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Determining the Level of Materiality in an Audit

Fayziev Umurkul Shukhratovich

PhD, Department of Audit, Tashkent state university of economics, Uzbekistan

Yulbarsova Ugiloy Muhammadsokhohid kizi

Student, BHA-23/23r, Tashkent state university of economics, Uzbekistan

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Abstract: The article examines the theoretical and practical aspects of determining the level of materiality in auditing under the conditions of a modern economy. It substantiates the key role of materiality as one of the fundamental elements of auditing, which has a direct impact on the planning and execution of audit procedures, as well as on the formation of the auditor's professional judgment. Particular attention is given to the relationship between the level of materiality and audit risk in the context of the requirements of International Standards on Auditing.

The study analyzes both quantitative and qualitative approaches used in determining materiality, highlighting the specifics of selecting benchmark indicators and establishing threshold values. Based on the analysis, the main challenges encountered in audit practice are identified, including the limitations of formalized methods, the instability of financial indicators, the high degree of subjectivity in professional judgment, insufficient integration with risk assessment, as well as the dynamic nature of materiality.

Special attention is paid to the specifics of applying the concept of materiality in developing economies, particularly in the Republic of Uzbekistan, where the role of auditing is increasing in the context of ongoing economic reforms and the growing requirements for transparency in financial reporting.

Keywords: Materiality, level of materiality, auditing, audit engagement, audit risk, financial statements, assessment methods, professional judgment, audit efficiency, risk-based approach, financial reporting, internal control, audit planning, performance materiality, quantitative and qualitative factors.

Introduction: In the context of a rapidly evolving economy, where financial transactions are becoming increasingly complex and the requirements for business transparency are continuously intensifying, the reliability of financial information acquires particular importance. Financial statements serve as the primary basis for decision-making by various groups of users, ranging from investors and creditors to government authorities. In such circumstances, even relatively minor misstatements may significantly affect the assessment of an organization's performance and lead to erroneous managerial conclusions. This, in turn, necessitates the conduct of independent auditing as a tool for confirming the reliability of the presented data.

In recent years, the Republic of Uzbekistan has been implementing large-scale economic reforms aimed at enhancing the transparency of financial reporting and developing the institution of independent audit. The adoption of the Law of the Republic of Uzbekistan "On Auditing Activity" and the improvement of the regulatory framework have strengthened the requirements for the quality of financial information and increased the significance of audit procedures. In this context, the concept of materiality serves as a fundamental analytical tool that determines the focus and depth of audit procedures, as it allows for determining the threshold beyond which misstatements begin to exert a real influence on users' decisions.

According to the provisions of International Standard on Auditing (ISA) 320, materiality is defined as the magnitude of misstatements that could influence the economic decisions of users of financial statements. It is important to note that this concept does not exist in isolation; rather, it is directly related to audit risk, the concept of which is disclosed in ISA 315. Their interrelationship requires a comprehensive approach to audit planning and execution, as it is the combination of these elements that enables the auditor to form a well-founded professional judgment.

In modern auditing practice, the concept of materiality is multi-level in nature and is not limited to a single indicator. In accordance with International Standards on Auditing, several types of materiality are distinguished, each applied at different stages of the audit process.

First, overall materiality is determined at the audit planning stage and reflects the maximum acceptable level of misstatements in the financial statements as a whole. This indicator serves as a benchmark for assessing the reliability of financial reporting and forming the auditor's opinion.

In addition, performance materiality is applied, representing a lower threshold used in the execution of audit procedures. Its purpose is to reduce the probability that the aggregate of undetected misstatements exceeds the overall materiality level.

In certain cases, auditors also identify specific materiality, which is applied to particular items of financial statements or transactions that are of heightened importance to users. This approach enables a more precise consideration of the risks of material misstatement in the most sensitive elements of financial information.

Figure 1 – Audit Risks

Objectives

The objective of this study is to conduct a comprehensive analysis of the theoretical and practical aspects of determining the level of materiality in auditing under the conditions of a modern economy. Within this objective, the study aims to examine existing quantitative and qualitative approaches to establishing materiality, analyze the key benchmark indicators and the criteria for their selection, and assess their impact on the planning and execution of audit procedures.

Main Body

The determination of the level of materiality is carried out at the audit planning stage and has a direct impact on the scope, nature, and direction of audit procedures. In practice, auditors apply quantitative benchmarks based on key financial indicators of the entity. The most commonly used bases include profit before tax, revenue, total assets, and equity. As reference points, auditors typically use 5% of profit, 1% of revenue, or 2% of assets. However, these indicators are not universal and require adjustment depending on the specific characteristics of the entity.

