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Accounting and Financial Audit : A lever for good corporate governance- Literature Review

Audit Comptable et financier : Levier d'une bonne gouvernance pour les entreprises - Revue de littérature

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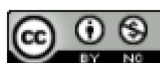

Abstract:

The fairness of financial statements is a primary objective that every company aims to achieve in order to obtain transparent information that can further improve its governance. Thus, the adoption of good governance practices appears to be the only way to attract investors and contribute to the improvement of its performance.

Indeed, the achievement of objectives necessarily requires a complete financial and accounting audit of the company, i.e. an examination by a professional observer of the way in which an activity is carried out, in relation to criteria specific to that activity. It meets the need to control and provides the necessary security to all partners of the company.

The quality of the audit conducted is therefore crucial, as it constitutes a key factor of good governance, guaranteeing the faithful image of the financial statements and mitigating the information asymmetry between the different stakeholders. Nevertheless, poor quality audit services can lead users of financial information to make the wrong decision.

This research work aims to examine the contribution and importance of the accounting and financial audit in ensuring a good corporate governance translated into a high financial performance.

Key words: Audit; Corporate governance; Faithful image; Transparent information; Financial performance.

Résumé:

Parmi les objectifs primordiaux que chaque société vise à atteindre est d'assurer la sincérité et la réalité de ses états financiers afin d'obtenir une transparence sur ces informations permettant d'améliorer davantage sa gouvernance. Ainsi, adopter des bonnes pratiques de gouvernance apparaît comme le seul moyen pour attirer les investisseurs et contribuer à l'amélioration de sa performance.

En effet, la réalisation des objectifs nécessite un passage par un audit financier et comptable de l'entreprise. C'est un examen mené par un professionnel indépendant sur la manière dont est exercée une activité, par rapport aux lois et réglementations qui régissent cette activité.

La qualité de cet audit mené est donc cruciale du moment qu'elle constitue un facteur clé de bonne gouvernance garantissant l'image fidèle des états financiers et atténuant l'asymétrie d'information entre les différentes parties prenantes. Néanmoins, une prestation d'audit de mauvaise qualité peut conduire les utilisateurs de l'information financière à la prise de la mauvaise décision.

Ce travail de recherche vise à examiner l'apport de l'audit comptable et financiet dans l'assurance d'une bonne gouvernance d'entreprise traduite par une performance financière élevée.

Mots clés: Audit; Gouvernance; Image fidèle; Informations transparentes; Performance financière.

Introduction:

Corporate governance is one of the most debated topics in management over the last ten years in the business, political and academic worlds. This is due to the diversity of actors involved (shareholders, customers, managers, financial backers...) but also to the multiplicity of issues raised, especially the distribution of power, control and management of companies.

Everyone has heard about the financial scandals that have taken place, whether it be Enron, WorldCom, Vivendi or others, the common point is that in each case, the control and governance boards were faulty, unable to prevent stock market or accounting malpractice. Indeed, various means of creative accounting were used by the administrative boards of these companies to make up the accounts and present a situation as favorable as possible to the shareholders.

It is in this perspective that the importance of internal control and auditing resources has increased in order to ensure, on the one hand, the reliability of the financial information communicated to the company's partners and, on the other hand, the degree of achievement of organizational objectives, and to enable the company to retrace its path if there are significant discrepancies between the goals set and the results achieved, and consequently to ensure good performance.

This regularity and performance, which is increasingly sought, is assessed through annual financial statements that are largely drawn up by the same people that we're looking to control: the company's managers & partners.

Then, the accounting and financial audit appeared to be an effective means of verifying that the company's activity is faithfully reflected in the annual accounts in accordance with the accounting standards. It thus meets the need for control and provides the necessary security to all the company's partners.

In the light of these observations, which constitute the backbone of our reflection, we wondered about the contribution and the importance of the financial audit in the assurance of the good governance of the company, and to measure this reflection.

