

## Limiting Civil Liability in the Sphere of Business Auditing

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**Abstract.** *The statutory audit of business entities is represented by the audit of annual financial accounts or consolidated financial accounts, according to the Community legislation transposed in national regulations. Negligence or imprudence in performing the activities related to this type of audit entail special consequences. It is to some of the elements derived from this context that we refer in this paper, especially as there is often the underlying risk for the auditor to be held liable. It is worth noting that one cannot claim several compensations for the same action. Then, the auditor is not jointly liable with the other authors of the illicit actions which have caused damages. On the other hand, limited liability does not apply to the situations when it has been proven that the auditor has breached his professional duties with direct intent.*

**Keywords:** auditing contract; insurance; negligence/imprudence in the performance of duties; civil liability; faults; offences; damages.

**JEL Codes:** M14, M41.

**REL Codes:** 5H, 14I, 14K.

## 1. Introduction

Romania, as a full member of the European Union, has to transpose in its own legislation the Directive 2006/43/CE of 17 May 2006 of the European Parliament and Council on statutory audits of annual accounts. As a result, the Government issued the Government Decree no. 90/2008 – on the statutory audit of annual accounts and consolidated accounts, published in the Official Journal of Romania, Part I no. 481 of 30/06/2008 *Official Journal no. 481 of 30/06/2008* (approved by Law no. 278/7, November 2008).

Besides the rigorous regulation of the field, both this legal document and other specific legal sources provide substantial content to the public oversight system for statutory audits and audit firms, based on European principles, thus modifying and amending substantially the Government Decree no. 75/1999 on statutory auditing activities (Bostan, 2009).

Expressly, Law no. 26 of 2 March 2010, which modified the Government Decree no. 75 of 1 June 1999 on financial audit activities, specifies that financial audits also encompass statutory audits.

## 2. Statutory audits at the level of business entities

### 2.1. Generalities. The usefulness of auditing reports for firms

Talking about audit in general – because statutory audit originates in societal norms – we could say that firms whose financial results are audited on a regular basis show more seriousness and security to potential investors. Besides these, the company's providers, financiers, employees, shareholders and managers are also interested in the results of auditing activities (Horomnea, 2010).

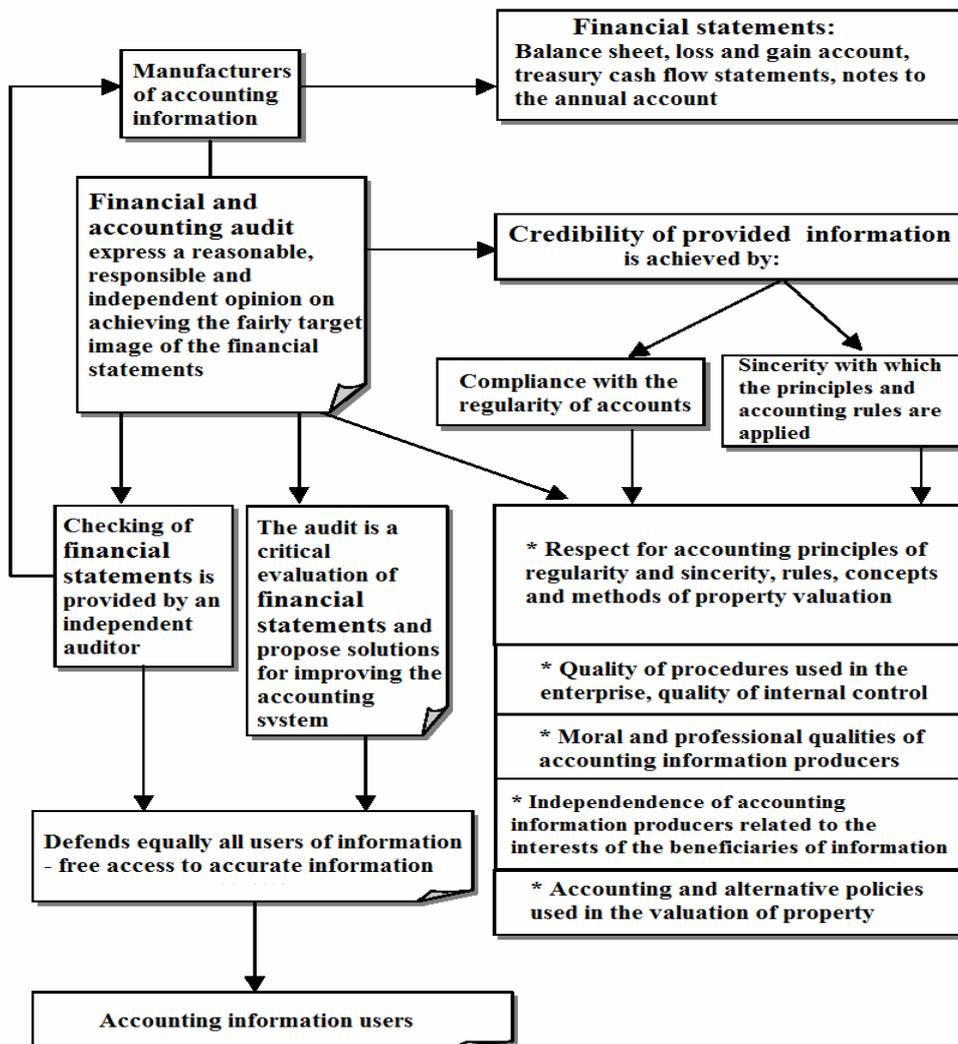
A scheme illustrating the role of these special activities is presented in Figure 1.

