

Conceptual Aspects Regarding The Materiality Threshold For Financial Statements As A Whole

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Abstract: One of the factors that determines the appropriateness and reasonableness of the auditor's opinion on the financial statements as a whole is the significance of the misstatements. Entity-specific circumstances are considered essential in the audit when they significantly influence the authenticity of the client's financial statements. Reasonable insurance is a high level of insurance. It is obtained when the auditor has obtained sufficient adequate audit evidence to reduce the risk of expressing an inadequate opinion when the financial statements are materially misstatement. An important step in the process of using the concept of significance threshold is the distribution of the preliminary value of the significance threshold. This article outlines some approaches to determining the level or levels of significance thresholds that will be applied to financial statements as a whole, with a focus on the simplest - the deductive approach, which avoids situations where the sum of significance levels for different accounts exceeds the allowable level for the entire financial reporting.

Keywords: financial statements as a whole; significance threshold; distortion; audit procedures; professional judgment; international auditing standards

JEL Classification: G30; G23; D25

Introduction

In conducting an audit of the financial statements, the auditor's general objectives are to obtain reasonable assurance that the financial statements as a whole are free from material misstatement, whether due to fraud or error, to enable the auditor to express an opinion. that the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework and to report on the financial statements and to communicate, in accordance with the ISAs, the auditor's findings². Circumstances related to certain misstatements may cause the auditor to assess them as material even if they are below materiality. It is not practical to develop audit procedures to detect all distortions that could be significant due only to their nature. However, taking into account the nature of potential uncorrected misstatements is relevant in designing audit procedures to address the risks of material misstatement. An important step in the use of the concept of significance

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² *Handbook of International Quality Control, Auditing, Review, Other Assurance, and Related Services Pronouncements*. Volume I. New York: IFAC, 2020. <https://www.ifac.org/system/files/publications/files/IAASB-2020-Handbook-Volume-1.pdf>, p. 349.

threshold is the distribution of the preliminary value of the significance threshold. In this context, the following sets out some approaches to determining the level or levels of significance thresholds that will be applied to the financial statements as a whole.

Material and Method

In the process of elaborating the scientific paper or applying various research methods, preference is given to the dialectical method as a universal basis of knowledge of matter, phenomena and processes with its component elements: analysis, synthesis, induction and deduction, monographic method, comparison method, classification and so on. The investigations were supported by the work of economists in the country and abroad, the fundamental conventions and basic principles of accounting and auditing, as well as the basic rules of the Law on the audit of financial statements (Ignat (coord.), 2021) the provisions of International Auditing Standards^{1,2,3,4}, legislative and normative acts^{5,6} (Ignat, 2013, pp. 255-258) related to the research topic.

Results and Discussions

The objective of an audit is to improve the confidence of targeted users of financial statements. This is achieved by the auditor expressing an opinion on whether the financial statements are prepared in all material respects in accordance with an applicable general financial reporting framework (Ignat et alli., 2020, p.75).

According to specialized sources, “Information is considered significant if its omission or distortion may influence the economic decisions made by users on the basis of financial statements” (Pepi, 2006, p. 265), and the significance threshold is defined as the importance (severity) of an omission or an erroneous presentation of accounting information which, in the light of general circumstances, generates the probability that the reasoning of a reasonable person based on that information has been altered or influenced by the omission or error in that presentation (Arens & Loebbecke, 2003, p. 288). At the same time, according to paragraph 2 of ISA 320 “Significance threshold in planning and conducting an audit”, financial reporting frameworks often address the concept of significance threshold in the context of the preparation and presentation of financial statements. Although financial

¹ Order of the Ministry of Finance “On the acceptance and publication of the Framework for audit quality: key elements that make up an environment for audit quality”. No. 113 from 05.08.2016. In: Official Gazette of the Republic of Moldova. 2016, no. 265-276. <http://lex.justice.md/index.php?action=view&view=doc&lang=1&id=366293>.

² *Handbook of International Quality Control, Auditing, Review, Other Assurance, and Related Services Pronouncements*. Volume I. New York: IFAC, 2020. <https://www.ifac.org/system/files/publications/files/IAASB-2020-Handbook-Volume-1.pdf>.