The interest of the present article comes first from the possibility that such a study offers to have an overview of the systems and subsystems of an organization and to study the role of the financial aspect in the analysis of the operational structure of the company.

Based on the hypothesis that the performance systems of Moroccan companies are deficient, that there is a bad governance and that there is asymmetry of information between the administrative boards is present, the problematic of our article will be summarized through

a central question: **To what extent can financial auditing, from internal control to financial control, contribute to good corporate governance?**

The answer to this problematic suggests taking into account the different theories and conclusions of different researchers in this subject.

On the one hand, the audit of the company's accounts and procedures sheds light on the path to performance for those involved and interested in the organization's management system. On the other hand, it is a tool among others that would allow raising possible dysfunctions, at the level of performance and governance, for the taking of necessary corrective actions.

A more in-depth analysis of the problem leads us to ask several questions to which answers should be provided during this research:

How can financial auditing remove the asymmetry of information between management and other stakeholders of the company?

How can it contribute to performance improvement, and what is its place in the life of the company?

Thus, and in order to ensure a better understanding of our key concepts, audit and its relationship with governance, we will devote the first part of this article to a literature review of the concept of audit and its conceptual framework.

The second part will be dedicated to the theoretical explanation of the concept of governance and the good governance practices to implement.

And finally, the third part will deal with the relationship, the role and the contribution of the audit (internal & legal) on the governance within the companies.

1. Literature review of the audit approach

1.1. Conceptual framework for the accounting and financial audit

The accounting and financial audit, considered as a concept that has been much talked about and studied enough given its preponderant importance in the business world. The audit is a guarantee that the internal control procedures are working and are adequate, and that the product or service will therefore comply with the standards in force. However, auditing practices that have been recognized and applied since the dawn of time are becoming increasingly outdated and obsolete, and laws and regulations are no longer a filter against fraudulent manipulation. Furthermore, the reconsideration of accounting and financial information as well as the implementation of new regulatory measures will allow for a better governance of the financial sphere and the audit profession.

On the one hand, external auditing will give greater credibility to financial information from an outside perspective on the quality of the information collected, processed and transmitted. On the other hand, internal control ensures that all transactions are properly understood and valued and comply with the regulations in force.

Thus, no one can ignore the contribution of the statutory auditor, which is becoming increasingly important within companies, not only for the purpose of certifying annual accounts in the case of a legal audit, but also through recommendations following contractual audit assignments. This being said, the accounting and financial audit has evolved from a simple verification and assessment mission of the sincerity, regularity and true and fair view of the accounts to a primordial approach of assessment of the effectiveness of the internal control set up within the companies and its contribution to the corporate governance of the companies.

As such, before expressing an opinion on the fairness and accuracy of the accounting and financial statements, the audit is based on the first phase of diagnosing the effectiveness of the internal control system implemented by the board, management and employees of the company in order to provide reasonable assurance regarding the achievement of objectives related to operations, reporting and compliance.

1.2. Internal control system

Internal control is defined as a system that allows companies to improve their performance, manage their risks and protect their assets, by putting in place procedures and measures and by setting operating rules.

The assessment of internal control is therefore a crucial step for the accounting and financial auditor in order to evaluate the degree of control of the internal system and its viability within the audited company.

The evaluation of internal control consists of ensuring that the company has a set of measures in place to achieve the following objectives:

- ***Controlling the company's costs:*** through the implementation of a management control function. This control is an obvious objective for the guarantors of the company's sustainability: the board of directors and the committee that define the objectives upstream, determine the budgets, the structures and the procedures.

- ***Protection of the company's assets:*** The administration is obliged to ensure that the company's assets are protected all times, and that the available funds are maintained by means of controls.

- ***Ensuring the reliability of information:*** The fairness, regularity and faithful image of the accounting and financial information provided are the main objectives of the administrative and supervisory boards.

