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Increased materiality judgments in financial accounting and external audit: a critical comparison between German and international standard setting

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Abstract: The materiality principle supports the information function of accounting in order to enhance investors' decisions. Therefore, materiality guides the entity to present relevant information and to prevent information overload. This decision is mostly subjective and is based primarily on the individual's judgement in applying vague legal concepts. This could result in a greater expectation gap between management information and investors' understanding. The EU accounting directive 2013/34/EU standardises materiality to harmonise with International Financial Reporting Standards (IFRS). However, the German legislator did not change the national accounting rules German Commercial Code (GCC). Moreover, the new EU audit regulation (EU) No 537/2014 requires the disclosure of the quantitative level of materiality thresholds in the audit report. Guidelines remain inadequate, although they are intended to provide clearly defined rules and to avoid boilerplate checklists. Our paper focuses on a conceptual comparison of materiality between the GCC and IFRS/ISA, and on the implications for eliminating the challenge involved in information overload.

Keywords: materiality; financial accounting; external audit; International Financial Reporting Standards; IFRS; International Standards on Auditing; ISA; German accounting.

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1 Introduction

International accounting and auditing standards such as the International Financial Reporting Standards (IFRS) and International Standards on Auditing (ISA) aim to increase the international standardisation in financial accounting and external audit. Consequently, financial reporting concentrates on providing a true and fair view of the firm. Companies achieve this true and fair view principle by executing a fast close in order to improve the decision-usefulness for the investor's decision-making by delivering significant information 'asap' (Hoffmann and Lüdenbach, 2012). Preparers and auditors have to judge whether information is material or not, which constitutes a highly subjective decision. To solve this problem, the new EU directive 2013/34/EU, which substituted the former Fourth and Seventh EU directives, focuses on materiality. It constitutes an explicit standardisation in the recognition, measurement, presentation, disclosure and consolidation of financial statements. The EU member states could choose to apply a codification of all fields (as mentioned above) or one limited to presentation and disclosure. The EU directive defines materiality as "information whose omission or misstatement could reasonably be expected to influence decisions that users make on the basis of the financial statements of the undertaking. The materiality of individual items shall be assessed in the context of other similar items" (EU directive, section 2 no. 16). This EU demand restricts national codification to the IFRS, which already governs the principle of materiality in the conceptual framework and in IAS 1. It also recommends a decision-relevant disclosure. The GCC has not standardised the principle of materiality centrally as it did with the principle of going concern as generally accepted accounting principles (GAAP). However, the GCC refers to it in several individual sections, which require a material judgement (Kreipl, 2013). Also, the question of how much information is to be disclosed regarding a true and fair view vs. information overload has been raised with the IASB in the disclosure initiative on 29 September 2014. One suggestion for solving this problem is based on a publication by EY who suggests that following the structure, adapting individual reports and applying materiality would result in a balanced and highly useful report (EY, 2014). The new EU audit regulation no. 537/2014 also recognises the increasing relevance of materiality in terms of the disclosure of the quantitative level of materiality applied in the audit report.

Our paper addresses a conceptual-based comparison between the interpretation of materiality in the GCC, and in the IFRS and US GAAP (chapter 2). Then, the application of materiality thresholds in German auditing standards will be compared with that of the ISA (chapter 3). Traditionally German accounting and auditing research during the last century was very normative and conceptual-based. Due to an increasing harmonisation with IFRS and ISA, the German accounting and audit research community opened to quantitative empirical studies (archival studies) and even methods of qualitative methods (e.g., interviews, surveys, experiments). Our comparison is conceptual-based but includes significant results of empirical studies from over the world. The last chapter summarises the results and offers recommendations for the application of the principle of materiality.

2 Materiality in financial accounting

2.1 German commercial code (GCC)

Materiality has not been explicitly standardised under GCC, but recognises it as an auxiliary GAAP (Hirschberger and Leuz 2012; Draxler and Kuntner, 2010). As a vague legal concept, it relativises codified GAPP, such as fair presentation and clarity, insofar as irrelevant information should not be disclosed for efficiency purposes. During the preparation of the financial statements, immaterial information that offers no benefit in decision-making for the stakeholder can be left out (Leffson, 1987; Ossadnik, 1993a; Hoffmann, 1995), which presumes an analysis of costs and benefits. If a larger number of entities preparing accounts aimed to recognise accounting items precisely when costs increase, the marginal utility could increase for the stakeholder of the financial disclosure. As preparers have to differentiate between significant and subordinate facts, upper and lower limits of disclosure are implied in order to guarantee efficient reporting (Mekat, 2009). The inclusion – or exclusion – of information requires highly subjective management judgement. This judgement is open to a wide scope of interpretation and application, resulting in the need for a disclosure policy. Therefore, a more precise approximation of a bright-line rule exercise [EY, (2014), p.17] is required for the application of materiality. This application would provide preparers and auditors with guidelines of judgement in order to achieve a high degree of standardised accounting and to reduce reliance on an appropriate level of discernment (IASB, 2014). By law, materiality is therefore limited by the true and fair view principle (section 264 para. 2 GCC) and consistency (sections 246 para. 3, 252 para. 1, no. 6 and 265 para. 1 GCC), deducing the upper limit of reporting means defining immaterial information which may be left out of disclosure. Thus, an insufficient exclusion of insignificant issues would result in information overload and could consequently obscure decision-relevant facts (EY, 2014).

