

## THE FINANCIAL AUDIT OF COMPANIES OPERATING IN THE METALWORKING INDUSTRIES

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In light of the effects of the economic-financial crisis and of the numerous changes occurring both on a European and a global level and altering the environment of the metalworking sector, the aim of the present paper is to focus on the specific alterations performed in the audit of the economic and financial activity and of the financial statements of each entity under consideration. Moreover, high quality audit is essential, especially in light of the numerous cases of fraud and corruption that have been documented in the past few years – occurrences we make reference to – and involving companies operating in this particular sector.

*Key-words:* economic-financial crisis, metalworking industrie performance, control system, audit procedures.

**Financijska revizija poduzeća djelatnih u metaloprerađivačkoj industriji.** U svjetlu posljedica gospodarsko-financijske krize i mnogih promjena kako u Europi tako i na globalnoj razini, čime se promijenilo i okruženje metaloprerađivačkog sektora, cilj je ovog priloga osvrnuti se na specifične promjene izvršene u reviziji gospodarsko-financijske aktivnosti i financijskih izvješća svakog razmatranog subjekta. Visokokvalitetna revizija od bitne je važnosti, posebice u svjetlu brojnih slučajeva prijevare i korupcije zabilježenih u proteklih nekoliko godina – o čemu vodimo evidenciju – u koje su bile umiješane tvrtke djelatne u konkretno ovome sektoru.

*Cljučne riječi:* gospodarsko-financijska kriza, stanje metaloprerađivačke industrije, sustav nadzora, revizijski postupci

### AN ECONOMIC APPROACH OF THE METALWORKING SECTOR

The current economic-financial crisis that affected the global economy has had particular effects on the entire production sector and has especially taken its toll on the metalworking industry that was severely shaken by the declining demand, both on a domestic and on a European and international level.

Thus, there was a significant decline of the investments, of the durable goods and semi-manufactures, alongside decreasing exports that affected the turnover of this particular economic sector.

From a historical standpoint, iron and its alloys, steel and pig iron, have played an essential part in the development of industrialized countries [1-3]; hence, metalworking has always been a key industry for these countries and only recently began to decline, due to the market globalization process [4].

It is a known fact that industrialized countries have recently withdrawn from certain markets, mainly because of the social and economic factors that have influenced their decision [5,6].

Numerous authors have had a keen interest in the history of metalworking and the profound changes that have gradually affected the development of this sector [7,8], as well as the difficulties and obstacles that arose

in various economic, social, historical and cultural circumstances that define each domestic economy: Baraldi (2007), Miller and Merwe (1994), Striver and Merwe (1969), Tylecote and Gilmour (1986), Day and Tylecote (1991), Waldbaum (1978), Baraldi (2005; 2007), King (2001; 2005), Salmoni (1994), Cavallini (2005), Nesti (2005), Bay and Preite (2006).

Metalworking industries have often been taken for granted as opposed to other industry sectors of the economy, but we're actually dealing with a very large sector that is spread across most cities and regions [9] – at least on a European level – while a considerable number of EU citizens are employed in companies operating in this sector.

Numerous large companies operate in the metals industry, but the small and medium sized companies (SMEs) generally prevail in the sector, operating as sub-suppliers for other industry sectors, such as automotive, aerospace, mechanical engineering, transport and construction industries. The metals industry is generally operated by flexible and innovative entities that employ a significant number of skilled workers.

In order to be thoroughly analysed, the metals industry should be divided into four sub-sectors, as follows: metal products; metal packaging, containers and boilers; metal processing such as casting, forging and coating metals; constructional metalwork [10,11].

Given the specific context of this paper, one should keep in mind that all the companies operating in the

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metals industry must observe a set of internal regulations and procedures specifically designed to prevent certain phenomena that may cause damage and have negative consequences on the economic activity of each entity [12].

An analysis of the economic circumstances must focus on outlining the risks these companies are exposed to and also emphasize the importance of the constant adjustment to the new circumstances of the existing audit system. In this respect, these specific protocols of the metals industry should be adopted by all the stakeholders in the manufacturing process – under the specific terms and procedures describing the competencies of these companies.

