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Indicator Method of Assessing Materiality

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ABSTRACT: The article presents a concept of materiality based on the information process organized for the benefit of company's managers. This approach allows to identify the parties interested in materiality assessment process and to evaluate the risk of potential conflict of interests between producers of information, data controllers and decision-makers. Common elements and differences in existing methods of assessing materiality have been defined Studies on the limits of materiality assessing methods have been reviewed. Systemic shortcomings of these methods allowed to define the approach used in them as functional and to establish the main cause of all the shortcomings: diverse interests of participants in the information process. The new indicator approach to the assessment of materiality is proposed as an alternative to the existing functional methods. This approach involves the use of indicators, taken into account by company's managers – participants in the decision-making process and allows to eliminate not only the conflict of interests, but also the main drawback of the currently used methods - their subjectivism. The article presents a new method for assessing materiality based on indicator approach.

Keywords: Information, materiality; calculation method, financial statements; indicator method.

I. INTRODUCTION

The role of information in the management of various systems is no longer debated today. Information management of economic entities is the focus of attention of many scholars investigating both management and information production processes. Nevertheless, the creation of high-level automated accounting systems for collecting, producing and reporting information was not enough to avoid misstatements.
The reasons for appearance of distorted information have both objective and subjective nature. But regardless of cause, managers are sometimes forced to take decisions based on misstatements. This was the reason for introducing the concept of materiality into accounting and auditing practices. The information is considered to be material if its absence or distortion could influence the economic decision of financial statements user.
The recognition of materiality as a qualitative characteristic of information or as an accounting principle could not avoid problems with its evaluation. Russian and Ukrainian leading scholars in economics, among whom Ya.V. Sokolov, S.M. Bychkova, V.V. Kovalev, Vit.V. Kovalev, S.I. Zhminko, L.G. Makarova, K.V. Bezverkhy, I.S. Egorova, V.V. Pugachev, V.A. Sitnikova, E.V. Kharlamov, S.I. Shilenko, D.A. Yudintseva, have been constantly discussing this problem over the last twenty years. But even now in Russia there is no common approach to the methods of assessing materiality.
So, the methods of materiality assessment for making management decisions are the subject of our study.
The purpose of the study is to establish the justification for indicator approach to assessing the level of materiality as an alternative to the existing functional approach. In accordance with the purpose of the study, its objectives are the following:
- to investigate and classify the interests of various groups of specialists participating in the assessment of materiality;
- to study and systematize existing methods of assessing materiality;
- to analyze the degree of satisfaction for various groups when applying methods of assessing materiality;
- to propose a materiality assessing method meeting the interests of managers.

II. METHODS

Our study is based on the fundamental principles of the theory of economic systems, accounting, analysis and auditing. The laws of formal logic and target approach were used in justifying the proposed index approach to the assessment of materiality. The method of determining the level of materiality on the basis of index approach was developed using economic and mathematical methods in the formalization of materiality as the value of error, resulting in incorrect management decisions.
The study is based on the analysis of international and Russian legislations relating to the financial statements of an economic entity, as well as on the studies of information support for companies' management.

III. RESULTS

One of the main conditions for ensuring effective management is its information support. But the fact of having an information system that provides the support for management process is not the guarantee of its effectiveness. The information generated in this system must meet certain requirements or possess the qualitative characteristics of relevance, completeness, timeliness, etc. Compliance with these requirements and appropriate qualitative characteristics of information will allow users to make fully informed

managerial decisions. Failure to comply with these requirements may result in unjustified decisions.

Thus, depending on the level of its compliance with the established requirements, information can be conditionally divided into reliable and unreliable. In this case, reliable information is one on the basis of which justifiable decisions are made, and unreliable information lays at the basis of unjustifiable decisions.

