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ACCEPTABLE AUDIT MATERIALITY FOR USERS OF FINANCIAL STATEMENTS

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Annotation
Materiality of financial statements is the most significant element of audit, which determines the scope of performed procedures and reliability level of data in financial statements. Having selected the level of materiality the auditor has to assess the significance of misstatements to the users of financial statements. If the materiality is selected not correctly then the risk increases, that adequate procedures will not be performed and financial statements will not meet the expectations of users of financial statements.
The aim of the article is to investigate the possibilities of harmonizing materiality expectations of the users of financial statements and materiality value applied by the auditor.
In the process of investigation it was determined that the value of materiality accepted by the users of financial statements differs from the one used by auditors. Therefore, the auditor's opinion about financial statements might not meet the users' expectations. On the basis of investigation results a test was suggested, which could help to harmonize auditor's applied materiality with expectations of the users of financial statements. Suggested test could also be used as a new and innovative method to calculate materiality. Suggested alternative way for calculating materiality is very important for future researches and science, because it is new technique to address materiality in a way that suits both, users of financial statements and auditors. This new technique could be used in the future researches searching and examining other materiality determination methods and if they are in the line with users' expectations.
Key words: materiality; clearly trivial; users of financial statements; expectations; misstatements; data reliability.

Introduction

The auditor, before planning and performing the audit, presumes that some misstatements and fraud can be detected in accounting and financial statements. Therefore, the presented data might not always be correct. The inaccuracies can be either material or immaterial. Insignificant misstatements and inaccuracies are not very important and they do not influence decisions made by the users of financial statements. Significant misstatements, 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 320, 2009).

The biggest problem faced by the auditor is the value of materiality, which may influence the reliability of financial statements and the decisions made by the users. The value of misstatement in some cases, might be material and in other cases – immaterial. The final decision on materiality is made by the auditor, thus it presents possibility for different auditors to interpret the same facts differently which is not acceptable in audit. Also, the materiality determined by the auditor does not always satisfy the users of financial statements.

This problem has a long history. In 1974 O'Connor and Collins raised the question what range of materiality are appropriate and what materiality base should be used (O'Connor and Collins, 1974). However, even today the problem has not been solved yet. The investigation, which was made in 2009, indicated that 74 % of respondents think, that materiality concept, which is applied today, is not perfect (Rooij, 2009), but so far situation has not changed. The investigation, which was made in United Kingdom in 2013, indicated that different audit companies apply different materiality to the same category of companies under audit (Audit..., 2013). The other analysis in 2015 produced by other author confirmed the same fact, i.e. that the auditors' decisions concerning materiality are different (Kristensen, 2015).

Due to the fact, that there does not exist clear materiality selection instructions there might arise interests' conflicts between auditors and users of financial statements, as the investigation which was made in 2003 indicated, that perceived materiality of users of financial statements is smaller than the materiality applied by the auditors (Cho et al., 2003).

The aim of investigation is to examine the possibilities of harmonizing materiality expectations of the users of financial statements and materiality value applied by the auditor.

Methodology: In the process of performing the investigation the archival and survey methodologies was used. First of all the investigation of previous researches, including the findings and proposals for future research, related to the topic, was made. During the investigation problems related to the materiality expectations of the users of financial statements and materiality value applied by the different auditors was summarized. The practice of materiality determination, on the basis of international standards on auditing, was generalized as well.

In addition, the survey of users of financial statements who are the experts in this field was made. The experts were asked about completely immaterial misstatement

level. Their results were compared to the previous researches made by other authors.

Finally, the alternative approach for the current materiality determination practice was suggested.

Historical background

Determination of materiality is a problem for a long time. Different researches have been made related to the materiality and its' determination (Table 1). While materiality, relatively, was new concept problems was associated with materiality value, i.e. what is material and what is not (Bernstein, L. A., 1967). However, soon, other problem came to light. Whole materiality concept is related to financial statement users and their economic decisions, thus materiality determination should be user oriented. However many researches confirmed, that materiality thresholds set by auditors are not in line with users' thresholds (Holstrum, G. L. and Messier, W. F. Jr., 1982; Jennings, M., et al., 1987; Iskandar, T. M. and Iselin, E. R., 1999; Cho, S. Y., et al., 2003; Messier, W. F. Jr., et al., 2005; Rooij, D., 2009; Kristensen, R. H., 2015; Eilifsen, A. and Messier, W. F. Jr., 2015).