The proper enforcement of these protocols guarantees the possibility of identifying the people in charge of decision-making, commissioning and development of the economic-financial activities. In this respect and in compliance with the internal audit/control principles (of separating the tasks and obligations), each activity should be developed in certain stages, by certain individuals whose competencies are clearly defined and known within the company, in order to prevent occurrences of granting unlimited and/or excessive power to any individual.

## RECENT FACTS AND FIGURES AND THE CONJECTURAL EVOLUTION OF THE METALS INDUSTRY

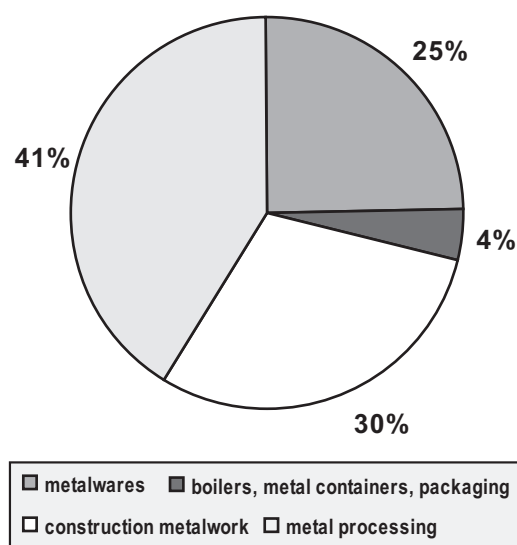
On a European level, Germany is the largest producer of metalworking industry goods, closely followed by Italy. Most of the other member states of the EU are still recording significant increases in their average output.

Eastern Asia accounts for 53,9 % in 2010 as compared to 45,6 % in 2007, mainly due to the exports from Japan. One can also note the decreased importance of other recipient markets, except for Central Asia and Central America. On a sector level, Asia remains the permanent leader, even if it has recorded a slight decline in the market quotas of the automotive industry, whereas the chemical industry and that of metal production has gradually strengthened.

The context-related evolution of this sector is highly sensitive to the global economic cycle, especially since certain sub-sectors that matter the most in certain domestic economies belong to the metals industry [12,13].

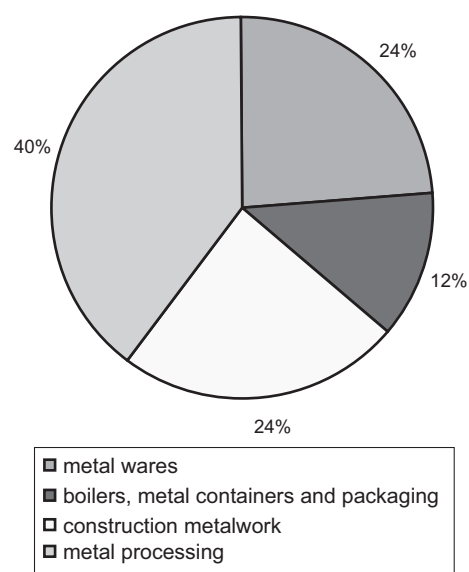
The metals production industry has a rather steady output level but has decreased levels of equipment use and thus needs to be associated with a further reduction of the profitability margins recorded by the companies operating in these sectors. The Share of enterprises in the EU-27 metalworking sector by product grouping in 2006 can be seen in Figure 1.

The metalworking industry is a considerable force for the EU economy and one of its major employers, as



Total: 407 000 enterprises

Figure 1 Share of enterprises in the EU-27 metalworking sector by product grouping in 2006 [14]



Total: € 506 bn

Figure 2 Share of enterprises in the EU-27 metalworking sector by product grouping in 2007 [14]

well as one of the most important and profitable sectors of the manufacturing industry in the EU. The Share of enterprises in the EU-27 metalworking sector by product grouping in 2007 can be seen in Figure 2.

