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CHARLES EDMUND HINES, JR.

1979

AN INVESTIGATION OF THE MATERIALITY DECISIONS OF
FINANCIAL STATEMENT PREPARERS, AUDITORS, AND
USERS IN CERTAIN ILLEGAL PAYMENT CASES

By

Charles Edmund Hines, Jr.

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ABSTRACT

AN INVESTIGATION OF THE MATERIALITY DECISIONS OF FINANCIAL STATEMENT PREPARERS, AUDITORS, AND USERS IN CERTAIN ILLEGAL PAYMENT CASES

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Do financial statement preparers, auditors, and users have similar views of materiality in varying illegal payment cases? This research examines this question for four different types of illegal payment cases and for up to eight situations per case.

The research instrument is a questionnaire with thirty-one case-situation combinations (i.e., questions). An example of one case-situation is "An American corporation made illegal political contributions to U.S. politicians. Top management was aware of and participated in the payment program." The case is an "illegal domestic political contribution" and the situation is "the illegal payment was made with top management knowledge."

The questionnaire was sent to a random sample of three hundred members in each of the following groups: (1) financial statement preparers in Fortune magazine's one-thousand largest U.S. industrial firms (i.e., preparers); (2) partners in the fifteen largest U.S. CPA firms (i.e., auditors); and (3) U.S. Chartered Financial Analysts (i.e., users). Each respondent was asked to indicate his "opinion of what

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information about these payments is material and significant to financial statement users" by selecting a disclosure response.

Based on the analysis of thirty-one specific research hypotheses corresponding to the thirty-one questions, the researcher reaches the following general conclusions: preparers, auditors, and users do not have similar views of materiality in varying illegal payment cases. This conclusion is supported by the results of tests on twenty-seven out of thirty-one specific hypotheses. Further analysis results in the following general conclusions: (1) preparers and users do not have similar views of materiality in varying illegal payment cases; (2) auditors and users do not have similar views of materiality in varying illegal payment cases; and (3) auditors and preparers do have similar views of materiality in varying illegal payment cases, except commercial bribery cases.

In addition, this research examines the consistency of materiality decisions made by each group given similar situations and varying illegal payment cases. For example, do preparers have the same view of materiality in each illegal payment case given the situation of an "off-the-books" (i.e., unaccounted for) fund as the source of the payment? Analysis of the research results indicates that group members were often not consistent across payment cases given similar situations. The researcher's a priori expectation was that each group's members generally would be consistent when given similar situations across varying payment cases, and thus, the research results would provide a basis for generalizing materiality decisions for similar situations to other types of illegal payment cases. The research results

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indicate that there is no basis for such a generalization.

Because auditor and preparer views of materiality are different than user views of materiality, the researcher concludes that materiality guidelines should be established by an authoritative body such as the Financial Accounting Standards Board or the Securities and Exchange Commission. Suggestions for further research also are offered.

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CHAPTER 1

INTRODUCTION

This chapter presents the research problem and the purpose for the research. It also includes a discussion of the materiality issue and how ~~it~~ relates to illegal payments, as well as a summary of the general ~~hypotheses~~ and statistical methodology used in the research. There is a ~~concise~~ description of the content of subsequent chapters.

Statement of the Problem

The purpose of this research is to seek empirical data providing ~~answers~~ to the following questions:

1. Do preparers, auditors, and users of financial statements have similar views of materiality in situations involving illegal payments?
- 2a. Do preparers have the same view of materiality in varying illegal payment cases (i.e., illegal domestic political contributions, illegal foreign political contributions, bribery of foreign government officials, and commercial bribery) involving similar situations? (E.g., each case may involve falsification of books and records.)
- 2b. Do auditors have the same view of materiality in varying illegal payment cases involving similar situations?
- 2c. Do users have the same view of materiality in varying illegal payment cases involving similar situations?

Purpose of the Research

This research has four basic purposes:

1. To provide additional empirical evidence which would either support or dispute the general belief that preparers', auditors', and users' views of materiality are dissimilar. The evidence provided would only be pertinent to illegal payment situations.
2. To seek information useful to the Financial Accounting Standards Board (FASB) and other authoritative bodies in developing materiality guidelines in illegal payment situations. The second general research question will allow the researcher to determine whether each group makes consistent decisions when situations are similar but the type of illegal payment has changed. If, for example, preparers made the same decision concerning materiality in all cases involving falsification of books and records, then a tentative basis for generalizing the materiality decision to other cases involving falsification of books and records could be established.
3. To evaluate the need for regulations and laws requiring disclosure in illegal payment situations.
4. To ascertain what information about illegal payments should or should not be disclosed. Some information may have a greater cost to investors if it is disclosed than if it is not disclosed. For example, disclosure may result in significant fines, loss of business, and/or foreign expropriation.

Background and Research Justification

Introduction--Materiality

On March 21, 1975 the FASB, the authoritative private body established for the purpose of promulgating accounting standards for reporting financial information, issued a Discussion Memorandum called "An Analysis of Issues Related to Criteria for Determining Materiality." The issuance of a discussion memorandum is a normal step preceding public discussion and hearings and possible issuance of formal standards. However, a formal standard was never issued, and the Discussion Memorandum probably raised more questions than it provided answers. One issue raised by the Discussion Memorandum, and also recognized by various authors in recent years, is the need for determining the consistency of preparer and auditor materiality decisions with user needs. The Discussion Memorandum states:

There is a general belief that preparers, auditors, and users of financial statements have dissimilar views of materiality. Because of the absence of specific knowledge of the manner in which materiality decisions are made and of the perceptions and decision processes of users of financial statements, it is not possible to determine whether the materiality decisions of preparers and auditors have been in keeping with the needs and expectations of the users of financial statements. This situation, and the belief by some that materiality criteria have been used at times to justify inappropriate practices, have contributed to the so-called credibility crisis in financial accounting and reporting.¹

Most of the past research into the materiality question has been oriented toward how materiality decisions are made by preparers and auditors and toward the development and recognition of quantitative criteria for determining the materiality of items in relation to income, to changes in income, and to various balance sheet items. (See Chapter 2 for a review of the relevant research.) A few studies have attempted to

ascertain investor decision models and materiality as reflected in investment decisions. Only two primary studies have attempted to determine whether there is a similarity in views of preparers, auditors, and users (Financial Executives Institute² and Boatsman³). Because the preparers and the auditors make disclosure decisions based on what they believe is material or immaterial to the users of financial statements, it is vitally important for the authoritative rule making bodies (FASB and the Securities and Exchange Commission) to know whether preparer and auditor decisions are consistent with user needs. If the decisions are not consistent with user needs it is up to these bodies to issue materiality guidelines.

The results of the Financial Executives Institute study reveal that there are judgmental differences between the materiality decisions of preparers and auditors. The study found that financial analysts (users) on the average considered an item to be material at 4.9% of current net income while financial executives considered an item to be material at approximately 6.0% of current net income. The same study revealed a materiality cut-off of 4.8% for CPAs.⁴ The difference between preparers and users is significant, especially since the study also revealed a great divergence among materiality decisions expressed by users. However, the consensus between auditors and users provides hope of a profession free of additional rules and guidelines, for auditors must decide on materiality questions before financial statements can be issued with an "unqualified" opinion. In another materiality study, Boatsman also concluded that there was consensus between auditors and security analysts (users) in all significant respects.⁵ Based on these two studies, it is reasonable to expect audited financial statements

bearing "unqualified" opinions to include information concerning all material facts.

In recent years, there has been a significant controversy about what is material or immaterial with respect to questionable and illegal payments. Auditors have apparently concluded that most, if not all, payments of questionable nature (foreign and domestic political contributions, payments to foreign government officials, and commercial bribery) have not been material since they have not been disclosed. Conversely, the Securities and Exchange Commission (SEC) has apparently taken the position that most of these payments are material and should be disclosed as indicated by its injunctive actions and extensive voluntary disclosure program. Since the SEC was established to protect the interests of investors, it seems reasonable to assume that there is a divergence in these sensitive situations between auditor materiality decisions and user needs.

In recent meetings which this researcher attended, partners in two of the "big eight" CPA firms expressed concern and dismay over the apparent requirements to disclose seemingly immaterial and insignificant items. One partner complained about the special efforts and costs involved in auditing these "inconsequential" items and the increased liability which may arise from failure to disclose these facts. It would seem that there is a need for research into the materiality of illegal payments specifically, and the subject of sensitive transactions in general, particularly research which addresses the question of the consistency of preparer, auditor, and user views of materiality in sensitive situations.

To further underscore this need, researchers have recently offered

empirical evidence to indicate that there is an "expectation gap" between preparers, auditors, and users of financial statements. In an article in the October 1977 issue of the Journal of Accountancy, the authors reported the results of a survey of preparers, auditors, and users concerning "three types of events [which] may require different degrees of auditor responsibility: (1) deliberate material falsifications, (2) other material misstatements, and (3) illegal acts not material in amount."⁶ They concluded that "auditors and nonauditors have significantly different beliefs and preferences on the extent of the auditor's responsibility for detecting and disclosing irregularities and illegal acts."⁷ However, the authors offered no proof that the different expectation levels are based on homogeneous respondent definitions of materiality. It is possible that given the same financial situation, preparers, auditors, and users may agree on auditor responsibility.

Because of the scope of the materiality issue, it is unlikely that a single research project can address the global question: "Do preparers, auditors, and users have dissimilar views of materiality?" However, significant progress has been made into the materiality issue by addressing meaningful segments of the dilemma. Each research project to date has provided new pieces to the materiality puzzle. This researcher proposes to attack one major segment of the materiality issue: Implemental Issue Five from the FASB Discussion Memorandum which asks "Should there be distinctive criteria for determining materiality in so-called sensitive situations?"⁸

This research will concentrate on illegal payments, one major type of sensitive situation. Disclosure of this type of sensitive situation

poses a major question of current interest to financial statement preparers and auditors, financial statement users, the Securities and Exchange Commission, and the U.S. Congress.

For the reader who is wondering whether the objective of this research is the study of disclosure or materiality, it is important at this point to recognize that the type of disclosure is dependent upon the materiality of the item. In his research on materiality, Boatsman states:

The logic of linking materiality directly to disclosure warrants comment. An underlying assumption of this experimental task is that, when alternative methods of disclosure are available for a given item, the materiality of the item determines the disclosure.... If there is any rationale underlying external reporting, then the more influential an item of financial information on the user, the higher order of disclosure it should receive.⁹

(See Chapter 4 for further discussion of the relationship between materiality and disclosure.)

Questionable and Illegal Payments--Background

In 1973, the Watergate Special Prosecutor charged several corporations and their executive officers with illegal domestic political contributions. Subsequently, as a result of these revelations, the SEC issued guidelines for disclosure in financial reports and filings. Additional inquiries by the SEC resulted in the discovery of not only illegal domestic political contributions, but also unrecorded "slush funds," circumvention of accounting internal controls, falsification of accounting records, payments to foreign government officials for illicit or questionable purposes, and corporate bribery; and in many cases, they found that top management condoned these actions.

The Commission's investigation resulted in injunctive actions

against nine corporations in the year following the Spring of 1974. In fourteen cases filed by May 10, 1976 "the corporate defendants have, without admitting or denying the allegations of the complaint, consented to the entry of a permanent injunction prohibiting future violation of the federal securities laws."¹⁰ It became clear that such questionable and illegal practices were widespread and that an additional disclosure mechanism was necessary. The SEC established a voluntary disclosure program and along with it developed "special procedures for registrants seeking guidance as to the proper disclosure of these matters."¹¹ In its report to the Senate Banking, Housing and Urban Affairs Committee, the SEC indicated the incentive for voluntary disclosure: "Although participation in the voluntary program does not insulate a company from Commission enforcement action, it does diminish the possibility that the Commission will, in its discretion, institute an action."¹²

The Commission required that any company participating in its voluntary disclosure program and "determining that it may have a disclosure problem with respect to questionable and illegal activities, including the improper recording or accounting of such activities, promptly take the following steps:¹³

1. Authorize a careful in-depth investigation...responsible to a committee comprised of members of the board of directors who are not officers of the company and who are not involved in the suspected questionable and illegal actions...
2. The board of directors should issue an appropriate policy statement...[which would] include a declaration of cessation of such activities, if any, and a prohibition against the maintenance of improper books and records and inadequate supporting documentation relating to such activities. The adoption of such a policy should be communicated to appropriate corporate personnel....¹⁴

In addition, the corporation should disclose the following in its annual report, registration statement, or other filing:

Material information developed regarding illegal or questionable transactions that occurred during the last five years. This frequently would include their purpose; the amounts involved; the extent of possible knowledge, approval or authorization by top management; details of any defalcations by corporate officials or personal benefits accruing to them, the accounting treatment accorded to the transactions, including whether false, fictitious or misleading entries were made to record such transactions; the existence of any unreconciled funds, "slush funds," unrecorded bank accounts or similar "off book" accounts; the possible foreign and domestic tax consequences, if any of the reported activities; and the amount of business related to such payments and the possible effect of cessation on consolidated income, revenues and assets or business operations of the company; as well as any other information that may be required on a case-by-case basis.¹⁵

As a result of the Commission's voluntary disclosure program, eighty-nine companies (as of April 21, 1976) made voluntary disclosures concerning questionable and illegal payments and practices. In the Commission's report on ninety-five companies (six companies made disclosures as the result of the Commission's enforcement actions), fifty companies voluntarily disclosed payments to foreign officials, and four of the six nonvoluntary disclosures admitted similar payments. Concerning "other foreign matters," twenty-seven companies disclosed other foreign payments, many constituting commercial bribery and violations of laws concerning foreign currency and exchange. Seventeen companies reported foreign political payments, and twenty-nine companies reported foreign sales-type commissions. Some of these commissions were indirect payments to foreign government officials.

Views on the Materiality of Illegal Payments

The SEC has taken a broad and not uncontroversial view of what information is material to the prudent investor. The source of the Commission's powers to demand disclosure of items not specifically required to be disclosed by statute is Schedule A of the Securities Act of 1933. Schedule A is a broad, nebulous statement interpreted by the Commission as providing it with the authority to require disclosure of anything which it deems to be material. In its voluntary disclosure program, the Commission requires participants to disclose all matters which may be indicative of the quality of management or which may indicate greater investor risk no matter how remote.

For example, questionable and illegal payments may be required to be disclosed regardless of the significance of the amount of payments because the payments may reflect on the quality of management. The Commission particularly believes that payments made from funds outside the normal system of accountability or obtained through falsification of accounting records should be disclosed because such practices reflect on the integrity and quality of management. Such practices may open up the corporation to risk of (in the case of foreign payments) foreign fines and expropriation, loss of a significant line of business if such payments are not continued, shareholder and regulatory suits, tax assessments, and unknown contingencies.

Homer Kripke, Professor of Law at the New York University Law School, made the following remarks at a recent symposium:

It is strange that the Commission has seemed to be moving on these problems of questionable and illegal payments without regard to the amounts involved or the question of the materiality of those amounts, and it seems to take the position that management integrity is of keen importance

regardless of the amounts involved. If one generalizes that, we can begin to wonder what sexual, what ethical, what other problems may get involved from that point of view.¹⁶

At the same symposium, David H. Doherty, Assistant Director of the Enforcement Division of the SEC, defended the Commission's position. Discussing the fact that many corporations had established secret funds and falsified corporate records often with the knowledge and approval of top management, he stated:

Such activities, in my view, are material to the investing public in a number of ways: They reflect on the integrity of management involved. They reflect on management's stewardship of corporate assets. These activities reflect on the integrity of the corporate books and records themselves. Particularly in the foreign area, I think these activities reflect on the ability of the corporation to procure business. Finally, I believe these activities significantly increase the risk that a company's earnings and assets may be adversely affected should such activities be discontinued or discovered.¹⁷

Continuing in the same vein, Commissioner Sommer of the SEC made the following statements about materiality:

The issue of materiality, in my estimation is really at the core of the problem, and it's the issue that probably has caused the greatest amount of consternation and uncertainty in this whole area. The first thing that I would reject out of hand is the idea that somehow or other materiality relates only to financial ratios; and that if a company is a billion dollar company, anything it does with a mere million dollars doesn't make any difference. I don't think that's a sound principle of law.¹⁸

Taking a more conservative point of view, Milton V. Freeman, member of the District of Columbia Bar and former SEC lawyer stated:

There used to be a simple rule as to what was material. It was the kind of thing that affected an investor's judgment as to whether to buy or not. It was the kind of information that could be expected to affect the market value of the stock in a substantial way...In those simpler days, which I say have not passed, investors were interested in what was happening to the bottom line in their companies.¹⁹

Freeman contends that the SEC has established a new theory of materiality in which illegality is itself significant whether or not the illegality may affect earnings, assets, or a stock's market value. He continues:

How does it happen that a Commission which makes a clear statement of its position that the investor is an economic man and is concerned only with economic consequences, finds itself engaged in all this litigation, which relates not to the economic consequences, but to the legality of the conduct?²⁰

These views of materiality are probably not as diverse as the discussants would have the reader believe. All seem to imply that the information is significant if it has economic impact as reflected in investors' decisions to buy or sell securities. Kripke and Freeman look for a direct economic impact on earnings and corporate assets and a predictable effect on market value. Doherty and Sommer are interested not only in the direct and material economic impact, but also in the indirect impact on investor valuation of securities resulting from disclosures which reflect on management integrity, the reliability of the accounting system, and possible contingent effects (e.g., foreign expropriation, potential loss of business, tax assessments, and penalties). Doherty and Sommer want all information concerning questionable and illegal payments and practices which may be useful in evaluating security risk and return to be disclosed.

The controversy indicates that there is a need to determine what information is useful to investors. In this study, financial statement users will provide evidence as to what information about illegal payments they perceive to be useful. This evidence may be valuable to authoritative bodies when establishing guidelines and decision rules

for similar illegal payment cases. These guidelines and rules could then be used by preparers and auditors when making materiality decisions concerning the appropriateness of disclosure of illegal payment information.

This research will also measure the consistency of preparer and auditor perceptions of what should be disclosed in financial statements with user perceived needs in varying illegal payment cases. This would provide additional information on whether preparer and auditor materiality decisions have been responsive to investor needs. Any conclusion that such disclosure decisions have not been dependent on or a function of user needs may indicate the need for authoritative intervention by the Auditing Standards Executive Committee of the American Institute of Certified Public Accountants (AICPA), or more regulation by the SEC and Congress.

The General Hypotheses, Research Instrument and Methodology

General Hypotheses

The scientific method for research necessitates the restatement of the research problem in a statistically testable form. The two general research problems may be restated in null hypothesis form as follows:

- (1) Preparers, auditors, and users have similar views of materiality in varying illegal payment situations.
- (2a) Preparers have the same view of materiality in varying illegal payment cases involving similar situations.
- (2b) Auditors have the same view of materiality in varying illegal payment cases involving similar situations.
- (2c) Users have the same view of materiality in varying illegal payment cases involving similar situations.

The Research Instrument

The research instrument is a questionnaire containing four types of illegal payment cases and up to ten different situations per payment case for a total of thirty-one case-situation combinations. Each respondent to the questionnaire was asked to select a disclosure response. The responses ranged from "do not disclose" to "always disclose" and included the possibility of disclosure if certain net income or dollar criteria were met. For those respondents selecting the if criteria, the questionnaire asks them to specify the appropriate materiality cut-off (i.e., if the payment was equal to or greater than the percentage or amount, then disclose the payment). Appendix A includes a copy of the questionnaire.

Methodology

For each of the thirty-one case-situation combinations in the questionnaire, there is a specific hypothesis (H_1 to H_{31}) used to test general hypothesis (1) listed above. The Chi-Square Test for Independence is used to test each of these hypotheses. From these tests it will be possible to conclude statistically for each hypothesis either that preparers, auditors, and users do have similar views of materiality or that they do not have similar views of materiality.

In addition, for those respondents selecting the percentage of income criteria, an analysis of variance will be conducted to determine whether preparers, auditors, and users have similar views as to the appropriate percentage of income to use as a materiality cut-off. Similarly, for those respondents selecting the dollar amount criteria, an analysis of variance will be conducted to determine whether preparers,

auditors, and users have similar views as to the appropriate dollar amount to use as a materiality cut-off. Chapter 5 provides an in-depth discussion of the research methodology related to hypotheses H_1 through H_{31} and the above mentioned analysis of variance tests.

Twenty-four specific hypotheses are used to test general hypotheses (2a), (2b), and (2c). Each general hypothesis has eight specific hypotheses for the eight similar situations appearing in two or more payment cases. The objective is to determine whether the members of each group are consistent in their disclosure decisions across cases involving similar situations. An analysis of variance repeated measures design is used to test these hypotheses. Chapter 6 provides an indepth discussion of the research methodology related to these hypotheses, H_{32} to H_{55} .

This researcher also is interested in finding out whether the disclosure responses for each group are different between legal and illegal payments given similar situations. Included in the questionnaire are two legal payment cases with situations similar to two illegal payment cases. An analysis of variance will be made to determine whether each group has the same view of materiality when a payment is legal as when it is illegal given similar situations. The related hypotheses are H_{56} through H_{61} . These too are discussed in detail in Chapter 6.

Organization of Chapters

The chapters are organized and presented as follows:

Chapter 2 - reviews past materiality research emphasizing the more significant studies.

Chapter 3 - draws together background information on illegal payment cases and situations which results in the development of detailed hypotheses. The

detailed hypotheses and the common bases for materiality decisions derived from past research provide the framework for the questionnaire development. Also considered in the questionnaire development are the issues raised by the Discussion Memorandum on materiality.

Chapter 4 - explains the sampling and mailing procedures. It also includes a review of the response, and tests for non-response bias.

Chapter 5 - contains the analysis related to the first general research problem: "Do preparers, auditors, and users have similar views of materiality in illegal payment situations?"

Chapter 6 - contains the analysis related to the second general research problem: "Do preparers (or auditors or users) have the same view of materiality in varying illegal payment cases involving similar situations?"

Chapter 7 - summarizes research conclusions, recognizes limitations of the research, and provides suggestions for future research.

Summary

What is or is not material to financial statement users? This question has long perplexed the accounting profession. Although significant strides have been made toward resolution of the materiality issue, much research is still needed. Research, which addresses the issue of the consistency of preparer, auditor, and user views, is especially needed.

This research will attempt to determine whether preparer, auditor, and user views of materiality are similar in varying illegal payment cases. Also, it will attempt to determine whether the responses of each group are consistent, given similar situations, across varying illegal payment cases.

This chapter provides a listing of the purposes for this research and the background and justification for the research. It also gives

a brief introduction to the general research hypotheses, research instrument, and research methodology. The chapter concludes with a brief summary of the remaining chapters.

FOOTNOTES

¹Financial Accounting Standards Board, An Analysis of Issues Related to Criteria for Determining Materiality (Stanford, Connecticut: FASB, 1975), p. 3.

²James W. Pattillo, "Materiality: The (Formerly) Elusive Standard" Financial Executive 18 (August 1975): 20-27.

³J. R. Boatsman and J. C. Robertson, "Policy-Capturing on Selected Materiality Judgments" The Accounting Review 49 (April 1974): 342-352.

⁴Patillo, p. 23.

⁵Boatsman, p. 351.

⁶C. D. Baron and others, "Uncovering Corporate Irregularities: Are we Closing the Expectation Gap?" Journal of Accountancy 144 (October 1977); 57.

⁷Ibid., p. 66.

⁸FASB, Materiality, p. 21.

⁹Boatsman, p. 346.

¹⁰Securities and Exchange Commission, Report of the Securities and Exchange Commission on Questionable and Illegal Corporate Payments and Practices, submitted to the Senate Banking, Housing and Urban Affairs Committee (May 12, 1976), p. 4.

¹¹Ibid., p. 8.

¹²Ibid.

¹³Ibid.

¹⁴Ibid., pp. 8-10.

¹⁵Ibid., p. 12.

¹⁶Homer Kripke, "Opening Remarks on the Corporation in Crisis" Business Lawyer 31 (March 1976): 1277.

¹⁷David P. Doherty, "The SEC's Management Fraud Program" Business Lawyer 31 (March 1976): 1280.

¹⁸A. A. Sommer, Jr., "The Disclosure of Management Fraud" Business Lawyer 31 (March 1976): 1284.

¹⁹ Milton V. Freeman, "The Legality of the SEC's Management Fraud Program" Business Lawyer 31 (March 1976): 1295.

²⁰ Ibid., p. 1298.

CHAPTER 2

REVIEW OF THE MATERIALITY RESEARCH

Introduction

This chapter reviews previous materiality research, separating it into two general categories: dissertation research on materiality and other materiality research.

On November 22, 1977, a computerized search of the doctoral dissertation abstracts revealed the existence of ten dissertations dealing with the concept of materiality. Two of these dissertations were comprehensive studies of the subject of materiality. One of these studies (Samuel M. Woolsey's¹) was the first materiality study. It is also one of the more significant research efforts made to date. The other study (Jack L. Dyer's²) is a follow-up study to Woolsey's dissertation; it also is a comprehensive research effort. Both of these studies have had a significant impact on the present research study. Therefore, they are reviewed in detail in this chapter. Several other dissertations on materiality, which were particularly interesting and unique, are also reviewed in a fairly detailed manner (Frishkoff,³ Waters,⁴ Boatsman,⁵ and Newton⁶). Four other dissertations are briefly reviewed because of their limited generalizability or lack of significant relevance to this research (Haddidi,⁷ Mortimer,⁸ Taylor,⁹ and Messere¹⁰).

The Financial Executives Research Foundation¹¹ study is particularly significant non dissertation materiality research. Its results are

reviewed in detail. There is also a brief review of some other studies which did not have a significant impact on this research but have interesting results.

Materiality Research--Dissertations

Woolsey

A dissertation by Samuel M. Woolsey, a doctoral student at the University of Texas in 1954, was the first comprehensive attempt to define materiality and offer materiality guidelines. His research included a review of the literature for definitions of materiality and instances of usage of the term, an examination of legal and court established definitions of materiality, and the development, distribution and evaluation of responses to ten case study type questionnaires. The questionnaires which made up the major part of Woolsey's study were distributed to "selected accountants, auditors, bankers and credit men, professors of accounting, and others."¹²

The ten case studies were:

1. Omission of a Branch from an Audit
2. Loss caused by Earthquake
3. Gain from the Sale of Fixed Assets
4. Unamortized Bond Discount Written Off
5. The Auditor's Observation of Inventory Taking
6. Long-term Leases
7. Expenses Which Have Been Improperly Capitalized
8. Contingent Liabilities
9. Confirmation of Accounts Receivable
10. Marketable Securities

In each case study, a hypothetical situation with related assumptions was described and accompanied by six "Cases" of financial facts. In each case study, Woolsey included the authoritative pronouncements which dealt with the situation at hand (e.g., The pronouncements on contingent liabilities would explain what a contingent liability was and how it was

accounted for under generally accepted accounting principles). Based on the hypothetical situation, the financial facts and the authoritative pronouncements, the respondents to the case study were asked to indicate whether an item was or was not material (e.g., the amount of a contingent liability may be material or immaterial) and to select the primary variable relevant to the materiality decision (e.g., the percentage relationship of the contingent liability to current net income; to average net income; to current liabilities; etc.). The analysis of the responses to the case study questionnaires revealed a primary variable for each case study which was used more often than any other variable in making materiality decisions. Woolsey suggested that that variable be used in establishing materiality standards.

There were three steps in setting a standard for a particular type of materiality decision:

1. Determine which factor should be given primary consideration in making a materiality decision.
2. Determine a tentative bracket for the area of doubt expressed in terms of the primary factor.
3. Set adjustment factors to show the effect which certain surrounding circumstances have on the limits of the area of doubt.¹³

Recognizing that once a primary variable was identified and that uniform agreement could not be obtained as to what point would be an appropriate cut off for separating immaterial from material items, Woolsey suggested a tentative bracket (e.g. 6 to 16 percent of current net income); within this bracket an item might be deemed as either material or immaterial based on the judgment of the decision maker. Amounts less than the lower end of the bracket would then automatically be deemed immaterial.

Also recognizing that his cases were based on situational

assumptions, he questioned respondents about the effect of changes in situational assumptions on their materiality decisions. He found that in many cases, materiality decisions were not significantly affected by changes in situational assumptions; however, in some cases, changes in situational assumptions significantly affected materiality decisions. He, therefore, suggested adjustment factors for changes in circumstances.

For each of the ten cases, Woolsey identified a primary decision variable, suggested a tentative bracket, and offered adjustment factors for changes in situational assumptions. The tentative bracket and the adjustment factors were based on his judgmental analysis of the responses to his questions. For example, in "Case 7 - Expenses Which Have Been Improperly Capitalized," Woolsey identified the "amount of error to the book value of the fixed assets" as the primary decision variable suggested a tentative bracket of 5 to 9%, and an adjustment factor of (.4)¹⁴ if the error was intentional (i.e., the factor of .4 would adjust the tentative bracket to 2 to 3.6%.)

Although a significant contribution in materiality research, Woolsey's study suffers from some fundamental weaknesses. He did not randomly sample respondent populations, and therefore, his results are not statistically generalizable to the populations of interest. His tentative brackets and adjustment factors are based on judgment rather than statistically determined measures. His study concentrates on how materiality decisions are made instead of how they should be made. Thus, the study is oriented toward how preparers and auditors of financial statements make their materiality decisions, not on what information is significant to users of financial statements. This is evidenced by the fact that out of an initial distribution of questionnaire cases,

only 27 out of 503 went to users (i.e., "investment bankers, security analysts, and other financial groups").¹⁵ In respect to this proposed research, he examined only a few "sensitive" situations, the results of which are arbitrary and not generalizable.

Dyer

In 1973, Jack L. Dyer, in a follow-up study to Woolsey's dissertation, used the case study questionnaire approach in an attempt to establish empirically determined materiality norms. With Woolsey's permission, Dyer modified and revised Woolsey's questionnaire.

Dyer selected public accounting practitioners as subjects for his study, classifying them as either members of "national" or "nonnational" public accounting firms. He limited his study to public accounting practitioners, concluding that it was impractical or unnecessary to try to establish user measures of materiality. His reasons for this limitation included lack of sufficient resources, unknown user decision models, a concurrent AICPA study which might result in duplication of efforts, and the fact that materiality decisions were directly influenced by auditors. It would be, in his opinion, useful in establishing materiality norms to know how materiality decisions were made in actual practice.

The questionnaire included ten case studies, each including hypothetical companies, related financial information, "situational assumptions," and current (at that time) authoritative pronouncements affecting the situation of interest. His purpose in each case was to determine what the primary decision variables were, establish indifference zones and examine changes in situational variables. He then

offered the primary decision variables and border zones as objective materiality norms or guidelines for public accounting practitioners subject to the analysis of changes in "situational assumptions."

Dyer's approach is best understood by examining one of the ten case studies in his questionnaire. His "Contingent Liabilities" case involves a company, Robinson Corporation, being sued for patent infringement. For five years the company has been using a self-developed, patented machine similar to one patented by the Young Company. The Young patent had been obtained prior to Robinson's patent. The case states: "Although the two machines are different, there is enough similarity to believe that there is at least some chance that Robinson Corporation will lose the suit."¹⁶ The situational variables given in the case and bearing on the materiality decision were:

1. The probability of losing the patent infringement suit was established by the company's attorney at one in ten.
2. The sales of the product associated with the machine in question constituted about 10 percent of the company's total revenue.
3. The company's earnings over the preceding five years had shown a steady rate of growth.¹⁷

The respondent was also given the directives of Accounting Research Bulletin No. 50 on accounting for contingencies. Then Dyer provided the respondent with six sub cases, each of which includes a gross damage claim (the contingent liability), current year's total revenue, current year's net income before extraordinary items, average net income before extraordinary items, and six ratios ranging from the ratio of the contingency to total revenue to the ratio of the contingency to stockholders' equity. Based on analysis of auditor responses, Dyer concluded that the primary decision variables for contingent liabilities were:

1. The ratio of the contingency to current net income after taxes and before extraordinary items.
2. The ratio of the contingency to average net income after taxes for the preceding five years.¹⁸

Using statistical techniques for confidence intervals, he established indifference zones for materiality decisions. For example, an indifference zone for the ratio of a contingency to current net income was 7.7 to 10 percent. The indifference zone would be interpreted as follows:

1. A contingency less than 7.7 percent of net income is immaterial.
2. A contingency greater than 10 percent of net income is material.
3. A contingency which is 7.7 percent or more but less than or equal to 10 percent may be deemed as material or immaterial depending on the determination of the decision maker.

