

# Qualitative Perspective of Audit Materiality: Empirical Evidence in Mexico and Colombia

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Our contribution analyzes the process of convergence with the International Standards of Audit (ISAs), particularly those that regulate the concept of materiality in Mexico and Colombia. Between other results, across a survey, it is demonstrated why the effective use of the factors that emerge of his qualitative slope can favor the quality of the financial information that publish the audited companies, the usefulness and the comprehensibility of the report of opinion. In general, the reliability, transparency, and relevancy of the financial statements will meet potentially favored with the strict application of these major and better normative instruments.

*Keywords:* qualitative perspective, materiality, financial statements, audit materiality, International Federation of Accountants (IFAC)

## Introduction

The new world economic order is necessary for the existence of a universal language to certify the reliability, comparability, and transparency of reporting by which to communicate the results and effectiveness in managing the resources contributed by investors to business organizations (Brickley, Linck, & Smith, 2003).

Regarding this, the International Federation of Accountants (IFAC), in the early years of this century started screening programs and clarity which were updated by the International Standards on Auditing (ISAs). The strict application of these new policy instruments has been endorsed by major world economic blocs, making them to be the only globally accepted methodology to ensure the fairness of the information that companies communicate with the financial statements (IOSCO, 2009; UN, 2008).

This global movement promotes the widespread application of ISAs, highlights the priority that has been the adoption of ISA 450: The evaluation of the misstatements identified during the audit (IFAC, 2010, pp. 368-379), for surely this controversial concept stands as a benchmark for the planning, execution and completion of the

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inspection work performed by auditors (Martínez García, Ramírez Cacho, Montoya del Corte, & Fernandez-Laviada, 2008, 2010).

### **Importance of Audit Materiality**

Besides being a concept that auditors use during the three stages at which fractures its work, the material is a qualitative characteristic of financial information and an element present in the regulatory framework of accounting and auditing around the world (Garcia Delgado, 1994).

These circumstances led to its reform has been one of the first steps in a path to try to strengthen the regulatory framework for the audit function, and thus anticipate, among other things, the presence of financial scandals (Benau Garcia, Humphrey, Moizer, & Turley, 1993; Brody, Lowe, & Company, 2003).

The audit materiality is seen both from a historical perspective—quantitative, for the determination of which is usually given 5% on corporate profits, and from a newly strengthened qualitative aspect, which promotes consideration—at the same level of importance that the numerical side—the nature and circumstances surrounding each error detected during the audit (Ng, 2007).

Indeed, the reform of this concept encouraged the IFAC focused on standardizing and included in ISA 450 the explicit consideration of such circumstances, capturing it in a forceful way through the next 11 qualitative factors (FC-450) that auditors should consider in determining to what extent—the errors detected and corrected will impact on your report or final opinion.

The new methodology states that those errors are not quantitatively significant, may lead to qualifications in audit reports, if they:

- (1) Affect compliance with regulatory requirements;
- (2) Affect compliance with debt covenants or other contractual requirements;
- (3) They relate to the incorrect selection or use of an accounting policy that has an immaterial effect on the financial statements of the current period, but probably has a material effect on the financial statements of future periods;
- (4) Show a change in earnings or other trends, especially in the overall economic and industry conditions;
- (5) Affect indicators used to assess the financial position of the entity, the results of operations or cash flows;
- (6) Affect segment information presented in the financial statements (for example, the importance of an issue for a segment or other part of the entity's business, which has been identified that play an important role in the operations of the entity or the profitability);
- (7) Have the effect of increase in compensation paid to the administration, for example, by ensuring that the requirements for a bonus or other incentives are satisfactory;
- (8) Are significant considering the auditor's understanding of communications previously known users, for example, in relation to the budget of profits;
- (9) They relate to matters that involve private parties (for example, if external parties to the transaction are related to members of the administration of the entity);

- (10) Constitute an omission of information not specifically required by the applicable financial reporting standards, but in the auditor's judgment is important for understanding of the users on the financial position, results of operations or cash flows of the entity;
- (11) Affects other information that will be communicated in documents containing audited financial statements (for example, information to be included in a "letter of suggestions to the administration" or "operating and financial review"), which may reasonably be expected to influence economic decisions of financial statements.