³ *Handbook of International Quality Control, Auditing, Review, Other Assurance, and Related Services Pronouncements*. Volume II. New York: IFAC, 2020. <https://www.ifac.org/system/files/publications/files/IAASB-2020-Handbook-Volume-2.pdf>.

⁴ *Handbook of International Quality Control, Auditing, Review, Other Assurance, and Related Services Pronouncements*. Volume. New York: IFAC, 2020. <https://www.ifac.org/system/files/publications/files/IAASB-2020-Handbook-Volume-3.pdf>.

⁵ International Auditing Standards issued by IFAC in 2018, received by the Ministry of Finance from 01.09.2020. <https://drive.gov.md/index.php/s/VxgyM219xpRrFiC>.

⁶ (2012). *Manual of international auditing and quality control standards. Code of ethics for professional accountants*. Chisinau: Moldpres.

reporting frameworks could address the topic of significance threshold in several ways, they generally explain that:

- distortions, including omissions, are considered to be significant if it can reasonably be expected that they, individually or in combination, will influence users' economic decisions made on the basis of financial statements;
- reasoning about the significance threshold is exercised in the context of the surrounding circumstances and is affected by the size or nature of the distortion or a combination of the two; and
- reasoning on issues that are important to users of financial statements is based on consideration of the common financial information needs of users as a group. The possible effect of distortions on specific individual users, whose needs may vary greatly, is not considered¹.

Generalizing the above, we can state that the auditor's obligation is to determine whether the audited entity's financial statements contain significant disclosures. If the auditor determines that there is a material misstatement of the information in the financial statements, then the auditor should report it to the client so that a correction can be made. Therefore, auditors must be extremely familiar with how to apply the concept of significance threshold (Balan & Malai, 2011, pp. 78-79).

It should be noted that the establishment by the auditor of the significance threshold is a matter of professional reasoning and is affected by the auditor's perception of the financial information needs of users of financial statements. In this context, it is reasonable for the listener to assume that users have certain perceptions (Figure 1).

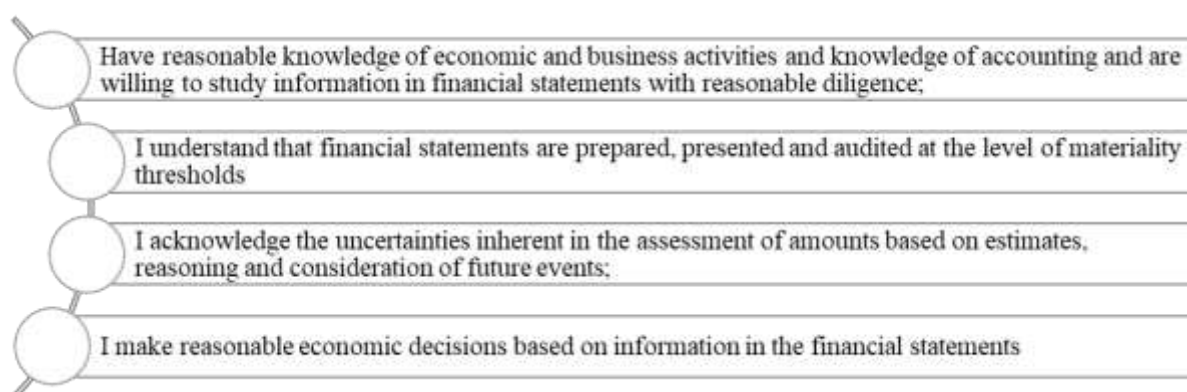


Figure 1. Main perceptions of users of financial information

Source: Developed by the author based on *Handbook of International Quality Control, Auditing, Review, Other Assurance, and Related Services Pronouncements*. Volume I. New York: IFAC, 2020.

<https://www.ifac.org/system/files/publications/files/IAASB-2020-Handbook-Volume-1.pdf>, pp. 346-347)

¹ *Handbook of International Quality Control, Auditing, Review, Other Assurance, and Related Services Pronouncements*. Volume I. New York: IFAC, 2020. <https://www.ifac.org/system/files/publications/files/IAASB-2020-Handbook-Volume-1.pdf>, p. 346.

