

THE CONCEPT OF MATERIALITY

by *ESB*

JOSEPH EUGENE PEIRCE

B. A., Allegheny College, 1966

---

A MASTER'S REPORT

submitted in partial fulfillment of the

requirements for the degree

MASTER OF SCIENCE

KANSAS STATE UNIVERSITY  
Manhattan, Kansas

1969

Approved by

*Merle E. Engler*  
Major Professor

LD  
2668  
R4  
1969  
P57

## TABLE OF CONTENTS

	Page
DEFINITIONS	3
EXAMPLES	7
GUIDELINES	14
FOOTNOTES	
BIBLIOGRAPHY	

Accounting and auditing literature constantly refers to material items. Materiality is important in reference to many aspects of accounting, auditing, and reporting of financial position. Materiality is the factor that determines if an item is important. If the item is not important, one should not waste time on it.

The concept of materiality is one of the main guides an auditor uses in the performance of his duties. Public Accountants in all size accounting firms deal with this concept daily. However, some accountants may not understand the concept of materiality and its uses as an effective tool in the conduct of audits. The purpose of this paper is to present definitions of materiality, examples of materiality, and guidelines that have been proposed to develop a better understanding of the concept of materiality.

Warren Reininga<sup>1</sup> pointed out that in literature before World War II there was little reference and very little discussion of materiality. However, the increased legal requirements of the Securities Exchange Commission (SEC) have been paralleled by the growth in accounting textbooks and literature of the use of the term. This is due to the increased responsibility that has been put upon the auditor.

Much of the discussion of materiality began with the Securities Act of 1933, and since then definitions and statements have tended to follow the concept expressed by Spencer Gordon<sup>2</sup>, the legal counsel for the American Institute of Certified Public Accountants (AICPA) in 1933.

In Mr. Gordon's speech before the Institute in 1933 he used the following definition.

A material fact . . . is a fact the untrue statement or omission of which would be likely to affect the conduct of a reasonable man with reference to the acquisition, holding, or disposal of the security in question.<sup>2</sup>

The 1936 revision of a booklet prepared by the Federal Reserve Board in cooperation with the AICPA<sup>3</sup> used the term material in reference to marketable securities as follows:

If the total market value of securities included under current assets is less than the total book value by any 'material' amount, a reserve for the shrinkage in value should be provided.<sup>3</sup>

Reininga feels that:

. . . much of the literature, such as SEC regulations, AICPA Statements and Auditing Procedures and auditing texts, merely instruct the reader to ignore, include, or disclose the item if material with no identification of the effects to be observed, or no discussion of the circumstances to be considered before this action is taken.<sup>3</sup>

The AICPA in ARB 43<sup>4</sup> refers to the term materiality, but does not define it.

The Committee contemplates that its opinion will have application only to items material and significant in the relative circumstances. It considers that items of little or no consequence may be dealt with as expediency may suggest. However, freedom to deal expediently with immaterial items should not extend to a group of items whose cumulative effect in any one financial statement may be material or significant.<sup>4</sup>

Norman J. Lenhart, and Philip L. Defliese<sup>5</sup> say in reference to materiality:

. . . if the client insists upon making a change, the independent public accountant is obliged to point out the inconsistent application of accounting principles where the effect of the



change is material, he may wish to express his approval. When there has been an inconsistency in the selection or application of an accounting principle, whether or not the change is approved by the independent public accountant, the effect in dollars upon the comparability of financial statements, if material should be indicated by footnote.<sup>5</sup>

. . . changes in classification which materially affect the comparability of items in financial statements, whether in the balance sheet or the statement of income should be disclosed in a footnote.<sup>5</sup>

Thus accounting and auditing literature constantly refer to items and matters that are material or immaterial yet no one definition of materiality has become the accepted guide. What is material?

#### DEFINITIONS

Homer A. Black and John E. Champion<sup>6</sup> define materiality in the following manner.

Materiality is a practical guide which helps the accountant decide to what extent to follow recording and reporting methods which would be dictated by the strict application of accounting principles.

They continue:

. . . an item in an accounting report is material if there is reason to believe that knowledge of it would influence the decisions of an informed user of reports.<sup>6</sup>

Therefore they conclude that the decision of what is material in accounting is a matter of using informed judgment not one of applying specific rules.

Mr. Moonitz<sup>7</sup> in Accounting Research Study No. 1 thinks of materiality as both a statistical concept and a psychological

concept.

Materiality is a statistical concept that says essentially that items of small significance need not be taken seriously. Logically, however, such a doctrine is unnecessary since insignificant things cannot also be significant.

He continues into the psychological concept.

. . . an item should be regarded as material if there is reason to believe that knowledge of it would influence the decisions of an informed investor.

. . . the fiction of an informed investor is a useful one. But this usefulness lies precisely in the fact that it cannot and should not be strictly defined. What the fiction means can be determined only in the light of a specific set of circumstances. Its meaning will therefore vary over a wide range of possibilities.

Moonitz, like Black and Champion, feels that materiality is not an analytical device, but it will remain as an element in the exercise of judgment.

Eldon Hendriksen<sup>8</sup> in his book, Accounting Theory, quotes the American Accounting Association's 1957 statement from the Accounting and Reporting Standards for Corporate Financial Statements and Preceding Statements and Supplements in defining materiality.

An item should be regarded as material if there is reason to believe that knowledge of it would influence the decisions of an informed investor.<sup>7</sup>

Hendriksen feels materiality is a matter of judgment. Therefore accounting theory should lay a framework for this judgment just as it lays out the standards of reporting to be followed.

Hendriksen further clarifies his definition of materiality

by saying that an item is material only if it adds more to the total information than it detracts by making statements overly detailed and difficult to analyze.

Hendriksen feels the question one should ask is: Is the addition of the information likely to improve most decisions made on the basis of the financial reports?

In the American Accounting Association's publication, Accounting Concepts and Standards Underlying Corporate Financial Statements and Supplements,<sup>9</sup> the two concepts of disclosure and materiality are tied together. Disclosure is considered inadequate if interested and informed investors are misled as to any material item, or if they are not advised of important matters concerning them of which they are entitled to be apprised.

They conclude that differences in disclosure reflect differences in judgment as to what is or is not material.

James Dohr's<sup>10</sup> definition of materiality is:

A statement, fact, or item is material, if, giving full consideration to the surrounding circumstances, as they exist at the time, it is such a nature that its disclosure, or the method of treating it, would be likely to influence or to make a difference in the judgment and conduct of a reasonable person. The same tests apply to such words as significant, consequent, or important.<sup>9</sup>

James W. Pattillo<sup>11</sup> follows Dohr's definition by saying that the determination of what is material is a matter of judgment. Likewise it is not always possible to know in advance how important an item might be to a particular reader of the statements.

Pattillo then gives his own definition of materiality.

Materiality is a device or criterion by which each item receives the emphasis to which it is entitled.

Inasmuch as materiality involves amounts, it is a statistical concept, inasmuch as it involves judgments about those amounts, materiality is also a psychological concept. The yardstick of materiality is risk. If the risk to the report user is negligible then the item can be considered immaterial.<sup>11</sup>

Richard Mattessich<sup>12</sup> defines materiality as:

A set of hypotheses (criteria) determining if and when an economic transaction or related event is to be reflected by an accounting transaction.<sup>12</sup>

Mr. Weldon Powell<sup>13</sup> reaffirms the idea that materiality is a word all accountants use frequently although it has never been defined clearly.