### **Global Convergence With ISAs**

The exchange of accounting reports has led the globalization of business, which has promoted the adoption of all or part of ISAs worldwide. Thus, we find that for example, the European Union (EU) adopted from 2010 with the adjustments each member deems appropriate and Mexico adopted in full in 2012.

Hence, in order to analyze the extent to Colombian professionals with authority to sign audit reports (CCPO) agree with the actual use of the FC-450, a study was made possible to obtain empirical evidence of that fact.

### **Convergence With Colombian ISAs**

Facing the reality of global audit function, Colombia issued Law 1314 of 2009 as a normative framework through which it undertakes a strong convergence process with action in the state. In this context, the government has the role and responsibility of issuing financial reporting standards, assurance standards and other reporting standards that apply in the country by joint action of the Ministry of Finance and Ministry of Commerce Industry and Tourism, based on proposals submitted by the Technical Board of Public Accountancy as a body for standardization in the field of competence (Technical Board of Public Accountancy, 2011, p. 11).

Given the above, within the said assurance standards are the historical financial auditing standards (Act 1314 of 2009, Art 5), the convergence process will be carried out taking as reference standards for audit and assurance information issued by the Standards Board International Auditing and Assurance Board (IAASB), because they meet the three conditions listed in the law to be accepted in Colombia: (1) that are globally accepted; (2) developed with best practices; and (3) in correspondence with the rapid evolution of business (Technical Board of Public Accountancy, 2011, p. 5).

This regulation will be applied differentially to three user groups: group 1: issuers and public interest entities; group 2: companies' large and medium other than issuers or public interest entities, as Colombian legal classification of companies (about one can see the Act 590 of 2000, Act 905 of 2004, Act 151 of 2007, Act 1429 of 2010, and Act 1450 of 2011); and group 3: small and micro enterprises as legal classification Colombian companies (Technical Board of Public Accountancy, 2011, p. 7).

In the case of financial auditing standards, its enforcement shall be binding on the part of groups 1 and 2 and for group 3, the government will authorize an information assurance at a moderate level.

Regarding the CTCF deadline has presented on June 30, 2010, a work plan which under Article 13 of Law 1314 shall be completed in 24 months (June 30, 2012), a term during which the council will submit for consideration of the respective ministries, projects that may arise. The rules issued will take effect on January 1 of the second taxable year following its enactment (Act 1314 of 2009, Art 14).

It should be noted in this process of convergence to ISAs as national institution of the Statutory Auditor “is a form of insurance other than international standards, as required coverage also provides for control functions in the public interest” (Technical Council Public Accounting, 2008).

However, according to Article 5 of Act 1314 of 2009, the auditor in the development of comprehensive audit financial audit should develop based on ISAs.

However, it is necessary to reassert the importance of adopting the ISAs in Colombia, as the Generally Accepted Auditing Standards (GAAS) referred to in Article Seven (7) of Act 43 of 1990, lack of the elements that guarantee the quality of auditor’s work.

### Convergence With Mexican ISAs

As noted by Ramirez Cacho and Oropeza Tagle (2011), in this country the process of convergence with the ISAs will be consummated on January 1, 2012, according to the pronouncement of the Mexican Institute of Public Accountants (IMCP, 2009), repeal the Auditing Standards Generally accepted and be replaced with the full contents of the International Standards on Auditing issued by IFAC.

### Methodology, Hypotheses, and Objectives

The objective (see Table 1) was analyzed to the extent that the effective use of the FC-450, that auditors should use to evaluate the nature and circumstances surrounding each error detected in the audit of financial statements—even though they are not numerically important, according to the new ISA 450, shall be documented, reported, corrected and, under certain circumstances, except as disclosed in the audit report and audited financial statements—favorably or adversely affects the quality of financial information that companies publish audited.

