European Research Studies Journal
Volume XXI, Issue 4, 2018

pp. 109-118

Materiality in Audit of Financial Reporting Party Conducting Accounting of Joint Activity

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Abstract:

The study aims to develop recommendations for auditors in determining the level of materiality in the audit of the financial statements of a legal entity that is a responsible party to the simple partnership agreement.

According to the author, for a separate balance sheet and income statement of the joint activity of the participants, the data which are not reflected in the statements of the audited entity conducting the joint activity and its accounting, is reasonable to be included in the calculation of materiality. The joint activity data plays an important role in the preparation of the audit plan, as being unverifiable by external supervisors, except for representatives of the parties under a simple partnership agreement.

An auditor applies his/her professional judgment, experience and theoretical knowledge in the field of accounting and taxation of joint activities under a simple partnership agreement, to independently determine the indicators of joint activities that can affect the audited financial statements. The author used the following research methods: analysis, synthesis, observation, experiment and so on, which are based on the practical activities of the author and participation in audits and consultations as an expert.

The study allowed recommendations for the auditors to choose indicators of financial statements during the audit, which will allow being cautious in the preparation of the audit report. Scientific novelty is the problem of determining the materiality in the audit in the actual presence of a separate balance sheet of joint activities, the data of which are not included in the audited statements but can affect it.

Keywords: *Materiality in auditing, joint activities, international audit standard 320, responsible party.*

JEL Classification: *M40, M42.*

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1. Introduction

Joint activities of organizations, including those with the participation of individual entrepreneurs, may be a diversification of commercial activities at the lowest cost when using certain preferences in accounting and tax accounting, possible under the simple partnership agreement, regulated by the Civil code of the Russian Federation (hereinafter – RF Civil Code) (Civil Code of the Russian Federation №51-FZ). A simple partnership agreement or a joint venture agreement gives the participants the right to combine funds, skills, efforts, contributions without forming a new legal entity, which greatly simplifies the algorithm of relations of all participants that are to be united. Issues related to the organization of joint activities, including management consulting, have become common in the last five years in the system of audit services (Kiselevich, 2011; Baldacchino *et al.*, 2017).

It is important to note that the civil code does not contain prohibitions on joint activities of Russian organizations and individual entrepreneurs with foreign organizations. The Tax Code of the Russian Federation (hereinafter – RF Tax Code) (International auditing standard 320, № 192n) requires joint operations for the purposes of tax accounting to the Russian party. If one of the parties of the joint activity is a foreign partner, the auditor should increase the labor costs at the stage of planning and drafting the audit plan, increasing the labor costs for the audit of tax calculations, as the Russian organization will be responsible for the calculation and payment of income tax. There may be a need to pay income tax, as the Russian side may be a tax agent. And if between the countries-participants of the joint venture agreement the international agreement on avoidance of double taxation is signed, there is a confirmation on registration of the foreign partner in this country, the profit tax is not calculated by the Russian side. At present, such joint activities with the participation of a foreign partner are not widespread in Russia but have been sufficiently studied and are of interest (Mokrousov, 2011; Osadchy *et al.,* 2018).

2. Research methods

Analysis, synthesis, observation, experiment, etc., which are based on the practical activities of the author in the direct participation in the creation of the project of joint activities, participation in the planning and preparation of working documents of the auditor in audits and consultations as an expert (Zhukova, 2018; Grima *et al.,* 2017; Ozen *et al.,* 2014).