Note: This illustration is an oversimplification of the indifference zone concept as illustrated in Dyer's paper. In Dyer's dissertation, when there are two primary decision variables, he establishes a more complex decision rule.

Dyer also inquired about the effect of the changes in situational variables on auditor materiality decisions.

For each of the ten cases, Dyer selected the one or two primary decision variables determined to be most prominent in decision analysis as reflected in the questionnaire and suggested the use of these variables and the related indifference zones as materiality norms for similar situations.

Dyer's research, like Woolsey's, failed to examine user information needs when attempting to establish materiality criteria.

Frishkoff

Paul M. Frishkoff examined auditor materiality decisions as reflected in auditor's opinions. He examined over 2,200 annual reports

of firms with fiscal years ending in the calendar year 1963. Of these reports, 217 contained accounting changes. After eliminating 27 reports which lacked sufficient information for the study, his final sample included 190 reports (60 with unqualified opinions and 130 with qualified opinions).¹⁹

Frishkoff used the following general model to determine which factors influenced materiality decisions: $Y = f(X_1, X_2, X_3, \dots, X_{17})$ where Y is the dependent variable and was coded as 1 if the opinion was qualified and 0 if the opinion was unqualified.²⁰ There were seventeen specified independent variables including various measures of the effect of the change on net income relative to net income, measures of the effect of the change on retained earnings, measures of the relative size of the CPA firm and the relative size of the client firm. The implicit assumption was that a qualified opinion would occur when there was a material inconsistency (i.e. change) and an unqualified opinion would occur when there was an immaterial inconsistency.

Frishkoff used multiple discriminant analysis and found that three variables had classificatory ability at the .10 alpha level:

- X_2 , the absolute effect of the accounting change divided by net income;
- X_{13} , the net worth of the company; and X_8 , the dummy variable coded 1 in cases of reclassification and 0 otherwise.²¹

He also found that there was no correlation between the three variables.

Variable X_2 , the relative income effect, was the only variable of the three possessing discriminatory information at alpha less than or equal to .025. However, use of this variable in "ex post analysis suggested that a majority (55%) of opinions were incorrectly classified in real life. He concluded:

if X_2 was in fact the only variable considered by accountants in these 190 cases, then there was in practice no discernible or even remotely uniform notion of materiality.²²

Frishkoff noted that his classificatory ability increased for determining what would be a qualified or unqualified opinion when he included the net worth and the reclassification dummy variables. However, he questioned whether this made sense. He found that firms with a net worth greater than \$150 million were less likely to receive qualified opinions while smaller ones were more likely to receive qualified opinions. He suggested two possibilities: (1) CPA firms with large audit clients and thus large audit fees would be less likely to offend those clients by giving them a qualified opinion; and (2) large firms because of their "blue-chip" nature would be less likely to merit a qualification even in cases of an inconsistency.

The reclassification dummy variable indicated that an accounting change which is a reclassification is more likely to receive a clean opinion than another kind of accounting change. Frishkoff stated that this is in line with common sense.

His research concluded with suggestions for improving audit opinion wording and the consistency standard in auditing.

Waters

Edwin D. Waters examined the decision-making process used in determining materiality in small businesses. Managers and partners in fifteen public accounting firms cooperated in the project. Waters selected the area of exceptions in audit reports and asked the firms to identify actual cases where materiality was a concern. The managers and partners identified thirty-eight cases and discussed the decision

making criteria used in the cases with Waters. Major decision factors identified in the interviews included: (1) the percentage relationships, (2) the bases, (3) the averages and trends, and (4) the nature of the items.

Waters found that accountants generally consider relative amounts rather than absolute amounts. Based upon his case studies, he was able to make the following recommendations. For the income statement, the item in question should be compared to normal net income or loss. He suggested that items less than 5% of normal net income or loss be considered immaterial, those greater than 8% of normal net income or loss be considered material, and items falling between 5 and 8% of normal net income or loss be considered as falling within an area of doubt subject to professional judgment.

For balance sheet items of questionable nature, Waters suggested relating the questionable items to a total account or total classification. For example, a liability to a vendor might be compared to total accounts payable, total current liabilities, total liabilities, or to net worth. Based on his case study analysis, he also offered percentage guidelines for this purpose.

He concluded that his proposed criteria would provide a frame of reference for making materiality decisions which must continue to be made with due care and professional judgment and with proper consideration of the surrounding circumstances.²³

Boatsman

Using interdisciplinary research methods, James R. Boatsman developed multivariate mathematical models which could be used to

predict materiality decisions with a high degree of accuracy. Boatsman developed 30 hypothetical cases, each containing eight situational variables. Using this as his research instrument, in a nonrandom field experiment, he administered the cases to eighteen CPA's and fifteen security analysts. Each participant classified each case as either "so immaterial as to require no separate disclosure of any kind" or as "sufficiently material as to require footnote disclosure but no separate line item disclosure on the face of the financial statements" or as "sufficiently material as to require separate line item disclosure on the face of the financial statements and possibly footnote disclosures as well."²⁴

The eight situational variables and the judgmental observations provided the basis for the development of a mathematical model useful for predicting materiality decisions. The eight situational variables which were most often cited in the literature as relevant materiality decision variables were: (1) the nature of the item (e.g., gain or loss on sale, change in accounting principle, and uncertainty), (2) the relationship of the item to current year net income, (3) the relationship of the item to total revenue and expense, (4) the effect of the item on net working capital, (5) the earnings growth rate, (6) the possibility of the item reversing the earnings trend, (7) the absolute size of the item, and (8) the risk.²⁵ In all Boatsman obtained 990 materiality judgment observations (each of 33 subjects evaluated 30 cases). From these observations, he developed a discriminant analysis policy capturing model with "three linear classification functions corresponding to the three disclosure types."²⁶ In ex-post analysis, the model was correct in predicting the respondent's disclosure decision

in 625 of 990 cases, a 63% predictive accuracy. He also found that of the predictor variables, only three were of practical significance with the variable "the relationship of the item to current net income" contributing "73% of the total predictive power,"²⁷ and the variable indicating the nature of the item and the risk variable providing 24% and 2% of the predictive power, respectively. He also found that the multivariate model was a more accurate predictor of subject's materiality decisions than using the single variable "the relationship of the item to current net income" as the only predictor.

Boatsman also tested the null hypothesis that there was no significant difference between the materiality decision processes of CPAs and security analysts. He used four different methods to test the hypothesis, and although one of the four methods indicated that there was a difference in judgmental processes, he concluded that there were no important differences in the judgmental processes of CPAs and security analysts.

Boatsman also developed a simple rule based on his empirical analysis that the dividing line between a material and immaterial item was 4% of net income. This rule correctly classified materiality decisions in ex-post analysis 65% of the time, and Boatsman observed that this rule tended to result more often in underdisclosure.

Newton

Lauren K. Newton performed a study of the relationship of the accountant's perception of risk relative to an item's materiality. She hypothesized that the greater the perceived risk and uncertainty, the more stringent would be the accountant's materiality criterion. Using

cardinal utility theory to evaluate materiality and perceived risk, Newton performed an empirical assessment of the utility curves of nineteen Certified Public Accountants. Each CPA was presented with three independent hypothetical cases: a standard gamble, a contingent liability case in which the amount of the damages from a lawsuit was uncertain, and a marketable securities case in which the performance of a decline in market value was in question. The second and third cases were used to determine the threshold point at which an uncertain situation became material enough for the auditor to qualify his report. Her research confirmed her hypothesis that accountants were risk averse when making materiality decisions. She used her conclusions to review prior studies and propose materiality guidelines, and she offered a probabilistic approach to making materiality decisions in uncertain situations.²⁸

Hadidi

Hansad Mohamad Hadidi used factor analysis to develop range and point estimates of materiality for five groups of accounts in the retail trade industry. He mailed questionnaires to 600 retail stores to obtain estimates of the averages of twenty accounts. His factor analysis of these accounts resulted in five groups:

- (1) Group 1 includes insurance, supplies professional services, transportation and freight-out, interest, and bad debt expense accounts; (2) Group 2 includes sales, purchases, rent advertising, and income tax expenses; (3) Group 3 includes only beginning and ending inventories; (4) Group 4 involves pension, depreciation, maintenance, utilities, and property tax expenses; and (5) Group 5 consists of payroll and general expenses.²⁹

Materiality criteria for these five groups were developed in terms of the portion of net income that would represent "the maximum allowable

dollar effect of departures from pronouncements and directives of the American Institute of Certified Public Accountants and the Securities and Exchange Commission in financial reporting."³⁰ He developed a single-point criterion and a range form criterion for materiality decisions for each group.

Mortimer

Dell LaVar Mortimer used the questionnaire approach to determine whether an objective standard for materiality in auditing existed or could be established. He surveyed a portion of California CPAs actively engaged in public accounting. These CPAs responded to various questions concerning materiality decisions in auditing by indicating the percentage and base which would be the dividing line between material and immaterial items. Mortimer concluded from his survey that CPAs seem to have pre-established amounts in mind when making materiality decisions, and these amounts are adjusted for changing situational factors. Based on his survey, Mortimer offered a set of guidelines for making materiality decisions in auditing.³¹

Taylor

Robert D. Taylor performed a search of the materiality literature including pronouncements of the AICPA and the SEC to determine whether comprehensive guidelines exist for materiality decision making. His research revealed incidental guidelines in some of the pronouncements, but nothing of a comprehensive nature.

In an attempt to determine whether guidelines exist in practice, he asked practicing auditors to identify actual cases requiring materiality decisions. Through this procedure he obtained sixty cases

which he then analyzed in terms of subject matter, decision criteria, and the decision (material or immaterial). Taylor's analysis revealed that there were certain commonly used decision criteria (net income, total assets, and net worth) and that for each decision criterion, there were common points of distinction between immaterial, questionable, and material items. Based on his analysis, he expressed these points as guidelines in quantitative terms.³²

Messere

Carl J. Messere's dissertation research was an empirical evaluation of two approaches to establishing materiality guidelines. One approach, the "static" approach, measures materiality as a percentage of some base, generally current income. The other approach, the "dynamic" approach, judges the materiality of an item by reference to its effect on the earnings trend. His purpose was to determine the more appropriate approach. Messere measured appropriateness of the models in terms of their sensitivity to changes in earnings. Since the static approach would automatically classify an item as material if its effect on income was greater than, or equal to, a specified percentage of net income, Messere's research concentrated on the dynamic approach. Using three earnings trend models, ten earnings changes, and six trend periods for a random sample of 93 firms during the years of 1965 to 1974, Messere tested the dynamic model. He found that the dynamic model would not be as sensitive to earnings changes between $\pm 25\%$ as the static model. Because the dynamic approach was not as sensitive to earnings changes, he concluded that the dynamic approach was an inappropriate basis for materiality guidelines. His research included

a critical comparison and an evaluation of the two approaches, as well as a recommendation that dynamic guidelines be abandoned or explicitly defined.³³

Other Materiality Research

Financial Executives Institute

In the August, 1975 issue of the Financial Executive, James W. Pattilo reported on a comprehensive materiality study performed by him for the Financial Executives Research Foundation. In a case study analysis, he obtained the responses to realistic cases involving materiality decisions from 700 participants including certified public accountants, financial analysts, accounting educators, bankers and financial executives. The cases involved three specific types of materiality decision cases: (1) accounting changes, (2) unusual or extraordinary items, and (3) contingencies. The results of the study verified many past research conclusions and supported some commonly held assumptions about the similarities (or dissimilarities) of materiality judgments of preparers, auditors, and users. Pattilo made the following general conclusions from analysis of the study:

1. There is "no single overall quantitative or qualitative materiality criterion [which] is appropriate for all accounting areas and in all circumstances."³⁴
2. "Materiality was measured in the normal situation as follows: For all companies on a combined basis, 5.5 per cent of current net income or loss, and expressed as a range for all groups, 4.8 percent to 6.2 percent of current net income or loss;"³⁵
3. The percentage relationships mentioned above are not generalizable to breakeven and low profit or loss firms with surrounding circumstances playing a greater role in materiality judgments in these situations.³⁶

4. "Significant differences were noted between the judgments of preparers and users."³⁷ Materiality expressed as a mean percentage of current net income or loss by participating groups were as follows: certified public accountants-4.8%, financial analysts-4.9%, accounting educators-5.0%, bankers-5.3%, financial executives in "not large" firms-5.8%, and financial executives in large firms-6.2%.³⁸
5. The study found that "the most widely used quantitative determinants are: the absolute dollar amount of the item, the trend of net income, average net income for a series of years, change in net income from the prior year, income before taxes, sales, gross profit, net income, assets, liabilities, equity and other relationships used by different groups."³⁹
6. "The introduction of unfavorable factors caused the materiality point to move downward. Favorable factors caused the materiality point to move upward."⁴⁰ The kinds of factors considered in the study and affecting the materiality decisions included "size of the firm; profitability, liquidity and solvency of the firm; price-earnings ratio; management credibility; trending of income; economic conditions; existence of similar and dissimilar items; quarterly reporting; certainty of the event's occurrence and effect; timing of the event and use of certain accounting policies."⁴¹

In a book review in the July, 1977 Accounting Review, Larry Lookabill made some significant comments about the Financial Executives Research Foundation study. After commending the researcher for undertaking such a difficult and important task, Lookabill pointed out that the study contained "no statistical analysis of any of the data"⁴² and that "all of the conclusions are based on an ad hoc comparison of the respondent group means under alternative sets of circumstances."⁴³ In addition, because of the survey design, he did not believe that an overall statistical test could be used to analyze the survey results. Lookabill concluded that this severely limited the usefulness of the research.

Rose, Beaver, Becker and Sorter

Rose, Beaver, Becker, and Sorter performed a controlled laboratory type experiment to determine the amount of changes in earnings per share necessary before the change would be perceived by graduate accounting students. They used a law developed in psychophysics, the Weber-Fechner law which states " $\Delta I/I=k$; that is, that the change in intensity of a stimulus necessary before it can be detected is a constant function of the amount of the stimulus present."⁴⁴ They hypothesized that there are different thresholds for data stimuli which are measurable and obey the Weber-Fechner Law.

The subjects were one hundred and twenty-one MBA students. The students were presented with sixty-six slides, each with comparative data for one company for two years. The comparative data consisted of earnings per share; total debt/total assets; and (cash + receivables)/current liabilities. The latter two ratios were designed so that changes between the two years were inconsequential. Earnings per share of \$2.50 was used as the standard stimulus and it was paired with earnings per share figures ranging from \$2.00 to \$3.00 at intervals of \$.10. The following question was asked of the subjects after the presentation of each slide: "Comparing 1967 with 1966, a share of common stock in 1967 should be selling for: essentially more, essentially the same, or essentially less."⁴⁵ When analysis of the stimuli led 50% or more of the subjects to the conclusion that the value of the stock should be different, the difference threshold would be reached. The authors deemed this to be the point where a material difference existed between the stimuli. The results indicated that on the average it took 6.6% to 7.0% change in stimuli to record a measurable difference. Thus

the dividing line between material and immaterial changes in earnings per share was determined to be a constant in the area of about 7.0%.

The authors recognized the problems of generalizing a laboratory type experiment to "real world" situations, and they discussed plans for extending their study to a "real world" environment of CPA's and financial analysts.

Bernstein

Leopold A. Bernstein studied the materiality of extraordinary items prior to the issuance of APB Opinion No. 9--"Reporting the Results of Operations." The applicable pronouncement at the time of Bernstein's research was Chapter 8 of Accounting Research Bulletin No. 43 which stated, in Bernstein's words:

that there should be a general presumption that all items of profit and loss recognized during a period should be included in the determination of net income. The only possible exception represents items that are in the aggregate material in relation to the company's net income and clearly not identifiable with or result from usual or typical operations.⁴⁶

Bernstein discovered a surprisingly strong lack of materiality guidelines and inconsistencies in practice between firms with similar financial situations. His study also "reveals that there is a definite bias towards showing extraordinary items with credit balances as special items on the income statement (65% of total credits) and debit items in retained earnings (77% of total debits.)"⁴⁷ Bernstein suggested that materiality guidelines were necessary to establish uniformity of practice, and he offered "10%-15% of net income after taxes"⁴⁸ as a cut-off point between material and immaterial items.

Neumann

Frederick L. Neumann performed an empirical study of the consistency of materiality decisions with respect to two specific types of accounting changes: (1) the change to accelerated depreciation as a tax deduction in 1954, and (2) the change of method for reporting the investment credit in 1964. The first change was prompted by the Revenue Act of 1954, and the second change was stimulated by APB Opinion No. 4, which allowed the flow-through method of accounting for the investment credit.

Neumann randomly selected 300 companies from the Fortune 500 companies for the appropriate years. He examined their statements for disclosure, nondisclosure, and degree of disclosure. From alternative sources, he also determined whether the companies made a change but did not disclose it. His purpose was "to ascertain the dimensions of materiality in the specific case in which a change in accounting principle takes place."⁴⁹

Neumann's detailed analysis of the two changes revealed a distinct lack of consistency in making materiality judgments. He found when using the "percentage relationship between the effect of an accounting change on net income after taxes and that on net income itself,"⁵⁰ (a commonly held operational standard for materiality) as a materiality measure that CPA firms and their clients did not follow this measure uniformly.

He concluded, "It is my opinion, as the result of this study, that the failure to more specifically define the dimensions of materiality has led to a lack of consensus as to 'when' and 'how' of the implementation of the consistency standard."⁵¹

Summary

In general, three facts become evident from this review of the materiality research. First, most researchers have concentrated their efforts on determining how materiality decisions are made by auditors and financial statement preparers, and very little effort has been made to determine what users consider to be material. In addition, very little effort has been made to determine whether what financial statement preparers and auditors consider to be material is consistent with what users would consider to be material. This is important because an item of information which the user might consider to be material probably would not be disclosed if the preparer and auditor did not consider that information to be material.

Second, two major comprehensive studies mentioned in this analysis (Woolsey and the Financial Executives Institute studies) lacked the generalizability which could have been gained through the use of carefully selected and designed statistical techniques. Dyer's study, which is relatively comprehensive and does include statistical analysis, is limited because the subjects included only public accounting practitioners.

Third, primary research into the materiality of sensitive transactions is sparse. Both Woolsey and Dyer touch on the subject when they suggest adjustment factors for sensitive situations, but their work in this area is limited and lacks generalizability for reasons previously mentioned.

Therefore, research which meets the following criteria is needed:

1. Research investigating the consistency of preparer, auditor and user views of materiality.

2. Research which can be generalized to populations because statistical sampling techniques are applied.
3. Research investigating the materiality of information concerning sensitive transactions.

FOOTNOTES

¹Samuel M. Woolsey, "Criteria for Judging Materiality in Certain Selected Situations" (Ph.D. dissertation, University of Texas, 1954).

²Jack L. Dyer, "A Search for Objective Materiality Norms in Accounting and Auditing" (Ph.D. dissertation, University of Kentucky, 1974).

³Paul M. Frishkoff, "An Empirical Investigation of the Concept of Materiality in Accounting and Its Application in Financial Reporting" (Ph.D. dissertation, Stanford University, 1970).

⁴Edwin D. Waters, "Some Criteria for Materiality Decisions in Financial Reporting for Small Businesses" (Ph.D. dissertation, The University of Alabama, 1971).

⁵James R. Boatsman, "A Policy-Capturing Model Approach to the Concept of Materiality in External Reporting" (Ph.D. dissertation, The University of Texas at Austin, 1973).

⁶Lauren K. Newton, "The Certified Public Accountant's Attitude Toward Risk and Materiality Decisions" (Ph.D. dissertation, The University of Alabama, 1976).

⁷Hamed M. Haddidi, "Criteria for Materiality Decisions in Accounting: A Statistical Approach" (D.B.A. dissertation, Texas Tech University, 1973).

⁸Dell L. Mortimer, "An Inquiry Into Certified Public Accountants' Concepts of Materiality in Auditing" (D.B.A. dissertation, University of Colorado, 1968).

⁹Robert D. Taylor, "Materiality Decisions in Accounting: A Study of Definitions, Decisions, and Decision Criteria " (D.B.A. dissertation, University of Colorado, 1974).

¹⁰Carl J. Messere, "An Empirical Investigation of Materiality Guidelines and Earnings Trends" (Ph.D. dissertation, University of South Carolina, 1976).

¹¹James W. Pattilo, The Concept of Materiality in Financial Reporting (New York: Financial Executives Research Foundation, 1976).

¹²Woolsey, p. 38.

¹³Ibid., p. 210.

¹⁴Ibid., p. 234.

¹⁵Ibid., p. 52.

- ¹⁶Dyer, p. 380.
- ¹⁷Ibid., p. 335.
- ¹⁸Ibid.
- ¹⁹Paul Frishkoff, "An Empirical Investigation of the Concept of Materiality in Accounting," Journal of Accounting Research 8, supplement (1970): 122-123.
- ²⁰Ibid., p. 121.
- ²¹Ibid., p. 124.
- ²²Ibid., p. 125.
- ²³E. D. Waters, abstract from "Some Criteria for Materiality Decisions in Financial Reporting for Small Businesses" (Ph.D. dissertation, The University of Alabama, 1970), Dissertation Abstracts International 32/09-A: 4769.
- ²⁴J. R. Boatsman and J. C. Robertson, "Policy-Capturing on Selected Materiality Judgments" The Accounting Review 49 (April 1974): 346.
- ²⁵Ibid., pp. 343-344.
- ²⁶Ibid., p. 347.
- ²⁷Ibid., p. 349.
- ²⁸Lauren K. Newton, "The Risk Factor in Materiality Decisions" The Accounting Review 52 (January 1977): 97-107.
- ²⁹H. M. Haddidi, Abstract from "Criteria for Materiality Decisions in Accounting: A Standard Approach" (D.B.A. dissertation, Texas Tech University, 1973) Dissertation Abstracts International 34/09-A: 5381.
- ³⁰Ibid.
- ³¹D. L. Mortimer, abstract from "An Inquiry Into Certified Public Accountants' Concepts of Materiality in Auditing" (D.B.A. dissertation, University of Colorado, 1968) Dissertation Abstracts International 29/02-A: 380.
- ³²Robert D. Taylor Jr., abstract from "Materiality Decisions in Accounting: A Study of Definitions, Decisions, and Decision Criteria" (D.B.A. dissertation, University of Colorado, 1974) Dissertation Abstracts International 35/08-A: 4761.
- ³³Carl J. Messere, abstract from "An Empirical Investigation of Materiality Guidelines and Earnings Trends" (Ph.D. dissertation, University of South Carolina, 1976) Dissertation Abstracts International 48/01-A: 344.

³⁴James W. Pattilo, "Materiality: The (Formerly) Elusive Standard" Financial Executive 18 (August 1975): 21.

³⁵Ibid.

³⁶Ibid.

³⁷Ibid., p. 22.

³⁸Ibid., p. 23.

³⁹Ibid., p. 22.

⁴⁰Ibid., p. 26.

⁴¹Ibid.

⁴²Larry Lookabill, review of The Concept of Materiality in Financial Reporting, by James W. Pattilo, The Accounting Review 52 (July 1977): 779.

⁴³Ibid.

⁴⁴J. Rose and others, "Toward an Empirical Measure of Materiality" Journal of Accounting Research 8, supplement (1970): 140-141.

⁴⁵Ibid., p. 141.

⁴⁶Leopold A. Bernstein, "The Concept of Materiality" The Accounting Review 42 (January 1967): 86.

⁴⁷Ibid., p. 87.

⁴⁸Ibid., p. 93.

⁴⁹Frederick L. Neumann, "The Auditing Standard of Consistency" Empirical Research in Accounting: Selected Studies, 1968 (Chicago: University of Chicago Press, 1971), p. 11.

⁵⁰Ibid.

⁵¹Ibid., p. 12.

CHAPTER 3

DEVELOPMENT OF RESEARCH HYPOTHESES AND THE QUESTIONNAIRE

Introduction

The need for research on the materiality of illegal payments has been developed in the preceding chapters. The research problems were stated, and then restated in general hypothesis form. In this chapter, those general hypotheses will be converted to sixty-one specific hypotheses which are statistically testable.

This chapter begins with a discussion of the four types of illegal payment cases used for the research and the circumstances surrounding the illegal payment cases. The illegal payment cases and circumstances are then related to the development of the specific research hypotheses and the research instrument.

Next, having developed the hypotheses and the specific cases related to these hypotheses which are a part of the research instrument, the selection and development of a response pattern to be used to measure the materiality of various case-situation combinations will be discussed.

Finally, since the response pattern provided in the questionnaire provides for varying degrees of disclosure, the relationship between the concepts of materiality and disclosure will be discussed.

The SEC Report - A Primary Information Source

Before beginning a discussion of the types of illegal payment cases and related circumstances used in the research, it is important to recognize the Report of the Securities and Exchange Commission on Questionable and Illegal Corporate Payments and Practices¹ (SEC Report) as a primary influence on the development of the research hypotheses and the research instrument. This report is a comprehensive document prepared by the SEC and submitted to a U.S. Senate Committee. It provides an historical perspective of the investigations and disclosures relating to questionable and illegal payments beginning with investigations made by the Watergate Special Prosecutor in 1973. In addition, this report provides a complete list of voluntary disclosures and disclosures made under the SEC's enforcement program through May 10, 1976. It also categorizes illegal payments and discusses the controversial circumstances surrounding these payments.

Types of Illegal Payment Cases

All of the questionable and illegal payments are categorized in the SEC Report as follows:

Payments to government officials

- (1) "corporate payments have been made in an effort to procure special and unjustified favors or advantages in the enactment or administration of the tax or other laws of the country in question."²
- (2) "corporate payments may be made with the intent to assist the company in obtaining or retaining government contracts."³
- (3) "A third purpose for payments is to persuade low-level government officials to perform functions and services which they are obliged to perform as part of their governmental responsibilities, but which they refuse or delay unless compensated."⁴

- (4) "Another type of payment is the political contribution. Where these contributions are illegal under law, they can be assimilated to bribery."⁵

Payments to Commercial Agents and Consultants

The SEC report points out that where payments are made to an agent with a close relationship to a "governmental entity or contracting party,"⁶ the agent may be serving as a conduit for a bribery payment, especially in those circumstances where payments are larger than normal industry practices or circumstances are unusual.

Commercial bribery

"The Commission also observed payments made to improperly influence a non-governmental customer's use of a company's product or services."⁷

Basically, when they are illegal, these types of payments may be categorized as follows:

- (1) Bribery of government officials (i.e., cases (1) and (2) under payments to government officials; and payments to agents which are indirect bribes of government officials.)
- (2) Facilitating payments (i.e., cases (3) under payments to foreign government officials.)
- (3) Illegal political contributions (i.e., case (4) under payments to government officials.)
- (4) Commercial bribery

The four types of cases selected for developing specific hypotheses based on incidence analysis in the SEC report and current notoriety were: (1) illegal domestic political contributions, (2) foreign political contributions, (3) bribery of foreign government officials (not including facilitating payments*), and (4) commercial bribery.

*Facilitating payments because of the low level of the government officials involved and the nature of the payments are generally considered to be less serious. The United States Congress excluded facilitating payments from regulation under the Foreign Corrupt Practices Act of 1977.

Circumstances Surrounding Illegal Payments

The next important consideration affecting the development of the hypotheses were the circumstances surrounding the payment. Each payment case mentioned in the SEC report exhibited some or all of the following circumstances:⁸

- (a) The payment was illegal;
- (b) accounting controls were circumvented in order to make or cover up the payment;
- (c) an "off-the-books" slush fund was maintained as a source for the payment;
- (d) top management approved of and participated in making these payments;
- (e) discontinuance of the payment may result in loss of sales;
- (f) disclosure of the payment may result in foreign expropriation of corporate assets;
- (g) disclosure of the payment may result in the loss of right to do business in that country;
- (h) disclosure may result in litigation against the corporation for misuse of corporate funds;
- (i) disclosure may result in the assessment of additional income taxes because of the disallowance of the deduction of the illegal payment; and
- (j) there may be an adverse effect on relations with other foreign customers if the payments are disclosed.

Each of these circumstances or situations may or may not be present in each illegal payment case. In most of the actual cases, more than one of the above situations occurred. In order to measure the impact of each situation on preparer, auditor, and user decisions, it was necessary to provide cases in which the effect of each situation was isolated from other situations. This brought the number of combinations for purposes of hypothesis development and instrument design down to a manageable number. In each case, only one situation in addition to the fact that the payment was legal or illegal was present.

The first situation, the payment was illegal, was generally present, and would occur with the other situations. Therefore, it is present in

most of the hypotheses along with one other situation. In order to isolate the effect of the first situation in each type of payment case, the first hypothesis concerning illegal payments included the situation the illegal payment is made (no surrounding circumstance is given).

Hypotheses were developed for each case which included the following similar situations:

- (1) Illegal payment is made (no surrounding circumstances given).
- (2) Illegal payment is made by circumventing normal accounting procedures and accounting internal controls.
- (3) Illegal payment is made with top management knowledge and approval.
- (4) Illegal payment is made without top management knowledge and approval.
- (5) Illegal payment is made from funds maintained outside the system of corporate accountability, i.e., "off-the-books" slush fund.
- (6) Disclosure of the illegal payment may result in income tax assessments for improperly deducted illegal payments.

In addition, the two cases on foreign payments included the following situations:

- (7) Disclosure of the illegal payment may result in expropriation of foreign assets.
- (8) Disclosure of the illegal payment may result in the loss of right to do business in the foreign country.

The payment case on foreign political contributions also included the following two legal situations:

- (9) Legal contribution is made to a foreign politician (no surrounding circumstances given).
- (10) Legal contribution is made to a foreign politician by circumventing normal accounting procedures and accounting internal controls.

The purpose of including these two situations was to determine whether there is a difference in the response of preparers, auditors, and users between:

- (a) Situation (1) illegal payment is made (no surrounding circumstance given), and Situation (9) legal payment is made (no surrounding circumstance is given).
- (b) Situation (2) illegal payment is made by circumventing normal accounting procedures and accounting internal controls, and Situation (10) a legal payment is made by circumventing normal accounting procedures and accounting internal controls.

The payment case on commercial bribery also includes a circumstance similar to situation (7):

- (11) Disclosure of the illegal payment may result in the loss of right to do business with the company whose officials were bribed.

A few of the circumstances originally mentioned were not included in the hypotheses. One circumstance excluded from the hypotheses and the questionnaire was (e) "discontinuance of the payment may result in loss of sales." It was excluded because it is a variant of "disclosure of the payment may result in the loss of right to do business." It was also excluded in order to keep the questionnaire reasonably simple and short. Circumstance (h) "disclosure may result in litigation against the corporation for misuse of corporate funds" was excluded because most of the litigation mentioned in the SEC report was against the corporate officers and not the corporation itself. Thus, it would not be likely to affect adversely the corporation financially. Circumstance (j) "there may be an adverse effect on relations with other foreign customers if the payments are disclosed" was excluded because analysis of such an effect would be much more difficult and nebulous for the questionnaire respondent, and for the sake of simplicity.

Specific Research Hypotheses

Introduction Hypotheses H_1 Through H_{31}

The null hypothesis for hypotheses H_1 through H_{31} will begin: "Preparers, auditors and users have similar views of materiality when: .."; and the alternative hypotheses for H_1 through H_{31} will begin: "Preparers, auditors and users do not have similar views of materiality when: . .".

Illegal Domestic Political Contributions

Hypotheses H_1 to H_6 deal with illegal domestic political payment cases and six possible situations related to those cases. These hypotheses correspond to the six case-situation combinations presented on page one of the research questionnaire.

For example, null hypothesis H_1 is read as follows:

Preparers, auditors and users have similar views of materiality when illegal domestic political contributions are made.

The related case-situation in the research instrument is:

An American company made illegal domestic political contributions to U.S. political parties.

The first six hypotheses are:

- H_1 : illegal domestic political contributions are made.
- H_2 : illegal domestic political contributions are made by circumventing normal accounting procedures and accounting internal controls.
- H_3 : illegal domestic political contributions are made with the knowledge and approval of top corporate management.
- H_4 : illegal domestic political contributions are made without the knowledge or approval of top corporate management.
- H_5 : illegal domestic political contributions are made from funds maintained outside the system of corporate accountability (i.e., "off the books" slush funds).
- H_6 : disclosure of illegal domestic political contributions may result in income tax assessments for improperly deducted political contributions.

