A Methodological Proposal for Studying Investors' Materiality Perceptions: Evidence from Share Purchase Agreements

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Abstract:

Audit materiality is often initially assessed using 'rules of thumb' derived from historical professional experience and industry standards. Given its role in ensuring that auditors provide meaningful service to stakeholders, understanding the perceptions of financial statement users regarding materiality is critical. Building on Vance's (2022) meta-analysis of five decades of empirical research, this study proposes an innovative research design that proxies investors´ materiality thresholds through indemnity basket clauses in Share Purchase Agreements (SPAs). Using a manually compiled dataset of 62 M&A transactions involving Czech target companies completed between 2014 and 2024, hypothetical basket bands ranging from 0.5 % to 1.5 % of deal value—constructed from ranges reported in prior practical legal studies—were recalculated as percentages of Earnings After Tax (EAT) and compared to benchmark materiality levels reported by auditors and investors. A 0.5 % basket corresponds to mean thresholds of 9.2 % of EAT, significantly higher than the 7.85 % mean materiality identified for auditors in Vance's (2022) meta-analysis—suggesting that auditors´ lower materiality thresholds may correspond to greater precision and a finer level of analytical detail than those applied by investors. Two-sample t-tests confirm partial alignment between investor-based benchmarks and empirical results at the 0.5 % basket level, indicating that the proposed research design provides a feasible basis for future empirical studies if detailed data from individual SPAs was made available, while also bridging law, accounting, and finance research by demonstrating how contractual thresholds can serve as observable indicators of investor materiality judgements.

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1 Introduction

Audit materiality is more than just a technical benchmark—it is the defining threshold that shapes the audit process and reflects auditors' professional judgment on what is significant in financial reporting. It determines the level of detail at which financial statements are scrutinized and influences decisions regarding misstatements, disclosures, and audit effort. Yet, despite its foundational role, materiality remains a subject of debate and variation, particularly when viewed from the perspectives of different financial statement users. What auditors may classify as immaterial may, for an investor negotiating an acquisition, mean the difference between a profitable investment and a costly miscalculation[1].

The concept of materiality has long been scrutinized, particularly in the wake of major audit failures. Materiality thresholds have played a key role in several high-profile scandals, including those involving Enron, US Surgical Corporation (USSC), and The North Face (Knapp, 2009). Beyond audit failures, researchers question whether financial statement users truly understand materiality or whether there is a disconnect between audit practices and stakeholder expectations (Christensen et al., 2020). Despite its importance, empirical evidence on investors´ materiality judgments remain limited, especially regarding the quantitative and qualitative factors that shape those judgments and how they compare with the thresholds applied by auditors in practise (DeZoort et al., 2023)[2].

Despite these criticisms, materiality remains indispensable. Auditing every transaction down to the last cent would be prohibitively expensive. Attempting to audit every transaction with absolute precision would not only be impractical but would also drive audit costs to unsustainable levels, outweighing any potential

[1] See the discussion paper by Bernstain (2021).

[2] The potential misalignment between investor expectations and audit materiality judgments is often referred to as the 'Audit Expectation Gap.' See, for example, Guruge & Jayamaha (2022).

benefits. Even if such exhaustive auditing were possible, absolute assurance is neither expected nor required in modern financial reporting.

Furthermore, whether investors fully grasp the technical definition of materiality is uncertain, yet evidence suggests they apply the concept intuitively. Baskin (1972) proposed that investors develop "materiality functions" as trade-offs between the effort required to acquire information and the value of that information in decision-making. Similarly, DeZoort et al. (2023) found that sophisticated investors' materiality judgments align more closely with auditors, while unsophisticated investors perceive materiality differently, highlighting a gap in understanding. This suggests that financial statement users rely on materiality judgments, even if they may not explicitly recognize or define them in line with professional audit standards.

The most comprehensive summary of existing empirical studies on materiality perceptions is Vance's (2022) meta-analysis, which synthesizes findings from 48 empirical studies across multiple stakeholder groups and research designs. Despite its breadth, the analysis highlights several gaps in the literature. Notably, 32 of the 48 studies (67 %) focus primarily on auditors, accounting for 24,530 (79 %) of all observations. Moreover, most research designs emphasize accounting-related issues and decisions rather than examining the economic decisions financial statement users make based on the information. Consequently, our understanding of how users define materiality based on their specific needs and circumstances remains limited. To address this gap, we propose a novel research design that, if the detailed contractual data were made available, could provide new evidence on investors´ materiality perceptions.

If auditors are to provide meaningful and useful assurance to all financial statement users, materiality thresholds—often initially set using "rules of thumb"—must be continuously tested and empirically validated. Unlike audit materiality, which relies on accounting discretion, indemnity baskets establish legally binding thresholds that reflect investors' explicit risk tolerance in financial transactions. This study builds on that distinction by examining whether such contractual thresholds can serve as empirical proxies for what investors consider as ´material´[3].

2 Regulatory Background

2.1 Audit Materiality

According to the International Auditing and Assurance Standards Board (IAASB), information is *material* when its *omission* or *misstatement* could influence the *economic decisions* of users taken on the basis of the financial statements. Materiality depends on the size of the item or error judged in the particular circumstances of its omission or misstatement. Thus, materiality provides a threshold or cut-off point rather than being a primary qualitative characteristic which information must have if it is to be useful (ISA320.2).

In essence, the IAASB emphasizes that materiality is a context-dependant and relative concept. Materiality is not a characteristic of the information itself but rather a threshold that determines the significance of that information in financial reporting. This means that auditors must use their *professional judgment* to determine whether a misstatement or omission in the financial statements is material and, if so, whether it needs to be corrected or disclosed in the audit report.

Similarly, the Financial Accounting Standards Board (FASB) describes materiality in Statement of Financial Accounting Concepts (SFAC) No. 2 as a concept where an immaterial misstatement is one that does not affect the *decisions of a typical or average user* (AICPA, 1984). For instance, an immaterial misstatement in financial statements would not influence an investor´s decision to purchase the respective stock or a creditor´s decision to provide a loan to the entity. The Public Company Accounting Oversight Board (PCAOB), a regulatory body that regulates audits of publicly traded companies in the USA, also defines materiality in terms of the magnitude of misstatements that, in the auditor's professional judgment, could reasonably be expected to influence the economic decisions of users (PCAOB AS 2105).