3. Research results

Joint activity can be considered as a legal way to optimize taxation and as a way to improve the balance sheet structure on the following facts:

- a party of the agreement may be an individual duly registered as an individual entrepreneur which facilitates the maintenance of accounting and tax accounting by exempting an individual entrepreneur from the requirements of accounting in full, reduced overall tax burden;
- distribution of profits between the companions is possible not only in proportion to the size of the participant's contribution but according to a different order fixed by the contract. A participant who has current losses from the main activity reduces his/her profit on joint activities;
- assets transferred to joint activities are not subject to value-added tax;
- participants of the joint activity carry out the business activity on other economic types, distributing the general administrative expenses;
- a new legal entity is not registered to carry out joint activities and the termination of activities is also not a difficult process for the participants;
- participants of the joint activity can apply various tax regimes in accordance with the tax code, ie., along with the application of value-added tax the application of special tax regimes is allowed;
- other advantages of pooling funds by participants to achieve specific goals through the establishment of a partnership.

An auditor, when agreeing to conduct an audit of an organization that makes up financial statements under International Financial Reporting Standards or Russian Accounting Rules, in the conditions of application of International auditing standards in Russia (hereinafter – ISA), must understand the principles of joint activities both from the point of view of drawing up a separate balance sheet, and from the point of view of Russian tax legislation, since each participant is aimed at profit with the least tax risks or their complete exclusion.

The authors have considered the peculiarities of the joint venture agreement, audit of accounting policy of participants of joint activity, planning in audit and other problematic issues taking place in the implementation of such an agreement (Zhukova, 2015; Hartikayanti *et al.*, 2018). The question of an auditor's determination of materiality is designated by the author as debatable for the following reasons:

- when reporting under the Russian Rules (Standards) of Accounting, the balance sheet data of the joint activities of the participants are not included in the balance sheet of the participant responsible for the conduct of general affairs and accounting;
- in the absence of the need to register a new legal entity, all taxes are calculated by each member of the joint activity independently according to the data provided by the member who conducts accounting and tax accounting;
- planning and methods of an audit of a separate balance of joint activities, not provided in any institutions, its relationship with the main balance of the responsible party are practically not considered in the Russian literature.

Let's consider those articles of the balance sheet and statement of profit and loss (statement of financial results) of an audited companion leading the accounting of the joint activity, which, in the opinion of the authors, should be analyzed as affecting the audited financial statements of the legal entity (Suryanto and Thalassinos, 2017; Suryanto and Ridwansyah, 2016). We have proposed the following additional numerical indicators of the audited balance sheet as basic indicators, along with the existing ones in the audit practice, for the calculation of the overall level of materiality and working materiality:

- financial investments in the joint activitiy;
- deferred tax liabilities related to the joint activity;
- deferred tax assets related to the joint activity.

From the separate balance sheet, which is audited by the participant, we offer the inclusion of the following values as basic indicators:

- value-added tax;
- calculations with the budget on taxes and fees;
- undistributed profit (uncovered loss).

From the statement of profit and loss of the balance sheet of the audited entity on the current practice, including in widely used audit programs, such as Audit-XP, apply indicators "other income" and "other expenses" with the value of the share, as a rule, 4%. We believe that it is reasonable to allocate the amount of other income and expenses on the main activity and joint activity when calculating the overall level of materiality, since the financial result of the joint activity, determined on a separate balance sheet, is reflected in the share of the audited participant under the terms of the agreement.

On joint activities, the financial result is determined and distributed among the participants of the party that keeps records. Let's call them a responsible participant. The profit is distributed and taxed as part of the non-operating income of each participant. The loss from joint activities is covered by each participant's own sources, i.e. for tax purposes, it is not taken into account – the income will not decrease by the number of losses received from the joint activity. This obliges the organization and other project participants to analyze the reasons for obtaining a negative financial result, to check the accounting and tax accounting by a trusted person, in our case – it is an audited organization.

In this regard, the financial result of the joint activity can significantly affect the items of the Income Statement (Profit and Loss Statement). It is advisable to include this indicator in the baselines for materiality separately with a large share of influence, as presented in Table 1.