Foreign Political Contributions

Hypotheses H_7 through H_{16} deal with foreign political contributions (both legal and illegal). These hypotheses correspond to the ten case-situation combinations presented on page two of the research questionnaire.

- H_7 : legal foreign political contributions are made.
- H_8 : illegal foreign political contributions are made.
- H_9 : legal foreign political contributions are made by circumventing normal accounting procedures and accounting internal controls.
- H_{10} : illegal foreign political contributions are made by circumventing normal accounting procedures and accounting internal controls.
- H_{11} : illegal foreign political contributions are made with the knowledge and approval of top corporate management.
- H_{12} : illegal foreign political contributions are made without the knowledge and approval of top corporate management.
- H_{13} : illegal foreign political contributions are made from funds maintained outside the system of corporate accountability.
- H_{14} : disclosure of illegal foreign political contributions may result in expropriation of foreign corporate assets.
- H_{15} : disclosure of illegal foreign political contributions may result in the loss of right to do business in the foreign country.
- H_{16} : disclosure of illegal foreign political contributions may result in income tax assessments for improperly deducted political contributions.

Bribery of Foreign Government Officials

Hypotheses H_{17} through H_{24} deal with bribery of foreign government officials. These hypotheses correspond to the eight case-situation combinations presented on page three of the research questionnaire.

- H_{17} : bribes are paid to foreign government officials.

- H₁₈: bribes paid to foreign government officials are made by circumventing normal accounting procedures and accounting internal controls.
- H₁₉: bribes paid to foreign government officials are made with the knowledge and approval of top corporate management.
- H₂₀: bribes paid to foreign government officials are made without the knowledge and approval of top corporate management.
- H₂₁: bribes paid to foreign government officials are made from funds maintained outside the system of corporate accountability.
- H₂₂: disclosure of bribes paid to foreign government officials may result in expropriation of foreign corporate assets.
- H₂₃: disclosure of bribes paid to foreign government officials may result in the loss of right to business in the foreign country.
- H₂₄: disclosure of bribes paid to foreign government officials may result in income tax assessments for improperly deducted illegal bribes.

Commercial Bribery

Hypotheses H₂₅ through H₃₁ deal with commercial bribery. These hypotheses correspond to the seven case-situation combinations presented on page four of the research questionnaire.

- H₂₅: commercial bribes are paid.
- H₂₆: commercial bribes are made by circumventing normal accounting procedures and accounting internal controls.
- H₂₇: commercial bribes are made with the knowledge and approval of top corporate management.
- H₂₈: commercial bribes are made without the knowledge and approval of top corporate management.
- H₂₉: commercial bribes are made from funds maintained outside the system of corporate accountability.
- H₃₀: disclosure of commercial bribes may result in a loss of business with the company whose officials were bribed.

H₃₁: disclosure of commercial bribes may result in income tax assessments for improperly deducted illegal bribes.

Introduction Hypotheses H₃₂ Through H₅₅

These hypotheses are directed at determining whether intra-group decisions are consistent when situations are similar across varying illegal payment cases. For example, null hypothesis H₃₂ states that:

Preparers have the same view of materiality in varying cases involving illegal payments.

A statistical test will be used to determine whether this statement should or should not be rejected based on the analysis of the responses to the four illegal payment cases in which no surrounding circumstances were given. Those four cases are:

1. An American company made illegal domestic political contributions to U.S. political parties.
2. An American company made illegal political contributions to foreign politicians.
3. An American company made illegal payments to foreign government officials.
4. One American company made bribery payments to officers of foreign companies.

There are three groups and eight similar situation sets per group for a total of twenty-four hypotheses.

Preparers H₃₂ Through H₃₉

The null hypothesis for hypotheses H₃₂ through H₃₉ will begin: "Preparers have the same view of materiality in the varying cases involving: .."; and the alternative hypothesis for hypotheses H₃₂ through H₃₉ will begin: "Preparers do not have the same view of materiality in the varying cases involving: ..".

H₃₂: illegal payments.

H₃₃: circumvention of normal accounting procedures and accounting internal controls when making illegal payments.

H₃₄: top management knowledge and approval of illegal payments.

- H₃₅: lack of top management knowledge and approval of illegal payments.
- H₃₆: funds maintained outside the system of corporate accountability.
- H₃₇: corporate disclosure which may result in income tax assessments for improperly deducted illegal payments.
- H₃₈: corporate disclosure which may result in expropriation of foreign corporate assets.
- H₃₉: corporate disclosure which may result in the loss of right to do business.

Auditors H₄₀ Through H₄₇

The null hypothesis for hypotheses H₄₀ through H₄₇ will begin: "Auditors have the same view of materiality in the varying cases involving: .."; and the alternative hypothesis for hypotheses H₄₀ through H₄₇ will begin: "Auditors do not have the same view of materiality in the varying cases involving: ..".

- H₄₀: illegal payments.
- H₄₁: circumvention of normal accounting procedures and accounting internal controls when making illegal payments.
- H₄₂: top management knowledge and approval of illegal payments.
- H₄₃: lack of top management knowledge and approval of illegal payments.
- H₄₄: funds maintained outside the system of corporate accountability.
- H₄₅: corporate disclosure which may result in income tax assessments for improperly deducted illegal payments.
- H₄₆: corporate disclosure which may result in expropriation of foreign corporate assets.
- H₄₇: corporate disclosure which may result in the loss of right to do business.

Users H₄₈ Through H₅₅

The null hypothesis for hypotheses H₄₈ through H₅₅ will begin: "Users have the same view of materiality in the varying cases involving: .."; and the alternative hypothesis for hypotheses H₄₈

through H₅₅ will begin: "Users do not have the same view of materiality in the varying cases involving: ..".

H₄₈: illegal payments.

H₄₉: circumvention of normal accounting procedures and accounting internal controls when making illegal payments.

H₅₀: top management knowledge and approval of illegal payments.

H₅₁: lack of top management knowledge and approval of illegal payments.

H₅₂: funds maintained outside the system of corporate accountability.

H₅₃: corporate disclosure which may result in income tax assessments for improperly deducted illegal payments.

H₅₄: corporate disclosure which may result in expropriation of foreign corporate assets.

H₅₅: corporate disclosure which may result in the loss of right to do business.

Introduction Hypotheses H₅₆ Through H₆₁

These hypotheses are directed at determining whether intra-group decisions are the same when situations are similar and the payment is legal as when it is illegal. For example, null hypothesis H₅₆ states that:

Preparers have the same view of materiality when payment of a foreign political contribution is legal as when it is illegal (no surrounding circumstances given).

A statistical test will be used to determine whether this statement should or should not be rejected based on the analysis of the responses to the following questions:

1. An American company made legal political contributions to foreign politicians.
2. An American company made illegal political contributions to foreign politicians.

There are two specific null hypotheses for each of the three groups comparing materiality decisions in legal versus illegal payment cases.

Preparers H₅₆ and H₅₇

The null hypothesis for hypotheses H₅₆ and H₅₇ will begin: "Preparers have the same view of materiality when:" and the alternative hypothesis for hypotheses H₅₆ and H₅₇ will begin: "Preparers do not have the same view of materiality when:"

H₅₆: payment of a foreign political contribution is legal as when it is illegal (no surrounding circumstances given).

H₅₇: a legal foreign political contribution is made by circumventing normal accounting procedures and accounting internal controls as when an illegal foreign political contribution is made by circumventing normal accounting procedures and accounting internal controls.

Auditors H₅₈ and H₅₉

The null hypothesis for hypotheses H₅₈ and H₅₉ will begin: "Auditors have the same view of materiality when:" and the alternative hypothesis for hypotheses H₅₈ and H₅₉ will begin: "Auditors do not have the same view of materiality when:"

H₅₈: payment of a foreign political contribution is legal as when it is illegal (no surrounding circumstances given).

H₅₉: a legal foreign political contribution is made by circumventing normal accounting procedures and accounting internal controls as when an illegal foreign political contribution is made by circumventing normal accounting procedures and accounting internal controls.

Users H₆₀ and H₆₁

The null hypothesis for hypotheses H₆₀ and H₆₁ will begin: "Users have the same view of materiality when:" and the alternative hypothesis for hypotheses H₆₀ and H₆₁ will begin: "Users do not have the same view of materiality when:"

H₆₀: payment of a foreign political contribution is legal as when it is illegal (no surrounding circumstances given).

H₆₁: a legal foreign political contribution is made by circumventing normal accounting procedures and accounting internal controls as when an illegal foreign political contribution is made by circumventing normal accounting procedures and accounting internal controls.

The Questionnaire Response Pattern

Having developed the specific hypotheses and the related questionnaire case-situations, it was next necessary to develop a meaningful materiality measure. That is, given a specific case-situation combination, respondents should be able to indicate in their response whether or not an item is material.

A review of the literature as summarized in Chapter 2 indicated that the most commonly used decision variable for making materiality decisions has been the relationship of the item to net income. Structuring the materiality measure around this criterion, the following questionnaire response pattern was developed:

- Response 1: Do not disclose the payment or circumstances.
- Response 2: Disclose the payment and surrounding circumstances regardless of payment size.
- Response 3: Disclose the payment if it is greater than some specified percentage of net income. Please specify the percentage you consider appropriate.
- Response 4: Disclose the payment if it is greater than some absolute dollar amount. Please specify the dollar amount you consider appropriate.

The response pattern allows the respondent a full range of possible responses from no disclosure (response 1), to disclosure based on degree (responses 3 and 4), to full disclosure (response 2). This response pattern will also allow this researcher to address some of the statements made and questions raised by the FASB Discussion Memorandum on materiality.

Issues Raised in the Materiality Discussion Memorandum

Several quotations from the Materiality Discussion Memorandum along with the research questions raised by these quotations follow:

(1) Quotation:

Some preparers and auditors believe that, absent unusual circumstances, an item generally should be considered material if it affects net income by 10 percent or more, and not material if it affects net income by 5 percent or less. They believe that materiality of matters whose effect on net income falls between 5 and 10 percent should be determined through careful analysis of the nature of the matter and the surrounding circumstances.⁹

Research Questions:

If questionable and illegal payments are unusual, should a sensitivity factor be applied to the above stated criteria? For example, should a sensitivity factor of .60 be used to reduce the materiality criteria to 3% (.6 x 5%) and 6% (.6 x 10%)? What are the characteristics of the sensitive situation which requires the application of a sensitivity factor? Can quantitative criteria be established in all situations or would a \$1,000 bribe paid by a multinational corporation with more than a billion dollars in assets always be a disclosable event?

(2) Quotation:

Many believe that the nature of all transactions involving greater than "normal risk" should be clearly described. Those espousing this position often support their views with references to instances of alleged use of misleading accounting and reporting practices to mask the substance and attendant risks of the operating practices followed in certain industries and to mask the "true state of affairs" in certain industries.¹⁰

Research Question:

The SEC report clearly indicates that the use of misleading accounting reporting practices occurred in attempts to cover up questionable and illegal payments. Does the circumvention of accounting controls and falsification of accounting records indicate a greater than normal amount of investor risk sufficient to require disclosure regardless of amounts involved?

(3) Quotation:

On an international scale, the political situation may be extremely complex; exposure to expropriation, loss of right to do business and currency restrictions are only a few of the special risks to which foreign operations are subject. Often the sensitivity of these situations is such that preparers and auditors weigh heavily the implications of the disclosure of the conditions for fear of endangering the enterprise's position in negotiating contract changes, settlement for expropriated assets, and the like.¹¹

Research Question:

Disclosure of questionable or illegal actions in foreign countries may result in expropriation or loss of right to do business in those foreign countries. Should financial statements disclose these questionable and illegal actions at all costs?

(4) Quotation:

Many auditors view the quality of management as one of the most important factors in assessing the appropriateness and reasonableness of managements financial accounting and reporting decisions.¹²

Research Question:

Does top management knowledge of the circumvention of accounting controls, establishment of "off the books" funds, the payment of bribes and influencing payments reflect on the quality of management? If so, should all information concerning questionable and illegal payments be disclosed if top management was aware of it? If top management was not aware of these questionable and illegal practices, is this fact also a measure of the quality of management?

(5) Quotation:

The influence of cost/benefit considerations on materiality judgments is unclear. Nevertheless, the costs to an enterprise and its stockholders that would result from implementing a decision are often considered by preparers and auditors. For instance, in some situations, it might be decided not to disclose certain information otherwise deemed desirable to disclose, although not necessary under generally accepted accounting principles, because of the cost of gathering information in reliable form. While some preparers and auditors may consciously consider cost benefit trade

offs, others may consider only the costs involved as benefits from the disclosure of a specific matter may be difficult to measure. The costs considered in such decision making might include direct incremental costs such as the cost of gathering and reporting additional information, and indirect costs such as increased liability exposure and legal fees, and any competitive implications.¹³

Research Questions:

Although amounts paid in attempts to influence foreign officials may be immaterial in relation to corporate net income, if disclosure results in discontinuance of foreign sales or foreign governments' contracts, the effect of the loss of sales in the foreign country may be material in relation to corporate income. Should the potential consequences of failure to continue to make improper payments be disclosed? What consideration should be given to the fact that disclosure may serve as a catalyst bringing lawsuits and tax proceedings against the company?

Conclusions About the Questionnaire Response Pattern

The response pattern will enable the respondent to consider many factors when making his materiality decision. For example, Response 1 will allow the respondent to consider the costs and benefits of disclosure (i.e., are the benefits to the financial statement user of disclosure of an illegal payment less than the costs of possible expropriation of assets or loss of right to do business?). Do the circumstances surrounding the illegal payment indicate disclosure is necessary regardless of amounts involved?, if so, the respondent may select response 2. Response 3 is the common basis for making materiality decisions, the relationship of the item to net income. Response 4 will allow the researcher to answer the question: Can quantitative criteria be established in all situations or would a \$1,000 bribe paid by a multinational corporation always be a disclosable event?

In addition, responses 3 and 4 allow the respondent to offer

percentage criteria or absolute dollar amounts respectively. For those respondents selecting response 3, a mean percentage may be computed for the materiality of an item as a percent of net income, a confidence interval may be developed (an indifference zone), and possibly sensitivity factors may be suggested for adjusting normal materiality criteria as expressed in previous research for situations involving illegal payments. For those respondents selecting response 4, a mean absolute dollar amount may be computed and a confidence interval may be established for the mean absolute dollar amount.

The Link Between Materiality and Disclosure

In each illegal payment case in the questionnaire, the following statement is made: "In order to determine YOUR OPINION of what information about these payments is material and significant to financial statement users in varying circumstances, four levels of disclosure response are offered below. For each circumstance, please indicate the disclosure response that YOU consider to be appropriate." There is in these two sentences the assumption of a direct link between materiality and disclosure. That is, it is presumed that if an item of information is useful in a material respect to the financial statement user, then it should be disclosed. Conversely, if an item of information is not consequential or significant to the financial statement user then it should not be disclosed.

There are, of course, two other possibilities. It is possible that the respondent may deem an item to be material and significant to financial statement users and choose the response "do not disclose" the payment or circumstances. It is also possible that the respondent

may deem the information not material or significant and yet choose a partial or full disclosure response. The material-disclosure combinations may be summarized as follows:

1. Item material, therefore disclose.
2. Item immaterial, therefore do not disclose.
3. Item material, however do not disclose.
4. Item immaterial, however disclose.

The first two combinations are strongly supported in the accounting literature but before they can be accepted, the reader must recognize the accountant's limited specification of the objectives of financial statements. The accountant's primary objective in the preparation and dissemination of financial statements is to provide information useful for decision making purposes; and any information which is material, significant, or consequential to that decision-making should be disclosed. This point of view is well established and is asserted in the authoritative literature.

In 1973 the AICPA issued a report called "Objectives of Financial Statements," also commonly called the "Trueblood Report." In this report, the Committee stated, "The basic objective of financial statements is to provide information useful for making economic decisions."¹⁴ Later on in the report it goes on to say, "Information should be disclosed in the financial statements when it is likely to influence the economic decisions of users of financial statements. Information that meets this requirement is material [emphasis added]."¹⁵ Thus the "Trueblood Report" supports the if-then link between materiality and disclosure. If the information is material to the investor, then it should be disclosed.

Regulation S-X of the Securities and Exchange Commission also

establishes this link. Rule 1-02 states:

The term "material" when used to qualify a requirement for the furnishing of information as to any subject, limits the information required [to be disclosed] to those matters about which an average prudent investor ought to be informed [emphasis added].¹⁶

In the foreward to the FASB Discussion Memorandum on Materiality, the FASB explicitly recognizes the link between materiality and disclosure.

Materiality commonly is thought of in terms of whether the disclosure of the matter or accounting treatment of it is either necessary for reasonable overall understanding of an enterprise's financial statements or likely to influence the conduct of a prudent investor. This fundamental matter has long been recognized in the authoritative literature [emphasis added].¹⁷

It is clear that the authoritative accounting literature supports the first materiality-disclosure combination (i.e., if an item is material, then it should be disclosed). At least implicitly it also supports the position that if an item is not of material interest to the financial statement user, then it need not be disclosed. Further, authoritative support may be found in the following statement from the "Trueblood Report":

Information contained [i.e., disclosed] in financial statements to satisfy users' needs should possess the quantitative characteristics of relevance and materiality... Information is not useful unless it is relevant and material to the user's decision.¹⁸

That is, if information is not material, it need not be disclosed.

The authoritative literature seems to indicate combinations (1) and (2) are the rule, and mentions combination (4) disclosure of immaterial information as an exception:

An enterprise may disclose certain matters because it is customary to do so even though they would not be disclosed if the decision were approached solely on

the basis of materiality.... Generally, decisions in this particular area involve questions concerning the need to disclose particular information and the manner and the detail in which it is to be presented. As a practical matter, there is little concern with the disclosure of immaterial information, unless such disclosures tend to obscure the importance of other data.¹⁹

If the respondents to the questionnaire take the following statement literally, "In order to determine YOUR OPINION of what information about these payments is material and significant to financial statement users in varying circumstances," then they will select Response 1 for immaterial information concerning illegal payments. They will conclude that because the information is immaterial to the financial statement user, then it need not be disclosed. However, if for some other reason, they should decide that an item of information should be disclosed even though it is not material, then combination (4) becomes an exception to the norm.

With respect to the illegal payments questionnaire, combination (4) (even though immaterial, the information should be disclosed) is a possibility. There may be those individuals (preparers, auditors, or users) who believe that immaterial information concerning illegal payments should be disclosed in the financial statements. Such disclosure they believe will serve as a sanction inhibiting continuing illegal payments and circumstances in the future.

The SEC's Advisory Committee on Corporate Disclosure recognized this problem when it recommended that the SEC adopt the following statement of objectives:

The Commission's function in the corporate disclosure system is to assure the public availability in an efficient and reasonable manner and as a timely basis of reliable, firm oriented information, material to informed investment, and

corporate suffrage decision-making. The commission should not adopt disclosure requirements which have as their principle objective the regulation of corporate conduct [emphasis added].²⁰

Thus the advisory committee on corporate disclosure, set up by the SEC to advise the SEC, concluded that only material information should be disclosed, and financial statements should not be used as a device to regulate management's actions.

However, the SEC refused to accept the statement of objectives and issued the following written response to the advisory committee:

The basic objective of the disclosure requirements is to increase investor confidence and to make the securities markets more efficient and as fair and honest as possible. Any endeavor to define these objectives more precisely would not be beneficial since disclosure requirements necessarily must be dynamic to meet the ever-changing environment in which the securities markets operate.²¹

Thus, the SEC prefers to maintain as an option the use of financial statements as a means of regulating corporate conduct, and thus it may possibly require the disclosure of immaterial information.

Combination (3), an item may be material but should not be disclosed, is also a possibility. Given a statement from the questionnaire such as the following: "For some firms, disclosure in corporate financial statements of illegal political contributions may result in the loss of right to do business in the country in which the illegal contribution occurred," the respondent may conclude that the benefits of such a disclosure to the user of material information (e.g., information useful for predicting the amount and timing of future cash flows; information concerning uncertainties) may be outweighed by the costs of such disclosure (e.g., loss of right to do business). Therefore, the respondent may decide that even though the information is

material, it should not be disclosed.

Since the questionnaire assumes that there is a direct link between materiality and disclosure, how will violations (combinations 3 and 4) of the direct link affect the primary research question, "Do preparers, auditors, and users of financial statements have similar views of materiality in sensitive situations?" First, assume combination (3), and the above stated case in which disclosure of a material item may result in the loss of right to do business. The disclosure decision is a direct function of the materiality of the information adjusted for cost-benefit considerations. In researching a segment of the materiality question, cost-benefit considerations are of concern as indicated in the following quote from the Materiality Discussion Memorandum:

The influence of cost/benefit considerations on materiality judgments is unclear. Nevertheless, the costs to an enterprise and its stockholders that would result from implementing a decision is often considered by preparers and auditors.²²

The validity of the null hypothesis related to the above payment case (H_{15} : Preparers, auditors, and users have similar views of materiality when disclosure of illegal foreign political contributions may result in the loss of right to do business in the foreign country) is not abrogated because the cost-benefit factor may outweigh the materiality factor in the disclosure decision. The researcher may still compare the sample responses to determine whether preparers, auditors, and users have similar views of materiality in a given case when cost-benefit is a factor and determine whether these views are similar by analysis of disclosure response patterns.

With respect to combination (4) item immaterial, however disclose,

the respondent may select Response 2 for the following question:

An American company made illegal payments to foreign government officials.

The respondent may reason that the payment should be required to be disclosed even though the amount is insignificant because requiring disclosure may serve as a deterrent against making further illegal payments. Again, the researcher may still compare the sample responses to determine whether preparers, auditors, and users have similar views of materiality in a given case when corporate morality or legality is a factor and determine whether these views are similar by analysis of disclosure response patterns.

For those readers who remain uneasy with the hypotheses which begin with "Preparers, auditors, and users have similar views of materiality" because they think it should read "Preparers, auditors, and users have similar views of disclosure" may wish to substitute the word "disclosure" for the word "materiality" in the hypotheses. It is important to recognize that the two words are not mutually exclusive, and although the primary research objective is to examine materiality criteria, much useful information concerning disclosure will also come from this study.

Summary

In this chapter, the development of the research hypotheses was discussed. The SEC Report²³ played a major role in identifying the types of illegal payment cases and situations surrounding these cases; many of which became an integral part of the research hypotheses and questionnaire design.

Following the development of the hypotheses, the measurement

instrument, in the form of a disclosure response pattern, was discussed. The review of the materiality literature and questions raised by the FASB Discussion Memorandum on materiality were useful in developing the response pattern.

Finally, because this is a materiality research study and the measurement instrument uses varying degrees of disclosure as indicators of materiality, the chapter concludes with a discussion of the link between materiality and disclosure.

FOOTNOTES

¹Securities and Exchange Commission, Report of the Securities and Exchange Commission on Questionable and Illegal Corporate Payments and Practices, submitted to the Senate Banking, Housing and Urban Affairs Committee (May 12, 1976).

²Ibid., pp. 25-26.

³Ibid., p. 26.

⁴Ibid., pp. 26-27.

⁵Ibid., p. 27.

⁶Ibid., p. 28.

⁷Ibid., p. 29.

⁸Ibid.

⁹Financial Accounting Standards Board, An Analysis of Issues Related to Criteria for Determining Materiality (Stanford, Connecticut: FASB, 1975), p. 68.

¹⁰Ibid., p. 72.

¹¹Ibid., p. 73.

¹²Ibid.

¹³Ibid., p. 75.

¹⁴American Institute of Certified Public Accountants, Objectives of Financial Statements (New York, New York: AICPA, 1973), p. 13.

¹⁵Ibid., p. 57.

¹⁶FASB, Materiality, p. 27.

¹⁷Ibid., p. 7.

¹⁸AICPA, Objectives, p. 66.

¹⁹FASB, Materiality, p. 66.

²⁰Ernst & Ernst, "Corporate Disclosure" Financial Reporting Developments (Cleveland, Ohio: Ernst & Ernst, 1978), p. 18.

²¹Ibid., p. 61.

²²FASB, Materiality, p. 75.

²³SEC, Questionable and Illegal Payments.

CHAPTER 4

THE QUESTIONNAIRE: PRETEST, SAMPLING, AND RESPONSE

Introduction

Pretesting a questionnaire is a necessary step in the research process for identifying and correcting any instrument deficiencies. This chapter reviews the questionnaire pretest, sample selection process and mailing procedures. The questionnaire response and the test for nonresponse bias are also discussed.

The Pretest

The questionnaire was pretested by sending copies to each of three top corporate financial officers, three CPA partners in "big eight" accounting firms, and three Chartered Financial Analysts. The selection of the individuals was based on their proximity to the researcher and their expected cooperation and likelihood of response. Of these nine individuals, four not only received letters but also met with the researcher.

In the initial contact letter, each individual was informed that the questionnaire was related to a dissertation proposal concerning the materiality of sensitive payments, that the researcher was a doctoral student in accounting at Michigan State University, and that the basic research question was, "Do financial statement preparers, financial statement auditors, and financial statement users have

similar views of materiality in varying circumstances involving illegal payments?" In addition, they were told that the final questionnaire would be sent to a random sample of members of these three groups, and that the researcher would like to obtain a critique and reaction to the questionnaire from a few financial experts in each group. These individuals were then either asked to critique and return the questionnaire or told that they would be contacted in a few days concerning the possibility of them meeting with the researcher.

Two of the three top corporate financial officers were asked to arrange personal meetings with the researcher. The other officer was asked to critique and return the questionnaire.

The first financial officer to visit with the researcher was the vice president and treasurer of a major U.S. manufacturer. He wrote the following comments on the contact letter:

- Disclosure decisions are also a function of legal judgment.
- Examples are clear.
- Quantification may be difficult.
- The facts of the situation are more important than the amounts. (\$ or % of earnings [sic])

This vice president and treasurer indicated that probably one of the first things that his company would do when confronted with a question concerning what should be disclosed would be to consult the corporate legal counsel to determine what the corporation was obligated to disclose under the law. He indicated that the cases and circumstances presented in the questionnaire were similar to those he had become familiar with and that he had no difficulty understanding them. He also considered the facts of the situation more important than the

dollar amounts, and he thought that any payments regardless of size which were illegal should be disclosed because of their nature.

This vice president-treasurer also asked the corporation's chief accountant, whom he described as the man responsible for dealing with the SEC and for fulfilling disclosure requirements, to review and comment on the questionnaire. The chief accountant's unedited comments are as follows:

If I were to answer this survey from the position of being uninvolved in the circumstances described, I feel I would always indicate disclosure to be necessary. To do otherwise would be to condone some level of activity which is illegal--to say that it is not the activity which is illegal but rather the amount.

If, however, I am a party to the circumstances, I would undoubtedly be inclined not to desire disclosure. To knowingly be involved in an illegal act and at the same time be desirous of public disclosure seems incongruous.

The survey is like asking when you quit beating your wife. The answer is I haven't quit because I never started. Similarly, I favor disclosure of illegal acts because I haven't and don't intend to commit such acts. However, if I knowingly or inadvertently commit such acts, I would be inclined to self-forgiveness and would feel disclosure not to be beneficial to anyone. Self-disclosure merely invites criminal prosecution.

It is the attitude and integrity of a company's management that is material and not the dollar measure placed on such acts. Small illegalities have a way of growing.

The vice-president for finance of another major U.S. manufacturing corporation also agreed to meet with the researcher. He also asked his corporate controller to participate in the meeting. Neither the vice-president for finance nor the corporate controller expressed any concerns about the questionnaire. They did express concern about getting a good response rate and suggested that a cover letter be included with Michigan State University letterhead as a means of increasing the

response rate. The remainder of the conversation was a discussion of the general business climate including the effect of public pressure groups. They did mention the "IRS list of 11 questions" sent to all major corporations as a general investigation of corporate slush funds. With respect to disclosure, the vice-president for finance said that he would disclose as little as legally necessary because public agencies and pressure groups often used such disclosures to the detriment of the corporation.

The third officer, a corporate controller, who was asked to critique the questionnaire and return it, filled out the questionnaire rather than critiquing it, and returned it.

One of the three CPA partners in "big eight" accounting firms was asked to arrange a personal meeting with the researcher. The other two CPA partners were asked to critique and return the questionnaire. One of these two did not reply.

The researcher met with the first CPA partner. This CPA did not express any concerns about the questionnaire itself. He was concerned about the amount of time the respondents in the CPA group would give to each questionnaire case. He said that if he were confronted with this kind of materiality problem, and had to make a disclosure decision, it would be one of the important decisions that he would have to make on any given day. He was afraid that the response to the questionnaire would not be given the same thorough consideration as a CPA would give to the real life situation. Concerning the results he expected from the study, this CPA partner stated that probably all disclosure responses from CPA's would be based on the item in relation to the percent of income.

The second CPA partner responded in writing and the portion of his letter relating to the questionnaire is quoted below:

I have read your draft of the questions for your research project and believe you have been very comprehensive. The only suggestion that I have for change is the possibility of grouping the questions on tax assessments into a separate section, since it does not seem to flow well in terms of response. This, however, may be just a personal reaction and others may not view it the same way.

One of the three Chartered Financial Analysts (CFA) was asked to meet with the researcher. The other two CFA's were asked to critique and return the questionnaire; one of these two did not reply.

The CFA who met with the researcher also asked his colleague, another CFA, to meet with us. They also did not have any concerns with the questionnaire itself. There were two salient comments made during this meeting. First, with respect to the use of CFA's as a surrogate for general investors, the CFA stated that general investors may be concerned with moral concerns in respect to illegal payments separately from the effects of such payments on investment value. He believed that most CFA's would only be concerned with investment value. Secondly, it was this CFA's opinion that economic constraints would always limit bribes to small and immaterial amounts, and therefore, they should never be disclosed in the financial statements.

The handwritten response from the other CFA responding said:

In order to get responses, the questionnaire must look simple as well as be simple. I would suggest cutting down on the verbage and repetitive parts in the forms. Note suggested changes I penned in on first two pages. Hard to read after it has been shrunk.

This CFA crossed out the major portion of the introductory comments on the questionnaire and stated, "All CFA's should already know this."

Observations from the Pretest

Several observations from the pretest have been useful in evaluating the questionnaire, developing the cover letters, and reviewing the research logic. These observations and comments concerning these observations are listed below:

1. There were several different conclusions made concerning what is material and should be disclosed.
2. Disclosure decisions are also a function of legal judgment.
3. An individual's disclosure decision may differ depending upon whether he or his company is actively involved, or he is rendering judgment as to what should be disclosed by others.
4. The amount of time spent making a disclosure decision in real life situations may be different from the amount of time spent on a questionnaire consisting of hypothetical cases.
5. CFAs may not be a good surrogate for general investors.
6. One CPA partner thought the questions on tax assessments should be grouped in a separate section.
7. One CFA thought that there was "excess verbage" in the questionnaire.

One of the initial concerns expressed by individuals who discussed the research question with the researcher was that respondents would always respond that full disclosure was necessary. The pretest indicates that this will not be the case since some pretest respondents advocated no disclosure, some advocated complete disclosure, and one advocated disclosure based on the percent of income concept.

The statement that disclosure decisions are partially a matter of legal judgment is true sometimes; however, the questionnaire asked for an OPINION of what information is material and the level of disclosure appropriate to the OPINION. Laws are ultimately based on the opinions

of the majority, and part of the purpose of this research is to evaluate the need for laws and regulations whether they are already established, or whether they may yet need to be established. Opinions reflected in this research may be useful to that end.

A serious point raised in the pretest is that an individual's decision concerning materiality and related disclosure when he and his company or client are not actually involved may be different from the decision that he would make if he were actually involved. That is, his opinion as to the appropriate level of disclosure may not coincide with the disclosure he would select for his company or his client. Since this research is attempting to ascertain whether preparers, auditors, and users have similar views of materiality, and since it is not attempting to determine whether each individual's views are consistent with how he would act given a real life situation, this point is moot. This does not mean that it would not be useful to determine whether a person's actions are consistent with his opinions. It merely means that this research will not attempt to resolve this question.

One of the criticisms of questionnaire research is that the respondent might react differently in a real life circumstance than he would to a hypothetical case. The respondent does not have the related professional and financial risks and all of the attendant circumstances when responding to a questionnaire; therefore, he will not spend as much time making the materiality evaluations in hypothetical cases. However, this does not invalidate this approach. Each financially adept individual will have developed opinions as to what is material and what should be disclosed, and given his background, he should be able to respond quickly and in a meaningful way to the cases and

circumstances in the questionnaire.

