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THE IMPORTANCE OF DETERMINING MATERIALITY IN STATUTORY AUDITING

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Abstract: *The purpose of this article is to improve statutory audit in terms of theory and practice through the perspective of materiality. Although it doesn't intend to provide new data and results that may be included into the practice of statutory audit, this paper brings forward a series of recommendations that may actually improve the methodology of determining materiality. After presenting the most significant theoretical aspects regarding the calculus of materiality, the article continues with the identification of the frequency of use of the financial analysis methods during the process of determining materiality. The methods and procedures of financial analyis should have an increasingly important role in discovering, assessing and turning into account the internal reserves of the enterprise's economy.*
Key words*: materiality, audit, analysis,indicators*

1. THEORETICAL BASIS

Materiality is "the amount or amounts set by the auditor as an error, an inaccuracy or an omission that may lead to annual misstatements, as well as the fairness of the results, of the financial statements and of the enterprise's patrimony" (ISA 320 ,Audit Materiality, 2007). In a first stage of its mission, the auditor must establish a global materiality in order to properly direct and plan the mission. During the audit mission, the established materiality stops the execution of the activities that will not have a role in substantiating the opinion regarding annual accounts. At the end of the mission, a possible overflow of materiality forces the auditor to suggest a correction of the errors or to mention them in the report. Equity capitals, the net result or the turnover are used as benchmarks in determining materiality. The elements noticed by the auditor could have two influences: on the outcome of the exercise and on the presentation of the balance sheet. These elements are known as benchmarks; against which materiality is determined in absolute or relative values (ISA 700, The Auditor's Report on Financial Statements, 2007).

2. RESEARCH ANALYSIS

The elements specific for materiality are (Arens, 2003):

2.1 The needs of the annual accounts' users

Annual accounts provide information to various categories of users: shareholders, associates, employees, creditors, fiscal authorities, unions, clients, statisticians, economists, financial analysts, etc. Therefore, depending on the demands and on the needs of the users, the auditor will determine materiality due to the fact users estabilish various elements as being significant elements.

2.2 The features of the enterprise

A few features that may be significant for materiality are:

– The activity sector – in certain activity sectors the net result of the exercise is replaced by indicators that are more typical.

– The size of the enterprise determines the maximum and minimum limits of materiality;

– Evolution over time of the enterprise – sometimes there are certain elements that significantly alter the evolution of important indicators.

– The socio-economic environment in which the enterprise operates, which includes legislation, the economic context, the political climate, competition, social climate, etc.

2.3 The features of the elements considered significant

a) Sensitivity – an element is „sensitive" if one small variation entails a large change in assessing annual accounts;

b) The degree of approximation – an error is more important when it refers to a position where precision and accuracy are required, rather then when it refers to a position determined through assessment.

c) The evolution of the element – an analysis of the evolution over time of the element may reflect an enhancement/reduction trend for dishonest reasons.

d) The accumulation of multiple elements.

The nature of erroneous information must be considered both quantitatively and qualitatively. The auditor must pay attention to the possibility of occurrence of inaccurate small values, which, in combination, may have a significant effect on financial statements.

For example, an error detected in the monthly closing procedure may be an indication of a potentially significant misstatement if the error occurs each month.

As can be seen, methods and techniques of financial analysis are specific for two out of three elements of materiality (the company's features and the features of the elements considered significant).

One can say that although establishing significant elements and materiality is important, their determining method is purely subjective; even more so because audit norms don't provide a certain level or a universally applicable mathematical formula. It is absolutely recommended to use the investigation methods of financial analysis in order to establish materiality.

Due to the numerous factors that must be considered and due to their relative importance, establishing them is left to the auditor's assessment. Thus, the experience of the auditor, his professional training and judgement are more important.

Assessing materiality (ISA - 320, Audit Materiality, 2007) in relation to financial transactions and to accounting balances helps the auditor decide which elements must be validated by using analytical procedures and samples. In determining materiality, these audit procedures, where the role of the financial analysis is the most visible, lead to reducing the audit risk to an acceptable level.