In practice, when planning an audit, the auditor should examine the nature and significance of both the financial statements as a whole and the individual balances of the accounts, the groups of economic operations and the notes on the financial statements¹. In this context, the auditor must determine the functional significance threshold for the purpose of assessing the risks of material misstatement and determining the nature, timing and extent of subsequent audit procedures (Balan; Graur & Iachim, 2021, pp. 113-114). In turn, the functional significance threshold represents the value or values set by the auditor at a lower level than the significance threshold for financial statements as a whole to reduce to an appropriate low level the likelihood that all uncorrected and undetected misstatements exceed the materiality threshold of the financial statements as a whole (Balan & Burlea, 2014, p. 64). Note that the functional significance threshold also refers to the value or values set by the auditor at a level lower than the significance threshold level or levels for certain classes of transactions, account balances or disclosures (Simunic, 1980, pp. 124-125). The character and the threshold of significance can be influenced by such factors as the requirements of legislative and normative acts, the factors regarding the individual balances of the accounts reflected in the financial statements and their interdependence. As a result of this influence there may be different levels of significance for different accounts (or groups of accounts), depending on the examined aspects of the financial statements.

The process of using the concept of significance threshold follows five closely correlated steps, which are summarized in Figure 2.

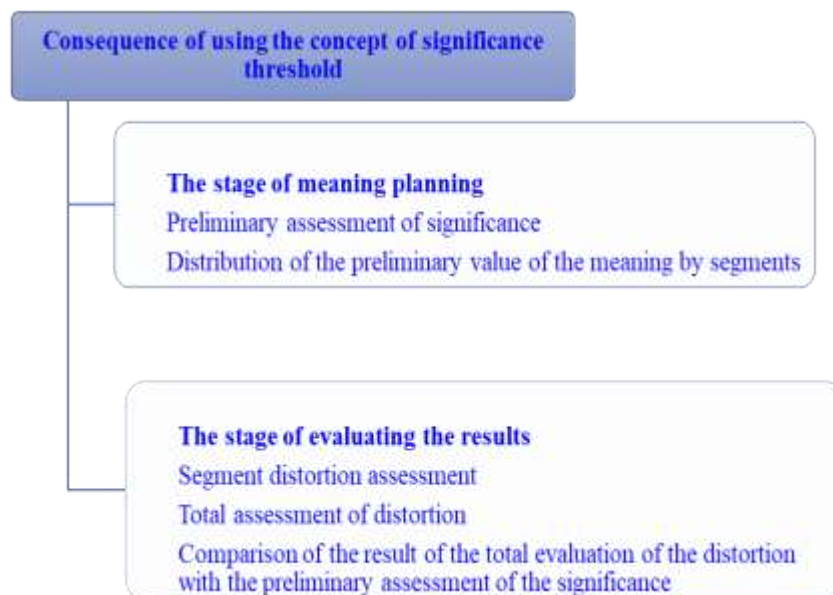


Figure 2. Consequence of using the concept of significance threshold

Source: Developed by the author, based on SNC "Presentation of financial statements". In: Official Gazette of the Republic of Moldova. 2013, no. 177 - 181. <http://www.mf.gov.md/actnorm/contabil/lawcontabil>, pp. 21-22

¹ Law on the audit of financial statements, no. 271 of 15.12.2017. In: Official Gazette of the Republic of Moldova. 2018, no. 7-17. <http://lex.justice.md/index.php?action=view&view=doc&lang=1&id=373727>, pp. 32-33.

In preparing the audit plan, the auditor should determine the combined amount of the misstatements of the financial statements that will be considered significant. International audit standards define this amount as the preliminary value of the significance threshold. It is so named because it is the result of subjective professional reasoning and could change over the course of the engagement if its circumstances evolve in a different direction than expected.