Many experts have previously discussed whether or not the principle of materiality should be centrally codified in the GCC. It is argued that the GCC was intended to serve multiple functions and the principle of materiality is regarded in numerous sections. Consequently, there is no need for further standardisation. This justification is based on the understanding that the main purpose of the GCC is creditor protection, which is highlighted in the principle of prudence and realisation (section 252 para. 1, no. 4 GCC); hence, the principle of materiality must be subordinate (Scheffler, 2007). On the other hand, materiality has a greater significance in terms of presentation, disclosure and consolidation, supporting the information function of financial accounting. The true and fair view, which is only mandatory for corporations and not for all firms in Germany, is basically linked to materiality with the component 'fair'. This link results in an actual insight into the company's assets, finance and earnings and espouses the information function (Niehus, 1981; Ossadnik, 1993b). Section 264 GCC imposes a merchant's duty of preparation of financial statements (section 243 para. 1 GCC) in compliance with German GAAP.

Shortly after transforming the fourth and seventh EU directives in 1985, the German legislator implemented materiality in several GCC sections, but had not codified it explicitly as GAAP (Biener and Berneke, 1986). Compared to other GAAP, materiality receives less attention in the literature (Claussen, 2011). Table 1 summarises the application of materiality in the GCC (Mekat, 2009).

Table 1 Materiality in individual sections of GCC

GCC	*Accounting topic*	*Content*
Section 240 para. 3 and 4, section 256	Permanent evaluation	Total value is of *minor importance* for the enterprise
Section 241	Sample inventory	Ascertained by means of recognised statistical methods based on random *sampling*
Section 255 para. 2 clause 1	Cost of production	Expenditures arising as a result of consumption of goods and use of services for the production of an asset, its expansion or *substantial* improvement beyond its original condition
Section 256	Procedures for simplifying valuation (LiFo, FiFo)	Valuation of *similar* inventory assets
Section 256a	Currency conversion	Remaining maturity of *one calendar year or less*
Section 264 para. 2 clause 1	True and fair view	Present a factually accurate picture of the corporation's net assets, financial position and results of operations in accordance with generally accepted accounting principles
Section 265 para. 7 no. 1	Aggregation of items of the balance sheet or p/l	An amount which is *not significant* for providing a factually accurate picture
Section 268 para. 4 clause 2	Notes	If amounts are shown under the 'other assets' item for assets that do not become legally existent until the close of the fiscal year, these amounts should be discussed in the notes provided that they have a larger scope
Section 268 para. 5 clause 3	Notes	If amounts are shown under the 'other liabilities' item that become legally existent only after the close of the fiscal year, these amounts should be discussed in the notes provided that they have a larger scope
Section 277 para. 4 clause 2	Notes	Explanation of 'extraordinary income' or 'extraordinary expenses', if the amounts shown are not of minor importance for the assessment of the income situation
Section 284 para. 2 no. 4	Notes	By application of section 240 para. 4 and section 256 clause 1 the amount of difference shall be shown in a lump sum for the respective group if the valuation shows a substantial difference compared to a valuation based on the last known exchange price or market price before the close of the fiscal year
Section 285 no. 3	Notes	Type and purpose and risks and advantages of transactions not included in the balances sheet provided that this is required for the assessment of the financial position

Table 1 Materiality in individual sections of GCC (continued)

GCC	*Accounting topic*	*Content*
Section 285 no. 3a	Notes	Total amount of other financial obligations which are neither included in the balance sheet nor to be disclosed pursuant to section 251 or no. 3, provided that this disclosure shall be required for the assessment of the financial positions
Section 285 no. 4	Notes	Breakdown of the turnover to the extent that the lines of business and geographically defined markets differ substantially from each other
Section 285 no. 9c)	Notes	the interest rates, the material terms and, where applicable, the amounts paid back in the fiscal year and contingencies and commitments entered into in favour of these persons
Section 285 no. 12	Notes	Provisions not shown separately in the balance sheet under the item 'other provisions' shall be discussed if their size is not insignificant
Section 285 no. 21	Notes	At least those transactions with related parties which were not entered into arm's length conditions, provided that they are material
Section 286 para. 2	Notes	Omitted, provided that the classification tends to inflict substantial disadvantage on the corporation or the enterprise
Section 286 para. 3 no. 1 and no. 2	Notes	Omitted, provided that they are of minor importance for presentation of the state of net assets, financial position and results
Section 289 para. 1 clause 3	Management report	Including the most important financial performance indicators for the company's business
Section 289 para. 1 clause 4	Management report	Assesses and explains the company's foreseeable future development with its material opportunities and risks
Section 289 para. 2 no. 1	Management report	Events of particular importance which occurred after the end of the year
Section 289 para. 2 no. 2a), b)	Management report	With regard to the use of the financial instrument by the company, provided that it is of relevance for the assessment of the position or presumable development
Section 289 para. 3	Management report	Including the most important non-financial performance indicators for the company's business
Section 289 para. 5	Management report	Material characteristics of the internal control and risk management system with regard to the accounting process
Section 294 para. 2 clause 1	Scope of consolidation	Composition of the enterprises has substantially changed
Section 296 para. 2	Inclusion of subsidiaries	A subsidiary does not need to be included in the consolidation financial statements if it is of minor importance with regard to the obligation to provide a factually accurate picture of the net assets, finance position and results of operations

