# MATERIALITY IN A MISSION TO REVIEW THE HISTORICAL FINANCIAL STATEMENTS

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***Abstract:*** *Accounting is a branch of the economy that is part of the social sciences. In this sense, it comes to support the society, aiming to offer the best services for the good development of society. Financial audit also is a part of this branch of social sciences, accompanying in various forms the field of accounting over time, with the initial aim of verifying the veracity of the work carried out by the persons involved in accounting, and then, in time, the purpose of the financial audit has changed, providing today to the participants in economic activities a high degree of confidence about the information provided by the financial statements. In the financial audit, auditors can carry out several types of missions, providing two types of insurance, either reasonable or limited, or even no type of insurance. In this case, a mission to review historical financial statements by an auditor may provide only limited assurance to users. The materiality calculated in this assignment provides a value through which it may reduce the risk that information in the financial statements will contain material misstatements.*

***Key words:*** *audit, review mission, materiality, historical financial statements.*
***JEL Classification:*** *M42.*

## 1. Introduction

The audit increases the confidence of participants in economic activities in the information provided by entities through financial statements. In the case of statutory audit, it is implemented following a legal obligation, respectively by all public interest entities and by the entities that have this obligation following the fulfillment of the criteria set out by the Order of the Minister of Public Finance no. 1802/2014, with subsequent amendments and completions. In the financial audit there is the possibility of auditing the financial statements also by the entities that do not meet the criteria set out above, and in order to increase the confidence of final users of the information provided by their financial statements, they have the opportunity to audit the historical financial statements, which can offer only limited assurance to users, and not a reasonable one, as in the case of statutory audit.

Auditing is a large-scale investigation of processes, systems, information, products, etc. existing within the organization or disseminated by it. The result of the activity is established naturally in a range of qualified points of view, formulated by specialists from different fields of activity, so that a general rating can be established (Domnișoru, 2011, p. 14).

Under the conceptual framework, there are two kinds of assurance missions that can be performed by a practitioner: a reasonable assurance engagement and a limited assurance assignment. The objective of a reasonable assurance engagement is to reduce the risk of the assurance engagement to an acceptably low level under the terms of a mission as a basis for the practitioner to express his conclusions in a positive form. The purpose of a limited assurance engagement is to reduce the risk of the assurance engagement to an acceptable level under the terms of the engagement, but greater than that of the reasonable assurance engagement, and it is therefore a basis for the practitioner to express the conclusions in a negative form (Socol, 2017, p. 24).

The review of historical financial statements is a limited assurance engagement. In a review of financial statements, the practitioner expresses a conclusion aimed at enhancing the confidence of the users concerned regarding the preparation of the financial statements of an entity in accordance with an applicable financial reporting framework. The practitioner's conclusion is based on obtaining limited assurance by the practitioner. The practitioner's report includes a description of the nature of a review mission to provide readers with the context of the report which allows the understanding of the conclusion. The practitioner mainly conducts interviews and analytical procedures to obtain sufficient and adequate evidence as the basis for the conclusion on the financial statements as a whole. If the practitioner becomes aware of an issue that causes him to believe that the financial statements can be materially misstated, the practitioner conceives and performs additional procedures that are considered appropriate to the circumstances in order to be able to draw a conclusion on the financial statements.

According to ISRE 2400, the goals of the practitioner in a review of the financial statements are (IAASB, IFAC, CAFR, Vol. II, ISRE 2400. 5-8, ISRE 2400.14, 2016, pp.3-5):

- Obtaining limited assurance, primarily by conducting interviews and analytical procedures, as to the extent to which the financial statements as a whole are free from material misstatement, thus enabling them to express a conclusion if he became aware of the issues that determine it to believe that the financial statements are not prepared in all material respects in line with an applicable financial reporting framework;
- Reporting on financial statements as a whole and communicating, as required by ISRE 2400.

Materiality is a basic instrument used in the process of auditing financial statements, its value is determined by the auditor through applying professional judgment on some financial statement indicators, based on general information about the work performed by the audited entity. Through this value, the auditor has the ability to identify those items that may contain material misstatements due to fraud or error.

The purpose of this paper is to present general information regarding materiality and to highlight how it is determined in the case of a review mission of historical financial statements.

## 2. Methodology of scientific research

In order to achieve the purpose of the present paper, at the basis of the applied scientific methodology is the presentation from a theoretical point of view on the general aspects regarding materiality and those related to the review mission of the historical financial statements, through the analysis of the specialized literature, and then the presentation from a practical point of view of a case study on determining materiality in a review mission of historical financial statements.