Table 1

#### *Specific Objectives and Hypotheses of the Empirical Study*

Purpose and hypothesis	
Compare the degree of agreement between auditors of Colombia (CCPO) for the effective use of the FC-450	
H0	H1
The ACo have a different degree of agreement on the effective use of the FC-450	The ACo have the same degree of agreement on the effective use of the FC-450

Pursued by the research hypothesis, which is focuses on comparing whether the degree of agreement between auditors on Colombia is equal to the effective use of qualitative materiality factors.

To test the hypotheses, the authors first used the Kolmogorov-Smirnov statistic to analyze the assumption of normality in the variables, confirming that in all cases there was a skewed distribution. Therefore, the tests used were, at first, non-parametric type. However, considering that in larger samples of 30 observations can be applied parametric tests, although the distribution of the variable deviates from normality, the authors used the *t* test (parametric) to test the significance of a mean difference with a value initial assumed equal to 3.

As a complement, the data were analyzed using descriptive statistical tools, with contingency tables, a frequency analysis, and the inferential statistical Mann-Whitney test (non-parametric test).

As an instrument for data collection was used to model the Montoya-del-Corte used for Spain (2008) and adaptation to Mexico by Ramírez Cacho (2009).

It consisted of a questionnaire with three blocks of questions designed to be answered as an anonymous survey response.

The first block contained a series of questions aimed to know certain attributes of the subjects that allowed respondents to characterize statistically.

The second block included 12 questions, and collected information that is relevant to the analysis presented.

The third block included 23 questions, each related to different consequences that could arise—for the strict application of the FC-450 on certain areas of the audit function. To sort and weigh the answers of Blocks II and III used a Likert scale, which considered a total disagreement with the number 1, with 2 partial disagreements, indifference to 3, a partial agreement with the 4 and the 1 position of total agreement with the issues raised.

By Cronbach's alpha index (1951), we determined that the subjects' responses to questions in Blocks II and III met with the required reliability, obtaining, according to Hair, Bush, and Ortinau (2004, p. 394) excellent results and, thus demonstrating that the questionnaire had a great internal consistency.

The sample analyzed consisted of those subjects who potentially had the power to issue audit opinions, as are those who ultimately decide the content and, therefore, the qualifications to enter therein.

Table 2 lists these and other aspects of the investigation.

Table 2

*Technical Details of the Survey*

Geographic scope and universe of subjects	Colombia 1600 Reviewers Accounts Officers based in Santa Fe de Bogota assigned to the Superintendencia Financiera de Colombia	Mexico Auditors assigned to the MIPA 6250
Method for obtaining information and sample selection	Random application online	Mass application online
period	December 2010-March 2011	October 2008-March 2009
Sample size and error	100 valid surveys	101 valid surveys
Confidence level	95% ( $z = 1.96$ ) for worst case	
Data processing	Software SPSS 18.00	

*Note.* Source: Prepared from Ramirez Cacho (2009) and Montoya del Corte (2008).

You specify the origin of the universe and sample auditing Colombians surveyed in Mexico and Colombia, as well as the periods of application and valid questionnaires obtained.

## Results

The authors described the methodology used, and then presents the main results, but this for space limited only to Colombia.

The data collected from the opinion survey applied to a sample of financial auditors and/or fiscal auditors practicing in the city of Bogotá DC were analyzed using techniques of descriptive and inferential statistics.

For a description of personal characteristics and auditors' professional respondents used the frequency analysis on the information obtained in Block I of the survey. The obtained results went the following ones.

### Personal Characteristics

The distribution of respondents in terms of gender variable is concentrated by 62% in men, so most of the financial auditors or statutory auditors are aged between 46 and 55 years old (38%), followed with a percentage

of 22% auditors located in the range of 26-35 years old and 36 to 45 years old.

### Professional Features

Regarding the academic training of auditors from the exhibit are 100% public accounting professionals, of which 84% has an experience of six to 10 years and 48% has a graduate degree in economic areas.