Table 1 Materiality in individual sections of GCC (continued)

GCC	*Accounting topic*	*Content*
Section 299 para. 3	Content and form of consolidated financial statements	If an enterprise with a different close of the fiscal year is not included in the consolidated financial statements, transactions which took place shall be taken into account, provided that these transactions are of particular importance for the net assets, financial position and results of the operations of an enterprise
Section 301 para. 3 clause 2	Notes	Items and material changes from the previous year shall be discussed in the notes
Section 303 para. 2	Debt consolidation	Waiver if the amounts to be omitted are of only minor importance for the presentation of a factually accurate picture of the net assets, financial position and results of operations of the group of companies
Section 304 para. 2	Treatment of interim results	Waiver if the treatment of interim results pursuant to para. 1 is of only minor importance for the presentation of a factually accurate picture of the net assets, financial position and results of operations of the group of companies
Section 305 para. 2	Consolidation of expenses and revenues	Waiver if the amounts to be omitted are of minor importance for the presentation of a factually accurate picture of the net assets, financial position and results of operations of the group of companies
Section 308 para. 2	Uniform valuation	Waiver if its impact on the presentation of a factually accurate picture of the net assets, financial position and results of operations of the group of companies is of only minor importance
Section 311 para. 2	Associated enterprises	Waiver if inclusion is of only minor importance for the presentation of a factually accurate picture of the net assets, financial position and results of operations of the group of companies
Section 313 para. 2 no. 4	Notes	importance for the presentation of a factually accurate picture of the consolidated company's net assets, financial position and results of operations (material defined as held by a parent or subsidiary listed on an exchange or a person acting for the account of one of these enterprises and if these participations exceed five percent of the voting rights)

Materiality can be expressed as (in)significant, (un)important, (un)essential, disclosure relevance, and decision useful, which results in an individual interpretation and application of accounting rules. A closer look at the various rules above reveals a greater connection to terms of disclosure than to recognition, which is exempted by consolidation issues. Further sources are mentioned in the German Stock Corporation Act, such as p.e. section 256 para. 5 and sections 258 ff. Also, civil law jurisdiction applies the principle of materiality while evaluating accounting mistakes (LG Frankfurt am Main, 2001).

A broad agreement has been reached in the literature in the construction of materiality, which requires the understanding of the stakeholders. *Leffson* proclaimed that during the preparation of financial statements all facts that could potentially influence the decision of stakeholders should be recognised (Leffson, 1987). Materiality is therefore determined by the ability of the addressee to understand the information, which may result in the worst case of information overflow. The challenge of regulating an appropriate level of detail in terms of disclosure, for a heterogeneous group of stakeholders with varying information needs, results in the problem of deciding when to stop. If information overflow occurs, stakeholders could be unable to discern the significant information; in a worst-case scenario they may exclude important facts from their decision-making process (Berndt, 2005). Conversely, studies reveal the dilution effect, whereby additional information can cause unintended decision behaviour (Haynes and Kachelmeier, 1998). For instance, addressees may mistrust an overload of information in management reporting. In practice, companies should therefore consider such potential side effects when devising their disclosure policies, and be mindful of how they display themselves.

Despite the economic need to include the principle of materiality, we have shown that there can be discrepancies in the application and interpretation which call for highly subjective judgement, although the literature has proposed a behavioural, informational, financial and capital market-orientated solution (Ossadnik, 1995). Universally valid thresholds and guidelines are limited due to the diversity and individuality of accounting information. The literature reveals a broad consensus on depreciating absolute thresholds in light of a comparability gap (Ossadnik, 1995). Low-value assets – i.e., assets below the threshold generally accepted under GCC – are exempted, according to section 6 para. 2, 2a German Income Tax Law (Haaker and Brösel, 2009).

Hirschberger and Leuz (2012) suggest a haircut of one percent from the total assets benchmark. Nevertheless, there are also criticisms in the literature concerning the relative minimum and maximum thresholds regarding the safe haven concept (Ossadnik, 1993b).

Due to the main influence of creditor protection and prudence (section 252 para. 1 no. 4 GCC), Adler et al. (1995) described materiality in the light of earnings management as follows: a high level of profits should be excluded from disclosure, which results in a moderate level of materiality judgement; conversely, losses should always be strictly recognised, resulting in a lower level of materiality. Winkeljohann and Schellhorn (2014) indicate several quantitative measurements used to apply thresholds for materiality, which they deduced using the true and fair view principle according to section 264 para. 2 GCC:

- at least 10% of annual profit and loss (resp. 5% of EBT) and additionally 0.25% of balance sheet assets
- at least 5% of balance sheet assets
- at least 10% of other items that could materially influence the judgement of management.

