative and qualitative considerations when determining materiality thresholds. However, two respondents_(2/12) pointed out that auditors typically follow the guidance provided by their firms and therefore, they inherently take into account both aspects.

Another factor marginally agreed_($\bar{x}=2.50$) to was auditor experience, in that auditors with extensive experience tend to set more precise materiality thresholds. Half the respondents_(6/12) emphasised that their respective firms provide guidance for all audit personnel to follow and therefore, even less experienced auditors are able to determine appropriate materiality thresholds. However, two of these respondents_(2/6) noted that, nonetheless, experience remains beneficial since it helps auditors to set more accurate materiality thresholds.

One factor which respondents did not agree_($\bar{x}=1.67$) to was auditor experience in the client's sector, whereby as auditors gain experience in a particular sector, they become better equipped to identify and address sensitive areas, which enables them to set higher materiality thresholds. Three respondents_(3/12) argued that

while a strong understanding of a sector helps in making better judgements, the determination of materiality thresholds is “*ultimately client-specific*”, based on the associated risk. Another three respondents_(3/12) remarked that their respective firms provide industry-specific guidance and therefore, auditor experience in the client’s sector does not influence materiality thresholds. However, these respondents_(3/3) also added that, for sole practitioners, auditor experience “*could play a role*” in determining materiality thresholds.

Another factor not agreed_($\bar{x}=1.57$) to by respondents was the longevity of the relationship with the client, whereby as the longevity of the auditor-client relationship increases, auditors set higher materiality thresholds. Three respondents_(3/12) explained that materiality thresholds do not depend solely on the longevity of the relationship, but also on other factors, such as the history of misstatements. For example, auditors may have long-standing relationships with certain clients, but if previous audits have revealed a significant number of misstatements, increasing the thresholds would not be appropriate in such cases. Two respondents_(2/12) also noted that auditors must be careful not to become “*too familiar with the client*” as this could lead to a relationship which extends beyond a professional audit relationship and potentially create a familiarity threat. Additionally, one respondent_(1/12) highlighted that certain controls are in place to mitigate potential familiarity threats, such as the audit partner rotation requirements.

Finally, respondents did not agree_($\bar{x}=0.83$) to the factor of audit firm size, whereby large audit firms typically set higher materiality thresholds than smaller audit firms. Two respondents_(2/12) emphasised that materiality thresholds depend on the client’s characteristics and associated risk, rather than on the size of the audit firm. One respondent_(1/12) also remarked that the audit procedures performed should be consistent among auditors and therefore, they should arrive at similar materiality thresholds.

The Client's Sector

Subsequently, respondents were asked⁴⁵ whether the sector in which the client operates influences materiality thresholds. In line with Popa, Span et al. (2013) and Iselin and Iskandar (2000)⁴⁶, respondents_(12/12) answered in the affirmative. While the majority_(9/12) argued that the sector influences both the selected benchmark and the applied percentage, a few_(3/12) noted that it only influences the benchmark. Furthermore, half of the respondents_(6/12) emphasised that the sector is linked to the nature of the entity and is, therefore, inherently considered when obtaining an understanding of the entity.

Most respondents_(9/12) argued that certain sectors are riskier than others and that, as a result, lower thresholds should be applied in such cases. For example, a few respondents_(3/9) highlighted that the gaming industry is considered to be riskier than other sectors. Others_(6/9) remarked that regulated entities and designated PIEs are usually riskier owing to the involvement of various stakeholders and their *“significant impact on the community”*. Some respondents_(4/12) also provided examples of how the sector influences the selected benchmark. For the telecommunications and retail industries, a typical benchmark is EBITDA_(1/4). For real estate companies, a typical benchmark is net assets or total assets_(1/4). For manufacturing companies, a typical benchmark is total revenue or profit before tax_(1/4). For investment entities, a typical benchmark is net assets_(1/4).

Client Financial Performance

In the following question⁴⁷, respondents were asked whether a stronger client financial performance leads to higher materiality thresholds. Contrary to Choudhary, Merkley et al. (2019)⁴⁸, respondents_(12/12) emphasised that, when determining materiality thresholds, the factors mentioned earlier⁴⁹, rather than client performance, should be taken into consideration. One respondent_(1/12)

⁴⁵ Vide Q.5 p.A3.1-4

⁴⁶ Vide S.2.2.2

⁴⁷ Vide Q.6 p.A3.1-4

⁴⁸ Vide S.2.2.2

⁴⁹ Vide Table 4.1 in S.4.2.2

added that a key reason for this is that “*the increase in profitability may have been a one-off*”, while another respondent^(1/12) noted that a stronger client financial performance “*could be indicative of potential fraud or errors*”. Interestingly, one respondent commented^(1/12) that, indeed, a stronger client financial performance can indirectly lead to higher materiality thresholds. This is because usually an entity with greater financial resources has stronger internal processes, for instance, a more competent and experienced accounting team, and enhanced internal controls, which ultimately reduce the RoMM.

Financial Reporting System

The next question⁵⁰ asked respondents whether a higher quality financial reporting system leads to higher materiality thresholds. The majority^(9/12) agreed with this view, thereby being in line with Choudhary, Merkley et al. (2019)⁵¹, citing two main reasons. Firstly, over half of these respondents^(5/9) highlighted that it is linked to the internal control environment. They explained that if a higher quality financial reporting system has sufficient internal controls within it, which are reliable and operating effectively, it will lead to higher thresholds. Secondly, the remaining respondents^(4/9) argued that a higher quality financial reporting system should “*reduce the risk of errors*”, which will ultimately result in higher thresholds. On the contrary, the other respondents^(3/12) disagreed, stating that the financial reporting system is not a factor which is considered in determining materiality thresholds.

Audit Committee Independence

Respondents were then asked⁵² whether a higher level of audit committee independence leads to higher materiality thresholds. Most respondents^(7/12) agreed, with five such respondents^(5/7) emphasising that it is linked to the internal control environment. They argued that, if the presence of an audit committee, enhanced by its independence, leads to a stronger internal control environment,

⁵⁰ Vide Q.7 p.A3.1-4

⁵¹ Vide S.2.2.2

⁵² Vide Q.8 p.A3.1-4

owing to better controls in place, this will result in higher thresholds. One respondent_(1/5) also stated that the audit committee is “*already providing oversight*”, and therefore, if it is reliable and operating effectively, the auditor can rely on it to some extent, this allowing for higher thresholds. Moreover, one respondent_(1/5) noted that the auditor would be willing to set higher materiality thresholds owing to “*an additional layer of scrutiny*”. However, such respondent also pointed out that, typically, the audit committee expects lower materiality thresholds to be set in order to ensure that the auditor carries out more audit work. Therefore, although the auditor may be willing to set higher thresholds for the aforementioned reasons, this might be quite challenging sometimes.

Conversely, five respondents_(5/12) disagreed, providing a number of reasons. Two respondents_(2/5) remarked that, rather than audit committee independence, they consider the “*strength of its oversight*” over the financial reporting of the company. Therefore, if the audit committee contributes towards a robust internal control environment, it will lead to higher materiality thresholds. However, one respondent_(1/5) noted that audit committees are often present in PIEs and that, for such entities, lower rather than higher thresholds are typically applied. Furthermore, one respondent_(1/5) simply stated that audit committee independence is not a factor which is considered in determining materiality thresholds, while another_(1/5) added that “*good governance*” is a factor, but not among the top ranked factors.

Change in Auditor

The next question⁵³ focused on whether a change in auditor leads to lower materiality thresholds. Almost all respondents_(11/12) agreed that a higher risk is associated with a first-year audit since the auditor lacks sufficient knowledge of the entity, including the nature of its operations, the internal controls in place and the number of misstatements identified in previous years. This is in line with one of the factors identified earlier with respect to overall materiality and performance materiality, namely the history with the client. They further noted that, in the first

⁵³ Vide Q.9 p.A3.1-4

year, the auditor should apply lower thresholds to gain a comprehensive understanding of the entity. These respondents also argued that, in the second year, the auditor may then decide to set higher thresholds, as deemed appropriate, based on the understanding of the client obtained in the first year. On the other hand, one respondent_(1/12) pointed out that a change in auditor does not necessarily lead to higher risk. Rather, it requires certain procedures to be performed *“to test and gain comfort on the opening balances”*. Therefore, according to this respondent, if there is a change in auditor, the materiality thresholds would remain unchanged.