The level of materiality is influenced by a combination of internal and external factors reflecting the specifics of the audited entity's operations. Among the key factors are industry characteristics, as the level of risk and the significance of particular indicators may vary substantially depending on the sector of activity. The scale of the business is also of considerable importance, as reflected in revenue, total assets, and the number of employees. For large organizations, even significant misstatements in absolute terms may be relatively immaterial.

In addition, the capital structure and the degree of dependence on external financing sources are taken into account. The presence of external users of financial statements, such as investors, creditors, and government authorities, increases the requirements for the accuracy of financial information and, accordingly, leads to a lower materiality threshold.

Another important factor is the level of regulatory oversight and legal requirements, as violations of laws and regulations may be considered material regardless of their quantitative value. Within the context of national practice, the application of these benchmarks also requires consideration of the characteristics of the national economy, the level of financial market development, and the specifics of business activities, which further enhances the role of the auditor's professional judgment. Despite the formalized nature of existing approaches, determining materiality remains a complex methodological task associated with a number of systemic challenges.

In auditing practice, various methods are used to determine the level of materiality, which may be applied either independently or in combination. The most common approach is the percentage-based method, which involves applying established ratios to key financial indicators such as profit, revenue, or total assets.

Another approach is the professional judgment method, where the level of materiality is determined based on the auditor's experience, the specifics of the business, and risk assessment. This method provides flexibility; however, it increases the degree of subjectivity.

The most effective approach is considered to be the combined method, which involves the use of quantitative benchmarks followed by adjustments based on qualitative factors and risk analysis. This approach allows for achieving a more balanced and well-reasoned result.

In practical auditing, the determination of materiality significantly influences not only the selection of audit procedures but also the depth and scope of testing. A lower materiality threshold typically leads to an increase in sample size and more detailed verification procedures, whereas a higher threshold allows auditors to focus on key areas with the greatest risk of misstatement.

Furthermore, materiality directly affects the evaluation of audit evidence and the formation of audit conclusions. The auditor must assess whether the aggregate of identified misstatements exceeds the established materiality level and determine their impact on the reliability of financial statements.

To illustrate the determination of materiality, the following example is provided:

Table 1 – Calculation of Materiality Based on Selected Financial Indicators

Indicator	Value	Percentage	Materiality
Profit before tax	200 000	5%	10 000
Revenue	1 000 000	1%	10 000
Assets	500 000	2%	10 000

The presented example demonstrates that different benchmark indicators may lead to similar materiality levels; however, their economic interpretation may vary significantly. Therefore, the selection of an appropriate base remains a critical aspect of the auditor's professional judgment.

Materiality Example			
Selected Banchmark	Operations	Plant	
Revenue	29,628,228		
Total Assets	-	21,844,768.00	
Overall Materiality (planning)	148,141	327,672	<< Total allowable misstatement
Factor Selected	0.5%	1.5%	

Section	User's tolerance for misstatements				
	Low	Low to Medium	Medium	Medium to High	High
Revenue	2%	1.75%	1.5%	1%	0.5%
Profit Before Tax	10%	8%	7%	6%	5%
Total Assets	2%	1.75%	1.5%	1%	0.5%
Net Assets/Equity	10%	8%	7%	6%	5%
Net Current Assets	10%	8%	7%	6%	5%

Performance Materiality (60% Overall)	88,885	245,754	<< FS Line Item
Account Level Materiality (25% Performance)	22,221	61,438	<< Account balance
Individually Significant Items (33% Account Level)	7,333	20,275	<< e.g. invoice
Trivial (1% Performance)	889	2,458	<< Pass at workpaper level

Figure 2 – Determining the level of materiality based on key financial indicators

One of the key problems is the mismatch between quantitative assessment methods and the actual economic nature of information. In practice, the determination of materiality is most often based on the establishment of specific numerical thresholds, which makes the evaluation process highly formalized. However, in reality, the significance of misstatements depends not only on their magnitude but also on the circumstances in which they arise and on the auditor's professional judgment. Even a minor deviation may be considered material if it is associated with violations of legislation, distortion of financial indicators, or attempts to conceal losses. In such situations, reliance solely on quantitative criteria proves insufficient and may lead to the underestimation of truly significant misstatements. As a result, a gap emerges between formalized approaches and the actual economic substance of information.

In the context of digital transformation, the process of determining materiality is increasingly supported by data analytics tools. The use of automated systems allows auditors to process large volumes of financial data, identify anomalies, and refine materiality thresholds based on real-time information. This contributes to improving audit quality and reducing the influence of subjective judgment.

Another important issue is the instability of the indicators used as a basis for determining materiality. Under conditions of economic uncertainty, an entity's profit may fluctuate significantly or even become negative, which complicates the application of standard benchmarks. In such cases, auditors are forced to rely on alternative indicators, such as revenue or total assets; however, these do not always provide an objective result. This is due to the fact that different indicators reflect different aspects of an entity's performance and are not interchangeable. Consequently, the selection of the calculation base largely depends on the auditor's professional judgment, which increases subjectivity and reduces the reliability of the established materiality level.

