THE IMPORTANCE OF MATERIALITY IN AUDIT

MORARU MARIA, DUMITRU FRANCA
WEST UNIVERSITY OF TIMIȘOARA, J.H.PESTALOZZI STR.,NR.16,TIMIȘOARA,ROMÂNIA
TIBISCUS UNIVERSITY OF TIMISOARA, DALIEI STR. NR.1A, TIMISOARA, ROMÂNIA
mariamoraru2002@yahoo.com, francadumitru@yahoo.com,

Abstract:
In the context of globalization the need of information becomes more and more important. The information dominate the economical life of entities, the access to information being an absolute necessary condition for the business success. The auditors issue a kind of warranty certificate concerning the information contained in the financial or non/financial statements. The work makes a study of the determination method of materiality, of its importance in the audit process, it presents the relationship that exists between the materiality and the audit risk.

Key words: *audit, materiality, audit risk, estimated value of errors, financial statements.*

JEL classification: *M42*

INTRODUCTION

The need of information became more and more stringent on the coordinates of continuous development of the civilized world. The information dominates the economical life of organizations, and the access to information is an absolutely necessary condition for the success in business.

In a globalized economy, in which the information that the companies provide to the external environment has a role that is so important in adopting decisions by various persons and institutions, that it is absolutely compulsory for all the involved participants in elaborating and supervising it to fulfill the tasks with the proper correctitude and professional interest.

The development of the contemporary economical and financial-accountancy sciences is inconceivable without auditors.

The financial audit has an important mission – that of offering credibility to the information needed in the decisional process and to influence in a benefic way the effective and efficient functioning of the operational flows at the level of capital markets and of economy.

RESEARCH METHODOLOGY

The main research method consisted in revising the most important opinions and approaches within the specialty literature, the articles and studies of the national and international press and the reports of the controlling authorities within the accountancy profession. We wanted to adopt a more critic approach regarding the importance of materiality in audit.

1. THE IMPORTANCE OF MATERIALITY

The term of audit originates from Latin, in the verb *"audire"* that means *"to listen"*. Later on the audit finds its origin in English in the verb *"to audit"* that means *"to examine, to verify"*.

By *audit* it is being understood "the official examination or verification of the accounts and records, especially of the financial accounts", according to Webster's Encyclopedic.

The British encyclopedias give this term a larger meaning, in the sense that by audit it is understood “an examination of a certain situation in a certain domain”.

The audit represents *a professional reasoning* that can be applied in any activity domain, *an important instrument* for the accomplishment of the objectives of a certain entity, which has as main purpose the assessment of discrepancies reported to a controlling frame in force creating the support necessary for conceiving some corrective measures necessary for the reduction or elimination of the identified discrepancies.

The process of financial audit is developed in a context settled by the legislation of each country and it is requested for offering an additional credibility to the financial statements published by entities.

The objective of financial audit consists in providing an assurance that the examined financial statements are complete and drawn up accurately and that the economical operations were effectuated according to the regulations in force.

In practice, in conditions of performance, the accomplishment of this objective is impossible so that the missions of financial audit made on the grounds of tests assure reasonably that the financial statements are complete and accurate.

The collected information by the financial auditors in the stages of knowing the audited entity, of making the analytic procedures, must assure a sufficient quantity information for defining the materiality.

The information are significant if their erroneous omission or presentation would influence the economic decisions of the users that were taken on the grounds of the financial statements.

In laying out the audit plan, the auditor establishes an acceptable level of signification in order to detect the erroneous presentations that are significant from a quantitative point of view.

“The objective of a financial statement audit is to offer the auditor the possibility to express an opinion regarding the drawing up of financial statements, from all the significant point of views, according to the general applicable frame for the financial report”.[1]

The materiality depends on the dimension of the element or of an error considering the specific circumstances of the erroneous omission or presentation. The auditor must take into consideration:

- the possibility of a significant erroneous presentation of some relatively small values that, accumulated, could have a significant effect on the financial statements;
- the materiality at the general level of financial statements, as well as concerning the transaction categories, the balances of accounts and information presentations;
- the auditor must take into consideration the materiality for:

- establishing the nature, the moment and the ampleness of audit procedures;
- the assessment of the significant erroneous presentation’s effect of financial statements.