The following question was not only raised in the pretest but also by a dissertation committee member: Are CFAs a good surrogate for investors? Reference to the Discussion Memorandum on Materiality indicates that because of the difficulty of obtaining information on general investors, or perhaps even defining who a general investor is, financial analysts are usually used as a surrogate for general investors. It is presumed that the financial analyst, a more sophisticated investor than the average investor, would certainly be aware of any information which would be useful to the general investor. One of the CFAs interviewed during the pretest indicated that CFAs would be interested only in economic data which would affect investment valuation and not with moral questions, whereas general investors may also be interested in moral data. To the extent that the general investor may desire more or less data of noneconomic nature, he may not be well represented by the CFA. However, because the CFA will be able to select the most useful information for investment analysis purposes, he is an important user in his own right, and he is the user surveyed in this research.

The researcher decided against grouping tax assessments into a separate section because such a grouping would complicate the questionnaire and make the questions seem interrelated to the respondent. It might also lead to an interaction between responses that might otherwise not be there.

The researcher also decided against eliminating the introductory comments which one CFA labeled "excess verbage" so that respondents would have a meaningful frame of reference. The researcher believes that such an elimination would tend to complicate rather than simplify

the questionnaire.

The final questionnaire (i.e., the one finally mailed to the random sample of the three groups) was substantially the same as the questionnaire sent to the selected pretest respondents. It did have one major difference. Each payment case in the pretest questionnaire included a type of company (For example: An American electronic manufacturer made illegal domestic political contribution to U.S. political parties). The type of company was eliminated in the final questionnaire (For example: An American company made illegal domestic political contributions to U.S. political parties). The reason the type of company was eliminated was that it might be a confounding variable. That is, an individual may require more disclosure from an oil company than an electronics manufacturer because of pre-conceived notions about oil companies. This allows the researcher to make statistical analysis of circumstances without concern for the confounding effects of company type.

Populations Sampled

Random samples of 300 were selected from each of the following groups: (1) CPA partners in the 15 largest public accounting firms in the United States (auditors), (2) financial executives in Fortune magazine's top 1,000 industrial firms (preparers), and (3) U.S. Chartered Financial Analysts (users).

The sample of auditors was restricted to partners in the top fifteen CPA firms in the country according to the 1976 edition of Who Audits America.¹ The sample could have been easily restricted to the "big eight" because they audit 71% of the companies audited and 94% of the total sales audited (\$1,501,664 million). In order to obtain a broader

base for analysis, however, the next seven largest public accounting firms who audit sales of approximately \$58,275 million were also included.

The sample of preparers was originally to be restricted to a random sample of Fortune's top 500 industrial firms. Since a sample of 300 out of 500 (60%) was an unnecessarily large sample for purposes of obtaining a representative sample, and since the generalizability of the research will be increased by increasing the population sampled, the sample of preparers was selected from Fortune's top 1,000 industrial firms. The top 500 industrial firms had sales for the fiscal year ending in 1976 of 971.1 billion² and the next 500 industrial firms had sales of 89.2 billion³ for the fiscal year ending in 1976 according to Fortune magazine.

The sample of users was selected from the population of U.S. Chartered Financial Analysts as listed in the Fifteenth Directory of Members 1977-1978⁴ of the Institute of Chartered Financial Analysts. This group, selected as a surrogate for general investors, is an important and knowledgeable user group in its own right.

Sample Selection

The 1976 AICPA List of Members⁵ was used to select partners in the top fifteen CPA firms. The names of the top fifteen CPA firms were obtained from the February, 1977 printing of Who Audits America⁶ and was based on total sales audited. They are as follows:

	<u>Total Sales Audited (in millions)</u>
Price Waterhouse & Co.	\$323,888
Arthur Andersen & Co.	241,328
Peat, Marwick, Mitchell & Co.	198,611
Haskins & Sells	191,836
Coopers & Lybrand	177,127
Ernst & Ernst	137,391
Arthur Young & Co.	128,286
Touche Ross & Co.	103,197
Main Lafrentz & Co.	13,139
Hurdman & Cranstoun	12,504
S. D. Leidesdorf & Co.	11,512
Laventhol & Horwath	7,836
Alexander Grant & Co.	7,280
Seidman & Seidman	3,112
J. K. Lasser & Co.	2,891

The last CPA firm, J. K. Lasser & Co. merged with Touche Ross & Co. during 1977; however, the AICPA list from 1976 showed the partners affiliation as J. K. Lasser & Co. For those partners selected in the sampling process from J. K. Lasser, the same name and address was used as listed in the AICPA listing, but the company name was changed to Touche Ross & Co.

The 1976 AICPA List of Members⁷ is 914 pages long with three columns per page and approximately 45 names and addresses per column. Within each column, there were generally zero to five CPA's who qualified as partners in the top fifteen CPA firms (Partners were designated as such with an asterisk next to their name).

The population of partners was further limited by eliminating partners' names who resided outside of the United States or its territories. (There were approximately five such members in the random sample.)

A computer generated random number listing was obtained for pages and columns. For example the first random number was page 805 column 1.

For the first 100 random numbers for page and column, the page and column were located and then the sample member was selected by reading from the top of the column down to the first qualifying partner (i.e., a partner in one of the top fifteen CPA firms). If there was more than one partner qualifying on that page and column, only the first one was selected. If there were no qualifying partners on that page and column, the selection went on to the next random number for page and column. In cases in which a page and column was selected twice, a second sample member was selected from that page if there was a second qualifying partner.

For the second 100 random numbers for pages and columns, the page and column were located and then the sample member was selected by reading from the bottom of the column up to the first qualifying member. The remaining procedures mentioned above remained the same.

For the next 75 random numbers for pages and columns, the page and column were located and then the sample member was selected by reading from the middle of the column down (as determined by using a ruler to locate the middle of the page) and then from the middle of the column up if no qualifying partner was found in the bottom half of the column.

For the next 75 random numbers for pages and columns, the page and column was located and then the sample member was selected by reading from the middle of the column up and then from the middle of the column down if no qualifying partner was found in the top half of the column.

For the next 15 random numbers for pages and columns, the page and column were located and the sample members were selected by alternating starting points from the middle of the column down and from the middle

of the column up.

It took 365 random numbers for page and column to select a sample of 300 qualifying partners.

Representatives of corporate financial statement preparers were selected in a two step process. First, a random sample of 300 corporations was selected from Fortune magazine's listing of the 1,000 largest industrial corporations as presented in the May, 1977⁸ and June, 1977⁹ issues of the magazine. Second, after obtaining the random sample of corporations, a representative of each corporation was selected from the listing of corporate officers in Dun and Bradstreet's Million Dollar Directory - 1978.¹⁰

The 1,000 largest industrial corporations were ranked according to their sales from the largest corporation (rank 1 - Exxon with 48.6 billion in sales) to the smallest in the group (rank 1,000 - United Nuclear with 100.6 million in sales). Using this natural listing of 1 to 1,000, a random sample of 300 corporations was selected using random numbers published in A Million Random Digits with 100,000 Normal Deviates,¹¹ by the Rand Corporation. Sampling without replacement was used. The sample consisted of 147 firms from the 500 largest industrial firms or 29.4% of these firms and 153 from the second 500 largest industrial firms or 30.6%.

Given each corporate name in the sample, the corporate officer was selected from the Dun and Bradstreet listing. The appropriate officer was selected as follows:

1. The list of officers was searched for an officer with the word controller or comptroller in his title. If the list of officers did contain an officer with these words in his title, he became the individual selected to receive the questionnaire. There were 215 officers

out of 300 with the word controller or comptroller in their title. Also included were two individuals with the title Vice President-Accounting.

2. If no officer was located with the word controller or comptroller in his title, then the list of officers was searched for an officer with the designation of Vice-President-Finance or Chief Financial Officer. (Note: anyone listed as Vice-President for Finance and Controller, or some variation, would be included in (1) above.) There were 31 officers out of the sample of 300 with these designations.
3. If no officer was located with the designations meeting the criteria in (1) and (2), then the list of officers was searched for an officer with the designation Treasurer in his title. There were 50 officers out of a sample of 300 with this word in their title and who did not fit the criteria in (1) and (2).
4. Two out of the sample of 300 were sent to corporate presidents because none of the officers met the criteria in (1), (2), and (3).

The selection of officers with corporate controllers being sought out first, vice presidents for finance as an alternative and treasurers as a second alternative is the result of the questionnaire pre-test. During the questionnaire pre-test stage, the questionnaires were sent to the vice presidents for finance of two major U.S. corporations. These vice-presidents implied that they were generalists dealing with the gamut of financial problems whereas controllers or chief accounting officers would deal more directly with financial statement presentation and disclosure. Therefore, it would be logical to address corporate controllers directly if possible, and as the next best alternative, the vice-president for finance. Finally, it is assumed that the treasurer in many corporations is the chief financial officer.

Representatives of the user group, CFAs, were obtained by taking a random sample from the Fifteenth Directory of Members 1977-1978¹² of the Institute of Chartered Financial Analysts. This directory was first

issued in April, 1978.

The directory is 243 pages long and contains a listing of members on pages 30 through 220. Each page contains two columns and up to thirteen members per column. For each member, the directory gave the name, address--generally business address--and educational information. The Institute contains members who reside in either the United States or Canada. The sample selection, however, was limited to members who reside in the United States according to the directory. Sampling without replacement was used.

A computer generated random number list was obtained which listed page number, column number, and column location. The pages listed were 30 through 220, the columns listed were one or two, and the location listed was one through thirteen. It took 379 random numbers to select 300 CFAs because it was necessary to eliminate Canadian residents, duplicate random numbers, and nonexistent members (i.e., not every column had thirteen members even though the random number for the location might be thirteen).

The Mailings and the Response

The questionnaire was mailed to the members of each of the three sample groups on May 15, 1978. The group members who had not responded to the first mailing were sent a second request on June 12, 1978.

From the first mailing, there were nine envelopes and questionnaires returned as "undeliverable as addressed." The researcher was able to obtain corrected addresses for eight of these and remailed them at the time of the second mailing. In the case of the ninth returned envelope, the sample member's former employer refused to provide a

forwarding address.

From the second mailing, there were four envelopes and questionnaires returned as "undeliverable as addressed." These were different sample members than those initial nine returned as nondeliverable. Two were CPA partners and two were CFAs. No follow-up was performed on these questionnaires to determine the correct address.

Questionnaire's which were returned fully or partially completed and received by the time statistical analysis was begun on August 3, 1978, were included in the statistical analysis. The quantity returned and related percentages of usable responses were as follows:

Auditors	77 out of	300	or	25.67%
Preparers	96 out of	300	or	32.00%
Users	<u>89</u> out of	<u>300</u>	or	<u>29.67%</u>
	262 out of	900	or	29.11%

In addition to the above quantity of partially or fully completed questionnaires, members of each group returned questionnaires with written comments or simply returned written comments explaining why they did not respond.

The returned non-responses by CPA partners may be summarized as follows:

1. CPAs who concluded that the subject was too complex to be answered using a questionnaire format or that more specific information would be needed. 6
2. CPAs who were not interested in participating in the study or who were too busy. 5
3. CPAs who were tax partners and therefore did not feel qualified to respond, or CPAs who did not feel qualified to respond for some other reason. 5
4. CPAs who were retired, ill, deceased, or no longer associated with the firm as a partner. 4

5. CPAs who sent the questionnaire to their national office concluding that their firm's policy should govern responses.	2
6. CPA who considered the level of disclosure to be a legal question rather than an accounting question.	1
7. CPA who concluded that users, not academics, should determine the appropriate level of disclosure.	1
8. CPA who stated, "In my opinion, the question of the corporate executives morality is not a subject for disclosure in financial statements.... However, when the acts mentioned in your survey... have an impact on the financial statements (i.e., potential fines, potential lawsuits, significant expenses, etc.), then the traditional disclosure rules would apply. In other words, it seems to me that an illegal political contribution should be reviewed in the same content as a potential lawsuit on a contract violation in order to determine disclosure requirements."	<u>1</u>
Total	<u>25</u>

The returned non-responses by CFAs may be summarized as follows:

1. CFAs who were not interested in participating in the study or were too busy.	8
2. CFAs who returned the questionnaire unanswered and without comment.	4
3. CFAs who were retired, deceased, or no longer associated with the firm where the questionnaire was sent.	3
4. CFA who did not feel qualified to respond.	1
5. CFA who thought the questionnaire was poorly designed.	1
6. CFA who wrote on the cover letter "Stupid Project."	<u>1</u>
Total	<u>18</u>

The returned non-response by financial statement preparers may be summarized as follows:

- | | |
|--|-----------------|
| 1. Preparers who were not interested in participating in the study or were too busy. | 6 |
| 2. One preparer responded: Our Corporate policy specifically prohibits payments of the nature discussed in the questionnaire regardless of amount. We believe this approach is a fundamental business principle which is not reconcilable with the concept of an "appropriate level of disclosure. | 1 |
| 3. One preparer responded: In the light of legislation already in existence prohibiting corporate political contributions in national elections or to candidates for national office and the disclosure required by the Securities and Exchange Commission, we believe that the company has no choice but to report all instances of improper or questionable payments | <u>1</u> |
| Total | <u><u>8</u></u> |

In addition to the 262 completed questionnaires, there were three completed questionnaires received after the analysis had been performed which are not included above. Two were from CFAs and one from a CPA.

The overall response rate, both usable and returned without meaningful response, may be summarized as follows:

Auditors	103	out of	300	or	34.33%
Preparers	104	out of	300	or	34.67%
Users	<u>109</u>	out of	<u>300</u>	or	<u>36.33%</u>
	316	out of	900	or	35.11%

Nonresponse Bias

One of the primary criticisms of survey research is that respondents to the questionnaire may not be representative of the entire sample. Since the overall response rate to the research instrument was moderate, as was expected for a questionnaire of this length, this

researcher believes that some nonresponse analysis is appropriate.

There are three approaches to non-response analysis. One approach is to select a random sub-sample of nonrespondents, and by extraordinary means, such as making personal visits, phone calls, and telegrams, extract a response from the sub-sample. This sub-sample then would be used as representative of the nonrespondents and could be compared to the respondents to determine whether there were significant differences between the two sub-sample groups. This researcher rejected this approach because it would be extremely costly and beyond the research budget.

The second approach to nonresponse analysis is to compare respondent and nonrespondent members of the sample on known characteristics such as "geographical location, date of birth,...sex, type of qualification, and so on"¹³ to determine whether the sub-samples are different. This approach was rejected because of the limited amount of information available from the sampling address sources.

The third approach is to assume that late respondents are representative of nonrespondents, and if it can be shown that late respondents are no different from early respondents, then it may be assumed that the sample of respondents is representative of the population from which the entire sample was selected. Oppenheim states, "it has been found that respondents who send in their questionnaire very late are roughly similar to nonrespondents." This approach was used to test for nonresponse bias for this research.

For each group (preparers, auditors and users), two t-tests were run comparing the response of the fifteen earliest respondents and the fifteen latest respondents for each of the thirty-one questions. One

t-test used a pooled variance estimate and the other t-test used a separate variance estimate. For each group for each question, the hypothesis of no differences between early and late respondents was tested at the 0.10 alpha level. The results are as follows:

Research decision: Do not reject the hypothesis of no differences for

	<u>Pooled variance estimate</u>	<u>Separate variance estimate</u>
Users	<u>31 out of 31 questions</u>	<u>31 out of 31 questions</u>
Auditors	<u>27 out of 31 questions</u>	<u>28 out of 31 questions</u>
Preparers	<u>30 out of 31 questions</u>	<u>30 out of 31 questions</u>

From this analysis, it is apparent that early and late respondents do not generally differ. Therefore, if the reader accepts the theory that late respondents are similar to nonrespondents, then the research results in this dissertation are generalizable to the populations from which the samples were selected. Although this researcher recognizes the fact that late respondents are not always representative of nonrespondents, in this research there is no evidence or information which would lead this researcher to believe that late respondents differ from nonrespondents in any significant respects.

Summary

The questionnaire pretest consisted of identifying individuals from each of the three sample groups and asking them to critique the questionnaire. This chapter includes their critiques and how they affected the research design. It also discusses the sample selection

process, the mailing procedures and the questionnaire response. The chapter concludes with observations about the possibility of non-response bias.

FOOTNOTES

¹Who Audits America 1976 (Menlo Park, California: Spencer Phelps Harris, 1977).

²"The Fortune Directory of the 500 Largest U.S. Industrial Corporations" Fortune 95 (May 1977): 364-391.

³"The Fortune Directory of the Second 500 Largest U.S. Industrial Corporations" Fortune 95 (June 1977): 204-232.

⁴The Institute of Chartered Financial Analysts, Fifteenth Directory of Members 1977-1978 (Charlottesville, Virginia: ICFA, 1978).

⁵American Institute of Certified Public Accountants, AICPA List of Members 1976 (New York, New York: AICPA, 1977).

⁶Who Audits America 1976.

⁷AICPA, List of Members 1976.

⁸"Fortune 500 Largest" (May 1977): 364-391.

⁹"Fortune Second 500 Largest" (June 1977): 204-232.

¹⁰Dun & Bradstreet, Million Dollar Directory 1978 (New York, New York: D & B, Inc., 1977).

¹¹A Million Random Digits with 100,000 Normal Deviates (New York, New York: The Free Press, 1966).

¹²ICFA, Directory.

¹³A. N. Oppenheim, Questionnaire Design and Attitude Measurement (New York: Basic Books, Inc., 1966), p. 34.

CHAPTER 5

ANALYSIS OF HYPOTHESIS H_1 THROUGH H_{31}

Introduction

Chapter 3 discussed the thirty-one specific research hypotheses (H_1 to H_{31}) used to test the general research hypothesis: Preparers, auditors, and users have similar views of materiality in varying illegal payment cases. Chapter 3 also related the thirty-one case-situation combinations in the questionnaire to the first thirty-one research hypotheses and explained the questionnaire response pattern. In this chapter, the responses to the questionnaire and the above mentioned hypotheses are analyzed.

The Chi-Square Test for Independence

The Chi-Square Test for Independence is used to determine whether each specific null hypothesis should or should not be rejected. This test is used because it has the advantage over other statistical tests in that it enables the researcher to compare the distribution of responses of the three groups rather than just comparing the groups on an aggregate characteristic such as the mean.

Null hypothesis H_1 and the related case-situation (i.e., question) from the questionnaire will be used to illustrate the Chi-Square analysis in this chapter:

H_1 : Preparers, auditors, and users have similar views of materiality when illegal domestic political contributions are made.

Question: An American company made illegal domestic political contributions to U.S. political parties.

The responses to this question may be summarized in the following three (group) by four (response) contingency table:

Count Row %	Response				Row Total
	1	2	3	4	
Group					
Auditors	2 2.7	30 40.5	21 28.4	21 28.4	74 29.1%
Preparers	3 3.2	48 51.6	15 16.1	27 29.0	93 36.6%
Users	4 4.6	65 74.7	10 11.5	8 9.2	87 34.3%
Column Total	9 3.5%	143 56.3%	46 18.1%	56 22.0%	254 100.0%

In statistical terms, the null hypothesis for the Chi-Square Test for Independence is:

H_0 : All the probabilities in the same column are equal to each other.¹

For null hypothesis H_1 , this means that the probability that users will select Response 1 equals the probability that preparers will select Response 1 equals the probability that auditors will select Response 1. The same statement applies to Responses 2, 3 and 4.

The Chi-Square analysis on the example question results in a raw Chi-Square test statistic of 25.847 with 6 degrees of freedom resulting in a significance level of 0.0002. This type of analysis is performed on each of the thirty-one hypotheses and is summarized in Column A of Table 5-1. Using the conventionally accepted alpha level of 0.1000 (that is, the probability of rejecting a true null hypothesis would

TABLE 5-1
RESULTS OF CHI-SQUARE TESTS

Payment Case and Question Number	Hypothesis	Significance Level*				
		A	B	C	D	E
		Group by Response		CPAs vs Users	Preparers vs Users	CPAs vs Preparers
		(3 x 4)	(3 x 3)			
<u>Illegal Domestic Political Contributions</u>						
Question 1	H ₁	0.0002*	0.0001*	0.0000*	0.0023*	0.3294
Question 2	H ₂	0.1134	0.0461*	0.0104*	0.1582	0.2923
Question 3	H ₃	0.0015*	0.0003*	0.0000*	0.0235*	0.1044
Question 4	H ₄	0.0000*	0.0000*	0.0000*	0.0001*	0.3242
Question 5	H ₅	0.4678	0.3043			
Question 6	H ₆	0.0001*	0.0002*	0.0000*	0.0055*	0.2187
<u>Foreign Political Contributions</u>						
Question 1	H ₇	0.0162*	0.0116*	0.0095*	0.0276*	0.7015
Question 2	H ₈	0.0009*	0.0004*	0.0001*	0.1455	0.0217*
Question 3	H ₉	0.0038*	0.0008*	0.0002*	0.0076*	0.4556
Question 4	H ₁₀	0.4352	0.2503			
Question 5	H ₁₁	0.0191*	0.0049*	0.0009*	0.3753	0.0439*
Question 6	H ₁₂	0.0008*	0.0001*	0.0001*	0.0006*	0.5544
Question 7	H ₁₃	0.0519*	0.0545*	0.0286*	0.0350*	0.8339
Question 8	H ₁₄	0.0426*	0.0184*	0.0028*	0.1069	0.2487
Question 9	H ₁₅	0.0206*	0.0049*	0.0009*	0.0703*	0.2160
Question 10	H ₁₆	0.0037*	0.0009*	0.0001*	0.0540*	0.0911*
<u>Bribery of Foreign Government Officials</u>						
Question 1	H ₁₇	0.0000*	0.0000*	0.0000*	0.0026*	0.0814*
Question 2	H ₁₈	0.0164*	0.0238*	0.0087*	0.1177	0.1023
Question 3	H ₁₉	0.0153*	0.0041*	0.0005*	0.0762*	0.1953
Question 4	H ₂₀	0.0001*	0.0000*	0.0000*	0.0009*	0.2008
Question 5	H ₂₁	0.0920*	0.1099			
Question 6	H ₂₂	0.0237*	0.0249*	0.0044*	0.0749*	0.4835
Question 7	H ₂₃	0.0164*	0.0047*	0.0012*	0.0230*	0.4496
Question 8	H ₂₄	0.0026*	0.0006*	0.0001*	0.0177*	0.1409
<u>Commercial Bribery</u>						
Question 1	H ₂₅	0.0004*	0.0001*	0.0001*	0.0715*	0.0141*
Question 2	H ₂₆	0.0193*	0.0099*	0.0135*	0.0393*	0.0981*
Question 3	H ₂₇	0.0009*	0.0003*	0.0001*	0.1783	0.0097*
Question 4	H ₂₈	0.0000*	0.0000*	0.0000*	0.0002*	0.2333
Question 5	H ₂₉	0.1274	0.1923			
Question 6	H ₃₀	0.0280*	0.0085*	0.0016*	0.1711	0.1157
Question 7	H ₃₁	0.0078*	0.0017*	0.0002*	0.1193	0.0658*

*Research decision is to reject the hypothesis of no differences at the significance level of 0.1000 or less.

Sample size range--Columns A & B (239 to 260), Column C (151 to 165), Column D (172 to 184), and Column E (154 to 172).

be acceptable if it were ten per cent or less), these tests resulted in the rejection of the null hypothesis for 27 of the 31 hypotheses.

Because an early critique of the results indicated that Response 3 and Response 4 were merely alternative approaches to materiality decisions based on relative size, and because concern was expressed that results presented in Column A of Table 5-1 may be the spurious consequence of treating Responses 3 and 4 as if they were different, a second set of Chi-Square Tests was developed which combined Response 3 and 4. The responses to the example question are summarized in the following three by three contingency table along with the Chi-Square test results on this distribution.

Count Row %	Response			Row Total
	1	2	3+4	
Group				
Auditors	2 2.7	30 40.5	42 56.8	74 29.1%
Preparers	3 3.2	48 51.6	42 45.2	93 36.6%
Users	4 4.6	65 74.7	18 20.7	87 34.3%
Column Total	9 3.5%	143 56.3%	102 40.2%	254 100.0%

Raw Chi-Square = 23.182 with 4 degrees of freedom
Significance level = 0.0001

Column B of Table 5-1 provides the results of the Chi-Square Test for the three groups (preparers, auditors, and users) by the three responses (Response 1, Response 2, and the combined results of Responses 3 and 4) contingency table for each of the thirty-one research hypotheses. Again

using the conventionally acceptable alpha level of 0.10, these tests resulted in the rejection of the null hypothesis for 27 of the 31 hypotheses. The research decision for hypothesis H_2 changed from a marginal decision not to reject the null at a significance level of 0.1134 in the first test (3 x 4 design) to reject the null hypothesis at a significance level of 0.0461 in the second test (3 x 3 design). The research decision for hypothesis H_{21} changed from a marginal decision to reject the null hypothesis at a significance level of 0.0920 in the first test to a marginal decision not to reject at a significance level of 0.1099 in the second test. For the other twenty-nine research hypotheses, the same research decision was made in the second test as in the first test.

Having determined that the responses of the three groups were different in 27 of the 31 tests reported in Column B of Table 5-1, Chi-Square Tests were used to pinpoint which groups were different for those twenty-seven hypotheses. Therefore, for each hypothesis, a Chi-Square Test was run comparing the auditor and user groups (Column C), the preparer and user groups (Column D), and the auditor and preparer groups (Column E) in a two group by three response contingency table.

The Chi-Square Test and the related contingency table for the example question comparing auditor and user groups follows:

Count Row %	Response			Row Total
	1	2	3+4	
Group				
Auditors	2 2.7	30 40.5	42 56.8	74 46.0%
Users	4 4.6	65 74.7	18 20.7	87 54.0%
Column Total	6 3.7%	95 59.0%	60 37.3%	161 100.0%

Raw Chi-Square = 22.2568 with 2 degrees of freedom
Significance level = 0.0000

Similar Chi-Square tests were generated comparing preparer and user groups and comparing auditor and preparer groups.

Illegal Domestic Political Contributions

In five of the six questions on illegal domestic political contributions, the null hypothesis is rejected. Hypotheses H_1 , H_2 , H_3 , H_4 and H_6 are rejected, and thus for these hypotheses it may be concluded that preparers, auditors, and users do not have similar views of materiality (see Column B of Table 5-1). Hypothesis H_5 is not rejected, and for this question it may be concluded that preparers, auditors, and users do have similar views of materiality.

For the five hypotheses which were rejected, further tests reveal that auditors have different views of materiality than users for all five rejected hypotheses (see Column C), that preparers have different views of materiality than users for four of the five rejected hypotheses (see Column D), and that preparers and auditors have similar views of materiality (see Column E).

Thus, as a generalization based on the various Chi-Square analyses,

it may be concluded that preparers, auditors, and users do not have similar views of materiality. Additionally, it may be concluded that both auditors and preparers have different views of materiality than users in cases involving illegal domestic political contributions, and that auditors and preparers views of materiality are similar in these payment cases.

Foreign Political Contributions

In nine of the ten questions on foreign political contributions, the null hypothesis is rejected. Hypotheses H_7 , H_8 , H_9 , H_{11} , H_{12} , H_{13} , H_{14} , H_{15} , H_{16} are rejected and thus for these hypotheses it may be concluded that preparers, auditors, and users do not have similar views of materiality (see Column B of Table 5-1). Hypothesis H_{10} is not rejected, and for this question it may be concluded that preparers, auditors, and users do have similar views of materiality.

For the nine hypotheses which were rejected, further tests reveal that auditors have different views of materiality than users for all nine rejected hypotheses (see Column C), that preparers have different views of materiality than users in six of the nine rejected hypotheses (see Column D), and that preparers and auditors have similar views of materiality in six of the nine rejected hypotheses (see Column E).

Thus, as a generalization based on the various Chi-Square analyses, it may be concluded that preparers, auditors and users do not have similar views of materiality. It also may be concluded that in cases involving foreign political contributions, auditors have different views of materiality than users, that preparers often have different views of materiality than users, and that auditors and preparers often

have similar views of materiality.

Bribery of Foreign Government Officials

In seven of the eight questions on bribery of foreign government officials, the null hypothesis is rejected. Hypotheses H_{17} , H_{18} , H_{19} , H_{20} , H_{22} , H_{23} , and H_{24} are rejected, and thus for these hypotheses it may be concluded that preparers, auditors, and users do not have similar views of materiality (see Column B of Table 5-1). Hypothesis H_{21} is not rejected, and for this question it may be concluded that preparers, auditors, and users do have similar views of materiality.

For the seven hypotheses which were rejected, further tests reveal that auditors have different views of materiality than users for all seven rejected hypotheses (see Column C), that preparers have different views of materiality than users for six of the seven rejected hypotheses (see Column D), and that preparers and auditors have similar views of materiality for six of the seven rejected hypotheses (see Column E).

Thus, as a generalization based on the various Chi-Square analyses, it may be concluded that preparers, auditors, and users do not have similar views of materiality. Additionally, it may be concluded that both auditors and preparers, in general, have different views of materiality than users in cases involving bribery of foreign government officials, and that auditors' and preparers' views of materiality are similar in these cases.

Commercial Bribery

In six of the seven questions on commercial bribery, the null hypothesis is rejected. Hypotheses H_{25} , H_{26} , H_{27} , H_{28} , H_{30} and H_{31} are rejected, and thus for these hypotheses it may be concluded that

preparers, auditors, and users do have similar views of materiality.

For the six hypotheses which were rejected, further tests reveal that auditors have different views of materiality than users for all six rejected hypotheses (see Column C), that preparers have different views of materiality than users in three of the six rejected hypotheses (see Column D), and that preparers have different views of materiality than auditors in four of the six rejected hypotheses on commercial bribery (see Column E).

Thus, as a generalization based on various Chi-Square analyses, it may be concluded that preparers, auditors, and users do not have similar views of materiality. It may also be concluded that auditors and preparers have different views of materiality in a majority of these cases. No general statement that preparers have or do not have similar views of materiality as users may be made based on this analysis.

Summary of Chi-Square Analysis

Reference to Table 5-1 reveals the following:

Column B - the overall Chi-Square Tests result in the rejection of the null hypothesis for 27 out of 31 hypotheses.

Column C - in 27 out of the 27 cases in which the null hypothesis was rejected, auditors had statistically significant differences in their views of materiality compared to users.

Column D - in 19 out of the 27 cases in which the null hypothesis was rejected, preparers had statistically different views of materiality compared to users.

Column E - in 19 out of 27 cases in which the null hypothesis was rejected, preparers and auditors did not have statistically significant differences in their views of materiality.

Chi-Square Analysis--General Conclusions

It is clear from this research that, in general, preparers, auditors, and users do not have similar views of materiality in varying illegal payment cases. Furthermore, this conclusion is reached at a very high level of statistical confidence. In the twenty-seven cases in which the overall Chi-Square test resulted in the rejection of the null hypotheses, twenty-one rejections were made with the probability of error of less than one percent and the other six rejections were made with the probability of an error of less than six percent (per Column B, Table 5-1).

Do auditors and users have similar views of materiality in varying illegal payment cases? The answer is no. The statistics (in Column C, Table 5-1) not only support this conclusion but also indicate that in twenty-four of the twenty-seven cases in which the null hypothesis was rejected, the probability of an error is less than one percent. Thus, there is a very high level of confidence in the conclusion that, in general, auditors and users have different views of materiality.

Do preparers and users have similar views of materiality in varying illegal payment cases? The resolution of this question is more difficult. In a majority (19 out of 27) of the Chi-Square tests comparing the views of preparers and users (Column D, Table 5-1), the conclusion is that preparers and users do not have similar views of materiality.

However, this does not mean that in 8 out of 27 cases preparers and users do have similar views of materiality. It means that in 8 out of 27 cases the researcher was not able to reject the hypothesis of no difference at an acceptable error level of ten percent or less. Reference to Column D in Table 5-1 reveals that in seven of those eight cases, the significance level falls within the range of 10.69% to 17.83% inclusive. So if the researcher were willing to take a greater risk of error, he could conclude that preparers' and users' views of materiality are not similar in these seven cases also. Therefore, as a general conclusion, it appears that preparers and users do not have similar views of materiality.

Do auditors and preparers have similar views of materiality in varying cases involving illegal payments? In general, the answer to this question is yes. Reference to Column E of Table 5-1 indicates, if the questions concerning commercial bribery are excluded, that 17 out of 21 Chi-Square tests comparing preparer and auditor responses do not result in the rejection of the hypothesis of no difference. However, for commercial bribery cases, the general conclusion would be that preparers and auditors do not have similar views of materiality in commercial bribery cases.