[3] This paper is based on Novotný (2025), which provides a more in-depth analysis of the topic. It aims to summarize key issues and findings from the original thesis.

The American Institute of Certified Public Accountants (AICPA) defines materiality similarly, noting that it is a matter of professional judgment within the context of the specific financial reporting framework used. According to the AICPA, misstatements, including omissions, are material if they could reasonably be expected to influence users' economic decisions based on the financial statements (ASB 138). By reviewing and integrating the definitions provided by different standard-setting bodies, it becomes evident that while there are slight variations in their terminology, they all converge on the notion that materiality serves as a threshold for determining the significance of information. Moreover, there is a consensus that materiality serves as a *threshold* concept requiring *professional judgment*, and that its determination involves evaluating both the *quantitative* and *qualitative* aspects of *misstatements* or *omissions*. It is also important to consider specific accounting framework (IFRS or local GAAP) relevant to the respective audit engagement.

All definitions of materiality largely converge on the idea that it represents a nominal monetary amount significant enough that its omission or misstatement could influence the economic decisions of financial statement users. These users encompass a wide array of stakeholders, including investors, creditors, suppliers, customers, government bodies (such as tax authorities and judges), and NGOs. The economic decisions affected by materiality may include whether a bank extends credit, whether investors buy or sell stock, whether suppliers engage in business with the entity, and how much the enterprise might pay in taxes and penalties.

In practice, audit materiality is assessed based on selected financial benchmarks, to which a percentage range is applied according to established "rules of thumb"—professional standards that have developed over time. While profit before tax (PBT) is the most commonly used benchmark for profit-oriented entities (ISA 320.A4)[4], recent research highlights a growing shift toward non-GAAP benchmarks, such as

[4] It should be noted that there is some inconsistency in the use of profit as the primary benchmark for materiality in profit-oriented entities. ISA 320 explicitly recommends profit before tax (PBT) as the preferred benchmark (ISA 320.A4), while some sources refer to net earnings (profit after tax, EAT). To ensure consistency and comparability of results, this study adopts net earnings (EAT) as its benchmark throughout the methodology.

adjusted profit before tax, to account for earnings volatility (Hallman et al., 2022). These non-GAAP measures may lead to higher materiality thresholds and relatively lower audit effort. Conversely, asset-based benchmarks tend to result in lower audit effort compared to profit-based benchmarks, as they remain relatively stable regardless of earnings fluctuations.

Audit textbooks generally suggest a rule of thumb range of 5–10 % of a company's net earnings (e.g., Knechel & Salterio, 2016). If profit measures are impractical, auditors may turn to alternative benchmarks such as Total Revenues (2.5–3 %) or Net Assets (typically 0.5–1 %). In cases where Net Assets are also impractical to use, such as with research startups that have no revenue — auditors might use other metrics, like amounts budgeted or expensed for research (Knechel & Salterio, 2016). Auditors then select the exact percentage from the suggested scale based on assessment of individual factors[5].

2.2 Share Purchase Agreements

A Share Purchase Agreement (SPA) is a legal contract that governs the sale of shares in a target company, outlining the terms under which a seller agrees to transfer ownership to a buyer for an agreed-upon price. SPAs ensure that both parties understand their rights and obligations, reducing uncertainty in the transaction. Key provisions typically include the purchase price, payment terms, representations and warranties, indemnities, and conditions precedent (Reyes, 2014; Hill Dickinson, 2020).

Indemnification baskets—one of the most common indemnity provisions—establish a threshold that must be exceeded before the buyer can seek indemnification from the seller, protecting sellers by ensuring that indemnification obligations are not triggered by minor breaches (CMS, 2021; Morse, 2024). Common types of baskets include deductible (excess only) baskets, where the seller

[5] Guidance in ISA320 is rather abstract, and consideratin of specific relevant factors is a matter of professional judgement, although it explicitly highlights ownership and financing structures (ISA 320.A3). Internal firm manuals often note that publicly traded entities should be assigned lower matriality thresholds (see, e.g., Elifsen&Messier, 2015; KPMG, 2022). The AFM (2021) notes that criteria used to determine audit matriality percentage were broadly similar across all Big Four audit firms.

is only liable for the portion of claims exceeding the threshold, and tipping baskets (first dollar baskets), where the seller becomes liable for all claims once the threshold is met. For example, if the basket is set at 1 % of the purchase price and the buyer's claims total 1.2 %, the seller is liable for the entire 1.2 % in a tipping basket but only for the 0.2 % exceeding the threshold in a deductible basket. A partial tipping basket, which is rather rare, combines both mechanisms.

Practical law studies confirm that majority of M&A deals use the basket clause. According to CMS (2024), 59 % to 72 % of European deals conducted under its scope included basket provisions, with an overall upward trend. Similarly, Morse (2024), citing data from the American Bar Association (ABA), reports that 90 % of U.S. deals included basket clauses during 2022 and Q1 2023. Norton Rose Fulbright (2019) noted that 56 % of deals completed in Asia under its scope in 2018 featured either basket provisions or retention thresholds. In a study from 2021, Norton Rose Fulbright reported that 71 % of sampled deals included either basket or retention threshold provisions (Norton Rose Fulbright, 2021). Factors influencing the size of indemnity provisions include the individual target company´s ownership structure, deal size, industry sector, the allocation of risk among other contractual mechanisms, bargaining power during negotiations, local jurisdiction and the involvement of legal or advisory professionals (e.g., Coates, 2011; Choi & Triantis, 2012; CMS, 2024).

Building on prior practical law studies, it appears that the central value for baskets in the U.S. is approximately 0.5 % of the total transaction value. In Europe, basket values exhibit greater dispersion, with the central value at or slightly below 1 %. However, a significant number of deals have baskets set at higher thresholds, with some reaching 1.25 % to 1.5 % of transaction value[6].

