

AN EXEMPLIFICATION ANALYSIS OF MATERIALITY COMPUTATION BASED ON THE CLIENT'S SPECIFICS

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Abstract

The study aims to assess the benchmark selection for the materiality level computation based on the auditee's specifics. The paper conducts an exemplification comparison analysis suggesting an appropriate benchmark for selecting the quantitative materiality level measurement of two entities that operate in different fields, have different business goals and are of interest for different categories of stakeholders. The paper exemplifies the rationale for selecting a benchmark based on the analysed companies' profile; one being profit-oriented, the most appropriate benchmark suggested is a blend between total revenue and profit before tax, while in the second case of a cost center company, a more relevant benchmark suggested is represented by the total expenses. After assessing the benchmark, the paper proposes the rule of thumb based on the suggested literature by considering that none of the entities is of public interest. The topic proposed in this study is of interest not only to the users of the financial statements and implicitly audit reports but also to the practitioners who could benefit from a deeper understanding of the rationale behind the materiality level benchmark selection. Moreover, this paper also contributes and expands the materiality literature about underlying materiality judgment.

Keywords: *Audit, Materiality, Financial Statements, Reporting*

JEL Classification: M40, M42

1. Introduction

There are multiple reasons for conducting an audit, including legal requirements imposed by the governments and their agencies or other authorised control authorities or for group purpose reporting. The auditor "seeks to achieve the main objective of the audit, i.e. to enhance the degree of confidence of intended users in the financial statements" (Masiulevičius & Lakis, 2018). In order to do so, according to ISA 200, the auditors have to identify whether "the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework".

Before the actual audit and assessment of the financial statements are made, the auditor expects that up to a certain level, some misstatements might occur in accounting and the financial statements. However, these possible inconsistencies might be considered material or not, depending on the materiality level set by the auditor. Anyhow, the insignificant misstatements should not impact any decisions that are to be made based on the financial statements. According to ISA 320, "significant misstatements, including omissions, are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements".

According to the applicable framework for financial reporting, materiality "is an entity-specific aspect of relevance based on the nature or magnitude (or both) of the items to which the information relates in the context of an individual entity's financial report" (International Accounting Standards Board, 2018)

Moreover, it is relevant to mention that the level of materiality used should be orientated towards the users of financial statements; however, due to the fact that there is no specific guideline for measuring the quantitative part of materiality, the auditors compute the materiality level by calculating a percentage of some financial statement items and select the benchmark based on their understanding of the auditee and professional judgment.

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A general business understanding refers to matters such as clients' goals, key performance indicators, type of business, orientation for profit, public profile (listed or not listed on the stock exchange), seasonality and of course, any other particular aspects.

The study aims to assess the benchmark selection for the materiality level computation based on the auditee's specifics. In this regard, an analysis of two entities that operate in different fields, have different business goals and are of interest for different categories of stakeholders is proposed.

The topic proposed in this study is of interest not only for the users of the financial statements and implicitly audit report but also for practitioners who could benefit from a deeper understanding of the rationale behind the materiality level benchmark selection. Moreover, this paper also contributes and expands the materiality literature about underlying materiality judgment.

2. Theoretical Background and Literature Review

The interest in the materiality concept has increased over the years, and it definitely plays a significant role in performing the audit of the financial statements. The key aspect, which is actually the most important for the users of the financial statements, is the final product of the audit, namely the audit opinion, which depends on the level of materiality used by the auditors (Lakis & Masiulevičius, 2017).

The financial statements are relevant for various categories of users for decision-making purposes; thus, they have to present a true and fair image of the company. The auditor "seeks to achieve the main objective of the audit, i.e. to enhance the degree of confidence of intended users in the financial statements" (Masiulevičius & Lakis, 2018). In order to do so, according to ISA 200, the auditors have to identify whether "the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework" (ISA 200, 2009).

Considering this, it is clear that "the aim of the audit is not to identify all the risks which would be of interest of the auditee but to carry out the audit within the framework of the materiality determined" (Masiulevičius & Lakis, 2018).

