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Materiality Thresholds in Maltese External Auditing: An Analysis

Peter J. Baldacchino[1], Matthew Pisani[1], Lauren Ellul[1], Norbert Tabone[1], Simon Grima[2,3*]

[1] Department of Accountancy, Faculty of Economics, Management and Accountancy, University of Malta, MSD2080 Msida, Malta
[2] Department of Insurance and Risk Management, Faculty of Economics, Management and Accountancy, University of Malta, MSD2080 Msida, Malta
[3] Faculty of Economics and Social Sciences, University of Latvia, LV-1050 Riga, Latvia

*Correspondence: Simon Grima (simon.grima@um.edu.mt)

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Abstract: The objectives of this study are to (i) ascertain the major quantitative and qualitative factors influencing the determination of materiality thresholds in the private sector external audits performed by large and medium-sized Maltese audit firms, (ii) assess the effectiveness of ISA 320 in the determination of such materiality thresholds, as well as the impact of introducing more prescriptive guidelines within the Standard, and (iii) assess the current level of professional judgement and its effectiveness in determining materiality thresholds, as well as ascertain the typical challenges involved in exercising such judgement. A predominantly qualitative mixed-methods approach was adopted. Semi-structured interviews were carried out with twelve audit partners from large and medium-sized Maltese audit firms. The findings indicated that the major quantitative factors influencing overall materiality were 5–10% of profit before tax and 1–3% of total revenue. The major quantitative factor influencing performance materiality and the clearly trivial threshold was 75% and 5% of overall materiality, respectively. Additionally, the major qualitative factors influencing materiality thresholds were fraud and litigation risk, quality of client internal controls, auditor critical thinking skills, client complexity, the client's sector and a change in auditor. Furthermore, the findings indicated that ISA 320 provided sufficient guidance for determining materiality thresholds. Moreover, the most cited benefit of introducing more prescriptive guidelines within the Standard was greater consistency among auditors, while the most cited drawback was the limitation on professional judgement. The findings also revealed that professional judgement was crucial and generally effective in determining materiality thresholds. However, auditors typically faced a few challenges when exercising such judgement, of which time pressure and the setting of appropriate thresholds are particularly significant.

Keywords: Materiality thresholds; ISA 320; Prescriptive guidelines; Professional judgement

JEL Classification: M42; M41; G38; D81; C83

1. Introduction

Materiality thresholds are numerical benchmarks used by auditors to identify misstatements that could affect financial statements. Setting these thresholds is a critical part of an audit, as they guide the auditor's judgement about what is considered significant (Bellandi, 2017; ICAEW, 2017).

According to ISA 320 *Materiality in Planning and Performing an Audit*, misstatements are material if they "*could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements*" (IAASB, 2009a). This means auditors must consider not only the size of a misstatement but also its nature, combining both quantitative and qualitative factors (Azzopardi & Baldacchino, 2009; Vorhies, 2005).

To apply materiality effectively, auditors set the following different thresholds during an audit:

1. Overall Materiality - The maximum misstatement that could reasonably influence users' decisions (IAASB, 2009a; ICAEW, 2017).

2. Performance Materiality - Set lower than overall materiality to reduce the risk that uncorrected or undetected misstatements together exceed the overall threshold (IAASB, 2009a).

3. Clearly Trivial Threshold - An amount below which misstatements are considered insignificant and need not be tracked (IAASB, 2009b).

Although materiality is central to auditing, little research to date has explored how thresholds are determined in private sector audits, even less so within the context of the small European island-state of Malta. Therefore, the objectives of this study are to: (i) ascertain the major quantitative and qualitative factors influencing the determination of materiality thresholds in the private sector external audits performed by large and medium-sized Maltese audit firms; (ii) assess the effectiveness of ISA 320 in the determination of such materiality thresholds, as well as the impact of introducing more prescriptive guidelines within the Standard, and (iii) assess the current level of professional judgement and its effectiveness in determining materiality thresholds, as well as ascertain the typical challenges involved in exercising such judgement.

The study intends to provide practical insights that help auditors establish more appropriate thresholds, while also pointing to possible improvements in ISA 320 and the role of professional judgement in Maltese auditing practices.

2. Literature Review

2.1 Major Factors Influencing Materiality Thresholds

2.1.1 Quantitative factors

Quantitative factors involve applying percentages to benchmarks such as profit before tax, total assets, and total revenue to determine overall materiality, performance materiality, and clearly trivial thresholds. Profit before tax is the most commonly used benchmark, followed by total assets, total revenue, and total equity (Choudhary et al., 2019; Costa, 2023; Eilifsen & Messier Jr, 2015; Quick et al., 2023). Benchmark choice depends on financial performance, user focus, entity nature, industry, stage of development, financing structure, and KPI relevance (IAASB, 2009a; ICAEW, 2017; Quick et al., 2023). Percentages applied follow common rules of thumb, e.g., 5–10% of profit before tax or 0.5–2% of total assets/revenue, with adjustments for client risk, industry, or financial statement use (Abilova, 2022; Steinbart, 1987).

Performance materiality typically ranges between 50–75% of overall materiality, occasionally up to 90%, influenced by prior misstatements, audit and fraud risk, staff turnover, and internal controls (Eilifsen & Messier Jr, 2015; IAASB, 2009a; Quick et al., 2023). Clearly trivial thresholds commonly range between 2–5% of overall materiality, influenced by prior misstatement history (ICAEW, 2017; Quick et al., 2023).

2.1.2 Qualitative factors

Auditors adjust preliminary thresholds based on qualitative factors as summarized in Figure 1. As may be seen, complexity, internal control quality, audit firm size, accountability pressure, sector experience, client relationship longevity, financial performance, fraud/litigation risk, and reporting system quality all influence thresholds (Blokdijk et al., 2003; Choudhary et al., 2019; Emil Popa et al., 2013). Auditor experience, rule observance, critical thinking and audit committee independence also play important roles (Abilova, 2022; Hasan et al., 2021). Contrary to expectation, new auditors sometimes set higher thresholds to reduce workload (Costa, 2023).

