

## ***Audit and Insurance Services – Companies’ Management Tools***

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**Abstract:** *The emergence of national and international companies has generated the need to insure the sponsors’ investments. The financial statements must be credible, both to the central management of the company as well as to external users, which has led to the introduction of innovative methods of communication and information reflected in the financial statements through the audit. The audit’s role is to assist the company’s management, examining the accounting systems and internal control.*

**Keywords:** *audit, insurance services, types of audit, tax services.*

### **Introduction**

In a society based on market economy, investors need independent insurances on financial information and on the results of companies’ performance indicators.

By the nature of professional training, financial auditors and certified public accountants offer some kind of insurance with regard to the information of companies’ financial statements, even by carrying out audits of historical financial statements.

Due to their independence and specialised technical knowledge, accounting professionals are valued for the support they can provide to companies, for the assessment of the internal controls and operations’ analysis, correcting the financial statements.

The recommendations auditors make contribute to the increase of companies’ profitability as a result of reducing costs, improving operational efficiency and decreasing the number of identified errors and frauds.

The need for insurance is not new. Accounting professionals provide insurances, especially on the information contained in financial statements and one of the activities is represented by certification services.

The certification service is a type of insurance by means of which an accountancy/auditing firm issues a written handout expressing a conclusion on the reliability of statements written by a third party. In the practice of certification services there have been distinguished three categories, namely:

- the audit of historical financial statements;
- the review of financial statements;
- other certification services.

### **1. The Audit of Financial Statements**

Is a service through which the auditor issues a written report, expressing his/her opinion on the conformity of the significant aspects of financial statements in relation to the generally accepted accounting principles. It is the most prevalent form of insurance services encountered in the practice of providers of this type of services. External users that rely on companies’ financial statements, in order to make economic decisions, make reference to the auditor’s report as an indicator of their reliability.

In the USA, the companies listed on the stock exchange are required to audit their financial statements concerning securities, by the Federal Act. Audit reports can be found in the annual financial report of

any quoted company and the audited financial statements can be viewed on the internet by logging into the database of Securities and Exchange Commission.

In order to provide a guarantee to investors, the companies listed on the stock exchange turned to audit services even long before being constrained by federal legislation. Private companies also joined this practice and they audited the financial statements in order to be able to make bank loans or to get financing from other financial institutions.

## **2. The Review of Financial Statements**

Represent a different type of insurance service whereby companies that are not quoted on a stock exchange provide external users with insurance on financial statements, but without incurring the costs of an audit.

In comparison with the audit, the level of this insurance service is average, motivated by the fact that the probatory level of the financial statements is lower. A simple review of the financial statements is often sufficient to meet the needs of users and is carried out at a lower fee.

Other certification services consist of independent insurances of other types of information. Through these services, auditors provide insurance on the information used by the company's management.

Together with the growth of different types of information available in a company, the types of risks faced by them also increased, fact that, implicitly, determines an increase in the number of forms of personal insurance services. In providing this kind of services, accounting professionals compete with specialized firms that offer services in the field of market studies. An advantage of expertise and audit firms on the market of insurance services is their reputation and competence as well as the independence towards the client.

Most users of financial statements confuse very often audit with accounting. The confusion is caused by the fact that most of the audit activities relate to accounting information and, in order to provide relevant information, auditors must have thorough knowledge of the principles and rules needed for the processing of accounting information.

In an audit of financial statements the most important thing is to determine whether the recorded information accurately reflects the economic events that have occurred during the financial year. In addition to a good understanding of accounting, the auditor must possess the necessary experience for the collection and interpretation of audit samples. The identification of appropriate audit procedures, the determination of the number and types of items and the evaluation of results, represent only a few of the problems of an auditor's work.

Auditors perform three fundamental types of audits: the audit of financial statements, presented above, the operational audit and the audit of conformity. The last two are also called audit activities, although they greatly resemble the insurance and certification services.

The financial statements covered by audit relate to the balance sheet, the profit and loss account, the cash-flow as well as the accompanying notes and annexes and the type of used audit should be in full accordance with the management purpose.

## **3. The Operational Audit**

Consists in analyzing any parts of the procedures and operational methods of a company, in order to evaluate their efficiency and effectiveness. After performing an operational audit, managers expect recommendations proposed by the auditor in order to improve operational activities.

A process of operational audit cannot be defined due to the large and diversified number of areas whose efficacy can be assessed. At a company, the auditor can evaluate the relevance and sufficiency of the information used by management in making decisions on the acquisition of assets, for example, while another company may analyze the efficiency of information flow.

