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MATERIALITY IN VOLUNTARY REPORTING

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ABSTRACT

This paper conducts a literature study on materiality in voluntary reporting. Standard-setters appear to have unclear, ineffective, and inefficient processes causing the concept of materiali-ty outdated for financial purposes. Consequently, the materiality concept for non-financial/ voluntary information is not covering the interests of practitioners. To overcome the short-comings stemming from standard-setters, this paper calls scholars to create a more concise definition of materiality with the goal of guiding accounting and audit professionals.

Keywords: Accounting. Auditing. Materiality. Regulation. Voluntary reporting.

Introduction

Multinational corporations report increasingly on non-financial information in the form of sustainability reports. Globally 95% of the 250 largest companies and 71% of the 100 largest companies in 41 countries (a total of 4,100 firms) have a sustainability report(KPMG, 2013). Institutional investors look increasingly to non-financial information in their investment decisions. There are now 1260 organizations who have stated to adhere to the Principles for Responsible Investment (PRI)[2]. These 1,260 companies represent roughly $45 trillion in assets under management and consider their investment decisions to be considered with sustainability criteria (PRI, 2014). In addition, the focus is increasingly on integrated reporting. An integrated report is a report in which the company reports on its strategy, governance, performance, and prospects in the context of its external environment (IIRC, 2013, p. 7). In an integrated report are thus both financial, and non-financial information included in a single report. Recent research conducted by Deloitte (2014) shows that the assessed enterprises accounted score well on 'reliability and completeness of their reports but score less well on conciseness. This indicates that the clear and concise view of both financial and non-financial

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[2] PRI is supported by the United Nations (UN) and was founded in 2005 by the former Secretary-General Kofi Annan, and has as its mission: "... an economically efficient, sustainable global financial system is a necessity for long-term value creation. Such a system will reward long-term, responsible investment and benefit the environment and society as a whole "(https://www.unpri.org/about).

information in an integrated report is not an easy task. This is, among other things, in that the rated companies want or need to meet several guidelines, frameworks, and ratings, such as IFRS,GRI, UNGC, DJSI, Transparency Benchmark and integrated reporting (Deloitte, 2014, p 7).

In the international context, there is a shift of voluntary reporting for non-financial information to mandatory reporting of non-financial(GRI, 2013, p. 14),with the main milestone of the European Commission's proposal to amend Directives 78/660/EEC and 83/349/EEC of the Council relating to the disclosure of non-financial information and information concerning diversity by certain large companies and groups.

The fact that many companies publish sustainability reports, does not mean automatically that the quality of these reports is sufficient. On the contrary, even though the quality of reporting has increased in the past decade, there is still a lot to gain when it comes to transparency in accounting (KPMG, 2013, Ernst & Young, 2009; TB, 2014). A study by Ernst &Young (2009), for example, shows that 76% of sustainability reports mostly positive news bring out, rather than a fair and balanced accountability.

Financial information in general and the financial statements are arranged so that reporting is informative for users. The financial statements users are defined by the Financial Accounting Standards Board (FASB) as "existing and potential investors, lenders, and other creditor ". To create transparent displaying of financial information detailed standards and guidelines are developed by the International Financial Reporting Standards (IFRS) in an international context. These guidelines clearly specify what information must be reported to be as informative as possible for the users of this information. For non-financial information, it is complicated, because there is an enormous heterogeneity existing regarding the (potential) users. This leads to issues to be reported to be a versatility. Non-financial information in general and sustainability reporting are designed to meet the information needs of the users. According to the definition of the FASB, this concerns all relevant stakeholders and not just the ones representing the capital.

The versatility of the information to be reported can cause sustainability reports to publish a lot of information, which is not always relevant to the stakeholders. Sustainability reports are often too broad and therefore difficult to read. To determine whether non-financial information is relevant, it should give an insight into the economic, environmental, and social impact of the company on its environment. Non-financial information is material if this information, or the omission thereof has substantial influence on the judgment and the choices made by the stakeholders based on the published information (GRI,2013, p. 11). The relevance of the topics that should be reflected in a sustainability report, is defined by the stakeholders through a

stakeholder dialogue. This dialogue may result in a materiality analysis, which is summarized in the most ideal situation in a materiality matrix. The materiality matrix can then be the basis for the sustainability report. The new GRI guidelines (version 4) emphasize the focus on material aspects for the content of sustainability reports:

"At the core of preparing a sustainability report is a focus on the process of identifying material Aspects – based, among other factors, on the Materiality Principle. Material Aspects are those, that reflect the organization's significant economic, environmental and social impacts; or substantively influence the assessments and decisions of stakeholders." (GRI, 2013, p. 7).