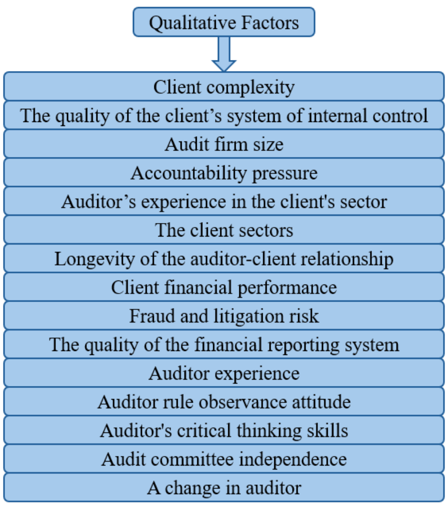

Figure 1. Major qualitative factors influencing materiality thresholds

2.2 Effectiveness of ISA 320 and Prescriptive Guidelines

2.2.1 Effectiveness of ISA 320

Although ISA 320 provides guidance, it largely relies on professional judgement and lacks specific rules, leading to perceived vagueness and inconsistent application, including in Malta (Abilova, 2022; Azzopardi & Baldacchino, 2009; Emil Popa et al., 2013).

2.2.2 Benefits of prescriptive guidelines

Clear guidelines could enhance comparability, consistency, transparency, and attention to qualitative factors (Azad et al., 2021; de Rooij, 2009; Hegazy & Salama, 2022; Ng & Tan, 2007). They would also strengthen consistency, both within firms (over time and across audit teams) and between firms, reducing the risk of subjective or arbitrary judgments.

2.2.3 Drawbacks of prescriptive guidelines

However, prescriptive rules may fail to address diverse entities and complex transactions, reduce auditor discretion, and promote mechanical processes (Abilova, 2022; Azzopardi & Baldacchino, 2009; Gao & Zhang, 2019). Such rigidity could reduce auditor discretion, potentially discouraging the exercise of professional skepticism and the consideration of entity-specific circumstances. In turn, this may lead to a reliance on mechanical, checklist-driven processes, where auditors focus narrowly on compliance with the rules rather than applying a principles-based evaluation of materiality.

2.3 Role of Professional Judgement

2.3.1 Importance

Professional judgement is essential owing to professional guidance being limited. It influences benchmark selection, percentages for overall and performance materiality, and clearly trivial thresholds (Abilova, 2022; Bagshaw & Selwood, 2014; IAASB, 2009a).

2.3.2 Challenges

Judgement quality is affected by external factors like time pressure and limited resources, and internal factors such as 'rush to solve' or reliance on shortcuts, potentially introducing bias (Bettinghaus et al., 2014; Fay & Montague, 2015; Glover et al., 2011).

3. Research Methodology

3.1 The Theoretical Framework

The theoretical framework employed for this study was the Agency Theory. Owing to potential conflicts of interest between the Board *(agents)* and the shareholders *(principals)*, the latter appoint external auditors to carry out the process of monitoring the activities of the former. With such a process, the principals become more confident that the information reported to them by the agents through the financial statements is fairly presented and free from material misstatements. The audit process hinges on the determination of materiality thresholds, which establish whether a misstatement or omission by the agents is significant enough to affect the stakeholders' decisions, particularly those of the principals.

3.2 The Research Tool

3.2.1 Semi-structured interviewing

Semi-structured interviews, including both open-ended and closed-ended questions, were deemed to be the most appropriate research tool for achieving the research objectives of this study. Such interviews were conducted by following a detailed interview schedule in order to ensure that these objectives are attained (Adams, 2015). The semi-structured design of the interviews provided the participants with flexibility to answer questions freely, which allowed them to provide detailed insights (McIntosh & Morse, 2015). Prompts and follow-up questions were also used to encourage participants to engage in further discussion or to elaborate on their responses (Roulston & Choi, 2018). Furthermore, the use of standardised questions facilitated the comparison and statistical analysis of the data collected (McIntosh & Morse, 2015).

3.2.2 Development of the interview schedule

The interview schedule developed for this study was applicable to audit partners from large and medium-sized Maltese audit firms. It comprised a combination of both open-ended and closed-ended questions. For the closed-ended questions, a five-point Likert scale was employed, with '0' corresponding to strongly disagree and '4' corresponding to strongly agree.

Furthermore, the interview schedule was divided into three main sections in line with the research objectives. The first section focused on the major quantitative and qualitative factors influencing the determination of materiality thresholds. The second section investigated the effectiveness of ISA 320 as a guidance tool and the impact of introducing more prescriptive guidelines within the Standard. The third section explored the role of professional judgement in determining materiality thresholds, as well as the typical challenges involved in exercising such judgement.

3.2.3 Addressing variability and bias

The inherent flexibility of the semi-structured questions posed a potential limitation, since this could have led to a degree of variability in the information collected. This was mitigated by ensuring that the same interviewer conducted all the interviews, whilst also using follow-up questions when deemed necessary. Moreover, the use of open-ended questions introduced the potential for researcher bias or varied interpretations. In order to address this limitation, the first two co-authors collaborated closely through thorough discussions to align their interpretations of the responses, thereby ensuring that the analysis remained objective and data-driven.

3.3 The Sample Population

The research participants of this study consisted of audit partners from Maltese audit firms. The list of such firms was obtained from the website of the Maltese accountancy regulator, namely the Accountancy Board website. The sampling technique used in this study was purposive sampling, whereby audit firms were purposively selected to be interviewed. For the purpose of this study, all the Big-Four firms as well as other large and medium-sized audit firms were selected.

A total of twelve interviews were conducted. After the final interview took place, it became evident that qualitative saturation had been reached. This saturation was established by concluding the interview process at the point where the data collected was no longer providing additional insights or revealing new themes, indicating that further interviews would be unnecessary. Criteria included the level of understanding obtained, the relative simplicity of the research topic, the consistency of responses, and the study's main objectives. The researchers also assessed whether the research objectives had been fully attained. Such saturation was continuously monitored throughout the data collection process.

3.4 Data Analysis

Each interview was promptly transcribed to maximise the effectiveness of the interviews conducted. These transcripts, along with the notes taken during the interviews, enhanced the data analysis. Qualitative data was obtained from the open-ended questions and the comments added by respondents when providing their ratings in the Likert scale questions. In order to facilitate thematic analysis, a summary for each transcript was prepared and mapped out in a spreadsheet. This enabled the comparison of the different responses and the identification of the emerging themes (Braun & Clarke, 2012).

Quantitative data was obtained from the closed-ended questions, primarily through the use of the Likert scale ratings. The Friedman Test was used to compare the mean rating scores assigned to the major qualitative factors influencing materiality thresholds, and to determine whether such scores varied significantly.

3.5 Other Limitations of the Study

Despite substantial efforts to conduct a thorough analysis of the research topic, the study still faces certain limitations. Participants' responses inevitably reflected a degree of subjectivity, and on a few occasions, participants did not answer all questions. The study reflects relevant studies and developments from local and foreign sources up to 31st March 2025.

