



THE CONCEPT OF MATERIALITY IN ESG AUDITING AND ITS SPECIFIC ASPECTS

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Abstract

In this article, in the context of sustainable development The concept of materiality in ESG auditing and its specific aspects the research was reviewed and suggestions and recommendations were made.

Keywords: Materiality by nature, materiality by quantity, dual materiality, audit strategy.

Introduction

In recent years, the widespread introduction of sustainable development principles in the global economy has fundamentally changed the criteria for evaluating the performance of enterprises. Along with traditional financial results, environmental, social, and corporate governance (ESG) indicators are also recognized as an important factor determining the long-term value of organizations. As a result, stakeholders — investors, creditors, government agencies, and society — are demanding that enterprises provide not only financial but also non-financial information that is transparent and reliable.

These increased demands have created a need to develop ESG reports and their independent auditing. The effectiveness of ESG auditing largely depends on the correct definition of materiality in the audit process. Since the auditor cannot examine all ESG indicators to the same extent; audit resources should be directed to the information that is most important and can influence the decisions of stakeholders.

In traditional financial auditing, materiality is primarily determined by quantitative financial metrics. However, in ESG auditing, the concept of materiality is more complex, encompassing qualitative factors such as environmental impact, social responsibility, reputational risks, stakeholder expectations, and impact on sustainable development goals. Therefore, the



process of determining materiality in ESG auditing requires a multidimensional and stakeholder-focused approach.

Literature review

The reason why immaterial (minor) errors are not checked by the auditor is:

- these errors are very small and do not significantly affect the decisions of users of financial reporting information in any situation;
- it takes a lot of time and money to identify and correct the cause of small errors;
- The time spent on identifying and correcting these errors can lead to delays in submitting substantive reports. (Akhmedjanov and Yakubov 2010)

Assessing materiality, risk, business risk, and control risk in an audit. Familiarity with the internal control system and assessing control risk. (Sanayev and Narziyev 2001)

Materiality is a measure of how much information can be omitted from financial statements. (Manson and Zaman 2001)

In other words, the level of materiality reflects the level of confidence provided by auditors to users of financial statements. (Cox et al. 2013)

Consequently, although materiality is directly related to audit performance and subsequent opinion, the lack of information about materiality has caused users (investors) and regulators to be very skeptical of auditors' application of materiality. (Tuttle et al., 2002)

Research methodology

The research used induction, deduction, systematic and comparative analysis, grouping, experimentation, adaptive methods, integrative approaches, and analysis and approbation of international experiences.

Analysis and discussion of results

The main objective of determining the level of materiality in an audit is to determine the presence of significant errors and irregularities that do not affect the decisions of clients in the audit being conducted, and to form a reasonable audit opinion. In this regard, the auditor requires a separate approach to the issue of materiality.

Based on this goal, several tasks are of importance:

- Identifying key metrics in financial statements that are important to the client;
- determine the level of importance of important indicators;
- increasing the objectivity and transparency of the audit opinions being formed;
- Identifying the impact of errors and disruptions on customer decisions, and other duties.

We can divide the concept of materiality into two types: material by nature and material by quantity. Materiality by nature encompasses the nature of the entity or error, such as non-compliance with laws and regulations, related party transactions, or fraud, and can include the following as examples.

- Related to compliance with the norms of regulatory and legal documents;
- Related to compliance with financial covenants;
- Financial reporting turns profit into loss;
- Changes the company's net assets to a negative state;
- Transactions with related parties;
- It is related to the coverage of upcoming legal proceedings or business continuity issues.

Quantitative materiality refers to the financial size of an item or error, usually expressed as a percentage of a financial statement line item such as revenue, profit, or total assets. The following figure illustrates these types of materiality.

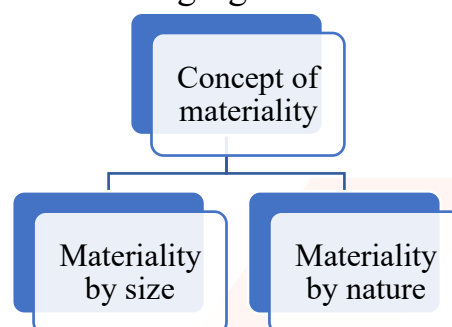


Figure 1. Materiality approaches in auditing¹

The main approach used in practice is the quantitative approach. In the figure below, we can see the following aspects of the quantitative approach.

¹Systematized by the author.



There are international standards that have a recommended nature for the application of quantitative significance. In particular, these recommended indicators include such indicators as net sales revenue, profit before tax, and total assets.

Table 1 The amounts of importance are of a recommendatory nature.²

| Indicators | Lower limit (in%) | Upper limit (% of the total) |
|-------------------|-------------------|------------------------------|
| Net sales revenue | 0.5 | 1 |
| Profit before tax | 5 | 10 |
| Total assets | 1 | 2 |

The concept of materiality also has its own characteristics in ESG auditing. As an example, we can cite the concept of “dual materiality”.

Dual importance is defined as the importance of information (or indicator) to sustainable development issues within enterprises and organizations, and its importance to the overall sustainable development issues of enterprises and organizations. Together, these situations are referred to as dual importance.

The auditor should directly identify and consider materiality issues in an ESG audit during the planning and execution stages of the audit. In this regard, the auditor may determine materiality based on its magnitude and nature.

When assessing the compliance of reporting criteria with the concept of "double-digit materiality", special attention should be paid to the following:

- Requires the auditor to evaluate the appropriateness of the reporting criteria and its relevance to the intended users as part of determining whether there are assurance responsibilities.
- In the absence of a material indicator, the auditor considers information related to compliance with transparent legal processes, as reflected in laws or regulations or established by authorized or recognized organizations, to be material.

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- If the data (indicators) are the basis for sustainable development and one of the main objectives of the assurance service (ESG audit), then the auditor should determine the materiality of this indicator.
- When determining significant information (indicators), it is appropriate for the auditor to determine the entity's performance, its legal status, or both.
- It is appropriate for the auditor to assess materiality based on five different aspects: relevance, completeness, reliability, objectivity, and understandability.
- It will be necessary to determine the criteria of importance for each aspect.
- The materiality determined for each aspect provides the auditor with information about the impact of the data (indicators) on sustainable development.
- The auditor should use two different approaches to determine the materiality of information (indicators) that influence users' decisions: assessing the information of the enterprise and organization in terms of its impact on sustainable development (impact materiality) and assessing the sustainability indicators in terms of their impact on the financial position and performance of the enterprise (financial materiality), or both (dual materiality).

Table 2 ESG audit materiality level determination table³

| Indicators | Importance impact | by Financial importance | Double importance |
|-------------------------------|-------------------|-------------------------|-------------------|
| Environmental indicators | | | |
| Social indicators | | | |
| Management-related indicators | | | |

When determining the level of materiality for each indicator, the auditor should use three different judgments: not material, material, and extremely material.

³Systematized by the author



Conclusion and suggestions

In conclusion, determining the level of materiality in an ESG audit allows for the proper allocation and use of resources, sufficient attention to important aspects of the audit, and the provision of quality audit services. The provision of quality audit services is explained by the provision of reasonable assurance on the results of the audit.

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