THE AUDIT OF FINANCIAL SITUATIONS – THE PROFIT AND LOSS ACCOUNT

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Abstract

From a personal perspective, I believe that all income accounts highlight the fact that, sooner or later, money will enter the enterprise, usually through a banking account or a pay office and all expenses accounts highlight the fact that, sooner or later, money will leave the enterprise, usually from the banking account or the pay office. In the results account we find all the costs and income generated after the consumption of resources (material, financial, informational) of an enterprise throughout a financial exercise. The role of the auditor is to follow the recording of all the income made through sales and to correctly analyse the expenses, in order to determine the real ones.

Key words: income, expenses, profit, loss, audit

JEl Classification: M41, M42

1. Conceptual clarifications regarding the income and the expenses

Measuring and reporting the performance is one of the most important functions of accountancy, because investors, managers, banks and third parties are interested in knowing if the firm generates profit or loss. The performance of the development of the enterprise's activity, namely the result of the enterprise's activity, is determined as the difference between income (I) and expenses (E). The result may be positive, in which case it is called <u>profit</u> (I>E) or negative, in which case it is called <u>loss</u> (E>I). The **performance** of the activity of an enterprise is established on the basis of the following equation:

Income – Expenses = ± Result → **Profit** (I>E)
→ **Loss** (E>I)

The accounting document known as the **profit and loss account** indicates the result / performance of a certain period of time (month, trimester, year), which assumes shape through the highlight of all the income and expenses of the enterprise, within a certain period of time.

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According to the active legislation, the definitions of income and expenses are the following:

The income represents an increase of economic benefits, which appeared during an exercise under the form of asset increase or of debt decrease towards third parties and which generated an increase of the capital, other than the infusion of capital from the owners.	Expenses represent the decrease of economic benefits, which appeared during an exercise under the form of asset reduction or debt increase towards third parties and which generated a decrease of the capital, other than the capital distribution towards the owners.

From a more simplified, personal perspective, I believe that the income accounts point out the fact that, sooner or later, money will enter the firm, usually in the banking account or the pay office and that all expenses accounts point out the fact that, sooner or later, money will leave the enterprise, usually from the banking account or the pay office.

In order to facilitate the understanding of the development of the profit and loss control, it is necessary to present the typology of income and expenses.

• income from exploitation • financial income • extraordinary income	**Current** income (ordinary and repetitive)
• exploitation expenses • financial expenses • extraordinary expenses	**Current** expenses (ordinary and repetitive)

2. The control over the income and loss account

In the results' account we find all the performed expenses and income generated after the resource consumption (materials: human, financial, informational) of an enterprise during the financial exercise. The role of the auditor is to follow the recording of all sale income and to correctly analyse expenses, in order to determine the real ones. Moreover, he/she has to establish if there were also extraordinary elements.

For a clearer view of the results' account, I propose a scheme in which the nature of the ***Profit, Loss, Income*** and ***Expenses*** accounts is accurately explained:

<table>
<tr>
<td rowspan="2">Profit / Income
———————— → level 0
(zero) Loss / Expenses
of the firm</td>
<td>Anything that is over the level 0 (zero) of the firm represents a <u>Debt</u> of the respective firm towards the shareholders (meaning that the enterprise has to give to the shareholders the income and the profit); therefore, the Income and the Profit are also <u>debts</u> of the firm towards the shareholders.</td>
</tr>
<tr>
<td>Anything that is below the level 0 (zero) of the firm represents a <u>Claim</u> of the firm towards the shareholders (meaning that the enterprise will receive money from shareholders in order to be invigorated); therefore, expenses and loss are claims of the firm towards the shareholders.</td>
</tr>
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Through the **audit's objectives** of the profit and loss account, the auditor has to make sure that, through the income and expenses accounts, a clear, accurate and complete image of the accomplished modifications is presented, modifications made by economic processes developed within the respective enterprise.

a) Audit objectives regarding the expenses accounts:

- ❖ In financial situations we find all expenses;
- ❖ All expenses have been correctly recorded;
- ❖ The recording of the expenses was made respecting the accounting principles;
- ❖ Expenses and acquisitions are developed in the current financial exercise;
- ❖ Expenses and acquisitions belong to the respective enterprise.

b) Audit objectives regarding the income accounts:

- ❖ In financial situations we find all income;
- ❖ All the income has been correctly recorded;
- ❖ The recording of the income was made respecting the accounting principles;
- ❖ The income and sales are developed in the current financial exercise;
- ❖ The income and sales belong to the respective enterprise.

Audit samples are obtained by comparing different categories of expenses and income with the accounts of the previous exercise and the rate of the turnover. As a result of this comparison, the auditor explains the main variations and evaluates the incidence on the control program of any unusual variation.