In a book published in 1967 Black and Champion joined Brown<sup>14</sup> in a discussion of materiality. This threesome defined materiality as:

A practical guide which helps the accountant decide to what extent he should follow recording and reporting methods which would be dictated by strict application of accounting principles.<sup>19</sup>

Therefore an item in an accounting report is material if there is reason to believe that knowledge of it would influence the decisions of an informed user of the report. Since there are no specific rules, the decision of what is material requires the use of informed judgment.

Howard Ross<sup>15</sup> says the question of materiality should be handled in the following manner:

No change in a balance sheet or income statement can be worth making that will not, in some way influence a prospective reader of the statement.<sup>15</sup>

The SEC defines materiality in Rule 1-02 of Regulation S-X as:

The item 'material', when used to qualify a

requirement for the furnishing of information as to any subject, limits the information required to those matters as to which an average prudent investor ought reasonably to be informed before purchasing the security registered.<sup>15</sup>

#### EXAMPLES

Since there is no clear definition of materiality, the decision of what is or what is not material is a matter of judgment. This judgment is based upon the idea of what a reasonable or informed user of financial statements needs to know in order to make his decisions. Therefore the best way to illustrate what a reasonable man needs to know in order to make decisions is through the use of examples.

Harold Bierman<sup>17</sup> uses the following example:

A gas company may have many meters, and each meter may have a small value, but the dollar value of all the meters in use may be large. Thus an item may be material, even though its per unit cost is small, if there are a large number of units.<sup>16</sup>

In another book Bierman continues:

An item below a certain cost will be charged as an expense in the period of purchase, even though it may have a life in excess of one year. The justification for the treatment is the criterion of materiality.<sup>18</sup>

He points out that the criterion of materiality should not be used to justify faulty accounting such as credit balances in accounts receivable used to reduce the asset, direct write-offs of bad debts, and using a gross price method of recording purchases. (This buries the loss on lapsed purchase discount.)

Bierman also points out that items may be immaterial from a general accounting point of view, but they may be material from

the point of view of management's concern for the control of cost.

Black and Champion<sup>19</sup> gave another example of materiality. A chair costing \$10.00 may be immaterial in a company that holds equipment of \$1,000,000.00 yet material in a company with total equipment of \$1,000.

It is true that the cost of the chair will benefit the operations of the firm in future years and should be accounted for as a long-term unexpired cost under the asset, equipment. The clerical cost of checking the custody of such an asset may outweigh the usefulness of this proper accounting treatment in the case of the large company. For convenience the company would probably debit the cost of such immaterial items directly to an expense account at the time of acquisition.

Black and Champion say materiality may be qualitative rather than quantitative. A transaction small in amount may be important if it is unexpected or improper or if it violates a law or contract. It also may be material because, although small, it indicates the probable course of future events or a significant change in business practice.

They add an example which involves a relationship between materiality and clarity.

The common practice of rounding off figures to the nearest dollar:

		Rounded
Cash	\$1,726,032.87	\$1,726,033
Accounts Receivable	4,591,191.34	4,591,191
Inventories	7,005,993.96	7,005,994

Although this is not acceptable in primary financial

statements, rounding to the nearest thousand may be clearer for special analysis.

	Rounded Nearest Thousand
Cash	\$1,726,000
Accounts Receivable	4,591,000
Inventories	7,006,000

Sometimes amounts on financial statements give a false appearance of exactness, while actually they are based upon estimates that are only rough approximations. An example is depreciation, which is measured on the basis of an indefinite future. Of course such accounts like cash can be measured accurately to the penny. It is customary to maintain the ledger accounts in terms of dollars and cents and to round amounts on financial statements.

Carman Blough<sup>20</sup> who feels that materiality should be considered in relation to net income over a period of years uses the following example of materiality.

If a company has been earning approximately \$100,000 year in and year out, and in the year in question has only earned \$10,000, before including an extraordinary item of income or expense of \$5,000, we should say that the extraordinary item should not be excluded from the determination of current income. The affect on one's judgment of the accomplishments of the company in the year in question is related to the prior years during which it has earned approximately \$100,000.

Lenhart and DeFliese<sup>21</sup> discuss the effect of a change in



handling a matter.

It is possible that a change may be instituted at a time when the effect of the change upon the current financial statements is small, but the effect in the future may be material.<sup>21</sup>

Eldon Hendriksen<sup>22</sup> feels that the pledging of certain assets may be material if the assets themselves are material in amount.

Meigs and Johnson<sup>23</sup> in their book, Intermediate Accounting, discuss the materiality of an error.

The materiality of an error is always a relative matter. A \$1,000 error is minor in a large firm and significant in a small firm.

They feel that the significance of errors affecting net income should be assessed in relation to the amount of revenues, expenses, and net income.

Finally it must be noted that a number of small errors in the same direction can cumulate to significant amounts. This is pertinent to the issue of materiality.

Meigs and Johnson conclude by saying that failure to correct an error on valid grounds of lack of materiality is a proper exercise of accounting judgment.

Stettler<sup>24</sup> talks of the way identical amounts can vary in materiality. For example an unrecorded liability of \$1,000 for merchandise in transit would normally receive less consideration than an unrecorded liability of \$1,000 covering machine repairs. The machine repair item will affect the net income figure for the year, and will cause a relatively greater change in the current ratio.



Robert Anthony<sup>25</sup> in his book, Management Accounting, defends the idea that accountants do not attempt to record items which are so insignificant that the work of recording them is not justified by the usefulness of the results. The following is an example. The treatment of pencils is the point at question. A brand new pencil is an asset of the company. Everytime someone writes with a pencil, part of the asset is used up, and the owner's equity decreases correspondingly. Theoretically one could determine the number of partly used pencils that are owned by the company and correct the records so as to show that fractional amount of the asset amount that remains, but the cost of such an effort would be gigantic, and no accountant would attempt to do it. He would consider the pencil as used at the time of purchase or when it was issued from inventory to the user.

Similarly materiality is important in the process of determining expense and revenue for a given period. Many expenses reported in a given accounting period are estimates and sometimes not close estimates. There is a point beyond which it is worthwhile to refine the estimates.

Howard F. Stettler<sup>26</sup> in his book, Auditing Principles, defends the idea that the greater the relative significance of an item in the financial statements, the greater is the auditor's concern that the item is fairly stated. For example factory supplies are fairly constant in terms of quantities used and quantities on hand. Even if the dollar figure for unused supplies at the end of the year were grossly misstated, the effect on cost of goods sold, net income, current assets, and total assets would

be negligible. Therefore the auditor's tests of year-end inventory of supplies tend to be limited, tests of production inventories are much more extensive.

He continues by saying that a 10% misstatement of production inventories, in contrast to a similar percentage misstatement of the supplies inventories, would have a much more significant effect on the financial statements, and the auditor seeks greater assurance of accuracy of final figures for production inventories by making more extensive tests.

Materiality is affected by factors other than relative size of the figures. For example an understatement of accounts payable would tend to be more material than an understatement of the liability for pension payments, even though the same amounts of misstatement were involved. The main reason is that accounts payable enters into the determination of a concern's current position and current ratio. The pension liability would be discharged over an extended period of time with the major part of the amount to be paid more than a year after the balance sheet date. Also a misstatement of pension amounts has less bearing on the ability of a concern to remain solvent by discharging its liabilities as they mature in the near future.