The information must be available in the form (implementation of a quality information system) and within the time limits prescribed by law to serve as a tool for third parties.

- ***Ensure the application of management instructions**:* This involves ensuring that decisions are in line with management policy, that plans and procedures are followed, and monitoring compliance with the orientations of the executive body.

- ***Promote performance improvement:*** through the economical and efficient use of resources; the promotion of operational efficiency, and the prevention and detection of fraud and error.

1.3. Audit of accounts

In the mission of auditing company's accounts, the auditor proceeds to:

- The preparation of the audit program;
- The performance of consistency tests;
- The realization of the validation tests;

The steps mentioned above are as follows:

Step 1: Development of the audit program

The statutory auditor develops his audit program on the basis of the results of the evaluation of the internal control system, which has enabled him to identify the strong points, for which a lighter audit program will be applied, and the weak points, for which the audits will be more thorough.

In general, the auditor will proceed on the basis of statistical tests or randomly. The difference between the audit of strengths and weaknesses will be reflected in the size of the samples and the extent of the tests applied.

Step 2: Consistency tests:

Consistency tests ensure that the information verified is consistent with each other. Two techniques are used at this level:

- *Analytical review*:

Analytical review is a set of audit procedures that provides a comparative view of the evolution and fluctuations and trends of accounting and financial information (balances) and identifies significant inconsistencies.

The analytical review is a procedure that fits very well into an audit engagement based on risk analysis.

- *Contradictory controls*:

They are based on techniques for cross-checking approximate information. They consist of analyzing the consistency of one or more variables.

Step 3: Validation tests:

The purpose of these tests is to verify the reality of accounting information. They include document checks, physical observation and direct confirmation of third parties.

- *Documentary control:*

The control of the documents received or created will allow ensuring the reality and the accuracy of the records and balances. It is essential to verify the valuation of an asset whose physical existence has been proven (the pointing of certain elements which consists in selecting a certain number of elements composing a balance to validate them because of their importance and the inherent risk).

- *Direct confirmation:*

Direct confirmation is a procedure that consists of asking a third party with business ties to the audited company to confirm directly to the auditor the reality of information concerning the existence of transactions, balances, or any other information. It is up to the auditor to determine the conditions to which it submits its implementation as well as the scope of its application. Generally, it is preferable to request confirmation of a balance or information at the closing date of the accounting period. Thus, the confirmed element will be directly usable within the framework of the verification of the closing summary statements.

- *Physical observation:*

Physical observation is a diligence that has evidentiary value. The scope of physical observation covers tangible assets (fixed assets, inventories, bills, cash). Its purpose is to ascertain the existence of an asset. The ownership and the valuation of the said asset must be checked (control on documents). Indeed, two diligence must be respected:

- The verification of the mathematical accuracy,
- The verification of the respect of the principle of separation of exercises.

The auditor chooses the assets to be audited based on his or her confidence in the internal control system and the significant value of the assets concerned. The auditor must ensure that the procedures put in place guarantee the reliability of the quantities recorded and advise the company on the measures to be taken if this is not the case. The auditor must also be present or be represented at the stocktaking operations to ensure that the procedures are correctly applied and to verify the proper use of the results of the company. He/she must also ensure that

transmissions (sales, purchases), assets (fixed assets) and liabilities are real, recorded in the appropriate accounts and valued according to the accounting methods in force.

2. Literature review of the concept of corporate governance

2.1. Definition of corporate governance

In recent decades, corporate governance has become a subject that has generated the most debate in academic and business management circles.

The traditional definition refers to the protection of shareholders' interests and the separation of management and control. It is a set of institutional mechanisms that organize the distribution of power within the firm (Charreaux, 1996; Gomez, 1997; Oman and Blume, 2005) and allow the firm to be efficient by creating more value in the long term (Aguilera and Jackson, 2003), either in the interests of shareholders (Norburn, 1992) or of all stakeholders (Monks and Minow, 2001).