The EU's metalworking sector delivers 10 % of the total value added in the manufacturing sector, accounting for 7,5 % of its manufacturing output.

## SPECIFIC PROCEDURES FOR THE AUDIT OF METALWORKING ENTITIES

The accounting framework in compliance with the National and International Accounting Standards must be thoroughly observed during the control and audit of

the balance sheet. In light of our specific topic, we shall only insist upon the economic-financial indicators auditors will have to focus on in order to avoid erroneous reports in the Audit Report, information that may mislead a considerable number of stakeholders.

The reason that supports our approach is best illustrated by the study conducted by Ernst & Young in 2011, on the fraud and corruption phenomena that have afflicted the companies in the metalwork industry [15].

So if companies could or should not over-invest in infrastructure, and governments are unable or unwilling to do so, where will the investment come from? Increasingly, customers are taking up this opportunity. For customers who have an appetite for infrastructure, such investment can provide a means of acquiring a long-term equity position in mineral production, if it facilitates an off-take arrangement. Miners are most concerned about loss of control of infrastructure resulting in monopoly pricing or failure to increase capacity when market conditions change. However, if customers receive off-take to provide port or rail access, there is less likelihood [15].

The efficiency and effectiveness of metalworking industry output should be addressed not only by control, but also by internal audit. Controlling should primarily ensure the planning and evaluation, and afterwards their screening should be ensured by an internal audit. Given that the very definition of efficiency and effectiveness is significantly influenced by the settings of the controlling system, it is most appropriate that a controlling audit should be made before internally auditing the efficiency and effectiveness of metalworking industry production [16].

We will further make reference to the main economic and financial indicators the auditor should provide information on, check whether they have been accurately calculated and reported, explain and clarify the recorded data and the documents claimed by the shareholders, clients, suppliers, public officials and other categories of stakeholders.

In this respect, special attention will be given to: turnover, fluctuation of turnover (in the current accounting period as opposed to the previous one); number of employees, the delineation of the basic economic activity and the area where the audit company develops its activities; Return on Investment (ROI) in percent value, Return on Equity (ROE) in percent value, Return on Sales (ROS) in percent value.

The fraud risk must be taken into account by the auditor, especially in the matter of the debts to third parties, as fictitious sales or cash misappropriation may occur if the same employee records sales slips and journalizes the transactions at the same time. Unauthorized commercial or financial discounts may also occur, etc.

Internal auditing of the customers and the related accounts focuses on the commercial activities with new customers and the analysis of the personal ledgers by checking a set of invoices. The importance of the audit

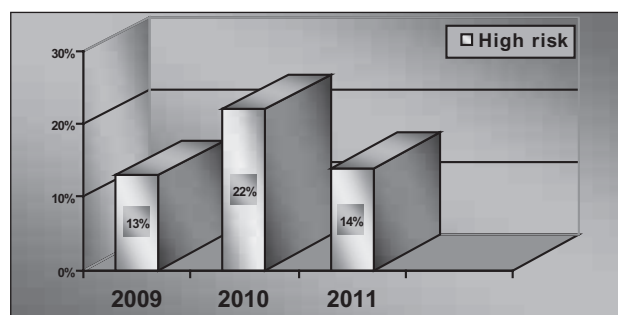


Figure 3 Target destination by high risk level, 2011 data for first five months only [15]

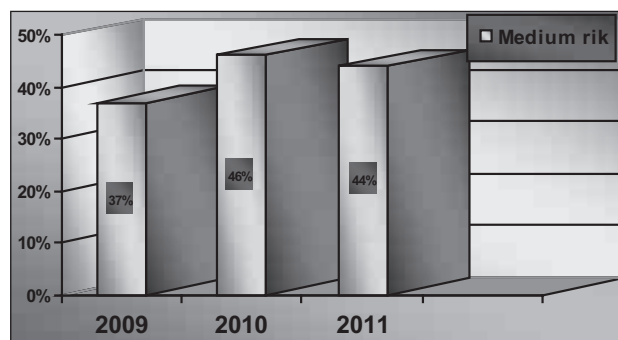


Figure 4 Target destination by medium risk level, 2011 data for first five months only [15]