According to the applicable framework for financial reporting, materiality "is an entity-specific aspect of relevance based on the nature or magnitude (or both) of the items to which the information relates in the context of an individual entity's financial report" (International Accounting Standards Board, 2018)

According to Lakis & Masiulevičius, 2017 even though "the understanding of materiality and application of it should be the same and not depend on what auditors or audit companies perform audit of financial statements", it often happens that "different auditors apply different materiality values; therefore, the reliability of financial statements can be different depending on auditor or audit company".

Moreover, it is relevant to mention that the level of materiality used should be orientated towards the users of financial statements. However, Lakis & Masiulevičius, 2017 concluded that "the materiality level expected by users of financial statements is lower compared to the one, applied by an auditor; therefore, a big risk exists, that in many cases, the financial statements do not present such level of reliability which the users expect of financial statements".

Considering that "accounting and auditing standards do not provide certain guidelines for measuring the quantitative part of materiality", the auditors compute the materiality level by calculating a percentage of some financial statement items (Azad, et al., 2021).

In order to be able to make assumptions about materiality levels, auditors have employed various methods for quantitative measurement of this significance threshold. The methods used are single rules, variable or size rules, bland or averaging methods and formula methods (McKee & Eilifsen, 2000). In the case of single rules, the rule of thumb uses a single

financial variable, such as 5% profit before tax, 2% of total assets, 1% total equities or 2% of total incomes (Azad, et al., 2021).

In the case of variable rules, there is a range to be considered in terms of applied percentages and the size of the company. For example, 2–5% for a gross profit of fewer than 20 billion Rials, 1–2% for gross profit between 20 and 100 billion Rials, 5–1% for gross profit between 100 and 1,000 billion Rials, 5% for a gross profit of more than 1,000 billion Rials (Azad, et al., 2021).

As far as the last two listed methods are concerned, the blended or average rules "usually use four or five thumb rules and compute the materiality based on the mean, while formula methods are used based on a statistical analysis of a big sample of firms' materiality level" (Azad, et al., 2021).

In relation to the chosen benchmark, relevant financial data includes prior period's financial results and financial positions, the period-to-date financial results and financial position, and budgets or forecasts for the current period, adjusted for significant changes in the circumstances of an entity (for example, a significant business acquisition) and relevant changes of conditions in the industry of economic environment in which the entity operates.

For example, when, "as a starting point, materiality for the financial statements as a whole is determined for a particular entity based on a percentage of profit before tax from continuing operations, circumstances that give rise to an exceptional decrease or increase in such profit may lead the auditor to conclude that materiality for the financial statements as a whole is more appropriately determined using a normalised profit before tax from continuing operations figure based on past results" (ISA 320, 2009)

There are cases when using the profit before tax as a benchmark might not be appropriate or entirely relevant for the business due to volatile earnings, start-up entities, and earnings only slightly above the break-even point. Based on the professional judgement, the auditor can use various elements from the financial statements as benchmarks such as total revenue, total expenses, EBITDA, current assets, net working capital, total assets, net assets, total equity, operating cash-flow, debt-to-equity ratio, return on equity ratio.

If the above situations occur, and the auditor decides that the benchmark is not the profit before tax, other benchmarks can be considered in the following discussed scenarios. In case of volatile earnings, the auditor can adjust the figures based on the unusual occurring cases; if not possible, an average value of the profit from the previous year can be computed and set as a benchmark (ICAEW, 2012)

In case the audited company has earnings only slightly above the break-even point, EBITDA can be an option, or other components such as total revenue or total assets, depending once again on the client's specifics and that component that pays significant importance to the users of the financial statements. If discussing about start-up entities, profit is definitely not a key component for a start-up; thus, a benchmark based on revenue, equity or assets seems more appropriate (ICAEW, 2012).