Moreover, corporate governance is now one of the key themes in management science research. Its quality has become one of the crucial aspects of interest to international rating agencies in the evaluation of companies.

Consequently, governance mechanisms protect the contribution of all the company's stakeholders to the creation of value.

2.2. Golden rules for good governance

To ensure good corporate governance, the Organization for Economic Co-operation and Development (OECD) has encouraged the following principles:

- The establishment of the foundations of an effective corporate governance regime by setting up an appropriate and effective legal, regulatory and institutional framework.

These regulations must be flexible, taking into account the characteristics of each company and based on the principle of "comply or be found": « Se conformer ou se justifier » (Fasterling et Duhamel, 2009).

- Rights and fair treatment of shareholders, and main functions of shareholders. Corporate Governance should protect the interests of all shareholders, especially minority and foreign shareholders.
- Principal for institutional investors, stock markets and other intermediaries: Through this principle, the corporate governance regime should institute sound incentives (OECD, 2015) especially for institutional investors to make public information about their holdings in companies and how they influence the management of the company.

- Definition of the roles of different stakeholders in corporate governance in order to protect them and preserve the financial health of the company.
- Ensure the transparency and dissemination of information. Indeed, to hold information is to hold power and therefore, to hold an advantage over others. This principle is therefore intended to show the importance of disseminating reliable and timely information to the various parties involved.
- Responsibilities of the Board of Directors. According to the OECD, directors must act in full knowledge of the facts, in good faith, treating all shareholders fairly and their actions must be in the best interests of the company and all its stakeholders.

2.3. governance and audit: what relationship?

While good governance is conducive to achieving very positive results, the opposite is also true. Weak governance can be detrimental to the company and its results, particularly in terms of two very valuable values: its reputation and its credibility.

Consequently, ensuring good governance is not mandatory but essential for any company wishing to build trust between all its partners and thus contribute to the creation of value.

In this context, the auditor occupies a central place in this relationship of trust insofar as he or she comes to ensure that the right to information of all stakeholders is respected while complying with the principles of good governance.

Hence, the importance of the audit as a control and governance mechanism.

2.3.1 The role of the legal auditor in corporate governance

In this sense, the use of an external audit allows for the reduction of managerial opportunism and agency conflicts between the actors of the firm, allowing for the protection of shareholders' interests and guaranteeing the quality of financial information.
The external audit limits the informational asymmetry between the management and the shareholders, with the aim of ensuring credible financial statements that will lead to better governance and better performance of the organization. In this context, the auditor comes to ensure that the shareholder's right to information is respected. Given the central place that the auditor occupies in this relationship of trust, it is essential that the procedures for appointing and dismissing the auditor be conducted in accordance with the principles of good governance.

In addition, Gramling et al (2004) see that corporate governance has four components: the external audit, the audit committee, management and the internal audit function.

Assuming the existence of a conflict of interest between managers and stakeholders, the existence of a control and monitoring mechanism is therefore a necessity in order to eliminate, or at least reduce, these conflicts.

This configuration is based on the classical assumptions of agency theory. For this reason, Jensen and Meckling (1976) have always emphasized the importance of calling on external auditing, which will make it possible to identify and reconcile the interests of the managers with those of the shareholders.

As for the legal audit, it is a necessity to validate the accounts and to give a judgment carrying advice and lessons to the companies. It is a mechanism that encourages or requires the individual (s) to whom responsibility has been delegated to act in accordance with the interests of the organization's stakeholders (Charreaux, 1997). Moreover, Morocco requires companies to have (at least) one auditor to control and monitor their corporate accounts while ensuring strict compliance with laws and regulations (stock exchange law, labor law, company law, commercial law, environmental protection laws, health and safety legislation).

The limited liability company for example, is obliged to appoint a statutory auditor when its turnover exceeds 50 million dirhams. While a public limited company is obliged to appoint an auditor whatever its turnover and this obligation becomes the appointment of two CAC when it makes a public call for savings and this, in accordance with the law 17-95 related to public limited companies.