Why don't preparers and auditors have similar views of materiality in the majority of the commercial bribery cases? When examining the response distributions, this researcher noted that preparers tended to select the response extremes. More preparers than auditors selected Response 1 (do not disclose) in every case in which the hypothesis of no difference was rejected. In addition, preparers in general were more likely to select Response 2 (always disclose). Apparently

preparers are basing their disclosure requirement for commercial bribery cases on value judgments as to the importance of the act itself rather than on the relative amounts involved; the auditors are more concerned with financial statement relationships.

In summary, the following general conclusions have been made based on the various Chi-Square tests:

1. Preparers, auditors, and users do not have similar views of materiality in varying illegal payment cases.
2. Auditors and users do not have similar views of materiality in varying illegal payment cases.
3. Preparers and users do not have similar views of materiality in varying illegal payment cases.
4. Auditors and preparers have similar views of materiality in illegal payment cases involving political payments and bribery of government officials.
5. Auditors and preparers do not have similar views of materiality in illegal payment cases involving commercial bribery.

Chi-Square Analysis--The Exceptions

Before proceeding further, it is appropriate to consider the exceptions: the four cases in which the overall Chi-Square Test (Column B, Table 5-1) did not result in rejection of the null hypotheses. "Why?" Before answering this question, it is appropriate to consider the four questions and their related Chi-Square significance levels (from Column B, Table 5-1):

1. An American company maintained a secret "off-the-books" fund from which illegal domestic political contributions were made. The funds were obtained from kickbacks from foreign legal consultants. (0.3043)
2. An American corporation made illegal foreign political contributions and covered up the contributions with false accounting entries in the corporate books and records. (0.2503)

3. An American corporation made payments to foreign government officials from an "off-the-books" fund. The purpose of the payments was to aid the corporation in obtaining foreign government contracts. (0.1099)
4. An American company financed commercial bribes from an "off-the-books" fund obtained from rebates on excessive sales commissions. (0.1923)

Three of the four questions which did not result in the rejection of the null hypotheses involved the maintenance of an "off-the-books" fund used as a source for illegal payments. An explanation of why these hypotheses were not rejected requires some background information.

Throughout this research it has been apparent that users advocate more disclosure than preparers and auditors. This is clearly indicated by examination of Table 5-2 which is a tabulation of the percentage of respondents selecting Response 2 (disclose the payment and circumstances regardless of payment size). The average Response 2 percentages for each group are auditors, 43.8%; preparers, 52.0%; and users, 66.0%.

In the four cases in which the overall Chi-Square test did not result in the rejection of the null hypothesis, auditors, and preparers have a much higher disclosure demand than average. In the questions related to "off-the-books" funds, auditors appear to be concerned about a company which would let unaccounted for funds accumulate. Perhaps this is a reaction to an audit area in which the auditors feel particularly vulnerable. The public accounting profession claims a lack of responsibility for failing to discover funds maintained outside the normal accountability system when they have no reason to suspect that these funds exist.* In contrast, financial statement users often

*Statement on Auditing Standards 16 "An Independent Auditor's Responsibility for the Detection of Errors and Irregularities," states:

TABLE 5-2

PERCENTAGE OF RESPONDENTS SELECTING RESPONSE 2: "DISCLOSE THE PAYMENT
AND SURROUNDING CIRCUMSTANCES REGARDLESS OF PAYMENT SIZE"

Payment Case and Question Number	Auditors	Preparers	Users	Total
<u>Illegal Domestic Political Contributions</u>				
Question 1 (e)	40.5%	51.6%	74.7%	56.3%
2 (c)	55.8	67.0	77.3	67.2
3 (b)	51.3	66.7	83.0	67.7
4 (f)	27.6	36.2	64.0	43.0
5 (a)	68.6	76.6	82.8	76.4
6 (d)	43.7	57.1	74.4	59.3
<u>Foreign Political Contributions</u>				
Question 1	5.3	8.3	21.6	11.9
2 (e)	37.0	53.8	67.4	53.7
3	25.0	33.0	54.5	38.0
4 (c)	71.1	68.8	76.4	72.1
5 (b)	57.3	71.0	77.3	69.1
6 (f)	28.2	36.2	57.5	41.3
7 (a)	71.1	68.8	78.2	72.7
8 (g)	46.3	47.2	56.0	50.0
9 (h)	44.8	51.7	52.4	50.0
10 (d)	44.3	55.4	66.7	56.1
<u>Bribery of Foreign Government Officials</u>				
Question 1 (e)	38.4	49.5	68.5	53.0
2 (c)	61.3	59.3	73.0	64.7
3 (b)	48.6	59.6	67.4	59.2
4 (f)	20.3	33.0	59.6	39.0
5 (a)	60.0	56.7	65.2	60.0
6 (g)	39.4	44.9	58.1	48.0
7 (h)	43.3	50.6	52.9	49.4
8 (d)	40.6	55.6	62.8	53.9
<u>Commercial Bribery</u>				
Question 1 (e)	30.1	45.7	62.8	47.0
2 (c)	53.9	53.8	72.1	60.1
3 (b)	44.0	59.1	72.1	59.1
4 (f)	19.4	30.1	60.5	37.5
5 (a)	60.5	60.9	73.3	65.0
6 (h)	41.2	51.6	64.7	53.3
7 (d)	40.0	53.8	67.9	54.7

(a) "off-the-books fund
(b) top management was aware
(c) normal accounting procedures circumvented
(d) possible additional tax assessments

(e) no circumstances given
(f) top management was not aware
(g) expropriation of assets
(h) loss of business

expect auditors to be aware of all corporate accounting improprieties regardless of size or circumstance. Thus this researcher suspects that the higher level of disclosure demand is a defensive reaction on the part of auditors.

In addition, the higher level of disclosure demanded in the second case listed above in which the illegal foreign political contribution was "covered up.. with false accounting entries," represents another case in which the auditors feel vulnerable because users would expect them to discover these irregularities regardless of their size and number. Again, this researcher suspects that the higher disclosure demand is a defensive reaction on the part of auditors.

The higher disclosure demand on the part of preparers also indicates a concern for the seriousness of the violations of the integrity of the accounting system.

The higher disclosure demand on the part of auditors and preparers made their views, in terms of relative percentages, close enough to the users' views so that the null hypotheses related to the above four questions were not rejected.

"Certain acts, such as collusion between client personnel and third parties or among management and employees of the client, may result in misrepresentations being made to the auditor or the presentation to the auditor of falsified records or documents that appear truthful and genuine. Unless the auditor's examination reveals evidential matter to the contrary, his reliance on the truthfulness or genuineness of records and documents obtained during his examination is reasonable. . . . Further the auditor cannot be expected to extend his auditing procedures to seek to detect unrecorded transactions unless evidential matter obtained during his examination indicates that they may exist. For example, an auditor ordinarily would not extend his auditing procedures to seek failures to record the receipt of cash from unexpected sources."²

Additional Analysis--Disclosure Responses

Table 5-2 summarizes the percentage of respondents selecting Response 2 for each question and each group. Response 2 was selected more than the other three responses and presents data indicative of the differences between the three groups. As stated previously the average Response 2 percentages for each group are auditors, 43.8%; preparers, 52.0% and users, 66.0%. These percentages are important because they support the general conclusion that preparers, auditors, and users do not have similar views of materiality. They also provide information about the general direction of the differences in disclosure demand between the three groups.

Users are demanding a much higher level of disclosure than auditors and preparers believe is "material and significant to financial statement users." One significant implication is that preparers and auditors may not be responsive to user needs. If this conclusion is accepted then perhaps some regulation or guidance from the Securities and Exchange Commission may be needed to insure that financial statement disclosures are responsive to user needs.

Another particularly disturbing conclusion drawn from the average Response 2 percentages is that the group which is supposed to be the unbiased guardians of the integrity of financial statements, the auditors, demand on the average the lowest level of disclosure of the three groups.

Further examination of Table 5-2 indicates that each of the three groups is more concerned about some questions than others. An analysis of the Response 2 percentages reveals a great concern on the part of all three groups in all four types of illegal payment cases for

disclosure of information concerning "off-the-books" funds (These case-situation combinations are designated as (a) on Table 5-2). This is reflected in the high proportion of respondents selecting Response 2 for this kind of situation. Also of great concern to all three groups in all four types of illegal payment cases are situations involving circumvention of normal accounting procedures (designated (c)) and situations in which top management was aware of and participated in the distribution of illegal payments (designated (b)). Analysis of Response 2 percentages reveals a moderate concern for disclosure of illegal payments when disclosure might result in additional income tax assessments (designated (d)) and analysis also reveals a moderate concern for illegal payments when no situational assumptions are given (designated (e)). All three groups had a low disclosure demand when top management was not aware of and did not approve of the illegal payments (designated (f)).

This ranking of situational importance makes intuitive sense. Members of the three groups should be more concerned about the integrity of the financial system and top corporate management than illegal payments made by lower level management officials or possible additional tax assessments. The former represent circumstances considered by many as indicators of the quality of management and as factors which affect investment risk and return. It seems unlikely that illegal payments by low level corporate officials or additional income tax assessments related to illegal payments would have a significant adverse affect on the firm.

Another interesting fact revealed by examination of Table 5-2 is that the groups demand a high level of disclosure even though disclosure

may result in foreign expropriation of corporate assets (designated (g)) or the loss of significant amounts of business (designated (h)). It was this researcher's a priori expectation that the groups would demand a low level of disclosure when the costs of disclosure (i.e., the possibility of expropriation or loss of business) might be greater than the benefits derived from disclosure. That expectation is not supported by Table 5-2.

Additional Analysis--Percentage of Net Income Approach

In addition to specifying a disclosure level by selecting one of the four responses, each respondent who selected Response 3 also was asked to specify the percentage of net income which he considered to be an appropriate cut-off for materiality decisions. The purpose of obtaining this information was to determine what the mean materiality cut-off percentages were for each group and to determine whether the group means were equal. This led to a sub-hypothesis for each of hypotheses H_1 to H_{31} which in general was: Preparers, auditors, and users who selected Response 3 have similar perceptions as to the appropriate percentage of net income which should serve as a materiality cut-off. A one-way analysis of variance (ANOVA) was used to test each of the thirty-one sub-hypotheses. Table 5-3 provides the following for each question: the mean percentages for each group, the overall mean, the results of the ANOVA test, and the research decision.

Examination of Table 5-3 reveals that the research decision for 28 of the 31 sub-hypotheses is do not reject the null hypothesis. That is, the general conclusion is that preparers, auditors, and users who selected Response 3 do have similar views of the appropriate materiality

TABLE 5-3

RESULTS OF THE ANALYSIS OF VARIANCE TEST FOR EQUALITY OF MEAN
PERCENTAGES PROVIDED BY RESPONDENTS SELECTING RESPONSE 3

Payment Case and Question Number	Sub- Hypothesis	Mean Percentage			Total	Significance Level F-Test	Research Decision
		Auditors	Preparers	Users			
<u>Illegal Domestic Political Contributions</u>							
Question 1	H ₁	4.25%	3.34%	4.00%	3.86%	0.616	DNR
2	H ₂	4.50	3.23	4.14	3.91	0.585	DNR
3	H ₃	4.04	3.86	5.00	4.14	0.790	DNR
4	H ₄	3.75	3.60	2.39	3.46	0.671	DNR
5	H ₅	4.28	3.21	4.67	3.05	0.579	DNR
6	H ₆	3.82	3.88	3.89	3.85	0.987	DNR
<u>Foreign Political Contributions</u>							
Question 1	H ₇	4.80	4.50	4.32	4.48	0.945	DNR
2	H ₈	4.03	2.90	4.18	3.70	0.370	DNR
3	H ₉	3.73	4.26	3.25	3.86	0.767	DNR
4	H ₁₀	4.28	3.04	5.11	3.97	0.182	DNR
5	H ₁₁	3.84	2.35	6.25	3.55	0.036	R
6	H ₁₂	3.52	3.72	2.46	3.44	0.670	DNR
7	H ₁₃	4.41	3.39	5.43	4.19	0.351	DNR
8	H ₁₄	4.22	3.65	7.57	4.55	0.050	R
9	H ₁₅	4.22	6.78	4.89	5.31	0.621	DNR
10	H ₁₆	4.17	3.24	5.13	3.94	0.253	DNR
<u>Bribery of Foreign Government Officials</u>							
Question 1	H ₁₇	3.58	3.03	4.78	3.63	0.310	DNR
2	H ₁₈	3.27	2.41	4.44	3.27	0.223	DNR
3	H ₁₉	3.39	2.23	5.29	3.34	0.013	R
4	H ₂₀	3.79	3.67	3.21	3.62	0.915	DNR
5	H ₂₁	4.46	3.17	4.73	4.03	0.342	DNR
6	H ₂₂	4.33	3.09	6.25	4.38	0.195	DNR
7	H ₂₃	4.59	6.15	5.22	5.34	0.841	DNR
8	H ₂₄	3.95	3.24	5.13	3.86	0.283	DNR
<u>Commercial Bribery</u>							
Question 1	H ₂₅	4.06	2.68	3.51	3.47	0.360	DNR
2	H ₂₆	3.91	2.88	3.62	3.46	0.476	DNR
3	H ₂₇	3.86	2.79	3.16	3.32	0.596	DNR
4	H ₂₈	3.65	2.98	2.40	3.14	0.355	DNR
5	H ₂₉	3.97	2.77	3.73	3.46	0.356	DNR
6	H ₃₀	4.85	3.78	3.96	4.25	0.624	DNR
7	H ₃₁	4.50	3.50	3.45	3.90	0.498	DNR

R means reject the null hypothesis at an α level of 0.10 or less

DNR means do not reject the null hypothesis.

Average sample size for questions: Auditors, 16; Preparers, 16; and Users, 9.

cut-off percentage.

The research decision is to reject the null hypotheses of the following three questions:

Foreign Political Contributions

Question 5 - Top management of an American corporation approved and participated in the payment of illegal political contributions to foreign politicians and foreign political parties.

Question 8 - The disclosure of an American company's corporate contributions may result in expropriation of assets in the country in which the illegal contributions occurred.

Bribery of Foreign Government Officials

Question 3 - The chief executive officer of an American company personally delivered funds to a foreign government official in order to obtain special corporate favors.

A Scheffe' post hoc comparison, using an alpha level of .05 revealed differences between preparers' and users' responses on both question 5 on Foreign Political Contributions and question 3 on Bribery on Foreign Government Officials. In both of these cases, the illegal payment was made with top management knowledge and approval, and preparers had the lowest overall mean percentage of net income while users had the highest overall mean percentage of net income. Since both of these questions involve top management knowledge and approval of illegal payments, it appears as if preparers are acting defensively by advocating low percentages of net income and thus correspondingly high disclosure levels for these acts. It is unclear why the users have selected, on the average, a significantly (statistically) higher percentage of net income (and thus a lower disclosure demand) for these illegal acts.

The Scheffe' post hoc comparison did not reveal any differences at the .05 level for question 8 on Foreign Political Contributions because the F-probability was .05. It is apparent from looking at the group means that a Scheffe test at the .10 alpha level would reveal a difference between preparers and users for this question also.

With respect to question 8 on Foreign Political Contributions, the high percentage of income selected by users appears to reflect their concern for the consequences of disclosure. The average percentage selected by users for both questions in which disclosure might result in expropriation of foreign assets is higher than average (7.5% and 6.25%). They apparently believe that the cost of disclosure (i.e., foreign expropriation) might exceed the benefits to the users of such disclosure. Therefore, they have selected a percentage which requires disclosure only when the payments are significantly larger. The result is that users have a statistically higher percentage of income cut-off than preparers (whose percentage appears to be about average relative to their other questions) on question 8.

Another interesting observation from Table 5-3 is that preparers have selected a higher percentage of net income for disclosure in both cases in which disclosure of illegal foreign payments might result in the loss of right to do business in a foreign country. The percentages are 6.78% for the question on Foreign Political Contributions and 6.15% for the question on Bribery of Foreign Government Officials. Preparers for some unknown reason are apparently more concerned about losing the right to do business in a foreign country than they are about having foreign assets expropriated. Again the result of selecting higher income percentages is that a lower amount of disclosure is advocated.

Table 5-4 summarizes total mean percentages from Table 5-3 by legality, payment case, and situation. Examination of Table 5-4 reveals that the mean percentages for the first six types of situations are in the range from 3.05 percent to 4.19 percent inclusive. These percentages are below most of the cited materiality cut-off percentages cited in the materiality literature. Reference to the literature review indicates that materiality cut-offs based on the percent of net income generally range from five to ten percent. The implication is that more stringent materiality standards are being suggested by respondents for these six situation sets.

Examination of Table 5-4 reveals that on the average respondents have selected higher percentages for situations (7) and (8) than for the first six situations. This is logical because in both of these cases the costs of disclosure (i.e., loss of business or foreign expropriation) are significant considerations which would be expected to result in higher percentages and thus lower disclosure expectations.

Table 5-5 provides a 95% confidence interval for the overall mean percentage of respondents selecting Response 3 for all questions. This table may be useful to the FASB and the SEC when establishing indifference zones for materiality decisions.

Additional Analysis--Absolute Dollar Amount Approach

Each respondent who selected Response 4 was also asked to specify the absolute dollar amount which he considered to be an appropriate cut-off for materiality decisions. The purpose of obtaining this information was to determine what the mean absolute dollar materiality cut-off was for each group and to determine whether the group means were

TABLE 5-4

OVERALL MEAN PERCENTAGES OF NET INCOME PROVIDED BY RESPONDENTS SELECTING RESPONSE 3

	Type of Payment			
	Domestic Political	Foreign Political	Bribery Government Official	Commercial Bribery
<u>Illegal</u>				
(1) No Surrounding Circumstances Given	3.86%	3.70%	3.63%	3.47%
(2) Circumvention of Normal Accounting Procedures and Accounting Internal Controls	3.91	3.97	3.27	3.46
(3) Illegal Payment Made With Top Management Knowledge	4.14	3.55	3.34	3.32
(4) Illegal Payment Made Without Top Management Knowledge	3.46	3.44	3.62	3.14
(5) "Off the Books" Slush Fund	3.05	4.19	4.03	3.46
(6) Possible Income Tax Assessments	3.85	3.94	3.86	3.90
(7) Expropriation of Foreign Corporate Assets		4.55	4.38	
(8) Loss of Right To Do Business		5.31	5.34	4.25
<u>Legal</u>				
(1) No Surrounding Circumstances Given		4.48		
(2) Circumvention of Normal Accounting Procedures and Accounting Internal Controls		3.86		

TABLE 5-5

95% CONFIDENCE INTERVAL FOR THE TOTAL MEAN
PERCENTAGES OF NET INCOME PROVIDED BY
RESPONDENTS SELECTING RESPONSE 3

Payment Case and
Question Number

Illegal Domestic Political Contributions

Question 1	3.06 to 4.67
2	2.83 to 4.99
3	2.97 to 5.32
4	2.42 to 4.50
5	2.92 to 5.17
6	3.01 to 4.70

Foreign Political Contributions

Question 1	3.23 to 5.73
2	2.92 to 4.48
3	2.82 to 4.91
4	3.00 to 4.94
5	2.56 to 4.54
6	2.47 to 4.41
7	3.09 to 5.29
8	3.39 to 5.70
9	2.99 to 7.64
10	3.11 to 4.78

Bribery of Foreign Government Officials

Question 1	2.79 to 4.46
2	2.36 to 4.17
3	2.53 to 4.14
4	2.57 to 4.68
5	3.07 to 4.98
6	3.07 to 5.69
7	2.99 to 7.68
8	3.02 to 4.69

Commercial Bribery

Question 1	2.68 to 4.26
2	2.73 to 4.19
3	2.40 to 4.24
4	2.47 to 3.80
5	2.72 to 4.21
6	3.25 to 5.24
7	3.06 to 4.73

equal. This led to a sub-hypothesis for each of hypotheses H_1 to H_{31} which, in general, was that preparers, auditors, and users who selected Response 4 have similar perceptions as to the appropriate absolute dollar amount which should serve as a materiality cut-off. A one-way analysis of variance was used to test each of the thirty-one sub-hypotheses. Table 5-6 provides the following for each question: the mean absolute dollar amount for each group, the overall mean, the results of the ANOVA test, the research decision, and the range of absolute dollar amounts.

Examination of Table 5-6 reveals that the research decision for 25 of the 31 sub-hypotheses is to not reject the null hypothesis. That is, based on the statistical tests for 25 sub-hypotheses, the general conclusion would be that preparers, auditors, and users who selected Response 4 do have similar views of the appropriate absolute dollar amount.

The reader may think that the mean statistics indicate, at least based on a visual analysis, that there is a difference between the means for most of the twenty-five sub-hypotheses which were not rejected. However, because of the relatively small number of respondents selecting Response 4 (especially in the case of users) and the wide range of absolute dollar amounts provided by the respondents, it is not statistically possible to say that the population means differ across the three groups. Because of the wide range of absolute dollar amounts provided by respondents and the variation across means within groups, it is apparent that there is no general consensus within or across groups as to appropriate absolute dollar amounts. Therefore, further analysis of any of the sub-hypotheses would be of dubious value.

TABLE 5-6

**RESULTS OF THE ANALYSIS OF VARIANCE TEST FOR EQUALITY OF ABSOLUTE
DOLLAR AMOUNTS PROVIDED BY RESPONDENTS SELECTING RESPONSE 4**

Payment Case and Question Number	Sub- Hypothesis	Mean Absolute Dollar Amount				Significance	Research Decision	Total Range	
		Auditors	Preparers	Users	Total	P-Test		Minimum	Maximum
<u>Illegal Domestic Political Con- tributions</u>									
Question 1	H ₁	\$ 12,800	\$ 51,328	\$160,125	\$ 53,989	0.194	DNR	\$100	\$1,000,000
2	H ₂	16,667	95,085	17,444	48,694	0.488	DNR	10	1,000,000
3	H ₃	12,805	82,047	203,500	70,247	0.196	DNR	100	1,000,000
4	H ₄	14,365	14,777	129,056	36,058	0.098	R	100	1,000,000
5	H ₅	22,500	24,689	174,571	67,675	0.261	DNR	100	1,000,000
6	H ₆	14,350	71,645	17,750	45,082	0.649	DNR	100	1,000,000
<u>Foreign Political Contributions</u>									
Question 1	H ₇	363,857	7,968	208,000	163,626	0.242	DNR	\$ 50	2,000,000
2	H ₈	24,635	71,311	333,875	96,680	0.009	R	100	1,000,000
3	H ₉	93,875	19,089	240,200	84,621	0.134	DNR	50	1,000,000
4	H ₁₀	36,429	32,300	274,000	97,426	0.126	DNR	100	1,000,000
5	H ₁₁	33,570	186,017	360,167	164,218	0.180	DNR	100	1,000,000
6	H ₁₂	114,481	12,584	160,750	78,065	0.200	DNR	100	1,000,000
7	H ₁₃	45,000	25,789	40,000	33,947	0.741	DNR	100	1,000,000
8	H ₁₄	67,075	28,325	188,500	86,100	0.443	DNR	100	1,000,000
9	H ₁₅	153,670	18,086	224,200	126,559	0.498	DNR	100	1,000,000
10	H ₁₆	89,725	14,236	270,167	98,424	0.165	DNR	100	1,000,000
<u>Bribery of Foreign Government Officials</u>									
Question 1	H ₁₇	28,224	21,793	239,167	51,166	0.202	R	100	1,000,000
2	H ₁₈	36,875	26,739	80,000	38,504	0.212	DNR	100	200,000
3	H ₁₉	32,400	38,418	83,750	41,766	0.239	DNR	100	200,000
4	H ₂₀	104,594	20,681	61,375	62,408	0.329	DNR	50	1,000,000
5	H ₂₁	47,625	29,940	46,250	37,596	0.610	DNR	100	100,000
6	H ₂₂	67,427	22,116	37,000	40,218	0.496	DNR	100	500,000
7	H ₂₃	163,170	23,210	38,333	86,035	0.372	DNR	100	1,000,000
8	H ₂₄	104,246	20,592	106,167	70,028	0.566	DNR	100	1,000,000
<u>Commercial Bribery</u>									
Question 1	H ₂₅	81,044	15,079	65,000	52,366	0.573	DNR	100	1,000,000
2	H ₂₆	32,500	21,239	68,750	32,488	0.094	R	100	100,000
3	H ₂₇	26,971	26,233	83,333	33,219	0.089	R	100	100,000
4	H ₂₈	142,975	16,038	54,429	67,237	0.193	DNR	100	1,000,000
5	H ₂₉	46,667	24,758	83,333	39,386	0.080	R	100	100,000
6	H ₃₀	154,770	13,888	68,333	88,752	0.472	DNR	100	1,000,000
7	H ₃₁	96,609	13,456	56,500	58,742	0.683	DNR	100	1,000,000

R means reject the null hypothesis at an alpha level of 0.10 or less
DNR means do not reject the null hypothesis

Average sample size for questions: Auditors, 12; Preparers, 13; and Users, 5.

Summary

This chapter examines empirical evidence supporting the following conclusions:

1. Preparers, auditors, and users do not have similar views of materiality in varying illegal payment cases.
2. Auditors and users do not have similar views of materiality in varying illegal payment cases.
3. Preparers and users do not have similar views of materiality in varying illegal payment cases.
4. With the exception of commercial bribery cases, auditors and preparers have similar views of materiality in varying illegal payment cases.
5. For those respondents selecting the percentage of net income approach to materiality decisions, preparers, auditors, and users have similar views as to the appropriate percent of net income to use for materiality decisions in varying illegal payment cases.
6. For those respondents selecting the absolute dollar amount approach to materiality decisions, no conclusion may be drawn as to whether preparers, auditors, and users have similar views as to the absolute dollar amount to use in materiality decisions.

FOOTNOTES

¹W. J. Conover, Practical Nonparametric Statistics (New York: John Wiley & Sons Inc., 1971), p. 151.

²American Institute of Certified Public Accountants, "The Independent Auditor's Responsibility for the Detection of Errors or Irregularities," Statement on Auditing Standards 16 (New York, N.Y.: AICPA, 1977), pp. 6-7.

CHAPTER 6

ANALYSIS OF HYPOTHESES H_{32} THROUGH H_{61}

Introduction

This chapter will concentrate on the analysis of hypotheses H_{32} to H_{61} . The purpose of this analysis will be to determine whether each group is consistent in their views of materiality across the varying payment cases given similar sets of circumstances. For example, do preparers have the same view of materiality when an "off-the-books" slush fund is used as the source of payment in the four illegal payment cases (illegal domestic political contributions, illegal foreign political contributions, commercial bribery, and bribery of foreign government officials)? Since there are basically two independent variables involved, group and payment case, a two-way analysis of variance was performed on each similar situation set.

In order to use the response data in the various analysis of variance tests, it was necessary to convert the responses from a descriptive response distribution to an ordinal disclosure distribution. This task was performed as follows: Response 1, which resulted in no disclosure was assigned a rank of 1; Responses 3 and 4, which resulted in disclosure if some criteria were met were assigned a rank of 2; and Response 2, which always meant disclosure was assigned a rank of 3.

The two-way analysis of variance was used to determine whether an interaction between the independent variables existed. A one-way

analysis of variance was also performed for each group across similar situations.

Analysis--Various Situations

No Surrounding Circumstances Given

In each questionnaire segment there was an illegal payment question in which no surrounding circumstances were given. The four questions (i.e., payment cases) with similar circumstances are:

1. An American company made illegal domestic political contributions to U.S. political parties.
2. An American company made illegal political contributions to foreign politicians.
3. An American company made illegal payments to foreign government officials.
4. One American company made bribery payments to officers of foreign companies.

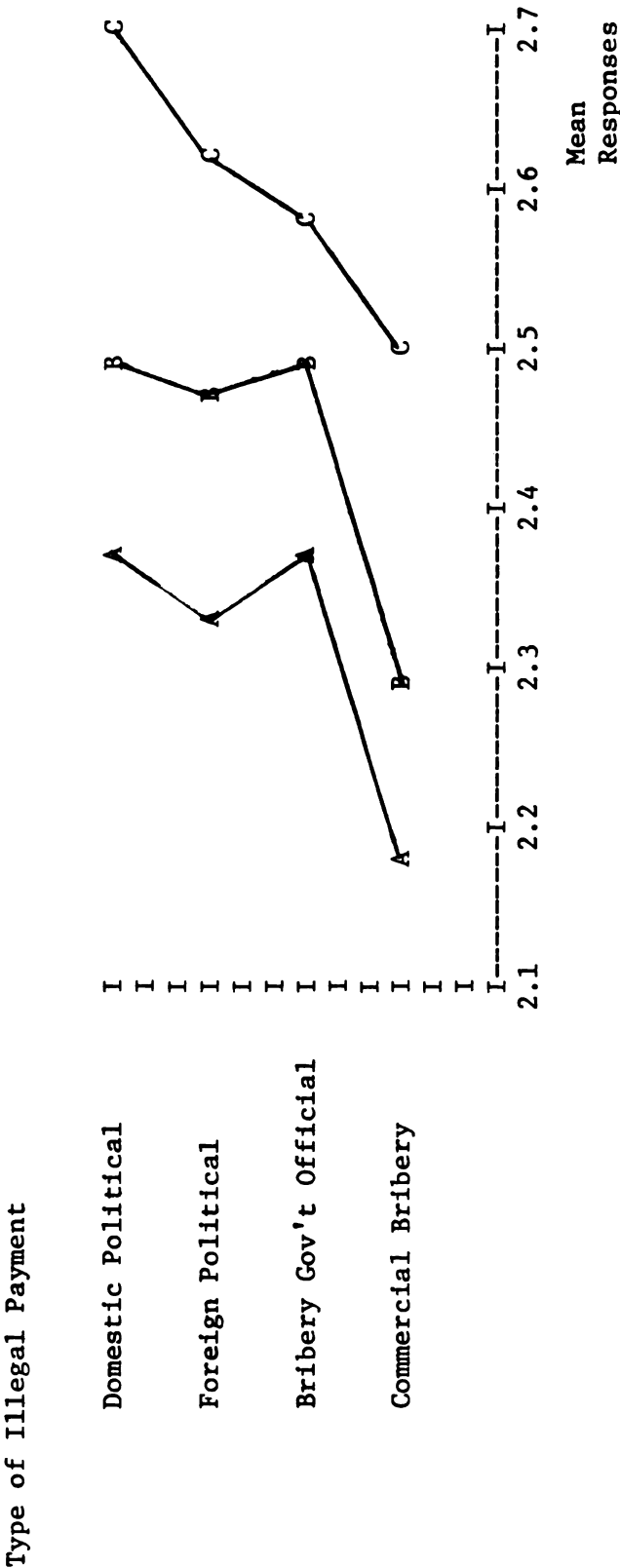
The two-way ANOVA for the situation, no surrounding circumstances given, gives an interaction probability of 0.63, which indicates that there is no group-by-payment interaction. Since there is no interaction, the results would indicate that the disclosure rankings would be consistent across groups. This is supported By Figure 6-1.

The results of the one-way ANOVA on each group are summarized by the following table:

<u>Group</u>	<u>n</u>	<u>Payment Case</u>				<u>F Prob-ability</u>
		<u>1</u>	<u>2</u>	<u>3</u>	<u>4</u>	
Auditors	(71)	2.366	2.338	2.366	2.183	0.0020
Preparers	(90)	2.489	2.467	2.477	2.289	0.0016
Users	(84)	2.702	2.619	2.583	2.500	0.0115

Examining the first line of the above table, it may be concluded that the mean responses for auditors across the four payment cases in which "no surrounding circumstances" were given are different. This analysis

FIGURE 6-1
NO SURROUNDING CIRCUMSTANCES GIVEN (A GRAPH OF THE MEAN RESPONSES FOR THE VARIOUS PAYMENT CASES IN WHICH THIS SITUATION WAS PRESENT)



SYMBOL TABLE:

Group	Symbol
Auditors	A
Preparers	B
Users	C

provides the basis for rejecting null hypothesis H_{40} for auditors. Similarly, null hypotheses H_{32} for preparers and H_{48} for users are also rejected. That is, for each group--auditors, preparers, and users, it may be concluded that the group does not have the same view of materiality in varying cases involving illegal payments when no surrounding circumstances are given.

