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The Current Relevance of Materiality: Voluntary Reporting, Fraud, Blockchain and Co-Operative Compliance

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ABSTRACT: *A literature review is performed on the current context of materiality. The concept of materiality is used mainly as a financial measure. In current company environment financial measures are only a part of the application of materiality levels. The current relevance of materiality is discussed based on the developments of voluntary reporting, fraud, blockchain and co-operative compliance. It is concluded whether materiality is outdated in the current company context.*

Keywords: *Materiality, voluntary reporting, fraud, blockchain, co-operative compliance, corporate social responsibility*

I. INTRODUCTION

The importance of integrated reporting is increasing for companies considering a societal perspective. The concept of integrated reporting is in scientific literature referred as voluntary reporting: the reporting of non-accounting information beyond the laws and regulations. For normative accounting voluntary reporting creates a new perspective. Where the reporting of IFRS is more and more globally accepted, voluntary reporting does not necessarily fit into IFRS. This caused by the type of information reported. The annual report used to be mainly the financial statements, disclosures and some additional less specific texts

Over the past decades the best-practice for reporting has been shifted to non-financial information. Voluntary reporting has stimulated the reporting of societal information. Examples are information of the footprint of the company and child labor. It is easy to make a statement that the footprint is a numerical value or that there is no child labor applicable within the company. The board of directors is responsible that the reported information is accurate. It is questionable whether the board of directors (or the external auditor) can actually make a statement about certain non-accounting information. Moreover, what if a statement is to some extent different from reality?

For financial statements differences are audited with usage of materiality: a percentage of a financial measure is determined as the maximum tolerable misstatement. For non-financial information the issue of materiality is more complex. For the example of the footprint it is possible to consider a percentage of the total foot print as tolerable misstatement. For the example of child labor it is more unclear. The materiality of zero (no child labor) is resulting theoretically in that every aspect of the company has to be considered when making a judgement about child labor. This is contradicting with the concept of materiality. The concept of materiality is initiated to focus on high risk aspects of the company: the amounts not considered relevant for stakeholders are less extensive or not at all audited. For voluntary reporting this is not in all circumstances possible to apply such a numerical measure. This paper aims to reconsider the existence of the materiality concept and make critical notes on the use of materiality in the current normative accounting context. A literature review is conducted considering materiality both form an economical and legal perspective and consider the application of materiality in the context of recent and current accounting and audit developments.

II. MATERIALITY – ECONOMICAL

The concept of materiality is investigated from different perspectives. Professional judgement is the basis of materiality. Judgement creates different interpretations when different individuals consider the same aspect. In reporting frameworks there is no rule of thumb for materiality. Consequently, the relevance of the applied materiality is a matter of discussion. Financial statements are prepared and audited with a predefined materiality. Separate financial statements have different materiality levels, even when the financial statements are from comparable companies within the same industry. This is the core of the problem: the lack of guidance on the materiality results in products with an arguable reliability level. Moreover, the applied materiality level is not published by companies and/ or their external auditors. Although, countries as the United Kingdom and The Netherlands have introduced the obligation to report on the applied materiality at public interest enterprises. Economic powers like the United States and Germany are not reporting publicly about materiality. The concept of materiality is therefore applied inconsequently in an international context.

The consequence of inconsequently applying materiality lies in the economic value of the aspect audited. The higher the materiality the less differences are considered important. This does not necessarily mean that the financial statements are giving no fair view of the company. It only implies that the financial statements are less thoroughly audited and therefore are more vulnerable for (smaller) unidentified misstatements.

III. MATERIALITY – LEGAL

The U.S. Supreme Court mentioned that ''an omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in making an investment decision''. This definition of materiality from a legal perspective is outdated. In current societies the application of materiality goes beyond investor decisions. Companies are considered to perform their societal duties. Besides, there are companies that have no commercial incentive at all. Examples are social housing companies, hospitals and non-commercial healthcare companies. For these companies the basis for defining the materiality is mostly the revenues as this determines the social impact. The profits are of less importance for such companies. Consequently, the legal definition applied by U.S. court is not current. The definition in the U.S. might stem from the lack of semi-government organizations. With the introduction of Obamacare this might increase in importance. A country with relative more semi-government organizations without the purpose of profit is the Netherlands. The Dutch definition of materiality is different from the definition in U.S. court. In the Netherlands the "investor" is replaced by "users of the financial statements". Therefore the relevant group is broader than just investors. This also widens the legal obligation of the auditor. However, it is in accordance with accounting regulations, also in the U.S.. In recent cases the U.S. supreme court referred to the definition of materiality in accordance with these regulations.