3 Prior Literature Review

Empirical research on materiality perceptions among financial statement users has been extensively explored, with Vance's (2022) meta-analysis being the most

[6] See Novotný (2025) for analysis of indemnity clauses and extensive analysis of prior practical law studies that examine indemnity basket clauses.

comprehensive study to date. As is noted above, analysis from Vance encompassed 48 empirical studies, covering 31,115 materiality decisions, and revealed significant variability in materiality thresholds, measured as percentages of net income[7]. The majority of these studies focuses on auditors. The mean materiality threshold was 7.84 % of net income, with a median of 6.81 %, aligning with the commonly accepted "rule of thumb" range of 5 % to 10 % (e.g., Knechel & Salterio, 2016).

Vance's findings also highlighted notable differences across user groups. Auditors reported a mean materiality threshold of 7.85 %, while bankers and creditors had the highest at 10.76 %, investors and analysts at 8.01 %, judges and attorneys at 7.66 %, managers and boards at 7 %, and professors and students at 9.16 %. These variations suggest that materiality judgments are influenced not only by professional expertise but also by the unique priorities and risk tolerances of each group. For instance, bankers and creditors—often considered primary users of financial statements in continental Europe—demonstrated the highest materiality thresholds, aligning with prior research showing that different user groups interpret audit reports and materiality differently (Gray et al., 2011; Asare & Wright, 2012).

While this body of research provides valuable insights into auditor behaviour, it highlights the overrepresentation of auditing practise at the expense of other stakeholders such as managers (7 studies) and bankers and creditors (5 studies), who remain underexplored. Furthermore, only four studies were published after 2010, with two-thirds dating before 2000, raising concerns about the continuing relevance of older findings in today's regulatory and economic environment (e.g., Lev & Gu, 2016). Additionally, most studies focus on the UK and US settings, where financial markets are more developed and regulatory frameworks more mature, thereby limiting generalizability to emerging economies.

Vance’s meta-analysis incorporates studies that employed various research designs and methodologies to measure materiality. For example, Bernardi and Pincus (1996) conducted a field experiment where Big Six audit managers assessed materiality

[7] Net income and earnings after tax (EAT) are used interchangeably throughout this paper, as both refer to company´s profit after deduction of taxes. Earlier literature predominantly uses term “net income“. It should also be noted that ISA 320.A4 identifies PBT as the primary benchmark for profit-oriented entities, while Vance and the prior studies included in the meta-analysis use net income.

and fraud risk in a simulated audit scenario, selecting their own audit evidence. Burgstahler et al. (2000) used a similar field experiment, testing whether auditors adequately considered projected misstatements by providing them with known errors in multiple accounts and requiring them to determine adjustments before issuing an audit opinion. Libby et al. (2005) combined a case study and debriefing questionnaire to analyse how auditors reacted to misstatements in income statements and footnote disclosures, quantifying their adjustment demands based on net income benchmarks.

Archival studies have also been used to infer materiality thresholds from financial reporting decisions. Acito et al. (2009) examined firms' choices between restating prior-year errors or using catch-up adjustments, comparing error magnitudes against firm earnings. Chewning et al. (1989) investigated whether companies classified debt-for-equity swaps as ordinary or extraordinary income based on materiality considerations. Cumming (1973) analysed firms' application of materiality in the segregation of extraordinary items in financial statements. Chewning et al. (1998) examined audit report modifications and whether changes in accounting principles were deemed material enough to warrant adjustments. Baskin (1972) investigated stock price reactions to firms' accounting policy changes, assessing whether investors implicitly applied materiality in decision-making. Chung et al. (2021) analysed "change in accounting estimate" disclosures under US GAAP, analysing whether these changes were considered material in financial statements.

Although these studies employ varied research designs and measure materiality across different financial statement elements, they predominantly focus on accounting-based contexts rather than directly investigating how various user groups apply materiality in economic decision-making based on financial statements.

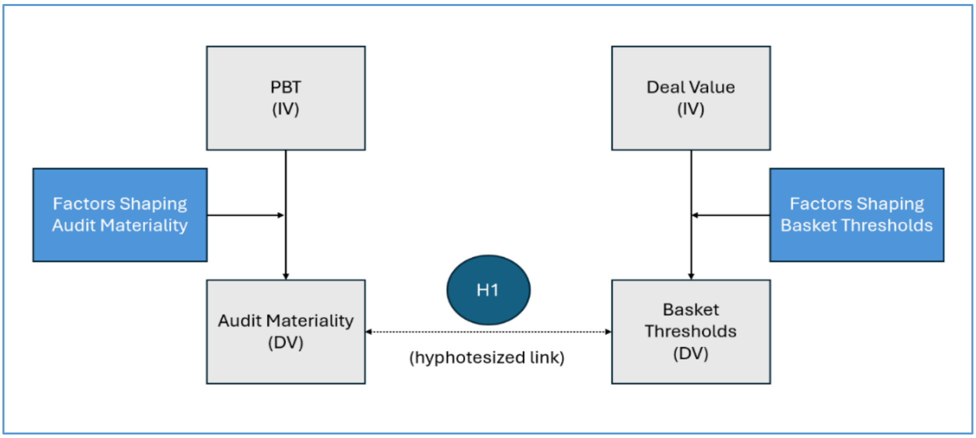
This gap forms the conceptual foundation for the present study. To address these limitations in current literature, this paper proposes a novel research design that extends beyond traditional accounting-based materiality assessments. Specifically, it focuses on Share Purchase Agreements (SPAs)—a cross-disciplinary domain that bridges accounting, finance, and law but remains underexplored in empirical financial research. By examining the quantitative thresholds negotiated in M&A

contracts (such as baskets), this study aims to introduce a replicable framework for observing investor-side materiality judgments in actual transactional setting. In doing so it contributes to broader understanding of how materiality judgments operate in broader context of financial decision-making.