He then goes into a discussion of depreciation. A client consistently charges a full year's depreciation on all plant assets in the year of acquisition and none in the year of disposition. This method was acceptable to the auditor since normal acquisitions and dispositions tend to produce about the same depreciation for the year as would have been charged had a more

precise calculation of the figure been made. The acquisition of a complete plant increasing capacity 50% was made shortly before the end of the fiscal year. Charging a full year's depreciation on assets under these circumstances would seriously distort the operating results for the year and the materiality of the excessive depreciation would probably cause the auditor to insist that the amount be changed to a more realistic figure, or else necessitate that he qualify his opinion as to the fairness of the statement.

There is also a cumulative effect when the auditor differs with the client over the amounts at which a number of items are stated. For example the auditor's tests reveal an overstatement of inventory in the amount of \$1,530, an overstatement of prepaid insurance \$625, and an understatement of accrued taxes \$1,780, each may be adjudged immaterial in relation to net income of \$30,000. The cumulative effect of these differences on net income would be another matter, since correction of all three matters would reduce the income figure by \$3,935.

Homer A. Black, John E. Champion, and R. Gene Brown<sup>27</sup> in their book, Business Decisions: Theory, Method, and Use, defend the position that relative size is more important than absolute size in determining whether an item is material. For example a chair costing \$50 is an immaterial item in a company which owns a total of \$1,000,000 in equipment. The \$50 item may be material in a company with equipment totalling \$1,000.

In deciding if an item is material or not it should be

looked at and compared to similar items and with the total of items in its class (such as total assets) and with net income. A group of items which are immaterial as single units may be material in the aggregate.

#### GUIDELINES

Warren Reininga<sup>28</sup> said there is a need to develop a guideline for determining materiality.

Little development and improvement of the materiality concept can be made until some orderly way is established for relevant facts to be made available to everyone interested.<sup>28</sup>

Even in annual reports and SEC filings where items are included or classified in some prescribed manner a reader can only surmise as to why the presentations were made in this manner.

For example a public company with net income of \$8 million had a nonrecurring income item of \$750,000. (How should this matter be shown?)

According to Opinion 9<sup>29</sup> of the Accounting Principles Board the \$750,000 should be included in the income statement unless it is related to a prior period, in which case it should be included in retained earnings. If it has no relation to prior periods, then it is included in the income statement either as income before extraordinary items, or as an extraordinary item, but before the calculation of net income.

Then the question is--on what basis is it classified<sup>25</sup> extraordinary?

The segregation in the income statement of the effects of events and transactions which have occurred

during the current period, which are of an extraordinary nature and whose effects are material requires the exercise of judgment . . . Accordingly there will be events and transactions of material effect which would not be expected to recur frequently and which would not be considered as recurring factors in any evaluation of the ordinary operation processes of the business.<sup>29</sup>

Still Opinion No. 9 does not define materiality or give a guideline to be followed in the determination of materiality other than to say it is a matter of judgment.

Reininga<sup>30</sup> feels the reasons for judging the materiality should be made available to a large interested group or the knowledge and background of the experience will be lost. Such things as the relationship to previous earnings, the 5 year trend in earnings, and earnings per share must be provided to the interested group.

He concludes that if the profession does not develop a better materiality concept, a creditability gap may develop and for expediency sake the government will pass an inflexible regulation.

Michael Chetkovich<sup>31</sup> feels the word materiality is being used as a refuge for escaping difficulty.

In arriving at the decision that an item is not material, we must be satisfied that the decision would be upheld by a court of informed opinion if the issue were raised.<sup>31</sup>

If a guideline for materiality were developed it would force the auditor to stand on his opinion and include only the pertinent facts. Presently the auditors may be overly cautious and include in a report immaterial facts in order to protect

their opinion. Chetkovich feels the materiality concept is being used in the latter sense.

Delmer Hylton<sup>32</sup> tends to agree with Chetkovich.

Essentially materiality is used to justify practices and procedures which we recognize as wrong, or at least as questionable.<sup>32</sup>

A study by Leopold A. Bernstein<sup>33</sup> revealed four rather interesting findings. First he found that out of 324 presentations of extraordinary items 214 or 66% were excluded from the determination of net income. This does not support the presumption for the inclusion of all items of loss and income in the determination of income.

Secondly Bernstein found that the size of an item in relation to net income appears hardly to have any important effect on whether the item is included in or excluded from the determination of net income. There appears to be no percentage range that is a border zone between what, under the Bulletin (ARB No. 43, Chpt. 8) should be considered as material or immaterial. There appears to be no agreed upon pattern.

Also he found that an individual major accounting firm does not appear to be guided by any discernible standard of materiality.

Finally Bernstein's study revealed a bias towards showing extraordinary items with credit balances as special items on the income statements (65% of total credits) and debit items in retained earnings (77% of total debits).

The lack of a definition of materiality can clearly be illustrated by the following examples.

1. Archer Daniels Midland Co., in its 1964 annual report included in net income a profit on sale of depreciable assets of \$1.1 million or 26% of net income. The item was not designated as extraordinary or nonrecurring. This should be contrasted with the treatment by Lily-Tulip Corp. in its 1963 annual report of a net realized gain on disposition of fixed assets of \$143M. This item, representing 3% of net income was credited directly to retained earnings.

2. Mueller Brass Co., in its 1964 annual report included in net income, without any special designation, prior years' investment credits of \$184,000 representing 41% of net income. This should be contrasted with the treatment of such prior-year investment credits by Tecumseh Products Company, in the amount of \$156,000, or about 1.3% of net income, which were credited to the retained earnings account in the company's 1964 annual report.<sup>33</sup>

Bernstein feels that the main danger, because of the absence of clear standards of materiality and the strong influence of management's views, is that an accountant may tend to apply criteria to a situation different from those applied by his fellow professionals.

Delmer Hylton<sup>34</sup> likewise feels there is a need to define materiality because of its growing importance to the profession. He supports this point by giving the results of a study he conducted to prove the wide variety of interpretations of materiality.

To a group of 23 persons, all interested in accounting and considerably trained in the field, he gave the following example. A firm with sales of \$30 million and total assets of \$20 million, of which cash, receivables, and inventory were \$2.5 million each, had an error in its inventory of \$100,000. Net profit was \$2 million. Can the \$100,000 error be dismissed as immaterial for



purposed of published financial statements? The vote was 18-5 for immaterial. Then the same people were asked to vote if the \$100,000 error was in receivables. The vote was then 14-9 for immaterial. If the error was in cash, then the vote was 12-11 for material. Finally if it was a misappropriation of funds by the president, it was 22-1 for materiality.

This clearly illustrates: 1. a difference of opinion, and 2. something more than the amount is considered by many in determining the answer to the question of materiality.

Don Rappaport<sup>35</sup> feels that users of financial statements look for guideposts in three areas: a. the amount shown as net income, b. the classification of dollar amounts on the financial statements, and c. adequate disclosure of other essential financial information.

Hendriksen<sup>36</sup> feels that an accountant has the responsibility to summarize data in a way to make it meaningful for users. He feels far too much data can be misleading and it tends to bury the revelant facts. However, too little information forces the reader to base his decisions probably on inadequate data and his decisions probably won't be sound. There is always this danger if the accountant has no guidelines to follow.

He feels the lack of consistency in reporting will lead to erroneous comparisons among several years and erroneous predictions based on apparent trends.

John L. Carey<sup>37</sup> says that just how large an amount is material has never been authoritatively determined. The absence of



standards for materiality may encourage misunderstanding. The CPA may feel 5% of net income is not material, however, an item so judged immaterial may mean that earnings per share might vary from \$1.05 to \$.95. The matter is normally not that simple.