No matter the definition of materiality, legal proceedings about materiality application could occur. The professional judgement of the auditor creates many interpretations of materiality. Disagreement could easily arise in court about the materiality of misstatements. From a legal perspective materiality considerations are sufficient when there is a substantial likelihood that the applied materiality is reasonable. Moreover, this likely materiality is applied on the reasonability of estimates. Legal claims also occur when there is a lack of materiality documentation: communication of audit information is one of the crucial aspects in legal materiality considerations.

IV. CURRENT DEVELOPMENTS

Recent developments and fast changing technologies altered the business environment. Companies has to follow major developments to stay in the lead. An aspect that has been applied for many year is materiality. It is only limited influenced by the changes in business environment. However, there are some developments that might require changes in the application of the materiality concept. The concept of materiality is based on numerical aspect. Not all items can be audited based on numerical aspects.

A. Voluntary reporting

One aspect where the numerical aspect is less clear is in voluntary reporting. The concept of voluntary reporting goes beyond financial measures. Voluntary reporting is about corporate social responsibility (CSR) and the reporting about CSR. Voluntary reporting consist of reporting several aspects indicating the social handling of companies. The reporting of voluntary information is not rule-bound and therefore the reported information is hard to compare between companies.

Voluntary disclosure increased as a result of the introduction of IFRS. Company characteristics are influencing voluntary reporting. Research find that top management executives has significant impact on voluntary reporting. More voluntary information is reported when the proportion of independent directors on a board is high. The extent of voluntary reporting is influenced by the country a company is headquartered: UK companies are intended to report more voluntary information than German and US companies. The amount of voluntary reporting might also be influenced by the company's economic position. Besides, voluntary disclosures have negative consequences. The introduction of voluntary disclosure initially causes increased tax evasion. The quality of voluntary reporting is positively influenced by the audit of the voluntary disclosures.

The audit of voluntary information is troubling when it is non-accounting based. In such a circumstance the materiality is applied as a social and behavioral phenomenon reflecting the divergent organizational priorities. Companies are more than profit centers. Companies are collections of people and could therefore have a large impact on societies. Company activities are important for societies. Reporting on company behavior is of importance for societies. Voluntary reporting is not necessarily accounting based. For example, companies operating in third world countries report about child labor. In such a circumstance it is reported that no child labor has occurred or that child labor has occurred but counter actions were applied.

One could argue that for child labor a materiality level of zero is applied. However, the realism of this arguing passes the meaning of materiality. The concept of materiality is defining what is considered an amount influencing the decisions of investors. Moreover, the materiality is the amount to determine the level of activities to perform. Setting the materiality at zero results in auditing all locations all over the world every day of the year for a specific company. This is obvious not the purpose of materiality; having no materiality at all has the same result on the amount of work performed.

So, materiality should be reconsidered when there is no monetary aspect. Auditing all activities is not the solution. For voluntary reporting some kind of materiality is applied, however, it is more based on professional judgement than the financial materiality. This higher reliance on professional judgement is also visible in changes in voluntary reporting materiality: auditors alter the voluntary reporting materiality in different directions when new circumstances are judged. The higher the reliance on professional judgement the less re-performability is possible. Moreover, what is considered material for voluntary aspects is different per country and even per industry. The materiality for voluntary reporting requires a holistic approach: the selected materiality for voluntary reporting is a consideration of the perceptions and expectations of stakeholders. This notion is in accordance with the notion in the legal materiality section, where was noted that "investors" might be not the appropriate term for legal proceedings.

From both the legal and economic perspective there is a solution proposed. Eccles & Youmans proposed the application of a "Statement of Significant Audiences and Materiality". In this statement the views of the corporate board are formulated showing stakeholders for both accounting and non-accounting information the considerations in determining materiality. Another principle proposed is the creation of guidelines for applying materiality on non-accounting matters.

B. Fraud

Another aspect with and without numerical aspects is fraud. The occurrence of fraud within a company is always undesirable, whether a fraud with monetary value or without monetary value occurs. In the auditing landscape the fraud triangle gives insight on fraud considerations. As fraud is undesired, one could argue that a separate materiality of zero is applied in such a circumstance. This is a doubtful conclusion as not all frauds has a monetary value (for example, fraud in documentation).

Fraud is always material no matter a quantitative or a qualitative aspect occurs. On fraud there is no materiality applied. The most effective department for discovering fraud is the internal audit function. Procedures are applied that doesn't involve materiality. For instance, transactions outside the regular business times represent a greater indication for fraud than any materiality standard can indicate. The fraud triangle generally applied has more indicative value for fraud detection than materiality.

C. Blockchain

A fast developing phenomenon is blockchain. Many banks consider blockchain the future of accounting. Blockchain is considered a change in both the accounting and auditing industry. The risk management of companies is changed by blockchain. Blockchain is the matching of administrations dispersed over different computers. If a transaction is requested in the administration the amounts on the different computers are matched ensuring that the requested amount hasn't been altered. This method of accounting should ensure the integrity of administrations.