Table 1: *Basic indicators of the Income Statement (Profit and Loss Statement) used along with the Balance sheet indicators to calculate the overall level of materiality*

Indicators of the Income Statement (Profit and Loss Statement)	Indicators at the beginning and at the end of the period, RUB.	Share, %	Intermediate levels of materiality	Note
Revenue		2.0		Balance of the audited entity
Costs		2.0		Income Statement of the audited entity
Other expenses		4.0		Income Statement of the audited entity without taking into account the joint activity data
Other expenses		6.0		Income Statement of the joint activity
Other income		4.0		Income Statement of the audited entity without taking into account the joint activity data
Other income		6.0		Income Statement of the joint activity

We have tested the following indicators of the balance of the audited entity, the data of which we must confirm or express an opinion with a reservation, we have applied in practice. We also took into account the indicators of the separate balance of joint activities, which is prepared by the responsible participant, in calculating the overall level of materiality, which is presented in Table 2.

Table 2: *Additional indicators of the separate balance sheet of the joint activity, made up by the responsible participant, to calculate the overall level of materiality, applied along with the indicators of the Income Statement (Profit and Loss Statement)*

Indicators of the balance sheet of the audited entity and separate balance sheet of the joint activity	Indicators at the beginning and at the end of the period, RUB.	Share, %	Intermediate levels of materiality	Note
Settlements with the budget		2.0		Separate balance of the joint activity
Financial investments in the joint activity		3.0		Balance of the audited entity
Value-added tax		4.0		Separate balance of the joint activity

Deferred tax assets		4.0		Separate balance of the joint activity
Deferred tax liabilities		4.0		Separate balance of the joint activity
Accounts payable		5.0		Separate balance of the joint activity
Accounts receivable		5.0		Separate balance of the joint activity
Undistributed profit (uncovered loss)		4		Balance of the audited entity

We will combine the indicators offered by us for calculation of the general and working level of materiality according to the reporting of the audited person and the separate reporting of the joint activity in Table 3 which is provided only to owners and other persons provided by the local documents accepted by all participants (companions).

Table 3: *Indicators of financial statements of the audited entity and the separate balance sheet of the joint activity, made up by the responsible participant, to calculate the overall level of materiality in the audit of the participant conducting general affairs and carrying out accounting of the joint activity*

Basic indicators	Indicators at the beginning and at the end of the period, RUB.	Share, %	Intermediate levels of materiality	Note
Non-current assets		8.0		Balance of the audited entity
Long-term and short-term loans and borrowings		7.0		Balance of the audited entity
Current assets		5.0		Balance of the audited entity
Balance currency		2.0		Balance of the audited entity
Settlements with the budget		2.0		Separate balance of the joint activity
Financial investments in the joint activity		3.0		Balance of the audited entity
Value-added tax		4.0		Separate balance of the joint activity
Deferred tax assets		4.0		Separate balance of the joint activity
Deferred tax liabilities		4.0		Separate balance of the joint activity
Accounts		5.0		Separate balance of the joint

payable				activity
Accounts receivable		5.0		Separate balance of the joint activity
Equity (excluding retained earnings or uncovered loss)				Balance of the audited entity
Undistributed profit (uncovered loss)		4		Balance of the audited entity
Revenue		2.0		Balance of the audited entity
Costs		2.0		Income Statement of the audited entity
Other expenses		4.0		Income Statement of the audited entity without taking into account the joint activity data
Other expenses		6.0		Income Statement of the joint activity
Other income		4.0		Income Statement of the audited entity without taking into account the joint activity data
Other income		6.0		Income Statement of the joint activity
Intermediate level of materiality, RUB.				
General level of materiality, RUB.				
Waiting for distortion				
Working materiality, RUB.				

4. Discussion of the results

From the provisions of ISA 320 (2016), it can be concluded that the auditor uses the level of materiality, which establishes the audited entity for the preparation of financial statements. It should be assumed that it is appropriate for the level of materiality to be established and agreed upon by all participants in the joint venture, and for the participant who accounts for the joint activity (responsible participant), materiality is assumed to be in accordance with the one that has already been adopted for the preparation of the financial statements of the responsible participant. It should be noted that the IT Audit program offers an auditor more than 500 samples of auditor's working documents. In this regard, an auditor, guided by the forms of working documents adopted in the organization, documents the information related to the calculation of the level of materiality and the fact of notifying the management of the participants of joint activities or persons responsible for the implementation of the partnership agreement about this fact (Hayes *et al.*, 2014; Chariri and Januart, 2017).