4 Research Design

Further elaborating on Bernstein (2020) and building on previous empirical research on audit materiality, this study establishes a conceptual link between the "thresholds" (baskets) used in M&A transactions, as described in Chapter 1, and the definitions of audit materiality outlined in Chapter 1. The key underlying connection is that crossing these thresholds (i.e., "filling the basket") triggers a consequential action—such as demanding additional compensation or renegotiating terms—which directly impacts the economic decisions of the transaction parties. This aligns with the broader definition of materiality as having an "impact on economic decisions". Figure 1 illustrates the conceptual framework linking audit materiality and basket thresholds, which forms the basis for the hypotheses developed in the following chapter.

Figure 1 Framework visualization prepared for hypothesis consideration.



According to the meta-analysis conducted by Vance (2022), materiality thresholds vary significantly across different professional groups. While investors generally exhibit a higher mean materiality threshold compared to auditors, their median threshold is lower, suggesting a steeper gradient. It should be noted that, aside from Christensen (2020), all studies included in Vance (2022) involving investors were published in or before 1987. Although the core principles of audit methodology may not have changed significantly over the past several decades, financial markets and investment practices have evolved substantially (e.g., Damodaran, 2008; 2012; Lev & Gu, 2016), justifying renewed empirical investigation of investor materiality perceptions.

Vance (2022) presents aggregated data on materiality thresholds across a diverse range of investors, including institutional investors operating in public markets. In contrast, this work focuses on basket thresholds in M&A transactions, which function as critical contractual mechanisms for allocating liability and addressing risks. Unlike audit materiality—determined by auditors to address the expectations of a wide range of financial statement users—as discussed earlier, basket thresholds are shaped by the unique transaction-specific risk profile and the negotiation dynamics between buyer and seller. While investors in M&A transactions seek to limit their risk exposure through due diligence, the act of investing inherently involves one of the highest levels of risk-taking compared to other stakeholders in the deal[8]. Although there is a conceptual link between audit materiality and basket thresholds, the differences in their purpose, scope, and influencing factors make direct comparisons challenging. As a result, it remains unclear to what extent materiality thresholds derived from basket amounts in M&A transactions correspond to those identified in Vance (2022).

Details of M&A contracts, including basket and *de minimis* amounts, are often confidential due to non-disclosure agreements (NDAs) (Noerr, 2024). The constraints discussed in Chapters 2 and 3—such as limited access to primary data,

[8] This is evident in the case of bankruptcy, where shareholders are entitled to receive only the residual assets remaining after all debts, obligations, and liquidation costs have been fully settled (e.g., Insolvency Act no. 182/2006 Col; Business Corporations Act no. 90/2012 Col.).

the relatively small size of the Czech M&A market[9], and the highly specialized nature of the field—rendered a field experiment to collect data impractical. Instead, this study relies on manually compiled data from proprietary databases, publicly available sources, and prior legal surveys to establish reference points for basket thresholds in M&A contracts.

5 Hypothesis Development

To assess the relationship between indemnity baskets and audit materiality, this study examines hypothetical basket thresholds in comparison with the meta-analytic findings of Vance (2022), which established materiality thresholds for both auditors and investors, measured as percentages of net income. Given that indemnity baskets are calculated as a percentage of transaction value, this basket levels set based on prior legal surveys were recalculated as percentages of net income to enable a meaningful comparison. This conversion allows for better alignment with Vance's established materiality thresholds and ensures consistency with recognized benchmarks in financial materiality research. The objective is to formalise testable hypotheses assessing whether the recalculated basket thresholds correspond to the materiality levels reported by auditors and investors in prior research.

In this context, the term "hypothetical baskets" refers to analytically derived basket ranges grounded in prior empirical legal studies, rather than actual thresholds disclosed in individual SPAs, given the constraints discussed above[10]. These serve as proxy estimates to test whether investor-oriented contractual thresholds correspond to audit materiality levels observed in prior research and examine whether the hypothesized conceptual link between audit and investor materiality could provide meaningful empirical evidence of investors´ materiality perceptions.

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[9] The Czech M&A market shares several characteristics common to emerging Central and Eastern European economies, including a predominance of mid-market transactions, frequent cross-border participation, and limited contractual transparency (CMS, 2025).

[10] While SPA terms may occasionally surface through public-company filings and litigations or merger-control records, indemnity mechanics (including baskets) may be absent in public deals and redacted in private ones; hence, such disclosures may not constitute a dependable data source. We nonetheless encourage further empirical research in settings or jurisdictions where access to full contractual documentation may be feasible.

Building on the discussions in the preceding chapters regarding the distinct factors influencing the determination of investors´ and auditors´ materiality thresholds and the noted uncertainty about how materiality thresholds derived from basket amounts in M&A transactions align with the findings of Vance (2022), we define the following null hypotheses:

***H1:** There is no significant relationship between auditors' materiality judgements (as reported by Vance, 2022) and basket thresholds recalculated as percentages of net income.*

***H2:** There is no significant relationship between investors and analysts' materiality judgements (as reported by Vance, 2022) and basket thresholds recalculated as percentages of net income.*

H1 tests whether the materiality levels recalculated from hypothetical baskets would correspond to auditors´ materiality judgement from prior empirical studies, thereby testing the hypothesized conceptual link. **H2** then evaluates whether materiality levels inferred from these baskets align with results reported by Vance (2022) for investors and analysts, thereby assessing whether this research design could provide a viable framework for future empirical studies on user-based materiality thresholds.

6 Data

Because Share Purchase Agreements (SPAs) are typically confidential, as discussed previously, this study relies on insights from prior legal and empirical research referenced in the cited sources. Previous studies indicate that indemnity baskets generally range from 0.5 % to 1.5 % of the purchase price with U.S. evidence showing a median basket of 0.5%, while European studies exhibit a broader range and distribution (Morse, 2024; CMS, 2024). Approximately 60 % of reported transactions feature a basket set at ≤1 %, and 73 % fall below 1.5 % of the purchase price in deals conducted between 2011 and 2023. Given the absence of detailed SPA data for individual transactions, we opted to analyse investors' materiality perceptions using five predefined basket ranges—**0.5 %**, **0.75 %**, **1 %**, **1.25 %,** and **1.5 %** of the respective total transaction values. This approach aligns with the study's primary objective: to evaluate the feasibility of the proposed research design rather than to provide direct empirical evidence. Significant divergence between the resulting materiality levels and the investor benchmarks identified in Vance (2022) would indicate limitations of the design and challenge the hypothesized conceptual link between basket thresholds and materiality perceptions. While the approach introduces constraints by relying on secondary sources rather than individual SPAs, it offers a reasonable framework for testing the conceptual viability of the proposed methodology.