4.3 The Effectiveness of ISA 320 and the Impact of Prescriptive Guidelines

The second section of the interview schedule consisted of nine questions (Q.10-18) relating to the effectiveness of ISA 320 and the impact of prescriptive guidelines. One respondent_(1/12) was unable to answer these questions owing to limited knowledge of ISA 320, stemming from the reliance on the respective firm's methodology.

4.3.1 The Effectiveness of ISA 320 as a Materiality Guidance Tool

Adequacy of ISA 320 Guidance

The first question⁵⁴ asked respondents whether ISA 320 provides sufficient guidance in determining appropriate materiality thresholds. Most respondents_(7/11) answered in the affirmative. Five of these respondents_(5/7) argued that ISA 320 provides adequate guidance since it offers valuable insights into what one should take into consideration. They also emphasised that the Standard ultimately leaves the determination of materiality thresholds to the auditor's professional judgement, adding that this is beneficial since a *“one size fits all”* approach is not practicable. Similarly, one of these respondents_(1/7) acknowledged that, while the Standard includes many judgemental areas, *“it is impossible”* to have a rule for

⁵⁴ Vide Q.10 p.A3.1-5

every circumstance and therefore, the guidance provided is sufficient. One of these respondents_(1/7) further highlighted ISA 320's adequacy by noting that the respective firm's "*audit manual is based on ISA 320*".

Furthermore, three respondents_(3/11) noted that the Standard provides concepts rather than prescriptive guidance and leaves a lot to the auditor's interpretation. They also remarked that, while ISA 320 does provide adequate guidance, it could offer more examples and detailed guidance. One of these respondents_(1/3) particularly emphasised the importance of the Standard outlining percentage ranges which may be applied. On the other hand, one respondent_(1/11) argued that ISA 320 does not provide sufficient guidance since it leaves a lot to the auditor's professional judgement, while acknowledging that this should be the case to some extent. However, this respondent added that, given the importance of materiality to the audit process, the Standard should be revised to provide more prescriptive guidance while still maintaining a degree of professional judgement.

ISA 320 Flexibility

Respondents were subsequently asked⁵⁵ whether ISA 320 allows for sufficient flexibility to account for the unique characteristics of different audited entities. Respondents_(11/11) agreed that the Standard provides sufficient flexibility, with most respondents_(9/11) citing the fact that it is "*more principles-based*" rather than rules-based and is therefore less prescriptive. Two respondents_(2/11) noted that, since ISA 320 leaves significant room for professional judgement, it allows auditors to adjust materiality thresholds, depending on the clients being audited. Furthermore, a few respondents_(3/11) added that ISA 320 allows somewhat too much flexibility. One of these respondents_(1/3) pointed out that this can create "*too many variations*" in the ways materiality thresholds are established.

⁵⁵ Vide Q.11 p.A3.1-5

Adequacy of ISA 320 Guidance on the Selection of a Benchmark

The following question⁵⁶ asked respondents whether ISA 320 provides adequate guidance on how to select the most appropriate benchmark in determining overall materiality for different types of entities. Most respondents^(7/11) answered in the affirmative, stating that the Standard outlines some factors which may influence the selection of an appropriate benchmark and also provides a few examples of benchmarks which may be appropriate for certain types of entities. However, some of these respondents^(5/7) added that it would be helpful if ISA 320 provides more illustrative examples.

On the other hand, four respondents^(4/11) emphasised that the Standard lacks sufficient guidance on the selection of an appropriate benchmark. Half of these respondents^(2/4) argued that, while it is understandable to leave the selection of a benchmark to the auditor's professional judgment, as it varies on a case-by-case basis, ISA 320 should provide more prescriptive guidance *"to allow for a clearer direction"*. Furthermore, one of these respondents^(1/4) noted that although it provides some guidance, primarily through examples, this is not enough. Another respondent^(1/4) also remarked that this is the *"main problem"* of the Standard and it needs to be more prescriptive in this regard.

Adequacy of ISA 320 Guidance on Performance Materiality

The next question⁵⁷ focused on whether ISA 320 provides adequate guidance on the concept of performance materiality. Respondents^(11/11) agreed that the Standard clearly explains the nature and scope of performance materiality and outlines some factors that should be considered when establishing this threshold. However, most respondents^(8/11) argued that ISA 320 does not provide adequate guidance on the determination of such threshold, since it leaves this to the auditor's professional judgement and does not indicate which percentages should be applied in specific circumstances.

⁵⁶ Vide Q.12 p.A3.1-5

⁵⁷ Vide Q.13 p.A3.1-5

Unclear or Challenging Areas Within ISA 320

In the next question⁵⁸, respondents were asked whether there are any areas in ISA 320 which are unclear or challenging when carrying out an audit. The majority_(6/11) agreed that there are no such areas. Most of these respondents_(4/6) explained that the main reason for this is that there will always be “*some grey areas*”, and therefore, materiality is ultimately based on the auditor’s professional judgement, which is one of the cornerstones of the profession. Two of these respondents_(2/6) also added that, while they consider ISA 320 to be clear since they follow their respective firm’s methodology which is based on the Standard, sole practitioners might find it to be somewhat unclear.

Conversely, the other respondents_(5/11) indicated that some areas of ISA 320 are unclear. One respondent_(1/5) highlighted that, with respect to both overall materiality and performance materiality, the Standard does not provide specific percentage ranges which may be applied. Furthermore, according to one respondent_(1/5), ISA 320 does not specify which benchmarks are inappropriate for certain circumstances. Another respondent_(1/5) remarked that it does not outline sufficient qualitative factors of the entity which should be considered in determining performance materiality. Interestingly, one respondent_(1/5) pointed out that “*almost the whole Standard*” is somewhat unclear and lacks the required level of detail. Similarly, another respondent_(1/5) noted that ISA 320 does not provide specific guidance, such as client-specific and industry-specific guidance.

ISA 320 as a Better Guidance Tool

Respondents were then asked⁵⁹ how ISA 320 can be revised to become a better guidance tool in the determination of materiality thresholds. Most respondents_(7/11) believed that the Standard could be improved to a certain extent and, as a result, provided some suggestions. Three respondents_(3/7) emphasised that, in general, it should provide more detailed and specific guidance, as well as additional examples. One of these respondents_(1/3) also remarked that the Standard should

⁵⁸ Vide Q.14 p.A3.1-5

⁵⁹ Vide Q.15 p.A3.1-5

be “modernised” to account for “IT-driven auditing techniques” which have developed since its introduction.

Another three respondents^(3/7) recommended that ISA 320 should outline additional factors to be considered when determining materiality thresholds. One of these respondents^(1/3) highlighted that it should also assign specific weightings to each factor to guide auditors in identifying which factors are the most important to consider. This respondent further stated that the Standard should specify which benchmarks are inappropriate for certain situations. Additionally, one of these three respondents^(1/3), along with another respondent^(1/7), advised that ISA 320 should indicate specific percentage ranges which may be applied in determining materiality thresholds.

To the contrary, four respondents^(4/11) stated that, overall, the Standard is quite clear. Most of these respondents^(3/4) pointed out that improving ISA 320 as a guidance tool is challenging because, ultimately, an element of judgement must always be present. They explained that, since the circumstances of the audit vary owing to differing entities, auditors should have some leeway to exercise professional judgement in order to determine what is most appropriate in each case. One respondent^(1/4) suggested that “market trends” should be published in a more easily accessible way. This respondent further remarked that it would be beneficial if the Maltese Accountancy Board publishes “market practices” since these would offer additional guidance and help bring “everyone more in line”.

The Need for More Prescriptive Guidelines Within ISA 320

The next question⁶⁰ asked respondents for their views on whether ISA 320 should be more prescriptive. The majority^(6/11) agreed that the Standard should not be more prescriptive since materiality is a matter of professional judgement and varies from one company to another. However, half of these respondents^(3/6) noted that it could provide additional examples and typical case scenarios. Conversely, the other respondents^(5/11) argued that ISA 320 should be slightly more prescriptive to provide better guidance. However, they also highlighted the

⁶⁰ Vide Q.16 p.A3.1-5

importance of balancing this with allowing some room for professional judgement. Furthermore, one of these respondents^(1/5) suggested that the Standard should be more structured. For example, it could state *“this is the percentage range”* typically applied and *“these are the factors”* which should be taken into consideration in determining the specific percentage within the range.