An auditor understands that the financial statements of the audited entity, which is a responsible participant, may contain material misstatements. This happens, for example, as a result of mistakes, unfair actions of the management, as well as the bad faith of the counterparty (Kiselevich, 2012), which, as shown by the analysis of arbitration practice, leads to a refusal to deduct value-added tax and, accordingly, to the misstatement of the items: "Value-added tax", "Calculations with the budget", "Retained earnings (uncovered loss)". In accordance with paragraphs, 4-6 and A1 of ISA 320, an auditor himself/herself determines materiality taking into account internal rules (standards), professional experience and judgment.

In practice, there is a situation when the person responsible for the preparation of financial statements, subject to the audit, in accordance with the job descriptions and administrative documents, communicated to all participants of the joint activity additionally compiles reports and tax declaration on joint activities. In this case, the testing of the internal control system of the audited entity will allow to understand and assess the level of its professional competence and to identify common errors in the accounting and tax accounting of the two balance sheets and risks (Safonova *et al.*, 2018; Kupec, 2018).

The fact of existing of the joint activity itself, especially the preparation of the audited entity of a separate balance sheet of the SD, is, as practice shows, a factor that increases the period of the audit and affects the risk of non-detection of material misstatements in the statements. In accordance with MCA 320, an auditor sets the materiality for the financial statements. In this case, he/she is not obliged to proceed from the materiality level adopted by the audited entity and to report in the audit report about the inference used as the basis for the audit. However, the tender documentation, the agreement (this is found in the audit of state and municipal enterprises) may request the information about the size and procedure for calculating materiality. It is particularly necessary to emphasize that the auditor when detecting non-essential misstatements, should inform the management of the audited person about this and agree on the fact of recognition of misstatements as non-essential. In our opinion, it is reasonable to inform about such facts the people responsible for the conduct of joint activities of individuals – representatives from each participant (companion).

Considering the business continuity issues, also indirectly affecting the materiality of the separate balance sheet of the joint activity, the auditor should send a request to the management of the participating organizations through the responsible person for maintaining a separate balance sheet on the assessment of the continuity of the joint activity. The auditor needs to understand that the opinions of the participants may not coincide. This may largely depend on the degree of awareness of the participant, the size of his/her contribution, the size of the distributed or accrued profit, the percentage (share) of the implementation of the plan of development of joint activities and the goals set in the simple partnership agreement. The main purpose of the joint activity of commercial organizations-participants of the joint activity is making a profit, new capital investments for the purpose of their operation for further profit, etc.

5. Conclusion

Each participant of the joint activity should provide information on the understanding of materiality, its impact on the financial statements and the auditor's conclusions at the request of the audited entity. If the participant of the joint activity, entrusting the accounting of the audited entity, except for the joint activity, does not perform any other financial-economic activity, the most important thing for him/her is to include risks of a separate balance sheet, that is not provided anywhere under the legislation of the Russian Federation, so external bodies do not verify and it doesn't belong to a new legal entity because a new legal entity is not created. This peculiarity should be taken into account when auditing the financial statements of the legal entity responsible for the accounting of joint activities.

Thus, the materiality in the audit of the financial statements of a participant who accounts for joint activities is determined by the auditor himself/herself, can be based on the materiality adopted by the audited entity, which is absolutely not necessary. Moreover, the author emphasizes that the data of the separate balance sheet of the joint activity are not included in the data of the audited balance sheet and the report on financial results, which is also important for the additional inclusion of some indicators in the basic indicators for the calculation of materiality.

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