

STATUTORY AUDIT AND PERFORMANCE AUDIT

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Summary: *The financial audit has two components: the statutory audit (mandatory for certain companies) made by financial auditors and the optional audit which can be done by other professionals (chartered accountants, evaluators, and tax matters members). The statutory audit represents the examination done by an authorized and independent professional of the financial statement of a company, in order to express a motivated opinion regarding the position, situation and financial performance. The statutory audit is established by law for those companies which have a significant public impact. The financial statement represents the management’s statement through which the firm communicates with the stakeholders: shareholders, creditors, investors, clients, debtors, contractors, employees, state institutions and the population. The objective of the performance audit is the efficiency and effectiveness with which the audited company uses its resources in order to accomplish its responsibilities. The audit committees have a greater responsibility especially after the scandals in the US (Enron, WorldCom, Adelphia), through the Sarbanes-Oxley act from 2002. The audit committee has the following attributions: it monitors the financial reports made by the executive management, helps internal investigations, monitors and evaluates the activity of the internal audit department, gives recommendations to the administration council regarding the problems encountered when communicating with the shareholders, replacing or extending the mandate of the external auditor and authorizes the approval of this person’s fees.*

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1. Introduction

In a globalized economy it is necessary to have clear and universal regulations to reflect correctly the financial and accounting information. The financial statements include the accounting balance sheet, profit and loss account, the treasury flow statement, the statement concerning the modification of the ownership equity and the financial statements’ annexes.

The balance sheet reflects the financial position (assets, debts and ownership equity), the profit and loss account shows the financial performance, the treasury flow statement indicates the company’s liquidity, the statement about the modification of the ownership equity signals the evolution of one’s own financing sources, and annotations bring additional information to the four previously mentioned components.

These financial statements made by the company’s management must be certified by an external, specialized organ, which must be trusted by the external users of the accounting information.

These demands are met by the professional accountants, who after evaluating the financial statements will offer an audit opinion regarding the statements of the companies’ managers.

The importance of the financial auditors has grown especially after the financial scandals from the US and Europe. In order to maintain a close bond with the financial auditors, but also to evaluate the activity of the internal auditors, big companies have created audit committees.

2. The body of the paper

2.1 Statutory audit

The financial statements are elaborated by the company’s management, who can use in its own interest the information meant for the users. It is the so-called “creative accounting” or “financial swindle” which is at the border of legality, and sometimes even crosses these limits. The great French economist Bernard Colasse, was truthful when saying: “Accountancy is such a strange instrument. Conceived to describe the enterprise, it provides only partial images, sometimes subjective and always vague. Needed in order to provide information, facilitate and enhance the decision-making process, it proves to be misleading, false, rhetorical and sometimes even deceitful.” [3].

The **financial statements** which have to be audited are:

- balance sheet (financial position);
- profit and loss account (financial performance);
- treasury flow statement;
- modification of the ownership equity statement;
- financial statements' annexes.

The financial statements represent the management's statements through which it communicates with the interested parties: shareholders, creditors, investors, clients, debtors, contractors, employees, state institutions and the population.

I join other authors in their attempt to try to elucidate the use of accounting settlements in order to promote an overvalued image of the company: "Creative accounting, a instrument used to shape the accounting information for the external users, undoubtedly chases a modification in the expectation and in the operation in the way desired by the administrative and executive management from the corporate governance" [4].

The insurance offered by the financial auditors regarding the financial statements strengthens the trust of everyone who is related to the companies.

A clear distinction must be drawn between **financial audit** and **statutory audit**.

Financial audit is performed to determine if the information and/or the financial statements are presented according to certain criteria (international or national regulations).

The **operational audit** represents the examination (analysis) of **any part** of the operational practice, procedures and methods of an organization, including the resources and the results, in order to evaluate their efficiency and efficacy.

Some examples of operational audits are: evaluation of the stocks, evaluation of the salary-related operation, evaluation of clients' satisfaction, evaluation based on some financial indicators of marketing activities, environmental protection, evaluation of the methods used to organize production. From these examples one can infer that the operational audit is a vast field, which does not refer only to the financial or accounting domain.

Defining the criteria to evaluate the information from an operational audit is a subjective problem, and the efficiency and efficacy of the audited operations is more difficult to evaluate than in case of the financial or statutory audit.

Because there aren't any European regulations regarding auditing the financial statements, The European Parliament and Council adopted the Directive 2006/43/CE (The 8th Directive), which brought a balanced approach of the statutory audit in the EU.

The **statutory audit** represents the evaluation done by an authorized and independent professional, concerning the financial statements of a company, compiled by the management, in order to express a motivated opinion regarding the position, situation and financial performance, in accordance with the accounting principles.

The statutory audit is **established by law** for those companies with a significant public impact, meaning those which satisfy 2 of the 3 size related criteria (turnover = 7,3 million euro, total assets = 3,65 million euro, number of employees = 50), national companies, firms listed on the stock market and credit institutions.