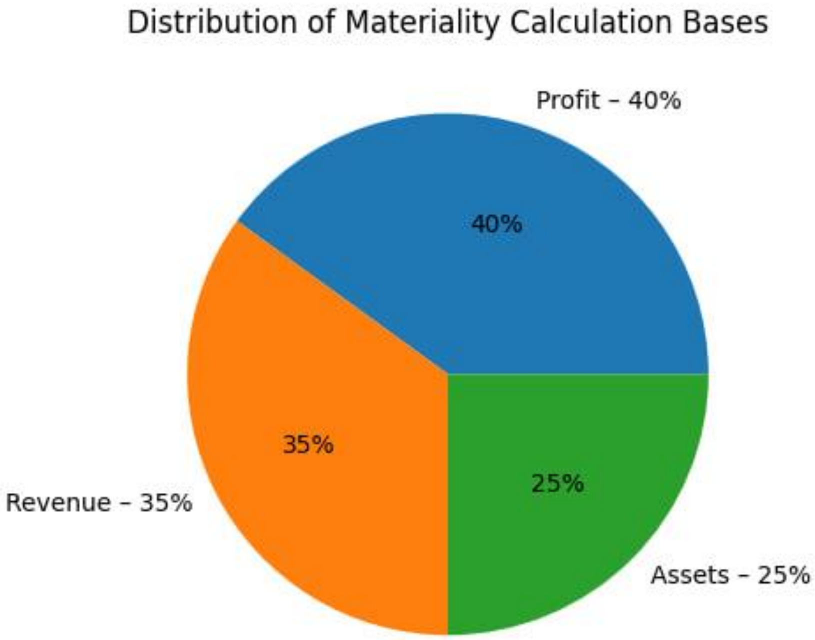

Figure 3 – Diagram of distribution of bases for calculating materiality

The diagram illustrates the relative importance of different benchmark indicators used in practice, highlighting the predominance of profit as the primary basis for materiality calculation.

Another significant issue is the insufficient alignment between the level of materiality and the assessment of audit risk. Although International Standards on Auditing explicitly emphasize the need for their interrelated application, in practice a formal approach is often observed, whereby materiality is determined independently of a thorough analysis of the risks of material misstatement. As a result, the established materiality threshold may fail to reflect the actual level of risk inherent in a particular entity's operations and financial reporting. This is especially evident in situations involving a high likelihood of fraud or the presence of significant errors, where the materiality level should objectively be reduced to ensure more rigorous audit procedures. However, in practice, such adjustments are not always made in a timely or sufficient manner, which may lead to a decline in audit quality and an increased risk of failing to detect material misstatements.

It should be noted that in developing economies, including the Republic of Uzbekistan, these issues are more pronounced due to the transformation of the economic system, changes in the regulatory environment, and increasing demands for the country's investment attractiveness.

In international practice, approaches to determining materiality are characterized by a certain degree of standardization based on the application of International Standards on Auditing. At the same time, differences in practical implementation can be observed across countries.

In developed economies, such as those of the European Union and the United States, considerable attention is given to integrating materiality with a risk-based approach, as well as to the active use of analytical procedures and digital tools.

In developing countries, including the Republic of Uzbekistan, the adaptation of international approaches is accompanied by the need to consider national specificities, including the level of financial market development, regulatory frameworks, and accounting practices.

A significant influence on the determination of materiality is exerted by the high dependence on the auditor's professional judgment. The absence of unified quantitative criteria and clearly established methodological approaches leads to situations where different auditors may determine substantially different levels of materiality under similar conditions. This reduces the comparability of audit results and may negatively affect the level of trust in audit opinions. Furthermore, the risk of external influence increases, including client pressure, resource constraints, or other organizational factors that may affect the objectivity of decision-making.

Particular attention should be given to the application of materiality at the level of individual financial statement items. The overall materiality level does not always allow for an adequate assessment of misstatements in specific accounts, especially those that are highly sensitive. In this regard, there is a need to determine performance materiality, which is applied during the detailed testing of individual elements of financial reporting. However, standardized approaches to its calculation remain insufficiently developed, creating additional challenges and increasing the likelihood of errors.

Moreover, materiality is inherently dynamic and may change during the course of an audit. As new information is obtained, additional risks are identified, or the financial condition of the entity is reassessed, the initially established materiality level may lose its relevance. However, in practice, such revisions are not always carried out in a timely manner, which reduces the effectiveness of audit procedures and may negatively affect the quality of the final audit opinion.