Furthermore, the main limitations of this study, specifically the potential for researcher bias and variability, and the purposively small sample size, have already been noted. However, it is important to elaborate further on these two limitations:

3.5.1 Researcher bias and variability

Although safeguards were implemented as outlined in Section 3.2.3, some degree of researcher bias and variability may still have influenced the study's design, data collection, analysis or interpretation. As a result, the findings might reflect the researchers' expectations rather than the objective reality. Despite efforts to mitigate this bias, it cannot be completely ruled out, which may subtly distort the findings.

3.5.2 Small sample size

The sample size reduces the study's statistical power, which makes it more challenging to identify meaningful effects and increases the likelihood that the results could be influenced by random variation. This limitation also impacts the findings' generalizability, since a smaller sample may not truly represent the larger population. As a result, although the findings provide insightful information, they should be interpreted cautiously since they may not be relevant in all contexts. Future research with larger sample sizes would be beneficial for verifying these findings and enhancing their generalizability.

4. Findings

4.1 Major Factors Influencing Materiality Thresholds

The first section of the interview schedule consisted of nine questions relating to major factors influencing materiality thresholds.

4.1.1 Quantitative factors

(i) Overall materiality: The first question was divided into five parts and related to overall materiality, which is determined by the application of a percentage to a selected benchmark.

(ii) Examples of commonly used benchmarks: In the first part of the question, respondents were asked to provide some examples of commonly used benchmarks and specify the circumstances in which they apply. In line with the findings of Azzopardi & Baldacchino (2009), they provided the following three benchmarks:

(a) Profit before tax: Consistent with Choudhary et al. (2019) and IAASB (2009a), respondents (12/12) agreed that this benchmark is typically used for profit-oriented operating entities. Furthermore, some respondents (4/12) noted that it is also used for entities where the users of the financial statements focus on earnings.

(b) Total revenue: Respondents (12/12) agreed that this benchmark is often used for revenue-driven operating entities.

(c) Total assets: Respondents (12/12) agreed that this benchmark is often used for asset-driven entities, such as investment companies, holding companies and real estate companies.

(iii) The top benchmarks: In the second part of the question, respondents were requested to rank in descending order the benchmarks most commonly used. One respondent (1/12) was unable to rank the benchmarks used. Most of the other respondents (6/11) reported profit before tax as the most commonly used benchmark, this being in line with the literature. Furthermore, contrary to the findings of Quick et al. (2023) and Costa (2023), most respondents (7/11) stated that total revenue is the second most commonly used benchmark. With respect to the third most commonly used benchmark, there was no clear favorite among respondents, with the majority citing total assets (3/11), profit before tax (3/11) and net assets (3/11).

(iv) Factors influencing the selection of a benchmark: The third part of the question asked respondents to outline the factors they consider in selecting an appropriate benchmark. In line with Quick et al. (2023), Bellandi (2017) and IAASB (2009a), one predominant factor is the nature of the entity, including the industry in which the entity operates (12/12). Closely linked to this factor, some respondents (5/12) mentioned that the entity's main driver (3/5) and its KPIs (2/5) also influence the benchmark selection, this being in line with Quick et al. (2023) and Abilova (2022).

In conformance with Bellandi (2017) and IAASB (2009a), another important factor is the primary area of focus for the users of the financial statements (7/12). Furthermore, two respondents (2/12) noted that the volatility of financial statement measures influences the benchmark selection, this being in line with Quick et al. (2023) and IAASB (2009a).

(v) Commonly used rules of thumb: In the fourth part of the question, respondents were requested to provide a few examples of rules of thumb typically used and indicate which one is the most commonly applied. With respect to profit before tax, the majority (8/12) agreed on a range of 5–10%, this being in line with the findings of Abilova (2022), Eilifsen & Messier Jr (2015), and Azzopardi & Baldacchino (2009). As for total revenue, almost half of the respondents (5/12) reported a range of 1–3%. In terms of total assets, two notable ranges emerged from the responses, specifically 1–3% (4/12) and 1–2% (4/12). The reported ranges for both total revenue and total assets are somewhat consistent with the findings of Abilova (2022), Eilifsen & Messier Jr (2015), and Azzopardi & Baldacchino (2009), who found that the typical range applied to both benchmarks is 0.5–2%.

With regard to the most commonly applied rule of thumb, one respondent (1/12) argued that it depends on the circumstances of the audit and was therefore unable to specify a particular rule of thumb. However, in line with Azzopardi & Baldacchino (2009), most of the other respondents (6/11) indicated that the rule of thumb most commonly applied is that of profit before tax.

(vi) Factors influencing the determination of a percentage: In the last part of the question, respondents were asked to outline the factors they consider in determining the specific percentage to be applied to the selected benchmark. One respondent (1/12) did not provide any factors since the respective audit firm's methodology establishes the specific percentage, depending on the entity being audited. However, the other respondents (11/12) provided the following major factors:

(a) Assessed risk: Consistent with Abilova (2022), one important factor is the assessed risk of the entity (6/11), whereby if an entity is considered to be of high risk, a percentage closer to the lower end of the range would be more appropriate.

(b) Public Interest Entity (PIE) client: In line with Abilova (2022), another important factor is whether the client is a PIE (6/11). In such cases, a lower percentage would be applied since the financial statements of PIEs are made available to "a wider range of people" and therefore, the impact on society would be more significant compared to non-PIEs.

(c) Number of users: Closely linked to the previous factor is the number of users of the entity's financial statements (4/11), whereby if multiple users are interested in the entity's financial statements, the impact of potential misstatements would be more significant and therefore, a lower percentage would be more appropriate in such case.

(d) History with the client: In conformance with Steinbart (1987), another key factor is the history with the client (4/11), whereby if it is a first-year audit, a lower percentage would be more appropriate. This is because, typically, the auditor would not have a full understanding of the client, and therefore, a more conservative approach is often adopted in the first year to obtain an understanding of the client and mitigate any potentially high risks.

4.1.2 Performance materiality

The next question was divided into two parts and focused on performance materiality, which is expressed as a percentage of overall materiality.

