

## **MATERIALITY - AN IMPORTANT METHOD AND TECHNIQUE FOR THE FINANCIAL AUDITING**

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### **Abstract**

The purpose of this press article is:

- to address the application of materiality in nature as one of the best techniques that provides assurance in auditing the financial statements,
- to precise the concept of materiality and his definition,
- to explain the relationship and difference that exist between materiality and the auditing risk,
- to explain the procedures to be followed in determining the assurance factor,
- to prove that the best efficiency in auditing financial statements, can be achieved if we apply materiality in nature,
- to explain the nature of indicators and the method of calculating,
- to illustrate through a practical case the methodology for calculating the indicators of materiality in nature and to interpret the data in comparison of indicators.

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**Keywords:** Audit, Audit risk, Financial audits, Audit findings, Material irregularities

### **Introduction**

The concept of materiality is essential for auditing the financial statement. It assures a standard to determine the tolerable level of irregularities and together with risk, determine the extent and direction of the audit work. Financial statements can rarely be completely accurate, even if it happens, there are few possibilities that their user requires this level of accuracy. Therefore, in their accuracy is accepted a certain degree of tolerance. This tolerance is materiality and represents: “An expression of the relative significance or importance of a particular matter in the context of the financial statements as a whole”.

Definition: *Information is material if its failure or wrong appearance, could influence the economic decisions made on the basis of the financial statements.*

### **The relationship between materiality and audit risk**

Materiality is the measurement of the size or magnitude, while the risk is measurement uncertainty. When the auditor conducts an engagement to audit the financial statements, it takes into account the preliminary audit risk assessments. Audit risk is the possibility for the auditor to give an unfit opinion for irregularities, errors or material inaccuracies containing financial statements. Audit risk to the financial statements consist of: inherent risk, control risk and the risk of non-disclosure.

- **Inherent risk.** Is the possible that the balance of an account or a category of transactions contain errors or irregularities material misstatement either individually or by joining other accounts surplus or other categories of transactions, assuming the controls to have been nonexistent.
- **Control risk.** Is the possibility that an irregularity, error or inaccuracy in the balance of an account or class of transactions that could be material, either individually as well as when they join or categories of transactions outstanding, could not be detected, corrected and prevented in timely accounting systems and control systems.
- **Risk of non-disclosure.** Is the possibility that the auditor's testing procedures will not be able to detect an irregularity, mistake or inaccuracy that exists in a surplus account or class of transactions that could be material individually or when joined with account balances or other transaction categories.

### **Research values and objectives**

Research values of this article consist in attempts to shed light on the application of materiality by nature. A matter of special importance is the practical dealing of the method of calculation of indicators of materiality by nature. In this regard, this study addresses all indicators, but more specifically sheds light on how the auditor should determine the "Assurance factor A". Recognition of certain aspects of accounting and financial management and control system (FMC), along with risk assessments enable the auditor:

- ✓ To determine the procedures necessary to audit the financial statements;
- ✓ To identify the types of irregularities, errors and possible material inaccuracies that may occur in the financial statements.
- ✓ To calculate the materiality indicators and make the necessary comparisons to come to conclusions on the accuracy of financial statements.
- ✓ Making recommendations for improving the organization's accounting system.

### **Research hypotheses**

This research is based on two research hypotheses

- a- Using materiality by nature can find all material errors in the financial statements of an organization.
- b- Can the auditors give reasonable assurance that an organization’s financial statements have no material errors if they determine the number of transactions solely on the basis of professional judgment without regard to the assurance factor “A”.

### Methodology and data

Audit of financial statements is performed by external audit structures with a common name “Supreme Audit Institution - SAI”. In Albania the role of external audit is played by “Supreme State Audit (SSA)”. Based on the achievements showed up to date ,this institution has achieved the aspirations of Articles 1-3 of the supreme audit doctrine, embodied in the Declaration of Lima, which regulates audit purposes, its forms ex ante and ex post, as well as the escalation in internal and external audit. As for aspirations of other articles, it can be claimed that are partially filled, because the main focus of SSA’s objective was to conduct combined audits (legality, regularity, evaluation), the legality and regularity audits (compliance with laws), thematic auditing and evaluation auditing.

