Review Paper

Materiality concept and accounting information overloading

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This paper examined the concept of materiality and disclosure requirement as stipulated by the relevant accounting standards vis-a-vis information overloading. Financial reporting is only concerned with information that is significant enough to affect evaluations or decisions. Materiality differs from relevance because relevance is a qualitative characteristic while materiality is quantitative in nature. The objective of the paper therefore, is to show that in the preparation and presentation of financial statements, the preparer of the financial statement must maintain a balance between what is material and the information needs of various users of the statement to guide against information overloading. The preparers of financial statements should have in mind the arrays of users of financial information and the information needs of individual. However, there is no clear cut method of deciding the materiality of a piece of information; hence materiality is obviously a relative term. One item may be material in one situation and in other situation may not be material. The financial information that will be provided therefore by the preparers of financial statements should be done in such a way to guide against information overloading.

Key words: Financial reporting, materiality, financial statement, information overloading.

INTRODUCTION

A critical look at the financial reporting disclosure shows that there is problem of too much disclosure of irrelevant information in financial statement which eventually culminates into information overload. Information overload can mean that useful information is obscured and that the connections between disclosures are not all that glaring.

Accounting information is the most basic input into any informed economic decision making (Akintoye, 2008) and aptly defined as language of business. Language is to communicate information; hence accounting as information system is expected to communicate information to those who are interested in accounting information particularly the shareholders and other prospective users of the information. This information is conveyed by means of financial statements. Therefore, the main objective of financial statements is to provide information about the reporting entity’s financial performance and financial position that is useful to a wide range of users for assessing the stewardship of the entity’s management and for making economic decisions. If accounting is to provide useful and reliable information the question now is what quantum of information should be provided in the financial statement to meet the aspiration of the users of the information and at the same time guide against information overloading. This therefore means that only information that is material is provided in the financial statement. Materiality concept plays a central role in any decision making related to all management fields and accounting field in particular (Ahmad, 2009). Items, transactions and events that are immaterial are not reported separately in the financial statement. This therefore informs stakeholders to be aware of all public information; both mandatory and non-mandatory information. According to Watts and Zimmerman (1986), in some instances investors give more attention to the released non-mandatory information.

The materiality concept, also called the materiality constraint, states that financial information is material to
the financial statements if it would change the opinion or view of a reasonable person. In other words, all important financial information that would sway the opinion of a financial statement user should be included in the financial statements.

The concept of materiality is relative in size and importance. Some financial information might be material to one company but might be immaterial to another. This is somewhat obvious when you think about a small company versus a large company. A large and material expense to a small company might be small and immaterial to a large company because of their size and revenue. The main question that the materiality concept addresses is does the financial information make a difference to financial statement users? If not, the company doesn't have to worry about including it in their financial statements because it is immaterial. Most of the time financial information materiality is judged on qualitative and quantitative characteristics. Professionals are often left up to their experience and good judgment to understand what material is and what isn't.

The concept of materiality is simple but it is central to the application of Generally Acceptable Accounting Principle (GAAP) and makes it a problematic issue for accountants (Bernstein 2001). In analyzing nexus between materiality and information overload, this article is organized in the following sections: present some definitions of materiality, general consideration, determinants of materiality, causes of information overload, the way forward and conclusion.

Materiality concept as viewed by accounting standards

International Accounting Standards Committee (IASC) contributed to the clarification of the concept of materiality. Financial Accounting Standard Board Concepts Statement No. 2, Qualitative Characteristics of Accounting Information (1980) defines materiality as follows:

“The magnitude of an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement” (Para. 132).

International Public Sector Accounting (IPSAS) No. 1 defines materiality as follows:

“Material Omissions or misstatements of items are material if they could, individually or collectively, influence the decisions or assessments of users made on the basis of the financial statements. Materiality depends on the nature and size of the omission or misstatement judged in the surrounding circumstances. The nature or size of the item, or a combination of both, could be the determining factor”. (IPSAS No. 1, Para. 7)

International Standard on Auditing (ISA) No. 320 defines materiality in the following ways:

“Misstatement, including omissions, are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements” (ISA No. 320, Para.2)

From all the definitions from the authoritative accounting bodies, accountants are left with no practical guide to indicate how accountants should apply materiality threshold. However, it recognizes that the judgment of accountants is fundamental in all decision making. This boils down to the fact that the accountants should adopt convincing and legal form of judgment with respect to the level of materiality without necessarily overloading the information in the financial statement.

The concept of materiality is very fundamental to the reporting of information. The paper focused on annual reports for a number of reasons (Hussainey, 2004). First, the annual report is a mandatory document which is required to be produced on an annual basis. Second, most companies release their annual reports within three to four months after the financial year-end, so timing differences are minimized. Third, because of their standard format, annual reports are more easily comparable among firms than other less formal communication channels like press release or direct contact with analysts. Fourth, prior studies rank annual reports high as a communication source by different groups of stakeholders (Chang and Most, 1985). Fifth, prior studies find that annual report disclosure scores are correlated positively with other media of financial communications (Botosan, 1997; Lang and Lundholm, 1993), suggesting that firms coordinate their overall disclosure policy. Finally, we use the annual report alone in this study because of its availability and ability to be scored. Other sources of information are not available, but it is recognized that, in practice, investors are likely to use all sources of information to make informed decisions about companies.