Even though the problem, that materiality should be user oriented, is known - little has been done besides identifying the problem. Several suggestions, how to set user oriented materiality have been made. In 2003 Turner suggested the determination of materiality based on the impact on earnings per share rather than based on methods as done presently (Turner, J. L., 2003). Juma'h in 2009 recommended that accountants and auditors should be more innovative and try to apply non-traditional methods (Juma'h, A. H ., 2009).

But situation have still not changed and the problem remains. Thus it is very important to further investigate materiality threshold differences between auditors and users and try to find new, innovative way haw to harmonize materiality expectations of the users of financial statements and materiality value applied by the auditor.

Table 1. Researches related to the materiality concept and threshold differences between users, prepares, and auditors. Source: Prepared by the authors according to the other authors researches.

Year	Article	Author (s)	Method	The objective of the research	Findings related to the topic	Future research suggestions related to the topic
1967	The concept of materiality	Bernstein, L. A.	Archival	The Concept of Materiality	Essential is the setting of a border zone between what is material and what is not.	-
1974	Toward establishing user-oriented materiality standards	O'Connor, M. C. and Collins, D. W.	Archival	Materiality guidelines consistent with the "average prudent investor" approach	Future development of materiality guidelines should be user-oriented	
1982	A Review and Integration of Empirical Research on Materiality	Holstrum, G. L. and Messier, W. F. Jr.	Archival	To review and integrate the relevant empirical research concerning the issue of materiality and to explore the significant implications of this research for current auditing practice and future auditing research	The research studies revealed differences between users, preparers, and auditors with respect to materiality thresholds	More work needs to be undertaken to examine the structural form of the materiality decision model. More rigorous work must be undertaken to examine the threshold levels of the various groups.
1987	A Reexamination of the Concept of Materiality: View of Auditors, Users, and Officers of the Court	Jennings, M., et al.	Experiment	The Concept of Materiality	Lack of materiality consensus between auditors and users	Given this lack of materiality consensus between auditors and users, more specific materiality standards, universally applicable across all cases, gain in appeal.
1989	Auditor Reporting Decisions Involving Accounting Principle Changes: Some Evidence on Materiality Thresholds	Chewning, E. G., et al.	Archival	The Concept of Materiality	Non-Big Eight partners have lower materiality thresholds than their Big Eight counterparts.	-
1998	Evidence on Auditor and Investor Materiality Thresholds Resulting From Equity-For-Debt Swaps	Chewning, E. G., et al.	Archival	How financial statement users' implied materiality judgments correspond with auditors implied materiality judgments	Auditors' implied materiality judgments exhibit some degree of congruence, but do not correspond completely, with the market's reaction.	Research on whether there is a fundamental difference between "audit report materiality" and "financial statement presentation materiality".
1999	A review of materiality research	Iskandar, T. M. and Iselin, E. R.	Archival	The objectives of the paper are to evaluate the development of research on materiality, identify variables that may have potential effects on materiality judgments, and establish the future direction of research in this area.	There is a lack of materiality consensus between auditors, preparers and users. In general, users use low materiality thresholds compared to auditors and preparers.	Future research is required to resolve lack of materiality consensus between auditors, preparers and users.
2001	The association between European materiality estimates and client integrity, national culture, and litigation	Arnold, D. F., et al.	Experiment	Differences in materiality estimates	European materiality estimates are higher than US estimates	-
2002	What does "Materiality" really mean	Chewning, E. G. and Higgs, J. L.	Archival	Concept of materiality and how materiality decisions are made	Research has found considerable variance in materiality judgments across decision makers (e.g.. financial analysts and bank loan officers).	A general standard, even one with a threshold different from a user's preference, would promote cross-sectional comparison and improved disclosure for investors.
2003	Factors Affecting Auditors' Assessments of Planning Materiality	Blokdijk, H., et al.	Experiment	Planning materiality assessment	Big 5 audit firms set materiality levels that are significantly lower than the planning materiality levels of non-Big 5 firms	-
2003	Measuring Stockholder Materiality	Cho, S. Y., et al.	Experiment	Investigation of empirically various quantitative factors that stockholders consider important in assessing whether earnings are materially misstated.	Materiality thresholds of users are substantially lower than those discussed in the pedagogical literature on auditing and those used in practice.	Different materiality thresholds should be consider for future research.