**Table 1** (Source: Reports on SAI activity, bulletin no. 4/2012)

Year	Total auditings	Auditings of					
		Combined (legality, regularity, evaluation)	Legality & regularity	Assessment	Thematic	Performance	Financial Certifications
2007	146	58	65	12	11	0	0
2008	152	83	51	3	5	4 pilot	6 pilot
2009	150	72	54	3	6	5	10
2010	153	79	42	5	7	3	17
2011	152	74	58	4	5	1	10
2012	158	50	81	2	4	4	17

From the analysis and examination of the data displayed above, is concluded that:

- ✓ Financial audits for certification of balance statements are a new category of audit and represent a 5-year experience. This type has only begun in 2008 with 6 pilot audit missions and then there was a gradual increase but with a limited number of them.
- ✓ Specific weight of the number of audits in this category is still very insignificant in relation to the total number of annual audits that SSA has implemented.
- ✓ For the special nature of audit engagements for the certification of financial statements, auditors and experts involved must implement not only methods, methodologies and techniques known in the audit process but also materiality.
- ✓ In essence, the financial audit is an objective study and critical review of the accounts and the quality of management in the accounting system. In 1987, Simons called

financial audit, verification of accounts so that they are confirmed, verified and certified.

**Methodology of study.** In dealing with issues associated with this study are used comparison, analysis and synthesis method.

Put in straightforward language, this means:

- ❖ Firstly, are given the concepts for materiality in nature, relevance and difference that exists between materiality and audit risk.
- ❖ Second, explain the nature of the indicators and the method of their calculation and the procedures to be performed to determine the safety factor.
- ❖ Thirdly, we explain the way of estimating the materiality in nature and interpret the data by comparing indicators.
- ❖ Finally, are given the conclusions and recommendations.

### **Materiality according to nature**

Materiality by nature, as the term itself says, has to do with inherent natural features, the interior of one or more conditions of accounts, not simply their value. Auditors should identify such condition accounts and determine the level of accuracy they believe that the audit report users expect to receive, and then to design audit tests. It is not possible to obtain a clear list of issues that tend to be based on material interest owners, as interests differ from one organization to another. Audit structures managers should be aware that the application of this technique provides more assurance and guarantee the existence or not of material misstatement in the financial statements.

#### **a- Calculation of indicators of in nature materiality**

**Materiality base**, represents the total gross expenditure, gross income to organizations that provide income and gain or gross assets for organizations that meet the financial statements based on accounting of accrued rights and obligations. Applying the technique of materiality in nature relates to the calculation of a series of indicators and compare them based on the audit findings. For accounts of public organizations authorized to spend public funds, the main focus of attention of the Parliament and the Government tends to be gross expenses. Similarly, private sector organizations ownership interest tends to be driven primarily on the amount of money collected and gross expenses.

**1. Planned level of Materiality (PLM).** Planned level of materiality is indicative calculation. It represents the product of the materiality base percentage that is applied on this basis. Sensitivity to the financial statements reflected in the percentage of ownership interest applied on the basis of materiality. Level that is commonly used is 0.5% to 2% of revenue or

expenses, and 5% to 10% of total assets or average profit. Lower percentage rate are applicable in exceptional circumstances, when the audit manager deems account as sensitive, whereas highest rates when the account does not have a high sensitivity.

**2. Expected error (EE)** is indicative calculation and represents 10% of the planned level of materiality.

**3. Possible rated error (PRE)** represents the amount of random error with systematic errors.

**Random errors** can occur in one of those transactions that have not been selected for testing. For example, if they find a misprint on a manual, basically implied that the error will be reflected in all transactions that are not selected to be tested. Consequently, it is necessary extrapolation of all errors for all of the account, in order to make a full assessment of this effect.