In addition to what has already been discussed, the reader is to note the following points:

Materiality of information: Misdescription of assets, liabilities, receipts and expenditures. Likewise, wrong classification between capital and revenue would also come under this category.

Materiality of amount: This is a highly relative term. A fraud or an error of $25,000 may be material in a small organization while not so in a large organization. That is why, the Companies and Allied Matters Act 2004 has indicated at different places as to the degree (relatively) of tolerance. For example, an item of expense should be
shown separately if it constitutes a certain percentage of the total expenses for the period.

**Materiality of procedure:** Every accountant knows that some procedures are superior to others for certain purposes. For example, the various methods of depreciation, treating liability for gratuity on Cash Basis and on Actuarial Basis, etc.

**Materiality of nature:** Some items are material by nature regardless of the amount involved and any other factor. A small error in such items will be considered as material always. For example, Director’s Fees, Audit Fees, amount due from directors etc.

**General consideration**

Materiality depends on item’s size, nature and circumstances. Dependence on size means that materiality is quantifiable in financial terms. In considering the materiality of uncertainties and contingencies, preparers have to make best estimates of the potential monetary amounts involved, taking into account the likelihood of crystallization. In considering the materiality of related party transactions for which no price is charged, preparers should have regard to the potential monetary amount involved. Whilst the quantification of materiality is fundamental and unavoidable, materiality can never be judged purely on the basis of absolute size. N1 million is a large amount but in relation to a potential misstatement of sales by a large multinational, it is likely to be immaterial. On the other hand in some cases, the nature and circumstances of an item can be of such importance to users that a size threshold is of little practical significance in determining materiality. For instance, N20,000 is a comparatively small amount but it might be seen it might be seen as material even for a large multinational if it relates to a benefit-in-kind which has been wrongly omitted from the disclosure of director remuneration.

The nature of an item is characterized by: (a) the transaction or other events giving rise to it (b) the legality, sensitivity, normality and potential consequences of the event or transaction (c) the identity of the party involved (d) the account captions and disclosure notes affected.

The materiality of information can only be judged in relation to its ultimate impact or potential impact on users. Consequently, the materiality of a given item of a given size will depend on the context of the accounting and other information available to users. It might be appropriate to focus on one or more of the following: (a) individual disclosures (b) primary statement captions and subtotals (c) the relevant primary financial statement as a whole (d) the financial statement as a whole (e) the entity’s financial position or the scale of its operations as indicated by the financial statements.

**Causes of information overload**

This section focuses on materiality threshold which should be the threshold for recognition of information to be disclosed in financial statements. From Figure 1, it means the issue of materiality is a function of interactive qualities which must be put into careful consideration. Hence the problem associated with information overloading.

According to guidance on materiality in financial reporting by UK entities, published in June 2008 by the Institute of Chartered Accountants in England and Wales, the main cause of information overload is that the concept of materiality is not being applied well as it should be in determining what information should be disclosed in the financial statements. The reasons why this may be the cases are as follows:

1. The behavior of those in the financial reporting process for instance:
   (i) preparers adopt a ‘better safe than sorry’ approach because of litigation and reputational pressures;
   (ii) preparers and auditors use a tick-box approach to disclosure;
   (iii) regulators challenge the removal of information, even when immaterial; and
   (iv) there are many regulatory bodies
2. The way in which some Standards are drafted suggest that the concept of materiality in International Accounting Standards 1 (IAS 1). Presentation of Financial Statements does not apply to the specific disclosure requirements in that Standard; and
3. The guidance on materiality in IAS 1 is not as clear as it could be.

**The way forward**

To guide against information overload in relation to materiality, materiality guidelines can be derived from answering the following questions:

(a) Who are the relevant users?
(b) What are their decision making needs?
(c) What types of financial information are likely to influence the decision of the users?
(d) For a given item, what is the appropriate context for assessing its materiality?
(e) In what range of values do items become critical in terms of materiality?
(f) How should particular items in these critical ranges be decided and reported? (ACA, England and Wales).

**Conclusion**

In the preparation and presentation of financial statements, it is expected of the reporting entity to follow
the disclosure requirement as stipulated by the national and international accounting standards as well as other regulatory agencies such as Security and Exchange Commission (SEC) and Bank and other Financial Information Act 1991 as amended (BOFIA). Therefore, as the disclosure requirement is the creation of the law as such, the reporting entity should balance on the sort of information to be disclosed to avoid information overloading the financial statement. Therefore, materiality is the final test of what information should be given in a particular set of financial statement. Materiality is therefore a threshold quality that is demanded of all information given in the financial statements. Furthermore, when immaterial information is given in the financial statements, the resulting clutter can impair the understandability of the other information provided in such circumstances, the immaterial information should be excluded to reduce incidence of information overload.

REFERENCES


Guidance on materiality in financial reporting by UK entities by the Institute of Chartered Accountants in England and Wales.


International Public Sector Accounting Standard (2000). Presentation of financial statements, paragraph, 7