Circumvention of Normal Accounting Procedures and Accounting Internal Controls

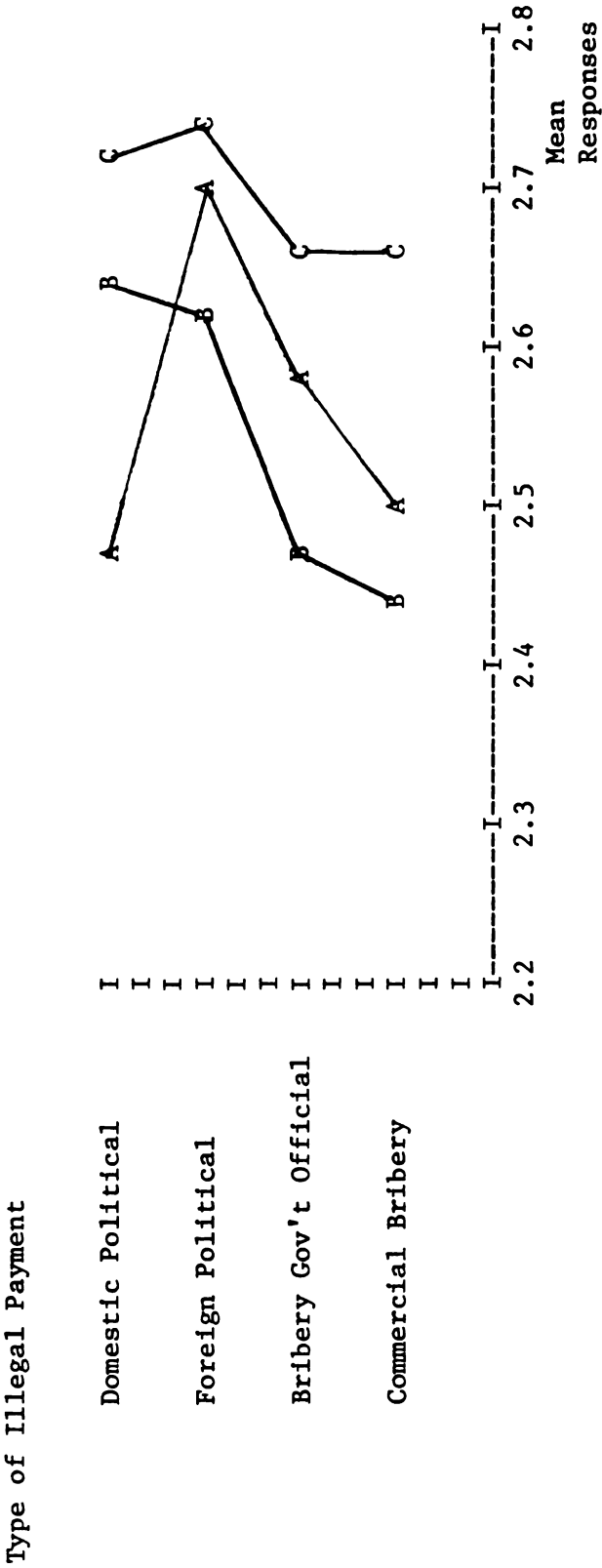
In each questionnaire segment there was an illegal payment question in which normal accounting procedures and accounting internal controls were circumvented. The four questions were:

1. An American company used employee bonuses as a means of financing political contributions. The employees were given bonuses and directed to pay the after tax balance to various U.S. political figures. These payments were recorded on the company's books as employee bonuses.
2. An American corporation made illegal foreign political contributions and covered up the contributions with false accounting entries in the corporate books and records.
3. An American corporation made payments to some foreign government officials. False invoices were used to generate the cash for these payments.
4. An American company bribed the purchasing agent of a corporate customer and covered up the payments with false expense vouchers.

The two-way ANOVA for the situation, circumvention of normal accounting procedures and accounting internal controls, gives an interaction probability of 0.05 which indicates that there is a group-by-payment interaction. That is, the respondents reaction to a given illegal payment question depends upon the group to which he belongs, and group reactions are not consistent across questions. This is apparent from examining Figure 6-2. With respect to the question on illegal domestic political

FIGURE 6-2

CIRCUMVENTION OF NORMAL ACCOUNTING PROCEDURES AND ACCOUNTING INTERNAL CONTROLS
(A GRAPH OF THE MEAN RESPONSES FOR THE VARIOUS PAYMENT CASES
IN WHICH THIS SITUATION WAS PRESENT)



SYMBOL TABLE:

Group	Symbol
Auditors	A
Preparers	B
Users	C

contributions, auditors have a lower mean disclosure demand than preparers and users, while in the other three questions, preparers have the lowest overall disclosure demand with auditors and preparers having higher mean responses.

The results of the one-way ANOVA on each group are summarized by the following table:

Group	n	Payment Case				F Prob- ability
		1	2	3	4	
Auditors	(74)	2.459	2.703	2.581	2.500	0.0004
Preparers	(90)	2.633	2.622	2.467	2.422	0.0001
Users	(85)	2.718	2.741	2.659	2.659	0.4056

Based on the above analysis, null hypothesis H_{41} for auditors and H_{33} for preparers would be rejected. Thus, it may be concluded that auditors do not have the same views of materiality in varying cases involving circumvention of normal accounting procedures and accounting internal controls. The same conclusion may be drawn for preparers. The above analysis does not result in the rejection of null hypothesis H_{49} for users. Thus, the conclusion would be that users have the same view of materiality in varying cases involving circumvention of normal accounting procedures and accounting internal controls.

Illegal Payment Made With Top Management Knowledge

In each questionnaire segment there was an illegal payment question in which the payment is made with top management knowledge and approval. The four questions were:

1. An American corporation made illegal political contributions to U.S. politicians. Top management was aware of and participated in the payment program.

2. Top management of an American corporation approved of and participated in the payment of illegal political contributions to foreign politicians and foreign political parties.
3. The chief executive officer of an American company personally delivered funds to a foreign government official in order to obtain special corporate favors.
4. An American company paid bribes to corporate purchasing agents in order to induce the agent to buy the company's products. The company's top officers actively encouraged these activities.

The two-way ANOVA for the situation, illegal payment made with top management knowledge, gives an ininteraction probability of 0.48 which indicates that there is no group-by-payment interaction. Since there is no interaction, the results would indicate that the disclosure rankings are consistent across groups. This is supported by Figure 6-3.

The results of the one-way ANOVA on each group are summarized by the following table:

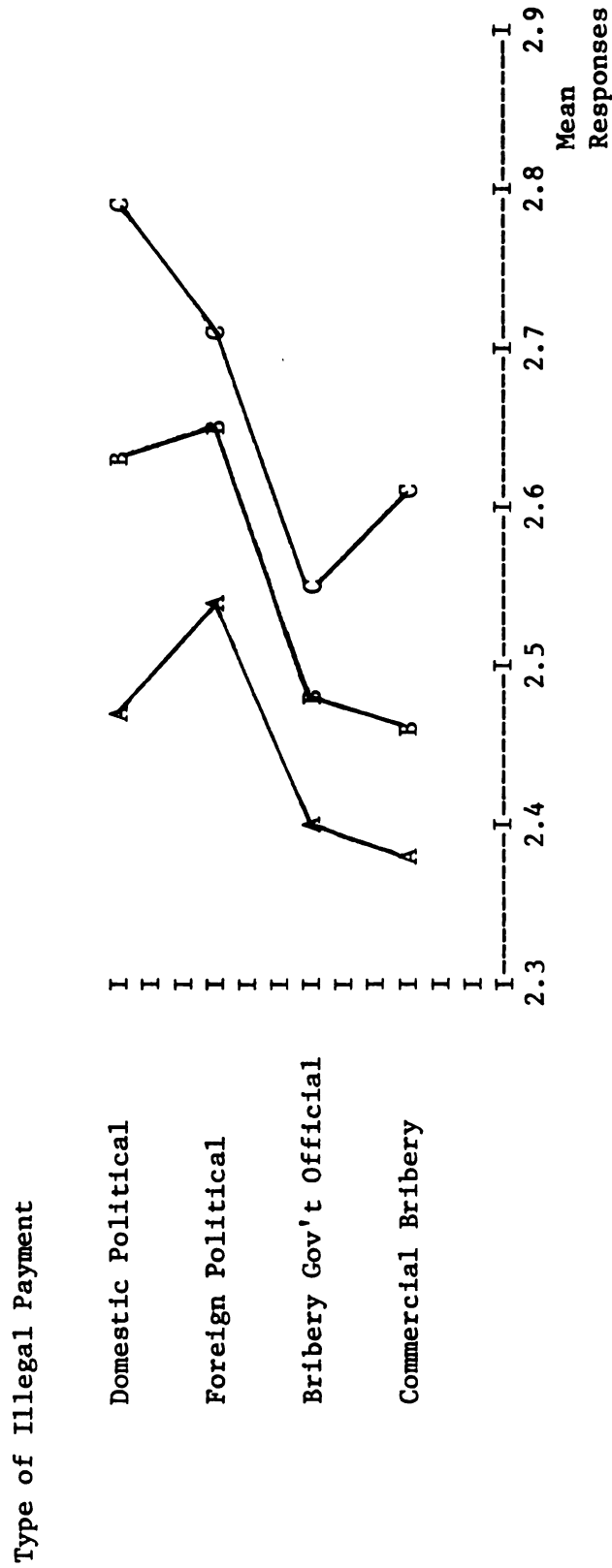
Group	n	Payment Case				F Prob- ability
		1	2	3	4	
Auditors	(72)	2.472	2.542	2.389	2.375	0.0509
Preparers	(88)	2.625	2.648	2.477	2.455	0.0003
Users	(85)	2.788	2.706	2.553	2.612	0.0057

Based on the above analysis, null hypotheses H_{42} for auditors, H_{34} for preparers, and H_{50} for users are rejected. Therefore, for each group, it may be concluded that the group does not have the same view of materiality in varying cases involving illegal payments in which top management is aware of and approves of the payments.

Illegal Payment Made Without Top Management Knowledge

In each questionnaire segment there was an illegal payment question in which the payment is made without top management knowledge or

FIGURE 6--3
ILLEGAL PAYMENT MADE WITH TOP MANAGEMENT KNOWLEDGE (A GRAPH OF THE MEAN RESPONSES
FOR THE VARIOUS PAYMENT CASES IN WHICH THIS SITUATION WAS PRESENT)



SYMBOL TABLE:

Group	Symbol
Auditors	A
Preparers	B
Users	C

approval. The four questions (i.e., payment cases) with similar circumstances are:

1. A member of the management team of a subsidiary of an American corporation made illegal political contributions to U.S. politicians against top management's orders and without its approval.
2. Mid-level officials of another American corporation made illegal foreign political contributions without top management knowledge and in violation of company policy.
3. An American company made payments to foreign government officials in order to obtain special favors. These payments were made without the knowledge or approval of top corporate management.
4. An official of an American company paid bribes to obtain sales contracts. Top corporate management was not aware of these payments.

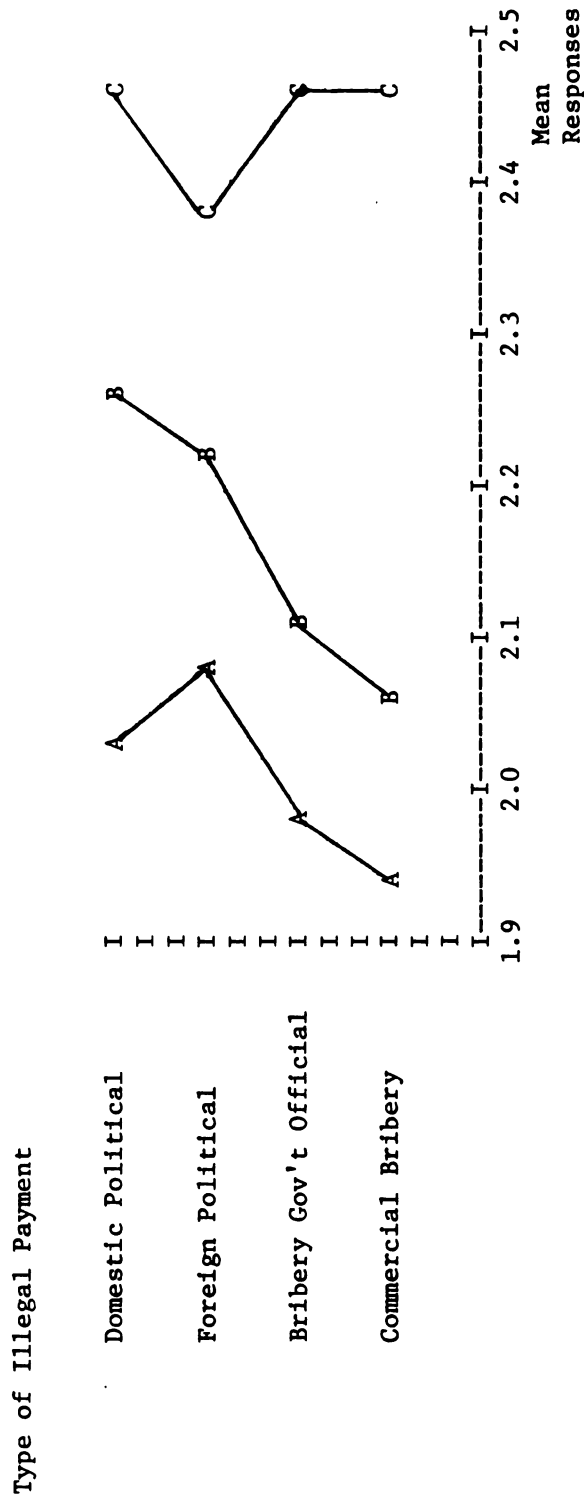
The two-way ANOVA for the situation, illegal payment made without top management knowledge, gives an interaction probability of 0.13 which indicates that there is no group-by-payment interaction. Since there is no interaction, the results would indicate that the disclosure rankings are basically consistent across groups. This conclusion is supported by Figure 6-4.

The results of the one-way ANOVA on each group are summarized by the following table:

Group	n	Payment Case				F Prob- ability
		1	2	3	4	
Auditors	(68)	2.029	2.074	1.971	1.941	0.0916
Preparers	(90)	2.256	2.222	2.111	2.056	0.0007
Users	(82)	2.463	2.378	2.463	2.463	0.6418

Based on the above analysis, null hypotheses H_{43} for auditors and H_{35} for preparers would be rejected. Thus, it may be concluded that auditors do not have the same view of materiality in varying cases

FIGURE 6-4
ILLEGAL PAYMENT MADE WITHOUT TOP MANAGEMENT KNOWLEDGE (A GRAPH OF THE MEAN RESPONSES
FOR THE VARIOUS PAYMENT CASES IN WHICH THIS SITUATION WAS PRESENT)



SYMBOL TABLE:

Group	Symbol
Auditors	A
Preparers	B
Users	C

involving illegal payments made without top management knowledge or approval. The same conclusion may be drawn for preparers. The above analysis does not result in the rejection of null hypothesis H_{51} for users. Thus, the conclusion would be that users have the same view of materiality in varying cases in which illegal payments are made without top management knowledge or approval.

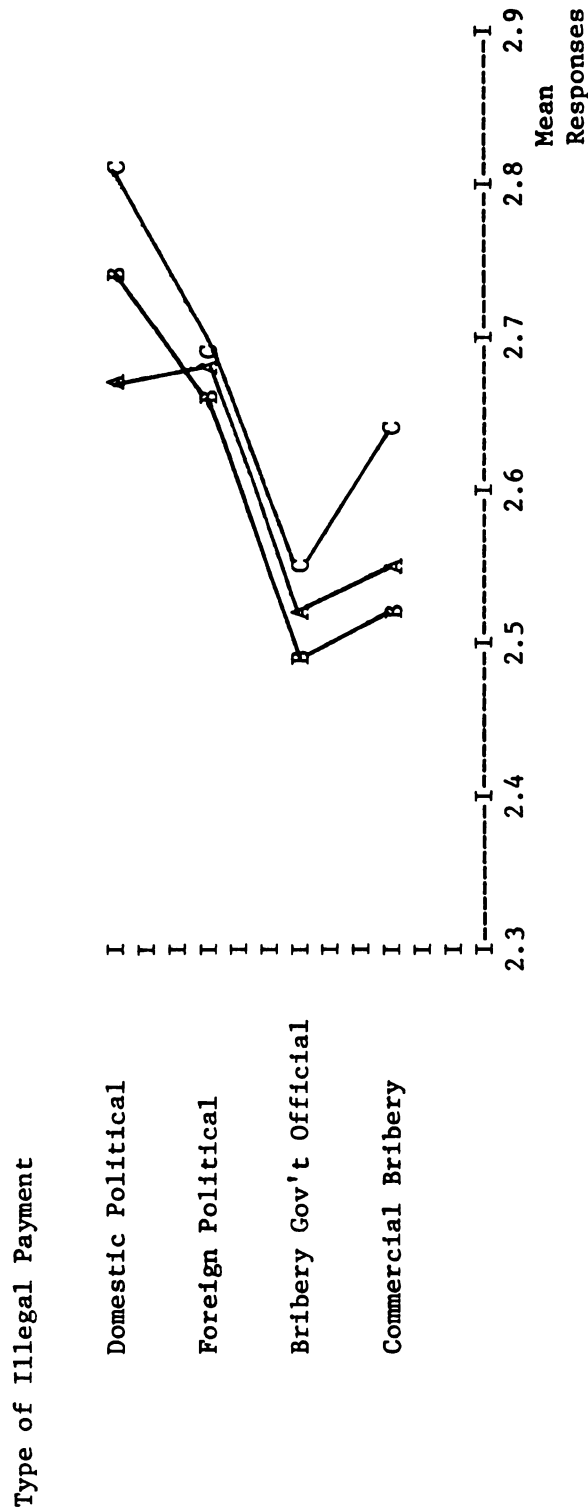
"Off the Books" Slush Fund

In each questionnaire segment, there was an illegal payment question in which the payment is made from funds maintained outside the system of corporate accountability (i.e., an "off-the-books" slush fund). The four questions were:

1. An American company maintained a secret "off-the-books" fund from which illegal domestic political contributions were made. The funds were obtained from kickbacks from foreign legal consultants.
2. An American firm made illegal foreign political payments from an "off-the-books" fund. The "off-the-books" fund was generated from rebates on consulting fees paid to foreign consultants.
3. An American corporation made payments to foreign government officials from an "off-the-books" fund. The purpose of the payments was to aid the corporation in obtaining foreign government contracts.
4. An American corporation financed commercial bribes from an "off-the-books" fund obtained from rebates on excessive sales commissions.

The two-way ANOVA for the situation, "off-the-books" slush fund, gives an interaction probability of 0.55 which indicates that there is no group-by-payment interaction. Since there is no interaction, the results would indicate that the disclosure rankings are basically consistent across groups. This is supported by Figure 6-5. Although Figure 6-5 shows that auditors have the lowest mean disclosure demand on

FIGURE 6-5
 "OFF-THE-BOOKS" FUND (A GRAPH OF THE MEAN RESPONSES FOR THE VARIOUS
 PAYMENT CASES IN WHICH THIS SITUATION WAS PRESENT)



SYMBOL TABLE:

Group	Symbol
Auditors	A
Preparers	B
Users	C

question 1, whereas the preparers have the lowest mean disclosure demand in questions 2, 3, and 4, this inconsistency is not significant enough to support the conclusion of an interaction effect.

The results of the one-way ANOVA on each group are summarized by the following table:

<u>Group</u>	<u>n</u>	<u>Payment Case</u>				<u>F Prob- ability</u>
		<u>1</u>	<u>2</u>	<u>3</u>	<u>4</u>	
Auditors	(75)	2.680	2.693	2.520	2.547	0.0039
Preparers	(88)	2.739	2.670	2.489	2.523	0.0000
Users	(84)	2.810	2.702	2.548	2.643	0.0007

Based on the above analysis, null hypotheses H_{44} for auditors, H_{36} for preparers, and H_{52} for users are rejected. Therefore, for each group, it may be concluded that the group does not have the same view of materiality in varying cases involving the use of an "off-the-books" slush fund as the source for illegal payments.

Possible Income Tax Assessments

In each questionnaire segment there was an illegal payment question in which disclosure of the illegal payment might result in income tax assessments for improperly deducted illegal payments. The four questions were:

1. For some firms, disclosure of illegal domestic political contributions may result in income tax assessments for improperly deducted political contributions.
2. For some firms, disclosure of illegal foreign political contributions may result in income tax assessments for improperly deducted political contributions.
3. For some firms, disclosure of bribes paid to foreign government officials may result in income tax assessments for improperly deducted bribes.

4. For some firms, disclosure of commercial bribes may result in income tax assessments for improperly deducted bribery payments.

The two-way ANOVA for the situation, possible income tax assessments, gives an interaction probability of 0.34 which indicates that there is no group by payment interaction. Since there is no interaction, the results would indicate that the disclosure rankings would be consistent across groups. This is supported by Figure 6-6.

The results of the one-way ANOVA on each group are summarized by the following table:

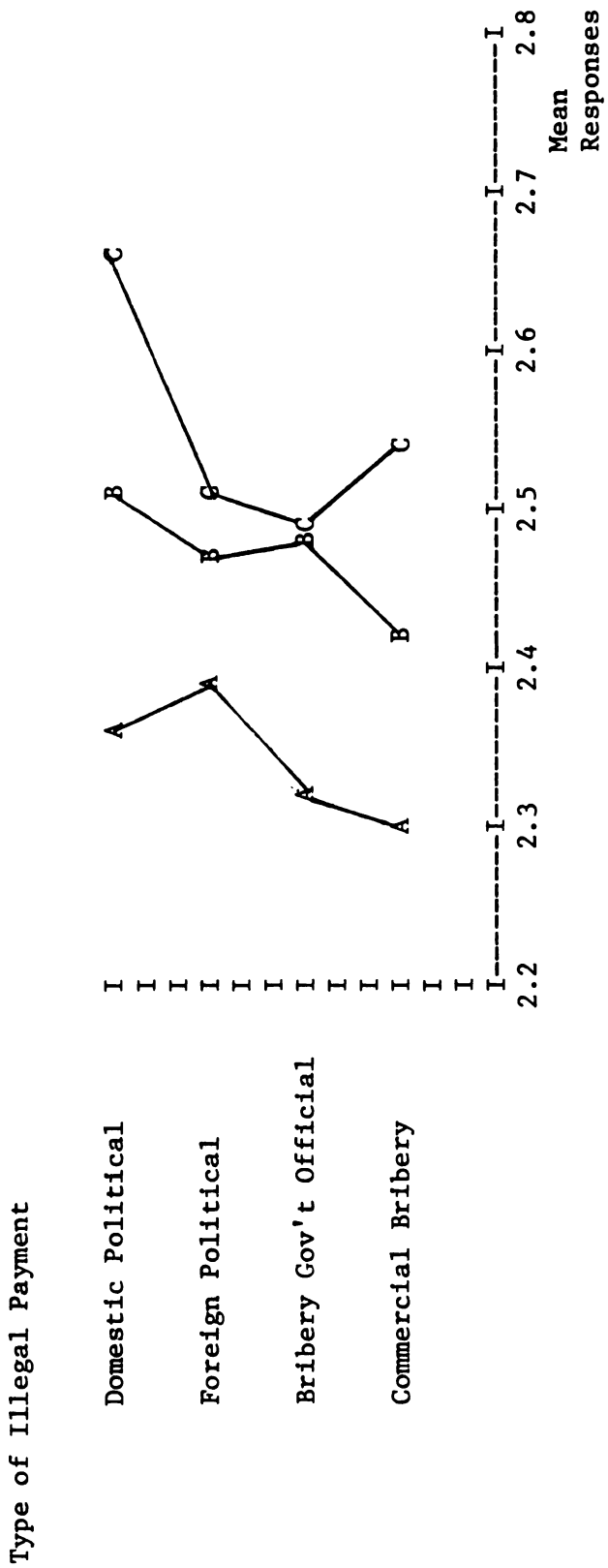
<u>Group</u>	<u>n</u>	<u>Payment Case</u>				<u>F Prob- ability</u>
		<u>1</u>	<u>2</u>	<u>3</u>	<u>4</u>	
Auditors	(69)	2.362	2.391	2.319	2.304	0.2923
Preparers	(88)	2.511	2.466	2.477	2.420	0.2387
Users	(80)	2.650	2.512	2.488	2.537	0.0984

Based upon the above analysis, null hypotheses H_{47} for auditors and H_{39} for preparers are not rejected. Therefore, for each of these two groups, it may be concluded that the group does have the same views of materiality in varying cases involving possible income tax assessments. However, the above analysis for users results in the rejection of the null hypothesis for users. Thus, it may be concluded that users do not have the same view of materiality in varying cases involving possible income tax assessments.

Expropriation of Foreign Corporate Assets

In the two questionnaire segments on foreign payments there was an illegal payment question in which disclosure of the illegal payment may result in expropriation of foreign corporate assets. The two questions were:

FIGURE 6-6
POSSIBLE INCOME TAX ASSESSMENTS (GRAPH OF THE MEAN RESPONSES FOR THE
VARIOUS PAYMENT CASES IN WHICH THIS SITUATION WAS PRESENT)



SYMBOL TABLE:

Group	Symbol
Auditors	A
Preparers	B
Users	C

1. The disclosure of an American company's corporate contributions may result in expropriation of assets in the country in which the illegal contributions occurred.
2. An American company made payments to a foreign customs official to avoid liabilities and penalties from alleged evasion of customs payments. The company fears that disclosure in the corporate financial statements may result in expropriation of its foreign property.

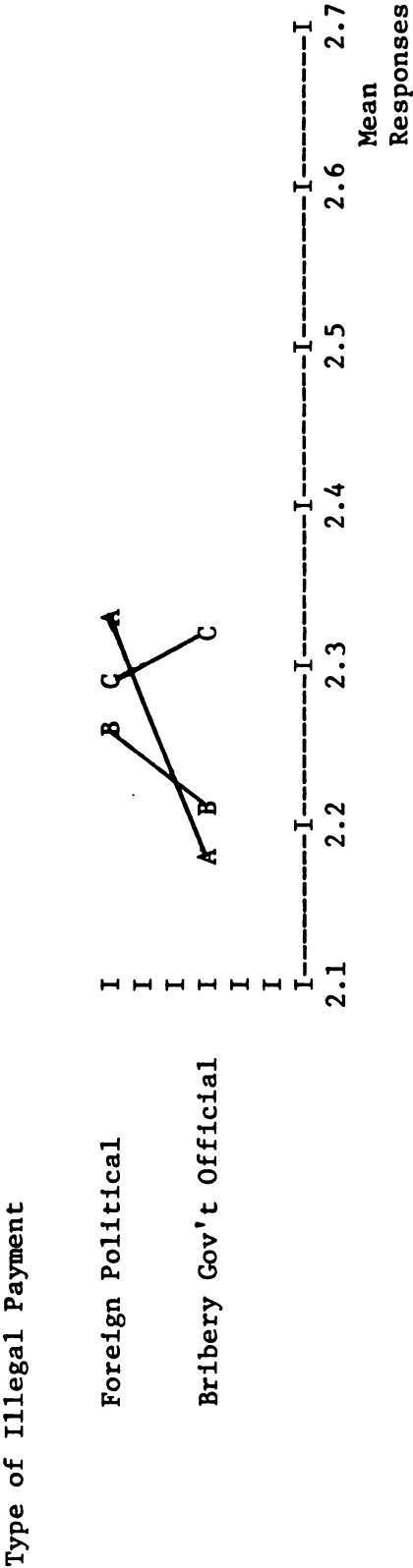
The two-way ANOVA for the situation, expropriation of foreign assets, gives an interaction probability of 0.10 which indicates that there is a group-by-payment interaction. This interaction indicates that disclosure response patterns are not consistent across groups, and the group to which the respondent belongs is a determining variable with respect to response across payments. This conclusion is supported by Figure 6-7. For some reason auditors demand the least disclosure as indicated by their mean response to question 1 and the most disclosure as indicated by their mean response to question 2.

The results of the one-way ANOVA on each group are summarized by the following table:

<u>Group</u>	<u>n</u>	<u>Payment Case</u>		<u>F Prob- ability</u>
		<u>1</u>	<u>2</u>	
Auditors	(66)	2.333	2.182	0.0319
Preparers	(87)	2.264	2.207	0.3561
Users	(84)	2.286	2.321	0.4418

Based on the above analysis, null hypothesis H_{46} for auditors is rejected. Thus, it may be concluded that auditors do not have the same views of materiality in varying cases in which disclosure may result in expropriation of foreign corporate assets. However, with respect to preparers and users, the above analysis does not result in the rejection of null hypotheses H_{38} for preparers and H_{54} for users. Therefore, for

FIGURE 6-7
EXPROPRIATION OF FOREIGN CORPORATE ASSETS (GRAPH OF THE MEAN RESPONSES
FOR THE VARIOUS PAYMENT CASES IN WHICH THIS SITUATION WAS PRESENT)



SYMBOL TABLE:

Group	Symbol
Auditors	A
Preparers	B
Users	C

each of these two groups, it may be concluded that the group does have the same views of materiality in varying cases in which disclosure may result in expropriation of foreign assets.

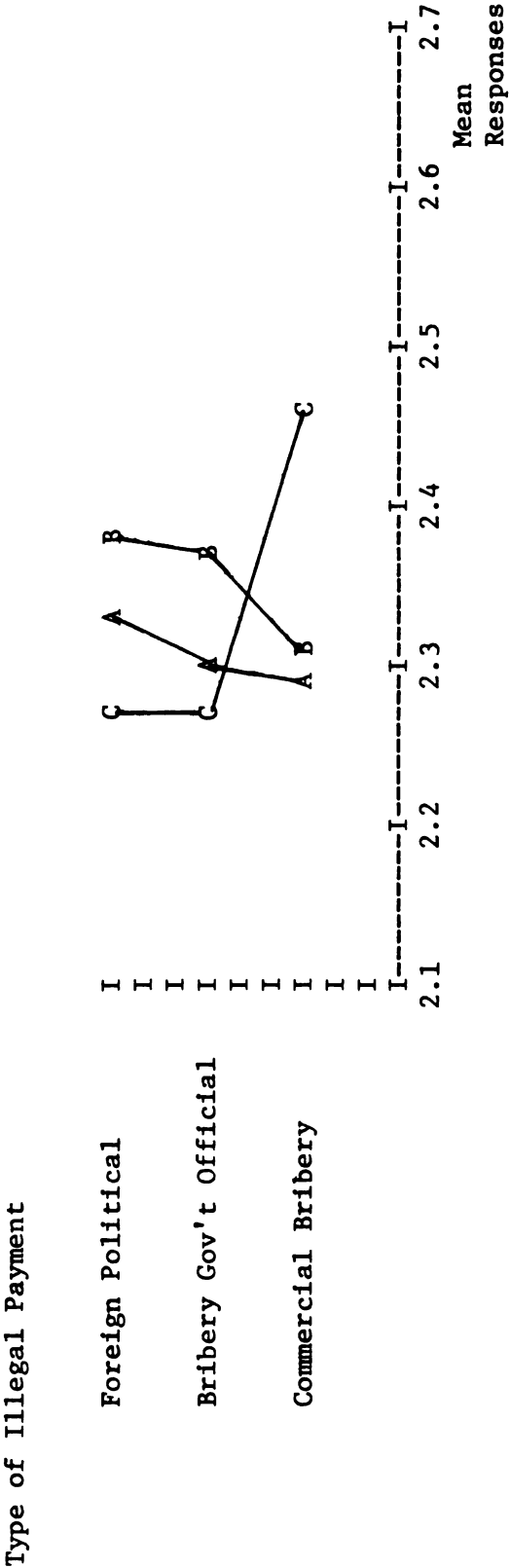
Loss of Right To Do Business

In three of the four questionnaire segments there are questions which have as a possible consequence of disclosure the loss of right to do business. These three questions are:

1. For some firms, disclosure in corporate financial statements of illegal political contributions may result in the loss of right to do business in the country in which the illegal contribution occurred.
2. For some firms, disclosure in the corporate financial statements of bribes paid to foreign government officials may result in the loss of right to do business in the country in which the bribe occurred.
3. For some companies, disclosure of commercial bribes may result in a significant loss of business with the company whose officials were bribed.