4.3.2 Benefits of Prescriptive Guidelines

The following question⁶¹ enquired about the benefits of introducing more prescriptive guidelines in ISA 320. In line with Hegazy and Salama (2022)⁶², almost all respondents^(10/11) agreed that the most important benefit would be greater consistency among auditors, whereby all auditors would perform the same audit procedures and arrive at similar materiality thresholds across different audits. Similar to Azad, Salehi et al. (2022) and de Rooij (2009)⁶³, four of these respondents^(4/10) further stated that this consistency would enhance the comparability of financial statements since auditors would assess material misstatements uniformly, thereby making it easier for users to compare financial statements across different companies or periods. In line with de Rooij (2009)⁶⁴, most respondents^(7/11) also highlighted that an important benefit would be clearer and more detailed guidance, which would lead to a better understanding of the determination of materiality thresholds.

According to four respondents^(4/11), another benefit is that, in addition to the common factors typically considered, prescriptive guidelines would require auditors to take into account factors that might otherwise be overlooked, thus echoing Bu-Peow NG and Tan (2007)⁶⁵. Two respondents^(2/11) also emphasised that a benefit of introducing more prescriptive guidelines would be less professional judgement since this would eliminate potential variations in the ways materiality thresholds are established. One of these respondents^(1/2) also

⁶¹ Vide Q.17 p.A3.1-5

⁶² Vide S.2.3.2

⁶³ Vide S.2.3.2

⁶⁴ Vide S.2.3.2

⁶⁵ Vide S.2.3.2

remarked that the driver of materiality thresholds should be what is “*critical to the users*”, rather than “*what the auditor decides*”.

4.3.3 Drawbacks of Prescriptive Guidelines

The next question⁶⁶ enquired about the drawbacks of introducing more prescriptive guidelines in ISA 320. Consistent with Gao and Zhang (2019) and Azzopardi and Baldacchino (2009)⁶⁷, most respondents_(10/11) noted that the major drawback would be the limitation on the auditor’s discretion to exercise professional judgement. They further stated that the determination of materiality thresholds would become a “*tick the box exercise*”, highlighting that this would go against the audit profession since professional judgement is a fundamental pillar of the profession.

Additionally, similar to Abilova (2022), Azzopardi and Baldacchino (2009) and Vadivel (2004) cited in Aqel (2011)⁶⁸, some respondents_(5/11) emphasised that it would be difficult for the Standard to address all the situations that auditors encounter and therefore, the introduction of more prescriptive guidelines would probably lead to inappropriate materiality thresholds. One respondent_(1/11) also pointed out that if ISA 320 becomes too prescriptive, it could become “*irrelevant or unworkable*” for certain industries or clients.

4.4 The Role of Professional Judgement and its Challenges

The final section of the interview schedule consisted of five questions (Q.19-23) relating to the role of professional judgement and its challenges.

⁶⁶ Vide Q.18 p.A3.1-5

⁶⁷ Vide S.2.3.3

⁶⁸ Vide S.2.3.3

4.4.1 The Role of Professional Judgement in Setting Materiality Thresholds

Materiality as a Matter of Professional Judgement

The first question⁶⁹ was divided into two parts and related to the view that the determination of materiality thresholds is a matter of professional judgment.

Professional Judgement in Determining Materiality Thresholds. The first part of the question⁷⁰ asked respondents to what extent they considered the determination of materiality thresholds to be a matter of professional judgement, rather than one of compliance with authoritative guidelines. Respondents^(12/12) agreed that professional judgement plays a crucial role in determining materiality thresholds. Similar to Abilova (2022), IAASB (2009b) and Pinsker, Pitre et al. (2006)⁷¹, most respondents^(9/12) argued that, since the circumstances of the audit vary, auditors must always exercise professional judgement to determine what is most appropriate in each case, keeping in mind the needs of the users. Three of these respondents^(3/9) also remarked that “*guidance, rather than authoritative rules*”, would be helpful in assisting auditors with the determination of materiality thresholds. Furthermore, in line with Abilova (2022) and Chewning Jr and Higgs (2002)⁷², the other respondents^(3/12) emphasised that, although there are guidelines with regard to materiality, they are not prescriptive and therefore, professional judgement must be applied.

The Impact of Limited Guidance on Professional Judgement. In the second part of the question⁷³, respondents were asked whether the determination of materiality thresholds is considered to be a matter of professional judgement primarily owing to the currently limited authoritative guidance. Most respondents^(8/12) disagreed, emphasising that professional judgement is crucial since materiality thresholds are established on a case-by-case basis, depending on the entity being audited. Half of these respondents^(4/8) stated that professional

⁶⁹ Vide Q.19 p.A3.1-6

⁷⁰ Vide Q.19a p.A3.1-6

⁷¹ Vide S.2.4.1

⁷² Vide S.2.4.1

⁷³ Vide Q.19b p.A3.1-6

judgement “*must always be applied*” since, in certain cases, failure to do so might lead to inappropriate materiality thresholds. Three respondents_(3/8) also highlighted that professional judgement is integral to the audit profession, since auditors, “*being professionals*”, are expected to apply their expertise and judgement in conducting audits. One of these respondents_(1/3) added that standardisation would mean that auditors would not “*add any value*” since they would simply be following the rules and “*ticking the box*”.

Furthermore, one respondent_(1/8) noted that while guidance can suggest some relevant factors to consider, it cannot provide the understanding of the client. Therefore, when determining materiality thresholds, auditors must obtain this understanding and apply their professional judgement accordingly since “*not every case is the same*”. On the contrary, the other respondents_(4/12) argued that while an element of professional judgement must always be applied, the limited authoritative guidance contributes significantly towards professional judgement’s prominent role.

Main Areas of Professional Judgement

The next question⁷⁴ asked respondents whether there are specific areas wherein they primarily exercise professional judgement when determining materiality thresholds. In line with Abilova (2022), Bellandi (2017) and IAASB (2009b)⁷⁵, almost all respondents_(11/12) agreed that professional judgement is primarily exercised when determining the percentages to be applied, with regard to both overall materiality and performance materiality. Furthermore, consistent with Bagshaw and Selwood (2014) and Popa, Span et al. (2013)⁷⁶, some of these respondents_(5/11) stated that professional judgement is also exercised when selecting the benchmark to be used. However, two respondents_(2/5) emphasised that this involves “*less judgement*” compared to the determination of the percentages. Similarly, the other respondent_(1/12) noted that, since the respective firm’s methodology establishes the percentages to be applied, professional

⁷⁴ Vide Q.20 p.A3.1-6

⁷⁵ Vide S.2.4.1

⁷⁶ Vide S.2.4.1

judgement is primarily exercised when selecting an appropriate benchmark. Additionally, two respondents^(2/12) highlighted that professional judgement is exercised significantly in first-year audits to obtain a thorough understanding of the client.

The Effectiveness of Professional Judgement

The following question⁷⁷ asked respondents whether, in their opinion, the current level of professional judgement is effective to determine appropriate materiality thresholds. Respondents^(12/12) answered in the affirmative, stating that auditors are highly trained professionals operating within a regulated profession. One respondent^(1/12) specifically noted that auditors are “*typically well informed*” about the client and the industry, enabling them to exercise sound professional judgement. In line with IAASB (2009b)⁷⁸, another respondent^(1/12) highlighted that auditors are required to reassess materiality thresholds throughout the audit process, thereby ensuring that such thresholds are set appropriately. Furthermore, one respondent^(1/12) remarked that, ultimately, professional judgement is adequate since the auditor’s role is not “*to detect every misstatement*” but to provide reasonable assurance that the financial statements give a true and fair view.

However, three respondents^(3/12) noted that, if an auditor lacks experience, this may lead to either over-testing or under-testing. One respondent^(1/12) also pointed out that, while auditors typically apply professional judgement adequately, a few still misuse it. Another respondent^(1/12) made an important distinction, arguing that, for large firms with established methodologies, the extent of professional judgement required is lower compared to smaller firms, which often lack such methodologies. For this reason, this respondent further stated that, while professional judgement is effective for large firms, it could be challenging for smaller firms.

⁷⁷ Vide Q.21 p.A3.1-6

⁷⁸ Vide S.2.2.1

4.4.2 The Challenges Involved in Exercising Professional Judgement

The final question⁷⁹ asked respondents whether they face any typical challenges when exercising professional judgement. Half the respondents_(6/12) agreed that one such challenge is setting appropriate materiality thresholds since failure to do so could lead to the risk of “*not capturing misstatements*” or “*wasting time*” on areas which are not particularly risky. Two of these respondents_(2/6) further stated that they ask themselves and reassess whether they applied the right judgement. Similarly, another two respondents_(2/6) added that they ask themselves whether another auditor in the same situation would arrive at the same conclusion.

