

THE BACKGROUND OF PROFESSIONAL JUDGMENT OF MATERIALTY IN STATUTORY AUDIT BASED ON QUALITATIVE FACTORS ANALYSIS

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The assessment of a significant ascertainment made by the auditor is particularly sensitive which shapes the quality of a mission as a whole. Materiality plays a primary role in determining the relevance of information provided by the users of financial statements. This material highlights the role of qualitative factors in determining materiality, as far as many practitioners are accustomed to consider this item only in terms of quantitative factors. Although legislation does not set precise rules in determining materiality, the issue is necessary because decisions of the auditors and users of audited information hang on this item.

Keywords: materiality, qualitative factors, professional judgment, financial statements.

JEL: M42

Introduction

Materiality is used in the audit process in all the three phases of the mission, which gives it great importance. Materiality is used in the planning phase, in the deployment phase and in the review phase. *ISA (International Standards of Audit) 320* defines materiality as that size over which the economic decisions or judgment on the accounts are likely to be affected. Materiality depends on the size of the item or error, judged in particular circumstances of omissions or distortion. In other words, materiality provides rather a limit (quantitative data), than a qualitative attribute on which information should be based in order to be useful. In recent years, IFAC and other professional bodies have expressed a great concern about the misapplication of materiality in auditing, with serious consequences on the information provided to the users. Major financial scandals, at the end of the last decade and in recent years (Enron, Parmalat etc), has revealed weaknesses, including in the audit missions. Specifically, the nature or the extention of the audit procedures have been incorrectly determined or were wrongly assessed the effects of distortions. Both statements are consequences of the insufficient background of materiality.

Previous studies in the literature

As a starting point of our analysis, we have a number of previous researches, which occupies a fairly broad area of literature. Qualitative factors in determining materiality began to represent the subject of researches since the early '70s. We draw attention to the arguments made in 1998 by Arthur Levitt, *SEC chairman*, who made a speech called "The game of numbers". This speech had an impressive impact in the accounting profession worldwide. Levitt, points out in an abusive manner, that materiality is a tool that shapes the auditors „flexibility” in the financial reporting. He argues against the use of materiality as a mean to hide or ignore „deliberate misstatements of performance”.

Another view is brought through the provisions of *SAB 99 (Staff Accounting Bulletin)* claiming that materiality can not be „reduced only to a numerical formula”. SAB has the merit of suggesting professionals to take into account the qualitative factors in determining materiality.

The determination of materiality-factors of influence

IFAC has long concerned about the approach of both types of criteria in determining materiality, both the quantitative and the qualitative factors.

a) Quantitative criteria refers to those elements that are easily quantified and expressed in value. The expression in currency is required in order to make comparisons with the amounts recorded in the financial statements. In practice, the calculus indicator for materiality can be represented by *total assets, equity or gross profit*. When choosing one of these indicators it must be considered the information needs of the users.

b) The qualitative criteria are related to the customer entity's environment and are interpreted differently by the auditors and by the users of the information provided in the financial statements. Thus, omissions or errors of equal value may have different impact both on auditors and on the users of the financial information. Some of the most important qualitative factors that form the background of the auditor's judgment are:

- The size of the audited company;
- The sector of activity in which the audited company operates;
- The size of the audit company;
- The characteristics of the calculus indicator of materiality.

Next, we will make several arguments that support each of these factors:

1) The size of the firm. Depending on their attitude, there are three categories of auditors: permissive auditors, moderate auditors and severe auditors (*Montoya del Corte, Franciso Martinez, 2008*). Related to the size of the audited firm, auditors are more permissive with large sized entities, at least for the following reasons:

- *Increased quality of the internal control.* Big sized firms are considered to be mature enough, to have a significant market share and not to want it's growth. Now, their goal is focused on maintaining the level of their business, so that they can manage the situation of the internal control in order to reach a quality as higher as possible. On the opposite side, the small and medium-sized firms, pursuing market expansion, tend to overlook the quality of their internal control. The auditor will determine materiality taking into consideration the quality of the provided information of the internal control.

- *The size of the auditors' fees.* The big entities which have a wider activity need to be audited by applying multiple tests and procedures. That means that the audit team has to be bigger and has to work for a longer period of time, so that the audit mission becomes more expensive. The fear of losing the customer can determine auditors to be more liberal with the entity. Moreover, a large company is much more likely to receive an qualified opinion, because of a high risk of litigation and a higher exposure to regulatory controls by the authorities in the field.

2) The sector of the entity client. Qualitative factors that define this criteria are:

- *The economic situation.* The sector of activity of the customer entity can be expanding or declining. Expansion, as shown, can lead to the overlook of the internal control quality, which involves setting a lower materiality. The decline may cause the intention to embellish the financial statements (the financial position and performance).

- *The profile of the industry.* If the client entity belongs to the financial sector, the level of materiality will be lower, influenced by the high risk of their assets diversion. (*Iskandar and Iselin, 2000*).