Year	Article	Author (s)	Method	The objective of the research	Findings related to the topic	Future research suggestions related to the topic
2003	Aligning Auditor Materiality Choice and the Need of a Reasonable Person	Turner, J. L.	Archival	Determination of materiality based on the impact on earnings per share rather than based on numerous heuristics as done presently.	Determining materiality on a per share basis provides greater information for users of financial statements with a common-size metric consistent across industries, across entities of different sizes, and across time.	-
2005	A review and integration of empirical research on materiality: two decades later	Messier, W. F. Jr., et al.	Archival	The paper: (1) reviews and integrates the empirical research on materiality since 1982, and (2) suggests some implications of this research for audit practice and research.	There were considerable differences between users, preparers, and auditors with respect to materiality thresholds. In general, users demonstrated lower materiality thresholds than preparers or auditors	Future research could examine audit manuals in order to update the degree of variability between firms in their guidance on materiality. Future research could investigate the effects of this variability and its effect on users of the financial statements. Lastly, future research could investigate alternative methods for allocating planning materiality. Also research is needed to determine what is material and how is it determined
2009	Materiality of misstatements from the perspective of the users of the financial statements - Narrowing the expectation gap between users and auditors	Rooij, D.	Survey	An empirical research if expectation gap regarding materiality of misstatements exists between users of the financial statements and auditors	A relevant expectation gap between users of the financial statements and auditors concerning materiality of misstatements does exist.	It is essential that every measure for improving the concept of materiality would be researched from the point of view of all the different stakeholders related to the measure (preparers, auditors, users).
2009	The Implications Of Materiality Concept On Accounting Practices And Decision Making	Juma'h, A. H.	Archival	The materiality concept	The absence of standards and guides to cover materiality in most situations implies that accountants were applied a variety of decisions and there is no consensus in many cases.	It is recommended that accountants and auditors should be more innovative and try to apply non-traditional methods.
2011	A Meta-Analysis of Empirical Materiality Studies	Vance, D. E.	Experiment	To summary of empirical materiality studies made before	There is a high degree of variability in materiality judgments ranging from a low of 0.44% net income to a high of 54.65% of net income. Materiality varies among interest groups. Managers, controllers and board members have the lowest mean materiality and bankers and creditors have the highest	-
2015	Judgment in an auditor's materiality assessments	Kristensen, R. H.	Archival	Materiality assessments	The analysis has revealed that there is a lack of consensus between users and auditors, which indicates that auditors are unable to foresee the needs of users or simply do not consider them when making the assessment	Future research could determine if heterogeneous materiality judgments are a problem for audit report users and, if they are, explore how to make auditors conduct more homogeneous materiality judgments
2015	Materiality Guidance of the Major Public Accounting Firms	Eilifsen, A. and Messier, W. F. Jr.	Archival	Materiality guidance for eight of the largest U.S. public accounting firms.	The results indicate a significant amount of agreement between the firms on the benchmarks (e.g., income before taxes, total assets or revenues, and total equity) and percentages applied to those benchmarks when establishing overall materiality	One area of research concerns whether the benchmarks and percentages used by the firms map to user needs

Materiality, applied in the process of financial statements audit, determination overview

Materiality is very important in performing audit of financial statements and making audit conclusions. The auditor's opinion depends on the value of materiality, whether financial statements present true and fair view. International Standards on Auditing define three different levels of materiality used by auditors:

Planning materiality (materiality for the financial statements as a whole) – misstatements, 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 320, 2009). The auditor, on the basis of his/her professional decision, sets the sum, which, in his/her opinion, may influence economic decisions made by the users.

Performance materiality – the amount or amounts set by the auditor at less than planning materiality to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds planning materiality (ISA 320, 2009).

Clearly trivial misstatement – matters that are clearly trivial will be of a wholly different (smaller) order of magnitude than materiality determined in accordance with ISA 320, and will be matters that are clearly inconsequential, whether taken individually or in aggregate and whether judged by any criteria of size, nature or circumstances (ISA 450, 2009). In other words, these are misstatements, which do not make any impact on company's performance and are not important for company's management, shareholders, investors and other users of financial statements.

All three materialities should be determined in every audit. The main and the most important materiality is planning materiality because this materiality should indicate whether the identified misstatements could influence the economic decisions made by the users of financial statements.