The control of the profit and loss account implies passing through certain phases:

The analysis of the current situation of income and expenses

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Establishing the correctness and accuracy of the income made through sales

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The reconciliation of the income made through sales to which we apply the VAT with the VAT expense account

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General analysis of sales

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Cancellation examination

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Examination of the arrear orders for a large period

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Summarizing purchases associated with the audited financial exercise

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The reconciliation of all inflow with VAT with the VAT expense account

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The analysis of purchases

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Examining expenses with the personnel and the situation of the personnel

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Verifying the correctness of the firm's contributions to the budget of social insurance, health insurance and other similar budgets

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Justifying situations for the notes of financial situations

■ **The analysis of the current situation of income and expenses** refers to the study of the dynamics of income and expenses. It is recommended to analyze the nature of the income and expenses, in order to highlight the evolution within each activity: of exploitation, financial and extraordinary.

■ **Establishing the correctness and accuracy of the income made through sales** is an essential part of the audit process and it consists of the recording of the manner in which the audited financial situations have been compiled and of obtaining the documents through which the individual digits can be justified. The income made through sales or the turnover represents an extremely important piece of information, which should be complete, precise and correctly dimensioned.

■ **The reconciliation of the income made through sales to which we apply the VAT with the VAT expense account** means the analysis of the appropiate documents in order to test the income made through sales and, subsequently, a reconciliation of the income with the accountancy regarding the VAT. Hence, the value of the income made through sales can be confirmed for certain.

■ **The general analysis of sales** has several secondary stages:

a) The analysis of the sale book keeping
b) The analysis of cash sales
c) The analytical examination of sales
d) The verification of a sample of merchandise sold on the basis of the expenditure register.

a) The analysis of the sale book keeping offers relevant information to the auditor. Verifying the procedure of the book keeping of sales imposes, on the one hand, the verification of an invoice sample, starting with their recording in the daily sales register, in the main register and in the corresponding account from the sales register and, on the other hand, the verification of a sample of recordings in the sales income account (or accounts) in the main register and in the daily sales register back to the respective invoices.

The purpose of this type of verification is that it offers the auditor the chance to make sure that the registered sales are real and that the accountancy concerning the sales is complete and accurate. If there is no sales register, then the auditor has to obtain sufficient evidence in order to determine the fact that the income made through sales and the final debtors' sale refers to real control transactions.

b) The analysis of cash sales is made in order to confirm if all cash sales are entirely and accurately registered in the accountancy. The auditor has to test the cash sales lists (receipts) with the accounting recordings (banking account, account of income made through sales, VAT account). If the majority of the firm's sales are in cash, their correct testing is extremely important, because the cash sales recording is often made incorrectly in the case of these firms.

c) The analytical examination of sales represents an important phase in the audit process. It means comparing the income made through sales which corresponds to the audited financial exercise with the one made in the previous year and maybe with the one forecast in the budget, if it exists. For the justification of the sum of the income made through sales, the auditor has to know the commercial conditions practised by the client. Moreover, this phase refers to the comparison of the leeway for the gross income which corresponds to the audited financial exercise with the one from the previous year. The discrepancies can indicate an overestimation or an underestimation of the income made through sales or errors in the value of sale cost.

d) The verification of a sample of merchandise sold on the basis of the expenditure register. It is important that we verify the fact that the goods and services have been invoiced at the correct price and that the correct VAT was applied. There are many starting points for a detailed verification of invoices. Besides the expenditure documents, other written notes or orders made by phone can exist. Sometimes, it is better to start the verification from these documents.

■ **The cancellation examination is important** because issuing cancellation documents directly influences the income made through sales. Such documents have to be authorised and properly registered in the accountancy. The auditor has to verify if the issuing of the cancellation documents has been authorised and the frequency with which they have been issued.

■ **Examination of the arrear orders for a large period** implies that the auditor has to examine the reasons for which the orders have not been answered to in due time and to verify if these orders were eventually and entirely honored and invoiced.

■ **Summarizing purchases associated with the audited financial exercise** reflects highly important information, which should be complete, precise and not underdimensioned.

■ **The reconciliation of all inflow with VAT with the VAT expense account** represents a means through which the auditor makes sure that all the corresponding purchases/expenses have been registered in the accountancy.

■ **The analysis of purchases** consists of a series of secondary stages:

a) The examination of the purchase register
b) The analytical examination of purchases
c) The verification of a sample of goods on the basis of receipts

a) The examination of the purchase register offers relevant information for the auditor. All invoices have to be entirely and accurately registered – also controlling the opportunity of expenses – in the daily purchase register and then in the main register and in the purchase register. It is recommended that this procedure should be tested by:

~ verifying an invoice sample, starting with their recording in the daily purchase register, then in the main register and in the adequate account from the purchase register;

~ verifying a sample of the records in the purchase and expense account from the main register and from the purchase register back to the respective invoices.