6.1 Data Sources and Reliability

Basket amounts are influenced by market conditions and negotiation dynamics, therefore using a longer time series minimizes short-term effects. ABA reports stable indemnity basket levels from 2005 to 2023 (Morse, 2024). CMS (2024) similarly finds no significant difference in basket amounts between 2011 and 2023. Bloomberg Law data indicates a shift in basket types but stable mean percentages (Bloomberg Law, 2021).

Transaction values were obtained primarily from the Capital IQ database for, which aggregates public and private sources. However, data reliability issues were observed. For example, the Net4Gas Holdings transaction was reported at over EUR 200 million, including earn-out payment (an initial payment of ≈ EUR 120 million and a contingent payment of ≈ EUR 80 million). Including the maximum consideration amount is deemed appropriate for empirical comparability. In contrast, Capital IQ reported EUR 0.34 million for the MSV Metal Studénka 2019 deal, whereas Moravia Steel's 2019 financial statements reported EUR 34.6 million — Capital IQ seems to aggregate data from various sources. Some deal values come from media reports or press releases, which can be vague. Because such discrepancies could not be always resolved by cross-referencing due to limited data, clear outliers and non-M&A transactions were excluded following a manual data review. Despite limitations, Capital IQ remains the most comprehensive database for Czech M&A transactions and provides a consistent baseline for empirical analysis.

Because Capital IQ provides profit-before-tax (PBT) data only for large companies, PBT figures were manually retrieved from financial statements published in the Czech Commercial Register for consistency. All PBT figures were drawn from financial statements with year ends closest to, but preceding, the transaction effective date[11], as reported by Capital IQ. PBT was converted to EAT[12] using a normalized 19 % tax rate[13]. The non-disclosure of financial statements is a pervasive issue in the Czech Republic (e.g., iROZHLAS, 2021), particularly for smaller companies. In some cases, financial statements for the year before the transaction were unavailable, and such deals were excluded. Where consolidated statements were used (i.e., in case of group sales), items from other comprehensive income were excluded-provided such segregation was disclosed to ensure comparability of results. Transactions not involving 100% ownership were also excluded for comparability[14].

EAT figures were converted to EUR using the average of monthly exchange rates published by the Czech National Bank, aggregated according to each entity´s fiscal year-end and reporting period length. This approach is consistent with the simplification option under IAS 21 and, together with the currency conversion to EUR, enables broader international comparability of the results. As documented in table 1, majority of financial statements were prepared in accordance with CZ GAAP.

[11] This approach reflects the information set that would have been available to investors at the time of the transaction and preserves conceptual link to audited financial data used in determining audit materiality.

[12] As discussed earlier, ISA 320.A4 identifies PBT as the primary benchmark for profit-oriented entities. However, prior empirical research typically reports materiality based on net income. To ensure compatibility with existing studies and to account for entity-specific tax differences, a normalized flat tax rate was applied, consistent with data standardization approach by Vance (2022). The use of a flat percentage also enables straightforward adjustment of results for subsequent analysis using PBT as the benchmark. For loss-making entities, no tax adjustment was applied.

[13] Although the statutory corporate income tax rate in the Czech Republic increased from 19% to 21% in 2024, all transactions were analyzed using the most recent available year-end financial statements preceding the transaction date. For 2024 deals, this corresponded to fiscal year 2023, when the 19% tax rate was still in effect.

[14] Linearly extrapolating transaction value from a partial shareholding is not a methodologically sound approach for estimating total enterprise value; see for example Mařík et al. (2018).

6.2 Sample Composition

Transactions were classified by sector according to the GICS methodology (MSCI, 2020). The dataset includes 72 transactions reported between 2014 and 2024, representing a combined transaction value of EUR 8.6 billion and an average deal size of approximately EUR 120 million. Eight transactions exceeded EUR 200 million, and two surpassed EUR 1 billion. The largest transaction was the acquisition of RESIDOMO, s.r.o. (EUR 2.05 billion) in the real estate sector, reflecting the significance of large-scale property transactions in the Czech M&A landscape (Colliers, 2023; CMS, 2023). The real estate sector dominated the sample by total transaction value, contributing over EUR 2.6 billion (> 30 % of total sample value). Another major deal involved CGS Holding a.s., an automotive supplier acquired for over EUR 1 billion in the materials sector.

The IT sector accounted for the largest number of transactions (15), totalling EUR 554 million. Many of these IT transactions involved successful startups acquired by larger international enterprises, reflecting the Czech Republic's growing role in the tech and innovation ecosystem (Mazars, 2023). The industrials and materials sectors collectively comprised 21 transactions (29% of the total sample) with a combined transaction value exceeding 3.1 billion EUR, demonstrating the manufacturing industry's traditionally strong role in the Czech economy (e.g., Markaki et al., 2021).

Table 1 summarizes the dataset's financial reporting characteristics. Of the 72 companies, 54 had audited financial statements, including 32 audited by the Big Four audit firms (Deloitte, PwC, EY, KPMG). Financial reporting was predominantly prepared under CZ GAAP standards (66 companies), while 6 used IFRS standards. Six companies reported a fiscal year-end other than 31st December[15]. Publicly recognized transactions in the sample include major deals such as Sellier & Bellot, Hamé, Meopta, Zentiva, and RWE Gas Storage, among others. Notably, CITY TOWER appeared multiple times in the dataset, as 100 % of its shares were sold to PPF in 2014, followed by PPF's subsequent sale of the asset in 2016.