The aspect of materiality is not necessarily changed by blockchain. Scholars consider blockchain the end of auditors. Scholars has been considering changes in accounting the end of auditing for decades. This shows the lack of scientific understanding about auditing. Accounting and auditing are related, not the same. Changes in accounting alters auditing. It does not make auditing disappear as auditing is the practice of ensuring the integrity of the financial statements, which could not be performed by an internal employee. A parallel is the movement from administrations on paper to digital administrations. This was also considered the end of auditors. As this only was a change in accounting, the auditing profession didn't disappear, it changed. This is also the case for auditing and therefore materiality. Blockchain ensures the integrity of data. This is only one aspect of the auditors work. Moreover, it doesn't impact the application of materiality. There is still need for a threshold defining what is considered a unacceptable mistake in the financial statements. The need for materiality stays. Blockchain could lower risk on certain transactions, new accounting risks might occur when blockchain is applied on large scale. In addition, changes in specific risks itself do not change the materiality level. Therefore the blockchain discussion is relevant for accounting and auditing; materiality stays relevant in a blockchain company.

D. Co-operative compliance

Many countries has implemented a form of co-operative compliance. The OECD initiative is changing tax considerations. Taxes used to be accounted based on manual calculations and audited based on detailed testing. The internal controls were not considered in tax accounting. The co-operative compliance initiative has obliged companies to change the approach on tax accounting. National tax administrations has published their perspective on tax controlling. Tax controlling is a basic requirement for participating in co-operative compliance.

As the approach on co-operative compliance is determined per national tax administration, the procedures for complying with the co-operative compliance regime is different per country. In the United Kingdom the tax administration has set specific guidelines on co-operative compliance. Meeting these guidelines results ultimately in unaudited tax filings. This requires such an internal control environment that the accuracy of tax accounting is ensured. Another approach on co-operative compliance is applied by the Dutch tax administration. The Dutch tax administration has no guidance specifically stating the requirements of a tax control framework. Consequently, it is possible to comply with the Dutch co-operative compliance approach, however, it is not possible that the tax administration is not auditing the tax filings.

The co-operative compliance approach impacts the application of materiality as there is a new aspect in tax: tax controlling. Tax administrations used to rely on detailed work and performed tax audits risk based (size/ revenue and indications for mistakes). Once there was one difference found – no matter the size – the tax administration started a more extensive tax audit. So a materiality of zero was applied. This situations is still applicable for companies not participating in co-operative compliance. The tax administrations apply a slightly different materiality approach for co-operative compliance. Let's consider again two extremes. The UK tax administrations has the policy of relying on the tax payers tax internal control environment if it meets all requirements. Therefore no materiality is applied: there is no detailed tax audit applicable. The Dutch tax administration audits no matter the level of tax control framework. When it decides to do so, it applies the same materiality as before: zero. So depending on the specific tax administration the application of materiality changes.

V. CONCLUSION

The concept of materiality is mainly used as a financial aspect to guide the extent of work on financial statements. Recent developments has put pressure on the materiality concept. From an economical/ legal perspective the view of a reasonable ground for materiality has been moved from the investor to the stakeholder. Financial considerations are too narrow for accounting/ auditing. Voluntary reporting, fraud, blockchain and co-operative compliance influence materiality theory and practice.

The main difficulty lies in the unclear standards for the separate developments. Voluntary reporting has to a limited extent guidance for audits and applying materiality. Voluntary reporting is not outdating materiality, it is changing the method of determining materiality. Future scientific research could focus on identifying the different materiality and accounting/ audit approaches applied to create a framework for applying materiality on voluntary reporting.

Fraud is an aspect that already requires another perspective on materiality. Where materiality is relevant for a risk based approach on financial figures, for fraud other procedures point to the relevant risk transactions. Blockchain is changing administrations, it is not fundamentally changing accounting/ auditing. Therefore the materiality concept is mainly unchanged by the introduction of blockchain. Future scientific research could focus on whether different perceptions on the materiality level occur as a result of the introduction of blockchain. To my opinion blockchain is just a change in accounting/ audit method and should not impact materiality. The final aspect is co-operative compliance. This aspect is not outdating materiality. It is extending materiality. The materiality should be determined for taxes where in the past the materiality was standard zero. Future research could focus on how tax materiality develops.

To conclude, the concept of materiality is not new. It is neither outdated. The application of materiality is changing as it currently should not only represent financial aspects. Non-accounting aspects become important for considering materiality. As materiality is only applied differently by these changes, but is not unused, the concept of materiality is still relevant. Moreover, materiality is more relevant than it used to be as the focus on materiality increased by recent developments.

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