Furthermore, one respondent_(1/12) highlighted that a typical challenge is that other parties, such as an “*engagement quality reviewer*” and “*an audit committee*”, might challenge the thresholds set, requiring auditors to justify their decisions. Another respondent_(1/12) emphasised that a typical challenge is that auditors must obtain a “*good understanding of the client*” before they exercise professional judgement because if they “*do not have information*”, they cannot apply their judgement. Similarly, one respondent_(1/12) noted that auditors might not always have the “*full picture*”, adding that this could ultimately result in auditors having to “*update all their testing*” halfway through the audit, which is “*costly and time-consuming*”. A few of these respondents_(2/9) also noted that there is the temptation to apply higher materiality thresholds to achieve “*a more efficient audit*”. However, they pointed out that this is not an excessive challenge. Additionally, they remarked that another challenge is time pressure, although this is often mitigated. On the contrary, the remaining respondents_(3/12) stated that they rarely face any challenges.

4.5 Conclusion

This chapter reported the findings obtained from the interviews. The next chapter will discuss these findings in detail.

⁷⁹ Vide Q.22 p.A3.1-6

Chapter 5

Discussion of Findings

5.1 Introduction

This chapter provides an analysis of the research findings obtained in Chapter Four, in the context of the literature reviewed in Chapter Two. As illustrated in Figure 5.1, Section 5.2 outlines the major factors influencing the determination of materiality thresholds. Thereafter, Section 5.3 discusses the effectiveness of ISA 320 and the impact of prescriptive guidelines, while Section 5.4 delves into the role of professional judgement and its challenges. Finally, Section 5.5 concludes the chapter.

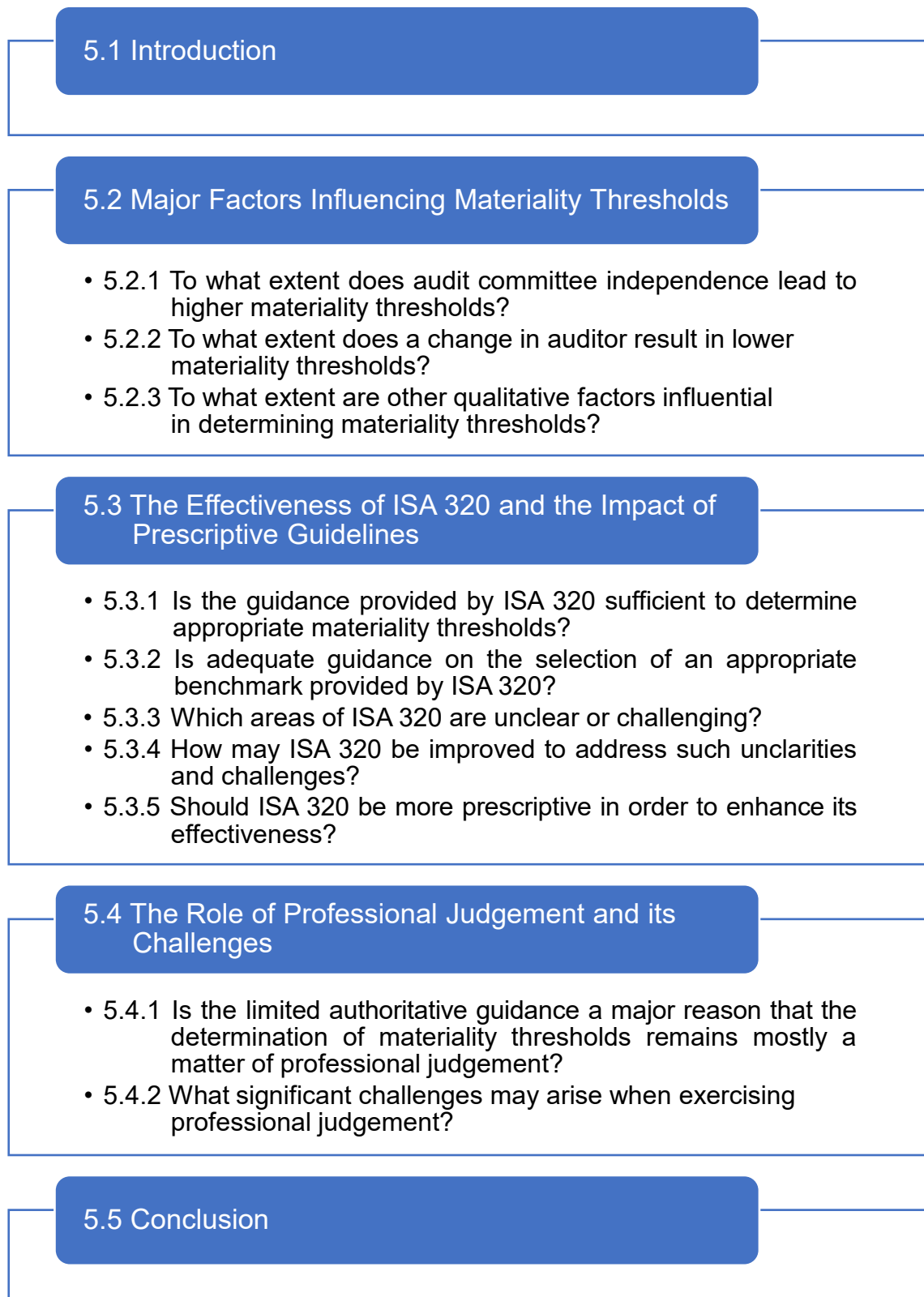


Figure 5.1: Outline of Chapter 5

5.2 Major Factors Influencing Materiality Thresholds

5.2.1 To what extent does audit committee independence lead to higher materiality thresholds?

Both findings⁸⁰ and literature⁸¹ suggest that audit committee independence often leads to higher materiality thresholds. However, for this to occur, the audit committee must not only be formally independent, but it must also be sufficiently experienced and possess the necessary expertise to be in a position to provide effective oversight over the company's financial reporting and to continually enhance the entity's internal controls. Otherwise, auditors will still perceive the client as high risk and set lower materiality thresholds. Therefore, audit committee independence remains an '*indirectly influencing factor*' in the setting of such thresholds. However, many entities in Malta are neither required to set up an audit committee nor do they voluntarily do so and therefore this factor becomes irrelevant in their case.

5.2.2 To what extent does a change in auditor result in lower materiality thresholds?

While Costa (2023)⁸² claimed that new auditors tend to set higher materiality thresholds, the findings⁸³ reveal that such auditors, in fact, typically set lower ones. Setting higher thresholds in the first year is unprofessional if, as Costa (2023) argued, this is done simply to reduce the amount of work carried out and subsequently be able to meet reporting deadlines in an as yet unfamiliar client. Such a stance also goes against the concept of professional scepticism.

Additionally, if auditors set higher materiality thresholds in the first year without conducting an adequate assessment of the entity's risks, they would in practice probably have to over-rely on management representations. In fact, the indications are that auditors tend to adopt a much more conservative approach

⁸⁰ Vide Audit Committee Independence in S.4.2.2

⁸¹ Vide Abilova (2022) and Stewart and Munro (2007) in S.2.2.2

⁸² Vide S.2.2.2

⁸³ Vide Change in Auditor in S.4.2.2

in the first year so as to be able to obtain a thorough understanding of the entity and mitigate any potentially high risks. Furthermore, one may argue that, by adopting such an approach, auditors are able to make more informed decisions regarding the determination of materiality thresholds in subsequent years. The question remains whether setting such lower thresholds simply because of being a new auditor results in a fair deal to the client. In this regard, further studies need to be undertaken to find ways to ensure that, in the first year, such thresholds are in fact set at a level which is neither too low nor too high.

5.2.3 To what extent are other qualitative factors influential in determining materiality thresholds?

The findings⁸⁴ indicate that, out of the ten other qualitative factors noted in the literature⁸⁵, seven of them influence materiality thresholds. The most important factor agreed to by respondents was *fraud and litigation risk*. This might be because this risk significantly heightens the likelihood of misstatements. As a result, auditors may set lower materiality thresholds, thereby adopting a more cautious approach, in order to ensure that they mitigate the potential impact of such risk on the financial statements.