2.3.2 The role of the internal auditor in corporate governance

In addition, Ziani (2019) confirms that the internal audit is primarily concerned by the corporate governance system, and we cannot dissociate them.

Indeed, following the financial scandals, which appeared because of the inefficiency of the internal control system (Ebondo, Wa. M, 2007), many laws were implemented to ensure the effectiveness of the internal control system.

These include the SOX law in July 2002 in the United States and the Financial Security Law (LSF) in August 2003 in France. The purpose of these laws was to improve the internal control system through new procedures.

First, it's important to increase transparency between shareholders regarding the internal control procedures implemented by the company, the working methods and the powers of the management boards.

Thus, ensuring good risk management is one of the levers of good governance.

The internal auditor must therefore be able to identify the risks facing the company while evaluating them and ensuring that the organization's objectives are consistent with its mission. Furthermore, the internal auditor plays a very important role in evaluating the corporate governance process while promoting ethical rules within the organization and providing adequate information to both the board and the external auditors.

3. The contribution of legal audit to the governance of the company

The use of an external control body, such as a statutory auditor, appointed by the owners of the company to control and certify the accounting and financial information produced by the company, is a mechanism for disciplining management, strengthening management's control of operations and contributing to sound corporate governance.

In recent decades, corporate governance has become a subject that has generated the most debate in academic and business management circles.

These annual financial statements provided by the external auditor constitute a summary of the company's activity favoring:

- Remuneration of shareholders through the payment of dividends based on annual results;
- Determination of executive compensation ;
- Determination of taxes and duties due to the state and other public authorities;
- Analysis of financial information by stakeholders (suppliers, customers and credit institutions) and determination of the company's solvency.

Furthermore, we highlight the fact that the annual accounts of the company are drawn up by its managers, who are themselves supposed to be controlled, having alone direct and real access to the activity of the company, hence the concept of **information asymmetry** causing a doubt on the sincerity of the information disseminated to the stakeholders.

The financial audit plays its role here, by removing this asymmetry of information between the managers and the other stakeholders. It is therefore part of the agency relationship around the company as a process of control of the accounts drawn up by the company in order to guarantee the dissemination of good financial information and to allow each party involved to make its diagnosis or decision in a climate of confidence.

The financial communication of a company comes down to the way in which financial information is disseminated to shareholders, investors, financial analysts, journalists of the specialized press and agents of the environment likely to be interested in the company, in a

policy of maintaining or improving its image. However, no one other than the company's management knows whether this image is valued at its fair and true value.

Furthermore, there is the problem of the company's honesty towards its shareholders concerning the information it provides them: *Is the information disseminated by the company faithful to the real situation? Does it reveal its true performance or is the firm trying to conceal its underperformance or is it clear about its failures?*

To answer these questions, financial analysts and others who review company documents rely on the audited financial statements and the audit report, which facilitate an understanding of the company as a whole, the results and the business environment over the past year.

The accounting and financial audit provides:

- **The guarantee of a more complete and constant information**

Audit reports are instruments of constructive dialogue within the governing boards. They provide an opportunity to discuss at greater length, than the board can do, the highly sensitive issues that are the source of the information published. It is not surprising then that good corporate governance practices, result in more effective preparation of the Board's work and decisions.

- **Clear information on the risk management process: keystone of internal control**

At the level of the report provided by the auditor, the auditors ensure that there is or is not a real ownership of the concept of internal control by the whole organization.

In practice, a huge number of companies consider that the role of the financial auditor consists of assessing internal control, "which must guarantee a certain adequacy between the responsibilities entrusted to the company's stakeholders and the use they make of them".

However, the committee's mission is not limited to validating tools. The auditor also takes into consideration the control environment, the control management, the information produced and its distribution.