(i) Commonly applied percentages: In the first part of the question, respondents were requested to indicate the percentage range typically applied to determine this threshold, as well as the specific percentage most commonly used. One respondent (1/12) did not provide a percentage range as the respective audit firm's methodology establishes the specific percentage to be applied, depending on the circumstances of the audit. As for the other respondents, the reported percentage ranges varied, thereby indicating that a commonly applied range does not exist. In fact, the variations in ranges were as follows: 50–75% (2/11), 50–90% (2/11), 65–85% (2/11), 50–80% (1/11), 50%–85% (1/11), 60–90% (1/11), 65–80% (1/11), and 70–90% (1/11).

These ranges are somewhat consistent with those found in previous international studies. With regard to the specific percentage most commonly applied, almost all respondents (11/12) cited *75%*, this being in line with the findings of Abilova (2022) and Choudhary et al. (2022).

(ii) Factors influencing the determination of a percentage: In the second part of the question, respondents were asked to indicate the factors they consider in determining the percentage to be applied. The respondent (1/12) identified in the first part of this question did not provide any factors for the same reason mentioned earlier. In line with IAASB (2009a), two factors outlined earlier in relation to overall materiality, namely the assessed risk of the entity (6/11) and the history with the client (4/11), are also influential with respect to performance materiality. In addition to these factors, respondents (11/12) provided the following major factors:

(a) History of misstatements: In line with IAASB (2009a), one predominant factor is the entity's history of misstatements (9/11), whereby if an entity has a history of a significant number of misstatements identified in previous audits, it would be more appropriate to apply a percentage closer to the lower end of the range.

(b) Expected level of misstatements: The expected level of misstatements identified during the audit (4/11) also influences the percentage to be applied, whereby if it is expected that a significant number of misstatements will be identified during the audit, it would be more appropriate to apply a lower percentage.

(c) Internal control environment: Similar to Eilifsen & Messier Jr (2015), the percentage to be applied is also influenced by the internal control environment of the entity (4/11), whereby the more robust the control environment and the more effective the internal controls, the lower the risk and therefore, a higher percentage may be applied.

(d) Competency of the finance team: According to two respondents (2/11), another factor is the competency of the finance team, whereby if an entity has a "highly experienced and competent finance team", the risk of material misstatement ("RoMM") would be lower, and therefore, a higher percentage may be applied.

4.1.3 Clearly trivial threshold

The following question was divided into two parts and related to the clearly trivial threshold, which is expressed as a percentage of overall materiality.

(i) Commonly applied percentages: In the first part of the question, respondents were asked to indicate the percentage range typically applied to determine this threshold, as well as the specific percentage most commonly used. Most respondents (8/12) did not provide a range since they simply apply 5% of overall materiality as the clearly trivial threshold. Each of the remaining respondents (4/12) provided a different range, specifically 2–3% (1/4), 3–5% (1/4), 3–10% (1/4) and 5–10% (1/4). These ranges somewhat contrast with those found in previous international studies.

As for the specific percentage most commonly applied, the majority (10/12) cited 5%, this being in line with the findings of Quick et al. (2023) and Abilova (2022). The most commonly applied percentage of 5% indicates an increase on the 2% threshold typically applied in Malta in 2009, as found by Azzopardi & Baldacchino (2009).

(ii) Factors influencing the determination of a percentage: The second part of the question enquired about the factors considered in determining the percentage to be applied. All the respondents who did not provide a range (8/12) emphasized that there are no factors because their respective firm's methodology requires them to apply a standard 5%. Three respondents (3/8) added that any potential factors would have already been considered in determining performance materiality.

The other respondents (4/12) who provided a range outlined a number of factors influencing the percentage to be applied. One factor mentioned earlier in relation to overall materiality and performance materiality, namely the assessed risk of the entity (3/4), was also highlighted as a key factor with respect to the clearly trivial threshold. Similarly, one factor mentioned earlier in relation to performance materiality, namely the entity's history of misstatements (1/4), was also identified with respect to the clearly trivial threshold. This is line with ICAEW (2017) and Eilifsen & Messier Jr (2015).

4.1.4 Qualitative factors

The next question asked respondents to rate their level of agreement with ten statements relating to qualitative factors influencing materiality thresholds. Table 1 displays the mean rating scores obtained, in descending order of agreement. The qualitative factor most agreed to by respondents was fraud and litigation risk ($\bar{x}$ = 3.25), followed by the quality of client internal controls ($\bar{x}$ = 3.08), auditor critical thinking skills ($\bar{x}$ = 3.08) and client complexity ($\bar{x}$ = 3.00). Conversely, the least influential factor was audit firm size ($\bar{x}$ = 0.83), followed by the longevity of the relationship with the client ($\bar{x}$ = 1.58) and auditor experience in the client's sector ($\bar{x}$ = 1.67).

Table 1. Major qualitative factors influencing materiality thresholds

		Mean	**Std. Dev.**
j.	Fraud and litigation risk: The higher the fraud and litigation risk, the lower the materiality thresholds.	3.25	0.452
b.	Quality of client internal controls: The more robust the system of internal control, the higher the materiality thresholds set.	3.08	0.669
i.	Auditor critical thinking skills: Auditors with strong critical thinking skills tend to consider both quantitative and qualitative information. This results in the setting of more accurate thresholds.	3.08	0.793
a.	Client complexity: The more complex the client, the lower the materiality thresholds set.	3.00	1.279
d.	Accountability pressure: As accountability pressure increases, auditors tend to become more cautious and sensitive to the risks involved in the specific circumstances of the audit. This leads to lower materiality thresholds.	2.58	1.084
h.	Auditor rule observance attitude: Auditors with a high rule observance attitude tend to place more emphasis on quantitative rather than qualitative aspects. This leads to the setting of less accurate materiality thresholds.	2.58	0.669
g.	Auditor experience: Auditors with extensive experience tend to set more precise materiality thresholds.	2.50	1.000
e.	Auditor experience in the client's sector: As auditors gain experience in a particular sector, they become better equipped to identify and address sensitive areas. This enables them to set higher materiality thresholds.	1.67	0.888
f.	Longevity of relationship with client: As the longevity of the auditor-client relationship increases, auditors set higher materiality thresholds.	1.58	0.996
c.	Audit firm size: Large audit firms typically set higher materiality thresholds than smaller audit firms.	0.83	1.030
	Scale from 0 (Strongly disagree) to 4 (Strongly agree) Number of respondents = 12	X^2 (9) = 50.261, $p <$ 0.001	

4.1.5 The client's sector

Subsequently, respondents were asked whether the sector in which the client operates influences materiality thresholds. In line with Emil Popa et al. (2013), respondents (12/12) answered in the affirmative. While the majority (9/12) argued that the sector influences both the selected benchmark and the applied percentage, a few (3/12) noted that it only influences the benchmark.