The preliminary value of the materiality threshold determines the maximum amount of erroneous disclosures, which in the auditor's opinion, although they testify to their presence in the financial statements, do not, however, affect the decisions of reasonable users. The importance of defining a preliminary value of the significance threshold lies in helping the auditor to plan the appropriate evidence to be collected. If the auditor sets a low monetary value, then more evidence will be needed than if this value were high. Thus, this reasoning is one of the most important decisions made by the auditor and requires a sound professional logic (Lupu & Şargu, 2020)

An important step in the use of the concept of significance threshold is the distribution of the preliminary value of the significance threshold by segments. This is necessary because audit evidence is accumulated on a segment basis rather than for financial statements as a whole. If the auditor has a preliminary value of the significance threshold for each segment, this helps him decide on the relative amount of appropriate audit evidence to be collected.

It should be noted that most auditors distribute the value of the materiality threshold over the accounts presented in the balance sheet rather than over the accounts presented in the profit and loss situation. This is largely due to the fact that most of the errors in the profit and loss accounts have an identical impact on the entity's balance sheet, due to the double entry accounting system. Therefore, the auditor can apply the materiality threshold to either the balance sheet or the profit and loss accounts. As the vast majority of audit procedures focus on the balance sheet, the allocation of the materiality threshold on the balance sheet accounts is the most appropriate alternative.

When determining the significance of the audit segment, two approaches are possible.

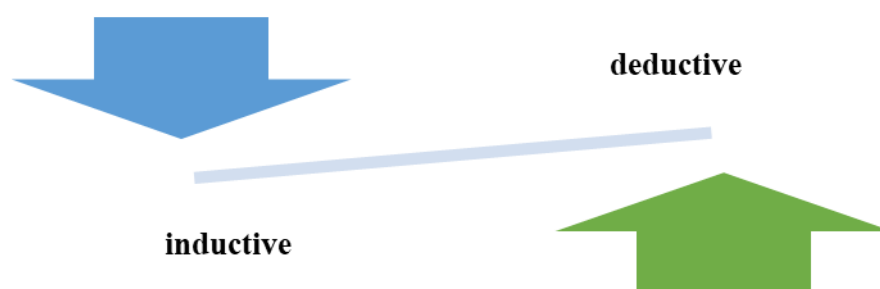


Figure 3. Types of approaches used to determine the significance of the audit segment

*Source: Developed by the author, based on SNC "Presentation of financial statements". In: Official Gazette of the Republic of Moldova. 2013, no. 177 - 181.
<http://www.mf.gov.md/actnorm/contabil/lawcontabil>*

The essence of the deductive approach is that initially the total significance is determined, which is then distributed among the significant items of the audited financial statements. This approach, from a theoretical point of view, is more of a predilection, because when using it, situations can be avoided when the cumulation of distortions or omissions in relatively small amounts from certain accounts can exceed the allowable size for the financial statements as a whole.

The quantitative level of significant misstatements in the financial statements can be determined by the following two methods:

- as a relative size of the basic indicators;
- as a result of complex calculation.

When applying the first method, as a basic indicator in most cases serves the profit or assets of the balance sheet. An example is the internal audit standard on the materiality threshold, according to which the absolute level of significance is determined as a percentage of the balance sheet asset at the end of the management period. At the same time, we mention that the provisions of the international audit standards do not offer to the practicing auditors concrete criteria of significance. This is generated by the fact that the pre-establishment of such distinct criteria can be applied by the auditors without taking into account all the difficult moments which in turn can influence their conclusions.

The second method presupposes the existence of a set of indicators that participate in the calculation and a complex calculation methodology. Next, based on two conventional examples, the practical application of the deductive approach to the determination of the significant level of the items of the financial statements as a whole is presented.

We acknowledge that according to the internal audit standard on the significance threshold of the audit entity Uenet & Audit S.R.L.:

a) the following items are established as basic indicators of the assets of the balance sheet of the economic agents (table 1):

Table 1. Basic indicators of the audited entity's balance sheet assets

The name	Symbolization	Amount, thousand lei	Weight,%
Fixed assets	AI	36793	29,3
Inventories	S	442002	35,2
Trade and calculated receivables	CCC	32520	25,9
Cash	N	5902	4,7
Total	X	119417	95,1
Balance sheet assets	A	125573	100

b) in order to determine the significance, the significance level of the balance sheet asset in the amount of 5% is established (with rounding up to hundreds of thousands).