Drawn up by independent entities, the audit report is the outcome of a series of strictly specialised investigations concerned with the firm's financial-accounting activities which verify if accounting data were registered according to the generally accepted framework (principles, norms, assessment rules and domestic procedures), how they were collected and prepared, etc.

If they identify registrations of doubtful transactions, auditors are allowed to use crossed inspection techniques, establishing contacts with the clients, the providers, the debtors or the creditors of the audited firm.

The auditor's opinion, expressed in the final part of the report, belongs only to him/her and is based exclusively on the results of his/her investigations. Compulsory for banks, companies listed on the stock market or in other cases

provided by the law for given entities, demanding rather high expenses, auditing has not managed to find a wide scope for itself at the level of domestic firms, although such a business card (a favourable audit report) could open the door to new business opportunities. This is all the more true if the "certificate of good behaviour" comes from one of the greatest specialised international companies in this field.



Source: Ana Stoian, *Audit financiar-contabil*, <http://www.biblioteca-digitala.ase.ro/biblioteca/pagina2.asp?id=cap1>

Figure 1. The role of financial audit

Nevertheless, after having been practiced for nearly half a century in the Western world, currently, it is believed that it is possible for the audit not to identify some deficiencies and risky situations present in the firm's activity. Besides the cases that are easily understandable (for instance, inadequate ulterior managerial decisions), the audit's lack of infallibility may be linked to the managing staff's lack of total cooperation in making available all the needed documents and data, which would be indiscernible from accounting registers, such as secret agreements with other firms (which have not come into force yet), accepting to guarantee for others, etc.

Thus, the audit report is not an insurance policy or a "blank cheque" for the audited company, but it is, by far, the central axis in the analysis of a given company's financial accounts.

## 2.2. The auditor and the statutory audit

Statutory audit originates in the law of commercial companies, and its specific missions are permanent in nature, implying the possibility for the auditor to apply the specific procedures at the level of the business entity at any moment during the financial year. These specific procedures may be related to the analysis and assessment of internal control, to physical inspection (inventory) or to the revision of financial accounts (Bostan, 2009).

The statutory auditor is the natural person authorised by the competent authority, i.e. the Romanian Chamber of Financial Auditors (CAFR), to perform statutory audits. Statutory auditors and audit firms must perform statutory audits in agreement with the International Standards on Auditing (ISA), the purpose of the examinations being for the auditors to express a motivated opinion regarding the true, fair and complete image of audited entity's financial position (assets), financial accounts and results.