**Systematic errors** can occur in defined circumstances and only affect a small group of transactions (these errors relate to transactions processed manually. When discovered a systematic error, it should be possible to implement testing 100% of transactions that can be affected.

**Estimated possible error** most likely represents a statistical number, which adjusts the level of materiality based on error than expected and is calculated as the difference between the projected level of materiality of error than expected.

**4. Pinpointing basic plan (PBP).** Whenever performed a selection, it is essential to assess the aggregation error that has not been tested. This has to do with the uncertainty of measurement and indicator selection in this case is called “Pinpointing basic plan (SBP)”, which is fixed at 85 - 90% of the estimated possible error.

**5. Suggested Model Size, (SMS)** represents the number of transactions to be selected for testing (the sample size). If the quantity of samples increases, of course, that the accuracy improves. The number of transactions for testing depends on the basis of materiality, basic accuracy and “assurance factor A”. The term “assurance factor A” refers to the security level required by the application of selection techniques for testing, which, in turn, depends on how security is achieved during the audit mission planning. Audit techniques, selected for each account field, depends on the level of “audit assurance”; that auditors require before they conclude that the financial statements contain no material irregularities. This assurance level represents:

- **Internal Security**, which represents the probability that, without taking into account the effect of the control of the entity or substantive testing procedures, financial statements do not contain material irregularities.
- **Assurance control**, which is based on the identification of high-level controls to prevent or detect errors that can lead to irregularities in the financial statements and ensure that the accounting system controls testing.
- **Independent Safety**, which refers to the level of the tests on the details and test essential application.

To determine the “**Assurance Factor A**”, auditors are based on three levels of tests, which are as follows:

- **Minimal level of substantive procedures**, which must be done if we seek to achieve maximum security controls. If this level is reached, the auditor should develop procedures using an “assurance factor A” at a rate up to 0.7.
- **Substantial level of standard essential procedures**, which should be carried out if there are identified risks that show material irregularity opportunities as and when auditors have not planned to rely on controls. If the technique is used at this level, the auditor should develop procedures using an “assurance factor A” at a rate of 0.7 to 2.0.
- **The level of focus essential procedures**, which must be done if we have identified a risk that shows the possibility of material irregularities and auditors do not plan to rely on controls that reduce risks. If the technique is used at this level, the auditor should develop procedures using an “assurance factor A” at a rate of 2.0 to 3.0

The way in which the above types of assurance are included in the audit’s decision is formulated in a form through a tree diagram, which is painted with green, yellow and red. The colors are explained as follows:

**Green color** -Indicates that for the identified risks, the management of the entity is operating the controls, which have been operating successfully. Therefore audit risk is small and has reached the minimum level of substantive procedures.

**Yellow color** - Indicates that there are not specific risks identified material but account area is considered important. High level of management has just begun recognizing controls. In this case, the auditor for efficiency reasons decide not to test controls, and then is adopted the Level of standard essential procedures.

**Red color** - Indicates that the identified risks can lead to the occurrence of material errors and where we are unable to rely on management control procedures, we need to adopt the level of focused substantive procedures.

After determining the “Assurance factor A” in accordance with the actual situation, **the size of the suggested model**, the determination of the number of transactions selected for testing , is calculated by the following formula:

$$\text{SMS} = \frac{\text{Materiality base} \times \text{Assurance factor}}{\text{Planned Pinpointing}}$$

After determining the size of the suggested model, thus the number of transactions to be tested, the audit team is ready to begin work on the field.

**6. Highest level of tolerable error** determines the highest tolerable limit of material misstatement accepted for the entire selected group. This is an indicator calculation and represents the amount of **planned base specification** with the **error** found by the audit of transactions selected for testing and tested during the fieldwork.