Those who deal with the statutory audit are called in different ways in different countries: account commissioners in France, certified public commissioners in Belgium, statutory auditors in Great Britain. In Romania, they were called independent external auditors, until the introduction of the legislation regarding statutory audit, meaning executive decree 90/2008 [7].

The financial audit has **two components**:

- ✓ **Statutory audit (legal), which is mandatory for some companies**, executed by professionals who are part of Chamber of Financial Auditors of Romania (auditors and audit companies authorized by the CFAR);
- ✓ **Optional audit**, which can be done by professionals belonging to different areas (financial auditors, chartered accountants, authorized accountants, experts in different fields), and companies **are not obliged by law** to audit financial statements, neither partly nor fully.

Statutory auditors and audit companies are registered in a Public Register, which can be accessed from CFAR's site. Statutory auditors must respect the principles of professional ethics and to perform audit missions according to the International Standards on Auditing.

Statutory auditors are named by the General Meeting of Shareholders (Associates), usually for a period of 3 to 5 years.

By publishing the financial statements of those companies which are required to have a statutory audit, it is presumed that the auditor examined the main transactions, the functioning of the internal verification (including internal auditing), accounting entries, evaluated the value of the firm's assets, debts,

ownership equity and profit, offering some insurance to the stakeholders through his/her opinion given in the report.

It should be mentioned that although the auditor evaluates the evidence with professional skepticism, he/she should not be considered a detective who discovers all the intended or unintended errors.

No one can guarantee that a fraud from the financial statements will be revealed through the audit missions, but the auditor can certainly infuse financial rigor, and if needed, he/she can report suspicions concerning fraud. However, the auditor cannot conduct a criminal investigation, as this is the task of approved bodies.

During auditing missions there are certain **general requirements** which must be respected to insure that the **statutory audit** process is performed in optimal conditions:

- all transactions, resources and liabilities must be taken into account and evaluated;
- it should reflect the company's most important problems;
- it should evaluate risk management and internal verification;
- it should be performed with professionalism, responsibility and honesty;
- it should refer to the transactions with the stakeholders;
- it should reveal the management's salary;
- it should show if the code of best practice of corporate governance has been applied or not;
- it should offer information about executive and non-executive management.

Because of the new international conditions, the statutory auditor's mission is getting more and more difficult. There are companies that use deceiving methods to fraud, which are very difficult to detect even by the approved bodies. A statutory audit mission cannot be considered as a guarantee against frauds, but only a modest "insurance efflux" [4].

2.2 Performance audit

Performance audit appeared in the 1960's and 1970's in the developed countries, when the members of the parliament started to search for reliable data to help them establish if their governments fulfilled their programs. In the Supreme Audit Institution (SAI) there is a **regularity audit** (financial) which is defined by the International Organization of Supreme Audit Institutions (INTOSAI) as:

- ❖ attestation of the companies' financial responsibilities, involving examination and evaluation of financial records and expression of opinions on financial statements;
- ❖ attestation of financial accountability of the administration;
- ❖ audit of financial systems and transactions, including an evaluation of compliance with applicable laws and regulations;
- ❖ audit of internal control functions;
- ❖ audit of the probity of the administrative decisions taken within the audited company;
- ❖ report of other aspects that arise from or that are related to the audit, that SAI considers that it should be disclosed.

Subsequently, there was a need to control the results and the way in they were obtained. Thus a new concept appeared, that of performance audit, which is defined by INTOSAI as "an audit of economy, efficiency and efficacy with which the audited entity uses its resources to fulfill its own responsibilities."

Developed countries experimented different methods and techniques of performance audit, established criteria to measure governmental performance and developed indicators for performance and control techniques.

The International Organization of Supreme Audit Institutions (INTOSAI) is a permanent, autonomous, independent and apolitical organization, which contains all the supreme auditing institutions from the countries that are members of the United Nations and which issues audit standards, methodologies and insures training in the domain of public auditing. INTOSAI's objective is to promote the exchange of ideas and experience among the supreme auditing institutions in the domain of countries' finance control. At the moment, there are 184 supreme auditing institutions which are part of INTOSAI, including the Romanian Court of Accounts.

The Court of Accounts conducts the **performance audit** to determine the way in which the state's and public sector's financial resources are spent, and also the way in which the state's and the territorial-administrative units' public and private heritage is administered.

The Court of Accounts performs an independent evaluation to determine if a public entity, a program, project, process or activity uses the public resources assigned to accomplish the objectives in an economic, efficient and effective manner. Performance audit can be conducted either at the end or while the projects, programs, processes and activities are still in progress. The performance audit activity is deployed according to a methodology which is specific to performance audit, based on INTOSAI audit standards and it is finalized by elaborating an audit report. Through its observations and recommendations, performance audit must lead to a **decrease in the cost of resources** or to an **enhancement of results**.