In order to provide a clear understanding of some of the usual percentages and benchmarks used, some examples are listed in the upcoming part of the paper. In the case of a not-for-profit entity, a value of up to one per cent (1%) of total expenses/ total revenues, or up to one per cent (1%) out of the total assets will be used, but in certain circumstances for non-PIE (companies that are not listed on stock-exchange and their shares are not traded), this may be increased up to three per cent (3%) (AICPA, 2019).

In the case of a profit-oriented entity, a value of up to five per cent (5%) of profit/loss before tax (when discussing about continuous operations), but in certain circumstances for non-PIE oriented entities, this may be increased up to ten per cent (10%) (AICPA, 2019).

In the case of entities where Earnings Before Interest, Tax, Depreciation and Amortisation (EBITDA) is used as the benchmark, a value of up to 2.5% of EBITDA will be

considered, but in certain circumstances for non-PIE entities, this may be increased up to 3.5% (AICPA, 2019).

In the case of entities where net assets are used as a benchmark, a value of up to one per cent (1%) of net asset value will be considered, but in certain circumstances, for non-PIE entities, this may be increased up to 2.5% (AICPA, 2019).

Considering the various materiality computation methods and the lack of a clear guideline, it is pretty understandable why Kranacher (2007) suggested that this concept caused frustration in the public accounting profession, as it "requires a substantial degree of auditor judgement regarding what is important to users of financial statements when making economic decisions". Also, it is quite a must to understand when establishing this relevance threshold how any piece of information may influence any stakeholders, and of course, there is a risk that the auditor's judgement "may be questioned and sometimes litigated in a court of law" (Kranacher, 2007).

According to Chen, et al. (2008), who investigated the correlation between the performance materiality computed based on quantitative benchmarks and the size of accounting misstatements corrected by financial statements restatements, concluded that "62 per cent of the restatements involve income levels less than the planning materiality level", suggesting that it is not often the case that the auditors reconsider the used materiality level or the judgement behind its computation.

Moreover, when examining the materiality guidance used by some of the largest public accounting firms, Eilifsen & Messier Jr. (2015) identified the fact that there is "a high level of consistency across the firms in terms of the quantitative benchmarks (e.g., income before taxes, total assets or revenues, and total equity) used to determine overall materiality, the related percentages applied to those benchmarks, the percentages applied to overall materiality for determining tolerable misstatement, and what constitutes a clearly trivial misstatement".

Regarding the different approaches used by audit companies, Blokdijk, et al. (2003) found out that "Big 5 firms use lower planning materiality values than non-Big 5 firms, ceteris paribus, which is consistent with the production of relatively higher audit quality levels by the Big 5".

When considering the most appropriate and relevant benchmarks for materiality computation, the auditors should also look into the auditee's specifics according to Masiulevičius & Lakis (2018), who suggests that "carrying out the determination of performance materiality based on the business needs to every area separately would help to provide more detailed comments and insights about the risks of the areas concerned".

Also, as far as the audited company's specifics are concerned, Blokdijk, et al. (2003) stated that "planning materiality is not a constant percentage of a base, but increases at a decreasing rate with client size, also, planning materiality values increase with the quality of the client's control environment and the magnitude of the client's rate of return on assets while decreasing with the complexity of the client". Moreover, Blokdijk, et al. (2003) also suggests that "auditors use lower materiality values in situations where earnings might be managed to show a small profit or a small loss".

When performing inter-industry research on the materiality computation, Pany & Wheeler, (1989) identified that "among the various rules of thumb for calculating the materiality, sizable differences can occur depending upon the method and the industry", suggesting, therefore, once again, that the client specifics influence the judgement behind the usage of the most appropriate benchmark and computation method.

With an opposite perspective regarding the studies above mentioned highlighting the lack of proper guidance for the materiality level calculation, Bernardi & Pincus, (1996) argued after reviewing and comparing various auditors' judgements that "while auditor materiality judgments differ, these differences were not statistically significantly related to either fraud risk judgments or the amount of evidence the auditors chose to examine before

rendering their judgments". Moreover, the previously discussed study did not support the need for clear quantitative guidance regarding materiality.