To define the criteria for assessing the information in an operational audit mission is a highly subjective issue. This fact makes the operational audit look more like managerial advice than what is normally meant by audit.

#### **4. The Audit of Conformity**

The audit conformity aims to verify whether the examined entity complies with certain procedures, rules or regulations defined by a higher level authority.

For example, in a private company, this type of audit may take the following forms: checking how the procedures recommended by the chief-accountant are met by the accounting staff, the examination of salaries in order to verify the compliance with the payment legislation or the examination of contractual arrangements with banks and other lenders in order to ensure the observance of terms.

There is a unanimous opinion that the operational audit refers to efficiency and effectiveness, but the use of these terms instils more controversy than one might think.

In order to describe the testing of efficiency and effectiveness of organizations, many people prefer to use the term of management audit instead of operational audit. However, there are differences among the terms *management audit* and *operational audit*, that is why the testing of the effectiveness of internal control mechanisms is done by an internal auditor who is part of the operational audit only if the purpose is to help an organization to manage its activities with more efficiency or effectiveness.

Between financial audit and operational audit there are main differences concerning the purpose of the audit, the recipient of reports and the inclusion of non-financial aspects in the case of operational audit.

##### *The purpose of the audit*

The emphasis of financial audit is on the accurate recording of historical information, compared with operational audit that is focused on the concepts of efficiency and effectiveness. The financial audit is past-oriented, while the operational audit has in view the future operational performance. An operational auditor, for example, would be able to evaluate whether a new type of raw materials is purchased at the lowest price, thus, saving money on future purchases of raw materials.

##### *The recipient of reports*

In the case of financial audit, the report is usually addressed to the numerous users of financial statements, such as shareholders, bankers, as opposed to operational audit reports that are mainly intended for managers. Due to the widespread distribution of the financial audit reports there has been imposed the use of very precise expressions and formulae in their content.

Taking account of the diverse aspects of efficiency and effectiveness, operational audits make the reports vary considerably from one to another, audit and thereby have a more restricted availability.

##### *The inclusion of non-financial operational aspects*

Operational audits cover any aspect of an organization' efficiency and effectiveness and can cover a wide range of activities. For example, the effectiveness of a promotion program or the efficiency of employees in production may be the subject of an operational audit at any time. Instead, financial audits are limited to issues that directly affect the reliability of presentations in financial statements.

Effectiveness relates to meeting the set objectives, while efficiency targets the used resources in order to meet the set objectives.

The results of such audits are usually intended for people within the entity, not being addressed to a wide range of users. Managers, as opposed to external users, represent the main group interested in the degree of compliance with certain procedures and predetermined rules.

Audits play an important role both nationally and internationally, being practised by both specialists in audit and by accountancy firms. For example, in the United States of America, with the exception of certain governmental organizations, the audit of financial statements is commonly performed by

accountancy firms. In addition to auditing services, the accountancy firms offer their clients other services, as well, such as tax and consulting services. The *Accounting Today* magazine publishes each year a list of the 100 largest accounting services companies and in the United States there are over 40,000 accountancy firms, operating from a single person up to more than 30,000 employees and associates.

Accountancy firms vary depending on the nature and range of services they offer, aspects affecting their way of organizing and structuring. The classification of audit and accountancy firms is carried out according to function and size, distinguishing four large categories:

**1. International Firms of “Big Five”.** The largest accountancy firms in the United States called “the group of five”. Before 1998, there were six major international audit firms. In 1998, by the merger of two companies in the group, Price Waterhouse and CoopersLybrand, the PricewaterhouseCoopers (PwC) was created, currently the top being held by five companies. The five companies have head offices in many cities in the United States and worldwide, carrying out both the audit of the majority of the largest companies in the United States and around the world, and the audit of a large number of smaller-sized companies.

**2. National firms.** In the United States, three firms of accountancy enjoy the title of “national firms”, due to the fact that they have representative offices in most major cities. National ranking firms provide the same services as the companies of “the group of five” and are in accordance with the latter to attract potential customers. Each national American firm is associated with similar companies in other countries, and therefore having an international sphere of activity.

**3. Regional companies and major local companies.** Statistics have shown that there are about 100 accountancy firms which have more than 50 specialists. Some of these companies have a single head office and serve primarily only local customers. Others have multiple representations in one State or region and serve a wider area. Numerous regional and local companies have cooperation agreements with partners of accountancy firms for the exchange of technical information and training and improvement of long life professional training. Some of the companies have also international affiliations.