In making decision about materiality the auditor has to evaluate the degree of distortion and existing circumstances. Therefore both, quantitative aspects, like mathematical error size and qualitative aspects like false disclosure of information or non-disclosure of it, misleading interpretation of facts, etc. are important. The audit standards do not define in detail what values should be used and how exactly materiality should be calculated, therefore, while determining materiality the auditor relies on his/her professional decision (Joldos et. al., 2010), however in all cases international audit standards obligate the auditor to identify whether, individually or in the aggregate, misstatements are material (ISA 450, 2009).

The most popular models of defining materiality, which can be applied by the auditor in making a

professional decision, presented in literature are (McKee and Eilifsen, 2000):

Single rule (a rule of thumb) – it is a model where materiality is calculated from a selected concrete financial indicator, considering different quantitative parameters, and applying a fixed percentage rate to it. E.g. 5 % of profit before taxes, 0,5 % of assets etc.

Size rule – this model is based on single rule model, but in this case a concrete percentage of the financial indicator is not applied. Every financial indicator, which can be applied, has a possible percentage interval, e.g. from 5 to 10 % of profit before taxes, 0,5-1 % of revenue, etc. The auditor, relying on his/her experience, on the basis of information about a company and on the basis of expectations of users of financial statements, selects a percentage and applies it while determining audit materiality.

Average rule – applying this model four or five financial indicators are usually used (on the basis of single rule) and every indicator has a weighted average which is determined by the auditor. For example, profit before taxes 20 % of weighted average is attributed, for gross revenue 40 %, assets 20 %, and equity 20 %. On the basis of weighted average formula the final materiality is calculated.

Formula method – a mathematical formula can be used, which is based on statistical analysis.

All these methods can be applied determining materiality, while performing audit of financial statements. The auditor makes a professional decision which method should be used. In practice, the most popular and most often applied method is size rule method. However, even the same method is applied differently. In 2013, in United Kingdom an investigation was made, where 6 biggest audit companies were surveyed. The survey participants indicated what percentage intervals they use in determining the materiality of audit of financial statements. In some cases, maximum materiality in different companies can vary even 10 times (Table 2). It indicates, that for the same company, which is audited by different auditors, different standards and different workload can be used. Most important, the value of misstatement determining whether distortion is material or not, can vary 10 times.

According to the effective standards, while evaluating error's materiality, the auditor presumes the following: users of financial statements have an appropriate knowledge of business and economic activities and accounting and a willingness to study the information in the financial statements with an appropriate diligence, understand that financial statements are prepared and audited to levels of materiality, recognize the uncertainties inherent in the measurement of amounts based on the use of estimates, judgment, and the consideration of future events, and, make appropriate economic decisions on the basis of the information in the financial statements (SAS 107, 2006). 320 International Standard on Auditing indicates, that judgments about matters that are material to users of the financial statements are based on a consideration of the common financial information needs of users as a group, however the possible effect of misstatements on specific individual users, whose needs may vary widely, is not considered (ISA 320, 2009). Therefore, the auditor, very often has to make assumptions when making a decision about 1) knowledge of users of financial statements 2) tolerance level to the size of the misstatement 3) expectations from audit of financial statements and etc. Therefore, if different assumptions are made, the materiality can be different as well.

Hence, the main criterion the auditor should use, while defining materiality, is misstatement's impact on the decisions made by the users of financial statements. However, a question arises, whether different methodologies used by different auditors in defining materiality, in all cases, comply with the expectations of users of financial statements?

Table 2. Audit planning materiality percentages used in six biggest audit companies in United Kingdom. Source: (Audit..., 2013).