The materiality is defined by The Council for International Accountancy Standards (IASB) in *The general code for drawing up and presenting the financial statements* in the following terms: “The information are *significant* if their omission or erroneous presentation could influence the economical decisions of users, took on the grounds of the financial statements. The materiality depends on the dimension of the assessed element or error in some circumstances of his/her omission or erroneous presentation.

[1] - The International Audit Standard 320 *“The materiality in audit”*.

The materiality is more, a limit apron or limit point, and not a main qualitative characteristic that the information must have in order to be useful.

The materiality shows “the importance of an omission or of an erroneous presentation of the accountancy information […] that makes the reasoning of a reasonable person that counts on those information to change”. [2]

The materiality that is adopted will represent the value in the report with which it is being determined if the errors, omissions or mistakes identified in the accounts, considered individually or cumulated, shows if the respective accounts offer a true, complete and accurate image of the financial position and performance of an entity.

The materiality represents, on one hand, what in Anglo-Saxon accountancy bears the name of *materiality* – the error level under which the understanding and interpretation of the financial statements will not be significantly affected, and, on the other hand, the admissible error level that is accepted in order to decide if the accounts are correct or not.

The main users of the financial audit report are the shareholders, although the auditor is hired by the entity’s management. On the grounds of the audit report the shareholders will know the way in which their business was conducted, making strategic decisions and it is being assessed by the financial auditor the observance of the true image of financial statements in the conditions in which the eventual deviation from this objective does not influence the decisions.

For determining the level of materiality the financial auditor must:

- identify the user it addresses to;
- establish the connection between the information provided by him/her and the process of making decisions;
- know what decisions the users will take on the grounds of the audited financial statements.

The financial auditor must make two important remarks concerning extent area of the financial audit that highlight the materiality and the risk:

- the financial auditor’s liability is limited to the significant information established by a materiality determined by the financial auditor on the grounds of the professional reasoning;
- provides a reasonable and not absolute assurance as far as the fidelity of financial statements is concerned, suggesting the existence of a certain risk, even when the opinion of the financial auditor is without reserves.

The factors that define the materiality are:

The relativity of materiality. The determined materiality has a relative character. A certain value established as materiality can be significant for an entity, while for another entity it can be insignificant.

The relativity of materiality imposes the expression of significance in relative sizes (percentage) applied to absolute values of the accountancy information quantified in the financial statements.

Comparison terms.

The relativity of materiality leads to the reference of its established level to a basis depending on which the identified errors are significant or not.

The most used is the size of profit that reflects the best the entity’s performances (between 1 and 10% of the profit’s size).

If we take into consideration this base of comparison, one of the following variants may be chosen: gross profit, net profit or dividends.

[2] - FASB (Financial Accounting Standards Board)

In the case in which the profit's level is not eloquent following an unusual evolution for the materiality, there can be chosen other comparison basis, such as the turnover, total assets and net assets.

The qualitative factors that affect the materiality are:

- *committing frauds,* for which the materiality is determined not only by the registered value level as in the case of errors;

Fraud is significant, even if at the same value level an unintended error is considered insignificant.

- *the effects of presentation errors,* that might have significant consequences;
- ***the change of evolution trends of some comparison basis,*** might be significant even if the level indicates insignificant values.

2. THE DETERMINATION OF MATERIALITY

In order to design the audit plan the auditors establish an acceptable materiality that is able to detect the significant erroneous presentations from the value (quantitative) and nature (qualitative) point of view.

In order to establish the materiality level from the value point of view there are two variants, meaning:

- *the direct variant* that consist in determining a certain absolute value;
- *the indirect variant* that consists in using a percentage of a certain indicator in order to calculate such a value.

For public entities that are financed from budget sources, the indicator for establishing the materiality is the total level of public expenses.

For private entities, the auditors establish the materiality by applying a percentage quota on the gross and net assets, on the profit and turnover.

