

# The importance and necessity of determining the level of materiality in audits

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**Abstract:** This article describes the importance and necessity of determining the materiality gap in audits. As a result of the conducted research, suggestions on the application of the level of importance have been developed..

**Key words:** audit, internal control system, materiality, audit risk, audit general plan, audit program.



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## INTRODUCTION

When planning the audit, the auditor should take into account facts that cause significant confusion in the financial statements. To decide what indicator of importance level to accept and which items of the financial statement to study with special attention based on the analysis of the balances in the accounting charts and the features of cash flow and in which cases to reduce the overall audit risk to an acceptable level using audit selection (selective) methods and analytical procedures must

The auditor should consider that there is an inverse relationship between the level of materiality chosen and the audit risk. This inverse relationship should be taken into account when determining the scope and duration of audits. Therefore, if the auditor finds it necessary to reduce the level of materiality, his audit risk increases and vice versa.

## MATERIALS AND METHODS

Brant E. Christensen, Aasmund Eilifsen, Steven M. Glover, William F. Messier Jr. said that "Professional investors who receive a disclosure of audit materiality are more likely to change the level of existing investment in a company than professional investors who do not receive materiality disclosures" [1].

According to Maria Silvia Avi "The concepts of relevance and materiality have, for decades now, been the subject of in-depth study by both doctrine and the bodies whose task it is to issue accounting standards. The aforementioned terms have different meanings in the various countries, although, in general, the difference in interpretation is only a nuance of concept that is often difficult even to identify" [2].

Niamh Brennan and Sidney J. Gray said that "The concept of materiality (in effect) builds flexibility into financial reporting. This can lead to abuse. Companies may intentionally record "small" errors within a defined percentage ceiling, so that auditors will not scrutinize such errors (as they are not material). Management excuse errors by arguing that the effect on the bottom line is so small as not to matter – it is immaterial. These small errors can build up and mislead the stock market and other stakeholders e.g. lenders, employees, creditors" [3].

According to Daniel Vilsănoiu and Simona Buzenche "In determining the most appropriate measurement basis for the calculation of the materiality level, an auditor needs to consider the nature of the entity's business and industry, the entity's current period operations as well as the understanding of the entity and its financial statement users" [4].

At the stage of auditing the accounting and internal control system, the auditor is always faced with the problem of how

to estimate the audit risk and how to minimize it.

Auditors work to ensure that there are no errors in the reports or that they are insignificant, and that they reflect the true picture of the financial and economic activities of the client company. Audit activity requires the independence of the auditor in justifying and making decisions. The company evaluates the errors found in the reports: these errors are divided into important and insignificant types according to their nature and content.

In fulfilling its contractual obligations, the audit organization cannot in practice fully cover the objects of inspection. As a result, it confirms the financial statements with a certain level of risk, without being able to guarantee that they are absolutely correct. Therefore, there is always a certain level of risk in the auditor's work. It can be seen that the opinion expressed in the auditor's opinion may not always be completely correct. However, information should almost always be useful to users. The provision of such utility is associated with a certain level of importance and risk and requires their proper assessment.

Probability within this range represents whether it is possible (or not possible) to determine the presence of errors affecting the reliability of the statements of economic entities, to assess these errors in order to make appropriate audit decisions. It is a component that qualitatively describes importance. The component that describes the quantitative aspect of importance is represented by its certain levels.

If an error significantly confuses the indicators of an accounting report and affects the decision made by the user of this report based on this report, it is important that it is not detected (inadvertently omitted). There are also situations where there are several subtle errors in an accounting report that add up to a large amount. The auditor may identify a single non-material error, report it in the audit report, and draw up an adverse audit opinion. In reality, there may be several minor errors in an accounting report that, when combined, turn out to be serious.

Auditors use the concept of materiality as a basis for planning the audit when identifying the most important, rare, and error-prone items and schedules. It is necessary to pay special attention to such articles and schemes. The level of materiality is also used in evaluating the audit evidence collected and making a decision about what audit opinion to draw.

Therefore, the concept of importance is the primary and fundamental source for determining the size of the error that can be made by the auditor and the scope of the audit, as well as for determining the form of the auditor's conclusion (positive or negative).

The identification of material errors by the auditor depends on many factors. In particular, the assessment of existing serious errors by both the management of the enterprise and the auditor; limited time and cost of inspections; the client "waiting" for the auditor to identify errors; auditor's degree of independence; his conscientiousness; confidence of the external auditor in the internal control system; details of the accounting policy adopted by the enterprise and some of its rules; compliance of the accounting policy with the requirements of regulatory documents.

The auditor should consider materiality in the following cases:

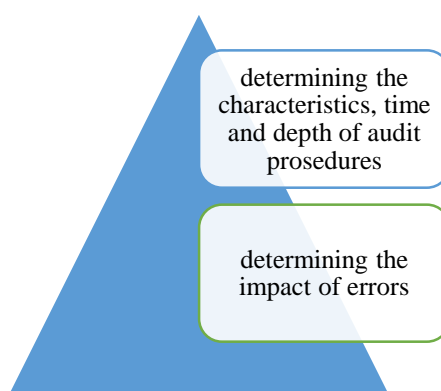


Figure 1. Situations to be considered with materiality level<sup>1</sup>

<sup>1</sup> Made by author

The economic nature and meaning of “materiality” is widely used in the practice of international auditing firms. In this case, the following steps for the practical implementation of importance are usually performed:

1. Preliminary calculation of the maximum allowable amount of errors for the object being inspected in general (first stage);
2. Distribution of the determined amount among the elements within the inspected facility (second stage);
3. Determining the actual amount of errors made based on testing of individual elements and the total volume (third stage);
4. Comparison of the initial calculated amount of the sum of the highest errors (the first and second stages) with the amount determined in practice (the third stage) and drawing a final conclusion (the fourth stage).

The first two stages relate to the planning of the audit, and the next to the evaluation and summarization of its results.

It is not easy to establish a clear and unequivocal criterion of importance. In order to interpret the nature of the information obtained during the "audit", it is important for the auditor to obtain any documents necessary to enrich his knowledge about the activity of the audited economic entity.

The auditor documents and records his knowledge of the activity of the economic entity in the form of the following permanent file:

- history of the development of the economic entity;
- the existing list of the type of activity;
- state of the accounting policy and its change;
- information important not only for the state of the economic entity at the time of the audit, but also for the future audit.

The main methods of obtaining knowledge about the activity of an economic entity are as follows:

- study of general economic conditions of the activity of the examined economic entity (for example, national economic policy, customs control and taxation system established on limits and quotas);
- analysis of territorial characteristics affecting the activity of an economic entity (for example, the geographical situation of the territory and tax conditions);
- Taking into account the characteristics of the network within the activity of the economic entity;
- Acquaintance with production technologies and organizations;
- Collecting information about personal capital structure, stock quote and location analysis;
- Gathering information about the personnel of the economic entity, the types of products produced, the accounting methods used (for example, the accounting policy, the form of the report, the type of depreciation calculation);
- Collecting information about the legal and financial obligations of the economic entity (determining the level of availability and internal economic risk);
- Familiarity with internal control system organizations.

The level of materiality should be expressed in the currency in which the accounting is kept and the accounting report is drawn up. The level of materiality should be determined for each audit after the audit planning phase is completed. The value of the determined materiality level should also be reflected in the overall plan of the audit. If the representatives of the

client-enterprise are interested in the procedure for determining the level of importance by the audit organization, then the auditors should provide them with this information.

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