Roger Patterson<sup>38</sup> also feels there is a need to develop a better concept of materiality. His reason is economic. An auditor can not afford to waste time on immaterial data. Therefore a materiality guideline would help the auditor eliminate the immaterial items and work on the material items. This would cause fees of public accountants to be less since time would not be wasted on trivia.

There are many reasons for the establishment of materiality guidelines. Some reasons are economic while other reasons are for uniformity and comparability. No matter what the reason for materiality guidelines, all agree some guideline or standard is needed.

Various guidelines have been proposed. Some advocate the use of a fixed percentage of another classification such as net income. Others recommend the use of case studies with the names of the companies not disclosed. Quantitative guidelines have also been proposed by some. Therefore a wide variety of materiality guidelines have been suggested.

The SEC requires that certain items be disclosed or shown separately if they exceed a fixed percentage of another classification.

The SEC regulations include.<sup>39</sup>

1. Further analyze the amount due from officers, directors, and

stockholders if it exceeds 1% of total assets or if it exceeds \$20,000.

2. Analyze additions to fixed assets if they exceed 5% of total assets.

3. Show an expense item separately if it exceeds 5% of total expenses.

4. Show a balance sheet account separately if it exceeds 5% of total assets or 10% of its balance sheet caption.

5. Show analysis of each marketable security if it exceeds 15% of total assets.

6. Show operating revenue of subsidiary if it exceeds 15% of annual net income (before taxes).

These are some suggested guidelines for judging if an item is material or immaterial or is in the range to be considered more carefully, that have been published in accounting literature.

1. Any account when it is in the range of 10 to 20% of average net income.<sup>40</sup>

2. Any balance sheet account when it is 20% of the balance sheet caption or any income statement account when it is 10% of annual net income, or 1% of the gross revenue.<sup>41</sup>

3. Any account if it exceeds \$1 million.<sup>41</sup>

4. Any income statement account if it exceeds 2% of gross profit on sales.<sup>42</sup>

5. Any balance sheet account if it exceeds 5% of its balance sheet caption.<sup>42</sup>

6. The rent on a long-term lease if it exceeds 6-18% of average net income.<sup>43</sup>
7. A decline in marketable securities if it ranges from 5 to 7.5% of the annual net income.<sup>43</sup>
8. The amount of a contingent liability if it exceeds from 1.5% to 6% of the working capital.<sup>43</sup>

There is opposition to use of a strict percentage system. Patterson<sup>44</sup> sees many shortcomings in the percentage system. For example for a large corporation with stable earnings a 10% factor of materiality is much too large. Conversely for a corporation roughly at the break-even point, a 15% materiality factor is too small. Also for a corporation whose sales and net worth are several million dollars with a profit of \$10,000, a \$5,000 adjustment is clearly immaterial, even though it is 50% of net income.

Hylton<sup>45</sup> is also against a percentage basis for determining materiality. First he feels there is a problem in determining what percentage to use. Also Hylton feels that a measuring device should not be variable if it is to be useful. If the results of measurement are varied, they are not comparable.

Hylton similarly feels that the problems of an unstable base for determining materiality becomes more acute when certain items on the income statement are used as the base. Another problem that arises when items are related to net profit is that at the time the entry is made, when we must decide the materiality, net profit will be likely unknown or undeterminable. When

balance sheet accounts are used the problem is less serious, but there is a drawback in effectively using income and expense accounts as a basis for materiality decisions.

Hendriksen<sup>46</sup> is also critical of the use of a percentage guideline. In deciding if an item should be excluded from the computation of net income some accountants have suggested, that if it exceeds 10% of net income before excluding the item, it is material. Hendriksen points out that this implies that if the true net income is more than 10% greater or smaller than the reported figure, the reader would be misled in making his decisions. He continues by saying that without the assumptions regarding what decisions are likely to be made and what information is relevant to these decisions the 10% rule or any other percentage criterion is not likely to provide any meaningful guide. Furthermore one difficulty of using income as the base is that it fluctuates yearly. Therefore a 10% rule would treat the item as material one year and not material the next.

Pattillo<sup>47</sup> says the comparing of relative figures is more reliable than the comparing of absolute figures; yet there are dangers in using percentages just as there are dangers in using fixed dollar amounts. The primary danger of using fixed percentages is that the percentages are computed upon variable bases. The results from using the variable bases are not very helpful unless these limitations are understood and compensated for accordingly.

Hendriksen<sup>48</sup> feels the best solution to the problem of

using net income as a base is to use average net income over several years as a guide. He would assume that the errors in the revenue and expense figures would be offsetting in periods of low income. Therefore for any firm and set of conditions the range of probable errors in the net income figure is likely to be much greater percentagewise in a poor year than in a good year. A reader must understand the range of errors on a financial statement in order for the statement to be meaningful.

Bernstein<sup>49</sup> feels his border zone guidelines are an answer to the shortcomings of the percentage base.

1. A border zone he feels has the advantage of meeting the arguments of those who point out 10% is not so different from 10.1%. Thus it brings the border or cut-off point clearer to the level of a concept and removes it from the numbers game. It has the added advantage of leaving room for judgment.

2. A border zone places the burden of proof on those who deviate from it.

3. Finally a border zone provides the profession and the users of financial statements with a known and explicitly stated norm. (Professional accountants can use it as a guide and an assurance of some degree of consistency of practice.)

His border zone would be 10-15% of net income after taxes. This he feels would provide users of financial statements with a basis of reliance. He clarifies his definition by defining net income as a figure which is typical of recently experienced (five-year average) earning power.

Bernstein modifies his suggestion by saying that it may not

always meet the needs of the users of financial statements. This is because many security analysts consider items that affect net results by as little as 5% to be material. Since the annual growth rate of earnings of a great many corporations is 5%, an influence on net earnings as great as the annual change due to growth factors generally is considered material. The border zone is a beginning.

A rather new guideline suggestion is the use of case studies. Reininga<sup>50</sup> suggests the use of a series of case studies with the emphasis on details and circumstances surrounding typical and unusual materiality decisions. These cases would be written up from the actual data, but they would be altered only to conceal the identities of the firms and the people involved.

Therefore Reininga feels the case studies would be appropriate for informing the neophyte why the auditor becomes "pernickety"<sup>50</sup> on one hand, then seems unconcerned about millions of dollars on another issue.

We can't judge materiality unless we can first come to grips with the factors that are important in the case. These reasons are the real standards and guidelines yet they are missing in most of our literature and illustrations involving materiality, as well as in the SEC standards.

There are items for which low standards of disclosure are required because almost any amount is material. Some representative items are:

1. Discrepancies in replies from confirmations.
2. Differences that arise in each examination.

3. Anything that would embarrass the client or auditor if not adjusted and later discovered.
4. Errors in transactions between related companies.
5. Advances to officers, especially if in violation of a provision of a financing agreement.
6. Errors in profit-sharing or pension plans.
7. Errors in disbursements of items such as income taxes, and social security.
8. Duplicate payment to vendor or anything similar that would save the client money.
9. Defalcations of any kind.

These items involve a potential conflict of interest or would embarrass the client or auditor if they were later discovered.

Rappaport<sup>51</sup> feels an auditor faces the following problems in deciding on materiality.

1. Are misleading inferences likely to be drawn from the amount shown as net income?

2. Are the classification of dollar amounts set forth in the financial statements reasonably informative and not misleading?