Statutory audits are concerned exclusively with annual accounts or with consolidated annual accounts, as specified by the Community legal framework transposed in national regulations: the balance sheet, the profit and loss account and the other components of financial accounts, depending on the applicable accounting referential; they also suppose the performance of other insurance missions and professional services, according to international auditing standards and to other regulations adopted by the Romanian Chamber of Financial Auditors.

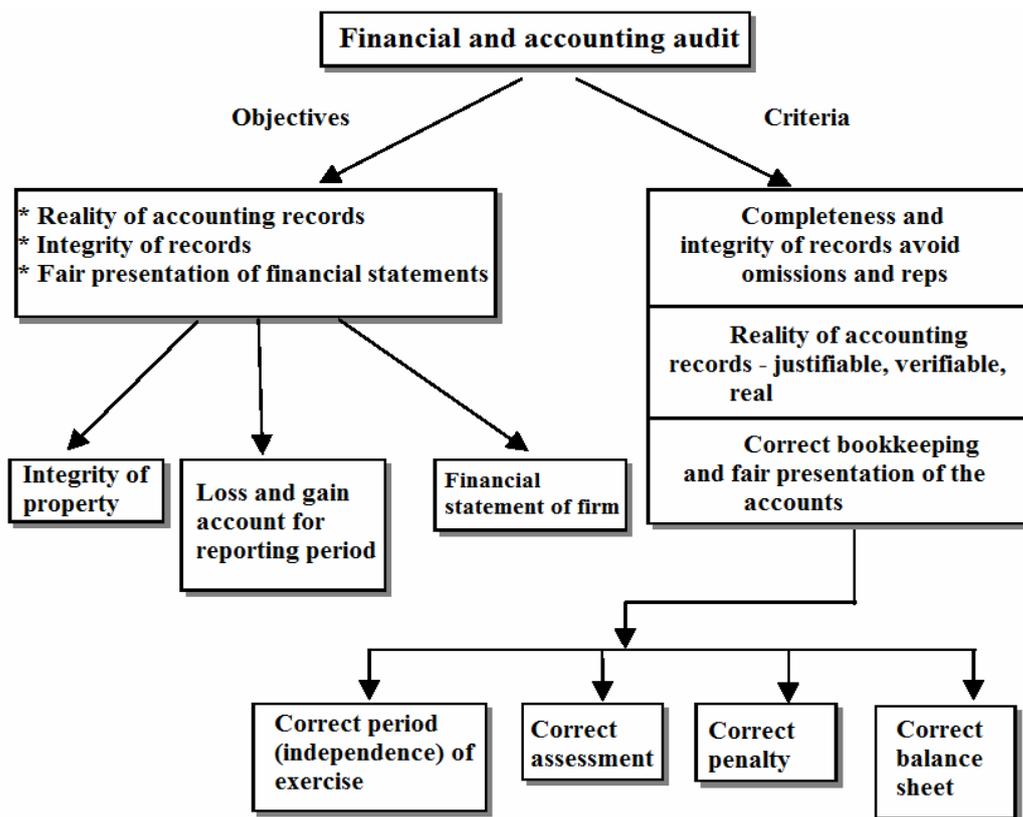
The specificity here seems to be given by the fact that within the auditing of financial accounts the auditor must apply a control methodology able to ensure – unlike other forms of audit – this independent opinion capable of judging or defending equally all the users of accounting information, all the entities

participating in the social-economic life, that is, the shareholders, the state (budget), the employees, the banks, the third-party debtors, the providers, etc.

The statutory auditor or the audit firm is appointed by the general meeting of the audited entity's shareholders or associates, for multiannual periods of usually 5-7 years.

Generally, the professional standards of auditing activities impose that this type of audit be carried out taking into account the International Standards on Auditing, the requirements of relevant professional organisations, the legislation and the regulations in force, the norms of reports, etc. (Horomnea, 2010).