Most respondents (9/12) argued that certain sectors are riskier than others and that, as a result, lower thresholds should be applied in such cases. For example, a few respondents (3/9) highlighted that the gaming industry is considered to be riskier than other sectors.

4.1.6 Client financial performance

In the following question, respondents were asked whether a stronger client financial performance leads to higher materiality thresholds. Contrary to Choudhary et al. (2019), respondents (12/12) emphasized that, when determining materiality thresholds, the factors mentioned earlier, rather than client performance, should be taken into consideration. One respondent (1/12) noted that a stronger client financial performance *"could be indicative of potential fraud or errors"*.

4.1.7 Financial reporting system

The next question asked respondents whether a higher quality financial reporting system leads to higher materiality thresholds. The majority (9/12) agreed with this view, thereby being in line with Choudhary et al. (2019). Most of these respondents (5/9) explained that if a higher quality financial reporting system has sufficient internal controls within it, which are reliable and operating effectively, it will lead to higher thresholds.

4.1.8 Audit committee independence

Respondents were then asked whether a higher level of audit committee independence leads to higher materiality thresholds. Most respondents (7/12) agreed, with five such respondents (5/7) emphasizing that it is linked to the internal control environment. They argued that, if the presence of an audit committee, enhanced by its independence, leads to a stronger internal control environment, owing to better controls in place, this will result in higher thresholds.

Conversely, five respondents (5/12) disagreed, providing a number of reasons. For instance, two respondents (2/5) remarked that, rather than audit committee independence, they consider the *"strength of its oversight*" over the financial reporting of the company.

4.1.9 Change in auditor

The next question focused on whether a change in auditor leads to lower materiality thresholds. Almost all respondents (11/12) agreed that a higher risk is associated with a first-year audit since the auditor lacks sufficient knowledge of the entity. They further noted that, in the first year, the auditor should apply lower thresholds to gain a comprehensive understanding of the entity.

4.2 The Effectiveness of ISA 320 and the Impact of Prescriptive Guidelines

The second section of the interview schedule consisted of nine questions relating to the effectiveness of ISA 320 and the impact of prescriptive guidelines. One respondent (1/12) was unable to answer these questions owing to limited knowledge of ISA 320, stemming from the reliance on the respective firm's methodology.

4.2.1 The effectiveness of ISA 320 as a materiality guidance tool

(i) Adequacy of ISA 320 Guidance: The first question asked respondents whether ISA 320 provides sufficient guidance in determining appropriate materiality thresholds. Most respondents (7/11) answered in the affirmative, with five of these respondents (5/7) highlighting its value in outlining key considerations while allowing sufficient room for professional judgement. They added that this flexibility is beneficial since a "one size fits all" approach is not practicable.

Furthermore, three respondents (3/11) noted that the Standard provides concepts rather than prescriptive guidance. They also remarked that, while ISA 320 does provide adequate guidance, it could offer more examples and detailed guidance. On the other hand, one respondent (1/11) argued that ISA 320 does not provide sufficient guidance since there are many judgmental areas.

(ii) ISA 320 flexibility: Respondents were subsequently asked whether ISA 320 allows for sufficient flexibility to account for the unique characteristics of different audited entities. Respondents (11/11) agreed that the Standard provides sufficient flexibility, with most respondents (9/11) citing the fact that it is "more principles-based" rather than rules-based and is therefore less prescriptive. Two respondents (2/11) noted that, since ISA 320 leaves significant room for professional judgement, it allows auditors to adjust materiality thresholds, depending on the client being audited.

(iii) Adequacy of ISA 320 guidance on the selection of a benchmark: The following question asked respondents whether ISA 320 provides adequate guidance on how to select the most appropriate benchmark for different types of entities. Most respondents (7/11) answered in the affirmative, stating that the Standard outlines some key factors and also provides a few examples of benchmarks which may be appropriate for certain types of entities. However, some of these respondents (5/7) remarked that additional illustrative examples would be beneficial.

On the other hand, four respondents (4/11) emphasized that the Standard lacks sufficient guidance on the selection of an appropriate benchmark. Half of these respondents (2/4) argued that, although professional judgement is important, more prescriptive guidance is required *"to allow for a clearer direction"*.

(iv) Adequacy of ISA 320 guidance on performance materiality: The next question focused on whether ISA 320 provides adequate guidance on the concept of performance materiality. Respondents (11/11) agreed that the

Standard clearly explains the nature and scope of performance materiality, and outlines some key factors However, most respondents (8/11) argued that ISA 320 does not provide adequate guidance on the determination of such threshold since it does not indicate which percentages may be appropriate in specific circumstances.

(v) Unclear or challenging areas within ISA 320: In the next question, respondents were asked whether there are any areas in ISA 320 which are unclear or challenging. The majority (6/11) agreed that there are no such areas. Most of these respondents (4/6) explained that the main reason for this is that there will always be "some grey areas", and therefore, materiality is ultimately based on the auditor's professional judgement.

Conversely, the other respondents (5/11) indicated that some areas of ISA 320 are unclear. One respondent (1/5) highlighted that, with respect to both overall materiality and performance materiality, the Standard does not provide specific percentage ranges which may be applied. Furthermore, according to one respondent (1/5), ISA 320 does not specify which benchmarks are inappropriate for certain circumstances. Another respondent (1/5) remarked that it does not outline sufficient qualitative factors of the entity which should be considered in determining performance materiality. Interestingly, one respondent (1/5) pointed out that *"almost the whole Standard"* is somewhat unclear and lacks the required level of detail. Another respondent (1/5) noted that ISA 320 does not provide specific guidance, such as client-specific and industry-specific guidance.

(vi) ISA 320 as a better guidance tool: Respondents were then asked how ISA 320 can be revised to become a better guidance tool. Three respondents (3/11) emphasized that, in general, it should provide more detailed and specific guidance, as well as additional examples. Another three respondents (3/11) recommended that ISA 320 should outline additional factors to be considered when determining materiality thresholds. Furthermore, one of these three respondents (1/3), along with another respondent (1/11), advised that ISA 320 should indicate specific percentage ranges which may be applied in determining materiality thresholds.

On the contrary, four respondents (4/11) stated that, overall, the Standard is quite clear. Most of these respondents (3/4) pointed out that improving ISA 320 as a guidance tool is challenging because, ultimately, an element of judgement must always be present.