K.V. Bezverkhiy defines materiality as “a criterion (threshold) to differentiate information in accordance with its qualitative characteristics and the degree of influence on the financial and economic decisions of financial statements users” (Bezverkhii, 2014). The space (zone) between reliable and unreliable information is created by errors (omissions, inaccuracies, etc.) made during its production. This vision is consistent with the definition made by Philip L. Defliese, Henry R. Jaenicke, Vincent MO` Reilly, Murray B. Hirsch : “The omission or misstatement of an item is material in a financial report, if, in light of surrounding circumstances, the magnitude of the item is such that it is probable that the judgment of a reasonable person relying upon the report would have been changed or influenced by the inclusion or correction of an item" (Defliese, Jaenicke, Reilly, Hirsch, 1997). A similar approach to the materiality has been followed by the International Accounting Standards Board, the UK Accounting Standards Board, and the US Accounting Standards Board. With insignificant differences in the wording, the definitions of materiality reflect its role in decision-making: “materiality is the magnitude of an omissions or misstatement of accounting information, that, in view of surrounding circumstances, makes it probable that the accounting information user relying on the information would have changed his initial opinion about accounting information based on trust in it ” (The Conceptual Framework or Financial Reporting, Bondarenko, 2002).

Thus, the concept of materiality is based on three components of the information process: production of information, control of its quality and use of this information. The final stage (use of information) determines the two preceding ones: production and control. As noted by V.A. Sitnikova, even the regulated subjectivism of accounting activities should be overcome with the help of the strategy “to disclose in the financial and accounting statements the most useful information for external and internal users” (Sitnikova, 2016).

Regarding the first component of the materiality concept, it should be noted that collecting and processing information should be aimed at producing information demanded by users. Therefore, the user must not only possess the information itself, but also the information about possible misstatements, i.e. the level of materiality.

Secondly, the concept of materiality is applied at two previous stages of accounting process. At the first stage, the level of materiality is one of the criteria for the company's regulations of recording property, liabilities, and the facts of economic activities. At the second stage, the materiality level is taken into account when disclosing information about the financial condition of the company and the financial results of its activities. Individual assets, liabilities, income, expenses and business transactions, as well as capital components should be presented separately in the financial statements if, without the knowledge of them, the interested users would fail to adequately evaluate the company’s financial position or financial results of its activities (IAS1). In other words, each significant indicator should be presented separately in the financial statements. Immaterial amounts should be combined.

Thirdly, the concept of materiality in control is closely related to the concept of materiality in management and accounting. The materiality concept has a different character in internal and external control, due to their different goals. In the system of internal information control, materiality serves as a criterion for choosing the order of errors recording in accounting. The misstatements in accounting records are due either to the non-disclosure of information on economic and financial operations, or to its distortion resulting from the following:

- Incorrect application of accounting legislation
- Incorrect application of local acts of the company;
- Incorrect identification and classification of the facts of economic activities;
– Incorrect evaluation of the facts of economic activities, and therefore, incorrect evaluation of property, liabilities and capital of the company;
- inaccuracies in calculations;
- maladministration and malpractices.

As noted by A. B. Bogopolsky, “from a practical perspective, materiality is not only a qualitative characteristic of financial statements but a threshold, a cut-off point, above which no error, neither distortion can be left by the reporting enterprise without a corresponding correction "(Bogopolsky, 2009).

The principle of materiality in external control is applied at planning and conducting audit, as well as at forming the auditor's opinion on the reliability of the company's financial statements (ISA 320). During the last stage of the audit (audit report production), materiality is important not only for auditors, but also for users of financial statements.

Thus, materiality arose from two circumstances: the need for reliable information to make informed management decisions and the existence of inaccuracies and omissions (distortions) of information. However, the concept of materiality is not only applied in decision-making process, but it also plays a significant role in the processes of information production and control over the quality of financial reports (audit). This view is shared by many scientists (Bezverkhii, 2014, Egorova, 2014, Ivanova, 2011, Makarova, 2013, Pugachov, 2013). In particular, L.G. Makarova notes that “the problem of materiality is related not only to auditing, but also to financial, economic and management activities, including the organization and maintenance of accounting, reporting, analysis and decision-making” (Makarova, 2013).