The lack of one overarching threshold in practices has already been demonstrated by *Ossadnik's* study, in which he investigated the 100 largest industrial firms (Ossadnik, 1995).

The reform of the GCC in 2009, which approximated HGB to IFRS by decoupling commercial and tax codes (Freidank and Velte, 2009), purposely failed to codify the principle of materiality (der Hochschullehrer Rechtswissenschaft, 2008). Following this trend, the German Accounting Standard (GAS) no. 20 named the principle of materiality in the management reporting of group companies (GAS 20.32–33). This milestone anticipated the EU directive in terms of disclosure in order to cope with information overload. In comparison with the GCC, non-incorporated entities are not strictly obligated to apply the GAS 20, but have to recognise its recommending influence (Förschle, 2014).

As part of the discussion surrounding the extent of standardisation (from recognition to disclosure), authors have debated several possibilities, such as a codification of a general norm, as in section 243 GCC, which would include every merchant (Velte, 2014; Velte and Haaker, 2014). The Institute of Public Auditors in Germany ('IDW') favoured a dedicated section on materiality, because this unwritten principle is used generally and is repeated in several individual sections (IDW, 2014). Furthermore looking to the auditing sections such as section 317 para. 1 GCC, it is postulated by law that the definition of materiality can be scrutinised. The Accounting Standards Committee of Germany (ASCG) countered that the principle of materiality is omnipresent in several sections of the HGB and therefore preparers would apply it automatically (ASCG, 2014). Consequently, they refused a codification which would steadily transform the HGB to Anglo-American case law. Due to existing individual sections on materiality, a codification would only serve the avoidance of doubt, but nothing more. Independently of the EU directive, materiality is applied for recognition and measurement (Table 1). Finally, the EU directive was transformed in German accounting law in summer 2015 and the principle of materiality was not standardised. The existing rules are sufficient to transform the minimum requirements on 'presentation and disclosure' set by the member states (Freidank and Velte, 2013).

2.2 IFRS

German individual financial statements are used for information, distribution and taxation (Freidank and Velte, 2013), whereas IFRS are strictly informative. Hence, the IASB conceptual framework explicitly declares the principle of materiality and defines it in QC 11 as follows: "information is material if omitting it or misstating it could influence decisions that users make on the basis of financial information about a specific reporting entity". In other words, materiality is an entity-specific aspect of relevance based on the nature or magnitude, or both, of the items to which the information relates in the context of an individual entity's financial report. Consequently, the IASB cannot specify a uniform quantitative threshold for materiality or predetermine what could be material in a particular situation. Due to the main purpose of IFRS accounting being disclosure, materiality is therefore emphasised in German accounting to provide clarity and include decision-useful information.

IFRS assumes that material information can influence the decisions of shareholders, who make decisions based upon financial facts resulting from an analysis of IFRS financial statements (OB2 f.). As mentioned above, the IFRS defines materiality as being entity specific; additionally, the IASB excludes any quantitative thresholds due to the inherent limits of comparability and 'boilerplate thinking'. In fact, materiality judgement integrates all circumstances of the company (Wawrzinek, 2013). Based on US accounting guidelines, attempts have been made to determine quantitative thresholds for IFRS purposes, whereupon cash flow, equity or inventories are consulted as benchmark (Wawrzinek, 2013). More general thresholds apply in the event of loss, cash out or by opening a new business segment. Contrary to German accounting principles, Baetge et al. (2013) propose basing thresholds on absolute or relative annual statement figures.

In addition to the conceptual framework, IAS 1.29 defines materiality thus: "An entity shall present separately each material class of similar items. An entity shall present separately items of a dissimilar nature or function unless they are immaterial". In the process of aggregation, each item has to be judged on its disclosure relevance. Moreover, immaterial information can be aggregated so that it becomes significant enough to warrant disclosure in financial statements, or even if it still lacks decision-relevance for financial statements it could be relevant for inclusion in the notes (IAS 1.30). If the information is still without relevant influence, it is not to be included (IAS 1.31). IAS 8 defines materiality as a limit of tolerance for recognition and measurement (Baetge et al., 2013).

The principle of materiality primarily grounds the information function of accounting statements in German and international standards in terms of disclosure interpretation – except in matters of GCC consolidation (Mekat, 2009). Although materiality is standardised centrally in the conceptual framework and IAS, interpretation of this concept still raises questions in relation to GCC and tax law. The subjective judgement opens the door for a wide range of accounting policies due to the freedom of judgement involved. In comparison to national law, IFRS offers advice on how to deal with immaterial items in accounting matters and explicitly outlines the exclusion of insignificant facts.