The second important factor agreed to by respondents was *the quality of client internal controls*. One possible reason is that auditors typically view strong internal controls as an indicator of a lower RoMM, this allowing them to set higher materiality thresholds. Furthermore, when internal controls are effective, auditors may be more confident in relying on them to detect and prevent errors or misstatements. As a result, this reduces the extent of testing required, ultimately enabling auditors to establish higher thresholds.

The third important factor agreed to by respondents was *auditor critical thinking skills*. Auditors who possess such skills are more likely to establish appropriate materiality thresholds. This may explain why critical thinking skills are considered

⁸⁴ Vide Table 4.1 in S.4.2.2

⁸⁵ Vide S.2.2.2 e.g. Blokdijsk, Driehhuizen et al. (2003) and Messier, Martinov-Bennie et al. (2005)

to be highly important.

The fourth important factor agreed to by respondents was *client complexity*. One possible reason is that auditors typically view client complexity as an indicator of a higher RoMM owing to the complex nature of the client's organisational structure, operations or transactions. As a result, auditors may set lower materiality thresholds to ensure that they thoroughly assess potentially risky areas and minimise the risk of overlooking material misstatements.

Contrary to the literature⁸⁶, the remaining three factors - namely *accountability pressure*, *auditor rule observance attitude* and *auditor experience* - were only marginally agreed to. Further studies may be needed to establish why such factors are perceived to be only slightly influential.

Furthermore, there were three factors which were not agreed to by respondents as being influential in Malta. The least important factor was *audit firm size*, the second least important factor was *the longevity of the relationship with the client* and the third least important factor was *auditor experience in the client's sector*. One possible reason why respondents did not agree that such factors are influential is that the determination of materiality thresholds is mainly influenced by the client-related factors referred to earlier⁸⁷. Moreover, with regard to the factor of auditor experience in the client's sector, this may not be relevant since such experience does not necessarily extend to the client's actual operations.

⁸⁶ Vide DeZoort, Harrison et al. (2006) and Hasan, Chand et al. (2021) in S.2.2.2

⁸⁷ Vide Para. 1, 2 and 4 of the same section

5.3 The Effectiveness of ISA 320 and the Impact of Prescriptive Guidelines

5.3.1 Is the guidance provided by ISA 320 sufficient to determine appropriate materiality thresholds?

The findings⁸⁸ reveal that ISA 320 provides adequate guidance on the determination of materiality thresholds, despite literature⁸⁹ suggesting otherwise. While the guidance provided by the Standard is not prescriptive, this is expected to be the case since the auditing profession inherently relies on professional judgement, particularly in setting materiality thresholds. Furthermore, the lack of prescriptive guidelines is intentional to allow auditors the necessary flexibility to tailor such thresholds to the specific circumstances of each audit. This is beneficial since entities differ in various aspects and as a result, auditors must adapt their approach accordingly to ensure that they conduct effective audits.

Overall, despite the concerns raised by literature⁸⁹ regarding the lack of specific guidelines, the Standard provides sufficient guidance. Particularly, it outlines clear principles on how to set the respective materiality thresholds, identifies some factors that should be considered and also offers relevant examples. Ultimately, ISA 320 provides an adequate basis for auditors to determine appropriate materiality thresholds by first following the guidance laid out in the Standard and subsequently applying professional judgement to account for the specific characteristics of the entity being audited. However, as with any other standard or regulation, there is always some room for improvement, as will be discussed later⁹⁰.

⁸⁸ Vide Adequacy of ISA 320 Guidance in S.4.3.1

⁸⁹ Vide S.2.3.1 e.g. Abilova (2022) and Popa, Span et al. (2013)

⁹⁰ Vide S.5.3.4

5.3.2 Is adequate guidance on the selection of an appropriate benchmark provided by ISA 320?

The findings⁹¹ indicate that the Standard provides sufficient guidance to enable auditors to select a suitable benchmark for each audited entity, depending on the specific characteristics of the respective entities. However, literature does not shed light in this regard. Although, as mentioned earlier⁹², literature raises concerns about the lack of detailed guidance, it does not delve into the specific areas of the Standard. Therefore, literature merely provides an overall view on the guidance offered by ISA 320, possibly implying that the Standard does not provide adequate guidance on the selection of an appropriate benchmark.

The selection of a benchmark is inherently subjective, thereby requiring auditors to exercise their professional judgement in determining the most suitable benchmark based on the circumstances of the audit. In this regard, the flexibility within the Standard is beneficial since it allows auditors to exercise their professional judgement, while also avoiding imposed benchmarks which may not be appropriate for every entity. With respect to the guidance provided, ISA 320 outlines key factors that auditors may consider when selecting a benchmark and it also offers some examples of benchmarks which may be appropriate, depending on the entity being audited. Additionally, it specifies the circumstances in which certain benchmarks may be appropriate. Therefore, one may argue that ISA 320 provides adequate guidance on the selection of an appropriate benchmark. However, in line with the findings⁹¹, additional illustrative examples of benchmarks that may be appropriate for specific types of entities would help to provide a clearer direction.

5.3.3 Which areas of ISA 320 are unclear or challenging?

As discussed earlier⁹³, literature suggests that ISA 320 does not provide sufficient guidance. This implies that literature perceives certain areas of the Standard to

⁹¹ Vide Adequacy of ISA 320 Guidance on the Selection of a Benchmark in S.4.3.1

⁹² Vide S.5.3.1

⁹³ Vide S.5.3.1

be unclear or challenging. However, it does not specify which areas present such unclarities or difficulties. On the contrary, the findings⁹⁴ remain inconclusive in this regard since some respondents concurred with the literature and identified certain unclear areas, while others opined that no such areas exist.

Although it was noted earlier⁹⁵ that, overall, ISA 320 provides sufficient guidance to enable auditors to determine appropriate materiality thresholds, a few areas of the Standard remain somewhat unclear. One such area is the determination of overall materiality. ISA 320 only provides examples of typical percentages applied for a few selected benchmarks. Therefore, for those benchmarks for which no examples have been provided, the commonly applied percentages remain unclear. Furthermore, while it is understandable that the Standard seeks to allow room for professional judgement, ISA 320 does not specify the minimum and maximum percentage which may be applied to each benchmark. As a result, auditors remain uncertain about what constitutes an acceptable level of overall materiality.

Another area is the determination of performance materiality. In this regard, the Standard does not provide any examples of percentages that are typically applied. Therefore, ISA 320 lacks clarity on commonly applied percentages which may serve as guidance for auditors in determining an appropriate percentage based on the circumstances of the audit. Similar to overall materiality, the Standard does not indicate the minimum and maximum percentage which may be applied when determining performance materiality. As a result, auditors remain uncertain about what constitutes an acceptable level of performance materiality.

⁹⁴ Vide Unclear or Challenging Areas Within ISA 320 in S.4.3.1

⁹⁵ Vide S.5.3.1

5.3.4 How may ISA 320 be improved to address such unclarities and challenges?

While, as mentioned earlier⁹⁶, literature suggests that ISA 320 does not provide adequate guidance, it does not specify how it may be improved to address any deficiencies. On the other hand, the findings⁹⁷ indicate that the Standard may be improved, with such statement being backed by a number of recommendations based on practical issues faced by auditors.

Since, as highlighted earlier⁹⁸, a few areas of ISA 320 remain somewhat unclear, the effectiveness of the Standard as a guidance tool can therefore be enhanced in various ways. Overall, the Standard could provide additional examples, thereby offering clearer guidance and enabling auditors to make more informed decisions. With regard to all the respective materiality thresholds, the Standard could also outline additional factors that should be considered when determining the percentage to be applied.

With respect to overall materiality, ISA 320 could provide examples of typical percentages applied for a wider range of benchmarks. Such examples would provide clearer guidance on the percentages which may be applied to the relevant benchmarks. The Standard could also specify the percentage range applicable to each benchmark, clearly indicating the minimum and maximum percentage which may be applied. This range would be beneficial since this would clarify what constitutes an acceptable level of overall materiality.

Furthermore, with respect to performance materiality, ISA 320 could provide examples of percentages that are commonly applied in specific circumstances. These examples would help guide auditors in determining an appropriate percentage, not only in such circumstances but also in similar scenarios. The Standard could also specify the percentage range applicable in determining performance materiality, clearly indicating the minimum and maximum

⁹⁶ Vide S.5.3.1

⁹⁷ Vide ISA 320 as a Better Guidance Tool in S.4.3.1

⁹⁸ Vide S.5.3.3

percentage which may be applied. This range would be beneficial since this would clarify what constitutes an acceptable level of performance materiality.