Benchmark	Company 1	Company 2	Company 3	Company 4	Company 5	Company 6
Profit before tax - Listed/PIE	Up to 5%	5%	3 % to 10%	3 % to 10%	5 % to 8%**	5 % to 10%
Profit before tax - non-Listed/PIE	5 % to 10%	5 % to 10%	3 % to 10%	3 % to 10%	5 % to 10%	5 % to 10%
Gross profit - Listed/PIE	Up to 2.5%	-	-	3 % to 10%	1 % to 2%	partner judgment
Gross profit - non-Listed/non-PIE	Up to 3.5%	-	-	3 % to 10%	1 % to 4%	partner judgment
Net assets - Listed/PIE	0.5 % to 1%*	0.5 % to 1%*	2 % to 5%	3 % to 10%	1 % to 2%	Up to 3%
Net assets - non-Listed/non-PIE	1.75 % to 2%*	0.5 % to 1%*	2 % to 5%	3 % to 10%	1 % to 5%*	Up to 3%
Revenue - Listed/PIE	Up to 1%	0.5 % to 2%	0.5 % to 2%*	0.5 % to 3%	0.5 % to 1%	0.8 % to 5%
Revenue - non-Listed/non-PIE	Up to 2%	0.5 % to 2%	0.5 % to 2%*	0.5 % to 3%	0.5 % to 2%	0.8 % to 5%
Total assets - Listed/PIE	Up to 0.5%	0.5 % to 2%	1 % to 2%	0.5 % to 3%	0.5 % to 1%	-
Total assets - non-Listed/non-PIE	Up to 2%	0.5 % to 2%	1 % to 2%	0.5 % to 3%	0.5 % to 2%	-

*Maximum percentage depending on whether entity was a Mutual or Pension Fund..
**Consultation required above 5%

The expectations of financial statements' users concerning the value of materiality

In performing audit, the auditor has to collect sufficient appropriate audit evidence. Sufficiency implies the amount of audit evidences, and appropriate evidence implies the quality measure of audit evidence (ISA 500, 2009). However, reasonable assurance does not imply absolute level of assurance because audit has certain inherent limitations (ISA 200, 2009).

The results of investigation, made in 2003, indicated that the immaterial misstatement understood by the users of financial statements is smaller than the values which are applied in practice by the auditors (Cho et al., 2003).

Accordingly only 0.1 - 0.2 % limit on profit before taxes was considered to be immaterial, whereas the auditors consider the limit to be 10 %, i.e. difference is 50 times. Limit of total assets which was considered to be immaterial by the users of financial statements made 0.01 - 0.025 % of total assets, when the auditors, accordingly, assess the limit of 3 % (difference is 120 times), depending on the circumstances. The investigation also indicated revenue misstatement which was considered to be immaterial - 0.01 - 0.02 %, while the auditors usually apply 5 % limit (250 times). Therefore, it could be stated, that the materiality applied by auditors might often differ from the expectations of users of financial statements.

Respectively, the misstatement, which the auditors consider to be possibly immaterial, can be evaluated as material for users of financial statements and their decisions.

In Lithuania, the survey of chief financiers, as the experts, of ten different companies' was made by the authors, concerning the most important financial indicators in making business management decisions, and what value of misstatement is considered to be immaterial. The experts were asked to identify: (1) the most important financial indicators in company's performance, (2) clearly trivial misstatement and (3) misstatement which might influence economic decision. The results are presented in Table 3.

Table 3. The materiality of financial indicators for the users of financial statements. Source: Prepared by the authors according to the expert survey results.

Company	Size of company	The most important financial indicators in company's performance	Clearly trivial misstatement, EUR	Misstatement which might influence economic decisions, %
Company 1	Small	Gross profit	100	1,0%
Company 2	Very small	Profit before tax	1.000	1% - 2,0%
Company 3	Very small	Assets	100	2% - 5,0%
Company 4	Medium-sized	Revenue	500	1,0%
Company 5	Medium-sized	Revenue	100	1% - 2,0%
Company 6	Medium-sized	Revenue	200	1,0%
Company 7	Medium-sized	Gross profit	500	1,0%
Company 8	Medium-sized	Gross profit	2.000	1% - 2,0%
Company 9	Medium-sized	Gross profit	1.000	2,0%
Company 10	Large	Gross profit	6.000	1% - 2,5 %
Average			1.150	2,0%

The experts identified the financial indicators and the value of misstatement, which is considered to be immaterial in making management decisions. The results of survey of experts are considerably different from the survey made in 2003. It indicates, that the materiality level perceived by the users of financial statements depend on concrete circumstances, therefore, it must be periodically revised.

The auditors agree, that the materiality concept should be clarified (Jacoby and Levy, 2016; Hitzig, 2016), therefore, it is logical, that the users of financial statements lack knowledge about materiality used in audit. It is rational, that existence of different materiality levels in the financial statements audit process reduces the understanding of misstatements and materiality by the users of financial statements. In 2003 in survey the users of financial statements indicated immaterial misstatements for them. However, a question arises, to which audit materiality indicated sizes are attributed to a) planning materiality; b) performance materiality; c) clearly trivial misstatement materiality? 0.01 - 0.02 % misstatement of revenue probably will not change the decision of the users of financial statements to invest or not into the company, therefore, a assumption can be made, that the misstatements indicated by the users of financial statements very often depict clearly trivial misstatements (bearing in mind the materiality perspective used by the auditors), however, indicated values not always influence the final decisions.