The two-way ANOVA for the situation, loss of right to do business, gives an interaction probability of 0.05 which indicates that there is a group-by-payment interaction. This interaction indicates that disclosure response patterns are not consistent across groups, and the group to which the respondent belongs is a determining variable with respect to response across payments. Examination of Figure 6-8 reveals a tendency on the part of users to have a low mean response when disclosure may result in the loss of right to do business with the foreign country, and it reveals a relatively high mean response when disclosure may result in the significant loss of business with a company whose officials were bribed. This disclosure response pattern is not consistent with the response patterns of the preparer and auditor groups.

FIGURE 6-8
LOSS OF RIGHT TO DO BUSINESS (GRAPH OF THE MEAN RESPONSES FOR THE
VARIOUS PAYMENT CASES IN WHICH THIS SITUATION WAS PRESENT)



SYMBOL TABLE:

Group	Symbol
Auditors	A
Preparers	B
Users	C

The results of the one-way ANOVA on each group are summarized by the following table:

<u>Group</u>	<u>n</u>	<u>Payment Case</u>			<u>F Prob- ability</u>
		<u>1</u>	<u>2</u>	<u>3</u>	
Auditors	(66)	2.333	2.303	2.288	0.6810
Preparers	(85)	2.376	2.365	2.306	0.3818
Users	(81)	2.272	2.272	2.457	0.0374

Based on the above analysis, null hypotheses H_{47} for preparers and H_{39} for auditors are not rejected. Thus, for each of these two groups, it may be concluded that the group does have the same view of materiality in varying cases in which disclosure may result in the loss of right to do business. In addition, the above analysis leads to the rejection of null hypothesis H_{55} for users. Therefore, it may be concluded that users do not have the same view of materiality in varying cases in which disclosure may result in the loss of right to do business.

Legal versus Illegal

In addition to the eight sets of situations mentioned above which test for consistency across payment cases for similar situations, this research includes two sets of questions which test consistency across levels of legality for similar situations. The first set of questions in which no surrounding circumstances are given is:

1. An American company made legal political contributions to foreign politicians.
2. An American company made illegal political contributions to foreign politicians.

A two-way ANOVA was performed for the variables group and legality.

This analysis gave an interaction probability of 0.53 which indicates that there is no group-by-legality interaction. Since there is no

interaction, the results would indicate that the disclosure rankings are basically consistent across groups. This conclusion is supported by Figure 6-9.

The results of the one-way ANOVA on each group which compares mean responses for the illegal payment are summarized in the following table:

<u>Group</u>	<u>n</u>	<u>Legality Level</u>		<u>F Prob- ability</u>
		<u>1</u>	<u>2</u>	
Auditors	(73)	1.342	2.329	0.0000
Preparers	(93)	1.376	2.452	0.0000
Users	(88)	1.648	2.591	0.0000

Based on the above analysis, null hypotheses H_{58} for auditors, H_{56} for preparers, and H_{60} for users are rejected. The conclusion for each group is that the group does not have the same view of materiality when the payment of a foreign political contribution is legal as when it is illegal (no surrounding circumstances given).

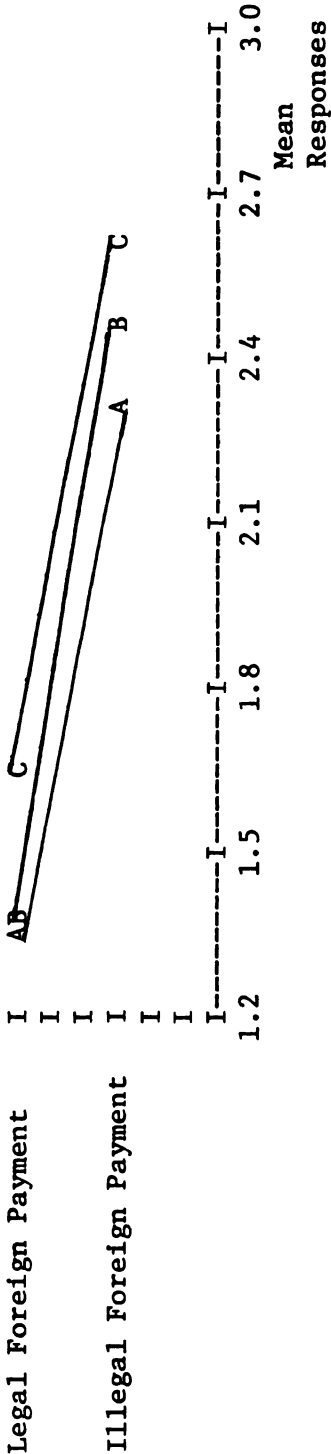
The second set of questions which test consistency across levels of legality for similar situations (in this case, the similar situation is the circumvention of normal accounting procedures and accounting internal controls) is:

1. An American company made legal political contributions to foreign politicians. These payments were accounted for improperly as payments to sales organizations.
2. An American corporation made illegal foreign political contributions and covered up the contributions with false accounting entries in the corporate books and records.

Again, a two-way ANOVA was performed for the variables group and legality. This analysis gave an interaction probability of 0.02 which indicates that there was a group-by-legality interaction. Since there

FIGURE 6-9

LEGAL VERSUS ILLEGAL - NO SURROUNDING CIRCUMSTANCES GIVEN (GRAPH OF THE MEAN RESPONSES FOR THE FOREIGN POLITICAL PAYMENT QUESTIONS IN WHICH NO SURROUNDING CIRCUMSTANCES WERE GIVEN)*



SYMBOL TABLE:

Group	Symbol
Auditors	A
Preparers	B
Users	C

*This scale is not comparable in size to the scales in Figures 6-1 through 6-8.

is an interaction, the results would indicate that the disclosure rankings are not consistent across groups. This conclusion is supported by Figure 6-10.

The results of the one-way ANOVA on each group which compares the mean responses for the legal payment in the circumvention of normal accounting procedures situation to the mean responses for the illegal payment in the circumvention of normal accounting procedures situation are summarized below:

<u>Group</u>	<u>n</u>	<u>Legality Level</u>		F Prob- ability
		<u>1</u>	<u>2</u>	
Auditors	(75)	1.893	2.693	0.0000
Preparers	(93)	1.968	2.613	0.0000
Users	(88)	2.250	2.705	0.0000

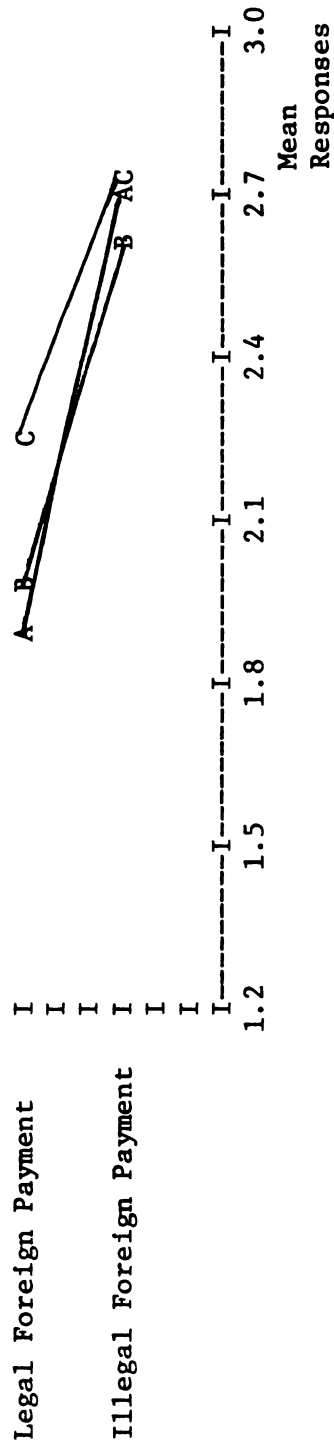
Based on the above analysis, null hypotheses H_{59} for auditors, H_{57} for preparers, and H_{61} for users are rejected. The conclusion for each group is that the group does not have the same view of materiality when a legal foreign political contribution is made by circumventing normal accounting procedures and accounting internal controls as when an illegal foreign political contribution is made by circumventing normal accounting procedures and accounting internal controls.

Conclusions H_{32} Through H_{61}

This chapter summarizes the results of the second major research objective, which was to determine whether each group makes consistent decisions across different payment cases given similar circumstances. Table 6-1 provides a summary of the hypotheses and related research decisions for the eight sets of similar circumstances. As stated in Chapter 1, the purpose of this research was:

FIGURE 6-10

LEGAL VERSUS ILLEGAL - CIRCUMVENTION OF NORMAL ACCOUNTING PROCEDURES
AND ACCOUNTING INTERNAL CONTROLS (GRAPH OF THE MEAN RESPONSES
FOR THE FOREIGN POLITICAL PAYMENT QUESTIONS IN WHICH
NORMAL ACCOUNTING PROCEDURES WERE CIRCUMVENTED)*



SYMBOL TABLE:

Group	Table
Auditors	A
Preparers	B
Users	C

*This scale is not comparable in size to the scales in Figures 6-1 through 6-8.
It is comparable to Figure 6-9.

The second general research question will allow the researcher to determine whether each group makes consistent decisions when circumstances are similar. If, for example, preparers made the same decision concerning materiality in all cases involving falsification of books and records, then a basis for generalizing the materiality decision to other cases involving falsification of books and records will be established.

The researcher's a priori expectation was that in most cases, each group would be consistent across payment cases with similar situation sets. Table 6-1 indicates that this is the exception rather than a general rule, and thus, it may be concluded that there is no broad basis for generalizing conclusions to similar situation sets in other types of illegal payment cases.

In addition to testing the consistency across different payment cases given similar circumstances, a group-by-payment interaction probability was computed for each of the eight sets of circumstances. No general trend was established which would tend to support a consistent (although not necessarily equal) disclosure reaction across groups in all or substantially all cases. In five of the eight situation sets, there was no group-by-payment interaction whereas in three of the eight cases, there was a group-by-payment interaction. This would tend to indicate that the group to which a respondent belongs may affect whether a given illegal payment case is more or less important in terms of disclosure than another illegal payment case.

Table 6-2 provides a summary of the hypotheses and related research decisions for the two sets of legal versus illegal payment cases given similar circumstances. In both sets of circumstances, all groups provide statistically different responses to circumstances involving a legal payment than for similar circumstances involving an

TABLE 6-1

SUMMARY OF RESEARCH DECISIONS FOR HYPOTHESES H_{32} to H_{55}
(Measuring Consistency Across Payment Cases)

Situations	Pre- parers	Auditors	Users	Group by Pay- ment Case Interaction
(1) No Surrounding Circumstances Given	R-H ₃₂	R-H ₄₀	R-H ₄₈	No
(2) Circumvention of Normal Accounting Procedures and Accounting Internal Controls	R-H ₃₃	R-H ₄₁	DNR-H ₄₉	Yes
(3) Illegal Payment Made <u>With</u> Top Management Knowledge	R-H ₃₄	R-H ₄₂	R-H ₅₀	No
(4) Illegal Payment Made <u>Without</u> Top Management Knowledge	R-H ₃₅	R-H ₄₃	DNR-H ₅₁	No
(5) "Off-the-Books" Slush Fund	R-H ₃₆	R-H ₄₄	R-H ₅₂	No
(6) Possible Income Tax Assessments	DNR-H ₃₇	DNR-H ₄₅	R-H ₅₃	No
(7) Expropriation of Foreign Corporate Assets	DNR-H ₃₈	R-H ₄₆	DNR-H ₅₄	Yes
(8) Loss of Right to Do Business	DNR-H ₃₉	DNR-H ₄₇	R-H ₅₅	Yes

R = Reject the null hypothesis.

DNR = Do not reject the null hypothesis.

TABLE 6-2

SUMMARY OF RESEARCH DECISIONS FOR HYPOTHESES H_{56} TO H_{61}
(Measuring Consistency Across Legality Levels)

Situations	Pre- parers	Auditors	Users	Group by Legality Interaction
(1) No Surrounding Circumstances Given	R- H_{56}	R- H_{58}	R- H_{60}	No
(2) Circumvention of Normal Accounting Procedures and Accounting Internal Controls	R- H_{57}	R- H_{59}	R- H_{61}	Yes

R = Reject the null hypothesis.

illegal payment. It is clearly evident that all three groups require a higher level of disclosure as indicated by mean responses when the payment is illegal than when it is legal.

General Observations

In Chapter 5, it was concluded that in general auditors have the lowest average disclosure demand and users have the highest average disclosure demand. Preparers held the "in between" position for average disclosure demand. This conclusion holds true for every case-situation combination in Figures 6-1, 6-3, 6-4, 6-6, and 6-9.

The domestic political contribution cases in Figures 6-2 and 6-5 also have this ranking. In the other three cases in Figures 6-2 and 6-5, preparers have the lowest average disclosure demand and users have the highest average disclosure demand with auditors falling in between.

Apparently, the higher amount of disclosure demand by auditors is a reaction to the seriousness of the circumstances. In each of the three cases in Figure 6-2 in which the auditors have a higher average disclosure demand than preparers, there is a situation involving falsification of the books or supporting documents. The word "false" appears in each of these case-situation combinations. As was mentioned in the preceding chapter, auditors probably would want a higher level of disclosure when overt violations of the integrity of the books and records would be expected to reflect adversely on them. This researcher suspects that the higher disclosure demand is a defensive reaction on the part of auditors. Conversely, in the domestic political contribution case in Figure 6-2, auditors have the lowest disclosure demand when employees were given "bonuses" and "directed to pay the after-tax balance to various U.S. political figures." This low disclosure demand occurs even though the payments were recorded on the books as "bonuses." The auditors apparently think that this is not a serious violation of the integrity of the books and records. They may even view it as a "misclassification" or a "gray" area in which the propriety of such payments is not clear.

In Figure 6-5, auditors apparently see another violation of the integrity of the books and records. In three of the four "off-the-books" fund case-situation combinations, auditors have a greater average disclosure demand than preparers. Again, this researcher concludes that these are situations that the auditors believe may reflect adversely on them. Thus, they require more disclosure on the average. It is unclear why auditors do not have a higher average disclosure demand than preparers in the domestic political contribution case

involving an "off-the-books" fund.

Examination of Figure 6-7 (expropriation of foreign corporate assets) reveals the same "general" ranking for the bribery of foreign government officials case as appears in Figures 6-1, 6-3, 6-4, 6-6, and 6-9. In contrast, in the foreign political contribution case, auditors want the highest amount of disclosure. One may only speculate as to why this occurs. It may be noted that the difference between preparers (the lowest) and auditors (the highest) in the average disclosure demand for this case-situation is only 0.069 ($2.333 - 2.264$) which, judgmentally, is not significant and may be the result of random chance. It is also possible that the auditors may require a high level of disclosure because they doubt that disclosure of an illegal foreign political contribution would result in asset expropriation whereas users may not consider payment of an illegal foreign political contribution as serious as bribery of a foreign government official.

Figure 6-8 reveals a shift in the average disclosure demand of users when there is a possibility that disclosure will result in the loss of the right to do business in a foreign country. This is one case in which users appear to consider the cost of disclosure as greater than the benefit. Thus, they are more reluctant on the average to require disclosure.

In general, the Figures in this chapter tend to support the conclusion that auditors have the lowest disclosure demand and users have the highest disclosure demand with preparers "in between." Moreover, it is apparent that auditors increase their disclosure demand when there are serious violations of the integrity of the financial accounting system.

In addition, further examination of Figures 6-1 through 6-8 reveals that on the average members of the three groups require a higher level of disclosure for illegal political contributions (domestic and foreign) than for bribery (foreign officials and commercial). There is no obvious reason why this occurs.

Summary

In this chapter, the results of the tests on hypotheses H_{32} through H_{61} are presented. These results are summarized under the caption Conclusions H_{32} Through H_{61} . In addition, some general observations are made about the levels of disclosure demanded by each of the three groups.

CHAPTER 7

CONCLUSIONS, IMPLICATIONS, AND SUGGESTIONS FOR FUTURE RESEARCH

Conclusions

In Chapter 1, the first stated purpose of this research was to provide empirical evidence which would affirm or deny the general belief that preparers', auditors', and users' views of materiality are dissimilar. (The evidence in this case would only be generalizable to sensitive situations.) Empirical evidence from this research indicates that in general, preparers, auditors, and users do not have similar views of materiality in varying cases involving illegal payments. This conclusion was derived from the results of Chi-Square tests on thirty-one specific null hypotheses, each of which tested the general null hypothesis that preparers, auditors, and users do have similar views of materiality. For twenty-seven out of thirty-one Chi-Square tests, the specific null hypothesis that preparers, auditors, and users have similar views of materiality was rejected.

Next, Chi-Square tests were used to determine whether auditors and users, preparers and users, and auditors and preparers, have dissimilar views of materiality. These tests resulted in the following conclusions:

1. Auditors and users do not have similar views of materiality in varying illegal payment cases.
2. Preparers and users do not have similar views of materiality in varying illegal payment cases.

3. Auditors and preparers have similar views of materiality in illegal payment cases involving political payments and bribery of government officials.
4. Auditors and preparers do not have similar views of materiality in illegal payment cases involving commercial bribery.

Additional empirical evidence was gathered to test the sub-general hypothesis: Preparers, auditors, and users who selected Response 3 have similar perceptions as to the appropriate percentage of net income which should serve as the materiality cut-off. A one-way analysis of variance was used to test each of the thirty-one specific sub-hypotheses. For twenty-eight out of thirty-one questions, the research decision was do not reject the null hypothesis. Thus, the general conclusion is that preparers, auditors, and users who selected Response 3 do have similar perceptions as to the appropriate percentage of net income which should serve as the materiality cut-off.

Analysis of the mean percentages of net income supplied by respondents selecting Response 3 led to the general conclusion that the groups have more stringent materiality standards for those illegal payment cases in which disclosure will not have a substantial cost to the corporation or its investors (i.e., a substantial cost may occur when disclosure may result in asset expropriation or loss of right to do business). That is, for those situations in which disclosure does not have a substantial cost the percentages of net income selected ranged from 3.05 percent to 4.15 percent. Reference to the materiality literature indicates that materiality cut-offs based on the percent of net income approach generally range from five to ten percent.

Additional empirical evidence was also gathered to test the sub-general hypothesis tht preparers, auditors and users who selected

Response 4 have similar perceptions as to the appropriate absolute dollar amount which should serve as a materiality cut-off. A one-way analysis of variance was used to test each of the thirty-one specific sub-hypothesis. For twenty-five out of thirty-one sub-hypotheses the research decision was to not reject the null hypothesis. However, a visual examination of the mean statistics indicates that there is a difference between the means for most of the twenty-five sub-hypotheses which were not rejected. It would appear that because of the relatively small number of respondents selecting Response 4 (especially in the case of users) and the wide range of absolute dollar amounts provided by respondents, it would not be possible to reach a meaningful conclusion about the equality of group means. In addition, it would seem that there is no consensus within groups as to the appropriate absolute dollar amount which should serve as a materiality cut-off.

The second stated purpose of this research was to determine whether each group makes consistent decisions when circumstances are similar. If, for example, preparers made the same decision in all cases involving falsifications of books and records, then a basis for generalizing the materiality decision to other cases involving falsification of books and records will be established. Twenty-four hypotheses were developed. Eight hypotheses were developed for each group for eight similar situation sets. The results of the one way analysis of variance tests are summarized in Table 6-1. The researcher's a priori expectation was that in most cases, each group would be consistent across payment cases with similar situation sets. Table 6-1 indicates that this is an exception rather than the general rule, and thus, it was concluded that there is no broad basis for generalizing conclusions to similar situation sets

in other types of illegal payment cases.

In addition to testing the consistency of materiality decisions across illegal payment cases for similar situations for each group, each group was tested across two sets of legal versus illegal payment cases with similar situations. It was evident from these tests that all three groups require a higher level of disclosure, as indicated by mean responses, when the payment is illegal than when it is legal. The results of these tests are summarized in Table 6-2.

Implications of This Research

The fact that preparers, auditors, and users do not have similar views of materiality in varying illegal payment cases is reason for concern. Auditors are required under generally accepted accounting standards to see that "informative disclosures in the financial statements are . . . reasonably adequate."¹ Statement on Auditing Standards No. 1 states "The fairness of presentation of financial statements in conformity with generally accepted accounting principles comprehends the adequacy of disclosures involving material matters."² But what is adequate informative disclosure based on materiality judgments of auditors may not be adequate informative disclosure based on the materiality judgments of users.

Who is right? The answer to this question depends on an individual's point of view, and as such, cannot be provided by this research. Having established that the three groups have different views of materiality, further research could attempt to determine why their views differ. For example, are auditors considering audit costs, that users are ignoring? Are auditors cognizant of user concern for qualitative

information concerning investment risk and return? Perhaps each group should attempt to educate the other groups in an attempt to achieve a universal concept of materiality.

It is this researcher's opinion that such intergroup educational programs in an area as controversial as materiality cannot lead to consensus. Therefore authoritative guidance is needed. Whether this guidance is provided by the Financial Accounting Standards Board, the Securities and Exchange Commission, the U.S. Congress, or some other authoritative body is a political question to be answered by those concerned.

It is this researcher's opinion that because financial statement users are the beneficiaries of financial statements, they are the most important group in terms of providing information on which should be disclosed. In this study, Chartered Financial Analysts were used as a surrogate for the general user group. Reference to Tables B3, B7, B11, and B15 reveal that in every case and situation in which an illegal payment was made, the majority of user respondents selected Response 2-- "disclose the payment and surrounding circumstances regardless of payment size." Even in those cases in which disclosure might result in foreign expropriation or loss of right to do business in a foreign country or with a customer, the majority of the users chose disclosure. Examination of Figures 6-1 through 6-10 reveals the fact that users had the highest average disclosure demand on all but three questions. Because of the very high level of disclosure expected by users, it would seem reasonable for some authoritative body to establish very high disclosure standards for illegal payments and very low materiality guidelines for such payments. This body when establishing these

standards would presumably consider the legitimate concerns of each group about information costs and benefits.

This researcher believes that because of the audit costs it is impractical to expect the auditor or top corporate management to be aware of all illegal payments. However, in line with recent strides toward attempting to strengthen internal controls as required by the Foreign Corrupt Practices Act of 1977, it may be reasonable to establish relatively low materiality cut-off percentages. For example, any illegal payments exceeding three percent of net income should be disclosed. The authoritative body may then allow adjustment of materiality decisions for situations in which the costs of disclosure are expected to be significant. For example, in those cases in which disclosure might result in expropriation of foreign corporate assets or the loss of right to do business in a foreign country, adjustment of materiality criteria may be appropriate.

Suggestions for Further Research

The research instrument asked the sample groups for their opinion of what information about the various payments was material and significant to financial statement users. It is important to realize that each respondent may give an opinion of what is material and should be disclosed which may be different from what he would disclose if he were in the position of making the disclosure decision. Perhaps, as a possible future research endeavor, it would be useful and interesting to find out if respondent opinion is consistent with respondent actions.

Second, as mentioned previously in this chapter, additional research could attempt to determine why preparer, auditor, and user views are

different. It could also be used to determine whether auditors are independent of preparers. Since in many cases preparer and auditor views are similar, the independence of auditors is a question of real concern because users depend on auditors for assurance that the financial statements are fairly presented.

Third, in the research instrument there were eight situations surrounding the illegal payments which were considered by the respondents when making their disclosure decision. Based on analysis of the selection of Response 2 as enumerated in Table 5-2 and discussed in Chapter 5, it appears as if respondents have recognized the severity of the situation when making disclosure decisions. For example, in the case of illegal domestic political contributions, respondents are most likely to select Response 2 (i.e., disclose the payment regardless of amount) when an "off-the-books" slush fund is generated and used as the source of illegal payments, and respondents are least likely to select Response 2 if the illegal payment is made without top management's knowledge. Additional research on these responses could determine whether these situational differences are statistically significant. This potential research effort could be useful to standard setting and rule making bodies when adjusting standards and rules for varying circumstances.

Finally as discussed in Chapter 6, examination of Figures 6-1 through 6-8 seems to reveal a greater concern on the part of respondents for disclosure of illegal political contributions than for disclosure of bribery payments, and these figures also seem to imply that the respondent groups are least concerned about the disclosure of commercial bribery. Further, research analysis could be used to ascertain whether

these differences are statistically significant. This could lead to a ranking of the importance of disclosure by type of illegal payment which might also be useful to standard setting and rule making bodies when adjusting standards and rules for varying circumstances.

FOOTNOTES

¹American Institute of Certified Public Accountants, "Codification of Auditing Standards and Procedures," Statement on Auditing Standards 1 (New York, N.Y.: AICPA, 1973), p. 5.

²Ibid., p. 78.

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APPENDIX A--THE COVER LETTERS AND THE QUESTIONNAIRE

GRADUATE SCHOOL OF BUSINESS ADMINISTRATION
OFFICE OF THE DEAN • (517) 355-8377

EAST LANSING • MICHIGAN • 48824

You are invited to participate in a research project of current and vital interest to financial executives, certified public accountants, and financial statement users. The project is an attempt to determine the appropriate level of disclosure of sensitive information concerning illegal corporate payments and to ascertain whether corporate financial executives, CPA's, and chartered financial analysts have similar views as to what is material and significant to financial statement users.

This study is being conducted by Mr. Charles E. Hines, Jr., a doctoral candidate in our Graduate School of Business Administration, as part of his dissertation research. The results of this study will be significant to the accounting profession in general, and may be useful to the Financial Accounting Standards Board and other authoritative bodies in setting accounting standards.

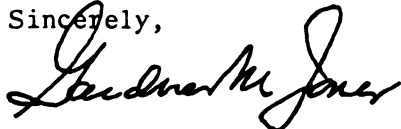
Using a statistical selection technique, you have been selected to represent the CPA partners in major accounting firms. Your views are important, and you have the opportunity to make these views known in an anonymous way by responding to the enclosed questionnaire.

In recognition of your right to privacy, no identification of you or your firm will be maintained, and your responses will be combined with other CPA's in the final analysis.

Please use the enclosed postage-paid envelope because it is cross-referenced to Mr. Hines' mailing list. This will allow him to remove your name from the mailing list for follow-up mailings. He will not begin tabulation of the results until all lists of names and addresses are destroyed. Please be assured that you will remain anonymous.

Your assistance and cooperation are sincerely appreciated.

Sincerely,



Gardner M. Jones, Ph.D., CPA
Associate Dean

GRADUATE SCHOOL OF BUSINESS ADMINISTRATION
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EAST LANSING • MICHIGAN • 48824

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This study is being conducted by Mr. Charles E. Hines, Jr., a doctoral candidate in our Graduate School of Business Administration, as part of his dissertation research. The results of this study will be significant to the accounting profession in general, and may be useful to the Financial Accounting Standards Board and other authoritative bodies in setting accounting standards.

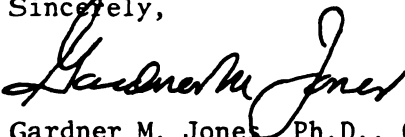
Using a statistical selection technique, you have been selected to represent the chief financial executives of major corporations. Your views are important, and you have the opportunity to make these views known in an anonymous way by responding to the enclosed questionnaire.

In recognition of your right to privacy, no identification of you or your company will be maintained, and your responses will be combined with other chief financial executives in the final analysis.

Please use the enclosed postage-paid envelope because it is cross-referenced to Mr. Hines' mailing list. This will allow him to remove your name from the mailing list for follow-up mailings. He will not begin tabulation of the results until all lists of names and addresses are destroyed. Please be assured that you will remain anonymous.

Your assistance and cooperation are sincerely appreciated.

Sincerely,



Gardner M. Jones, Ph.D., CPA
Associate Dean

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You are invited to participate in a research project of current and vital interest to financial executives, certified public accountants, and financial statement users. The project is an attempt to determine the appropriate level of disclosure of sensitive information concerning illegal corporate payments and to ascertain whether corporate financial executives, CPA's, and chartered financial analysts have similar views as to what is material and significant to financial statement users.

This study is being conducted by Mr. Charles E. Hines, Jr., a doctoral candidate in our Graduate School of Business Administration, as part of his dissertation research. The results of this study will be significant to the accounting profession in general, and may be useful to the Financial Accounting Standards Board and other authoritative bodies in setting accounting standards.

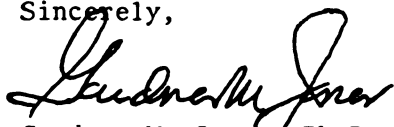
Using a statistical selection technique, you have been selected as a representative of chartered financial analysts. Your views are important and you have the opportunity to make these views known in an anonymous way by responding to the enclosed questionnaire.

In recognition of your right to privacy, we will not maintain an identification of you, and your responses will be combined with other financial analysts in the final analysis.

Please use the enclosed postage-paid envelope because it is cross-referenced to Mr. Hines' mailing list. This will allow him to remove your name from the mailing list for follow-up mailings. He will not begin tabulation of the results until all lists of names and addresses are destroyed. Please be assured that you will remain anonymous.

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Sincerely,



Gardner M. Jones, Ph.D., CPA
Associate Dean

GRADUATE SCHOOL OF BUSINESS ADMINISTRATION
OFFICE OF THE DEAN • (517) 355-8377

EAST LANSING • MICHIGAN • 48824

As a partner in a major public accounting firm, you know that your success in audit and tax work often requires the cooperation of client customers, vendors and various third parties. Without accounts receivable confirmations, vendor's statements, attorney's letters and bank confirmation letters, many of the audits performed by your firm would be difficult if not impossible. Success in academic research also requires this kind of cooperation.

About four weeks ago, you were sent a questionnaire which was designed to determine your opinion as to the appropriate level of disclosure of sensitive information concerning illegal corporate payments. This questionnaire is part of the dissertation research of Mr. Charles E. Hines, Jr., a doctoral candidate in our Graduate School of Business Administration. Your response is needed for his research to be statistically sound and successful. I ask you to please take the time needed to fill out Mr. Hines' questionnaire and help him successfully complete his project.

As I mentioned in my previous letter, no identification of you or your firm will be maintained, and your responses will be combined with other CPA's in the final analysis.

Please use the enclosed envelope because it is cross-referenced to Mr. Hines' mailing list. This will allow him to remove your name from the mailing list. He will not begin tabulation of the results until all lists of names and addresses are destroyed. Please be assured that you will remain anonymous.

Your cooperation is needed and will be greatly appreciated.

Sincerely,



Gardner M. Jones, Ph.D., CPA
Associate Dean

GMJ:kw

GRADUATE SCHOOL OF BUSINESS ADMINISTRATION
OFFICE OF THE DEAN • (517) 355-8377

EAST LANSING • MICHIGAN • 48824

As a financial executive, you have likely found that often success in your own undertakings is critically dependent on the help of other people, often from outside your own firm. In the academic world as in the business world, success is often dependent on cooperation. We need your cooperation.

About four weeks ago, you were sent a questionnaire which was designed to determine your opinion as to the appropriate level of disclosure of sensitive information involving illegal corporate payments. This questionnaire is part of the dissertation research of Mr. Charles E. Hines, Jr., a doctoral candidate in our Graduate School of Business Administration. Your response is needed for his research to be statistically sound and successful. Please take the time necessary to fill out Mr. Hines' questionnaire and help successfully complete his project.

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Associate Dean

GMJ:kw

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As a chartered financial analyst, you probably have found that success in your own undertakings is often critically dependent on the help of other people. In the academic world as in the world of business and finance, success is often dependent on cooperation. We need your cooperation.


About four weeks ago, you were sent a questionnaire which was designed to determine your opinion as to the appropriate level of disclosure of sensitive information involving illegal corporate payments. This questionnaire is part of the dissertation research of Mr. Charles E. Hines, Jr., a doctoral candidate in our Graduate School of Business Administration. Your response is needed for his research to be statistically sound and successful. Please take the time necessary to fill out Mr. Hines' questionnaire and help successfully complete his project.

As I mentioned in my previous letter, we will not maintain an identification of you, and your responses will be combined with other financial analysts in the final analysis.

Please use the enclosed envelope because it is cross-referenced to Mr. Hines' mailing list. This will allow him to remove your name from the mailing list. He will not begin the tabulation of the results until all lists of names and addresses are destroyed. Please be assured that you will remain anonymous.

Your cooperation is needed and will be greatly appreciated.

Sincerely,



Gardner M. Jones, Ph.D., CPA
Associate Dean

GMJ:kw

THE QUESTIONNAIRE

ILLEGAL DOMESTIC POLITICAL CONTRIBUTIONS

In the past, some American Corporations have made illegal contributions to U.S. politicians and U.S. political parties. These illegal payments came to light because of the post-Watergate climate, the efforts of the special Watergate prosecutor, and voluntary revelations by corporations. Listed below are several cases involving illegal domestic political contributions. In order to determine YOUR OPINION of what information about these payments is material and significant to financial statement users in varying circumstances, four levels of disclosure response are offered below. For each circumstance, please indicate the disclosure response that YOU consider to be appropriate. (PLEASE CHECK ONLY ONE RESPONSE IN EACH CASE.)