In addition to the guidance provided by ISA 320, the Maltese Accountancy Board could publish common audit practices relating to materiality thresholds. Such practices would be beneficial since these would offer insights into how auditors typically set materiality thresholds.

5.3.5 Should ISA 320 be more prescriptive in order to enhance its effectiveness?

As discussed earlier⁹⁹, literature notes that ISA 320 lacks specific and detailed guidance on how to determine materiality thresholds. This implies that the literature advocates for more prescriptive guidelines within the Standard. On the other hand, the findings¹⁰⁰ remain inconclusive in this regard since some respondents concurred with the literature, while others opined that ISA 320 should not be more prescriptive.

It is understandable that some auditors oppose the introduction of more prescriptive guidelines within ISA 320 on the basis that an important element of professional judgement must be retained when setting materiality thresholds. However, without going beyond reasonable limits, some form of additional prescriptive guidance is still required to reach a more balanced approach without sidelining professional judgement, which is one of the cornerstones of the profession. This balanced approach would help towards achieving greater consistency among auditors while still maintaining sufficient flexibility to account for the specific circumstances of each audit.

⁹⁹ Vide S.5.3.1

¹⁰⁰ Vide The Need for More Prescriptive Guidelines Within ISA 320 in S.4.3.1

5.4 The Role of Professional Judgement and its Challenges

5.4.1 Is the limited authoritative guidance a major reason that the determination of materiality thresholds remains mostly a matter of professional judgement?

Although literature¹⁰¹ acknowledges the crucial role of professional judgment in determining materiality thresholds, it identifies the currently limited authoritative guidance as the major driver behind this role. On the other hand, the findings¹⁰² indicate that the determination of materiality thresholds remains mostly a matter of professional judgement, primarily since such thresholds need to be established on a case-by-case basis, depending on the entity being audited.

As highlighted earlier¹⁰³, although the Standard provides adequate guidance overall, there are still certain areas which require slightly more prescriptive guidance. Therefore, while the currently limited authoritative guidance is not the major reason behind materiality thresholds being primarily determined through professional judgement, it still contributes to some extent. Rather, the major driver of professional judgement's prominent role is the need to tailor materiality thresholds to the specific entity being audited. This role seems to be reinforced by the profession's inherent reliance on such judgement. Further studies on such reliance, including its implications on audit effectiveness, would be helpful.

5.4.2 What significant challenges may arise when exercising professional judgement?

The findings¹⁰⁴ and the literature¹⁰⁵ refer to a few typical challenges faced by auditors when exercising professional judgement. Two such challenges may be considered significant. One challenge commonly identified by both sources is time pressure while the other challenge, identified only in the findings, is that of determining appropriate materiality thresholds. As regards the latter challenge,

¹⁰¹ Vide Abilova (2022) and Chewning Jr and Higgs (2002) in S.2.4.1

¹⁰² Vide The Impact of Limited Guidance on Professional Judgement in S.4.4.1

¹⁰³ Vide S.5.3.3

¹⁰⁴ Vide S.4.4.2

¹⁰⁵ Vide S.2.4.2 e.g. Ranzilla, Chevalier et al. (2011) and Maule and Edland (2002)

its absence from the literature could be due to the fact that the audit profession is constantly evolving and therefore '*new challenges*' may have emerged in recent years.

Although only a few local auditors cited time pressure, it is likely to be a common issue among auditors internationally since they are all required to meet deadlines to complete the audits of their respective clients. In this regard, it is crucial that this pressure is mitigated since failure to do so may lower the quality of judgements made, ultimately leading to inappropriate materiality thresholds. In fact, the findings²⁶ indicate that this pressure is often mitigated when it arises.

Furthermore, the determination of appropriate materiality thresholds was probably highlighted as an increasing challenge in the findings²⁶ because auditors are becoming more aware that they need to apply the right judgement in setting such thresholds. Mitigating this challenge is crucial since failure to do so may lead to inappropriate thresholds, ultimately resulting in either over-testing or under-testing. In fact, the indications are that auditors reassess their judgements and consider whether other auditors in the same situation would make similar judgements to ensure that they have set appropriate materiality thresholds.

5.5 Conclusion

This chapter presented a discussion on the main research findings. The following chapter will provide a summary and conclusion of the discussion, while also offering a number of recommendations.

Chapter 6

Summary, Conclusions and Recommendations

6.1 Introduction

This Chapter concludes the dissertation. As shown in Figure 6.1, Section 6.2 summarises the findings of this study, while Section 6.3 delineates the conclusions reached. Section 6.4 then puts forward several recommendations, while Section 6.5 identifies areas for further research. Finally, Section 6.6 presents the concluding remarks.



Figure 6.1: Outline of Chapter 6

6.2 Summary

This study had three objectives. The first objective was to ascertain the major quantitative and qualitative factors influencing the determination of materiality thresholds in the private sector external audits performed by large and medium-sized Maltese audit firms. The second objective was to assess the effectiveness of ISA 320 in the determination of such materiality thresholds, as well as the impact of introducing more prescriptive guidelines within the Standard. The third objective was to assess the current level of professional judgement and its effectiveness in determining materiality thresholds, as well as to ascertain the typical challenges involved in exercising such judgement.

In order to achieve these objectives, a predominantly qualitative mixed-methods approach was adopted. Semi-structured interviews were carried out with twelve audit partners from large and medium-sized Maltese audit firms.

Several quantitative and qualitative factors were found to be influencing the determination of materiality thresholds. The major quantitative factors influencing the determination of overall materiality were noted to be 5-10% of profit before tax and 1-3% of total revenue. With regard to performance materiality, the major quantitative factor was noted as 75% of overall materiality. As for the clearly trivial threshold, the major quantitative factor was noted as 5% of overall materiality. On the other hand, the major qualitative factors influencing materiality thresholds were found to be fraud and litigation risk, the quality of client internal controls, auditor critical thinking skills, client complexity, the client's sector and a change in auditor.

Furthermore, the findings indicated that, overall, ISA 320 provides sufficient guidance to enable auditors to determine appropriate materiality thresholds. The findings also highlighted various benefits and drawbacks of introducing more prescriptive guidelines within ISA 320. The most cited benefit was greater consistency among auditors, while the most cited drawback was that prescriptive guidelines limit the auditor's discretion to exercise professional judgement.

The findings further revealed that professional judgement plays a crucial role in determining materiality thresholds. Moreover, the indications were that the current level of professional judgement is effective to determine appropriate materiality thresholds. However, the findings identified a few typical challenges faced by auditors when exercising professional judgement.

6.3 Conclusions

This study concludes that various quantitative and qualitative factors influence the determination of materiality thresholds. The first major quantitative factor influencing overall materiality is 5-10% of profit before tax, which is commonly applied for profit-oriented operating entities. The next major quantitative factor is 1-3% of total revenue, which is typically applied for revenue-driven operating entities. With respect to performance materiality and the clearly trivial threshold, the study concludes that a major quantitative factor in the form of a commonly applied percentage range does not exist. However, a major quantitative factor in the form of a commonly applied percentage exists for both thresholds as follows: 75% of overall materiality with regard to performance materiality and 5% of overall materiality with respect to the clearly trivial threshold.

The study also concludes that one major qualitative factor influencing materiality thresholds is fraud and litigation risk, which typically leads to lower thresholds owing to the heightened RoMM. With respect to the quality of client internal controls, the presence of robust internal controls operating effectively often leads to higher materiality thresholds since such controls reduce the RoMM. Auditor critical thinking skills also influence materiality thresholds. However, these skills do not directly result in lower or higher thresholds. Rather, auditors with strong critical thinking skills tend to set more appropriate thresholds. Furthermore, client complexity typically leads to lower thresholds since it presents a higher RoMM. As for the client's sector, whether it leads to higher or lower thresholds depends on the level of risk associated with the sector in which the client operates. Finally, a change in auditor often leads to lower thresholds in the first year due to the higher risk typically associated with a first-year audit. Additionally, the study

concludes that audit firm size, the longevity of the relationship with the client and auditor experience in the client's sector are not influential factors in Malta.

