THE THRESHOLD OF SIGNIFICATION IN AUDIT

PRAGUL DE SEMNIFICAȚIE ÎN AUDIT

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Abstract: *Within the framework of an audit of accounting data, the most important thing is to determine whether the information registered in financial reports reflects in an accurate way the economic events happened during the accounting period. The definition of the threshold of signification allows to the auditor even from the beginning of his mission to appreciate better the systems and the account liable to contain errors or significant inaccuracies, and at the end of the mission to appreciate if the anomalies discovered have to be correlated during the taxable year, for the purpose of expressing an opinion without reservation.*

Key words: *audit, threshold of signification, audit risk*

INTRODUCTION

In a more and more active business world, the performances of economic entities are expected by its partners- shareholders, financial analysts, suppliers, creditors etc. The assembly of enterprise's activities, transposed in accounting language, is in the first stage, the object of some internal verifications, accomplished by internal auditors or administration supervisors, which intervene in the domain of entitity's business administration, contributing to the improvement of enterprise's organization and by this, to the capacity to attain the objectives established by the unit direction.

MATERIAL AND METHOD

Within the pages of this article, I tried to present a little inroad through the specialty literature in view of studying thoroughly the notion of threshold of signification and its relation with the audit risk, committing to paper their most significant aspects. We shall present also a few examples

regarding the interpretation way of the threshold of signification, as well as the relation between the audit risk and the threshold of signification.

RESULTS AND DISCUSSIONS

By threshold of signification, we define „ the level, size of a sum, over which the auditor considers that an error, an inacurracy or an omission can affect not only the regularity and the correctness of annual accounts, but also the true image of the result, of the financial situation and of enterprise's patrimony." (Toma M., Chivulescu M., 1995)

The Financial Accountancy Standards Committee (FASB) defined the threshold of signification thus: „The importance (gravity) of an omission or of an incorrect presentation of accounting information which from the point of view of general circumstances, gives rise to the probability that the reasoning of a reasonable person relying on the respective information had been changed or influenced by the omission or the respective error presentation". The auditor's duty is to determine whether the financial situations contain significant errors. In the case one notices the existence of a significant error in the presentation of information, the auditor will announce it to the client, in order to make a correction. If the client refuses to correct the situation, an opinion with reservations or an unfavourable opinion should be expressed, depending on the relative importance of the error (its signification). Consequently, the auditor must know very well the way of application of the threshold of signification concept.

The definition given by FASB emphasizes the reasonable users relying on the financial reports when taking decisions. Therefore, the auditors must know who are the possible users of the client's situations and what decisions will be taken on the basis of these situations. For instance, if an auditor knows that financial situations will constitute the information basis for a sale and purchase agreement of the entire economic entity, the sum considered significant by the auditor could be smaller than in an audit with similar conditions, but with another objective. In practice, auditors might not know all the users or the type of decisions that they will take.(„ Audit- An Integrated Approach", 2003)

In „ The General Frame for Drawing Up and Presentation of Financial Situations" of the Committee for International Standards of Accountancy, the threshold of signification was defined in the following way: „ The informations are significant if their omission or incorrect

declaration could influence the economic decisions of users, taken on the basis of financial situations. The threshold of signification depends on the element's size or of the error judged in the specific circumstances of omission or incorrect declaration. Thus, the threshold of signification rather offers a limit than a primary qualitative characteristic that the information should have in order to be useful".

The threshold of signification is a professional concept that could vary depending on the use of financial situations, of the degree of public interest, as well as of any other need of reference foreseen by the legislation. However, this variation is registered within some limits, according to the international practice (example: 0,5%-2% for expenses).

Example: Let's suppose that the total sum of payments for the economic entity "Z" due to the accounting period N is of 200.000 lei. If the level of the threshold of signification is established to 1 % this means that the value is of 2000 lei (200.000*1%) and it is the maximum tolerable level of allowed errors. If the level of errors established by the auditor is greater than 2000 lei then, the accounts are not presented with accuracy.

Steps of application of the threshold of signification principle

The process of application of the threshold of signification principle follows five steps tightly correlated, presented above(Arens, Loebbecke, 2003):

Step I: Determination of preliminary value of the threshold of signification;

Step II: Assignment of preliminary value of the threshold of signification on audit segments;

Step III: Determination of preliminary value of the threshold of signification;

Step IV: Estimation of combined value of incorrect presentations;

Step V: Estimation comparison of combined values with preliminary or revised value of the threshold of signification ;

We have to underline the fact that the decisions regarding the threshold of signification refer to more than the determination of a sum for the financial situations. The reasons depend of certain factors, as for example:

1. An error to a certain level as part of the financial situations, referring to:

a) Total incomes from the profit and loss account;

b) Totality of assets from the balance sheet;

c) Totality of assets from the balance sheet.
2. Qualitative factors, as:
a) Probability that illegal payments were made;
b) Probability that irregularities may appear;
c) Clauses from the clients contracts with the bank to foresee that certain indicators from the financial situations be maintained at a minimum level;
d) An interruption of the cashing flux;
e) The direction attitude regarding the integrity of financial situations.
The auditor has in view the threshold of signification, respectively the dimension and the limit of error in the specific circumstances of the omission or incorrect declaration.

Relation between the threshold of signification and the audit risk

According to the Audit Standard 320 „ The objective of an audit of financial situations is to allow to an auditor the expression of an opinion, according to which the financial situations have been drawn up under all significant aspects, in accordance with an identified general frame of financial reference". The threshold of signification expresses the maximum tolerable level of error accepted in order to decide if the accounts are correct or not.