In order to establish the level of materiality by nature, the auditor must decide if a non-material element as value can be considered material because of its inherent nature or because of its characteristics.

An erroneous presentation by nature would be the incorrect description of an accountancy policy, in the case in which there is the possibility that by these deficiencies one user to be mislead about the financial statements.

An error or omission may be considered material because of the context or circumstance in which it appears.

An element can be material because of its effects on some key-points of the financial statements, namely: the transformation from budgetary excess to budgetary deficit and vice versa, the transformation of a profit into a loss and vice versa.

The auditors determine the materiality at the general level of the financial statements, as well as connected to the categories of transactions, with the balance of accounts and with the information presentations.

In the case in which the users of the financial statements request a higher accuracy for some accounts, the auditors can establish a more reduced level of materiality for these.

When planning the audit mission the auditor can establish a lower level of materiality than in the case he/she intends to use it for evaluating the audit's results. This has the purpose of offering the auditor a safety margin when evaluating the effects of the erroneous information discovered during the audit.

The principle of materiality can be applied in two stages[3]:

- the planning of the depth of tests (establishing the preliminary materiality, the division of the preliminary materiality on audit segments);

[3] -**Arens Loebbecke – Audit. An integrated approach, 8th edition, ARC press, 2003, Chisinau, page 289**

- the assessment of results (identifying the value of errors on each audit segment, determining the total value of errors, comparing the total value of errors with the level of the preliminary materiality).

Establishing the materiality

The establishment of materiality is made in the phase of planning the financial audit engagement, being an important phase because there is a proportional inverse relationship between the size of materiality and the quantity of planned work to be provided in the engagement of financial audit.

The establishment of the preliminary materiality at a lower level than it is necessary determines the risk that within the financial audit engagement to be effectuated an additional activity of audit evidence collecting, which are not necessary.

The establishment of materiality at a higher level than it should be imposed determines the risk of not identifying some significant errors, of expressing an inadequate audit opinion.

The division of the preliminary materiality level on audit segments

In the planning phase the level of the established preliminary materiality can be divided to the level of accounts, individual transactions, determining the individual materiality of the account or of the respective transaction.

In the specialty literature, the materiality assigned to each segment following the division of the preliminary materiality is called *tolerable error*.

The division procedures of the materiality are chosen by the financial audit according to the professional reasoning, this is why it presents some limits.

In the case of the preliminary materiality division on the grounds of the final weight of the accounts into total residues of the verification balance, there can appear inconveniences because:

- regardless of the values that the balances of some accounts give, some accounts have a higher significance because of their importance and because of the number of transactions reported by the account's turnover.
- regardless of the sizes given by some accounts, their susceptibility of containing errors can be reduced because of the influence of some factors, conclusion to which the auditor can get only on the grounds of his/her experience, reasoning.

The assessment of the results

The assessment of the results contains the following three procedural phases made by:

- applying audit procedures;
- registering in the work documents the identified errors;
- estimating the total value of the erroneous presentations in order to compare them with the preliminary or revised materiality.

If the cumulated value of the discovered and uncorrected values is higher than the materiality, the financial auditor, for the diminution of the audit risk, shall apply additional procedures and will request the entity's management to correct the discovered errors.

If the cumulated value of the discovered and uncorrected values is lower than the materiality, the financial auditor shall make an assessment of the undiscovered errors that he/she will add up with the value of the discovered and uncorrected errors, the obtained sum comparing it with the materiality.

The estimated value of the undiscovered errors along with the value of the discovered and uncorrected errors constitutes *the estimated value of errors*.

$$\text{Estimated value of errors} = \frac{\text{Errors discovered in the sample}}{\text{Total value of the sample}} \times \text{Total value of the analyzed amount (of the audited account)}$$

Between the materiality and the level of the audit risk there is an inverse proportion report, respectively, the higher is the level of materiality, the smaller is the audit risk.

Within the audit missions, the auditors consider this correlation with the occasion of establishing the nature, the moment and ampleness of the audit procedures.

If after the planning of some audit specific procedures the auditor establishes that the acceptable level of materiality is smaller, the risk of audit is higher.