Materiality is an increasing important aspect concept within voluntary reporting (Zadek & Merme, 2003; Lydenberg et al., 2010; GRI, 2013; Eccles et al., 2015) although the research on accounting for sustainability is limited (O'Dwyer & Unerman, 2016). Companies intend to report voluntary information not in the general interest but in their own interest (Feenstra, 2012; Clarkson et al., 2008), despite the importance of materiality for voluntary reporting (GRI, 2013, p. 32), and that reporting about the actual material aspects make reports more relevant, reliable, and usable (Eccles et al., 2012; Lydenberg et al., 2010; Zadek & Merme, 2013).

This paper defines the current scientific literature on the materiality in relation to voluntary reporting. Although voluntary reporting mainly concerns non-financial information, which is increasingly mandatory to report about, this paper is still using the term voluntary reporting as in many countries the reporting of non-financial information is to a large extent voluntary. Continuing along the lines of Edgley (2014) this paper contributes to the call for social sustainability research by O'Dwyer & Unerman (2016). Edgley defined the different perspectives on materiality. From the different perspectives described this paper elaborates on the materiality as a moral responsibility perspective. This paper analyzes this perspective from an economical background. For a thorough understanding this paper continues with elaborating the economical materiality. Once the definition of materiality is set from an economical perspective materiality as a moral responsibility is discussed in more detail. Thereafter, the relation of materiality with voluntary reporting is discussed. Finally, there is concluded on the current state of the scientific literature.

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Materiality – economical

The definition of materiality is originated from accounting and auditing (Edgley, 2014, p. 257) and is defined by the FASB[3] as follows:

"Information is material if omitting it or misstating it could influence decisions that users make on the basis of the financial information of a specific reporting entity."

Hereby is important to recognize that material information is company specific and the users of the information are defined as "existing and potential investors, lenders, and other creditors"[4].

Materiality as a moral responsibility

A moral responsibility refers to norms or duties that guide interactions between individuals and is often interwoven within legal or social power structures (Edgley et al., 2015). So, from the moral responsibility perspective the materiality concept represents an ethical aspect. To have a deeper understanding of the moral responsibility the standard setting is considered as this creates understanding on how ethics are integrated within standard setting and therefore what the current context is of the moral responsibility perspective.

The revision of conceptual frameworks is discussed by Pelger (2016). The focus of this paper is on the change from a financial perspective. Referring to the IASB and FASB Pelger mentions valuation usefulness as the single objective of financial reporting with these conceptual frameworks. How this is possible in the current expanding focus on non-financial information is analyzed by considering the process leading to a change. All relevant professionals involved in the change process considered decision usefulness. Although this considered importance, the discussion on implementing a broader perspective was not accomplished. This is remarkable as conceptual frameworks in financial reporting are supposed to serve as guidelines for the day-to-day activities of standard-setters and to frame their discourses with constituents institutionally (Pelger, 2016, p. 51). Pelger identified the difficulty in setting appropriate conceptual frameworks by difficulties in the decision/ change process.

[3] Financial Accounting Standards Board, Statement of Financial Accounting Concepts No. 8 p. 17

[4] Definition of users according to IFRS.

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Shortcomings in the conceptual framework setting can both harm the relation with the practice and create confusion in the application of the definitions. Erb & Pelger (2015) researched the definition setting of the IASB and FASB the consequences of unclear definitions. Actions of the standard-setters were identified to create an understanding of the definitions in practice. By conducting historical analysis, it was concluded that a small group of practitioners are the basis for change (Erb & Pelger, 2015, p. 34). Instead of clarifying the term "reliability" the confusion on the definition was used to introduce an entirely new definition: "representational faithfulness". The paper explicitly excludes the concluding on whether the outcome is creating more clarity for practitioners.

While the standard-setters struggle with the creation of clear conceptual frameworks, the practice develops with company areas which received less attention in the past. The corporate accountability develops beyond the financial measures (O'Brien & Dhanarajan, 2016). O'Brien & Dhanarajan conducted research to set human rights in the current corporate social responsibility context. Although it is concluded that the change is still slow and unsatisfactory (O'Brien & Dhanarajan, 2016, p. 555), the developing company accountability and the developing regulations on corporate behavior – and consequently the reporting on these matters – is pushing companies increasingly to a more stringent company behavior.

Continuing the concept of representation faithfulness of the IASB/ FASB, Kuhner & Pelger (2015) argue that there are several shortcomings in the reasoning of both institutions. Kuhner & Pelger take the perspective from the accounting system with the factors – among others – freedom of error and freedom of bias. The relation between stewardship and valuation is criticized by the authors: in the presence of earnings management trade-offs between properties of accounting differ for stewardship… our results raise doubts as to the appropriateness to state generally a positive relationship between stewardship and valuation and valuation purposes (Kuhner & Pelger, 2015, p. 405).