With respect to the guidance provided by ISA 320, the study concludes that the Standard provides adequate guidance on the determination of materiality thresholds. This is because the Standard offers valuable insights into how the respective materiality thresholds should be established, while leaving the final determination of such thresholds to the auditor's professional judgement. However, slightly clearer guidance is required with respect to overall materiality and performance materiality. Moreover, additional examples, both general and specifically related to the selection of an appropriate benchmark and to the typical percentages applicable when determining performance materiality, would help provide better guidance and therefore enhance the effectiveness of ISA 320 as a guidance tool. With regard to the impact of introducing more prescriptive guidelines within the Standard, the study concludes that the major benefit would be greater consistency among auditors. Another significant benefit is that of having clearer and more detailed guidance, this ultimately resulting in a better understanding of how materiality thresholds are determined. On the other hand, the major drawback is the limitation on the auditor's discretion to exercise professional judgement, this potentially leading to a *'tick-the-box exercise'*. Another significant drawback is that it is difficult for prescriptive guidelines to address all possible situations and therefore, such guidelines may ultimately result in the setting of inappropriate materiality thresholds.

The study also concludes that auditors exercise significant professional judgement in determining materiality thresholds. This is owing to the fact that the circumstances of the audit vary and, as a result, auditors are required to exercise such judgement in order to determine what is most appropriate in each case. Furthermore, the current level of professional judgement is considered to be effective in determining appropriate materiality thresholds since auditors are well-trained professionals who are also operating within a regulated profession. Nevertheless, auditors still face a few challenges when exercising professional judgement, such as setting appropriate materiality thresholds, justifying their decisions when challenged by other parties, obtaining a thorough understanding

of the client and making sound judgements under time pressure. Two of these challenges are particularly significant. One such significant challenge is that of setting appropriate materiality thresholds. This is because failure to apply the right judgement may lead to such thresholds being set inappropriately, this ultimately leading to ineffective audits. The other significant challenge is time pressure, whereby auditors may apply lower-quality judgements in order to complete audits on time and thus meet their deadlines. Therefore, auditors must be able to mitigate these challenges to ensure that the current level of professional judgement is effective in determining appropriate materiality thresholds.

6.4 Recommendations

This study recommends that:

A. ISA 320 provides additional illustrative examples of benchmarks that may be appropriate for specific types of entities (S.5.3.2)

Although the Standard already provides a few examples of benchmarks that may be appropriate for certain types of entities, it is recommended that ISA 320 provides additional illustrative examples to offer clearer and more practical guidance. Such examples would help auditors select an appropriate benchmark for various types of entities, particularly in cases where the most appropriate benchmark is not immediately clear.

B. With respect to all the materiality thresholds, ISA 320 outlines additional factors that auditors should consider when determining the percentage to be applied (S.5.3.4)

With regard to all the materiality thresholds, it is recommended that the Standard outlines additional factors influencing the determination of the percentage to be applied. This would help auditors take into consideration all the relevant factors, thereby ensuring that appropriate materiality thresholds are set.

C. ISA 320 provides additional examples of typical percentages applied to selected benchmarks (S.5.3.4)

Although ISA 320 provides examples of such typically applied percentages, it only does so for a few benchmarks. Therefore, it is recommended that the Standard provides such examples for a wider range of benchmarks since these would offer a clearer direction regarding which percentages may be the most appropriate to apply to the relevant benchmarks.

D. ISA 320 provides examples of percentages that are commonly applied in setting performance materiality (S.5.3.4)

While ISA 320 clearly explains the nature and scope of performance materiality, it is recommended that the Standard provides examples of percentages that are commonly applied in specific circumstances to set such threshold. These examples would offer clearer guidance and assist auditors in determining an appropriate percentage based on the circumstances of the audit.

E. ISA 320 specifies the percentage range applicable in determining overall materiality and performance materiality, respectively (S.5.3.4)

Such percentage ranges would clarify what constitutes an acceptable level of overall materiality and performance materiality since these would clearly indicate the minimum and maximum percentage which may be applied, respectively. Ultimately, such ranges would guide auditors in setting such thresholds appropriately.

F. The Maltese Accountancy Board publishes common audit practices relating to materiality thresholds (S.5.3.4)

In addition to the guidance provided by ISA 320, auditors would benefit from having access to common audit practices since these may offer insights into how materiality thresholds are typically established in practice, thereby enabling auditors to make more informed decisions when determining such thresholds.

Therefore, it is recommended that the Accountancy Board publishes such common audit practices relating to materiality thresholds.

G. ISA 320 adopts a balanced approach by introducing more prescriptive guidelines without sidelining professional judgement (S.5.3.5)

Such an approach would provide clearer guidance on the determination of materiality thresholds and help achieve greater consistency among auditors, while still allowing sufficient flexibility to account for the specific circumstances of each audit.

6.5 Areas for Further Research

This study recommends the following areas for further research:

A. The Setting of Appropriate Materiality Thresholds Upon Maltese Statutory Auditor Changes: An Investigation (S.5.2.2)

This study indicated that auditors in Malta tend to set lower materiality thresholds in the first year following a change in auditor, whereas auditors in foreign countries tend to set higher thresholds in such cases. Therefore, a further study may investigate ways to ensure that, in the first year, materiality thresholds are set fairly at a level which is neither too low nor too high.

B. The Impact of Accountability Pressure, Auditor Rule Observance Attitude and Auditor Experience on Materiality Thresholds (S.5.2.3)

This study revealed that accountability pressure, auditor rule observance attitude and auditor experience are perceived to be only slightly influential in determining materiality thresholds. Therefore, a follow-up study may explore why these factors are viewed in this way and assess whether their actual impact is greater than currently perceived.

C. Auditor Reliance on Professional Judgement and its Implications on Audit Effectiveness: An Analysis (S.5.4.1)

This study delved into the impact of professional judgement on the effectiveness of the determination of materiality thresholds. A follow-up study may analyse how auditor reliance on professional judgement impacts audit effectiveness.

6.6 Concluding Remarks

The determination of materiality thresholds is central to the audit process since such thresholds influence the nature, timing and extent of audit procedures designed to detect potential material misstatements which could influence the economic decisions of the users of the financial statements. By understanding the various quantitative and qualitative factors that influence materiality thresholds, auditors will be in a better position to set such thresholds appropriately. Furthermore, while ISA 320 provides sufficient guidance overall, professional judgement continues to play a crucial role in determining materiality thresholds. Therefore, it is evident that the determination of materiality thresholds requires a balance between following the guidance provided by ISA 320 and exercising professional judgement. After all, as one respondent stated:

“Determining materiality thresholds in an audit is like steering a ship: the compass provides the direction while the navigator’s experience and judgement ensures that the journey is successful.”

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Appendices

Appendix 3.1 Interview Schedule

This appendix presents the interview schedule that was used during the interviews conducted for this study. The schedule further lays out the responses for each Likert scale question in *italics* and **bold**.

Section 1: Major Factors Influencing Materiality Thresholds

Objective 1: To ascertain the major quantitative and qualitative factors influencing the determination of materiality thresholds in the private sector external audits performed by large and medium-sized Maltese audit firms.

1. **Materiality for the Financial Statements as a Whole**, often referred to as '**Overall Materiality**' (*Vide def. 1 in Section A1*), is determined by the application of a percentage to a selected benchmark.
 - a. Can you provide some examples of commonly used benchmarks and specify in which circumstances they apply?
 - b. Can you rank the top three benchmarks in the order you most commonly use?
 - c. Which major factors do you consider when selecting an appropriate benchmark?
 - d. Can you provide a few examples of rules of thumb typically used and indicate which one is the most commonly applied?
 - e. Which major factors do you consider when determining the percentage to be applied to the selected benchmark?
2. **Performance materiality** (*Vide def. 2 in Section A1*) is expressed as a percentage of overall materiality.
 - a. Can you indicate the percentage range typically applied as well as the specific percentage most commonly used?
 - b. In this regard, which factors do you consider when determining the percentage to be applied?
3. The '**Clearly Trivial Threshold**' (*Vide def. 3 in Section A1*) is expressed as a percentage of overall materiality.
 - a. Can you indicate the percentage range typically applied as well as the specific percentage most commonly used?
 - b. In this regard, which factors do you consider when determining the percentage to be applied?