In order to diminish the audit risk, the auditor seeks:

- on one hand, the attenuation of the evaluated risk by erroneous presentation and by sustaining the reduced level by making some additional or extended tests of control;
- on the other hand, the reduction of the risk of external non-detection, by modifying the nature, the moment and ampleness of the planned background control.

In the moment of initial planning of the mission towards the moment of the assessment of the audit procedures results, the auditor can make a different evaluation concerning the materiality and audit risk caused by some modifications of the situation or of the auditor's knowledge after accomplishing the audit procedures. In this sense:

- if the audit procedures are accomplished before the end of the period, the auditor anticipates the results of the operations and the financial status;
- if the real results of the operations and financial status differ in a significant way, the evaluation of materiality and of the audit risk can be modified.

In planning the audit activity, the auditor can establish intentionally an acceptable materiality level that is more reduced than the one that follows to be used for the assessment of the audit's results in order to assure a safety margin when evaluating the effect of the erroneous presentations discovered within the audit.

The auditor takes also into consideration the materiality in the process of expressing his/her opinion.

The auditor, in order to evaluate if the financial statements are drawn up according to the general applicable frame for the financial report, must examine if the *total of erroneous presentation* that were identified during the audit is significant.

This total consists of:

- specific erroneous presentations identified by the auditor including the net effect of identified uncorrected erroneous presentations within the audit of the previous periods;
- the best assessment of the auditor concerning other erroneous presentations that cannot be identified exactly, meaning forecasted errors.

The auditor compares their total with the level of materiality, and in the case in which the total of the uncorrected presentations approaches the materiality level he/she acts for the reduction of the audit risk by making additional audit procedures or by requesting the management to adjust the financial situations for the identified erroneous presentations.

3. CONCLUSIONS

- The materiality constitutes the expression of materiality and expresses the maximum admissible error level of the reported data in the financial statements in order to avoid the possibility of affecting the decisions of the users.
- The materiality constitutes an essential element in the decisional process of the financial audit in the phase of its planning, in the stage of executing the approved audit plan's provisions and in the part of reporting the conclusions of the financial audit.
- The auditor, regardless of the used base for the assessment of the materiality with the purpose of planning the audit, reevaluates the materiality when evaluating the results of the audit procedures taking into consideration the final version of the project of financial statements that contains all the agreed adjustments and obtained information during the development of the audit.
- In the report stage, although the materiality is evaluated in quantitative terms, there is no clear limit value, but more values in the limits of which the auditor uses his/her reasoning.
- The auditor's opinion, although his/her planning might have been based on a quantitative evaluation of materiality, takes into consideration not only the quantity, but also the qualitative nature of the erroneous presentations not adjusted within the financial statements.
- The audit opinion is founded on the audit evidence collected by the financial auditor in his/her engagement, depending on the size of the materiality, as follows:
- if the materiality has a high level, the financial auditor shall apply more restricted audit procedures;
- if the materiality is smaller, the financial auditor shall plan more audit procedures, shall collect more audit evidence.
- Anytime the auditors make a financial audit, they have the obligation to take into consideration the materiality and the relationship with the audit risk.
- For reporting their conclusions, the auditors must have in view the result of the correlation of the total identified erroneous and uncorrected presentations with the established and adopted level of the materiality.

BIBLIOGRAPHY

1. Alin Dumitrescu- Detectarea fraudelor și erorilor în auditul financiar, editura Mirton, Timișoara, 2010
2. Alin Dumitrescu – The detection of frauds and error in the financial audit, Mirton Press, Timisoara, 2010
3. Marcel Ghiță, Ion Pereș și colaboratorii-Guvernanța corporativă si auditul intern, Editura Mirton, Timișoara, 2009.
4. Marcel Ghiță, Ion Pereș and collaborators – The corporatist government and internal audit, Mirton Press, Timisoara, 2009
5. Standardul Internațional de Audit 320 "Pragul de semnificaţie al auditului"
   The International Audit Standard 320 "The materiality of audit"
6. http://www.cafr.ro
7. http://www.estandardsforum.org