In order to support the theoretical basis of this article, we will try to facilitate the understanding of the procedure through an actual analysis (Chamber of Financial Auditors of Romania, 2006), exemplified in table 1:

Financial statements	Current year -required-	Previous years n-1 -required-
Total assets (before debt relief)	27,121,274	28,454,257
1%	271,213	284,543
2%	542,425	569,085
Turnover	48,302,646	35,414,240
0.5%	241,513	177,071
1%	483,026	354,142
Profit before tax	298,589	99,694
5%	14,929	4,985
10%	29,859	9,969
Materiality	241,513	
Planning stage	241,513	

Tab. 1. Benchmarks for materiality

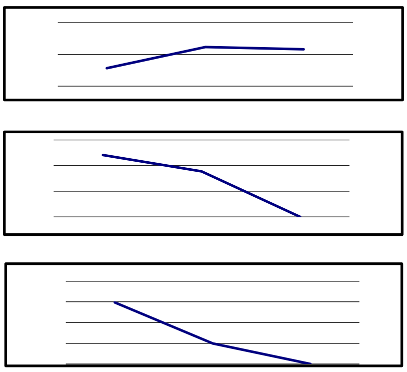

Fig 1. The evolution of benchmarks

Materiality was calculated in accordance to the turnover, indicating a growth rate in the last years and a high ratio at the expense of the other two benchmarks (fig. 1).

The research will continue with the illustration of one the assertions above regarding the use of financial analysis methods in recognizing and evaluating balance sheets. The cycle of the operations within the stocks section begins with (Chamber of Financial Auditors of Romania, 2006) (tab. 2):

Step 1- processing a synthetic balance on audit sections;

Step 2- determining materiality (exemplified above);

Step 3- the accounts that exceed materiality will be audited; the accounts below materiality will be added up and divided to materiality.

Account symbol	Debit balance	Credit balance	Exceeding materiality	Below materiality	
301	2,482,005	0	2,482,005	0.00	
302	1,461,359	0	1,461,359	0	
303	7,047	0	0.00	7,047	
341	32,213	0	0	32,213	
345	680,437	0	680,437	0	
351	615,409	0.00	615,409	0.00	
371	144,445	0	0	144,445	
378	0	71,551	0	-71,551	
381	9,424	0	0	9,424	
				157,902	0.65

Tab. 2. The process of determining audit materiality

Step 4 – the accounts exceeding materiality will be required to be audited; the accounts below materiality will be added up and divided to materiality.

The materiality established during the planning stage of audit is mainly used to determine the sample size, dividing turnovers and balances in accounts exceeding materiality and accounts below materiality. The accounts that exceed materiality will be audited. The ones below materiality are added up and divided to materiality; if their sum exceeds half of total, we audit another account below materiality. According to the above analysis, the mandatory audit will be imposed for the following accounts: 301, 302, 345 and 351.

3. THE CONSEQUENCES OF MATERIALITY

The auditor draws up a list of his findings at the end of his mandate. If the enterprises' management accepts the corrections of the auditor, then he writes a qualified opinion report. If the contrary happens, then the audit report can be: an unqualified opinion report, an adverse opinion report and a disclaimer of opinion report.

Given the consequences of materiality described above, mainly over the nature of the audit report, we can conclude without exaggerating that the nature of the audit report depends also on the accuracy of the financial analysis methods that accompanied the determination of materiality, namely the entire process of getting to know the entity.

4. RECOMMENDATIONS ON THE CHOICE OF MATERIALITY

If after the analysis of the assets, the ratio of the frozen assets is high (generally over 50%); it is recommended to use the frozen assets instead of the total assets as calculus base. Similarly, if the rotation speed of the current assets is high (an indicator of financial analysis), it's recommended to take into account the value of working assets instead of the total assets. Also, if the bankruptcy risk is high (risk determined by the bankruptcy risk analysis specific to financial analysis), then the recommended base of calculus is total equity capitals instead of the profit before taxation criterion. If the projected turnover has an increased growth rate (over 15-20%), then the size of materiality must take into account this base (turnover) rather than other criteria.

5. CONTINUING RESEARCH

On this basis, the results of our approach refer to the fact that is useful to further expand the procedures and methods of financial analysis within statutory audit, both in scope (expanding more on the analysis of the external environment, quality management, the efficiency of internal control and others) and in relevance (expanding mainly on the assessment and acknowledgement of the balance positions – an essential aspect regarding financial position, but also expanding on the assessment of the bankruptcy risk, of the sampling, of the specific risks and others).

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