- Response 1: Do not disclose the payment or circumstances.
 Response 2: Disclose the payment and surrounding circumstances regardless of payment size.
 Response 3: Disclose the payment if it is greater than some specified percentage of net income. Please specify the percentage you consider appropriate.
 Response 4: Disclose the payment if it is greater than some absolute dollar amount. Please specify the dollar amount you consider appropriate.

	RESPONSES				Amount
	1	2	3	%	
1. An American company made illegal domestic political contributions to U. S. political parties.				%	\$
2. An American company used employee bonuses as a means of financing political contributions. The employees were given bonuses and directed to pay the after tax balance to various U.S. political figures. These payments were recorded on the company's books as employee bonuses.				%	\$
3. An American corporation made illegal political contributions to U.S. politicians. Top management was aware of and participated in the payment program.				%	\$
4. A member of the management team of a subsidiary of an American corporation made illegal political contributions to U.S. political parties against top management's orders and without its approval.				%	\$
5. An American company maintained a secret "off-the-books" fund from which illegal domestic political contributions were made. The funds were obtained from kickbacks from foreign legal consultants.				%	\$
6. For some firms, disclosure of illegal domestic political contributions may result in income tax assessments for improperly deducted political contributions.				%	\$

FOREIGN POLITICAL CONTRIBUTIONS

2

Some American Corporations have made political contributions to foreign politicians and foreign political parties. Some of these contributions have been legal and some have been illegal. Listed below are several cases involving foreign political contributions. In order to determine YOUR OPINION of what information about these payments is material and significant to financial statement users in varying circumstances, four levels of disclosure response are offered below. For each circumstance, please indicate the disclosure response that YOU consider to be appropriate. (PLEASE CHECK ONLY ONE RESPONSE FOR EACH CASE.)

- Response 1: Do not disclose the payment or circumstances.
 Response 2: Disclose the payment and surrounding circumstances regardless of payment size.
 Response 3: Disclose the payment if it is greater than some specified percentage of net income. Please specify the percentage you consider appropriate.
 Response 4: Disclose the payment if it is greater than some absolute dollar amount. Please specify the dollar amount you consider appropriate.

	RESPONSES				Amount
	1	2	3	4	
1. An American company made legal political contributions to foreign politicians.			<input checked="" type="checkbox"/>		\$
2. An American corporation made illegal political contributions to foreign politicians.			<input checked="" type="checkbox"/>		\$
3. An American company made legal political contributions to foreign politicians. These payments were accounted for improperly as payments to sales organizations.			<input checked="" type="checkbox"/>		\$
4. An American corporation made illegal foreign political contributions and covered up the contributions with false accounting entries in the corporate books and records.			<input checked="" type="checkbox"/>		\$
5. Top management of an American corporation approved of and participated in the payment of illegal political contributions to foreign politicians and foreign political parties.			<input checked="" type="checkbox"/>		\$
6. Mid-level officials of another American Corp. made illegal foreign political contributions without top management knowledge and in violation of company policy.			<input checked="" type="checkbox"/>		\$
7. An American firm made illegal foreign political payments from an "off-the-books" fund. The "off-the-books" fund was generated from rebates on consulting fees paid to foreign consultants.			<input checked="" type="checkbox"/>		\$
8. The disclosure of an American company's corporate contributions may result in expropriation of assets in the country in which the illegal contributions occurred.			<input checked="" type="checkbox"/>		\$
9. For some firms, disclosure in corporate financial statements of illegal political contributions may result in the loss of right to do business in the country in which the illegal contribution occurred.			<input checked="" type="checkbox"/>		\$
10. For some firms, disclosure of illegal foreign political contributions may result in income tax assessments for improperly deducted political contributions.			<input checked="" type="checkbox"/>		\$

BRIBING FOREIGN GOVERNMENT OFFICIALS

3

A Securities and Exchange Commission report to the Senate Banking, Housing and Urban Affairs Committee on questionable and illegal corporate payments stated: "Typically, a corporation would not, in the ordinary course of business, make payments to government officials in their individual capacities. Such payments, therefore, are usually a form of bribery...." The Commission observed that some "payments have been made in an effort to procure special and unjustified favors or advantages in the enactment or administration of the tax or other laws of the country in question" and some "payments may be made with the intent to assist the company in obtaining or retaining government contracts."

Listed below are several cases involving bribery of foreign government officials. In order to determine YOUR OPINION of what information about these payments is material and significant to financial statement users in varying circumstances, four levels of disclosure response are offered below. For each circumstance please indicate the disclosure response that YOU consider to be appropriate. (PLEASE CHECK ONLY ONE RESPONSE FOR EACH CASE.).

- Response 1: Do not disclose the payment or circumstances.
 Response 2: Disclose the payment and surrounding circumstances regardless of payment size.
 Response 3: Disclose the payment if it is greater than some specified percentage of net income. Please specify the percentage you consider appropriate.
 Response 4: Disclose the payment if it is greater than some absolute dollar amount. Please specify the dollar amount you consider appropriate.

	RESPONSES				Amount
	1	2	3 %	4	
1. An American company made illegal payments to foreign government officials.			<input type="checkbox"/>		\$
2. An American corporation made payments to some foreign government officials. False invoices were used to generate the cash for these payments.			<input type="checkbox"/>		\$
3. The chief executive officer of an American company personally delivered funds to a foreign government official in order to obtain special corporate favors.			<input type="checkbox"/>		\$
4. An American company made payments to foreign government officials in order to obtain special favors. These payments were made without the knowledge or approval of top corporate management.			<input type="checkbox"/>		\$
5. An American corporation made payments to foreign government officials from an "off-the-books" fund. The purpose of the payments was to aid the corporation in obtaining foreign government contracts.			<input type="checkbox"/>		\$
6. An American company made payments to a foreign customs official to avoid liabilities and penalties from alleged evasion of customs payments. The company fears that disclosure in the corporate financial statements may result in expropriation of its foreign property.			<input type="checkbox"/>		\$
7. For some firms, disclosure in the corporate financial statements of bribes paid to foreign government officials may result in the loss of right to do business in the country in which the bribe occurred.			<input type="checkbox"/>		\$
8. For some firms, disclosure of bribes paid to foreign government officials may result in income tax assessments for improperly deducted bribes.			<input type="checkbox"/>		\$

COMMERCIAL BRIBERY

4

A Securities and Exchange Commission report to the Senate, Banking, Housing and Urban Affairs Committee on questionable and illegal corporate payments included the following statement about commercial bribery: "The Commission also has observed payments made to improperly influence a nongovernmental customer's use of a company's product or services."

Listed below are several cases involving commercial bribery. In order to determine YOUR OPINION of what information about these payments is material and significant to financial statement users in varying circumstances, four levels of disclosure are offered below. For each circumstance, please indicate the disclosure response that YOU consider to be appropriate. (PLEASE CHECK ONLY ONE RESPONSE FOR EACH CASE.)

- Response 1: Do not disclose the payment or the circumstances.
 Response 2: Disclose the payment and surrounding circumstances regardless of payment size.
 Response 3: Disclose the payment if it is greater than some specified percentage of net income. Please specify the percentage which you consider appropriate.
 Response 4: Disclose the payment if it is greater than some absolute dollar amount. Please specify the dollar amount you consider appropriate.

	RESPONSES				
	1	2	3	4	Amount
1. One American company made bribery payments to officers of foreign companies.			<input checked="" type="checkbox"/>		\$
2. An American company bribed the purchasing agent of a corporate customer and covered up the payments with false expense vouchers.			<input checked="" type="checkbox"/>		\$
3. An American company paid bribes to corporate purchasing agents in order to induce the agent to buy the company's products. The company's top officers actively encouraged these activities.			<input checked="" type="checkbox"/>		\$
4. An official of an American company paid bribes to obtain sales contracts. Top corporate management was not aware of these payments.			<input checked="" type="checkbox"/>		\$
5. An American company financed commercial bribes from an "off-the-books" fund obtained from rebates on excessive sales commissions.			<input checked="" type="checkbox"/>		\$
6. For some companies, disclosure of commercial bribes may result in a significant loss of business with the company whose officials were bribed.			<input checked="" type="checkbox"/>		\$
7. For some firms, disclosure of commercial bribes may result in income tax assessments for improperly deducted bribery payments.			<input checked="" type="checkbox"/>		\$

This image shows a single sheet of white paper with horizontal ruling lines. The lines are evenly spaced and run across the width of the page. There are no margins, text, or other markings on the paper.

Charles E. Hines, Jr.
Michigan State University

APPENDIX B--TABLES SUMMARIZING THE QUESTIONNAIRE RESPONSES

TABLE B1
AUDITOR RESPONSE PERCENTAGES FOR THE QUESTIONNAIRE SEGMENT
ON ILLEGAL DOMESTIC POLITICAL CONTRIBUTIONS

	Responses				Total
	1	2	3	4	
1. An American company made illegal domestic political contributions to U.S. political parties.	2.7%	40.5%	28.4%	28.4%	100.0%
2. An American company used employee bonuses as a means of financing political contributions. The employees were given bonuses and directed to pay the after tax balance to various U.S. political figures. These payments were recorded on the company's books as employee bonuses.	9.1	55.8	18.2	16.9	100.0
3. An American corporation made illegal political contributions to U.S. politicians. Top management was aware of and participated in the payment program.	3.9	51.3	18.4	26.3	99.9*
4. A member of the management team of a subsidiary of an American corporation made illegal political contributions to U.S. political parties against top management's orders and without its approval.	19.7	27.6	28.9	23.7	99.9*
5. An American company maintained a secret "off-the-books" fund from which illegal domestic political contributions were made. The funds were obtained from kickbacks from foreign legal consultants.	2.6	68.8	15.6	13.0	100.0
6. For some firms, disclosure of illegal domestic political contributions may result in income tax assessments for improperly deducted political contributions.	7.0	43.7	31.0	18.3	100.0

*0.1% rounding error

TABLE B2

PREPARER RESPONSE PERCENTAGES FOR THE QUESTIONNAIRE SEGMENT
ON ILLEGAL DOMESTIC POLITICAL CONTRIBUTIONS

	Responses				Total
	1	2	3	4	
1. An American company made illegal domestic political contributions to U.S. political parties.	3.2%	51.6%	16.1%	29.0%	99.9%*
2. An American company used employee bonuses as a means of financing political contributions. The employees were given bonuses and directed to pay the after tax balance to various U.S. political figures. These payments were recorded on the company's books as employee bonuses.	5.3	67.0	11.7	16.0	100.0
3. An American corporation made illegal political contributions to U.S. politicians. Top management was aware of and participated in the payment program.	4.3	66.7	10.8	18.3	100.1*
4. A member of the management team of a subsidiary of an American corporation made illegal political contributions to U.S. political parties against top management's orders and without its approval.	12.8	36.2	24.5	26.6	100.1
5. An American company maintained a secret "off-the-books" fund from which illegal domestic political contributions were made. The funds were obtained from kickbacks from foreign legal consultants.	3.2	76.6	8.5	11.7	100.0
6. For some firms, disclosure of illegal domestic political contributions may result in income tax assessments for improperly deducted political contributions.	6.6	57.1	13.2	23.1	100.0

*0.1% rounding error

TABLE B3

USER RESPONSE PERCENTAGES FOR THE QUESTIONNAIRE SEGMENT
ON ILLEGAL DOMESTIC POLITICAL CONTRIBUTIONS

	Responses				Total
	1	2	3	4	
1. An American company made illegal domestic political contributions to U.S. political parties.	4.6%	74.7%	11.5%	9.2%	100.0%
2. An American company used employee bonuses as a means of financing political contributions. The employees were given bonuses and directed to pay the after tax balance to various U.S. political figures. These payments were recorded on the company's books as employee bonuses.	6.8	77.3	8.0	8.0	100.1*
3. An American corporation made illegal political contributions to U.S. politicians. Top management was aware of and participated in the payment program.	4.5	83.0	5.7	6.8	100.0
4. A member of the management team of a subsidiary of an American corporation made illegal political contributions to U.S. political parties against top management's orders and without its approval.	16.3	64.0	10.5	9.3	100.1*
5. An American company maintained a secret "off-the-books" fund from which illegal domestic political contributions were made. The funds were obtained from kickbacks from foreign legal consultants.	2.3	82.8	6.9	8.0	100.0
6. For some firms, disclosure of illegal domestic political contributions may result in income tax assessments for improperly deducted political contributions.	10.5	74.4	10.5	4.7	100.1*

*0.1% rounding error

TABLE B4

TOTAL RESPONSE PERCENTAGES FOR THE QUESTIONNAIRE SEGMENT
ON ILLEGAL DOMESTIC POLITICAL CONTRIBUTIONS

	Responses				Total
	1	2	3	4	
1. An American company made illegal domestic political contributions to U.S. political parties.	3.5%	56.3%	18.1%	22.0%	99.9%*
2. An American company used employee bonuses as a means of financing political contributions. The employees were given bonuses and directed to pay the after tax balance to various U.S. political figures. These payments were recorded on the company's books as employee bonuses.	6.9	67.2	12.4	13.5	100.0
3. An American corporation made illegal political contributions to U.S. politicians. Top management was aware of and participated in the payment program.	4.3	67.7	11.3	16.7	100.0
4. A member of the management team of a subsidiary of an American corporation made illegal political contributions to U.S. political parties against top management's orders and without its approval.	16.0	43.0	21.1	19.9	100.0
5. An American company maintained a secret "off-the-books" fund from which illegal domestic political contributions were made. The funds were obtained from kickbacks from foreign legal consultants.	2.7	76.4	10.1	10.9	100.1*
6. For some firms, disclosure of illegal domestic political contributions may result in income tax assessments for improperly deducted political contributions.	8.1	59.3	17.3	15.3	100.0

*0.1% rounding error

TABLE B5

AUDITOR RESPONSE PERCENTAGES FOR THE QUESTIONNAIRE SEGMENT
ON FOREIGN POLITICAL CONTRIBUTIONS

	Responses				Total
	1	2	3	4	
1. An American company made legal political contributions to foreign politicians.	72.4%	5.3%	10.5%	11.8%	100.0%
2. An American corporation made illegal political contributions to foreign politicians.	4.1	37.0	30.1	28.8	100.0
3. An American company made legal political contributions to foreign politicians. These payments were accounted for improperly as payments to sales organizations.	36.8	25.0	25.0	13.2	100.0
4. An American corporation made illegal foreign political contributions and covered up the contributions with false accounting entries in the corporate books and records.	1.3	71.1	15.8	11.8	100.0
5. Top management of an American corporation approved of and participated in the payment of illegal political contributions to foreign politicians and foreign political parties.	4.0	57.3	22.7	16.0	100.0
6. Mid-level officials of another American Corporation made illegal foreign political contributions without top management knowledge and in violation of company policy.	18.3	28.2	31.0	22.5	100.0
7. An American firm made illegal foreign political payments from an "off-the-books" fund. The "off-the-books" fund was generated from rebates on consulting fees paid to foreign consultants.	2.6	71.1	18.4	7.9	100.0
8. The disclosure of an American company's corporate contributions may result in expropriation of assets in the country in which the illegal contributions occurred.	13.4	46.3	28.4	11.9	100.0
9. For some firms, disclosure in corporate financial statements of illegal political contributions may result in the loss of right to do business in the country in which the illegal contribution occurred.	11.9	44.8	28.4	14.9	100.0
10. For some firms, disclosure of illegal foreign political contributions may result in income tax assessments for improperly deducted political contributions.	5.7	44.3	31.4	18.6	100.0

TABLE B6

PREPARER RESPONSE PERCENTAGES FOR THE QUESTIONNAIRE SEGMENT
ON FOREIGN POLITICAL CONTRIBUTIONS

	Responses				Total
	1	2	3	4	
1. An American company made legal political contributions to foreign politicians.	71.9%	8.3%	7.3%	12.5%	100.0%
2. An American corporation made illegal political contributions to foreign politicians.	8.6	53.8	15.1	22.6	100.1*
3. An American corporation made legal political contributions to foreign politicians. These payments were accounted for improperly as payments to sales organizations.	36.2	33.0	18.1	12.8	100.1*
4. An American corporation made illegal foreign political contributions and covered up the contributions with false accounting entries in the corporate books and records.	7.5	68.8	14.0	9.7	100.0
5. Top management of an American corporation approved of and participated in the payment of illegal political contributions to foreign politicians and foreign political parties.	7.5	71.0	12.9	8.6	100.0
6. Mid-level officials of another American corporation made illegal foreign political contributions without top management knowledge and in violation of company policy.	16.0	36.2	25.5	22.3	100.0
7. An American firm made illegal foreign political payments from an "off-the-books" fund. The "off-the-books" fund was generated from rebates on consulting fees paid to foreign consultants.	4.3	68.8	14.0	12.9	100.0
8. The disclosure of an American company's corporate contributions may result in expropriation of assets in the country in which the illegal contribution occurred.	22.5	47.2	18.0	12.4	100.1*
9. For some firms, disclosure in corporate financial statements of illegal political contributions may result in the loss of right to do business in the country in which the illegal contribution occurred.	18.0	51.7	19.1	11.2	100.0
10. For some firms, disclosure of illegal foreign political contributions may result in income tax assessments for improperly deducted political contributions.	10.9	55.4	18.5	15.2	100.0

*0.1% rounding error

TABLE B7

USER RESPONSE PERCENTAGES FOR THE QUESTIONNAIRE SEGMENT
ON FOREIGN POLITICAL CONTRIBUTIONS

	Responses				Total
	1	2	3	4	
1. An American company made legal political contributions to foreign politicians.	56.8%	21.6%	13.6%	8.0%	100.0%
2. An American corporation made illegal political contributions to foreign politicians.	7.9	67.4	15.7	9.0	100.0
3. An American company made legal political contributions to foreign politicians. These payments were accounted for improperly as payments to sales organizations.	29.5	54.5	10.2	5.7	99.9*
4. An American corporation made illegal foreign political contributions and covered up the contributions with false accounting entries in the corporate books and records.	5.6	76.4	12.4	5.6	100.0
5. Top management of an American corporation approved of and participated in the payment of illegal political contributions to foreign politicians and foreign political parties.	9.1	77.3	6.8	6.8	100.0
6. Mid-level officials of another American corporation made illegal foreign political contributions without top management knowledge and in violation of company policy.	21.8	57.5	12.6	8.0	99.9*
7. An American firm made illegal foreign political payments from an "off-the-books" fund. The "off-the-books" fund was generated from rebates on consulting fees paid to foreign consultants.	9.2	78.2	10.3	2.3	100.0
8. The disclosure of an American company's corporate contributions may result in expropriation of assets in the country in which the illegal contributions occurred.	27.4	56.0	9.5	7.1	100.0
9. From some firms, disclosure in corporate financial statements of illegal political contributions may result in the loss of right to do business in the country in which the illegal contribution occurred.	29.8	52.4	11.9	6.0	100.1*
10. For some firms, disclosure of illegal foreign political contributions may result in income tax assessments for improperly deducted political contributions.	15.5	66.7	10.7	7.1	100.0

*0.1% rounding error

TABLE B8

TOTAL RESPONSE PERCENTAGES FOR THE QUESTIONNAIRE SEGMENT
ON FOREIGN POLITICAL CONTRIBUTIONS

	Responses				Total
	1	2	3	4	
1. An American company made legal political contributions to foreign politicians.	66.9%	11.9%	10.4%	10.8%	100.0%
2. An American corporation made illegal political contributions to foreign politicians.	7.1	53.7	19.6	19.6	100.0
3. An American company made legal political contributions to foreign politicians. These payments were accounted for improperly as payments to sales organizations.	34.1	38.0	17.4	10.5	100.0
4. An American corporation made illegal foreign political contributions and covered up the contributions with false accounting entries in the corporate books and records.	5.0	72.1	14.0	8.9	100.0
5. Top management of an American corporation approved of and participated in the payment of illegal political contributions to foreign politicians and foreign political parties.	7.0	69.1	13.7	10.2	100.0
6. Mid-level officials of another American corporation made illegal foreign political contributions without top management knowledge and in violation of company policy.	18.7	41.3	22.6	17.5	100.1*
7. An American firm made illegal foreign political payments from an "off-the-books" fund. The "off-the-books" fund was generated from rebates on consulting fees paid to foreign consultants.	5.5	72.7	14.1	7.8	100.1*
8. The disclosure of an American company's corporate contributions may result in expropriation of assets in the country in which the illegal contributions occurred.	21.7	50.0	17.9	10.4	100.0
9. For some firms, disclosure in corporate financial statements of illegal political contributions may result in the loss of right to do business in the country in which the illegal contributions occurred.	20.4	50.0	19.2	10.4	100.0
10. For some firms, disclosure of illegal foreign political contributions may result in income tax assessments for improperly deducted political contributions.	11.1	56.1	19.5	13.4	100.1*

*0.1% rounding error

TABLE B9
AUDITOR RESPONSE PERCENTAGES FOR THE QUESTIONNAIRE SEGMENT
ON BRIBING FOREIGN GOVERNMENT OFFICIALS

	Responses				Total
	1	2	3	4	
1. An American company made illegal payments to foreign government officials.	2.7%	38.4%	28.8%	30.1%	100.0%
2. An American corporation made payments to some foreign government officials. False invoices were used to generate the cash for these payments.	4.0	61.3	22.7	12.0	100.0
3. The chief executive officer of an American company personally delivered funds to a foreign government official in order to obtain special corporate favors.	9.7	48.6	20.8	20.8	99.9*
4. An American company made payments to foreign government officials in order to obtain special favors. These payments were made without the knowledge or approval of top corporate management.	24.6	20.3	29.0	26.1	100.0
5. An American corporation made payments to foreign government officials from an "off-the-books" fund. The purpose of the payments was to aid the corporation in obtaining foreign government contracts.	8.0	60.0	20.0	12.0	100.0
6. An American company made payments to a foreign customs official to avoid liabilities and penalties from alleged evasion of customs payments. The company fears that disclosure in the corporate financial statements may result in expropriation of its foreign property.	21.1	39.4	22.5	16.9	99.9*
7. For some firms, disclosure in the corporate financial statements of bribes paid to foreign government officials may result in the loss of right to do business in the country in which the bribe occurred.	13.4	43.3	26.9	16.4	100.0
8. For some firms, disclosure of bribes paid to foreign government officials may result in income tax assessments for improperly deducted bribes.	8.7	40.6	31.9	18.8	100.0

*0.1% rounding error

TABLE B10

PREPARER RESPONSE PERCENTAGES FOR THE QUESTIONNAIRE SEGMENT
ON BRIBING FOREIGN GOVERNMENT OFFICIALS

	Responses				Total
	1	2	3	4	
1. An American company made illegal payments to foreign government officials.	7.7%	49.5%	16.5%	26.4%	100.1%*
2. An American corporation made payments to some foreign government officials. False invoices were used to generate the cash for these payments.	13.2	59.3	11.0	16.5	100.0
3. The chief executive officer of an American company personally delivered funds to a foreign government official in order to obtain special corporate favors.	12.4	59.6	13.5	14.6	100.1*
4. An American company made payments to foreign government officials in order to obtain special favors. These payments were made without the knowledge or approval of top corporate management.	22.0	33.0	22.0	23.1	100.1*
5. An American corporation made payments to foreign government officials from an "off-the-books" fund. The purpose of the payments was to aid the corporation in obtaining foreign government contracts.	8.9	56.7	15.6	18.9	100.1*
6. An American company made payments to a foreign customs official to avoid liabilities and penalties from alleged evasion of customs payments. The company fears that disclosure in the corporate financial statements may result in expropriation of its foreign property.	24.7	44.9	11.2	19.1	99.9*
7. For some firms, disclosure in the corporate financial statements of bribes paid to foreign government officials may result in the loss of right to do business in the country in which the bribe occurred.	16.1	50.6	18.4	14.9	100.0
8. For some firms, disclosure of bribes paid to foreign government officials may result in income tax assessments for improperly deducted bribes.	8.9	55.6	20.0	15.6	100.1*

*0.1% rounding error

TABLE B11
 USER RESPONSE PERCENTAGES FOR THE QUESTIONNAIRE SEGMENT
 ON BRIBING FOREIGN GOVERNMENT OFFICIALS

	Responses				Total
	1	2	3	4	
1. An American company made illegal payments to foreign government officials.	12.4%	68.5%	11.2%	7.9%	100.0%
2. An American corporation made payments to some foreign government officials. False invoices were used to generate the cash for these payments.	11.2	73.0	10.1	5.6	99.9*
3. The chief executive officer of an American company personally delivered funds to a foreign government official in order to obtain special corporate favors.	18.0	67.4	9.0	5.6	100.0
4. An American company made payments to foreign government officials in order to obtain special favors. These payments were made without the knowledge or approval of top corporate management.	18.0	59.6	12.4	10.1	100.1*
5. An American corporation made payments to foreign government officials from an "off-the-books" fund. The purpose of the payments was to aid the corporation in obtaining foreign government contracts.	15.7	65.2	13.5	5.6	100.0
6. An American company made payments to a foreign customs official to avoid liabilities and penalties from alleged evasion of customs payments. The company fears that disclosure in the corporate financial statements may result in expropriation of its foreign property.	25.6	58.1	10.5	5.8	100.0
7. For some firms, disclosure in the corporate financial statements of bribes paid to foreign government officials may result in the loss of right to do business in the country in which the bribe occurred.	29.4	52.9	11.8	5.9	100.0
8. For some firms, disclosure of bribes paid to foreign government officials may result in income tax assessments for improperly deducted bribes.	18.6	62.8	11.6	7.0	100.0

*0.1% rounding error

TABLE B12

TOTAL RESPONSE PERCENTAGES FOR THE QUESTIONNAIRE SEGMENT
ON BRIBING FOREIGN GOVERNMENT OFFICIALS

	Responses				Total
	1	2	3	4	
1. An American company made illegal payments to foreign government officials.	7.9%	53.0%	18.2%	20.9%	100.0%
2. An American corporation made payments to some foreign government officials. False invoices were used to generate the cash for these payments.	9.8	64.7	14.1	11.4	100.0
3. The chief executive officer of an American company personally delivered funds to a foreign government official in order to obtain special corporate favors.	13.6	59.2	14.0	13.2	100.0
4. An American company made payments to foreign government officials in order to obtain special favors. These payments were made without the knowledge or approval of top corporate management.	21.3	39.0	20.5	19.3	100.1*
5. An American corporation made payments to foreign government officials from an "off-the-books" fund. The purpose of the payments was to aid the corporation in obtaining foreign government contracts.	11.0	60.6	16.1	12.2	99.9*
6. An American company made payments to a foreign customs official to avoid liabilities and penalties from alleged evasion of customs payments. The company fears that disclosure in the corporate financial statements may result in expropriation of its foreign property.	24.0	48.0	14.2	13.8	100.0
7. For some firms, disclosure in the corporate financial statements of bribes paid to foreign government officials may result in the loss of right to do business in the country in which the bribe occurred.	20.1	49.4	18.4	12.1	100.0
8. For some firms, disclosure of bribes paid to foreign government officials may result in income tax assessments for improperly deducted bribes.	12.2	53.9	20.4	13.5	100.0

*0.1% rounding error

TABLE B13

AUDITOR RESPONSE PERCENTAGES FOR THE QUESTIONNAIRE SEGMENT
ON COMMERCIAL BRIBERY

	Responses				Total
	1	2	3	4	
1. One American company made bribery payments to officers of foreign companies.	12.3%	30.1%	34.2%	23.3%	99.9%*
2. An American company bribed the purchasing agent of a corporate customer and covered up the payments with false expense vouchers.	3.9	53.9	26.3	15.8	99.9*
3. An American company paid bribes to corporate purchasing agents in order to induce the agent to buy the company's products. The company's top officers actively encouraged these activities.	8.0	44.0	25.3	22.7	100.0
4. An official of an American company paid bribes to obtain sales contracts. Top corporate management was not aware of these payments.	25.0	19.4	38.9	16.7	100.0
5. An American company financed commercial bribes from an "off-the-books" fund obtained from rebates on excessive sales commissions.	6.6	60.5	23.7	9.2	100.0
6. For some companies, disclosure of commercial bribes may result in a significant loss of business with the company whose officials were bribed.	13.2	41.2	30.9	14.7	100.0
7. For some firms, disclosure of commercial bribes may result in income tax assessments for improperly deducted bribery payments.	10.0	40.0	32.9	17.1	100.0

*0.1% rounding error

TABLE B14

PREPARER RESPONSE PERCENTAGES FOR THE QUESTIONNAIRE SEGMENT
ON COMMERCIAL BRIBERY

	Responses				Total
	1	2	3	4	
1. One American company made bribery payments to officers of foreign companies.	19.6%	45.7%	17.4%	17.4%	100.1%*
2. An American company bribed the purchasing agent of a corporate customer and covered up the payments with false expense vouchers.	12.9	53.8	17.2	16.1	100.0
3. An American company paid bribes to corporate purchasing agents in order to induce the agent to buy the company's products. The company's top officers actively encouraged these activities.	15.1	59.1	14.0	11.8	100.0
4. An official of an American company paid bribes to obtain sales contracts. Top corporate management was not aware of these payments.	25.8	30.1	24.7	19.4	100.0
5. An American company financed commercial bribes from an "off-the-books" fund obtained from rebates on excessive sales commissions.	8.7	60.9	15.2	15.2	100.0
6. For some companies, disclosure of commercial bribes may result in a significant loss of business with the company whose officials were bribed.	18.7	51.6	18.7	11.0	100.0
7. For some firms, disclosure of commercial bribes may result in income tax assessments for improperly deducted bribery payments.	14.3	53.8	19.8	12.1	100.0

*0.1% rounding error

TABLE B15

USER RESPONSE PERCENTAGES FOR THE QUESTIONNAIRE SEGMENT
ON COMMERCIAL BRIBERY

	Responses				Total
	1	2	3	4	
1. One American company made bribery payments to officers of foreign companies.	12.8%	62.8%	17.4%	7.0%	100.0%
2. An American company bribed the purchasing agent of a corporate customer and covered up the payments with false expense vouchers.	7.0	72.1	15.1	5.8	100.0
3. An American company paid bribes to corporate purchasing agents in order to induce the agent to buy the company's products. The company's top officers actively encouraged these activities.	11.6	72.1	11.6	4.7	100.0
4. An official of an American company paid bribes to obtain sales contracts. Top corporate management was not aware of these payments.	14.0	60.5	16.3	9.3	100.1*
5. An American company financed commercial bribes from an "off-the-books" fund obtained from rebates on excessive sales commissions.	9.3	73.3	12.8	4.7	100.1*
6. For some companies, disclosure of commercial bribes may result in a significant loss of business with the company whose officials were bribed.	16.5	64.7	14.1	4.7	100.0
7. For some firms, disclosure of commercial bribes may result in income tax assessments for improperly deducted bribery payments.	13.1	67.9	13.1	6.0	100.1*

*0.1% rounding error

TABLE B16

TOTAL RESPONSE PERCENTAGES FOR THE QUESTIONNAIRE SEGMENT
ON COMMERCIAL BRIBERY

	Responses				Total
	1	2	3	4	
1. One American company made bribery payments to officers of foreign companies.	15.1%	47.0%	22.3%	15.5%	99.9%*
2. An American company bribed the purchasing agent of a corporate customer and covered up the payments with false expense vouchers.	8.2	60.0	19.2	12.5	99.9*
3. An American company paid bribes to corporate purchasing agents in order to induce the agent to buy the company's products. The company's top officers actively encouraged these activities.	11.8	59.1	16.5	12.6	100.0
4. An official of an American company paid bribes to obtain sales contracts. Top corporate management was not aware of these payments.	21.5	37.5	25.9	15.1	100.0
5. An American company financed commercial bribes from an "off-the-books" fund obtained from rebates on excessive sales commissions.	8.3	65.0	16.9	9.8	100.0
6. For some companies, disclosure of commercial bribes may result in a significant loss of business with the company whose officials were bribed.	16.4	53.3	20.5	9.8	100.0
7. For some firms, disclosure of commercial bribes may result in income tax assessments for improperly deducted bribery payments.	12.7	54.7	21.2	11.4	100.0

*0.1% rounding error

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