2.3 US GAAP

Our current understanding of the principle of materiality is based on the US-American accounting system, because it heavily influenced the IFRS principles (Freidank/Velte). The principle of materiality was first declared in the Rule 10b-5 of Sec. 10 (b) of Securities Exchange Act (SEA) from 1934 (Mekat, 2009) and means the judgement of limitation of liability. 17 CFR 210.1-02 lit. o (Regulation S-X) defines materiality as follows "The term material, when used to qualify a requirement for the furnishing of information as to any subject, limits the information required to those matters about which an average prudent investor ought reasonably to be informed". This definition opens various interpretations which were misused in the past, p.e. accounting scandals. The Financial Accounting Standard Board (FASB) recognised the problem of misinterpretation and published the statement of financial accounting concept (SFAC) no. 2 in Mai 1980. The FASB clarified that quantitative threshold should not solely be used for the judgement of materiality (SFAC 2.131). The judgement of materiality is rather an experienced human judgment, which contains beside quantitative also qualitative facts (Mekat, 2009).

The US-American case law emphasised a qualitative judgement of materiality, which interprets the principle through the eyes of the investors. The Securities and Exchange Commission (SEC) also recognised the need to clarify the principle and issued the Staff Accounting Bulletin (SAB) no. 99 on 12 August 1999. The SEC considered the case law and, in contrast to German accounting rules, does not differentiate between accounting and auditing standards. SAB 99 allows the use of quantitative thresholds but also recognised their limitations clearly; therefore they should only be the first orientation. After calculating a threshold the users should evaluate the result and consider in their judgement of materiality also qualitative facts.

The US-GAAP and SEC publications define the principle of materiality like the IFRS. The investors and their information needs are more in focus. In comparison to the IFRS and GCC, the US-American accounting rules are more influenced by case law and are less principle-based, therefore the rules refer to past court decisions. In comparison to German rules, the US-American do not differentiate between accounting and auditing rules, in order to define the principle.

2.4 The disclosure initiative: materiality applied with the IFRS notes and implications for companies reporting under GCC

The IASB recognises the heterogeneous interpretation (Houghton et al., 2011) of materiality in IFRS notes, causing subjective judgements and obstructing a fair presentation in terms of standardised corporate reporting (IASB, 2014). This problem has already been examined in practice; for example: the European Securities and Markets Authority (ESMA) interrogated preparers and auditors about the principle of materiality in November 2011. They concluded from the answers given that there is an overall understanding of the concept but that, due to subjective judgement, it is applied heterogeneously and creates differences (ESMA, 2013). Preparers have concerns about the extent of the notes demanded, which may result in an information overload. To solve this, appropriate application of materiality is required; hence, ESMA aims to intensify interpretation guidelines and workshops, but claims that the responsibility of interpretation rests with the IASB as the accounting board. A call for more training in terms of materiality was highlighted by empirical studies, which would provide the basis for better comprehension (Houghton et al., 2011). Therefore, the IASB has launched the initiative on materiality in order to seek general guidance or training material (IASB, 2014). The exposure draft ED/2015/8 Application of Materiality to Financial Statements was published in October 2015 and has to be commented on until 26 February 2016. The draft defines the characteristics of the principles consistently, introduces applications guidance and differentiates between material or immaterial misstatements and omissions (ED/2015/8).

A similar movement started in the US-American accounting rules, too. The SEC created the disclosure effectiveness, in order to improve the disclosure for companies and investors, and presented their report to the congress in December 2013. Comments are still received.

Stakeholders of IFRS notes – and generally of financial accounting – need to reach decision relevant information in order to clearly understand the financial situation – reflecting the purpose of the information function of accounting. Recent studies have revealed the problem of information overload, because the information needs of stakeholders are not fulfilled; hence, accounting is not entirely fulfilling its duty concerning the information function. Firstly, the problem of applying materiality may originate from a lack of understanding of the concept, as well as the use of unclear language (IASB, 2014). Secondly, this gap is caused by overfilling the notes, because preparers and auditors work together on the quality of reporting up to the date of disclosure. To achieve 'disclosure quality' and to avoid potential problems which may result in liability cases and loss of reputation, they prefer to ensure their work. They check mechanically off lists that contain every single item of IFRS disclosure, in a 'mere compliance mode' [EY, (2014), p.3] rather than relying on their professional judgement to decide the decision-relevance of the issues. Consequently, the quality of disclosure –

measured by comparability, transparency and decision-relevance – decreases, while the extent increases through boilerplate, generic and redundant information. This circle leads to information overload and ineffective disclosure (EY, 2014). It also appears that a higher qualitative materiality standard results in improved acknowledgement of such work by preparers and auditors, as it achieves a higher degree of trust and relevance (Montaya del Corte et al., 2010). The lack of assessment and evaluation of information to be classified as either material or immaterial can be compensated if preparers lose their reluctance to employ the principle of materiality (IASB, 2014; EY, 2014).