**a- Assessment of the results for the mistakes from planned testing**

Identified error in the group testing is calculated by applying selection techniques. The main principle upon which these techniques consists in the assumption that where financial errors detected in a test transaction, this error affects in any currency to spend. Assume that a voucher worth 10 000 € to be added to 1 000 €, the error in this case is 10%. If there are tested 100 transactions and has only one violation found, the level of error is 0.01%. So in this case the selection, the average error is 0.01% or 1 /100 parts of audited transactions.

Materiality theory does not refer to the actual percentage error found, because in audit practice it may happen that the biggest mistakes are made in transactions that were not examined. To give the necessary guarantees on the accuracy of financial statements, materiality considers that every 1 (one) unit of error in a transaction receives 10% inaccuracy (errors materials) in the financial statements.

The success of implementation of materiality in nature lies in planning procedures, the correct selection of transactions and complete their examination for the entire period covered by the audit. If that fails, the audit findings will ultimately prove to be inaccurate and consequently conclusions on the results of the audit would be wrong. It is recommended that, when the findings are insignificant, increase the number of samples that tested or reviewed the possibility of selection. As a general rule, the number or size of the sample in this case, should be increased by at least 10%.

If any of the assumptions about the group undergoes a significant change, e.g. if the basis of materiality varies by more than 10%, then the auditor will need to change the number or size of the selection of examples, in order to achieve the planned level audit coverage. In all cases, the realization of a commitment to an audit of financial statements, assumed to be found from material misstatement arising from acts contrary to the provisions applications, calculations wrong, false accounting, the application of depreciation rates, estimates in wages, property mismanagement or material resources and pinpoint inventory etc.

Three situations may arise when the highest level of tolerable error (HLTE) compared to the planned indicator of materiality. These are:

1. Highest level of tolerable error does not exceed the planned level of materiality and audit findings are lower than expected error.
2. Highest level of tolerable error does not exceed the planned level of materiality, but the audit findings are larger than expected error.
3. Highest level of tolerable error exceeds more than 10% of the planned level of materiality.

**In the first case**, the auditor could reasonably conclude that no material irregularities and, therefore, is not required to place any additional work.

**In the second case**, while the highest level of tolerable error is less than materiality, indicates that it is unlikely that there are material irregularity. However, when the findings are larger than the expected error intolerant, meaning that they are greater than 10% level of materiality means that material irregularities may exist, so further work is required.

**In the third case**, the auditors say with certainty that there are irregularities and financial statements contain errors that affect decision making. In this case, the audit team should return to materiality planning procedure review on the functioning of the control tests, the method of selection of transactions and increase the number of tests.

Increasing the number of test transactions for a significant number until they reached the conclusion that we have no departure and other errors where the highest level of tolerable error is expected to fall. Increasing the number of transactions carried out according to the following formula:

Increasing the size of the model suggested =  $([A] / [B])$

Where: [A] = highest level of tolerable error is achieved

[B] = highest level of tolerable error desired (basic accuracy)

### **Search results**

Finally, based on how we handle the above in response to the **first hypothesis**, we can say that using materiality by nature it is not possible to find all material errors in the financial



statements (FS) of an organization. But however, auditors are applying this technique, being able to see the trend of material misstatement of the financial statements, on the financial condition, operation of the accounting system and on this basis, certify the balance as well as make recommendations for improvements in the future.

Whereas in response to the **second hypothesis**, we can say that auditors cannot provide reasonable assurance that the financial statements of an organization have no material errors if they determine the number of transactions solely on the basis of professional judgment without taking into account the assurance factor “A”.

To apply the technique of materiality in nature is necessary in the planning stage of the audit engagements, auditors estimate the 5 indicators and based on the audit findings to estimate the sixth index, which represents the basic indicator to assess the presence of material errors to the financial statements.

