Materiality Uncertainty and Earnings Misstatement

Abstract

The concept of materiality provides a basis for auditors to ignore small misstatements, but the definition of small in this context is ambiguous. The issue of “materiality-standard-setting” has been raised recently by Arthur Levitt of the Security and Exchange Commission. We examine how materiality uncertainty affects the auditor’s evaluation of (or report on) the audit evidence and a manager’s choice of earnings overstatement in a strategic auditing model where earnings misstatements also include random error. We find that an uncertain materiality threshold, when compared to a (well-defined) materiality standard, results in a more conservative auditor evaluation of the audit evidence and a decrease in the amount of intentional overstatement. While materiality uncertainty provides leeway in the interpretation of materiality, it also increases the range of possible material misstatements, which in turn increases the auditor’s expected cost of an undetected material misstatement. This causes the auditor to behave more conservatively that concurrently influences the manager to reduce the amount of earnings overstatement.