(vii) The need for more prescriptive guidelines within ISA 320: The next question asked respondents for their views on whether ISA 320 should be more prescriptive. The majority (6/11) agreed that the Standard should not be more prescriptive since materiality is a matter of professional judgement and varies from one company to another. However, half of these respondents (3/6) noted that it could provide additional examples and typical case scenarios. Conversely, the other respondents (5/11) argued that ISA 320 should be slightly more prescriptive to provide better guidance, while still allowing sufficient room for professional judgement.

4.2.2 Benefits of prescriptive guidelines

The following question enquired about the benefits of introducing more prescriptive guidelines in ISA 320. In line with Hegazy & Salama (2022), almost all respondents (10/11) agreed that the most important benefit would be greater consistency among auditors. Similar to Azad et al. (2021) and de Rooij (2009), four of these respondents (4/10) further stated that this consistency would enhance the comparability of financial statements since auditors would assess material misstatements uniformly.

In line with de Rooij (2009), most respondents (7/11) also highlighted that an important benefit would be clearer and more detailed guidance, which would lead to a better understanding of the determination of materiality thresholds. According to four respondents (4/11), prescriptive guidelines would help ensure that auditors consider factors that might be overlooked, thus echoing Ng & Tan (2007).

4.2.3 Drawbacks of prescriptive guidelines

The next question enquired about the drawbacks of introducing more prescriptive guidelines in ISA 320. Consistent with Gao & Zhang (2019) and Azzopardi & Baldacchino (2009), most respondents (10/11) noted that the major drawback would be the limitation on the auditor's discretion to exercise professional judgement, thereby leading to a "*tick the box exercise*".

Additionally, similar to Abilova (2022), Azzopardi & Baldacchino (2009) and Vadivel (2004) cited in Aqel (2011), some respondents (5/11) emphasized that the introduction of more prescriptive guidelines would probably lead to inappropriate materiality thresholds since it would be difficult to address all the situations that auditors encounter.

4.3 The Role of Professional Judgement and its Challenges

The final section of the interview schedule consisted of five questions relating to the role of professional judgement and its challenges.

4.3.1 The role of professional judgement in setting materiality thresholds

The first question was divided into two parts and related to the view that the determination of materiality thresholds is a matter of professional judgment.

(i) Professional judgement in determining materiality thresholds: The first part of the question asked respondents to what extent they considered the determination of materiality thresholds to be a matter of professional judgement, rather than one of compliance with authoritative guidelines. Respondents (12/12) agreed that professional judgement plays a crucial role in determining materiality thresholds.

Similar to Abilova (2022), IAASB (2009a) and Pinsker et al. (2006), most respondents (9/12) argued that, since the circumstances of the audit vary, auditors must always exercise professional judgement to determine what is most appropriate in each case, keeping in mind the needs of the users. Furthermore, in line with Abilova (2022) and Chewning Jr & Higgs (2002), the other respondents (3/12) emphasized that, professional judgement must be applied since the guidelines are not prescriptive.

(ii) The impact of limited guidance on professional judgement: In the second part of the question, respondents were asked whether the currently limited authoritative guidance is the major driver behind professional judgement's crucial role. Most respondents (8/12) disagreed, emphasizing that professional judgement is crucial since materiality thresholds are established on a case-by-case basis.

Half of these respondents (4/8) added that professional judgement *"must always be applied"* since, in certain cases, failure to do so might lead to inappropriate materiality thresholds. On the contrary, the other respondents (4/12) argued that while an element of professional judgement must always be applied, the limited authoritative guidance contributes significantly towards professional judgement's prominent role.

4.3.2 Main areas of professional judgement

The next question asked respondents whether there are specific areas wherein they primarily exercise professional judgement when determining materiality thresholds. In line with Abilova (2022), Bellandi (2017) and IAASB (2009a), almost all respondents (11/12) agreed that professional judgement is primarily exercised when determining the percentages to be applied, with regard to both overall materiality and performance materiality.

Furthermore, consistent with Bagshaw & Selwood (2014) and Emil Popa et al. (2013), some of these respondents (5/11) stated that professional judgement is also exercised when selecting the benchmark to be used.

The effectiveness of professional judgement: The following question asked respondents whether, in their opinion, the current level of professional judgement is effective to determine appropriate materiality thresholds. Respondents (12/12) answered in the affirmative, stating that auditors are highly-trained professionals operating in a regulated profession. One respondent (1/12) specifically highlighted that auditors are required to reassess materiality thresholds throughout the audit process, thereby ensuring that such thresholds are set appropriately.

4.3.3 The challenges involved in exercising professional judgement

The final question asked respondents whether they face any typical challenges when exercising professional judgement. Half the respondents (6/12) agreed that one such challenge is setting appropriate materiality thresholds since failure to do so could lead to the risk of *"not capturing misstatements"* or *"wasting time"* on areas which are not particularly risky. Two of these respondents (2/6) further stated that they reassess whether they applied the right judgement. Similarly, another two respondents (2/6) added that they ask themselves whether another auditor in the same situation would arrive at the same conclusion.

Furthermore, one respondent (1/12) highlighted that a typical challenge is that other parties, such as an *"engagement quality reviewer"* and *"an audit committee"*, might challenge the thresholds set, requiring auditors to justify their decisions. Another respondent (1/12) emphasized that a typical challenge is that auditors must obtain a *"good understanding of the client"* before they exercise professional judgement because if they *"do not have information"*, they cannot apply their judgement. Similarly, one respondent (1/12) noted that auditors might not always have the *"full picture".* A few of these respondents (2/9) remarked that another challenge is time pressure, although this is often mitigated. On the contrary, the remaining respondents (3/12) stated that they rarely face any challenges.

5. Discussion of Findings

5.1 Major Factors Influencing Materiality Thresholds

5.1.1 To what extent does audit committee independence lead to higher materiality thresholds?

In consistency with Abilova (2022) and Stewart & Munro (2007), the findings suggest that audit committee independence often leads to higher materiality thresholds. However, for this to occur, the audit committee must not only be formally independent, but it must also be sufficiently experienced and possess the necessary expertise to be in a position to provide effective oversight over the company's financial reporting and to continually enhance the entity's internal controls. Otherwise, auditors will still perceive the client as *'high risk'* and set lower materiality thresholds. Therefore, audit committee independence remains an *'indirectly influencing factor'* in the setting of such thresholds.