Nevertheless, the literature also considers the current expectation gap about the materiality understanding, and in this regard, Houghton, et al. (2011) stated, "in general, stakeholders perceive that the concepts involved in audit materiality are not well understood and they point to the difficulty in providing educative materiality about it". In line with these findings, De Martinis & Burrowes, (1996) concluded that "a significant factor causing a widening, or at least a reinforcement, of the AEG is the non-disclosure of materiality and risk judgements in financial reports". Thus, in order to diminish this expectation gap, De Martinis & Burrowes, (1996) suggest that the auditors should disclose the materiality and the risk judgements in the financial reports.

3. Methodology

The study aims to assess the benchmark selection for the materiality level computation based on the auditee's specifics. In this regard, an analysis of two entities that operate in different fields, which, however, has no impact on the audit mission, have different business goals and are of interest for different categories of stakeholders is proposed.

Hence, the study performs a comparative analysis of the most relevant items from the financial statements of these two entities, provides a general business understanding highlighting the differences between the companies' orientations and suggesting an appropriate benchmark and the selection of the quantitative materiality level measurement. The data used in this paper are multiplied with a non-material coefficient, and it is used for exemplification purposes, as well the proposed business understanding and the companies' description.

The rationale behind the companies selection method is based on the fact that both entities require a financial audit, and the paper intends to present two opposite companies as far as the business model is concerned, but also regarding how the materiality level is computed, hence these two entities were considered suitable for this analysis.

4. Case Study Description

For the purpose of this exemplification case study, two companies operating in different industries are assessed, one that provides transport services and the other one that is an auto batteries producer. In this sense, the financial data from 2018 is used, which is considered to be, for both companies, one of the most stable financial years.

For exemplification purposes, the study refers to these two companies as "SC Transport SRL" and "SC Auto Batteries SRL". "SC Auto Batteries SRL" is currently one of the largest auto batteries producers in Romania. The company is the national leader, and its production capacity exceeds 2 million batteries/ year. The product portfolio includes multiple types of batteries that have reached numerous countries from Europe.

Another important aspect related to this company is the seasonality of the business. Due to the fact that the batteries have a greater exposure to crash in the cold periods of the year, sales have a sharp increase during the months of December to March.

"SC Auto Batteries SRL" is a joint-stock company, not listed on any stock exchange market, therefore considered by auditors as a non-PIE client. The company's revenue stream is mainly represented by the selling of batteries (finished products) to third party car-producers/re-sellers, and it also generates a low percentage of revenue from selling residual products and merchandise.

Another topic that is of importance to our analysis regarding business and environment understanding is represented by the regulations that have an impact on the company's activity, namely, Government decision no. 152/2005 regarding the control and prevention of pollution

production, Government decision no. 1132/2008 regarding battery, accumulator and waste, Law no. 818/2003 regarding the environment authorisation. Moreover, the company has to be also compliant with the statutory reporting framework OMF 1802/2014, and it is also subject to the fiscal code.

The company has been owned (more than 90%) since 2012 by a foreign entity. The Company is financed mainly by cash generated through operating activities, and the additional financing is ensured through bank loans (including factoring arrangements) and also grants received from the authorities. The statutory financial statements are prepared in accordance with OMFP 1802/2014.

The second company, "SC Transport SRL", provides transport services, and most of the revenues (90%) are generated through the relationship with the parent company from a foreign European country. The purpose for opening the Romanian subsidiary was the fact that the labour costs and other administrative expenses were lower than in other European countries.

The company has a large fleet of trucks, most of them being financed through financial leasing contracts. The company does not have any bank loans nor overdrafts, the activity being financed through cash obtained from operations.

The cyclicity or seasonality is not particularly relevant, as the transport business functions all year round and brings quite a stable income to the company. The level of technology used is quite common for transportation. The company continuously invests in the fleet. In 2017 the entity acquired 30 tractors head, while currently, it has over 200 trucks. The supply chain and supply costs are stable; no unexpected fluctuations were noted from one period to another. The legal and regulatory framework applicable to the entity is OMF 1082/2014, Fiscal code, Labor Law, Civil code for contractual basis and Competition Law.