[15] Due to the small sample sizes within the subcategories related to financial reporting methods, audit characteristics, and fiscal year-end dates, no further statistical testing was conducted on these dimensions.

Table 1 Descriptive analysis

	Original selection		Adjusted (first) sample - Excl. Outliers		Adjusted (second) sample - Excl. Outliers and Loss	
Observed data	**72**		**62**		**41**	
Audited Financial Statements	54		49		35	
Audited Financial Statements from B4*	32		29		20	
CZ GAAP Standards	66		56		36	
IFRS Standards	6		6		5	
Year-End Other than 31st Dec.	6		5		1	
Sector (GICS)	**n**	**Transaction Value (mEUR)**	**n**	**Transaction Value (mEUR)**	**n**	**Transaction Value (mEUR)**
IT	15	554	10	432	6	406
Industrials	14	1,604	13	1599	9	1583
Health Care	10	1,030	10	1030	7	801
Materials	7	1,531	6	1525	3	1255
Real Estate	6	2,599	5	2457	4	2430
Consumer Discretionary	6	168	5	102	5	102
Consumer Staples	5	395	5	395	2	196
Energy	4	574	4	574	3	570
Financials	3	180	2	33	1	31
Communication	2	11	2	11	1	2
Total sample	**72**	**8,648**	**62**	**8,159**	**41**	**7,378**

** B4 refers to the Big 4: Deloitte, PwC, EY, and KPMG.*

6.3 Outlier Categories and Characteristics

The identified outliers fell into three principal categories: (i) start-ups, (ii) real estate or holding companies, and (iii) entities with exceptionally low absolute net profit margins. In general terms, outliers had valuations that significantly diverged from their financial statements. Consequently, baskets recalculated as percentages of net profit were either disproportionally large or immaterially small, with the former predominating.

Start-ups—particularly in the IT sector—frequently display valuations that are weakly correlated with current financial performance. For example, Integromat s.r.o., a Czech software company acquired by Celonis in October 2020 for EUR 91.7 million, reported less than EUR 0.5 million in revenue and a net loss in 2019. Approximately half of all outliers belonged to this category.

Real estate and holding companies represented a second group of outliers. For instance, in 2024, Komerční banka sold its subsidiary VN42 to the Prague municipality. Despite reporting only EUR 6.5 million in revenue and a net income of EUR 84.5 thousand in 2023, VN42's sale price exceeded EUR 140 million. The valuation in such cases likely reflect unrealised gains – such as land and building appreciation – that may not be fully captured by GAAP (e.g., CMS, 2015). These gains in practise are driven by factors such as the building's strategic location and historical significance.

The third group comprised companies with very low absolute net profit margins, typically between -1.7 % and +1.3 %. These firms´ minimal profitability caused basket ratios expressed as percentages of EAT to appear artificially inflated. Notably, 70 % of all outliers identified shared this characteristic. Audit standards and textbooks offer limited guidance on whether profit is a suitable benchmark for audit materiality when an entity incurs a loss.

6.4 Post-adjustment analysis

After excluding outliers, baskets thresholds expressed as percentages of EAT were manually compared with hypothetical audit materiality thresholds for each transaction based on the respective financial statements. These benchmarks were based on two reference points: the 7.65 % EAT threshold suggested by Vance and the 10 % upper range recommended by audit literature (Knechel & Salterio, 2016). Interestingly, audit materiality calculated as an absolute value from a loss-based benchmark (net loss) was broadly comparable to the basket levels, suggesting that the primary limitation of earnings as a benchmark for audit materiality arises from low profit margins (in absolute terms) rather than mere presence of losses.

To enhance robustness, the hypotheses defined in Chapter 4 were tested on two adjusted samples:

(1) A dataset excluding outliers, and
(2) A dataset further excluding loss-making companies.

Table 1 presents the characteristics of this further adjusted dataset, which includes 41 deals.

7 Results and Discussion

Table 2 presents the results for the first adjusted sample, which excludes outliers (n= 62). The calculated mean materiality of 9.2 % for the **0.5 %** basket rangeexceeds both Vance's reported thresholds of 7.85 % for auditors and 8.01 % for investors and analysts. In the broader context of auditing and the overarching objective of auditors providing a useful service, as outlined in the Introduction, this finding carries positive implications. The fact that investors exhibit a higher threshold for what they consider as ´material´ suggests that financial statements are subjected to a greater level of scrutiny during the audit process—that is, they identify smaller misstatements as material relative to investors´ implicit thresholds.

Table 2 Results of experiment and descriptive statistics

	0.50% (EAT)	Basket 0.75% (EAT)	1.00% (EAT)	Basket 1.25% (EAT)	1.50% (EAT)
Mean	**9.20%**	**13.80%**	**18.40%**	**22.29%**	**26.75%**
Standard Deviation	**6.36%**	**9.54%**	**12.72%**	**16.55%**	**19.86%**
Q1	4.41%	6.61%	8.82%	10.05%	12.06%
Median	**7.67%**	**11.50%**	**15.33%**	**18.91%**	**22.69%**
Q3	12.57%	18.86%	25.14%	31.43%	37.71%
90th Percentile	19.33%	29.00%	38.67%	48.33%	58.00%
Weighted Average	11.37%	17.05%	22.74%	26.67%	32.01%
Comparison to Auditors (Vance, 2022)					
Two-sampled t-test	1.9999	4.6821	6.0757	6.0547	6.5748
P-value	0.0505	p < 0.0001	p < 0.0001	p < 0.0001	p < 0.0001
Comparison to Investors & Analysts (Vance, 2022)					
Two-sampled t-test	1.4277	3.9722	5.4955	5.6950	6.2912
P-value	0.1582	p < 0.0001	p < 0.0001	p < 0.0001	p < 0.0001

To test the hypothesis defined in Chapter 4, two-sampled t-test were performed with degrees of freedom calculated utilising the Welch´s formula, assuming unequal variances between the datasets under comparison. Tests were conducted at the 95 % confidence level (critical value ≈ 1.98). For the 0.5 % basket range, **H1** was marginally rejected and **H2** rejected, indicating partial alignment between the empirical results and the meta-analytical benchmarks for auditors and for investors and analysts. For baskets ≥ **0.75 %**, both hypotheses were rejected, as the calculated t-statistics exceeded critical value and p-values approached zero, confirming significant differences between this study´s results and the reference means.