A bridge between financial and non-financial information is created by Rooney & Dumay (2016). In their paper, they argue on the accounting intellectual capital. As intellectual capital has no predefined value there is a high level of subjectivity in the accounting of intellectual capital. The benefit of the paper is not limited to intellectual capital. The paper shows that a material matter with high subjectivity can easily be interpreted differently between professionals. Moreover, this can have far reaching company consequences. This shows that the clear frameworks for accounting are essential and that once there is judgement in accounting the reliability and relevance of matters declines.

The accounting issues are related to the audit issues. Andon, Free & O'Dwyer (2015) analyze accounting issues from an audit perspective. In this perspective, there are also issues arising with regards to sustainability reporting. According to Andon et al. it is the increased attention for verification in societies that has caused the evolvement in sustainability attention. Moreover, the selection of materiality is discussed. The selection of materiality might be a matter which is to be selected by others than the accounting specialists and/ auditors: some Big-4 firms have even suggested that stakeholders should select the material issues for assurance in sustainability engagements (Andon, Free & O'Dwyer, 2015, p. 1411).

A key issue in sustainability is – besides the accuracy of reported – the matter of completeness. Sustainability reporting is related to several company aspects and therefore sustainability reporting can exist of many factors. As the sustainability accounting frameworks are still developing it is possible that only a selection of factors is selected which create a positive appearance to the stakeholders. According to Unerman & Zeppettini (2014) the materiality consideration should be part of the sustainability reporting process. Although, they also recognize that the materiality level can be altered. Moreover, they recognize the difficulty in setting an accurate materiality.

Voluntary reporting

The elaboration of the materiality definition for non-financial information has been initiated by the report "Redefining Materiality" published by Accountability (Zadek & merme, 2003). Zadek and Merme present the defining of relevant aspects for voluntary reporting. They apply five aspects: direct short-term financial impacts, policy-related performance, business peer-based norms, stakeholder behavior and concerns, and societal norms. They define materiality as follows:

"A meaningful definition of 'materiality' must effectively identify information that, if omitted or misstated, would significantly misrepresent the organization to its stakeholders, and thereby influence their conclusions, decisions and actions" (p. 17).

Lydenberg, Rogers and Wood (2010) argue that industry specific key performance indicators (KPI's) contribute to a more relevant reporting. They respond to the GRI by criticizing the directive in version 3, because this directive would be unspecific which would limit the usability. The results of their research led to the Materiality Map of the Sustainability Accounting Standard

Board[5]. Lydenberg et al. has separated the materiality concept for an industry in five categories: financial impacts/risks, legal/regulatory/policy drivers, peer-based norms, stakeholder concerns and societal trends, and opportunity for innovation. These different KPI categories contribute to materiality setting in different industries for:

"comparable, complete data sets on material sustainability issues, and to be able to make peer-to-peer comparisons." (Eccles et al., 2012, p. 71)"

As an organization performs a materiality selection and then select topics of great importance for the organization's sustainability report which makes relevance more concrete. It is also important to mention that not every sector has the same substantive issues. This is caused by the simple reason that materiality is organization-specific and industry specific. For this, the SASB has per industry described the most material issues in their Materiality Map. The GRI published in 2013 a research report in which the most material issues, chosen by the relevant stakeholders, are published by industry (GRI, 2013). This organization-specific focus, in the form of a materiality selection is also supported by a discussion of a Deloitte paper, where it is argued that:

"Using a concept such as materiality in the context of ESG[6] issues is, that it helps narrow down the broad universe of ESG information to those items, that help inform investors and other stakeholders about a business's ability to create and sustain value. In other words, it helps emphasize a business-centric view" (cited from Eccles et al., 2012, p. 67).

The Transparency Benchmark (TB, 2014) emphasizes the importance of materiality and further discloses that the materiality determination remains a major challenge:"Some reports tell a lot, but not what really is relevant". The results of the transparency benchmark show that almost 80% of the companies provides an explanation of the organization on the topics they consider material. Only 27% of these organizations fully elaborates on the materiality determination, including the relative importance of the material issues aspects identified and a graphical representation thereof (TB, 2014, p. 13).

The creation of the content of the sustainability report according to GRI, consists of four steps which are determined by four principles in four steps: sustainability context, materiality, completeness, and stakeholder inclusiveness. The second step, prioritizing, refers to the principle of materiality and results in a materiality matrix.

[5] https://www.sasb.org/materiality/sasb-materiality-map/
[6] Environmental, Social en Governance

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Conclusion

In this paper the concept of materiality in relation to voluntary reporting is discussed. Applying an economical approach resulted in the difficulties surrounding the materiality as a moral responsibility. Confusion about the meaning and application of moral responsibility among scholars appears as a burden for current normative accounting literature. The confusion stems from both standard setters/ practitioners and the scientific literature itself. To conclude, materiality in voluntary requires scientific development. Scientific literature is mainly focused on the shortcomings by standard-setters. Therefore, scholars are part of the definition problem. Future research should focus on the solutions for the current misinterpretations.

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