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Problems of Determining Materiality and Risk in Audit Engagements

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ABSTRACT

This article analyzes the theoretical and methodological foundations of determining and assessing materiality and audit risk in audit engagements. Based on the requirements of International Standards on Auditing (ISA) 320 and ISA 315, the study examines the issues of subjectivity arising in determining materiality levels, the practical limitations of the audit risk model, and the challenges specific to auditing practice in Uzbekistan. Based on the research findings, scientifically grounded recommendations have been developed for improving the methodology of assessing materiality and risk, enhancing auditors' professional competence, and further harmonizing national auditing standards with international requirements.

Keywords: Audit, Materiality, Audit Risk, Inherent Risk, Control Risk, Detection Risk, Professional Judgment, Risk-Based Audit, Internal Control System, Audit Procedures, Financial Statements.

Introduction

In the modern market economy, auditing activity is becoming increasingly important as a key mechanism for ensuring the reliability and transparency of financial information. In the audit process, two concepts materiality and audit risk constitute its methodological foundation. The proper determination of these concepts directly affects not only the quality of the audit opinion but also the efficient use of audit resources. International Standard on Auditing International Auditing and Assurance Standards Board ISA 320, "Materiality in Planning and Performing an Audit," and ISA 315, "Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment," establish the theoretical basis for materiality and audit risk. However, auditors encounter a number of difficulties and challenges in the practical application of these standards. In particular, these issues possess distinctive characteristics within the auditing market of Uzbekistan. The purpose of this article is to systematically analyze the main problems arising in determining materiality levels and audit risk during audit engagements, examine their causes and consequences, and develop scientifically grounded recommendations for improving current practices.

Methodology

Materiality, in accordance with ISA 320, is defined as the threshold at which an error or misstatement becomes significant enough to influence the economic decisions of users of financial statements. Materiality is expressed quantitatively in monetary terms and is applied during the stages of audit planning, selection of audit procedures, and evaluation of audit results. The concept of materiality has two main aspects: quantitative materiality the threshold value expressed in monetary terms; and qualitative materiality factors such as violations of law, fraud, or intentional manipulation by management. In practice, auditors often rely primarily on quantitative indicators and may fail to give sufficient consideration to qualitative aspects.

Results and Discussion

Problems in Determining Materiality Levels

The first and most significant problem is the high degree of subjectivity involved in determining the materiality threshold. ISA 320 does not establish a specific formula or fixed rule, but instead relies on the auditor's professional judgment. As a result, different audit firms may determine different levels of materiality for the same financial statements, which complicates the comparability of audit opinions.

The second problem concerns the selection of an appropriate benchmark indicator. In companies demonstrating unstable financial performance — for example, during periods of economic reform or financial crisis — materiality based solely on profit indicators may not be appropriate. In such cases, determining whether to use assets, revenue, or equity as the benchmark requires a high level of professional knowledge and contextual understanding from the auditor.

The third problem is the failure to revise materiality levels in a timely manner. When significant new information is identified during the audit, materiality should be reassessed and recalculated. However, in practice, auditors often continue to rely on the initially established level without modification, which negatively affects the effectiveness of the audit engagement.

The fourth problem arises in evaluating qualitative materiality. Errors that may be quantitatively insignificant but legally or ethically important — such as intentional management adjustments or the improper application of tax incentives — may remain undetected if auditors rely exclusively on quantitative materiality criteria.

Problems in Assessing Audit Risk

The primary challenge in assessing inherent risk is its dynamic nature. Inherent risk may increase substantially when the business environment changes, new accounting standards are introduced, or the organization alters the direction of its activities. This issue is particularly relevant in Uzbekistan, where frequent changes in tax legislation and accounting standards keep inherent risk in a state of constant fluctuation.

In assessing control risk, auditors rely on the entity's internal control system. However, in practice, obtaining a comprehensive understanding and evaluation of internal controls requires significant time and resources. In small and medium-sized enterprises, internal control systems often either do not formally exist or operate without proper documentation. Under such circumstances, auditors tend to assess control risk at the maximum level (100%) and rely primarily on substantive procedures, which may significantly increase detection risk.

The challenge in managing detection risk lies in the fact that it is calculated as a residual component of inherent and control risks. In practice, however, auditors cannot directly control detection risk itself; they can only manage the scope and quality of audit procedures. Consequently, detection risk may not be reduced to an acceptable level, thereby adversely affecting audit quality.

Another important issue is the interdependence of risks. The classical audit risk model treats risks as independent variables. In practice, however, inherent risk and control risk may be closely related. For example, companies dealing with complex financial instruments often simultaneously exhibit high inherent risk and high control risk. This weakens the logical basis of the traditional formula and may lead to incorrect interpretation of audit risk assessments.

Specific Problems in the Auditing Practice of Uzbekistan

In the auditing practice of Uzbekistan, several country-specific problems arise in determining materiality and audit risk. First, due to the relatively small size of many audit firms and the shortage of experienced specialists, calculations based on professional judgment are often not performed with sufficient depth and accuracy.

Second, long-term relationships and economic dependence between auditors and clients may limit auditor independence, creating a tendency to establish higher materiality thresholds and underestimate audit risks.

Third, the process of fully harmonizing national auditing standards with international standards in Uzbekistan has not yet been completed, which creates difficulties in the consistent interpretation and application of ISA 320 and ISA 315 requirements in practice.

Fourth, when auditing financial statements intended for users with limited financial literacy, auditors face additional difficulties in adequately assessing the concept of materiality and its practical implications.

Recommendations for Improvement

Based on the conducted analysis, the following recommendations have been developed:

1. To develop industry-specific coefficients for determining materiality levels and introduce them as recommended guidelines by the Ministry of Finance of Uzbekistan.
2. To prepare standard audit risk matrix models for audit firms, particularly simplified versions designed for the small and medium-sized business sector.
3. To strengthen regular external quality control reviews of materiality and risk assessment processes conducted by audit firms. This is especially important within the framework of inspections carried out by the Chamber of Auditors of Uzbekistan.
4. To include specialized training on materiality and audit risk assessment in auditors' continuous professional development programs. In addition, opportunities for integrating artificial intelligence and data analytics tools into the risk assessment process should be explored.
5. To enhance the importance of qualitative materiality by introducing a separate section in audit reports devoted to qualitative factors and by studying advanced international practices in this area.

Conclusion

This article examined the theoretical foundations and practical challenges associated with determining materiality and audit risk in audit engagements. The analysis demonstrates that the problems in this area are not only methodological in nature, but also structural, including issues related to professional competence, auditor independence, and the harmonization of standards.

The concepts of materiality and audit risk constitute the core of audit quality: incorrect assessment of these concepts may lead, on the one hand, to inappropriate audit opinions and, on the other hand, to the inefficient use of audit resources. International practice shows that the consistent application of a risk-based audit approach significantly enhances audit quality.

In Uzbekistan, improving the methodology for assessing materiality and audit risk should be recognized as a strategic priority in the development of the national auditing system and implemented through coordination among the Ministry of Finance, the Chamber of Auditors of

Uzbekistan, and educational institutions. Future research should focus on the practical identification of local risk profiles and materiality coefficients while taking into account the specific characteristics of the country's financial reporting system.

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