3. Is certain other information which is necessary to make the statements reasonably informative and not misleading adequately disclosed in the body of the financial statements or in footnotes?<sup>51</sup>

Rappaport looks at financial statements as being prepared for the financial analyst. Since the financial analyst is interested in net income because it is an earning power indicator, extraneous items may be misleading for the long-run analysis. Therefore one of the main guidelines in deciding whether to in-

clude an extraneous item in net income for the current year is to ask the question does it properly belong in net income of a previous year. Also would an extrapolation of earnings that included the extraneous item result in erroneous inferences because the item preserves the appearance of regularity in trend where no regularity exists and conversely? He feels that nondisclosure of extraneous items that are less than 10% of net income is not likely to mislead investors.

For the determination of materiality as related to comparability he sets forth the following guidelines:

1. Determine if the amount exceeds 10% of net income.
2. Study the significance of the amount in relation to other amounts on the financial statements.

Hylton<sup>51</sup> suggests that auditors use the following totals as the basic figures from which to make tests of materiality for balance sheet items. The bases are: Total Current Assets, Total Plant and Equipment (net of accumulated depreciation), Total Net Worth, Total Current Liabilities, and Total Long Term Debt.

The accounts to be measured are: Current Assets, Plant and Equipment and related depreciation, Other Asset Accounts, Current Liabilities, and Bonds Payable, etc.

Also he feels that materiality for balance sheet accounts should be defined: "no item exceeding 5% of its related total may be considered immaterial."<sup>52</sup> This does not mean that an auditor may not decide an item of less than 5% is material.



Because legal requirements affect capital stock, no designation of materiality has been included for these accounts.

Rappaport<sup>53</sup> sets forth general guidelines for materiality decision-making for selected balance sheet problems.

1. Cash-The disclosure of restrictions on withdrawal of certain cash. The guidepost would be the adequacy of a ratio of free cash plus receivables to current liabilities. Say 1 to 1.

2. Marketable Securities-The balance sheet value when market value is less than cost. The guidepost is the comparison of unrealized loss to current position and net worth, but not net income as sometimes is suggested; i.e., write-down would not directly reduce future earning power of the business.

3. Receivables-The use of a separate caption for customers' account receivables, other receivables, and reserve for doubtful accounts. The guideline is the distortion created in the computation of the number of days an average customer receivable is outstanding.  $(\text{Receivable}/\text{Sales for Year} \times 365 \text{ days})$  or the trend of this ratio from year to year.

4. Inventories-The disclosure of components, i.e., raw materials, work in process, and finished goods. The guidepost is whether unreasonable turnover proportions, i.e., inventory to cost of sales, etc. and adverse trends in such proportions are hidden.

5. Property, plant, and equipment-These should be broken down by major classifications. The guidepost is that the im-

portance of the breakdown, which enables computation of effective depreciation rate and shows the average age of fixed assets, depends on dollar amount of fixed assets to total assets and depreciation expense to cost of sales.

6. Current bank loans—These should be disclosed separate from accounts receivable. The guidepost is that if borrowings are larger than cash and receivables combined, serious difficulty may be indicated through such special classification.

7. Treasury stock—A disclosure should be made of the minor amount carried as an asset. This is significant only if the company is buying its own stock to shrink capital or to make future acquisitions of assets for stock.

8. Current position—The inclusion in working capital of borderline classifications (deferred charges, cash surrender value of life insurance) that may not be converted to cash in the operating cycle, and the netting of current assets and current liabilities.

Rappaport continues by saying that classifications on the balance sheet may matter more when unfavorable conditions exist. For example when the number of days that average customers' receivables are outstanding is increasing, but this fact is disguised by a classification in the balance sheet that combines customer and other receivables, it is materially misleading.

The manner in which a corporation's obligation must be met has a more important bearing on future earnings than the mere amount of the obligation.

One should disclose the interest rate, maturity date, and the amount of periodic repayment of the long-term liabilities or the conversion rate if it is convertible into stock. Also changes in pension plans and information as to whether payments on account of past services are included in the current accounts. Finally the amount of annual rentals to be paid under long-term leases and the length of the leases should be disclosed.

The basis one uses for deciding whether to disclose or not depends on: 1. The comparison of annual payments to funds generated from operations, the stability of such fund generation, and the adequacy of the working capital. 2. The percentage relationship of such fixed charges to gross profit, a view of the potential impact of the fixed interest, and the pension and lease expenses on net income. 3. The guaranteed debts or notes receivable discounted or other contingent liabilities that might need to be set forth. If the contingency is extraneous or normal to the business operation, the potentially unfavorable impact is chiefly measurable with respect to working capital or book value. Current net income is no guide for damage to the earning power would be indirect by reducing the income producing assets. 4. The number of shares of common stock under option and the option price may be a factor in estimating the future earnings per share. Therefore stock option information must be disclosed on transactions with management, but we usually need not study the quantitative relationships. Accounting information is also required in order to interpret

statements properly. With a lack of information it is nearly impossible to interpret financial accounts or to choose between two or more concepts.

What information should be disclosed? This accounting information includes: (a) the method of inventory pricing, (b) the principles of consolidation, (c) the method of accounting for installment sales or long-term contracts, (d) the basis for carrying plant and equipment, and (e) the basis for carrying investments.

Hendriksen<sup>54</sup> also proposes some guidelines for the accounts on the balance sheet. He feels the materiality of quantitative data on the balance sheet is not generally considered as important as the determination of materiality in the income statement. The balance sheet is considered a statement of unallocated debits and credits. It is also considered a trial balance sheet to be elevated to a position where it is more meaningful and useful, the concept of materiality should also be applied to the valuation of assets and liabilities. In reality what is material as related to assets and liabilities depends on the relative accuracy expected by the reader of the financial statements.

Cash and related items can be measured quite accurately, the current value of receivables is less accurate to measure, and intangibles are valued only with a relatively wide range of reliability. Therefore the disclosure of uncertainties in cash items such as deposits in closed banks or in foreign currencies may be considered material while an intangible item of the same

amount may not be considered material. The reason for the difference is that an informed reader generally places more reliance on some items on the balance sheet than on others and he should be able to expect the proper disclosure if this assumption is not justified. Also information that can't be expressed in quantitative terms is more difficult to evaluate as to its materiality because it is given various weights by those using the information in decision-making. Generally information that is given greater weight in decision-making is more material than information given less weight. The point of cutoff where information is said to be of little importance and it should be omitted is difficult to determine. Conversely the point where information is important and shouldn't be omitted is difficult to determine.

The materiality of certain nonquantitative information can be determined by the materiality of the quantitative data to which it relates. For example if certain assets are pledged as security, the pledging may be a material fact if the assets themselves are material in amount. If the assets are not material, generally descriptive information is not relevant. The exception is the loss of an immaterial amount of inventory or cash. This may be a material fact if it is due to fraudulent management. Thus nonquantitative information is material if relevant to the decision-making process and should be disclosed.

Meigs, Johnson, and Keller,<sup>55</sup> feel errors affecting the balance sheet should be evaluated in relation to the amount of the asset or the liability in question and in relation to total as-

sets and total liabilities. An error not important in terms of the overall company results may warrant correction because it has a material impact on a department or division or on the operating results when determined by customer or product.

There are also proposed guidelines for the income statement. Hylton<sup>56</sup> suggests that materiality for income statement accounts should be stated as "no item exceeding 2% of gross profit on sales may be considered immaterial."<sup>56</sup>

Rappaport<sup>57</sup> suggests the following guidelines for the inclusion of an extraneous item in net income for the current year are: (a) Whether the extraneous item belongs in a computation of an average income over a period of years. (b) Whether the extraneous item affects the measurement of earnings stability. (c) Whether the extraneous item results in erroneous inferences from a trend because the item preserves the appearance of regularity where no regularity exists or conversely.