- *The financing of the listed companies.* For these companies the auditors show an additional responsibility, because they consider that the investors give a greater importance to them. The major financial scandals of the last two decades, involving the large firms, determined the auditors to pay more attention, in particular, when establishing materiality for the large entities whose potential problems might have an important social and economical impact.

3) *The size of the audit firm.* The studies conducted till now have examined the influence of certain characteristics of the audit firms in determining materiality. They show that the larger audit firms, especially multinationals (Blokdiik et al, 2003) determine a lower level of materiality, as may use more extensive and multiple procedure that provides a higher quality of the samples obtained.

4) *The characteristics of the calculus indicator of materiality.* The determination of materiality is achieved by comparing the effect of inaccuracy to the calculus indicator. But the calculus indicator is not always consistent. For example, the indicator Total assets will lead to an allocation of materiality and tolerable errors, for each group of assets, proportional with their share in total assets, but also by adjusting them with an adjustment coefficient (k). Professional judgment in determining this coefficient is influenced by many qualitative factors such as: differential liquidity of assets, the number of operations of the asset categories, the quality of the internal control.

Next, we would like to illustrate the determination of the materiality in the review phase, taking as an example a company that has registered the following indicators (according to Minimum Auditing Norms).

	Financial year 2008	Financial year 2009
Total assets	<u>19.501.977</u>	<u>25.810.074</u>
- 1%	195.020	258.101
- 2%	390.040	516.202
Turnover	<u>56.486.101</u>	<u>73.511.225</u>
- 0,5%	282.430,5	367.556
- 1,0%	564.861	735.112
Gross profit	<u>2.479.107</u>	<u>1.448.048</u>
- 5%	123.955	72.402
- 10%	247.910	144.805

Each element, in balance, can be determined as follows:

Elements in balance	Final balance 31.12.2009	Overall share %	Unadjusted tollerable errors	Adjustment coefficient k	Adjusted tollerable errors
1	2	3	4	5	6=4x5
<u>I. Noncurrent assets – total</u>	<u>10.941.494</u>	<u>42,4</u>	<u>218.870</u>	<u>0,66</u>	<u>144.454</u>
1 – Intangible asstes	363.055	1,40	7.227	0,66	4.767
2 – Tangible assets	10.398.020	40,28	207.926	0,66	137.231
3 – Financial assets	180.419	0,72	3.717	0,66	2.453
<u>II. Current assets-total</u>	<u>13.902.658</u>	<u>53,9</u>	<u>278.233</u>	<u>1,017</u>	<u>282.963</u>
2 – Receivables	3.349.476	13,0	67.106	1,017	68.247
3 – Short term investments	0	0	0	1,017	0
4 – Petty cash and bank accounts	-16.448.758	-66,9	-345.339	1,017	-351.210
III. Prepayments	<u>965.922</u>	3,7	19.009	1,00	19.009
TOTAL ASSETS (I+II+III)	<u>25.810.074</u>	<u>100</u>	<u>516.202</u>	<u>1,00</u>	<u>516.202</u>
IV. Debts – total	14.547.783	56,4	291.138	1,00	291.138
V. Accrued income	0	0	0	1,00	0
VI. Equity	11.262.290	43,6	225.064	1,00	225.064
TOTAL LIABILITIES (IV+V+VI)	<u>25.810.074</u>	<u>100</u>	<u>516.202</u>	<u>1,00</u>	<u>516.202</u>

Considering the professional judgment of the auditor, the adjustment coefficients (k) were determined as follows:

- for noncurrent assets have been set lower adjustment coefficients (0,66), because these accounts can be fully audited with lower costs and in these accounts the auditors do not expect to discover significant misrepresentations;
- for current assets the coefficients are higher (1,017) because their volume changes faster, therefore, the samples taken in the survey will be larger. In this situation the costs of the audit mission will be higher, even in conditions of a high materiality level.
- for the other balance sheet items the size of materiality has not been adjusted.

Conclusions

This work represents a new perspective, which aims to highlight the need of achieving complementarity between quantitative factors and qualitative factors in determining materiality. We start from the quantitative limits, already a rule in practice, to increase the relevance of materiality by examining qualitative factors that define the client company and the professionals who conduct the audit mission.

Avoiding such issues as the environment in which the audited company operates and its characteristics, but also the position of the company involved in carrying out the audit may result in avoiding detection of distortions, which then may have repercussions on decisions taken by the users of the information provided through audited financial statements. Ensure a high relevance of the information provided through financial statements, accurate determination of the performance and financial position of companies audited are necessary conditions that can be satisfied only by using a materiality threshold as relevant as possible. This can be done successfully by determining this element both in the light of quantitative factors and the qualitative ones. The increase of the audit quality and the whole economic process of information among users can be achieved by applying a combination of qualitative factors with quantitative factors in determining materiality.

To strengthen this hypothesis, we propose for the next materials, using some empirical studies, to demonstrate how to determine the adjustment coefficient of the tolerable errors in the balance, in particular assets. The notion of professional judgment is pretty much discussed by practitioners auditors, so we believe that an econometric model could resolve the differences encountered in practice in the determination of materiality.

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