The expert survey showed, that some differences exist between the materiality value applied by the auditor and the expectations of financial statements users. One of the reasons, why the difference exists between materiality applied by the auditor and expected materiality of users of financial statements lies in the fact, that very often the users make great requirements for audit. The auditor cannot achieve the users' aims because of limited control means and inherent audit limitations. Also the auditor is not obliged to perform certain procedures and tasks, because professional standards do not require it even though the users of financial statements expect it (Porter, 1993). What is more, many investigations confirmed the fact, that users lack knowledge about materiality (Rooij, 2009; Houghton et al., 2011; Considerations..., 2012), therefore, the expectations can be in no proportional to auditor's possibilities.

Today a new statement about application of materiality in financial statements is under consideration. On the basis of preliminary project, the statement will cover characteristics of materiality, the concept of materiality, and defining the misstatement as material or

immaterial (Application..., 2015). This standard is devoted to people who prepare financial statements; therefore, the understanding of materiality between people who prepare financial statements and who use it should increase. However, today, because of the lack of knowledge, the understanding of materiality by the users of financial statements and materiality applied by the auditors is a nowadays problem.

Because of the different understanding of materiality among auditors and users of financial statements, the solutions are searched. In 2005 Brennan and Gray investigated the applied materiality problems during audit and they presented a suggestion that more detailed materiality disclosures are needed (Brennan and Gray, 2005), which could bridge the gap between auditor's understating and the users understanding. The other suggestion which might minimize the risk of different perception of materiality is the disclosure of materiality applied by the auditor. Having disclosed it, the size of misstatement, which possibly was not corrected, would be clear for financial statements users. The survey which was made in 2009 stated that about 98% of respondents agree, that the materiality applied by the auditor should be disclosed (Rooij, 2009). The other survey, which was made few years later, also revealed the fact, that it should be disclosed that materiality is used and that audit does not perform 100% check-up (Houghton et al., 2011). Hence, the difference between perceived understanding of materiality by auditors and users of financial statements would be reduced.

There is no doubt, that very often the users of financial statements understand materiality differently than the materiality used by the auditors in practice. There are some proposals how to minimize the difference, but due to great number of different opinions, no concrete solutions were made and this problem is still of great importance to-day.

The method for harmonizing materiality expectations of the users of financial statements and materiality value applied by the auditor

To improve audit process and minimize the risk, that the materiality which was applied by the auditor, will not comply with the expectations of the users of financial statements, is possible when an additional test is performed. To assess what misstatement in financial statements might change the users economic decision is very complicated (it usually depends on many circumstances), however, to identify the size of misstatement which would be completely immaterial is much simpler. Very often this misstatement corresponds the clearly trivial misstatement out of three materialities used by the auditor. In 2015 the biggest 8 audit companies in United States of America underwent survey and the clearly trivial materiality values in percentage they use are presented in Table 4. All companies apply very similar percentages: 3 - 8% of planning materiality. Most often 5 % of planning materiality is applied.

Table 4. The size of clearly trivial misstatements with reference to 8 biggest audit companies in United States of America. Source: Created by the authors on the basis of (Eilifsen and Messier, 2015).

	Clearly trivial misstatement
Company 1	Most often 3 % of planning materiality.
Company 2	Most often 5 % of planning materiality.
Company 3	Most often 3-5 % of planning materiality.
Company 4	3-5 % of planning materiality.
Company 5	5 % of planning materiality.
Company 6	Most often 3-8 % of planning materiality.
Company 7	5 % f planning materiality.
Company 8	5 % f planning materiality.
AVERAGE ≈	**5%**

Three-step test is suggested which could help to define planning materiality during audit, which would correspond to the expectations of users of financial statements.

1. The inquiry of the main users of financial statements about clearly trivial misstatement in value terms (EUR);
2. Application of formula (2) to evaluate planning materiality;
3. The comparison of results to materiality determined in traditional manner and selection of final materiality.