In the accounting process, materiality is especially important for the following operations:

- identification and classification of accounting items;
- selection of accounting procedures;
- production of financial statements items;
- disclosure of information in the financial statements of the company;
- procedure for correction of the errors made in the information system.

In monitoring activities, materiality is important for:

- evaluating the magnitude of misreporting;
- organizing control operations (planning, conducting of audit, selection of type of audit report).

The importance of materiality for a large number of financial statements users and specialists in various fields of economic activities determines the importance of methods of its assessment. However, this issue of materiality assessment always stays relevant in contemporary Russia. There is no proper regulation covering the procedure for determining the level of materiality in accounting and auditing practice. Audit firms establish it independently based on the recommendations of existing standards (IAS1). These recommendations are conceptual in nature and take account of three important factors:

1. focus on the usefulness of information for its users;
2. objective uncertainty of company's prospects;
3. the subjectivity of professional judgment in the procedure of information production and determining the level of its materiality.

IFRS, US GAAP, ISA contain neither specific instructions on the procedure for determining the level of materiality, nor basic items for quantitative values in this matter. Therefore, experts in audit have developed a large number of different methods of determining the level of materiality. All existing methods of determining the level of materiality can be divided into three main groups, depending on the deductive or inductive approach, and the ways of taking account of materiality qualitative component.

The first group of methods, called 'quantitative' by some experts, is characterized by the deductive approach in determining the general level of materiality. The logical content of this approach “from the general to the specific” determines the procedure for calculating the level of materiality. According to this approach, the total (cumulative) level of materiality calculated at the first stage is then distributed between the material items of financial statements in proportion to their share (Bondarenko, 2002, Ghazaryan,. Sobolev, 2005, Zhelezniakova, 2013).

The second group of methods (financial indicators method, qualitative method) is based on the inductive approach: at the first stage, the level of materiality of the significant financial statements is calculated taking account of their weighting factors. The general (total, cumulative) level of materiality is equal to the sum of particular levels of materiality of significant reporting items. This group of methods involves taking account of qualitative errors detected during the audit (Bondarenko, 2002, , Ghazaryan,. Sobolev, 2005, Zhelezniakova, 2013).

The third group of combined methods requires the distribution of general level of materiality between the reporting items based on their significance for decision-making (Bondarenko, 2002, Ghazaryan,. Sobolev, 2005, Ivanova, 2011, Zhelezniakova, 2013).

All methods of assessing the materiality are based on the use of basic indicators, constituted only by financial statements. As noted by V.I. Bondarenko, “the issue of assessing materiality in auditing consists primarily in choosing a base that may include one or several indicators of financial statements and a method for calculating the quantitative materiality criterion which is the value of maximum permissible error” (Bondarenko, 2002).

The following procedures are common for all methods:

- identification of financial statement items, operations, accounting objects, to which the materiality concept should be applied;
- selection of a basic indicator for assessing materiality;
- the establishment of absolute or relative quantitative thresholds of materiality.

Differences in the ways of evaluating materiality consist in sets of elements to which the concept of materiality is deemed applicable, basic indicators and the “thresholds” of materiality (Egorova, 2014). These differences, according to the researchers, arise from two factors: the type of company's economic activities (commercial, non-profit, insurance, financial services, leasing, etc.) and the type of services provided by the auditor (confirmation of reports, agreed procedures, review engagement, tax audit, etc.) (Bondarenko, 2002, Ghazaryan,. Sobolev, 2005, Ivanova, 2011, Makarova, 2013, Pugachov, 2013, Yudintseva, 2017, Zhelezniakova, 2013).

The shortcomings of existing methods of assessing materiality, as a rule, encourage specialists to search for new ones. Many experts note the lack of argumentation for choosing basic indicators, and, consequently, the subjectivity of this procedure (Makarova, 2013, Sitnikova, 2016).