The objectives and the criteria used include, to a great extent, those presented in Figure 2.



Source: Ana Stoian, *Ibid.*

Figure 2. Financial and accounting audit objectives and criteria

It should be noted that when they perform the hereby analysed audit, statutory auditors and audit firms may apply a national standard, adopted by the CAFR, if the European Union has not approved yet an ISA referring to that field, mentioning this element in the audit report. When an audit firm performs a statutory audit, the audit report is to be signed at least by the statutory auditor(s) who performs the audit on the behalf of that firm.

The possibility for the auditor to express an opinion – in the audit report – regarding the financial accounts and all their significant aspects, according to a general framework of financial reporting, supposes a specific process, characterised by a special type of complexity (Bostan, 2009). This is carried out step by step, starting with the auditor's approval for the mission, the orientation/planning of the audit, the assessment of internal control, the verification of accounts and financial accounts, and finishing with the audit conclusions and the report.

We would like to point out that since statutory audit is based to a great extent on random selection, there is no all-encompassing validation of the way the transactions and flows of the financial year have been treated in accounting records.

In what regards the report, it should mention clearly the name of the person who has drawn it up along with the individual number of registration in the public Register.

### 3. The auditor's legal liability and the applicable system of penalties

Statutory auditors or audit firms may be dismissed only when there are proper grounds. Under all circumstances divergence of opinions on accounting treatments or audit procedures shall not be proper grounds for dismissal or other similar measures (Bostan, 2009, Horomnea, 2010).

In what regards investigations and penalties, the Council for the Public Oversight of Statutory Audit Activities (CSPAAS) establishes efficient systems in order to detect, correct and prevent inadequate execution of statutory audit.

The penalties applied (according to Chapter VII, Government Decree 90/2008) should be effective, proportionate and dissuasive for statutory auditors and audit firms when statutory audits are not performed according to the specific legal framework. At the same time, the penalties applied should not interfere with the system of civil liability and the measures taken or the penalties applied to statutory auditors and audit firms should be appropriately disclosed to the public.

Audit firms are to be held liable, according to Government Decree no. 90/2008 – on the statutory audit of annual accounts (art. 32-37), if one of their associates, administrators or employees who does not have the quality of statutory auditor intervenes in the independent execution of the profession of statutory

auditor. This happens only if the intervention affects the independence of the statutory auditors who carry out this activity on the behalf of the audit firm.

Faults are to be established and penalties are to be applied only by the people who have been mandated in this respect by the CAFR or CSPAAS, the legal framework being supplemented with the provisions of the Government Decree no. 2/2001 on the general legal regime of contraventions.

It is worth noting that performing statutory audits without having been qualified as a statutory auditor is a criminal offence and is punishable according to the criminal law. The penalties applied by CAFR to statutory auditors and audit firms are: admonishment, written admonition, withdrawal of the right to perform statutory audits (for a period of three months up to one year) and withdrawal of approval accompanied by the withdrawal of the quality of statutory auditor.

We point out that the withdrawal of an audit firm's approval entails its lawful dissolution and liquidation. Then, during the period for which their right to perform has been withdrawn, people are not entitled to perform any activity of statutory audit, under any circumstances, they are forbidden to use their quality of statutory auditors and to take part in the CAFR activities. Faults punishable by sanctions and the procedure to detect and sanction them are established by the Regulations of CAFR, with the approval of CSPAAS, and the sanctions applied, made irrevocable after all the legal forms of contestation have been used, are published in the Official Journal.

If a legal court has issued a definitive decision to convict a statutory auditor for criminal offences related to his/her activity as a statutory auditor or if it applies the criminal sanction which is supplemental to the interdiction to perform this activity, the auditor is erased from the Public Register.

Statutory auditors or audit firms are liable for any damages they have caused, intentionally or by negligence, in the performance of their mission. An audit firm is jointly liable with the statutory auditor who has carried out a mission on its behalf for the damages caused by the statutory auditor.