Step No. 1. Firstly, the auditor should get information from the main users of financial statements about clearly trivial misstatements (the value expressed in EUR, which do not make any impact on company's performance and are not important to company's managers, shareholders, investors and other users of financial statements). Main groups of users of financial statements are: investors, creditors, suppliers, employees, customers, state institutions, public in general (Conceptual..., 2005). In every case, the users, who are interested in financial statements and its' information, are different. If the company has some loans – the creditors will be interested in financial position of the company, if the company wants to expand and searches for investors – the investors will be interested in company's activities. If the company satisfies public needs or company's activity is important for public – corresponding state institutions will be interested in company's performance. However the employees' interests in financial statements can be separated from other groups. This group of people are interested in financial statements and financial state of the company because their welfare directly depends on it. While performing the audit, the auditor not always has possibility to evaluate the opinion of certain users groups and get the information. But the auditor can get information from company's shareholders, employees and management (CEO, CFA etc.). Therefore, it is recommended to enquire this group, what is the value of misstatements or inaccuracies in financial statements, expressed in value terms, that will be not important for them and make no impact. Having this value and using Formula No. 2 the auditor could evaluate, whether the materiality which he/she applies complies with

expectations of the users of financial statements (concrete groups). The main goal of an auditor is to survey those users who has the most interest in financial statements. The survey can be performed verbally or in a written form, but according to the evaluation of audit evidence – the information presented in a written form is more reliable than verbal, therefore, it is recommended to make a survey in a written form. When the auditor gets the results of the test, could add this information to the documents related with the calculation of materiality. The company's performance, financial situation and the importance of financial statements to the users usually changes, therefore, the survey must be done before every audit.

Step No. 2. The auditors, while calculating clearly trivial misstatements, usually apply 3-8% of planning materiality. The average value which is usually applied makes 5% (Table 4), thus:

$$\begin{matrix} \textit{Clearly trivial} \\ \textit{misstatement, EUR} \end{matrix} = \begin{matrix} \textit{Planning} \\ \textit{materiality} \end{matrix} x\, 0{,}05 \quad (1)$$

Accordingly, if the value of clearly trivial misstatement is known, a reverse formula can be applied and it is possible to calculate what planning materiality should be. The auditors, in defining clearly trivial misstatement usually apply 5% (Table 4) of planning materiality, therefore, this value is suggested in formula

$$\begin{matrix} \textit{Planning} \\ \textit{materiality} \end{matrix} = \frac{\textit{Clearly trivial misstatement, EUR}}{0{,}05} \quad (2)$$

The calculation of planning materiality according to the formula is presented in Table 5.

Step No. 3. In the last step the auditor should compare the obtained results with suggested formula with the results got in a traditional way. The final determination of materiality in all cases depends on auditor's professional decision, therefore, the auditor has to make a final decision, however the suggested test can give a lot of useful information to the auditor. If the determined materiality using suggested formula is not bigger that materiality got in a traditional way – the auditor gets an additional assurance that the applied materiality complies with the expectations of the users of financial statements. And vice versa, if the calculated materiality is smaller – the auditor will have some indications, that, maybe, applied materiality and audit procedures are not suitable and the main goals of audit might not be achieved. Consequently, the auditor could: a) select a smaller materiality; b) ascertain the needs of the users of financial statements and materiality tolerance in more details; c) consult with another auditor. These measures will minimize the risk of making wrong professional decision.

The situation can be illustrated by the example. Let's say, that the initial, traditional materiality is 10 000 EUR. Consequently, from the calculations made in Step 2 it is seen that for the companies No. 2, 8, 9 and 10 the expected materiality by the users, which was obtained applying Formula No. 2 is bigger, than the one applied by the auditor, therefore, there does not arise risk for wrong materiality. The materiality in companies No. 4 and 7 comply with the calculations made by the auditor, therefore, there is no risk there as well. However, in companies No. 1, 3, 5 and 6 the obtained materiality are smaller compared to the results gained by the auditor when the calculations were made in a traditional way. Hence, the risk exists, that the auditor, probably, applies too high materiality and he/she needs to perform one out of three named measures to minimize risk.

Most of the researches before was oriented towards identifying the problem related to the different materiality thresholds between users and auditors, however very few suggestions how to eliminate the problem was suggested. Furthermore, suggestion of this article for calculating materiality is the probably the first attempt to calculate materiality directly involving the users of financial statements, thus it is very important for science as well as future researches further developing suggested method and cannot be compared to other authors suggestions.