Under the terms of the example presented above, the auditor will perform the following calculations when determining the materiality threshold of the balance sheet assets using the deductive approach:

Table 2. Determination of the significance threshold of balance sheet assets

The content	Symbols	The threshold of significance		
		calculation order	the amount	approximate value, million lei
1. Determine the significance threshold of the balance sheet asset	SA	$125573 \times 5 \%$	6278,65	6,3
2. To determine the significance threshold of fixed assets	SAI	$29,3 \div 95,1 \times 6,3$	1,94	2,0
3. Determine the significance threshold of stocks	SS	$35,2 \div 95,1 \times 6,3$	2,33	2,3
4. To determine the significance threshold of trade and calculated receivables	SCCC	$25,9 \div 95,1 \times 6,3$	1,72	1,7
5. Determine the significance threshold of cash	SN	$4,7 \div 95,1 \times 6,3$	0,31	0,3
6. To compare the value obtained of the single materiality threshold of the balance sheet asset with the sum of the materiality thresholds in absolute size of each balance sheet item established as a basic indicator	X	$2,0 + 2,3 + 1,7 + 0,3$	X	6,3

We acknowledge that in accordance with the internal audit standards of the audit entity Uenet & Audit S.R.L. in order to determine the significance threshold of the profit and loss positions, the following significance levels of the basic indicators are established:

- for sales revenues (SVV) - 2%;
- for the profit from the operational activity (SP) - 5%.

According to the audit program regarding the verification of the profit and loss situation of the entity “XYZ” S.R.L. the auditor must determine the materiality thresholds for the items of the situation that relate to the entity's operating activity.

Table 3. Statement from the profit and loss statement of S.R.L. “XYZ”

Indicators	Management period
Sales revenue (VV)	152335
Cost of sales (CV)	129868
Other income from operational activity (VAO)	22857
Other operating expenses (CAO)	33144
Result from operational activity: profit (loss) (P)	12180

According to the conditions of the example presented above, the auditor in determining the significant thresholds of the profit and loss positions through the deductive approach is to perform the following calculations:

Table 4. Determination of the significance threshold of the balance sheet asset items

The content	Symbols	The threshold of significance		
		calculation order	the amount	approximate value, million lei
1. Determine the significance threshold of sales revenue	SVV	$152335 \times 2 \%$	3046,7	3000
2. To determine the significance threshold of the profit from the operational activity	SP	$12180 \times 5 \%$	609,0	600
3. To determine the significance threshold of the cost of sales	SCV	$129868 \div (129868 + 22857 + 33144) \times (3000 - 600)$	1676,90	1700
4. To determine the significance threshold of other operating revenues	SVAO	$22857 \div (129868 + 22857 + 33144) \times (3000 - 600)$	295,14	300
5. To determine the significance threshold of other expenses from the operational activity	SCAO	$33144 \div (129868 + 22857 + 33144) \times (3000 - 600)$	427,97	400
6. To compare the value obtained of the single significance threshold of sales revenues with the sum of the levels of significance in absolute size of each item of the profit and loss situation that refers to the operating activity of the entity	X	$1700 + 300 + 400 + 600$	X	3000

Conclusions

In the audit activity, the circumstances that can considerably influence the veracity of the presentation of the accounting information in the client's financial statements are considered significant. As a quantitative characteristic of these circumstances appears the threshold of significance. At the same time, the simplest approach applied to the determination of the significance threshold of an audit segment is the deductive approach. The essence of the deductive approach is that initially the total significance is determined, which is then distributed among the significant items of the audited financial statements.

At the same time, it should be mentioned that when determining the quantitative level of significant misstatements in the financial statements, practitioners mainly apply the method of relative size of basic indicators that is established independently of audit entities in separate internal company standards. The main advantage of the deductive approach is that it avoids situations where the cumulation of distortions or omissions in relatively small amounts from certain audited accounts may exceed the allowable amount calculated for the financial statements as a whole.

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