MATERIALITY IN FINANCIAL AUDIT

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One of the decisional factors of the opinion expressed in the report elaborated by the financial auditors is the „materiality”, element depending on the size of which is decided, at the end of the mission, taking into account a number of other aspects associated with the company life, whether or not is provided a true and fair view through the financial statements. It is recognized that the certification of financial statements by accredited accountant professionals provide a high level of credibility of the information contained in these financial reports. In order to assess to what extent the various beneficiaries of information from the financial statements may take correct decisions based on them, we shall clarify the role of materiality in conducting the financial audit.

Keywords: materiality, materiality by value, materiality by nature, materiality by context, significant account, significant system, reference base, preliminary value, revised value, audit opinion.

M: Business Administration and Business Economics; Marketing; Accounting.

1. The concept of materiality in the audit

The *materiality* is the measure determined by the auditor, over which every error, inaccuracy or omission affects the regularity and fairness of financial statements, more exactly, true and fair view of them.

The *Framework for the Preparation and Presentation of Financial Statements* of the International Accounting Standards Board define *materiality* in the following terms: „*Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements. Materiality depends on the size of the item or error judged in the particular circumstances of its omission or misstatement” (Paragraph 30).*

As is known, „*the objective of an audit of financial statements is to enable the auditor to express an opinion whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework”* (ISA 320 *Audit materiality*). In consequence, the auditor finds if the financial statements comply *in material respects* with that reporting framework. The assessment of what is material depends on the professional judgment (the materiality is subjective).

Do the appearance of errors, inaccuracies or omissions in the financial statements means that they are not providing a true and fair view? Depends on whether these omissions or misstatements lie or not below the materiality level. If errors, inaccuracies, omissions are below the materiality level can then say that the financial statements give a true and fair view of financial position, performance and other information relating to the activity of a company, and if the omissions or misstatements are not below the materiality level is not offered a true and fair view through the financial statements.

On how express the opinion, the auditor say that the financial statements „give a true and fair view” or „presents fairly in all material respects” the financial position, performance and changes in financial position of the company. He doesn’t say that the financial statements give *true and fair view* which would mean an exact image without omissions or misstatements, but that the financial statements give *a true and fair view*, that is one of several possible. Why more true and fair view possible? There are several possible depending on the level at which the auditor

determines the materiality, namely, according to the level of omissions or misstatements accepted.
Materiality can be defined in three ways: by value, by nature and by context.
Materiality by value is assessed according to the value of omissions or misstatements that the auditor can accept in the financial statements. For example, it can be concluded that omissions or misstatements in excess of 1% of turnover are material.
Materiality by nature consists in assess the omissions or misstatements by their nature, having regard to specific issues about which it is known that users of financial statements will be interested in a greater extent, which requires a high degree of accuracy on some parts of the financial statements, and financial statements as a whole. Examples of material aspects by nature may be: the cash flows, special payments, financial losses etc.
Materiality by context is due to circumstances in which omissions or misstatements occur and, the effect they have on the key points of financial statements. Examples of material aspects by context can be: the transformation of a profit in a loss or vice versa, a changing trend in the financial statements in general or for some structures, artificial increase of the losses beyond the allowed limits, including the presentation of these in the financial statements.
In consequence, the financial statements may contain several types of omissions or misstatements: quantitative or value omissions or misstatements, quality omissions or misstatements (related to the nature of the information) and omissions or misstatements related to the context in which they appear.

2. Determining audit materiality

The materiality is determined:
- *at the beginning of the mission*: establish a global materiality level (setting a preliminary value of materiality) is required to determine the significant accounts (those whose nature or value can contain significant risk of misstatement) and the significant systems (those which contain repetitive data), which means the elements will be given attention;
- *during the mission*: it is determined a materiality level for each section or segment of financial statements (account balances, classes of transactions, disclosures), more specifically, the preliminary value of materiality is allocated on sections or segments; these materiality levels are generally lower than global materiality level, taking account of possible total of misstatements noted; after this allocation, there are estimated the misstatements of each section or segment and then the total misstatements;
- *at the end of the mission*: the global materiality level (the preliminary or revised value of it) allows the auditor to determine whether the observed misstatements must be corrected or to be mentioned in the report where the company refuses to correct; at this stage it is compared the combined value of the misstatements with the preliminary or revised materiality level (significant misstatements, which weren't adjusted are summarized to decide if their total exceeds the materiality level).

In assessing materiality are used quantifiable terms, more exactly, relative values or absolute values, not unquantifiable terms (very low, low, medium, high).
As *basis of reference* in determining materiality, the audit minimal norms recommend total assets (before deduction of debts), turnover and profit before taxation. Other elements of reference that can be used are: equity, exploitation result, net result, the capacity of self-financing etc.
Starting from the values for the three criteria specified by the norms (total assets, turnover, profit before taxation), six factors are calculated by applying two percentage rates on each reference base. The percentages recommended by audit minimal norms to be applied to determine these factors are: 1% and 2% in total assets, 0.5% and 1% in turnover, 5% and 10% in profit before taxation. The auditor may consider, for example, if he only takes into account factors determine on the basis of value of total assets, that an error of less than 1% of total assets is insignificant, an