## 3. Using materiality in a mission to review historical financial statements

Review missions of historical financial statements may only provide limited assurance regarding the posibility that the information provided by the financial statements may contain material misstatement due to fraud or error. As in audits that provide reasonable assurance, the auditor uses materiality as the primary tool to identify possible misstatements in that information.

In general terms, a financial-accounting problem, ultimately an economic one, can be considered significant if its knowledge or ignorance could influence the perception of the user of the financial statements or the audit report. In other words, the information is significant if its omission or erroneous declaration could influence the economic decisions of users taken on the basis of the financial statements. Materiality represents the relative importance of the element or error judged in the specific circumstances of the omission or misstatement. Thus, materiality is rather a limit, rather than providing a primary qualitative attribute that information must have in order to be useful. (Domnișoru, 2011, pp. 207-208)

When preparing the audit plan and on the occasion of its subsequent modification, the auditor takes into account those specific account balances and those classes of transactions that are significant and need to be further examined. Depending on the materiality level established, the auditor selects audit procedures or procedures combinations to ensure a reduction in audit risk to an acceptable level. There is an inverse relationship between materiality and the level of audit risk. The higher the value of materiality, the lower the audit risk and vice versa. If the auditor establishes a low level of materiality, it is likely that certain distortions will become significant, exceed this threshold and hence increase the audit risk. To reduce auditing risk, the auditor extends control tests (which reduce control risk) and tests on details (which reduce the risk of non-detection), thereby increases the amount of audit evidence and confidence in the content of the financial statements. The establishment of the preliminary level of materiality is made both at the level of the financial statements as a whole, as well as at the level of categories of transactions or groups of accounts (Oprean, Popa and Lenghel, 2007, pp.205-206).

For determining the level of materiality, the financial auditor must (Dănescu, 2007, p.53):

- Identify the user to whom they are addressed;
- Establish links between the information he provides and the decision-making process;
- Know what decisions users will take based on audited financial statements

Determining materiality involves the exercise of professional reasoning. A percentage is often applied to a benchmark chosen as the starting point for determining materiality for the financial statements as a whole. Factors that may affect the identification of an appropriate benchmark include: elements of financial statements (for example, assets, liabilities, equity, income, expenses) if there are elements that users of an entity's financial statements tend to focus on, the nature of the entity, the ownership structure of the entity and the way it is funded, and the relative volatility of the benchmark. Examples of benchmarks that may be appropriate depending on the circumstances of the entity include reported income categories, such as profit before tax, total income, gross profit and total expenditure, total equity or net asset value. Profit before tax from continuing operations is often used for profit-making entities. When profit before tax from continuing operations is volatile, other benchmarks may be more appropriate, such as gross profit or total revenue (IAASB, IFAC, CAFR, 2016, pp. 341-342).

There is another important notion, namely the trivial error, the clearly insignificant error. All estimated/identified errors that are less than the trivial error (after their extrapolation to the population) are ignored by the practitioner and can not significantly affect the financial statements or other reports or situations that are the subject of the mission. Amounts above this level are reported and discussed with the client's management, and if, for example, it is a review mission, it is required to correct those identified misstatements (Păunescu and Radu, 2018, p. 62).

Thus, materiality provides the auditor with a framework through which it can identify those information from financial statements that may be erroneous or even fraudulent.

## 4. Case study on determining materiality in a review mission of historical financial statements

The entity S.C. ALFA S.R.L. carries out the review of the historical financial statements of the S.C. BETA S.A. entity. This is the second year in which S.C. ALFA S.R.L. reviews the financial statements of S.C. BETA S.A. In the previous financial year, the conclusion of the report was unmodified, and nothing drew the auditor's attention to the fact that the financial statements could be materially misstated. As in the previous year, in the initial phase of the audit, the risks analyzed are small and all the indicators analyzed are positive and are increasing compared to the previous financial years.

The object of S.C. BETA S.A.'s activity is *Processing and preserving meat*.

The S.C. BETA S.A. entity is not listed on the stock exchange and the general reporting framework applied by it is Order of the Minister of Public Finance no. 1802/2014, the entity not being required to audit their financial statements.

The entity of S.C. BETA S.A., being a joint stock company, its shareholders are made up of 5 shareholders, three of which hold 70% of the total shares, and two shareholders of the three are part of the entity's management team.