5.1.2 To what extent does a change in auditor result in lower materiality thresholds?

While Costa (2023) claimed that new auditors tend to set higher materiality thresholds, the findings reveal that such auditors typically set lower ones. Setting higher thresholds in the first year is unprofessional if, as Costa (2023) argued, this is done simply to reduce workload and subsequently meet reporting deadlines.

Additionally, if auditors set higher materiality thresholds in the first year without conducting an adequate assessment of the entity's risks, they would probably have to over-rely on management representations. In fact, the indications are that auditors tend to adopt a much more conservative approach in such year so as to be able to obtain a thorough understanding of the entity and mitigate any potentially high risks.

5.1.3 To what extent are other qualitative factors influential in determining materiality thresholds?

The findings indicate that, out of the ten other qualitative factors noted in the literature, seven of them influence materiality thresholds. The most important factor agreed to by respondents was fraud and litigation risk. One possible reason is that this risk significantly heightens the likelihood of misstatements and thus, auditors may set lower materiality thresholds to mitigate its potential impact on the financial statements.

The second important factor agreed to by respondents was the quality of client internal controls. Auditors typically view strong internal controls as an indicator of a lower RoMM. Furthermore, effective controls enable auditors to place greater reliance on them to prevent and detect errors or misstatements. As a result, auditors typically set higher materiality thresholds when the client's internal controls are robust.

The third important factor agreed to by respondents was auditor critical thinking skills. This may be because auditors who possess such skills are more likely to establish appropriate materiality thresholds.

The fourth important factor agreed to by respondents was client complexity. One possible reason is that complex organisational structures, operations and transactions typically indicate a higher RoMM. As a result, auditors may set lower materiality thresholds to thoroughly assess potentially risky areas and minimise the risk of overlooking material misstatements.

Contrary to the literature, the remaining three factors - namely accountability pressure, auditor rule observance attitude and auditor experience - were only marginally agreed to.

Furthermore, audit firm size, the longevity of the relationship with the client and auditor experience in the client's sector were not agreed to by respondents as being influential in Malta. One possible reason is that the determination of materiality thresholds is mainly influenced by the client-related factors referred to earlier.

5.2 The Effectiveness of ISA 320 and the Impact of Prescriptive Guidelines

5.2.1 Is the guidance provided by ISA 320 sufficient to determine appropriate materiality thresholds?

The findings reveal that ISA 320 provides adequate guidance on the determination of materiality thresholds, despite Abilova (2022), Emil Popa et al. (2013) and Aqel (2011) suggesting otherwise. While the guidance provided by the Standard is not prescriptive, this aligns with the profession's inherent reliance on professional judgement and is intentional to allow auditors the necessary flexibility to tailor such thresholds to the specific circumstances of each audit.

Overall, despite the concerns raised by literature, the Standard provides sufficient guidance. Particularly, it outlines clear principles on how to set the respective materiality thresholds, identifies some factors that should be considered and also offers relevant examples. However, as with any other standard or regulation, there is always some room for improvement, as will be discussed later.

5.2.2 Is adequate guidance on the selection of an appropriate benchmark provided by ISA 320?

The findings indicate that the Standard provides sufficient guidance to enable auditors to select a suitable benchmark for each audited entity. In contrast, as mentioned earlier, literature merely provides an overall view on the guidance offered by ISA 320, possibly implying that the Standard does not provide adequate guidance in this regard.

Given that the selection of a benchmark is inherently subjective, the flexibility within the Standard is beneficial since it allows auditors to exercise their professional judgement, while also avoiding imposed benchmarks which may not be appropriate for every entity. Furthermore, one may argue that ISA 320 provides adequate guidance on the selection of an appropriate benchmark since it outlines key factors, offers some examples of benchmarks and specifies the circumstances in which certain benchmarks may be appropriate. However, in line with the findings, additional illustrative examples of benchmarks that may be appropriate for specific types of entities would help to provide a clearer direction.

5.2.3 Which areas of ISA 320 are unclear or challenging?

Although, as discussed earlier, literature suggests that ISA 320 does not provide sufficient guidance, it does not specify which areas are unclear or challenging. On the other hand, the findings remain inconclusive since some respondents identified certain unclear areas, while others opined that no such areas exist.

Although it was noted earlier that, overall, ISA 320 provides sufficient guidance, a few areas of the Standard remain somewhat unclear. One such area is the determination of overall materiality. ISA 320 only provides examples of typical percentages applied for a few selected benchmarks, thus the commonly applied percentages for other benchmarks remain unclear. Furthermore, while it is understandable that the Standard seeks to allow room for professional judgement, ISA 320 does not specify the minimum and maximum percentage which may be applied to each benchmark. As a result, auditors remain uncertain about what constitutes an acceptable level of overall materiality.

Another area is the determination of performance materiality. In this regard, the Standard does not provide any examples of percentages that are typically applied. Therefore, ISA 320 lacks clarity on commonly applied percentages which may serve as guidance for auditors in determining an appropriate percentage based on the circumstances of the audit. Similar to overall materiality, the Standard does not indicate the minimum and maximum percentage which may be applied when determining performance materiality. As a result, auditors remain uncertain about what constitutes an acceptable level of performance materiality.

5.2.4 How may ISA 320 be improved to address such unclarities and challenges?

While, as mentioned earlier, literature suggests that ISA 320 does not provide adequate guidance, it does not specify how it may be improved to address any deficiencies. On the contrary, the findings indicate that the Standard may be improved, with such statement being backed by a number of recommendations based on practical issues faced by auditors.

Since, as highlighted earlier, a few areas of ISA 320 remain somewhat unclear, the effectiveness of the Standard as a guidance tool can therefore be enhanced in various ways. Overall, the Standard could provide additional examples, thereby offering clearer guidance and enabling auditors to make more informed decisions. With regard to all the respective materiality thresholds, the Standard could also outline additional factors that should be considered when determining the percentage to be applied.

With respect to overall materiality, ISA 320 could provide examples of typical percentages applied for a wider range of benchmarks. The Standard could also specify the percentage range applicable to each benchmark.

Furthermore, with respect to performance materiality, ISA 320 could provide examples of percentages that are commonly applied in specific circumstances. The Standard could also specify the percentage range applicable in determining performance materiality.

5.2.5 Should ISA 320 be more prescriptive in order to enhance its effectiveness?

As discussed earlier, literature notes that ISA 320 lacks specific and detailed guidance on how to determine materiality thresholds. This implies that the literature advocates for more prescriptive guidelines within the Standard. On the other hand, the findings remain inconclusive in this regard.