error greater than 2% of total assets is significant and a error between 1% and 2% is or not significant depending on professional judgment.
The audit minimal norms say that the audit materiality level should normally be in the interval indicated by the six factors. For example, if the current value of the total assets would be 120.000 RON, turnover of 210.000 RON and profit before taxation of 30.000 RON, the six factors determined would take the following values: 1.200, 2.400, 1.050, 2.100, 1.500 and 3.000. Given these information, materiality must place, as mentioned before, among the smallest and the biggest of the six key factors, namely, in the interval 1050 - 3000. But there may be situations where it is appropriate to establish the materiality level above or below the interval indicated, especially when the criteria themselves (the three proposed by normalized) is amended quickly from one year to another. However, the reasons for the choice of materiality level should be documented.
For selecting a suitable value as materiality is indicated that the auditor compare the values held by the three criteria in the current period and the previous financial year or earlier financial years. Generally, when choosing a value for the materiality, it's opting for one of the factors related to the criterion which known a less considerably development in time.
The materiality level settled above represent *the materiality level at the planning stage of the audit* and it may differ from *the materiality level at the reporting stage*. We have a situation like this, for example, when certain circumstances change, or the knowledge accumulated by the auditor as a result of completion of audit procedures change. Moreover, when planning the mission, the auditor can deliberate determine the level of materiality lower than which is intended to be used in evaluating the results of the audit, for example, to reduce the likelihood of existence of significant misstatements and provide a margin of safety when assessing the effect of misstatements found.
The materiality should be determined by reference to the latest available information and should be revised once there are known the figures for the current year (if there aren't known the figures for the current year, the auditor uses some possible estimations for the current year or a budget for the current year, and if estimations (budget) are not available, he use the figures from the previous year and/or previous years, which will then be revised). *In exceptional cases, when a further review has as result a significant reduction of „the level of the materiality at the audit planning stage", may be necessary to extend audit tests already completed*.
The level of the materiality at the reporting stage is determined once the current financial statements are available and is most likely based on the potential adjustment of the results. Materiality at the reporting stage should be used to see if areas of disagreement or uncertainty in the financial statements are sufficiently significant so as to impose a qualified opinion where uncertainty or disagreement can not be resolved.
The materiality at the planning stage of the audit is used primarily to determine the sample size and the materiality at the reporting stage to determine whether necessary final adjustments of the financial statements.
There is an *inverse relationship* between materiality and the level of audit risk, namely: if the auditor considers that the audit risk is low, he establishes a higher materiality level; if the auditor considers that the audit risk is high, he establishes a lower materiality level.
The reduction of the materiality determines the decrease of the likelihood of undiscovered wrong information, but increased the timing and extent of audit procedures. Where the materiality is set at a very high level, it appears the risk that misstatements, though usually significant, not to be discovered.
Inverse relationship between materiality and audit risk is taken into account when determining the nature, timing and extent of audit procedures. If, after the planning of the audit, the auditor concludes that the materiality level is low, then the audit risk is increased and he will improve this situation: either reducing the assessed level of risk of significant misstatements, where this is

possible, and maintaining the reduced level by carrying out extended or additional tests of controls, or reducing the risk of undetection by modifying the nature, timing and extent of planned substantive procedures.

3. The objectives of determining the materiality and the consequences of a certain level of misstatements

The audit materiality allows:

- *better orientation and planning the mission* by focusing on significant accounts and systems (this doesn't means that the auditor won't check the other elements, but rather, that he will pay less attention to insignificant elements – the examination of all accounting records and ensuring fairness they are made, reflected, classified and comprised in the financial statements is, usually, impossible to achieve);
- *avoiding unnecessary work*, namely, the avoidance of some elements research which, although they would be distorted, the misstatements would be below the materiality level;
- *giving reasons for the expressed opinion*: fidelity does not mean exactness, and the financial statements give a true and fair view, even if they contain errors, if their aggregate value is less than materiality.

Let's see how the auditor *evaluates the uncorrected misstatements effect* in the financial statements. According to the International Standard on Auditing 320 *Audit materiality*, the total uncorrected misstatements include:

- specific misstatements identified and uncorrected by auditor, including the net effect of uncorrected misstatements identified during the audit engagement of previous periods; and
- the best estimate of the auditor of other misstatements which can not be specifically identified (i.e., projected errors).

There are three cases here:

- if the total of identified and uncorrected misstatements *isn't material,* is required that management correct the financial statements: if management agrees, it's expressed an unqualified opinion in the audit report; if management does not accept, but presents additional information in the explanatory notes to the financial statements, it's expressed an unqualified opinion in the audit report, but it's added an emphasis of matter paragraph (the disagreement with the management, being made references to explanatory notes);
- if the total of identified and uncorrected misstatements *approaching to the materiality level*, the auditor will assess whether it is likely that undetected misstatements with uncorrected misstatements exceed the materiality level: if it's not likely to overcome the materiality level and management not correct the financial statements, it's required presentation of additional explanations in the notes and it's expressed an unqualified opinion in the audit report, but it's added an emphasis of matter paragraph (the disagreement with the management, being made references to explanatory notes); if it's probable overcome materiality level, the auditor done this: ask management to correct the financial statements or attempts to reduce audit risk by extending audit procedures, express an opinion other than an unqualified one, or an unqualified one with an emphasis of matter paragraph, depending on circumstances;
- if the total uncorrected misstatements *is material* the auditor requires management to correct the financial statements or attempts to reduce audit risk by extending audit procedures and expresses, as a rule, an opinion other than an unqualified one.

Because the auditors can not examine, as a rule, all events and transactions reflected in financial statements, they see the need to accept a certain level of omissions or misstatements in the financial reports. Using professional judgment in determining the level of errors, inaccuracies or omissions accepted may lead to different opinions about the fidelity of information in the financial statements.

To avoid expressing an unqualified opinion with an emphasis of matter paragraph when the materiality is set at a high level is indicated to mention the materiality level in the published audit report or in the explanatory notes, at least in the situation it is expressed such an opinion. A mention like this is necessary since it is certified that the financial statements give a true and fair view, even if they contain omissions or misstatements if their aggregate value is less than materiality level.

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