There is a tight correlation between the threshold of signification and the audit risk. When he realizes an audit, the auditor must take into consideration the threshold of signification and its bond with the audit risk. As it is specified in the Standard of Audit 320"The Threshold of Signification", the relation between this one and the audit risk is inversely proportional. The higher the threshold of signification level, the lower the audit risk and inversely. This relation is inversely proportional when the auditor determines the nature, the duration and the extent of audit procedures. For instance, if after the planning of specific audit procedures, the auditor determines that the acceptable level of the threshold of signification is low, then the audit risk is high. The auditor will compensate this either by reducing the evaluated level of the control risk, if reduction is possible or by supporting the reduced level and making some extended or additional control tests, or by reducing the fund non detection risk in the phase of audit planning.(Standard of Audit nr.320 "The Threshold of Signification in audit")

According to the Standard of Audit 320 „ The evaluation by the auditor of the threshold of signification and of the audit risk at the initial

moment of the commitment planning can differ from the one in the moment of the evaluation of audit procedures results", as a result of the new appeared circumstances or because of some changes in the knowledge stored by the auditor during the audit. When the total of unadjusted incorrect information approaches the threshold of significations level, the auditor considers the risk reduction through the application of some additional procedures or solicits to the direction to make the corrections in the financial situations due to the discovered incorrect information.

Examples regarding the way of interpretation of the threshold of signification

Example 1:

At the company "X", during the mission planning, the auditor determined a threshold of signification of 10% from the net profit; and for the stocks, which are badly controlled by the enterprise, the value of the threshold of signification determined by the auditor is of 650 lei, taking into account the total threshold, the effect of possible errors plurality and the fiscal incidence.

The errors found by the auditor during his checkings are of 400 lei and of 1400 lei in stocks evaluation. All the data are presented in the following table:

Data	-lei-	The thresholds of signification -lei-	Found errors -lei-
Total balance	420.000		
Stocks	45.000	650	400+1400
Turnover	150.000		
Personal capitals	53.000		
Net result	9.000	10%*9000=900	
Cumulated		1550	1800

Between the two found errors, none is superior to the total threshold of signification (400lei<1550lei; 1400lei<1550lei). Regarding the threshold of signification level determined by the auditor for stocks, the found error of 1400 lei exceeds the threshold of signification value (650 lei). Owing to the fact that the plurality of the two errors is superior to the total threshold (1800 lei> 1640 lei), the other error cannot be removed.

The influence of found errors over the above data will be determined through the correction of these errors with the percentage of profit tax (16%), due to the fact that the threshold of signification was established taking the net profit as base of reference.

The incidence of found errors over the characteristic figures is:

-over the net result= $\frac{(400+1400)-(1800*16\%)}{9000}=0.168=16,8\%$ from the net result,

-over the personal capitals= $\frac{(400+1400)-(1800*16\%)}{53000}=0,0285=2,85\%$ from the personal capitals;

-over the turnover= $\frac{(400+1400)-(1800*16\%)}{150.000}=0,01008=1,008\%$ from the turnover;

-over the stocks= $\frac{(400+1400)-(1800*16\%)}{45000}=0,0336=3,36\%$ from the stocks;

Taking into consideration the incidence over the net profit and the fact that the cumulated error is superior to the total threshold of signification, the auditor must suggest the correction of stocks post to certificate without reservations the annual accounts.

Example 2:

Let's suppose that within the financial situations of a company, we are presented the income from the exploitation activity in amount of 600.000 lei, the assets in amount of 1.270.000 lei and the total current debts of 380.000 lei. For instance, the auditors can decide that some information which distort the image much than 9% from the incomes total will be significant and will be the subject of a qualitative consideration. If the misrepresentation is smaller than 4% from the total of exploitation incomes, the auditors can consider them as non significant. The image distortions between 3% si 8% will be judged by the auditor. Thus, in this example, *the bounds of the threshold of signification* for the declarations regarding the exploitation income are between 24.000lei (600.000* 4%) and 54.000 lei (600.00 * 9%). We proceed in the same way for the other posts taken from

the balance, establishing the following bounds of the threshold of signification:

-for assets: between 50.800 lei and 114.300 lei;

-for current debts: between 15.200 lei and 34.200 lei;

If the cumulated value of presentation errors within the exploitation incomes is inferior to the limit of 24.000 lei, we shall consider that the financial situations present a real image; if the combined value of errors will exceed the value of 54.000 lei, then we consider that the financial situations don't present a real image; and for the values situated between 24.000 lei and 54.000 lei, a rigorous analysis will be imposed to all the information put at disposal.

Consequences of threshold of signification

At the end of its mandate, the auditor draws up the recapitulative list of his findings and checkings. When the enterprise accepts the rectifications made by the auditor, this one can give a certification without reservations. Otherwise, the significant or non significant character of his findings will determine the auditor's attitude and the content of his certification. In this sense (Marin Toma, 2005):

- If his findings don't have a significant character, the auditor will give a certification of the regularity and exactness of annual accounts without reservations;
- In the situation when his findings have a significant character, the auditor, if it's case, will be determined to adopt a certification without reservations or to refuse the certification;
- The impossibility of certification, which appears in the situation when the auditor considers that the economic entity hasn't put at his disposal or couldn't supply enough elements to settle his conclusions. In this case, he will write down in his report that he is not in the position to express an opinion;

CONCLUSIONS

The most frequent modality through which the users can obtain true information consists in the effectuation of an audit. Afterwards, the audited information is used in the final process, starting from the assumption that this information is reasonably complete, exact and impartial. The determination of the significant elements and of the threshold of

signification is left to the auditor's judgement, because in audit, the professional judgement is totally irreaplaceable, due to the great number of factors to take into consideration and to the subjectivity of their relative importance.

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