EY (2014) published a three-line proposal, containing disclosure structure, tailoring and the principle of materiality, in order to solve the problem of information overload in the context of notes. Some of their proposals are:

1 Structure: constitutes the main piece of the solution triangle and includes:
   - improving navigation through content list, cross-references, indices etc. in order to summarise information for the reader and group similar information within sub-headings plus a combination of mentioned structuring measures
   - restructuring the order of disclosure items based on importance, which already includes a prioritisation of facts according to the principle of materiality
   - summarising the main developments of the financial year in line with management reporting as an introduction to the notes.
2 Tailoring: preparers' use of boilerplate presentation should be reduced in order to achieve transparency; for instance, if an accounting policy is not used, then it should not be disclosed.
3 Materiality: preparers and auditors should be discouraged from relying only on mechanical checklists. They should be encouraged to determine the material from immaterial information, in order to concretise disclosure in an entity-specific manner and combine quantitative with qualitative factors as best practice. For instance, the materiality principle tends to be stricter in the situation of misstatements or fraud, non-recurring transactions, and transactions with related parties (IAS 24).

If the second points of tailoring with the third point of materiality are combined, it would exclude the description of a company's policy of financial instruments, which are not kept by the company, as well as discounted operations, which the company has not executed from disclosure (EY, 2014). Finally, as the IASB points out, preparers and auditors have to understand the information needs of their stakeholders, which may result in a heterogeneous picture of facts to be disclosed (IASB, 2014).

How does the disclosure initiative influence the understanding of the application of the principle of materiality in GCC? Firstly, German disclosure policies are highly influenced by international standards; for instance, group corporations shall disclose only IFRS financial statements according to section 315a GCC or companies may publish an additional IFRS individual financial statement according to section 325a paragraph 2a GCC. The GCC is strongly focused on debt protection. Naturally, the understanding according to IFRS will impact the typical German understanding which is more stakeholder-oriented. Secondly, due to the obligations of publishing IFRS statements, German preparers have to make disclosure judgements within the IFRS notes. But still, they are obligated to prepare total or just extra GCC notes which are shorter than those of the IFRS and more focused on terms of recognition and measurement. Thus, they have to reflect similar items for IFRS and GCC disclosure, which creates interdependencies. Finally, apart from an IFRS or GCC financial statement, German corporations have to disclose a management report according to sections 289, 315 GCC. Compared to the items for disclosure within the IFRS notes, there are common subjects such as risk reporting in terms of financial instruments (IFRS 7). Disclosing this subjects in both reports results again in a larger and therefore more opaque disclosure. Consequently there is a loss of decision-relevant information. To deal with the information overload, the solutions proposed by EY (2014) could also be applied to national accounting codes, in order to achieve a transparent and highly decision-useful reporting. Hereby the disclosure may be added in the form of an integrated reporting which, according to the principle of information connectivity, may result in a more material-orientated disclosure. The materiality initiative of the IASB seeks not only to cope in terms of presenting in the notes, but in fact it also includes primary statement items (IASB, 2014).

3 Auditing

3.1 GCC and national auditing standards

According to section 317 para. 1 and section 264 para. 1 GCC German auditing aims to guarantee the regularity and conformity to law of accountancy and annual financial statements. Furthermore, according to section 317 para. 1 and section 264 para. 1 GCC seeks to examine the judgement of accord between the management report and the information of the company's financial situation. Through third-party auditing, the accounting assertions shall become more trustworthy, allowing stakeholders to make decisions on financial matters [IDW PS 200, (2000), p.8]. The audit procedures specify the extent of the audit, and have to include all audit assertions (Schmidt and Almeling, 2014). While planning and conducting the audit, the auditor has to consider the materiality (section 317 para. 1 clause 3 GCC). Materiality, in comparison to financial accounting, is explicitly standardised in order that errors and violations which materially affect the presentation of the net assets, financial position and results of operations of the enterprise pursuant to section 264 para. 2 will be recognised, provided that professional diligence is applied (section 317 para. 1, 3 GCC). In consequence, the audit is not an in-depth examination of all of the client's transactions. However, all audit actions conducted are guaranteed to cover a reasonable assurance level including judgement regularity, conformity to law and accounting standards [IDW PS 200, (2000), pp.19–25]. To achieve this aim, auditing has to be efficient and to integrate materiality [IDW PS 200, (2000), p.21], which consequently leads to an audit of risk assessment and audit procedures in samplings (business risk audit).

To interpret the GCC the IDW has concretised its auditing interpretations and examples of best practice auditing standards in the form of publications. The auditor can deduce materiality by:

1 measuring quantitative criteria as a threshold for a cross-section of a benchmark

2 judging qualitative criteria, updating his assessment throughout the audit.

Also, he has to consider that each immaterial omission or misstatement may separately have an insignificant influence on the true and fair view of the financial statement and therefore be classed as a 'tolerable error'. However, collectively they may mislead the investor; hence, aggregated misstatements may be decision-relevant [IDW PS 250, (2012), pp.7–9].

The definition of the IDW is similar to the IFRS based on the widely recognised information function of the financial statement. The quality of presentation and disclosure is constituted by the externally published auditor's opinion pursuant to section 322 GCC. The definition focuses on the needs of the stakeholder and decision-relevance, although the stakeholder group is not concretised in more detail (compared to IFRS). The IDW does not offer fixed thresholds or measurement principles; hence, the priority is given to the qualitative interpretation of materiality based on professional judgement. Compared to the IFRS, the professional guidelines lack clear guidance, leaving the door wide open to interpretations formed through subjective professional judgement.