These activities contribute to the assessment of risk control, which is necessary to guarantee the efficiency of the company. The auditor thus forms an opinion on the execution of operations, the reliability of financial communication and compliance with laws and regulations. This active monitoring allows him to detect weaknesses and thus alert the operational boards, in order to restore the proper functioning of the organization, aiming at apprehending the risks that are exercised in the internal and external environment of the company.

- **Informed information to shareholders:**

The interests of the shareholders will not be partially satisfied, if their curiosity is not fed by tangible information.

Through the audit report, the auditor gives himself the opportunity to express, he implicitly pushes the managers to listen to him better and the opinion provided by him has all the more strength when he has a good knowledge or experience of the company's activity sector.

The audit work is perceived by the shareholders as a stimulus that allows the company to better face financial and operational risks, whether current or exceptional, in periods of restructuring or development. By its very existence, the financial audit contributes to bringing problems to the surface and having them dealt with directly.

Finally, the auditor's attention must be focused on the company's compliance with irreproachable financial communication from the shareholder's point of view. The data to be taken into consideration goes beyond the simple framework of the annual financial statements: it covers the half-yearly closings, specific information as well as the media most frequently consulted by the shareholders.

Conclusion

In a context of crisis that is upsetting the environment in which Moroccan companies evolve, and in the presence of several problems that influence the performance of these companies, including the lack of qualification of human resources, and the incompetence of some management bodies, often of a family nature, the accounting and financial audit legal or contractual finds all its interest.

We have placed the theme of the accounting and financial audit in its theoretical context while analyzing its contribution to corporate governance. And this, by answering several questions in the above chapters.

We have been led to clarify the concept of financial auditing, which consists, among other things, of examining financial statements in order to make a judgment about them, but beyond this definition, it appears that financial auditing is not limited to analyzing accounts.

In fact, its objective differs according to the type of audit conducted, and a distinction is made between various types depending on the nature of the audit, the status of the auditor and the relationship between the auditor and the company.

If we talk about the contractual financial audit, it is not an anarchic process, on the contrary, it is a regulated process that respects the standards established by international and national organizations. Its implementation process goes through several stages, including

getting to know the company and its control environment, then auditing its accounts and issuing recommendations or opinions.

We have also discussed the concept of internal control, which can be summarized as the implementation by management of control measures to ensure the protection of assets and the reliability of records. The role of the auditor is to evaluate the reliability of this system, which involves describing the procedures and implementing the necessary tests to ensure the compliance and permanence of the controls, and then analyzing the strengths and proposing recommendations for the weaknesses detected.

Finally, we have provided elements of response for the process of evaluation of accounts and the various techniques and tests used (consistency, etc.), then we have focused at the end of this work, in relation to the problem studied, on the contribution of the audit in the agency relationship of the company, and in the existing relationships between stakeholders and the reduction of information asymmetry between them.

Moreover, the implementation of control mechanisms aimed at ensuring the transparency of information and avoiding any drift in the behavior of the manager is perceived as a prejudice to the management of companies. For the defenders of this hypothesis, it would be necessary to leave enough freedom to managers so that they can create wealth that will then be distributed among all the partners of the firm.

In this view, too many controls on a manager can be detrimental to economic efficiency because they prevent the manager from using the full potential of his or her managerial skills, and thus reduce the company's economic and financial performance.

However, the limitation of the present research lies in the circumvention of control mechanisms by some managers and the development of personal strategies of enrichment and/or entrenchment or the use of the accounting tool as a means of power when it is above all a means of control in the service of corporate governance.

On the other hand, as far as employees are concerned, even if the control of their operations seems to be under control, it is nevertheless true that they can indulge in loitering or poorly perform a link in a chain or a task in the process, which can potentially create conflicts of interest.

To this end, it would be interesting to study in future research the extent to which internal control and auditing contribute to the resolution or at least the reduction of conflicts within family businesses where there is no real market control and where problems of an often different nature are acutely felt.

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