There are also situations in which the firm does not compile a purchase register and the auditor has to obtain sufficient documents regarding purchases, expenses and the final sale of the creditors, through which he/she has to demonstrate that these records were determined by real transactions.

b) The analytical examination of purchases implies the comparison of purchases and expenses which correspond to the audited financial exercise with those from the previous year and those which are forecast in the budget. The value of the purchases has to be correlated with the value of the income made through sales (taking into account the stocks' variation) and any discrepancies must be investigated. Another comparison should be made in the records from each expenses account and unusual variations must be investigated. In this manner, we can identify the lack of records (or double records) and the allocation of certain expenses in the wrong account.

c) The verification of a sample of goods on the basis of receipts means establishing the fact that goods and services have been invoiced at the correct price and recorded at the correct quantities. If there are receipts of purchased goods/records of the stocks, they have to be used as a starting point for verification and a sample from the purchased goods should be correlated with the corresponding invoices.

■ **Examining expenses with the personnel and the situation of the personnel** is an important and difficult phase because it implies:

a) Summarizing all expenses made with the personnel
b) Verifying a sample of records of expenses made with the personnel
c) The analytical examination of expenses made with the pesonnel
d) Verifying new employees or employees who recently left.

a) Summarizing all expenses made with the personnel means knowing the expenses made with the personnel, especially the ones concerning the wage tax, insurances and social protection, because they often represent important pieces of information, which have to be complete, precise and not underdimensioned.

b) Verifying a sample of records of expenses made with the personnel by auditing the pay roll in which the expenses with the personnel have to be entirely and exactly registered. The main purpose of these tests is that the auditor makes sure that the records of expenses with the personnel are real and correct and that there are no fictitious employees.

This procedure can be tested by:

~ verifying a sample of records from the main register on the basis of all expenses with the wages and payments – it is important that the numbers from the main register reflect expenses and real payments which correspond to real employees.

~ verifying a sample of the total of the wage expenses on the basis of the personnel records, in order to confirm the existence of the respective employees and the correct recording of the wage tax and of the expenses with insurances and social protection.

c) The analytical examination of expenses made with the pesonnel implies the verification of the expenses made with wages every year. Starting from the results obtained through the examination of the activity of the audited firm, the auditor has to decide if the expenses with the personnel from the audited financial exercise are in accordance with the firm's activity and if the variation of the number of employees and paid taxes (if there is such a variation) from each year correspond to the variation of the expense.

d) Verifying new employees or employees who recently left means determining the correctness with which, in the pay roll, at the appropriate date, the new employees and those who ceased to work are registered. In some cases, it is possible that there are frauds of the personnel regarding salaries. Although they are insignificant concerning the accuracy with which the financial situations reflect "a faithful image" of the firm, the auditor will have to take into account the responsibilities that he/she has towards the client.

■ **Verifying the correctness of the firm's contributions to the budget of social insurance, health insurance and other similar budgets** implies that the auditor should make sure that the correct calculation was made regarding the firm's contributions to these budgets and verify the manner in which the payment was made. In the case of payments with delays, the auditor should verify if the penalties are correctly calculated and if they were accounted. In the case in which the penalties surpass a significant level, it is necessary to add a suplementary note to the audit report.

■ **Justifying situations for the notes of financial situations.** The auditor must obtain justifying situations for the notes of financial situations. The accounting standards mention the necessary presentations, which should be followed accordingly. Regarding the salaries of the directors, a correct and precise presentation is imposed, even if in this field the sums do not surpass a significant level.

3. Conclusions

Alongside the management of the audited firm, the auditor analyses the errors that he/she discovered and recommends the appropriate corrections. The auditor analyses the comparative situation of income and expense accounts on the basis of intermediate inventory solds and establishes certain conclusions in relation to the evolution of these indicators.

In the end, before putting down the audit report, the financial auditor makes one more verification of the entire activity with a view to evaluating the results. In this sense, he/she has to revise and evaluate all the conclusions which result from the audit evidence obtained as a basis for expressing an opinion regarding the financial situations. This revisal implies taking into account the fact that financial situations have been compiled according to a general framework of approved financial reference, standards or relevant national practices.

Audit reports have an essential role in the audit commitments because they communicate the verdict of the auditor, verdict which leaves its mark on the future activity of the analysed enterprise.

In conclusion, the auditor has to take into account the fact that:

- ✓ all documents which compose the set of financial situations (balance sheet, profit and loss account, the situation of the modification of the firm's capital, the situation of the treasury fluxes, policies and explanatory notes) are included in the finacial situations of the respective firm;
- ✓ in compiling the financial situations the current accounting regulations have been respected;
- ✓ the framework of financial reference adopted by the management in order to compile the financial situations is acceptable;
- ✓ sufficient probative information was accumulated;

- ✓ the audit evidence is sufficient and adequate, so that it reduces the risk of the existence of certain significant misrepresentations within the financial situations to a low level;
- ✓ the accounting policies reflected and applied are in accordance with the financial reference and adequate in the given circumstances;
- ✓ the accounting estimations made by the management are relevant, attainable, easy to compare and understand;
- ✓ the information presented in the financial situations, including the accounting policies, are relevant, attainable, easy to compare and understand;
- ✓ the analysed financial situations accurately present transactions and major events in a manner which offers a faithful image over the information presented by them.

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