3.2 ISA

The interpretation of materiality by the international standard-setter of auditing standards (IAASB) has a stronger focus on the information needs of the users than the IFRS interpretation. As a result, the clarity project of ISA elaborated on the ISA 320 (revised) 'materiality in planning and performing an audit', classifies four categories of materiality; namely:

- overall materiality
- performance materiality
- specific overall materiality
- specific performance materiality.

Moreover, ISA 450 'evaluation of misstatements identified during the audit' deals with how to evaluate misstatements in light of audit procedures, as well as how to judge the effects of uncorrected misstatements on the fair presentation of financial statements.

The reworked German audit standard 250 concurs entirely with ISA 320 and ISA 450 [IDW PS 250, (2012), p.3]. Due to the constant process of transformation from the ISA to German auditing standards, both concepts of materiality are equal in their stakeholder orientation. Both seek to guarantee a faithful presentation of the financial statements that will disclose decision-relevant information, hence equals the IFRS' definition. Nevertheless, both auditing standards may differ in several individual rules. The IDW tried to close this gap by publishing Questions and Answers on the reworked standard 250 (IDW Q&A IDW PS 250, 2013), which indicate the rules of ISA 320. The IDW Q&A do replace neither the auditing standards nor the auditing recommendations, but provide additional advice to auditors on how to cope with the concept of auditing [IDW Q&A IDW PS 250, (2013), section 2].

The ISA are applicable for auditing procedures of past information. However, the International Standards on Assurance Engagements (ISAE) are used in financial statements in terms of auditing ordinary services. The ISAE 3000 'assurance engagements other than audits or reviews of historical financial information' offers guidelines on how to make judgments on forecasting and non-financial information

(Kunellis, 2013), in which case materiality must be updated in every phase of the audit and will influence every auditing procedure (ISAE 3000.44). Compared to the ISA, the definition of the IDW PS and IFRS is orientated around decision-relevance, as stated: "[…] materiality is based on the information needs of intended users" (ISAE 3000. A92). Consequently, materiality is based on quantitative thresholds on one hand and qualitative criteria for the professional judgement on the other. This determines the wording, disclosure format, level of misstatement and whether any misstatement was caused negligently or intentionally, etc. (ISAE 3000.A94-A98). The ISAE 300, however, focuses its definition on the object of the audit and omits guidelines on how to measure quantitative thresholds (ISAE 3000.A99). Materiality is also a key topic in the field of corporate social responsibility (CSR) assurance and integrated reporting assurance.

The survey of the ESMA also included auditors and determined that a checklist of materiality would lead to narrow-minded boilerplate thinking and hamper professional judgement (ESMA, 2013). Additionally, discussion points were given to make auditors aware of how to deal with uncorrected misstatements and how to measure materiality in interim reporting. The ESMA will send these discussion points to the IAASB in order to evaluate them. Finally, all standards share a stakeholder-orientated definition of the concept of materiality and although quantitative thresholds may be handy, set standards outline the overall meaning of professional judgement in terms of evaluating the fair presentation of financial statements.

The next chapter aims to strengthen our understanding by presenting a general concept of materiality based on professional judgement and discussing auditing standards as potential guidelines to cope with the problem of information overload.

3.3 Professional judgement of materiality

Quantitative thresholds are not absolute; due to the variety of company sizes and branches, auditors have to deduce appropriate benchmarks and safety percentage (Ossadnik, 1993a). In transforming ISA 320 to the reworked German audit standard 250, the following definitions were established (Kunellis, 2013):

- Overall materiality comprises all information of the financial statement (balance sheet, p/l, notes and management commentary). From this threshold above, the stakeholder would be influenced in his decision by an omission or misstatement (single or aggregated).
- Performance materiality refers to misstatements of the financial statement or to single assertions. This threshold defines the general comprehension of detection risk of the business risk approach. It is measured by a safety discount of overall materiality.
- Specific overall materiality is calculated for each piece of information for the whole financial statement in order to cover the special information needs of the addressee.
- Specific performance materiality differs from performance materiality in that it presents the threshold of tolerable misstatements for each particular financial line item. Its application requires the predefinition of specific overall materiality.

The concept of quantitative thresholds is supported by a minimum level beneath which misstatements are immaterial and shall not be listed in the sum of uncorrected misstatements, insofar as the aggregated misstatements do not significantly influence the fair presentation overall [IDW PS 250, (2012), p.19].

Overall materiality is calculated by a safety percentage and a benchmark. The appropriate benchmark is determined by the professional judgement of the auditor due to an absence of further guidelines. ISA 320.A4 proposes earning before taxes (EBT), revenues, EBIT, and the sum of expenses or equity [IDW Q&A IDW PS 250, (2013), section 3.2.1].