4. To what extent do you agree with the following statements? *Kindly rate from 0 to 4 (with 0 being strongly disagree and 4 being strongly agree) as shown in Section A2, adding comments, if any.*

	Strongly Disagree	Disagree	Neutral	Agree	Strongly Agree
a. Client complexity: The more complex the client, the lower the materiality thresholds set.	1	1	0	5	5
b. Quality of client internal controls: The more robust the system of internal control, the higher the materiality thresholds set.	0	0	2	7	3
c. Audit firm size: Large audit firms typically set higher materiality thresholds than smaller audit firms.	6	3	2	1	0
d. Accountability pressure: As accountability pressure increases, auditors tend to become more cautious and sensitive to the risks involved in the specific circumstances of the audit. This leads to lower materiality thresholds.	0	3	1	6	2
e. Auditor experience in the client's sector: As auditors gain experience in a particular sector, they become better equipped to identify and address sensitive areas. This enables them to set higher materiality thresholds.	0	7	2	3	0
f. Longevity of relationship with client: As the longevity of the auditor-client relationship increases, auditors set higher materiality thresholds.	1	6	2	3	0

g. Auditor experience: Auditors with extensive experience tend to set more precise materiality thresholds.	0	3	1	7	1
h. Auditor rule observance attitude: Auditors with a high rule observance attitude tend to place more emphasis on quantitative rather than qualitative aspects. This leads to the setting of less accurate materiality thresholds.	0	1	3	8	0
i. Auditor critical thinking skills: Auditors with strong critical thinking skills tend to consider both quantitative and qualitative information. This results in the setting of more accurate thresholds.	0	1	0	8	3
j. Fraud and litigation risk: The higher the fraud and litigation risk, the lower the materiality thresholds.	0	0	0	9	3

5. Does the sector in which the client operates influence materiality thresholds?
Please give reason/s for your reply and examples, if any.
6. Does a stronger client financial performance lead to higher materiality thresholds?
7. Does a higher quality financial reporting system lead to higher materiality thresholds?
8. Does a higher level of audit committee independence lead to higher materiality thresholds? *Please give reason/s for your reply.*
9. In your view, does a change in auditor lead to lower materiality thresholds?
Please give reason/s for your reply.

Section 2: The Effectiveness of ISA 320 and the Impact of Prescriptive Guidelines

Objective 2: To assess the effectiveness of ISA 320 in the determination of such materiality thresholds.

10. Does ISA 320 provide sufficient guidance in determining appropriate materiality thresholds? *Please give reason/s for your reply.*
11. Does the guidance provided by ISA 320 allow for sufficient flexibility to account for the unique characteristics of different audited entities? *Please give reason/s for your reply.*
12. Do you think that ISA 320 provides clear guidance on how to select the most appropriate benchmark in determining Overall Materiality for different types of entities? *Please give reason/s for your reply.*
13. In your view, does ISA 320 provide adequate guidance on the concept of Performance Materiality? *Please give reason/s for your reply.*
14. In your view, are there any areas in ISA 320 which are unclear or challenging when carrying out an audit?
15. How can, if in any way, ISA 320 be revised to become a better guidance tool in the determination of materiality thresholds?
16. In your view, does ISA 320 need to be more prescriptive? *Please give reason/s for your reply.*
17. In your view, what would be the benefits of introducing more prescriptive guidelines in ISA 320?
18. In your view, what would be the drawbacks of introducing more prescriptive guidelines in ISA 320?

Section 3: The Role of Professional Judgement and its Challenges

Objective 3: To assess the current level of professional judgement, its effectiveness in determining materiality thresholds and also to establish whether further regulation is required to ensure appropriate materiality thresholds.

19. ISA 320 states that the “*determination of materiality [thresholds] is a matter of professional judgment*” (IAASB 2009b, Para. 4).
 - a. In your experience, to what extent do you find such determination to be so, rather than a matter of complying with authoritative guidelines?
 - b. In your view, is it mostly owing to the currently limited authoritative guidance that such determination of materiality thresholds is considered to be a matter of professional judgement?
20. Are there specific areas wherein you mostly exercise professional judgement when determining materiality thresholds? *You may wish to provide examples.*
21. In your opinion, is the current level of professional judgement effective to determine appropriate materiality thresholds?
22. Do you face any typical challenges when exercising professional judgement?
23. Other comments, if any.

Section A1 – Definitions

1. **Overall Materiality:** A materiality threshold above which misstatements, including omissions, *“could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements”* (ISA 320, IAASB 2009b, Para. 2).

2. **Performance Materiality:** A materiality threshold *“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”* (ISA 320, IAASB 2009b, Para. 9).

3. **‘Clearly Trivial Threshold’:** A materiality threshold set by the auditor *“below which misstatements would be clearly trivial and would not need to be accumulated because the auditor expects that the accumulation of such amounts clearly would not have a material effect on the financial statements”* (ISA 450, IAASB 2009c, Para. A2).

Section A2 – Likert Scale

Likert scale to be used for question 4:

0	1	2	3	4
Strongly Disagree	Disagree	Neutral	Agree	Strongly Agree

Appendix 3.2 Statistical Data Analysis using the Friedman Test

The Friedman test was used to compare the mean rating scores provided to several statements relating to qualitative factors influencing materiality thresholds. The mean rating scores range from 0 to 4, with 0 corresponding to 'strongly disagree' and 4 corresponding to 'strongly agree'. Therefore, a higher mean rating score indicates a greater level of agreement.

The **null hypothesis (H_0)** specifies that the mean rating scores provided to the statements are similar and is accepted if the p -value exceeds the 0.05 level of significance.

The **alternative hypothesis (H_1)** specifies that the mean rating scores differ significantly and is accepted if the p -value is less than the 0.05 criterion.

The bar graph included in this appendix complements Table 4.1. This graph provides a visual representation of the differences, whether significant or not, between the level of agreement with the factors outlined in the Likert scale questions, and also portrays the results obtained from the Friedman Test.

The error bar graph displays the 95% confidence interval of the actual mean rating score provided to each statement if all large and medium-sized Maltese audit firms had to be included in the study. When two confidence intervals overlap, their mean rating scores are similar and thus do not differ significantly. On the contrary, when two confidence intervals do not overlap or overlap slightly, their mean rating scores differ significantly.

Section 1: Qualitative Factors

Figure A3.1 depicts the respondents' level of agreement with the statements relating to qualitative factors. As may be seen, some error bars do not overlap with each other, thereby indicating that the mean rating scores provided to these statements are significantly different. This is substantiated by the p -value being less than the 0.05 level of significance.

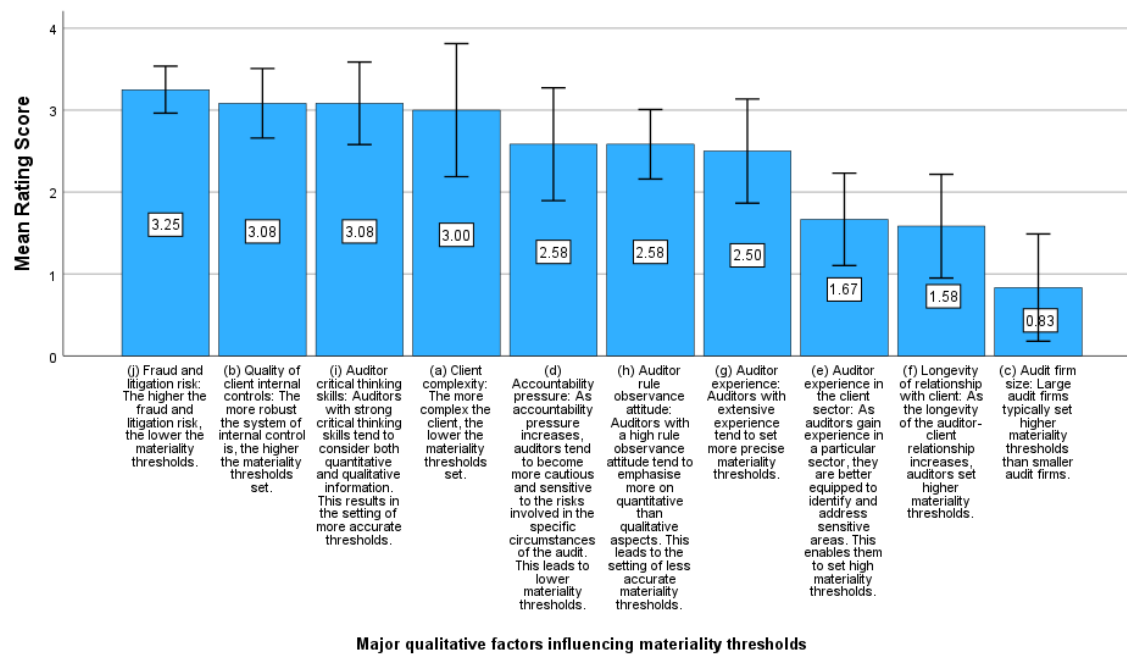


Figure A3.1: Agreement with qualitative factors (Q.4)