This is why it is recommendable for both the statutory auditor (physical person) and the audit firm to get mandatory insurance in order to cover professional risks.

#### **4. Limiting the auditor's liability for the damages caused**

The regulation on limiting the civil liability of statutory auditors and audit firms states that liability is directly bound to the damages caused through the performance of specific missions, with direct or indirect intent or as a result of negligence or imprudence. This type of liability is limited to the amount of three audit fees established in the auditing contract, owed by the client to the auditor,

according to the clauses of the auditing contract referring to the statutory audit of the annual accounts of a commercial company which does not belong to the category of public interest entities.

If the audit targets a public interest entity, the liability cap amounts to five audit fees. We stress here that the category of public interest entities includes credit institutions, insurance companies, the entities regulated and monitored by the National Commission of Assets, companies whose assets have been accepted for transaction on a regulated market, national companies and societies, legal persons belonging to a group of companies and entering the consolidation perimeter of a mother-company that applies IFRS, legal persons that have received non refundable grants or grants guaranteed by the state.

The abovementioned regulation, issued by the Council for the Public Oversight of Statutory Audit Activities (CSPAAS) based on the Government Decree nr. 90/2008 on the statutory audit of accounts, also brings other important specifications in this matter. Thus, the amount of damages represents the maximum cumulated cap corresponding to all the damages caused as a result of having performed statutory audit activities based on the same auditing contract that the statutory auditors or audit firms can be compelled to pay, regardless of the number of people who have suffered damages or of the total amount of the allegedly caused damages.

One cannot claim several damages for the same fault committed as a result of the auditing activity carried out in order to draw up the audit report regarding the individual annual accounts and/or consolidated accounts of the same audit client, for the same financial year and based on the same proven damages.

Then, the statutory auditor or the audit firm is not jointly liable for the damages caused with the other authors of the illicit actions which have caused damages. However, liability is not limited in the cases when it is proven that the auditor has intentionally breached his professional duties, that is, when the perpetrator foresees the results of his/her action/lack of action and seeks to produce them.

Based on the annual accounts that have allegedly caused damages to the client/third-party, the auditor may be sued in court, according to the auditing contract, under the penalty of withdrawal of approval. However, the deadline to sue the auditor, fixed by CSPAAS, cannot be longer than three years since the day on which the audit report was issued.

## 5. Conclusions

Statutory audits originate in the law of commercial entities and are concerned exclusively with annual accounts or with consolidated annual accounts, as specified by the Community legal framework transposed in national regulations. The procedures established at the level of business entities are

permanent in nature and may be concerned with the analysis and assessment of internal control, with physical inspection (inventory) or the revision of financial accounts.

Statutory auditors or audit firms are liable for any damages they have caused, intentionally or by negligence, in the performance of their mission. An audit firm is jointly liable with the statutory auditor who has carried out a mission on its behalf for the damages caused by the statutory auditor.

The fact that the missions specific to this type of audit are quasi-permanently accompanied by risks made the lawmakers provide and regulate some aspects related to the auditor's civil liability, the applicable system of penalties and the limiting of the auditor's liability related to the damages caused.

The penalties applied should be effective, proportionate and dissuasive for statutory auditors and audit firms when statutory audits are not performed according to the specific legal framework. At the same time, the penalties applied should not interfere with the system of civil liability and the measures taken or the penalties applied to statutory auditors and audit firms should be appropriately disclosed to the public.

The legal norms mentioned in our paper provide that liability is directly bound to the damages caused through the performance of specific missions, with direct or indirect intent or as a result of negligence or imprudence. This type of liability is limited to the amount of three audit fees established in the auditing contract, owed by the client to the auditor, according to the clauses of the auditing contract referring to the statutory audit of the annual accounts of a commercial company which does not belong to the category of public interest entities.

All these justify the fact that both the statutory auditor (physical person) and the audit firm should get mandatory insurance in order to cover professional risks.

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