Thus, according to L.G. Makarova, “the right of economic entities to independently determine the set of indicators by financial reporting items reinforces the relevance of the problem of identifying and disclosing material information in financial statements of business entities, as well as auditors control over the compliance of financial statements with the disclosure requirements. The lack of sound methods of assessing materiality results in an insufficient availability of information required by users of accounting (financial) statements ” (Makarova, 2013). It should be noted that the set of basic indicators and elements to which the concept of materiality is applied is limited to financial statements. This runs counter to the interests of information users, and we noted it in our earlier publications on the results of conducted research (Karzaeva, 2012).

Researchers draw attention not only to the subjectivity and groundlessness of basic indicators selection, but also to their values, taken to calculate materiality threshold (Egorova, 2014, Kharlamova, 2015, Makarova, 2013, Pugachov, 2013). In most cases, the indicators are calculated for a specified date (commonly, the end of the reporting year), which does not allow to take into account their dynamics and atypical situations that they may reflect. E.V. Kharlamova calls for the use of averaged indicators (for example, the average annual value of assets, etc.) and accounting the "normality" of the dynamics of basic indicators. The point is that if any atypical operation had influenced the basic indicator during the reporting period, this can result in distortion of information on the level of materiality” (Kharlamova,2015; Martins, 2018).

From our point of view, management plans that may change these indicators should also be taken into account in the assessment of the basic indicators adopted to estimate materiality.

The subjectivity in adopting “quantitative thresholds” to assess materiality was also mentioned as a disadvantage by some experts (Yudintseva, 2017, Zhelezniakova, 2013). But there is no unanimity on this issue. So, E.V. Kharlamova insists that “from a practical point of view, it would be inappropriate to recommend a quantitative threshold of 0.5%, 5% or 10% for all cases of materiality assessment. It is advisable to establish quantitative materiality thresholds based on the needs and interests of users, as well as on the intentions of enterprises to communicate the information on the

most important aspects of their activities to these users" (Kharlamova, 2015).

All the above-considered drawbacks of the existing methods of assessing the materiality encourage their modification, eliminating the subjectivity and ensuring the objectivity of all procedures. However, few researchers give attention to the causes of this subjectivity. It actually lies on the surface, and we noted it in our earlier publications (Karzaeva, 2012; Nasiri, et al 2014). The so-called "subjectivity" is a result of separating the procedure of materiality assessment from the persons in whose interests it should be carried out. This procedure is determined by the persons who produce and control the information. But the accounting and control procedures, in turn, depend on the adopted threshold of materiality. This circumstance can lead to a conflict of interests between decision-makers and those who produce information and confirm its qualitative characteristics. This conflict of interests is not obvious in the procedure of assessing the materiality. According to E.V. Kharlamova, "the use of the competence approach in determining the standard of materiality attaches importance to an accountant's professional judgment, while imposing an imprint of "subjectivity" on the information presented in financial statements, increasing information risk for financial statements users (Kharlamova, 2015).

Technically, the assessment procedure is carried out. But it is fully based on financial statements that managers do not take into account in making decisions, which is proof of a conflict of interest. Regardless of number of basic indicators used for the assessment of materiality, and their composition, existing methods do not allow them to be considered as responsive to the information needs of users. For making management decisions, financial indicators are used (Table 1).

Table 1: Key financial indicators of a company.