### **Practical case of applying materiality in nature**

In a public organization, which represents a central institution that has high sensitivity and parliamentary, governmental and departmental interest, for the spending of public funds, which is responsible for the implementation of the internal control system, training of employees and harmonizing the activities of organizations public, annual costs are 2500000 € In planning the engagement auditors have decided to use the following coefficients

1. Materiality coefficient	1%
2. Coefficient for expected error	10%
3. Coefficient for potential error	90%
4. Coefficient for accuracy	90%
5. Assurance factor A	75%
6. Total no. of transactions	12000

Based on the above mentioned coefficients audit team calculated the planned indicators of materiality as follows:

1	Materiality base (MB)	2 500 000 €
2	Planned level of materiality (PLM)	12 500 €
3	Expected error (EE)	1 250 €
4	Possible estimated error (PEE)	11 250 €
5	Base accuracy (BA)	10 125 €
6	SMS suggested model size (No. of tests)	185 cases

During the audit, the audit team in 185 transactions has found an error of 5 450 € and on this basis the estimated level to highest tolerable error = 15 580 €

**Estimates for the above indicators are:**

1. Materiality base (MB) according to the data is = 2 500 000 €
2. Planned level of materiality (PLM) is = 12 500 €(2,500,000 x 0.5%).
3. Expected error 10% on PLM, is = 1 250 €(12,500 x 10%)
4. Possible estimated error is = **11 250** €(12 500 – 1 250) or (12500x90%).
5. Planned basic accuracy is= **10 125** €(11 250 x 90%).
6. Suggested model dimensions (SMS) considering “assurance factor A” 0.75, is:
 

□ SMS=	$\frac{\text{Materiality base (2 500 000)} \times \text{assurance factor 75\%}}{\text{Planned accuracy (10 125)}}$	185 cases
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7. Highest level of tolerable error, according to the findings is = **15 580** €(10125 + 5 455)

**Conclusions and recommendations of the research**

**Conclusions**

1. By comparing the projected level of materiality with the highest level of tolerable error findings, the result is that the highest level of tolerable error is greater than the planned level of materiality,

$$HLTE > PLM, \text{ so } 15\,580 > 12\,500 \text{ for a value of } 3\,080 \text{ €}$$

In this case, except that the auditors shall be returned to all planning procedures, risk assessment, the method of selection of transactions for testing, should increase the size of the model (the number of transactions for testing) and test the operation of control system.

2. Increasing the size of the suggested model represents an adding percentage on the number of tested transactions in the first time that is calculated from the ratio of the highest level of error that is achieved with the highest level of error that is desired (usually precise). According to planned data and resulting from the tests, in this case we have:

1. Highest level of tolerable error that is achieved [A] = 15 580 €
2. Highest level of tolerable error that is desired [B] = 10 125 €

Replacing the data we will obtain the percentage for increasing of transactions:

$$\text{Increased SMS} = 15\,580 : 10\,125 = 1.54\%$$

So on the first quotient tests were 185 transactions will increase by 54% (154% - 100%) calculation is:  $185 \times 54\% = 100$  additional transactions for testing.

**Recommendations**

1. To implement the method of materiality, audit managers should keep in mind that the content and preparation of working documents requires the engagement of auditors with:

- ✓ High degree of qualification for the engaged auditors,
- ✓ Experience in auditing the financial statements,
- ✓ Good knowledge on accounting standards and operation of this system

2. The audit team should apply with caution and intelligence:

- ✓ Coefficients applied to calculations

- ✓ Determining materiality of the transactions that will be tested to argue conclusions.
3. In all cases, the audit team (auditor) should:
    - ✓ Provide support for the findings,
    - ✓ Provide complete and accurate evidence for the findings, and
    - ✓ Provide conclusions and recommendations
  4. Auditors at the end of the audit should prepare a detailed report, which should include: the realization of the objectives, scope and methodology of the audit, audit results, findings, **conclusions and recommendations.**

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