Available online at www.sciencedirect.com
ScienceDirect
Procedia Economics and Finance 15 (2014) 935 – 942
Procedia Economics and Finance
www.elsevier.com/locate/procedia

Emerging Markets Queries in Finance and Business

Determining audit materiality in the banking industry - a knowledge based approach

Daniel Vîlsănoiu[a,*], Simona Buzenche (Matei)[a]

[a]Bucharest University of Economic Studies – Doctoral School, 11 Tache Ionescu Street 010352, Bucharest, Romania

Abstract

Determining the audit materiality is a key step in the planning of the audit process. The authors point out several of the specific issues encountered in determining materiality in financial audit engagements. Based on the authors experience and on best practice standards, a set of rules is presented for computing the audit materiality for clients in the banking industry. There is a two steps process: establishing a computation base for the materiality (e.g. Profit Before Tax) and choosing a certain percentage to be applied to the computation base. Additionally, the authors argue that the rules presented above may be incorporated in the knowledge base of an expert system by constructing production rules (in the form of Horn clauses) that would simulate the rationale of audit professionals. Ultimately, this expert system may be used for guiding auditors in the process of determining audit materiality.

Selection and peer-review under responsibility of the Emerging Markets Queries in Finance and Business local organization

Keywords: financial audit; performance materiality; banking industry; knowledge based expert system

1. Introduction

ISA 320 states that misstatements, including omissions, are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements.

Determining the performance materiality is an important phase in the planning the audit process, because this threshold has a direct impact on the extent and duration of substantive testing procedures to be performed.

* Corresponding author. Tel.: +4-0721-197-687
E-mail address: dan.vilsanoiu@gmail.com.

Selection and peer-review under responsibility of the Emerging Markets Queries in Finance and Business local organization
doi:10.1016/S2212-5671(14)00569-3

Executing these procedures is generally a time consuming process, therefore we argue that the time spent in addition to establish the materiality level will save time during the fieldwork.

We focused our study on the banking sector, because of the public scrutiny this industry has been facing following the global financial crisis. Sikka, 2009 points out that most financial institutions that sought for state support at the beginning of the crisis, had unqualified audit opinions from Big 4 companies. This fact raised questions about the quality of the audits performed for banks and other financial institutions.

This is why we consider that more research on improving the quality of the audit process is needed. Based on our professional experience, we believe that a major subject for improvement is the process for determining the audit materiality.

The first part of the paper covers the basic theoretical aspects of the performance materiality and deals with some of the specific aspects of determining it when performing audits for clients in the banking industry. Here we also present a rationale that may be used by auditors for determining the performance materiality. This rationale is based both on our research and our experience. There are two key items that auditors must consider:

- the computation base for the performance materiality
- the percentage to be used

In the second part of the paper we include our rationale in a set of rules that may be built into a knowledge based expert system.

We argue that such an expert system would be a valuable tool for audit professionals because it would help them in applying their professional knowledge and establishing the materiality level and it would save time that would improve the engagement economics or may be used on other sensitive areas of the audit.

1.1. Research methodology

The first part of the article is based on studies of the professional and academic literature concerned with determining the performance materiality and on reviews of regulatory documents and training materials from audit companies. To this, the authors added their experience in audit and extended discussions with several audit professionals regarding the subject for defining a rationale that may be generally applied on typical audit engagements for clients in the banking industry for determining the performance materiality.

Then we formalized this rationale in a set of Horn clauses that we argue that may be used for developing an expert system designed to aid auditors during this stage of the audit.

2. The rationale for determining the audit materiality for clients in the banking industry

Coate et al., 2002 state that the concept of reasonable assurance requires auditors to plan and perform an audit to provide reasonable (but not absolute) assurance that a material misstatement will be detected. The reasonable assurance concept recognizes the possibility that a material misstatement will exist in the financial statements (i.e. it was not detected by the auditors).

Farajzadeh and Azizzadeh, 2012 point out that materiality is a threshold quality in accounting which has priority over other qualitative characteristics of financial information. This means that financial information is important in the decision-making process only when it is important with respect to this to definition. Omitting or altering significant information can change the judgment and decisions of logical behaving users over the affairs of a business entity.

Determining the materiality level requires the consideration of a number of factors and the exercise of professional judgment. Auditors should consider what is important to the users of the financial statements, their perspectives and expectations, as well as the nature of the entity's business.

As per Houghton et. al., 2011 stakeholders generally perceive that the concepts involved in audit materiality are not well understood, especially in relation to qualitative materiality, to retail investors in particular.