Financial indicator	Formula for calculating	Designations
Equity to total assets	E/FR	E – equity, FR – financial result
Level of financial leverage	(LTD+STD)/E	LTD – long-term debit STD – short-term debit E – equity
Interest coverage ratio	EBIT/IE	EBIT – earnings before interest and taxes IE – interest expenses
Debt cover ratio	EBIT/(LTD+STD)	EBIT – earnings before interest and taxes LTD – long-term debit STD – short-term debit
Liquidity coverage (working capital) ratio	CA/CL	CA – current assets CL – current liabilities
Price-to -sales ratio	P/S	P – net profit S – sales proceeds
Price-to -earnings ratio	P/E	P – price per share E – earnings per share
Profitability ratio EBITDA	EBIT/S	EBIT – earnings before interest and taxes, S – sales
Receivable turnover	S/AR	S – sales, AR – accounts receivable
Accounts payable turnover ratio	P/AP	AP – accounts payable, P – net profit
Earnings per share	(P – D) / n	P – net profit, D - preference dividends, n - number of ordinary shares
Share price to profit ratio	(Pr x n) / (P – D)	Pr- market price per share, P – net profit, D - preference dividends, n - number of ordinary shares

Therefore, to decide that the misstatement is material we suggest quantifying changes in financial statements resulting from their distortion or omission (Karzaeva, 2012). Materiality depends on the magnitude of changes that will affect managerial decisions. The threshold of materiality is established for each financial statement for a certain period of time (e.g., a year).

IV. DISCUSSION

Let us devise a formula for calculating the level of materiality for the price-to sales ratio, the threshold of its materiality is conditionally set at 0.01. The distortion of information about the volume of sales (its understating) (b) affects the indicators of net profit and sales proceeds. Taking into account the distortion (b), the previously generated data on the volume of net profit and sales proceeds should be increased by this value. Then the price to sales ratio will take the following form:

$(P+b) / (S+b)$ (1)

In accordance with the established materiality threshold, the deviation of price to sales ratio with a possible error should not exceed its value calculated without adjustment of 0.01:

$|(P+b)/(S+b) – P/S| < 0,01$ (2)

This equation allows to calculate the materiality level:

$|b| \leq 0,01S^2 : (0,99S - P)$ (3)

Substituting the values of sales proceeds and net profit for the previous period, we can calculate the error value and, therefore, the materiality level. All errors, exceeding the calculated value, should be recognized as material.

Formulas for calculating the level of materiality based on financial indicators are presented in Table 2.

It should be noted that the index approach proposed by us emphasizes that the professional judgment framework includes all errors considered above (in expenses, income, etc.).

Given the possibility of both positive and negative error value and the difference between financial statements, we take into account their absolute value and compare it with the criterion.

Table 2: General formulas for calculating the materiality level.