**4. Small local firms.** Over 95% of the total number of accountancy firms have a group of professionals with more than 25 people and operate in single head offices. They provide audit services and other similar services in particular in smaller firms and non-profit entities, although only a few of them have one or two customers quoted on the stock exchange. Numerous small local firms do not perform audits, offering clients mainly accounting services and tax-related services.

In addition to audits, accountancy firms have expanded the scope of services covered by insurance and certification.

Additional services currently offered include: accounting services and bookkeeping, services related to tax and management consulting services. Service providers continue to create new products and services, including new specializations in financial planning and economic evaluation of companies.

There are three fundamental factors influencing the organizational structure of the company, namely: the need for independence towards the customer, the importance of a structure that encourages the legal competence and the risk of legal disputes to which the auditors are subjected.

Usually, more complicated audit missions are carried out by teams containing one or more auditors in each hierarchical level of the company.

In order to promote their competence and serve their customers as well as possible, numerous accountancy firms are organized according to specialization in fields of activity. The auditors at each hierarchical level may specialize in the audit of certain economic sectors, for example, the audit of financial and banking institutions, fees and taxes, information technology, etc.

By specialization branches, auditors arrive at a deeper understanding of their clients’ economic activity. For example, a group specializing in pharmaceutical institutions can bring together tax specialists and consultants specialized in medical services.

In addition to accountancy and audit firms, companies employ also internal auditors to perform both operational and financial audits. Their role in the audit area has greatly increased in the last two decades, in particular because of the increase in size and complexity of most companies.

As internal auditors dedicate their whole working time to a single company, their knowledge on operations and internal control mechanisms of the company are far deeper than those obtained by external auditors.

The objectives of internal auditors are considerably more extensive than those pursued by the external auditors. This offers internal auditors the flexibility necessary to meet all the company's needs.

There are differences between companies in terms of the depth of internal audit and the spheres on which internal auditors focus. For example, a company might decide that internal auditors should assess each year the internal control mechanisms and the financial statements of each Department, while other companies might consider sufficient an audit carried out once every 3 years.

Internal audit reports are not standardized either, as the reporting needs differ from one company to another and, on the other hand, the reports do not form the basis of external users' decisions.

The specialized rules for internal auditors are defined by the Institute of Internal Auditors (I.I.A.). The organization is similar to the American Institute of Certified Public Accountants (I.A.C.P.A.), its role being to define the ethical and practice standards, and to provide training courses to and to encourage professionalism of its approximately 60,000 members.

I.I.A. played a major role in increasing the influence of internal audit. For example, it created a program, which has resulted in the granting of the title of authorized internal auditor (A.I.A) to persons who meet all the requirements of testing and experience.

The standards of practice of the Institute of Internal Auditors comprise five categories of recommendations concerning both financial audit and operational audit, namely: independence, professional competence, the perimeter of works, audit and management of the Department of internal audit. The directives relating to the internal audit standards are issued by the Internal Audit Standards Commission (I.A.S.B.) in order to provide a formal and binding interpretation of such standards.

There are both similarities and differences between the responsibilities and the way audits are carried out by internal and external auditors. The main difference is the authority to which each of them is responsible. The external auditor refers to the users of financial statements, which are based on the fact that the auditor brings credibility to these statements, while the internal auditor is responsible to the company's management.

There are also relations of interdependence between those two categories of auditors. External auditors are based on the internal auditors' work through the use of the audit risk model. When internal auditors are effective, external auditors significantly reduce the risk of control, decreasing, thus, the quantity of substantial tests.

Usually, when there is a very well appreciated internal audit function, external auditors' fees are significantly reduced due to a reduction in the volume of work. Most often, external auditors considered that internal auditors are effective when they are independent towards the audited entities, and competent, well trained and they have applied the relevant tests on internal control mechanisms and financial statements.

### **Conclusions**

Competitive companies are fully aware of the need to involve the audit function in this field, whereas a high level of insurance decreases losses and increases profitability. At the same time, the companies' management has learned in time to use, depending on their interest and the targets set in the medium and long term, both internal and external audit.

The management-auditor partnership, considered as an investment in the audit function, both internal and external, is safe and generating much higher profits than the actual costs and leads to improving the quality of information offered to decision-makers.

Whatever the type and form of insurance service demanded by management, the audit function is prepared to approach a diversified range of activities and areas being a tool used in the management of companies.

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