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The association between European materiality estimates and client integrity, national culture, and litigation☆

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Abstract

The research examines the differences in materiality estimates for a sample of 181 experienced auditors from Big-Six firms located in Denmark, Ireland, Italy, Spain, Sweden, The Netherlands, and the UK. We asked each auditor to estimate materiality for a client whose integrity his/her firm rated as either high or low [Ir. Account. Rev. 1 (1994) 1.]. The research found that low client-integrity ratings resulted in lower materiality estimates for the European auditors. The research also indicates that as the cultural construct of Uncertainty Avoidance [Hofstede, G. (1980). *Culture's consequences*. Beverly Hills: Sage.] increased, materiality estimates also increased. Although one might have anticipated that materiality would decrease with the level of litigation, it, in fact, increased. We also compared the data from the western European countries with the estimates from a group of 83 auditors from the same Big-Six firms located in the United States.[1] © 2001 University of Illinois. All rights reserved.

Keywords: Materiality; Client integrity; Culture; Litigation

1. Introduction

The Accountants International Study Group (1974) compared the existent practices and examined materiality concerns in financial reporting. The report not only enumerated the arguments in favor of setting materiality guidelines (par. 28) but also the arguments against

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[1] Since the data were gathered, the Big-Six firms have become the Big-Five firms.

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the prescription of guidelines on materiality (par. 29). The International Accounting Standards Committee (IASC) endeavored to create a set of standards that will lead to "the improvement and harmonization of regulations, accounting standards and procedures relating to the presentation of financial statements" (IASC, 1999a). Another possibility is mutual recognition. Unlike harmonization, mutual recognition does not require a country to change its rules. Rather, each country agrees to accept the accounting rules and regulations of other countries. However, before a country adopts a policy of mutual recognition, it should be confident that, even though specific audit procedures may vary, the level of audit precision is constant between the two countries. Consequently, culture (Hofstede, 1980, 1991) might influence an auditor's decision-making process and thus influence materiality estimates.

To date, there is no empirical evidence to support the premise that implementing international standards provides comparable statements of equal precision. This research examines the effects of client-integrity ratings (Bernardi & Arnold, 1994; Estes & Reames, 1988), culture (Hofstede, 1980, 1991), and the level of litigation within a country (Wingate, 1997) on materiality estimates from an international perspective. The research also compares the European materiality estimates with the estimates from a group of US auditors (Bernardi & Arnold, 1994). The European sample includes 181 auditors (25 partners, 67 senior managers, and 89 managers) with Big-Six auditing firms from Denmark, Ireland, Italy, The Netherlands, Spain, Sweden, and the UK. The US sample includes 83 auditors (31 senior managers and 52 managers) from Big-Six firms (Bernardi & Arnold, 1994). The research questionnaire (Appendix A) was developed with the assistance of representatives of Big-Six firms located in the United States; representatives of the European firms participating in this research validated the questionnaire.

2. Theory development

2.1. Overview

In selecting the countries to investigate auditors' determination of materiality, we carefully considered each country's accounting system and culture. A system of rules and regulations such as an accounting system does not develop in a vacuum. Rather, the system is the result of the interactions and compromises between various environmental factors. These factors include the type of economy, the stage of economic development, the nature and development of capital markets, the management and ownership of corporations, the main providers of corporate capital, the regulatory framework, and cultural attitudes (Radebaugh, 1975). There are several key differentiating factors that led to the selection of the western European countries in the sample. Of specific interest were the providers of corporate capital, type of tax system, legal systems, and legal and regulatory structure.

Historically, European countries have been financed primarily using debt or equity. For instance, German firms primarily use debt financing and firms in the UK use equity financing. This suggests different disclosure requirements because of creditors' and investors' ability to bargain for specific accounting disclosures. Nobes and Parker (1988) suggest

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