Rejection of **H2** for the 0.5% basket range—that is, similarity of results between this study and the investor materiality levels reported meta-analysis of prior empirical studies by Vance (2022)—suggests that the proposed research design can capture investor materiality perceptions. Likewise, the marginal rejection of **H1**, provided evidence of a measurable relationship between auditors' materiality judgements and hypothetical basket thresholds derived from transactional values.

Table 3 Results of experiment and descriptive statistics, adjusted data

	0.50% (EAT)	Basket 0.75% (EAT)	1.00% (EAT)	Basket 1.25% (EAT)	1.50% (EAT)
Mean	**9.96%**	**14.93%**	**19.91%**	**23.81%**	**28.58%**
Standard Deviation	**6.22%**	**9.33%**	**12.44%**	**16.68%**	**20.02%**
Q1	5.21%	7.81%	10.42%	11.20%	13.44%
Median	**8.41%**	**12.61%**	**16.82%**	**21.02%**	**25.23%**
Q3	13.03%	19.54%	26.06%	32.57%	39.09%
90th	19.16%	28.73%	38.31%	47.89%	57.47%
Weighted Average	11.83%	17.75%	23.67%	27.65%	33.17%
Comparison to Auditors (Vance, 2022)					
Two-sampled t-test	2.3706	5.6542	7.3925	7.4007	8.0509
P-value	0.0198	0.0000	0.0000	0.0000	0.0000
Comparison to Investors & Analysts (Vance, 2022)					
Two-sampled t-test	1.5690	4.5469	6.4438	6.7995	7.5722
P-value	0.1216	$p < 0.0001$	$p < 0.0001$	$p < 0.0001$	$p < 0.0001$

Table 3 summarizes the results for the second adjusted sample, which excludes both outliers and loss-making target companies (n = 41). Mean materiality values increased slightly, while standard deviations declined, likely reflecting the smaller and less volatile sample. The critical t-value for this sample was 2.02. Across all basket levels, the null hypothesis **H1** was rejected, as t-values exceeded the critical threshold and p-values were below the 0.05 significance level. For **H2**, rejection persisted only at the 0.5 % basket level, while higher baskets again differed significantly from Vance´s (2022) investor benchmarks.

These results collectively support the internal validity of the proposed research design: despite changes in sample composition, the 0.5 % basket range repeatedly yields materiality estimates statistically comparable to investor-based results from prior research. The consistency indicates that the framework can serve as a feasible proxy for investor materiality perceptions in future empirical studies.

While European industry studies and legal research reports reported higher basket amounts compared to the U.S. median of 0.5 % (e.g., Morse, 2024; CMS, 2024), it should be noted that the majority of studies in Vance's (2022) meta-analysis are based in the U.S. and U.K. settings. Accordingly, auditor´s materiality thresholds for most Czech target companies would likely gravitate towards the 10 % upper bound suggested by Knechel & Salterio (2016) rather than Vance's mean of 7.85 % for auditors. This observation aligns with the characteristics of the Czech M&A environment—limited capital market depth, lower litigation exposure, and different ownership structures[16]—factors commonly associated with higher materiality thresholds. Only two target companies in the dataset had publicly traded securities. This reinforces the need for further cross-regional research on materiality judgements in emerging European markets, where institutional and legal frameworks differ markedly from those underlying most prior empirical studies.

8 Conclusion

This study proposes a novel empirical framework for examining investors' materiality perceptions by linking audit materiality thresholds with indemnity basket clauses in Share Purchase Agreements (SPAs). Empirical results suggest that this research design yields outcomes broadly consistent with prior investor-focused studies at the 0.5 % basket level, indicating its potential for application in future materiality research—provided that detailed SPA data (primarily basket thresholds combined with transaction value and profit figures) were publicly available. Moreover, the relatively higher materiality thresholds observed in this study, compared to those reported in prior investor research, suggest that auditors may apply more conservative (lower) thresholds, recognizing as material misstatements and omissions that investors might not consider as significant.

Basket levels above 0.5 % still provide relevant empirical evidence of what investors perceive as ´material´. As discussed earlier, regional and firm-specific characteristics of target companies—such as differences in financing structures,

[16] The Czch financial system is predominantly bank-based, with approximately 90% of corporate financing provided through banks rather than capital markts (World Bank, 2018; OECD, 2020). Local corporate covernance practises remain relatively weak, particularly compared to frameworks such as the U.S. Sarbanes-Oxley Act (SOX) (Havel et al., 2023). Czech companies also exhibit relatively more concentrated ownerhip structures, which is consistent with post-transition European economis (e.g., Konecny, 2015). Collectivelly these and other factors limit the range of potential financial-statement users.

ownership concentration and corporate governance requirements—affect these perceptions. The higher materiality thresholds observed when expressed as percentages of targets´ EAT correspond to overall higher baskets thresholds typically reported in European markets compared to the United States (e.g., Morse, 2024; CMS, 2024) and in turn audit materiality given the above mentioned characteristics would also be higher[17].

This paper also contributes methodologically by bridging the domains of auditing, finance and business law—fields that rarely intersect into mainstream finance literature. Business-law aspects of M&A transactions remain underrepresented in finance and accounting journals and are often confined to specialised legal practise[18]. This limitation is particularly visible in developing markets such as the Czech Republic, where the absence of large international investment banks concentrates expertise within a small group of professionals. While lawyers often serve to “translate” investors' intentions into SPAs as functional instruments, expanding knowledge and accessibility in this field could improve understanding of contractual risk allocation mechanisms in SPAs and their implications for materiality assessments.

Lack of transparency in financial disclosures emerged as a recurring constant in the empirical analysis. As noted earlier, many Czech target companies failed to publish complete or readable financial statements in the Commercial Register[19], and ownership structures—particularly of joint stock companies—were often obscure.