When contracting financial services for reviewing the financial statements, the S.C. BETA S.A. entity does not have commercial credits, but wants to contract such a loan in the coming year because it wants to acquire state-of-the-art equipment to increase its production capacity to those of the highest standards in the field, with the long-term goal of expanding the business and opening outlets to sell their own products in locations from across the region in which they operate.

In this respect, the management, the shareholders and, implicitly, the banking company that will grant the necessary credit, are mainly interested in the turnover registered by the entity and its evolution.

Turnover is one of the main indicators by which the entity monitors the growth of its business and the achievement of its objective.

Within Table no. 1 are presented the calculations made by the auditor in order to determine materiality.

**Table no. 1. The determination of materiality**

| Indicators | The current exercise - lei | Previous exercise - lei |
|---|---|---|
| **Total Assets (before Debt Reduction)** | **62.066.991** | **63.676.974** |
| 1% | 620.670 | 636.770 |
| 2% | 1.241.340 | 1.273.540 |
| **Turnover** | **266.096.159** | **269.361.750** |
| 1% | 2.660.962 | 2.693.618 |
| 2% | 5.321.923 | 5.387.235 |
| **Profit before tax** | **86.125.818** | **89.061.095** |
| 5% | 4.306.291 | 4.453.055 |
| 10% | 8.612.582 | 8.906.110 |
| **Materiality** | **5.321.923** | |
| **Trivial error** | **266.096** | |

In order to determine materiality, the auditor analyzed the following indicators: total assets, turnover and profit before tax.

The value of materiality determined is that related to the value of the turnover to 2% of its value, namely 5.321.923 lei.

Based on the judgment used by the auditor, there are several arguments in determining materiality.

In the case of the judgment of choosing the turnover indicator to determine the materiality value, the auditor relied on several arguments. First of all, the S.C. BETA S.A. entity wishes in the coming year to contract a commercial credit to increase its production capacity by acquiring state-of-the-art equipment with the aim of expanding its business. In this respect, the management, the shareholders and, thus, the banking company that will grant the necessary credit, are mainly interested in the turnover registered by the entity and its evolution. Depending on this indicator, the entity monitors the increase in activity and the achievement of its objective.

In the case of the judgment of choosing the percentage of 2% applied to the turnover to determine the value of materiality, the auditor relied on several arguments. Firstly, the mission is one of reviewing the historical financial statements that offer a limited assurance to users. If the S.C. ALFA S.R.L. entity carried out an audit mission that provided reasonable assurance about the financial statements of S.C. BETA S.A., then the auditor would have chosen the percentage of 1% applied to the turnover. The mission is a recurring one, being the second year in which the audit entity performs the review mission of the financial statements of entity S.C. BETA S.A. For the previous financial year, the auditor did not identify significant misstatements in the financial statements. As in the previous financial year, the risks analyzed at the initial stage are small, the economic and financial indicators of the entity are positive and growing.

At the same time, in order to reduce the risk at a low level, the auditor also determines the trivial error, through which, within the mission, he analyzes only the elements that exceed this value and, depending on his judgment, he applies the analytical procedures in order to obtain sufficient and adequate evidence on the basis of which it can establish the conclusion of the financial statements review mission. According to the auditor's manual of procedures, the percentage of trivial error applied is 5% of the materiality value, so the value of the trivial error is 266.096.

As a review mission, the auditor will review the value of materiality, either during the mission, or as long as he considers it is necessary, but also at the end of the mission, and in doing so will make all the necessary adjustments.

Even in the case of a financial statement review mission that provides end-users with limited assurance, the auditor applies professional judgment to determine the materiality value, thereby reducing to a low level the likelihood that the financial statements will contain material misstatements.

## 5. Conclusions

In order to meet the diverse needs of society, financial audit provides several types of audit engagements that can be performed by auditors. These engagements can be classified by the type of assurance they can provide, respectively reasonable assurance, limited assurance or non-assurance. In a review of historical financial statements, the auditor may provide limited assurance to users that the information provided by the financial statements may contain errors or even frauds.

In the review missions of historical financial statements, as in an audit mission that provides reasonable assurance, materiality is a tool used by the auditor to identify what information may be affected by errors or frauds. The determination of this value is influenced, first of all, by the auditor's judgment, then by the general data regarding the work performed by the audited entity.

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