The Court of Accounts audits the way in which the authorities involved in the privatization domain **respect the methods and procedures of privatization** provided by the law, and also the way in which they ensure compliance with the clauses established in the privatization contracts, irrespective of the moment when the privatization occurred.

The Court of Accounts also performs an audit of the **IT systems** of public entities. The Court of Accounts audits a good financial management of public acquisitions, concessions, rents or other forms of administration of goods and services belonging to the state's or territorial-administrative unity's public or private domain.

2.3 Audit committee

Audit committees were created in the US in the 19th century, their main task being that of facilitating the communication with external auditors. Because the role of the internal auditors became more and more important through the audit committees, they felt that it was their duty to ensure that the published financial information was correct and that the ethical rules were respected.

In 1993, in Great Britain, Cadbury Commission proposed that some independent committees should be created (audit and wages' committees, also committee for electing managers) to guarantee the accounts and reports of shareholders. The codes of the corporate governance mention the necessity for audit, nomination and wages' committee. Corporate governance can be defined as the system through which companies are directed and controlled, which specifies the way in which the rights and responsibilities are distributed among their stakeholders.

Audit committees became even more important after the scandals from the US (Enron, WorldCom, Adelphia), through the Sarbanes-Oxley Act from 2002. Thus the Best Practice Codes appeared, which increase the responsibilities of those involved. The Codes can be voluntary, based on the principles established by OECD (Organization for Economic Co-operation and Development), or mandatory for certain firms which are on the capital market (**Combined Code** in the United Kingdom, or **Sarbanes-Oxley Act**, in the US) [4].

Combined Code establishes the formation of an audit Committee, having at least **3 non-executive independent members**, from which at least one has to have solid knowledge in the financial and accounting domain. Audit Committees will focus on 3 main problems: supervising, evaluation and revision. The members of the audit Committee cannot be involved in any way in the company's executive activity.

The internal audit compartment can be subordinated to the management but also to the **audit Committee**. According to the law no. 31/1990 concerning corporations, modified through the law no. 441/2006, the administration Council can create advisory committees having at least 2 members which are part of the Council and which will have to conduct investigations and to make recommendations for the administration Council in the domain of auditing, management's, director's, auditors' and personnel's wages, and also to nominate candidates for different management jobs. The audit and wages' committee must have only non-executive managers. In case of joint-companies, in which the yearly financial statements are subject to a financial audit, having an audit committee is mandatory.

The audit Committee has the following **tasks**:

- monitors the annual financing report compiled by the executive management;
- monitors the compiling of the report regarding the company's audit;
- monitors and oversees the intermediate reporting process;
- monitors the internal control process;
- monitors and evaluates the internal audit department's performance;
- makes recommendations to the administrative council related to the problems encountered when communicating with the shareholders, replacing or prolonging the external auditor's mandate, and approves his/her fees;
- revises and monitors the external auditor's independence and objectivity, and also the efficiency of his/her actions;
- monitors risk management policies and practices.

Companies with securities that are allowed in transactions in a regulated market and which have their headquarters registered in the Community must be obliged to present an **annual declaration of corporate governance**, as an easily identifiable section of the annual report. This declaration must offer to the shareholders at least some easily accessible key information about the effectively applied corporate governance practices, including a description of the main features of the existing management risk system and internal control, in relation to the financial reporting process.

The management's report must include the following detailed information about:

- a) direct or indirect significant share ownership (including indirect possessions through pyramidal structures and cross ownership of shares);
- b) the owners of any securities that are subject to special controls and a description of their rights;

- c) any restriction concerning the rights to vote, such as restrictions in the voting rights for those who have an established percentage or number of votes, the period for the exercise of the voting right or systems through which, by cooperating with the company, the financial rights attached to securities are separated from the ownership of securities;
- d) rules that deal with the election or change of the members of the administration council and with changing of the company's articles of incorporation;
- e) the authority of the members of the administration council and especially the authority referring to issuing or ransom of shares.

3. Conclusions

The audit represents the process done by legally authorized people, through which the information related to a certain company is analyzed and evaluated, in a professional manner, using specific techniques and procedures, in order to obtain evidence which will be used to formulate a responsible and independent opinion, by using well established criteria.

Financial auditors are the link between the company's management and stakeholders (shareholders, creditors, managers, employees, authorities, business environment) because the reports compiled by the auditors offer some guarantees about the information given in the financial statements. Accordingly, the stakeholders can take the best decision.

Although appropriate measures have been taken after the great financial scandals, there is still a justifiable deterrence from the part of the stakeholders. Financial auditors cannot provide an absolute insurance regarding the company's statements, but only a reasonable one. In order to increase the trust in the auditors' reports, there is a need for a stronger harmonization between the main theories available worldwide (IFRS, European Directives and FASB), a reduction in the alternative accounting treatments and better regulations of the financial instruments.

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