Stettler<sup>58</sup> also sets forth some criteria for the determination of materiality for balance sheet accounts.

The relation of the amount of an item to the amount of other items similarly classified, to final balance sheet totals, and to net income for the current year as well as for past years, will indicate the relative significance of an item. Since the fairness of the financial statements will be most seriously affected by misstatement of a material item, relatively more evidence should be examined in support of a material figure than would be necessary in support of a figure which is not material.<sup>58</sup>

Materiality suggestions were made for other such as errors. Meigs, Johnson, and Keller<sup>59</sup> feel that when an error is found it should be considered for its relative size and for the impor-

tance of the dollar amount in relation to net income and the overall financial position of the company. Generally when an insignificant error is found no correction is necessary. Some small errors are corrected because the correction simplifies subsequent recordkeeping or the error is significant to someone outside the business. For example a minor error in the raw material inventory should be corrected so the control account and the subsidiary ledger agree. Similarly nonmaterial errors in accounts receivable should be corrected for customer relations. A minor error in recording prepaid expenses may not be worth the trouble of correction. The materiality of an error is always a relative matter. A \$1,000 error is minor in a large firm and significant for a small firm.

Stettler<sup>60</sup> links relative risk and errors together to determine materiality. The risk of an error with respect to the accounting records and procedures system is tempered by the materiality of the items susceptible to error or misrepresentation. The cumulative effect of small or insignificant errors may be material. It may indicate a chronic breakdown in controls which portends future major deficiencies. Therefore the auditor must be on guard at all times to note trends or tendencies reflected by presently immaterial errors.

Other comments on the concept of materiality have been made. Husband<sup>61</sup> feels that although the basis of what constitutes a material modification is solvable only in terms of the judgment of the practicing accountant, it may be considered that anything



is material which modifies the measured income figure by an amount approaching 5 to 10%.

Robert Anthony<sup>62</sup> also agrees that materiality is essentially a matter of judgment. The accountant has no exact line separating material events from immaterial events. Therefore the problem of deciding what to record is not easily solved.

Pattillo<sup>63</sup> feels an accountant applies judgment from the vantage point of hindsight. The company accountant does not have the opportunity to decide materiality from the vantage point of hindsight. The company accountant needs a better basis for making his decisions.

He also feels the determination of materiality is dependent in large measure upon individual value judgments. Materiality is a state of relative importance or relative magnitude of amounts or items. The nature and size, or both combined, must be considered as to whether an item or amount is material.

Pattillo reiterates the idea of relative importance when talking of errors that relate to financial statements. Errors in the amount at which property, plant, and equipment are stated will be less material in their effect on the financial or operating picture than would be true of an error in stating any of the current assets. The current assets and the current ratio are much more important to creditors and stockholders than are noncurrent asset figures. Also it has been noted by Pattillo that net income is not affected to the same extent by an error in the figure for plant assets as by an error in the figure for



current assets.

Black, Champion, and Brown<sup>64</sup> hold the view that the dividing line between what is material and what is not material varies according to the company, circumstances surrounding the transaction, and the use to which the information is likely to be put. This would mean no rigid set of guidelines for the determination of materiality are possible.

Ross<sup>65</sup> has a completely different idea of materiality.

He feels:

It will be found that relatively large amounts can be deducted or added to different items without really changing in any material way the resulting picture, and in this way an appreciation can be gained of how wide the limits of materiality are.<sup>65</sup>

It can be seen that the concept of materiality is essentially a question of utility. An alteration to a financial statement is material if it will prove useful to someone making a decision and not otherwise.

This information that should not be disclosed not because it is not important or material, but because it might be useful to the wrong parties. For example the sales volume of a specific product in a given area might be useful information to competitors and could affect future sales and income adversely even though it might be helpful to investors. Also an estimate of the expected liability to arise from a lawsuit might influence the outcome of the suit itself.

Some feel that failure to disclose material information for the above reasons is generally not considered justified. It is the duty of the large corporations to disclose certain amounts of

material information to investors despite the fact that the reaction to the information may be detrimental to the corporation. The corporation has its first duty to the stockholders.

Many guidelines have been proposed. Some advocate the use of a percentage guideline. To others this method is too rigid and the results may be variable if the base used is net income. Bernstein proposed a borderline guideline that counters the arguments of those who say there is little difference between 10% and 10.1%. His method is more flexible and can fit different situations. Reininga proposed the use of case studies. His reasoning is that unless one knows the facts that lead to the decision, the reader can not determine why the decision was made. Others propose different bases for each balance sheet account. Finally some feel materiality is essentially a matter of judgment and each situation is different. No set of guidelines can be set that will help in all situations.

Reininga<sup>66</sup> feels no real decision of materiality is possible. No simple test or standard can be applied in determining materiality, nor can one be devised, since the variables are different in each situation. Each decision must be based on the pertinent relationships determined by the professional judgment of the auditor, since materiality decisions are exercises of judgment based on the existing criteria. The problem of determining the surrounding circumstances has also been left unsettled.

Howard Stettler<sup>67</sup> feels the ability to judge soundly in

such situations so that every decision corresponds with what other auditors would decide under the same circumstances can come only from adequate training and experience, coupled with a full knowledge of current thinking in the profession, and the business world as well.

Another important consideration is whether the effect of the questionable treatment of an item would be sufficient to cause an investor to buy or sell, cause a banker to loan, call, or extend an existing obligation, or cause a customer or vendor to establish, discontinue, or resume relations.

Newman and Mellman<sup>68</sup> feel that in the absence of specific criteria, the concept of materiality makes its impact on the accountant by instilling a sense of alertness and vigilance, and a sensitivity to the necessary requirements if the financial statements are not to be misleading.

In the final analysis, the proof of the proper exercise of accounting judgment as to what is material can be established only when, in an individual case, the charge is made that the concept of materiality has been disregarded and successful defense is made against that charge.<sup>68</sup>

The concept of materiality is used daily by public accountants in the performance of audits. It also appears frequently in current accounting literature.

Since Spencer Gordon gave his definition of materiality in 1933, little change has been made in the definition of materiality. His definition essentially was that anything which would influence the behavior of a reasonable man is material. Materiality is a matter of judgment.

Since no good definition of materiality has been developed, examples have been suggested as a guide for the accountant in making his materiality decisions. Bierman said that to a gas company each gas meter is an immaterial amount. However, when one considers all the gas meters together, this total is a material amount. Black and Champion gave a similar example. A \$50 chair is insignificant for a corporation with \$1,000,000 in total assets while for a company with \$1,000 in assets the \$50 chair is a material item.

Others pointed out some things that may be material just because of the nature of the items. These would include defalcations of any kind, discrepancies indicated by confirmations, and errors in transactions between related companies.

It has been shown by studies that some guidelines for materiality are needed. Bernstein found in his study that different companies handle the same or similar items in a different manner. Delmer Hylton found that his experimental group had a difference of opinion on how to handle various items in terms of materiality. Also he found that something more than the amount seemed to be considered in determining the answer to the question of materiality. These differences lead to little if any comparability among financial statements of different companies.

Others fear the absence of materiality standards may lead to misunderstandings. Certain material facts may be omitted from reports or certain immaterial items may be included in the reports. Both situations are bad.

In answer to the need for a guideline several proposals have been made. Fixed percentage guidelines have been required by the SEC in their reports. However, many are against the use of a fixed percentage guideline because there is a problem of what percentage to use and each situation is different so the base may vary. The results under the above circumstances would be of little if any value.