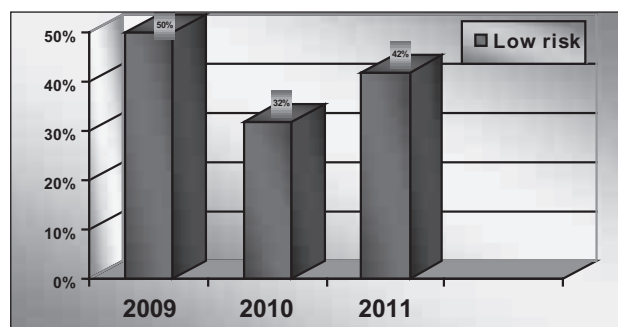


Figure 5 Target destination by low risk level, 2011 data for first five months only [15]

performed in metalworking industries especially resides in the need to fully disclose the economic, financial and capital asset information and data with the aim of preventing the fraud and corruption occurrences in this specific industry.

Ernst & Young research shows that in 2010 the share of M&A investment into high risk destinations increased from 13 % in 2009 to 22 % in 2010. In the first five months of 2011, the statistic was already at 14 %.

The target destination by risk level, 2011 data for first five months only can be seen in Figures 3, 4 and 5.

Case studie of inconsistencies and fraud identified by applying the financial audit procedures in metalworking industry companies [17]:

#### • Metal Connection

One of the most recent and resonant operations directed against fiscal fraud in this industry occurred in April 2011 and was conducted by the Finance Division

of Campagna di Magenta, Italy. The operation was called “Metal Connection” and the officials conducting it levied current accounts and liquidities amounting to over € 500 million. The charges included fiscal fraud, issue and use of fake invoices and money laundering. The operation involved over 30 companies in the north of Italy, among which: MP Metal, Metalmarsa, Cusago Metalli, Pram Metall, etc.

#### • Metalbland

The greatest financial toll was taken on Metalbland; an investigation was started in 2010, as a consequence of the fact that even if the company had recorded a turnover of millions of Euro, it presented a financial statement that was completely different in relation to the above mentioned turnover. The controversy started as a consequence of the very small amounts reported by the partners who also provided fake invoices as support and accounting proof of the “illicit” purchases and transports they had performed with other firms. For each document (fake invoice), the issuing party received a 4 % commission from the value charged to their customers. The extent of this phenomenon was eventually measured by means of a thorough examination of the accounting records of the companies using these fake vouchers that have long been fostering an organised crime system, with severe consequences and damage for the domestic economy.

The future analysis and forecasting related to audit and examination activities in the metalworking industries, should mainly focus on: the price of steel and its future cost evolution; the assessment of the auditor market in the field; the current trends in the purchase of non-ferrous metals.

## CONCLUSIONS

One of the major assets of the metalworking industry is its extensive spread across all regions of the world and the provision of a wide variety of jobs, trainings and opportunities. The metalworking sector is to be found in most EU countries – except in Germany – and is mostly dominated by small enterprises.

A sustainability policy would entail a continuous process of change and adjustment to the new economic, social, cultural and historical circumstances that currently influence the activity of metalworking industry enterprises. Profit is no longer the single objective and the management of these entities are embarking on a new mission that is mainly based on the control and audit system.

In this respect, a *cultural rejuvenation* will be needed to encompass the specific corporate governance regulations and best practices, as well as the strategic management activities.

The importance of the above statement relies on the fact that the specific market for the metal products has been highly volatile in the past few years and thus determined companies to adopt new business models that would ensure their future economic development. Nevertheless, this specific market is directly and indirectly conditioned by the control and audit systems.

Thus, audit has become essential for ensuring the reliability, accuracy and transparency of the economic and financial information and a key factor for attracting new investors.

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**Note:** The responsible for English language is the lecturer from Faculty of Economics, Suceava, Romania