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[17] Empirical studies directly compering actual overall materiality between US/UK and continental Europe are rare, although some jurisdictions, such as UK and Netherlands recently mandated disclosure of materiality in audit reports, offering future empirical research opportunities. Our perceptions stem from previously identified general differences and their potential effect on auditors´ considerations when selecting percentage applied to the selected materiality benchmark.

[18] Initial screening of finance and accounting academic journals on specific SPA deal terms and the M&A process mechanics initially yielded very limited results, mostly focusing on earn-outs. See for example Denis & Macias (2010), Chemla et al. (2007), Cain et al. (2007), Even-Tov et al. (2024).

[19] Section 21a(2) and (4) of the Czech Accounting Act (Act No. 563/1991 Coll., on Accounting) require accounting entities that are entered in the public register to publish their financial statements and annual reports be depositing them in the Collection of Deeds within 30 days after audit and approval, and in any case no later than 12 months after the balance-sheet date).

Financial statements prepared under Czech statutory law frequently prioritized compliance with legislative form over substantive information. For example, disclosures about company's core business activities often used generic and formal descriptions such as *"Manufacturing, trade, and services not specified in Annexes 1 to 3 of the Trade Licensing Act"*[20] providing little insight into the underlying operations. In numerous cases, the source or composition of reported revenues could not be discerned from the accompanying disclosures, illustrating the limited explanatory value of statutory financial statements.

These transparency gaps pose significant challenges for emerging economies. Transparency is essential for fostering economic growth, efficient resource allocation, and trust in financial systems (Forssbaeck and Oxelheim, 2015; Glennerster and Shin, 2008; Shi, Ausloos, and Zhu, 2017). The World Bank (2001) underscores the importance of reliable and timely information, noting that transparency improves resource allocation, enhances government accountability, and reduces corruption. Furthermore, insufficient transparency heightens perceived risk among investors, discouraging critical capital inflows and limiting growth opportunities (World Bank, 2001).

Addressing these deficiencies requires improvements in both the quality of disclosures and the availability of financial data. Although Czech companies are legally required to submit their financial statements to the Commercial Register and tax authorities, many filings remain in non-standardized or low-quality formats, such as scanned photocopies, some of which are nearly unreadable. Transitioning to a unified electronic submission format—SEC's EDGAR system—could greatly enhance transparency and facilitate academic research, regulatory oversight, and stakeholder analysis.

In summary, while audit and investor materiality perceptions have been studied extensively, this paper demonstrates that contractual mechanisms in M&A contracts offer a viable empirical proxy for investor materiality judgments. Many studies addressing investors' perspectives are dated or narrow, often focusing solely on accounting or disclosures. Expanding this research would provide auditors with

[20] The quote refers to the Annex of the Czech Trade Licensing Act (No. 455/1991 Coll.)

critical insights to better align their practices with stakeholder expectations. Further research should examine regional and institutional differences in materiality thresholds, especially across less developed capital markets with variations in ownership concentration, legal enforcement, and financing structures. Examining how local economic and regulatory factors influence materiality could yield valuable insights and enhance the relevance of audits in diverse contexts.

Used abbreviations

ABA - The American Bar Association

AICPA - The American Institute of Certified Public Accountants

DV - Dependent Variable

EAT - Earnings after taxes

EDGAR - SEC's Electronic Data Gathering, Analysis, and Retrieval system

FASB - The Financial Accounting Standards Board

GAAP - General accepted accounting principles, accounting framework

IAASB - The International Auditing and Assurance Standards Board

IV - Independent Variable

M&A - Mergers and Acquisitions

PCAOB - The Public Company Accounting Oversight Board

PBT - Profit before taxes

SEC - The Securities and Exchange Commission

SOX - Sarbanes–Oxley Act, SOX compliance

SPA - Share Purchase Agreement

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Metodologický návrh pro studium vnímání materiality investory: důkazy ze smluv o nákupu akcií

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Abstrakt:

Materialita auditu je často zpočátku hodnocena pomocí "rules of thumb" odvozených z historických profesních zkušeností a průmyslových standardů. Vzhledem k jeho roli v zajištění poskytování smysluplných služeb zainteresovaným stranám je zásadní porozumění vnímání uživatelů finančních výkazů ohledně materiality. Na základě metaanalýzy pěti desetiletí empirického výzkumu od Vance (2022) tato studie navrhuje inovativní výzkumný design, který zastupuje prahy materiality investorů prostřednictvím klauzul o náhradním koši v dohodách o koupi akcií (SPA). Na základě ručně sestaveného souboru dat 62 transakcí M&A zahrnujících české cílové společnosti dokončených mezi lety 2014 a 2024 byly hypotetické košová pásma v rozmezí od 0,5 % do 1,5 % hodnoty obchodu – sestavená z rozmezí uvedených v předchozích praktických právních studiích – přepočítána jako procenta zisku po zdanění (EAT) a porovnána s referenčními úrovněmi materiality hlášenými auditory a investory. Košík 0,5 % odpovídá průměrným prahům 9,2 % EAT, což je výrazně více než 7,85 % průměrná materialita identifikovaná u auditorů v metaanalýze Vance (2022)—což naznačuje, že nižší prahy materiality auditorů mohou odpovídat větší přesnosti a jemnější analytické detailnosti než ten, který aplikují investoři. Dvouvzorkové t-testy potvrzují částečnou shodu mezi benchmarky založenými na investorech a empirickými výsledky na úrovni koše 0,5 %, což naznačuje, že navrhovaný výzkumný design poskytuje proveditelný základ pro budoucí empirické studie, pokud by byla k dispozici podrobná data z jednotlivých SPA, a zároveň propojuje právo, účetnictví a finanční výzkum tím, že ukazuje, jak smluvní prahy mohou sloužit jako pozorovatelné ukazatele hodnocení materiality investorů.

Klíčová slova:

Audit Materiality, Share Purchase Agreements (SPA), Basket Clause

JEL classification: M42, G34, K12, M41