In terms of professional experience in audit, 41% is in the range of five to 10 years, while 27% have an experience in this field over 20 years. With regard to the manner of exercise of the audit, 56% work as independent accountant and holds 26% partner of a firm of auditors. On the level of turnover to 30% of the independent auditors earns between \$26,640,000 and \$66,660,000 compared to 22% which earns income in excess of \$66,660,000. While 46% of companies are reported earnings exceed the sum of \$666,660,000. Taking into consideration the number of companies audited in the past year, 16% report having evaluated more than 20 companies, 16% of professionals carry out its work in publicly traded institutions, 4% in credit institutions and 80% in other sectors of the economy.

### Colombian Auditors Position Against the Qualitative Materiality Factors

Regarding the degree of agreement between auditors of Colombia (CCPO) for the effective use of the qualitative factors listed in NIAR 450, we have concluded that:

Table 3 shows the scale obtained from the evaluation by financial auditors and/or statutory auditors to each of the qualitative factors and their respective standard deviation.

Table 3

#### *The Willingness of Auditors Colombians to Use the FC-450*

Qualitative factors of materiality in audit (NIAR 450)	Mean	Deviation typical
1. Affects compliance with regulatory requirements.	3.92	0.944
2. Affects compliance with debt covenants or other contractual requirements.	4.10	0.647
3. It relates to the incorrect selection or use of an accounting policy that has an immaterial effect on the financial statements of the current period, but probably has a material effect on the financial statements of future periods.	3.56	0.97
4. Shows a change in earnings or other trends, especially in the overall economic and industry conditions.	3.86	0.88
5. Affects indicators used to assess the financial position of the entity, the results of operations or cash flows.	3.74	1.08
6. Affects segment information presented in the financial statements (for example, the importance of an issue for a segment or other part of the entity's business, which has been identified that play an important role in the entity's operations or profitability).	3.74	0.89
7. Has the effect of increase in compensation administration, including by ensuring that the requirements for a bonus or other incentives are satisfactory.	3.72	1.06
8. It is significant considering the auditor understands with respect to communications previously known users, for example, in relation to the budget of profits.	3.72	0.73
9. It relates to issues involving interests (for example, if external parties to the transaction are related to members of the directors of the company).	4.10	0.86
10. It is an omission of information not specifically required by the applicable financial reporting standards, but in the auditor's judgment is important for the understanding of the users on the financial position, results of operations or cash flows of the entity.	3.74	1.02
11. Affects other information that will be communicated in documents containing audited financial statements (for example, information to be included in a "Letter of suggestions to the administration" or "Operating and financial review" that can reasonably be expected to influence decisions economic of financial statements.	3.80	0.99
Average value of eleven qualitative factors		<b>3.82</b>

*Notes.* Scale values for the qualitative factors: The evaluation was made based on the 5-point Likert scale as follows: 1 = strongly disagree, 2 = disagree, 3 = not important, 4 = agree, and 5 = strongly agree.

Based on the average of the values obtained (3.82), one can conclude that auditors revealed Colombians surveyed agree to disclose, as a qualification in the audit report and audited financial statements, findings identified in the audit (related to the eleven factors identified in the NIAR 450).

Particularly noteworthy is the position of general agreement for all the factors shared by the respondents.

Since the valuation of different factors, Table 4 shows the scale of importance of each.

Table 4

*Position of the Auditors to the Qualitative Factors*

Qualitative factors of materiality in audit (NIAR 450)	(1-2) %	(3) %	(4-5) %
1. Affects compliance with regulatory requirements.	12	12	76
2. Affects compliance with debt covenants or other contractual requirements.	2	10	88
3. It relates to the incorrect selection or use of an accounting policy that has an immaterial effect on the financial statements of the current period, but probably has a material effect on the financial statements of future periods.	22	12	66
4. Shows a change in earnings or other trends, especially in the overall economic and industry conditions.	12	10	78
5. Affects indicators used to assess the financial position of the entity, the results of operations or cash flows.	18	20	62
6. Affects segment information presented in the financial statements (for example, the importance of an issue for a segment or other part of the entity's business, which has been identified that play an important role in the entity's operations or profitability).	2	10	74
7. Has the effect of increase in compensation administration, including by ensuring that the requirements for a bonus or other incentives are satisfactory.	4	14	74
8. It is significant considering the auditor understands with respect to communications previously known users, for example in relation to the budget of profits.	4	32	64
9. It relates to issues involving interests (for example, if external parties to the transaction are related to members of the administration of the entity).	10	2	88
10. It is an omission of information not specifically required by the applicable financial reporting standards, but in the auditor's judgment is important for the understanding of the users on the financial position, results of operations or cash flows of the entity.	18	14	68
11. Affects other information that will be communicated in documents containing audited financial statements (for example, information to be included in a "Letter of suggestions to the administration" or "Operating and financial review" that can reasonably be expected to influence decisions economic of financial statements.	12	12	76
Overall percentage	11	14	75