Bernstein suggested a border zone guideline to satisfy those who say there is little difference between 10% and 10.1%. His border zone would be 10-15% of net income after taxes. This border zone allows an accountant to fit the desired percentage to the situation.

Reininga feels case studies would be the answer for disclosing why an accountant was particular on one occasion about a small amount, and then apparently unconcerned about millions of dollars on another occasion. Without a knowledge of the facts that caused the decision, a reader can only surmise why the decision was made.

Several guidelines have been proposed by Hylton, Hendriksen, Rappaport, and others for dealing with the balance sheet accounts. Similarly guidelines have been proposed for the income statement.

Many feel materiality is essentially an exercise of judgment and no guidelines can be developed to fit each situation. Only experience in auditing and a knowledge of current thinking in the accounting profession and business world will help one decide the question of materiality.

Therefore little progress has been made since Spencer Gordon gave his definition in 1933. Several definitions and guidelines have been proposed, but none has become an accepted guide. Materiality decisions are still essentially a matter of using informed judgment.

## F O O T N O T E S

1 Warren Reininga, "The Unknown Materiality Concept," Journal of Accountancy, Vol. CXXV(February, 1968), p. 31.

2 Spencer Gordon, "Accountants and the Securities Act," Journal of Accountancy, Vol. LVI(November, 1933), p. 438.

3 Reininga, loc. cit.

4 Accounting Research Bulletin No. 43, "Restatement and Revision of Accounting Research Bulletins," (New York: American Institute of CPA's, 1953), p. 9.

5 Norman J. Lenhart, and Philip L. DeFliese, Montgomery's Auditing(New York: The Ronald Press Company, 1957), p. 80.

6 Homer A. Black, and John E. Champion, Accounting in Business Practice(Englewood Cliffs: Prentice-Hall, Inc., 1961), p. 190.

7 Maurice Moonitz, The Basic Postulates of Accounting Research Study No. 1(New York: The American Institute of CPA's, 1961), p. 47.

8 Eldon S. Hendriksen, Accounting Theory(Homewood: Richard D. Irwin, Inc., 1965), p. 453.

9 Accounting Concepts and Standards Underlying Corporate Financial Statements and Supplements(Columbus: American Accounting Association, 1948), p. 36.

10 James L. Dohr, "Materiality-What Does It Mean In Accounting?" Journal of Accountancy, Vol. XCII(July, 1950), pp. 54-56.

11 James W. Pattillo, The Foundation of Financial Accounting(Baton Rouge: Louisiana State University Press, 1965), p. 82.

12 Richard Mattessich, Accounting and Analytical Methods(Homewood: Richard D. Irwin, Inc., 1964), p. 45.

13 Weldon Powell, "Inventory of Generally Accepted Accounting Principles," Accounting: New Perspectives in Business Economics(Boston: D. C. Heath and Company, 1967), p. 9.

14 Homer A. Black, John E. Champion, and R. Gene Brown, Accounting in Business Decisions: Theory, Method, and Use(Englewood Cliffs: Prentice-Hall, Inc., 1967), p. 14.

15 Howard Ross, The Elusive Art of Accounting(New York: The Ronald Press Company, 1966), p. 52.

16 Benjamin Newman, and Martin Mellman, Accounting Theory: A CPA Review(New York: John Wiley and Sons, Inc., 1967), p. 48.

17 Harold Bierman, Financial Accounting Theory(New York: The MacMillan Company, 1965), p. 10.

18 Harold Bierman, Financial and Managerial Accounting (New York: The MacMillan Company, 1963), p. 13.

19 Homer A. Black, and John E. Champion, Accounting in Business Decisions(Englewood Cliffs: Prentice-Hall, Inc., 1961), p. 190.

20 Carman G. Blough, Practical Applications of Accounting Standards(New York: The American Institute of CPA's, 1957), p. 222.

21 Lenhart, and Defliese, loc. cit.

22 Hendriksen, op. cit., p. 455.

23 Walter B. Meigs, Charles E. Johnson, and Thomas F. Keller, Intermediate Accounting(New York: McGraw-Hill, 1963), p. 154.

24 Howard F. Stettler, "Auditing Standards and Competence of Evidence Matter," The Accounting Review, (January, 1954), p. 122.

25 Robert N. Anthony, Management Accounting(Englewood Cliffs: Prentice-Hall, Inc., 1961), p. 97.

26 Howard F. Stettler, Auditing Principles(Englewood Cliffs: Prentice-Hall, Inc., 1961), p. 97.

27 Black, Champion, and Brown, loc. cit.

28 Reininga, loc. cit.

29 APB Opinion No. 9, "Reporting the Results of Operations," (New York: American Institute of CPA's, 1966), par. 21, p. 115.

30 Reininga, op. cit., p. 30.

31 Michael N. Chetkovich, "Standards of Disclosure and Their Development," Journal of Accountancy, Vol. C(December, 1955), p. 50.

32 Delmer P. Hylton, "Some Comments on Materiality," Journal of Accountancy, Vol. CXII(September, 1961), p. 63.



33 Leopold A. Bernstein, "The Concept of Materiality," The Accounting Review, Vol. XLII(January, 1967), p. 86.

34 Hylton, loc. cit.

35 Donald Rappaport, "Materiality," Journal of Accountancy, Vol. CXV(April, 1964), p. 42.

36 Hendriksen, op. cit., p. 452.

37 John L. Carey, The CPA Plans for the Future(New York: American Institute of CPA's, 1965), p. 145.

38 Roger G. Patterson, "Materiality and the Economic Environment," The Accounting Review, Vol. XLII(October, 1967), p. 772.

39 Reininga, op. cit., p. 32.

40 Carman G. Blough, "Some Suggested Criteria for Determining Materiality," Journal of Accountancy, Vol. LXXXIX (April, 1950), pp. 252-54.

41 Reininga, loc. cit.

42 Hylton, loc. cit.

43 Samuel M. Woolsey, "Development of Criteria to Guide the Accountant in Judging Materiality," Journal of Accountancy, Vol. XCVII(February, 1954), pp. 167-73.

44 Patterson, loc. cit.

45 Hylton, loc. cit.

46 Hendriksen, op. cit., p. 454.

47 Pattillo, op. cit., p. 83.

48 Hendriksen, loc. cit.

49 Bernstein, op. cit., p. 93.

50 Reininga, op. cit., p. 33.

51 Rappaport, op. cit., p. 44.

52 Hylton, op. cit., p. 64.

53 Rappaport, loc. cit.

54 Hendriksen, op. cit., p. 455.

55 Meigs, Johnson, and Keller, loc. cit.

56 Hylton, loc. cit.

57 Rappaport, loc. cit.

58 Howard F. Stettler, op. cit., p. 90.

59 Meigs, Johnson, and Keller, loc. cit.

60 Stettler, loc. cit.

61 George R. Husband, Accounting, Administrative and Financial(Philadelphia: Chilton Company, 1960), p. 126.

62 Robert N. Anthony, loc. cit.

63 Pattillo, op. cit., p. 82.

64 Black, Champion, and Brown, loc. cit.

65 Ross, loc. cit.

66 Reininga, op. cit., p. 32.

67 Stettler, op. cit., p. 99.

68 Newman, and Mellman, op. cit., p. 49.

## B I B L I O G R A P H Y

APB Opinion No. 9, "Reporting the Results of Operations,"  
American Institute of CPA's. 1966.

Accounting Research Bulletin No. 43. "Restatement and Revision  
of Accounting Research Bulletins," American Institute of  
CPA's. 1953.

