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Rikke Holmslykke Kristensen is a researcher at the Department of Entrepreneurship and Relationship Management at University of Southern Denmark, affiliated with the research group "Accounting and Auditing". She conducts research on auditing and auditors from a behavioural and institutional perspective. In her dissertation she demonstrates how auditors draw on different logics, especially those embedded in audit firms' manuals, when making materiality judgments. She obtained her MSc in Business Administration and Auditing from University of Southern Denmark and also holds a certificate as State-Authorised Auditor.



PhD Dissertation of

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### Auditors' Materiality Judgments — an Institutional Logics Perspective

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# Auditors' Materiality Judgments

## an Institutional Logics Perspective

'Materiality' is considered a key audit concept, both in theory and in practice. The concept is problematized by standard setters, regulation enforcers and legislators, who all express concern about differences in the perceived understanding of the concept between preparers, auditors and users of financial statements, and even between auditors themselves. This heterogeneity is supported by prior research. The overall objective of the dissertation is to open the 'black box' of auditors' materiality judgments, structured around the central research question: How do auditors make materiality judgments, and why are they heterogeneous?

The central theoretical field of the dissertation is materiality theory, whilst the theoretical lens, used methodologically to inform the field, is the theory of institutional logics. More specifically, how macro-level institutional logics influence the activation of knowledge in auditors' materiality judgments is analysed.

*Paper 1* provides an analysis of prior research within materiality judgments, and identifies the important quantitative and qualitative components of materiality judgments. The paper reveals that assessment of materiality is a complex judgment including a task, a person and interpersonal interactions in line with audit judgment and decision-making theory; despite prior research primarily treating assessment of materiality as an audit task, focusing on the quantitative element.

*Paper 2* focuses on how audit firms attempt to prime auditors' knowledge activation, in order to

reconcile professional, corporate and market logics, when they make materiality judgments. The paper illustrates how the audit manuals of audit firms prime auditors so that they respond to a certain stimulus event with a particular response; by listing different situations with appropriate responses. This is exemplified through a case study of the audit manuals of the Big-Four audit firms.

*Paper 3* centres its attention on how individual auditors conduct materiality judgments. The paper illustrates how the different steps in the materiality judgment process are shaped by macro-level institutional logics. Empirically, the paper contains a case study comprising 28 interviews with State-Authorised Auditors from the Big-Four audit firms.

By taking a holistic, original and deep look at auditors' materiality judgments, and by providing a deeper understanding of how these judgments are made, the dissertation opens up more of the 'black box' of auditors' materiality judgments and contributes to existing materiality and auditing theory. Three main contributions are made. First, this understanding reveals how attempts from the regulators to ensure that the quintessential characteristic of the audit profession, i.e. the ability to make mindful professional judgments with professional scepticism, can result in the opposite, i.e. a profession where compliance with rules, procedures and systems becomes so important that mindless judgment based on these systems are preferred, at the cost of mindful professional judgment.

Second, the dissertation provides evidence that all three theoretically-established institutional logics (professional, corporate and market logic) co-exist and interact in auditors' materiality judgments, although the professional and corporate logics are more dominant than the market logic. This might be part of the explanation for heterogeneous materiality judgments, since the outcome of the assessment will vary depending on the logic(s) used. Where an assessment based on a professional logic will emphasize the mindful use of professional judgment (the correct materiality level in relation to the public good), a corporate logic will emphasize mindless compliance with rules and the use of default choices (a materiality level based on the systems rules and regulations), and a market logic will emphasize profit-maximizing (in terms of as high a materiality level as possible).

Third, this study contributes by showing how the accessibility of certain benchmarks and percentages used in the materiality judgment can, through priming, be made extremely high. This can lead to auditors using these accessible benchmarks and percentages and suppressing other benchmarks or percentages that, based on the given situation, might be more applicable. As a result, a decoupling between the standards' demands for professional judgment and the actual materiality judgment is found.

## Department of Entrepreneurship and Relationship Management

The Department of Entrepreneurship and Relationship Management is mainly located at the University of Southern Denmark, campus Kolding, and employs approximately 85 people. This location is central to the growth centres within the Triangle Region and offers a unique opportunity to close cooperation with the companies and public authorities in the region in respect to research and educational projects.

For several years the research of the department has been based on learning networks with companies and trade promotion institutions. In addition to this, the department has a long tradition of problem-based cooperation across traditional business research areas and very often by means of external funding. The research of the department concentrates on two key areas: entrepreneurship and relationship management and originates from traditional research areas such as marketing, applied economics, accounting, operations management and organization.

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