Notes. The evaluation was conducted based on 5-point Likert scale as follows: 1 = strongly disagree, 2 = disagree, 3 = not important, 4 = agree, and 5 = strongly agree.

Following the hypothesis of equality Table 4 confirms the degree of agreement of the counters to the application of the factors, showing how the factor 2 and 9 obtained the highest percentage of importance. The same analysis shows a level of less relevance to the factors 5.8 and 3.

Finally, in applying the *t*-test procedure with a neutral value equal to 3 (indifference), confirming the validity of the hypothesis "the CCPO have a different degree of agreement on the effective use of the FC-450" (see Table 5).

Table 5

*Level of Significance of the Qualitative Factors T-test (t-test)*

Qualitative factors of materiality in audit (NIAR 450)	<i>t</i>	Difference mean
1. Affects compliance with regulatory requirements.	6.890*	0.920
2. Affects compliance with debt covenants or other contractual requirements.	12.025*	1.100
3. It relates to the incorrect selection or use of an accounting policy that has an immaterial effect on the financial statements of the current period, but probably has a material effect on the financial statements of future periods.	4.073*	0.56000

(Table 5 continued)

Qualitative factors of materiality in audit (NIAR 450)	<i>t</i>	Difference mean
4. Shows a change in earnings or other trends, especially in the overall economic and industry conditions.	6.904*	0.86000
5. Affects indicators used to assess the financial position of the entity, the results of operations or cash flows.	4.825*	0.74000
6. Affects segment information presented in the financial statements (for example, the importance of an issue for a segment or other part of the entity's business, which has been identified that play an important role in the entity's operations or profitability).	5.819*	0.74000
7. Has the effect of increase in compensation administration, including by ensuring that the requirements for a bonus or other incentives are satisfactory.	4.759*	0.72000
8. It is significant considering the auditor understands with respect to communications previously known users, for example, in relation to the budget of profits.	6.978*	0.72000
9. It relates to issues involving interests (for example, if external parties to the transaction are related to members of the administration of the entity).	9.012*	1.10000
10. It is an omission of information not specifically required by the applicable financial reporting standards, but in the auditor's judgment is important for the understanding of the users on the financial position, results of operations or cash flows of the entity.	5.098*	0.74000
11. Affects other information that will be communicated in documents containing audited financial statements (for example, information to be included in a "Letter of suggestions to the administration" or "Operating and financial review" that can reasonably be expected to influence decisions economic of financial statements).	5.715*	0.80000

Notes. Whereas a degree of Sig. (bilateral) significant at 5%, this table presents the average values achieved by the responses of Colombians surveyed auditors; \* Next (bilateral) = 0.000.

### Conclusions

The study shows the importance that financial auditors and/or statutory auditors in Colombia give the qualitative aspect of materiality. This situation indicates the urgent need for approaching the ISAs, as the Generally Accepted Auditing Standards of Colombia (GAAS) are not a sufficient reference for the development of the audit function in the country.

The investigation also shows the degree of agreement between financial auditors and/or statutory auditors in Colombia (CCPO), regarding the effective use of qualitative materiality factors listed in the International Standard on Auditing (NIAR 450).

This based on the view given by those consulted, regarding the need for disclosure as an exception in the audit report and audited financial statements related findings identified qualitative factors reduced amount.

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