It is understandable that some auditors oppose the introduction of more prescriptive guidelines within ISA 320 on the basis that an important element of professional judgement must be retained when setting materiality thresholds. However, without going beyond reasonable limits, some form of additional prescriptive guidance is still required to reach a more balanced approach without sidelining professional judgement. This balanced approach would help towards achieving greater consistency among auditors while still maintaining sufficient flexibility to account for the specific circumstances of each audit.

5.3 The Role of Professional Judgement and its Challenges

5.3.1 Is the limited authoritative guidance a major reason that the determination of materiality thresholds remains mostly a matter of professional judgement?

Although Abilova (2022) and Chewning Jr & Higgs (2002) acknowledge the crucial role of professional judgment in determining materiality thresholds, they identify the currently limited authoritative guidance as the major driver behind this role. In contrast, the findings indicate that the determination of materiality thresholds remains mostly a matter of professional judgement, primarily since such thresholds must be established on a case-by-case basis.

As highlighted earlier, although the Standard provides adequate guidance overall, there are still certain areas which require slightly more prescriptive guidance. Therefore, the currently limited authoritative guidance contributes to professional judgement's prominent role to some extent. However, in line with the findings, the major driver is the need to tailor materiality thresholds to the specific entity being audited.

5.3.2 What significant challenges may arise when exercising professional judgement?

The findings and the literature refer to a few typical challenges faced by auditors when exercising professional judgement, two of which may be considered significant. One such challenge, identified in both the findings and previous studies conducted by Glover et al. (2011) and Maule & Edland (2002), is time pressure. The other challenge, identified only in the findings, is that of determining appropriate materiality thresholds.

Although only a few local auditors cited time pressure, it is likely to be a common issue internationally since all auditors must meet client deadlines. Mitigating this pressure is crucial since failure to do so may lower the quality of judgements made, ultimately leading to inappropriate materiality thresholds. In fact, the findings indicate that this pressure is often mitigated when it arises.

Furthermore, the determination of appropriate materiality thresholds was probably highlighted as an increasing challenge because auditors are becoming more aware of the importance of applying sound judgement. Mitigating this challenge is critical to avoid over-testing or under-testing. In fact, the indications are that auditors mitigate this challenge by reassessing their judgements and considering whether other auditors in the same situation would make similar judgements.

6. Conclusion

This study concludes that various quantitative and qualitative factors influence the determination of materiality thresholds. The first major quantitative factor influencing overall materiality is 5–10% of profit before tax, which is commonly applied for profit-oriented operating entities. The next major quantitative factor is 1–3% of total revenue, which is typically applied for revenue-driven operating entities.

With respect to performance materiality and the clearly trivial threshold, the study concludes that a major quantitative factor in the form of a commonly applied percentage range does not exist. However, a major quantitative factor in the form of a commonly applied percentage exists for both thresholds as follows: 75% of overall materiality with regard to performance materiality and 5% of overall materiality with respect to the clearly trivial threshold.

The study also concludes that one major qualitative factor influencing materiality thresholds is fraud and litigation risk, which typically leads to lower thresholds owing to the heightened RoMM. With respect to the quality of client internal controls, the presence of robust internal controls operating effectively often leads to higher materiality thresholds since such controls reduce the RoMM. Auditor critical thinking skills also influence materiality thresholds. However, these skills do not directly result in lower or higher thresholds. Rather, auditors with strong critical thinking skills tend to set more appropriate thresholds.

Furthermore, client complexity typically leads to lower thresholds since it presents a higher RoMM. As for the client's sector, whether it leads to higher or lower thresholds depends on the level of risk associated with the sector in which the client operates. Finally, a change in auditor often leads to lower thresholds in the first year due to the higher risk typically associated with a first-year audit. Additionally, the study concludes that audit firm size, the longevity of the relationship with the client and auditor experience in the client's sector are not influential factors in Malta.

With respect to the guidance provided by ISA 320, the study concludes that the Standard provides adequate guidance on the determination of materiality thresholds. This is because the Standard offers valuable insights into how the respective materiality thresholds should be established, while leaving the final determination of such thresholds to the auditor's professional judgement.

However, slightly clearer guidance is required with respect to overall materiality and performance materiality. Moreover, additional examples, both general and specifically related to the selection of an appropriate benchmark and the typical percentages applicable when determining performance materiality, would help provide better guidance.

With regard to the impact of introducing more prescriptive guidelines within the Standard, the study concludes that the major benefit would be greater consistency among auditors. Another significant benefit is that of having clearer and more detailed guidance, this ultimately resulting in a better understanding of how materiality thresholds are determined.

On the other hand, the major drawback is the limitation on the auditor's discretion to exercise professional judgement, this potentially leading to a *'tick-the-box exercise'*. Another significant drawback is that it is difficult for prescriptive guidelines to address all possible situations and therefore, such guidelines may ultimately lead to inappropriate materiality thresholds.

The study also concludes that auditors exercise significant professional judgement in determining materiality thresholds. This is owing to the fact that the circumstances of the audit vary and, as a result, auditors are required to exercise such judgement in order to determine what is most appropriate in each case.

Furthermore, the current level of professional judgement is considered to be effective in determining appropriate materiality thresholds since auditors are well-trained professionals who are also operating within a regulated profession. Nevertheless, auditors still face a few challenges when exercising professional judgement, such as setting appropriate materiality thresholds, justifying their decisions when challenged by other parties, obtaining a thorough understanding of the client and making sound judgements under time pressure.

Two of these challenges are particularly significant. One such significant challenge is that of setting appropriate materiality thresholds. This is because failure to apply the right judgement may lead to such thresholds being set inappropriately, this ultimately leading to ineffective audits. The other significant challenge is time pressure, whereby auditors may apply lower-quality judgements in order to complete audits on time and thus meet their deadlines. Therefore, auditors must be able to mitigate these challenges to ensure that the current level of professional judgement is effective in determining appropriate materiality thresholds.

In conclusion, the determination of materiality thresholds is central to the audit process since such thresholds influence the nature, timing and extent of audit procedures designed to detect potential material misstatements which could influence the economic decisions of the users of the financial statements. This study also highlights that the determination of materiality thresholds requires a balance between following the guidance provided by ISA 320 and exercising professional judgement. After all, as one respondent stated, *"determining materiality thresholds in an audit is like steering a ship: the compass provides the direction while the navigator's experience and judgement ensures that the journey is successful."*

Data Availability

The data used to support the research findings are available from the corresponding author upon request.

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Conflicts of Interest

The authors declare no conflict of interest.

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