Thus, materiality should not be considered as a fixed numerical threshold, but rather as a flexible analytical tool that evolves throughout the audit process in response to changing risk conditions and newly obtained information.

The main issues related to the determination of materiality are summarized in the following table:

Table 2 – Summary of Key Issues in Materiality Assessment and Their Impact on Audit

Problem	Essence of the problem	Consequences
Limitations of methods	Qualitative factors are ignored	Risk of missing errors
Instability of indicators	Profit fluctuations	Calculation errors
Subjectivity	Different approaches by auditors	Incomparability
Relationship with risk	Insufficient integration	Reduced audit quality
Dynamism	Infrequent reviews	Loss of relevance

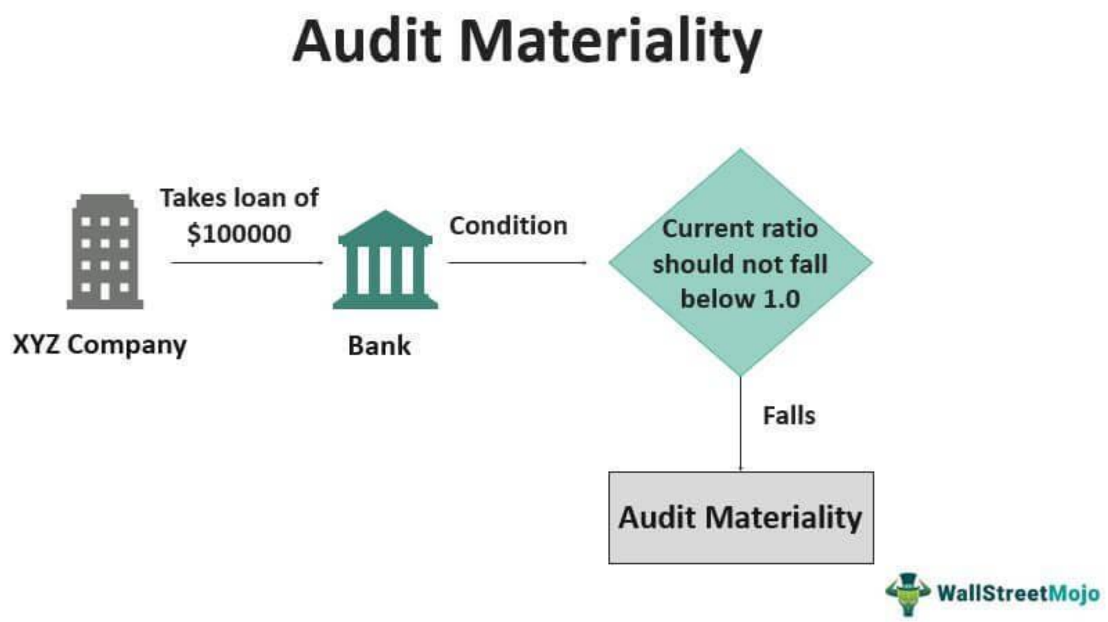

Figure 4 – Main issues in determining the level of materiality in audit

Conclusions and Recommendations

The conducted analysis leads to the conclusion that existing approaches to determining the level of materiality require further improvement in light of modern economic conditions and the increasing demands for the quality of audit information.

Thus, materiality represents a key element of the audit process, directly affecting the quality and reliability of audit outcomes. Its proper determination enables auditors to allocate resources efficiently and to focus on the most significant areas of financial reporting.

At the same time, the analysis has shown that current approaches to determining materiality are characterized by a number of significant limitations. The predominance of quantitative methods does not allow for a full consideration of the qualitative characteristics of misstatements, which may result in the underestimation of their actual impact. Moreover, the strong reliance on the auditor's professional judgment reduces the comparability of audit results and increases the risk of subjectivity.

Particular importance should be placed on the need for closer integration of materiality with audit risk assessment. In conditions of high uncertainty and a dynamic economic environment, the level of materiality should be flexible and subject to timely revision throughout the audit process.

In the future, the improvement of the methodology for determining materiality should be aimed at:

- incorporating qualitative factors alongside quantitative measures;
- developing more standardized approaches;
- enhancing the role of professional analysis and expert judgment;
- integrating materiality within a risk-based audit framework.

The implementation of these directions will contribute to improving the effectiveness of audit procedures, increasing confidence in financial reporting, and strengthening the role of auditing within the system of economic relations. These measures are of particular importance in the context of ongoing economic reforms in the Republic of Uzbekistan, as the improvement of materiality assessment methodologies directly influences the quality of audit opinions and the level of trust among investors and other stakeholders.

Overall, the concept of materiality remains a critical element of audit methodology, and its continuous development is essential for ensuring the reliability, transparency, and credibility of financial reporting in a rapidly changing economic environment.

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