In determining the benchmark, the auditor needs to consider the effects of accounting interpretations and policies that could essentially influence the calculation (Ossadnik, 1993a). There is no obligation to use a safety percentage, but depending on the chosen benchmark, ISA 320.A7 suggests the following as appropriate ratios:

- 5% of EBT
- 1% of revenues
- 1% of the sum of expenses [IDW Q&A IDW PS 250, (2013), section 3.3.1].

The performance materiality is a fraction of the overall materiality which, according to a study of the IDW, may move between the following ranges:

- 70–80%
- 70–90%
- 50–80% [IDW Q&A IDW PS 250, (2013), section 4.4].

As the expectation gap highlights the stakeholder's lack of information, neither the auditor's opinion nor the auditor's report offers detailed support concerning misstatements of applied thresholds. section 11 para. 2 of the EU regulation no. 537/2014 for auditing public interest entities (PIEs) require that auditors shall disclose the quantitative materiality to the audit committee (or a supervisory board) in the audit report. In 2013, the UK and Ireland already reworked their auditing standards of auditor's judgments, ISA 700 UK and IRE [ISA 700/UK and Ireland, (http://www.frc.org.uk), 19A b, A13B]. This rule may lead to a higher level of transparency and comprehension of auditor reporting while reducing the expectation gap (Ruhnke et al., 2013). Moreover, it may lead companies to adopt the accounting practice insofar as it allows a deliberate interpretation of benchmarks and stakeholders may be able to better comprehend the work of the auditors and may refer to the quality more frequently (Houghton et al., 2011). Explanations about materiality used by auditors are limited due to a complex application that could not be expressed 'in layman's terms', [Houghton et al., (2011), pp.495–496]. The EU solution, that materiality should be reported – at least internally –, offers a higher level of stakeholder protection. But it may open the door to accounting policy which might be realised in bad faith. Therefore, preparers should be encouraged to pay closer attention to their thresholds and to disclose them voluntarily to the stakeholders.

The concept of materiality also comprises qualitative criteria which, in contrast to the quantitative measurement, are the central input for professional judgement during the audit. ISA 450 lists the following examples (please note that this list is not exhaustive):

- compliance with the code and financial covenants
- reversing effects on p/l
- increasing influence on performance indicators used as the basis of corporate valuation
- influence of particular parties etc. (ISA 450.A16).

No comparable catalogue of qualitative criteria exists in the revised German auditing standard 250, so German auditors can revert to the international standard as a guideline. Qualitative criteria require professional judgement even more in terms of disclosure in the notes and the management report, because auditors have to weigh words and consider the effect of each item on fair presentation, considering the appropriate approach and evaluating the decision-relevance [IDW PS 250, (2012), p.28]. If a disclosure is wrong, or a significant line item of the financial statement is omitted, it is considered a material misstatement. Empirical studies have recommended increased training for auditors in terms of interpreting qualitative criteria in order to appropriately apply professional judgement (Houghton et al., 2011). The debate about the standardisation of materiality as a codified GAAP has not been influenced in light of auditing procedures; rather, the discussion about presenting the applied thresholds of the regulation no. 537/EU will impact the comprehension of auditing.

4 Conclusions

Materiality, which has (from a traditional point of view) less meaning in GCC in comparison to IFRS, is gaining more attention as a result of the EU accounting directive. The literature has attempted to concretise the materiality principle, e.g., specific thresholds, but has been limited by the incomparability of the methods and the entity-specific interpretation of the vague legal term. But the German legislator did not implement materiality as an explicit accounting principle in the GCC after the transformation of the EU accounting directive.

Nevertheless, preparers and auditors are obliged to accept the materiality principle. It has a central function in achieving an efficient audit. This is reflected by the codification of section 317 GCC and the German audit standard no. 250 and IDW Q&A, which refers to the ISA 320. In this context, materiality in external audit is highlighted by the EU auditing regulation no. 537/2014. Auditors of PIEs must disclose the quantitative levels of materiality in their audit report to the audit committee.

Although auditors can refer to different guidelines, it is still challenging to decide upon the appropriate benchmark and percentage and to achieve the right level of professional judgement. One possible solution would be for the IDW to provide more specific advice in the Q&A. Moreover, current developments which have arisen from the study of ESMA will further affect the relevance of materiality.

The international accounting rules, IFRS and US-GAAP/SEC, issued more guidance of the interpretation of the materiality. Their definitions recognise the information needs of an average and prudent investor, whereas the German rules are more stakeholder orientated. In contrast to IFRS and GCC the US-American accounting rules are less principle-based due to a high influence of case law.

Comparing all three accounting and auditing regimes, a common judgement of materiality crystallises: quantitative thresholds are a first orientation. Qualitative facts should secondly be considered, which display the information needs of the main investors of the company in order to disclose decision useful information.

Due to the lack of codification, the principle of materiality cannot be standardised with clearer recommendations. Possibilities may include the disclosure initiative of the IASB in order to solve the problem of auditors' reluctance to deal with the materiality principle and move away from boilerplate checklists towards confident professional judgement, according to national and international accounting and auditing standards and clear guidelines.

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