American Accounting Association Committee on Accounting Concepts  
and Standards. Accounting Concepts and Standards  
Underlying Corporate Financial Statements and Supplements.  
1948.

Anthony, Robert N., Management Accounting. Richard D. Irwin, Inc.  
1964.

Barr, Andrew, "Accountants and the Securities and Exchange  
Commission," Journal of Accountancy, September, 1961,  
pp. 61-64.

Bernstein, Leopold A., "The Concept of Materiality," The  
Accounting Review, January, 1967, pp. 86-95.

Bierman, Harold, Financial Accounting Theory. The MacMillan  
Company. 1965.

Bierman, Harold, Financial and Managerial Accounting. The  
MacMillan Company. 1963.

Black, Homer A., Champion, John E., Accounting in Business  
Decisions. Prentice-Hall, Inc. 1961.

Black, Homer A., Champion, John E., and Brown, R. Gene,  
Accounting in Business Decisions: Theory, Method, and  
Use. Prentice-Hall, Inc. 1967.

Blough, Carman G., Practical Applications of Accounting  
Standards. American Institute of CPA's. 1957.

Blough, Carman G., "Some Suggested Criteria for Determining  
Materiality," Journal of Accountancy, September, 1961,  
pp. 352-54.

Carey, John L., The CPA Plans for the Future. American  
Institute of CPA's. 1965.

Carey, John L., and Doherty, William O., Ethical Standards of  
the Accounting Profession. American Institute of CPA's.  
1966.

- Chetkovich, Michael N., "Standards of Disclosure," Journal of Accountancy, December, 1955, pp. 48-52.
- Dixon, Robert L., Hepworth, Samuel R., and Paton, William A., Essentials of Accounting. The MacMillan Company. 1966.
- Dohr, James L., "Materiality-What Does It Mean In Accounting?" Journal of Accountancy, July, 1950, pp. 54-56.
- Gilman, Stephen, Accounting Concepts of Profit. The Ronald Press Company, 1939.
- Gordon, Spencer, "Accountants and the Securities Act," Journal of Accountancy, November, 1933, pp. 438-451.
- Grady, Paul, Inventory of Generally Accepted Accounting Principles for Business Enterprises. American Institute of CPA's. 1965.
- Griffin, Charles H., "Pedagogical Implications of the Materiality Concept," The Accounting Review, April, 1959, pp. 298-300.
- Hendriksen, Eldon S., Accounting Theory. Richard D. Irwin, Inc. 1965.
- Husband, George R., Accounting, Administrative and Financial. Chilton Company. 1960.
- Hylton, Delmer P., "Some Comments on Materiality," Journal of Accountancy, September, 1961, pp. 61-64.
- Kohler, Eric L., Accounting for Management. Prentice-Hall, Inc. 1965.
- Lenhart, Norman J., and Defliese, Philip L., Montgomery's Auditing. The Ronald Press Company. 1957.
- Mattessich, Richard, Accounting and Analytical Methods. Richard D. Irwin, Inc. 1964.
- Meigs, Walter B., Johnson, Charles E., and Keller, Thomas F., Intermediate Accounting. McGraw-Hill. 1963.
- Moonitz, Maurice, The Basic Postulates of Accounting, Accounting Research Study No. 1. American Institute of CPA's. 1961.
- Morrissey, Leonard E., Contemporary Accounting Problems. Prentice-Hall, Inc. 1961.
- Newman, Benjamin, and Mellman, Martin, Accounting Theory: A CPA Review. John Wiley and Sons, Inc. 1967.

- Patterson, Roger G., "Materiality and the Economic Environment," The Accounting Review, October, 1967, pp. 772-774.
- Pattillo, James W., The Foundation of Financial Accounting. Louisiana State University. 1965.
- Powell, Weldon, Inventory of Generally Accepted Accounting Principles. D. C. Heath and Company. 1967.
- Rappaport, Donald, "Materiality," Journal of Accountancy, April, 1964, pp. 42-48.
- Rappaport, Louis H., SEC Accounting Practice and Procedure. The Ronald Press Company. 1956.
- Reininga, Warren, "The Unknown Materiality Concept," Journal of Accountancy, February, 1968, pp. 30-35.
- Ross, Howard, The Elusive Art of Accounting. The Ronald Press Company. 1966.
- Stettler, Howard F., Auditing Principles. Prentice-Hall, Inc. 1961.
- Stettler, Howard F., "Auditing Standards and Competence of Evidence Matter," The Accounting Review, January, 1954, pp. 121-26.
- Woolsey, Sam W., "Development of Criteria to Guide the Accountant in Judging Materiality," Journal of Accountancy, February, 1954.

THE CONCEPT OF MATERIALITY

by

JOSEPH EUGENE PEIRCE

B. A., Allegheny College, 1966

---

AN ABSTRACT OF A MASTER'S REPORT

submitted in partial fulfillment of the

requirements for the degree

MASTER OF SCIENCE

College of Commerce

KANSAS STATE UNIVERSITY  
Manhattan, Kansas

1969

The concept of materiality is used daily by public accountants in the performance of audits. It is also frequently used in current accounting literature.

Since Spencer Gordon gave his definition of materiality in 1933, little change has been made in the definition of materiality. His definition essentially was that anything which would influence the behavior of a reasonable man is material. Materiality is a matter of judgment.

Since no good definition of materiality has been developed, examples have been suggested as a guide for the accountant in making his materiality decisions. Bierman said that to a gas company each gas meter is an immaterial amount. However, when one considers all the gas meters together, this total is a material amount. Black and Champion gave a similar example. A \$50 chair is insignificant for a corporation with \$1,000,000 in total assets while for a company with \$1,000 in assets the \$50 chair is a material item.

Others pointed out some things that may be material just because of the nature of the items. These would include defalcations of any kind, discrepancies indicated by confirmations, and errors in transactions between related companies.

It has been shown by studies that some guideline for materiality is needed. Bernstein found in his study that different companies handle the same or similar items in a different manner. Delmer Hylton found that his experimental group had a difference of opinion on how to handle various items of materiality.

Also he found that something more than the amount seemed to be considered in determining the answer to the question of materiality. These differences lead to little if any comparability among financial statements of different companies.

Others fear the absence of materiality standards may lead to misunderstandings. Certain material facts may be omitted from reports or certain immaterial items may be included in the reports. Both situations are bad.

In answer to the need for a guideline several proposals have been made. Fixed percentage guidelines have been required by the SEC in their reports. However, many are against the use of a fixed percentage guideline because there is a problem of what percentage to use and each situation is different so the base may vary. The results under the above circumstances would be of little if any value.

Bernstein suggested a border zone guideline to satisfy those who say there is little difference between 10% and 10.1%. His border zone allows an accountant to fit the desired percentage to the situation.

Reininga feels case studies would be the answer for disclosing why an accountant was particular on one occasion about a small amount, and then apparently unconcerned about millions of dollars on another occasion. Without a knowledge of the facts that caused the decision, a reader can only surmise why the decision was made.

Several guidelines have been proposed by Hylton, Hendriksen, Rappaport, and others to deal with the balance sheet accounts.



Similarly guidelines have been proposed for the income statements.

Many feel materiality is essentially an exercise of judgment and no guidelines can be developed to fit each situation. Only experience in auditing and a knowledge of current thinking in the accounting profession and business world will help one decide the question of materiality.

Therefore little progress has been made since Spencer Gordon gave his definition in 1933. Several definitions and guidelines have been proposed, but none has become an accepted guide. Materiality decisions are still essentially a matter of using informed judgment.