The company has only one operating point, and the Romanian subsidiary is a cost center; most of the clients are intercompany; therefore, they are assessed based on the level of expenses. The entity's financing structure is similar to other companies in the industry, using operational profits, financial leasing agreements and intercompany loans.

5. Results and Discussion

The following section presents a suggested method for materiality computation in the case of the previously presented two companies explaining why a particular benchmark is more relevant in each auditee's case.

If analysing "SC Auto Batteries SRL", it is noted that both revenue and profit before interest are relevant. The revenue is essential for the company as part of the client's KPIs is to increase the revenue level from one period to another. Considering this, it is appropriate to compute the materiality based on the average between revenue and profit before interest. The rationale behind the benchmark selection is the following:

- (1) The Company's main objective is to increase market share while enhancing profitability.
- (2) Main KPI's are Revenue and EBITDA, but also PBT (profit before tax) .
- (3) During the past years, the company recorded an increase in the revenue with 13% in 2016, 10% in 2017 and 8% in 2018, and the profit had a sinuous trend (with a PBT/Revenue ratio between 2.6% and 7.5%) being influenced mainly by market conditions like raw material prices (mainly lead price) and competition.

The considerations for the rule of thumb are the following:

- (1) As mentioned at the beginning of the chapter, "SC Auto Batteries SRL" is a Non-PIE client, meaning that it is not listed on the stock exchange.
- (2) The audit risk is considered low as the entity is not a higher-network risk client and does not operate in a high-risk industry.
- (3) The categories of users of financial statements are limited.

- (4) The company has one main shareholder.
- (5) The Company is not listed, and therefore financial statements are not largely visible and are subject to the local statutory reporting.
- (6) The Company has limited debt to banks.

Also, another relevant aspect when selecting the appropriate benchmark is also to take into account the audit history. There is a history of limited audit adjustments with no impact on fraud or management override risks. The financial statements are relatively simple; no particular issues were identified in the prior years, a proper business understanding was obtained, and there are no significant adjustments proposed in the prior years.

Considering all the mentioned above aspects, a mixed benchmark between revenues and PBT is an example of an appropriate benchmark for computing overall materiality, and it is consistent with the general guidance.

As a result, after exercising professional judgement, the following formula is considered in order to compute the overall materiality: $50\% * [(PBT * 9.5\%) + (Revenues * 2.5\%)]$. The actual amounts calculated based on this formula are presented in Table 1. Please note that the actual numbers were multiplied with a coefficient for confidentiality issues; the overall result, however, does not change in any significant ways.

Table 1. Materiality computation for SC Auto Batteries SRL

Benchmark Value	Previous year	Current year
	RON	RON
Total operating income	395.8 mil.	415.5 mil.
Total financial income	2.1 mil.	1.5 mil.
Total income	397.9 mil.	417.1 mil.
2.5%	9.9 mil.	10.4 mil.
Profit Before Tax	24.8 mil.	31.2 mil.
9.5%	2.4 mil.	3.0 mil.
Overall materiality value	6.2 mil.	6.7 mil.

(Source: author's own calculations)

The second assessed company is "SC Transport SRL", and a suggested appropriate benchmark for the materiality level computation is represented by the total expenses. As explained in the theoretical part, if the company is not a profit-oriented entity, another, a more relevant component of the financial statement is considered.

"SC Transport SRL" obtained profits in the last six years; however, the entity's target is not necessary to obtain profits as the local management has little influence on the result. This is due to the fact that the profit is set by the group company, and also tariffs are set by the group for intercompany sales (which represent 90% of total turnover). The purpose of running the Romanian subsidiary is to reduce costs at the group level, as the payroll and administrative costs are lower in Romania.

The company is considered a cost center for the sole shareholder from a foreign European country. Thus, 90% of the total turnover is generated from the transport services provided to the mother company, based on kilometers recorded on the EU territory and on the fixed price according to the contract. Therefore, the business model on which the company operates is cost plus mark-up agreed through an agreement signed yearly.