Financial indicator	Formula for its calculation	General inequation for calculating the materiality of error	Type of misstatement	Materiality level
Equity to total assets ratio	E/FR	$\lvert (E+y)/(FR+y) - E/FR \rvert < 0{,}01$	y –misstatement of expenses	$\lvert y \rvert \geq 0{,}01FR^2/(0{,}99FR-E)$
		$\lvert E/(FR+k) - E/FR \rvert < 0{,}01$	k–any mistake except misstatement in the amount of expenses	$\lvert k \rvert \geq 0{,}01FR^2/(E+0{,}01FR)$
Level of financial leverage	(LTD+STD)/E	$\lvert (LTD+STD+d)/(E-d) - (LTD+STD)/E \rvert < 0{,}01$	d – misstatement in the amount of borrowed funds when calculating interest	$\lvert d \rvert \geq 0{,}01E^2/(1{,}01E+LTD+STD)$
		$\lvert (LTD+STD)/(E-y) - (LTD+STD)/E \rvert < 0{,}01$	y–misstatement of expenses	$\lvert y \rvert \geq 0{,}01E^2/(0{,}01E+LTD+STD)$
Liquidity coverage (working capital) ratio	EBIT/(LTD+STD)	$\lvert (EBIT+d)/(LTD+STD+d) - EBIT/(LTD+STD) \rvert < 0{,}01$	d–misstatement in the amount of borrowed funds when calculating interest	$\lvert d \rvert \geq (0{,}01LTD^2+0{,}02LTD xSTD+0{,}01STD^2/(0{,}99LTD+0{,}99STD-EBIT)$
		$\lvert (EBIT-y)/(LTD+STD) - EBIT/(LTD+STD) \rvert < 0{,}01$	y – misstatement of expenses	$\lvert y \rvert \geq 0{,}01(LTD+STD)$
		$\lvert (EBIT)/(LTD+STD+m) - EBIT/(LTD+STD) \rvert < 0{,}01$	m–misstatement in the amount of borrowed funds except interest accrued	$\lvert m \rvert \geq (0{,}01LTD^2+0{,}02LTD xSTD+0{,}01STD^2/(EBIT+0{,}01LTD+0{,}01STD)$
Liquidity coverage (working capital) ratio	CA/CL	$\lvert (CA+z)/(CL+z) - CA/CL \rvert < 0{,}01$	z–any misstatement in the current assets and payables occurred simultaneously	$\lvert z \rvert \geq 0{,}01CL^2/(0{,}99CL-CA)$
		$\lvert (CA)/(CL+y) - CA/CL \rvert < 0{,}01$	y – misstatement of expenses	$\lvert y \rvert \geq 0{,}01CL^2/(CA+0{,}01CL)$
		$\lvert (CA+h)/CL - CA/CL \rvert < 0{,}01$	h–misstatement in the current assets, not resulting in a change in accounts payable (for example, accounts receivable, work in process)	$\lvert h \rvert \geq 0{,}01CL$
Price-to-sales ratio	P/S	$\lvert (P+b)/(S+b) - P/S \rvert < 0{,}01$	b–misstatement of sales volume	$\lvert b \rvert \geq 0{,}01S^2/(0{,}99S-P)$
		$\lvert (P-y)/S - P/S \rvert < 0{,}01$	y-misstatement in the expenses volume	$\lvert y \rvert \geq 0{,}01S$
Price-to earnings ratio	P/E	$\lvert (P+y)/(E+y) - P/E \rvert < 0{,}01$	y - misstatement of expenses	$\lvert y \rvert \geq 0{,}01E^2/(0{,}99E-P)$

V. CONCLUSION

1. The main condition for making informed economic decisions is the availability of reliable information. Materiality is the border zone separating reliable and unreliable information.
2. The concept of materiality is based on three components of the information process: information production, its use and quality control. In the accounting process, the concept of materiality is applied in identifying and classifying accounting objects, choosing accounting procedures, including correcting errors, detailing or aggregating statements and disclosing information in financial reports. The concept of materiality is also used in organizing the control activity and evaluation of misstatements. Thus, materiality is at the intersection of interests of different users of financial statements.
3. The materiality level is currently assessed by participants of accounting and monitoring processes. Our study revealed the potential conflict of interests between those who produce and control the quality of information, on the one hand, and, on the other hand, those who use the information to make managerial decisions.
4. All the methods of assessing materiality are conditionally divided into three groups: the first are based on the deductive approach, the second - on the inductive approach, the third includes combined approaches. However, all the assessment methods consider financial statements, which are the subject of both accounting and monitoring activities, as indicators for assessing materiality. Selection of these indicators lays at the base of the differences in ways of assessing materiality.
5. Based on the analysis of methods of calculating materiality, we have summarized their principal drawbacks:
- subjectivism in adopting criteria of materiality,
- no consistency in argumentation for the selection of indicators and level of their materiality,
- subjectivism in adopting "quantitative thresholds",
- failure to take into account the dynamics of indicators during the reporting period,
- limited understanding of users needs for information.

We have identified two more drawbacks. First, by calculating and implementing the materiality level, accounting and control functions can be optimized to the detriment of users' interests. Secondly, the materiality level may be influenced by the plans of company's management for subsequent periods.

6. All the shortcomings of the existing methods of assessing materiality are due to the same cause: direct interest of persons applying these methods. These methods are all based on the functional approach, involving appropriate procedures based on the materiality concept. In order to address the conflict of interests between participants in the information process, we suggest to apply a target-specific (or indicator) approach to the assessment of materiality level.

7. The indicator approach to the assessment of materiality level consists in using the indicators considered by the company managers in making their decisions.

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