The suggested test is very important for both, science and practice, because it could also be used as a new and innovative method to calculate materiality (only steps 1 and 2). Also, alternative way for calculating materiality is new technique to address materiality in a way that suits both, users of financial statements and auditors, thus this technique could be used in the future researches searching and examining other materiality determination methods and if they are in the line with users expectations.

Table 5. Suggested calculation of materiality. Source: Produced by the authors

Company	Size of the company	The most important indicators in company's activity	Clearly trivial misstatement, EUR	Calculation of planning materiality according to the suggested formula
Company 1	Small	Gross profit	100	Planning materiality = Clearly trivial misstatements, EUR / 0,05 = 100 / 0,05 = 2000 EUR
Company 2	Very small	Profit before taxes	1.000	Planning materiality = Clearly trivial misstatements, EUR / 0,05 = 1000 / 0,05 = 20000 EUR
Company 3	Very small	Total assets	100	Planning materiality = Clearly trivial misstatements, EUR / 0,05 = 100 / 0,05 = 2000 EUR
Company 4	Medium-sized	Revenue from main activities	500	Planning materiality = Clearly trivial misstatements, EUR / 0,05 = 500 / 0,05 = 10000 EUR
Company 5	Medium-sized	Revenue from main activities	100	Planning materiality = Clearly trivial misstatements, EUR / 0,05 = 100 / 0,05 = 2000 EUR
Company 6	Medium-sized	Revenue from main activities	200	Planning materiality = Clearly trivial misstatements, EUR / 0,05 = 200 / 0,05 = 4000 EUR
Company 7	Medium-sized	Gross profit	500	Planning materiality = Clearly trivial misstatements, EUR / 0,05 = 500 / 0,05 = 10000 EUR
Company 8	Medium-sized	Gross profit	2.000	Planning materiality = Clearly trivial misstatements, EUR / 0,05 = 2000 / 0,05 = 40000 EUR
Company 9	Medium-sized	Gross profit	1.000	Planning materiality = Clearly trivial misstatements, EUR / 0,05 = 1000 / 0,05 = 20000 EUR
Company 10	Large	Gross profit	6.000	Planning materiality = Clearly trivial misstatements, EUR / 0,05 = 6000 / 0,05 = 120000 EUR

Conclusions and future research possibilities

The correct determination of materiality during financial statements audit is one of the most important tasks for auditor, in order to perform it correctly – to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework.

Even though, the understanding of materiality and application of it should be the same and not depend on what auditors or audit companies perform audit of financial statements, however, different auditors apply different materiality values, therefore, the reliability of financial statements can be different depending on auditor or audit company.

The determination of materiality should be orientated towards the users of financial statements, but the surveys indicated that the materiality level expected by users of financial statements is lower compared to the one, applied by an auditor, therefore, a big risk exists, that in many cases the financial statements do not present such level of reliability which is expected by the users of financial statements.

The suggested test could improve the audit process in different aspects. Firstly, today, there does not exist unanimous planning materiality determination method among auditors. The auditors apply different materiality determination methodologies, thus, different materiality might be applied for the same company under audit by different auditors. While applying the suggested test it might be possible to determine the unanimous materiality of financial statements. Also, the defined planning materiality value should reflect the situation whether the economic decisions made by the users of financial statements will change, therefore, while calculating materiality the users' opinion has to be considered. However, there does not exist clear practical or methodological guidelines how the auditors should consider it. With the help of suggested test, the auditors will get information directly from users, hence the risk, that the planning materiality will not comply with the users' expectations, will decrease.

Most of the researches before was oriented towards identifying the problem related to the different materiality thresholds between users and auditors, however very few suggestions how to eliminate the problem was made. Thus, the suggested test is very important for both, science and practice, because it could also be used as a new and innovative method to calculate materiality (only steps 1 and 2) and replace currently used methods, which, from the conclusions of the previously made researches, does not ensure, that materiality thresholds used by the auditors are the same thresholds, as users expect.

Suggested alternative way for calculating materiality is very important for future researches because it is new technique to address materiality in a way that suits both, users of financial statements and auditors. Also, this new technique could be used in the future researches searching and examining other materiality determination methods and if they are in the line with users' expectations. Suggested method for calculating materiality is probably the first attempt to calculate materiality directly involving the users of financial statements, thus it is very important for future researches to further evaluate the suitability of the method. And if possible findings are made, it could be used as the basics for other materiality determination techniques.

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