The rationale for rule of thumb selection which is 3.5% out of the total expenses, is the following:

(1) The distribution of, and the use of, the financial statements is limited to few users: the primary user is the parent company (sole shareholder of "SC Transport SRL").

(2) The entity has no loans or overdrafts neither from banks nor from the group; there are many financial leasing contracts signed by "SC Transport SRL", but these financial leasing contracts do not have covenants attached.

Considering these aspects, the overall materiality is computed as 3.5% out of the total expenses, and the calculation is presented in Table 2. Please note that the actual numbers were multiplied with a coefficient for confidentiality issues; the overall result, however, does not change in any significant ways.

Table 2. Materiality computation for SC Transport SRL

Benchmark Value	Previous year	Current year
	RON	RON
Total operating expenses.	216.5 mil	229.5 mil
Total financial expenses	6.0 mil	3.4 mil
Total Expenses	222.5 mil	232.9 mil
3.5%	7.8 mil	8.2 mil
Overall materiality value	7.8 mil	8.2 mil

(Source: author's own calculations)

As observed, in both companies' cases, the selection of the suggested benchmark is based on the relevance for the users of financial statements. In the case of the second company, the sole user is the mother company and considering that the company is a cost center, the most relevant benchmark is represented by the total expenses. On the contrary, the auto batteries producer company has a different purpose and KPIs; therefore, a benchmark such as total expenses would be not relevant for this client; hence, a suitable combination of the benchmarks PBT and Net income is more appropriate.

6. Conclusions

The aim of this paper is to assess the benchmark selection for the materiality level computation based on the auditee's specifics. In this regard, an analysis of two entities that operate in different fields, have different business goals and are of interest for different categories of stakeholders was conducted.

Based on the overall business understanding of the selected companies, one providing transport services and the other one that is an auto batteries producer, a benchmark that is the most significant to the users of the entity's financial statements was selected. In the case of "SC Auto Batteries SRL", the suggested relevant benchmark was a blend between total revenue and profit before tax based on the entity's focus and key performance indicators.

This decision was back-up taking into account that the entity's objective is to increase market share while enhancing profitability, but also due to the fact that over the prior analysed period, the company increased both financial statements line items mainly due to favourable market conditions like raw material prices.

As far as the rule of thumb is concerned, half of the 2.5% out of Net Income and half of 9.5% PBT were used for the overall materiality computation as the entity is not listed on a stock exchange. The applicable percentage range suggested by the literature is higher than in the case of a listed company; also, the audit risk is set at a low level, no significant prior year

adjustments were identified, and the categories and number of users of the financial statements are limited.

In the case of "SC Transport SRL", the situation was quite different, the company is considered a cost centre, obtaining 90% out of its total revenue based on the services rendered for the parent company. Therefore, the business model on which the company operates is cost plus a mark-up. Under these circumstances, the suggested benchmark was Total Expenses.

In addition, the rationale for selecting the rule of thumb of 3.5% out of the Total Expenses is the fact that distribution and the use of the financial statements are limited to few users: the primary user is the parent company. Also, the entity has no loans or overdrafts, neither from banks nor from the group. There are many financial leasing contracts signed by "SC Transport SRL", but these financial leasing contracts do not have covenants attached. Moreover, no significant prior periods adjustments were identified, and the overall client risk is low.

In conclusion, it can be observed that without adequately understanding the business and implicitly the company's risks, the auditor cannot establish an appropriate benchmark for the materiality level computation.

When selecting the materiality computation method, the auditors should consider the fact that some industries are more volatile, unpredictable and unstable than others, but also that some companies have a particular seasonality, facts that should all be considered from the planning phase of the audit.

The topic proposed in this study is of interest not only to the users of the financial statements and implicitly audit reports but also to the practitioners who could benefit from a deeper understanding of the rationale behind the materiality level benchmark selection. Moreover, this paper also contributes and expands the materiality literature about underlying materiality judgment.

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