# STUDY OVER THE INFLUENCE OF INTERNAL CONTROL IN FINANCIAL REPORTINGS FOR UNLISTED ENTITIES

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**Abstract:**

In Romania, for organizing an internal control, the unlisted entities can choose one of the various models control, according to what they consider to be adequate for realizing the proposed objectives. Our hypothesis states that the effect of this phenomena is creating a different non-compliance risk for each entity. In the absence of mandatory submission of an audit and therefore on the quality assessment of internal control and financial statements this risk eliminates investor's interest regarding unlisted entities. The objective of this comparative research is to determine the influence of the internal control model over financial information reported by these entities. Through critical analysis, by organization and systematization of the information, we will study and conclude, given the circumstances of the entities investigated, the most suitable model of internal control which ensures the diminution of the non-conformity risk on financial statements.

## Introduction

Significant internal control regulations in Romania are adopted for different types of entities among which public entities, banking entities, insurance companies, entities whose stock actions are admitted to trading on a regulated market. In this regard we take note of International Standards on Auditing (ISAs), International Financial Reporting Standards (IFRS), Norm 17/2003 on banking institutions, Government Ordinance no. 119/1999 regarding the internal control management and financial control of public entities, the Government general secretary Order no. 400/2015 approving the internal control management of public entities.



Arhipelag XXI Press, Tîrgu Mureș, ISBN: 978-606-8624-03-7

The entities which are unlisted on the Romanian stock market, do not have standardized framework for internal control, so they have the option to adopt and implement from a various range of procedures.

The International Auditors Standard no. 315 establishes the fact that in the control process for financial reports, not all the elements of internal control can be considered relevant; the relevant ones are the ones which are considered by the financial auditor[1]. The unlisted entities which are not obliged to contract an audit do not benefit of a real feedback on the elements of internal control, managing this process based on previous experiences, not on recognized models of internal control or other professional capacities in this field of work.

**Research Methodology**

A first approach in our research was the theoretical documentation and critical analysis of information and the second step was the empiric research, on methods and processes of internal control. The empiric research consisted of participative and non-participative observation of the internal control processes in unlisted entities. Interviews were also used as a addition to the non-participative observation. An important factor in the research process was our experience and knowledge level on audit and accounting practices. The internal control processes of 30 unlisted entities based in Mureș County and with different financial statuses and different main activity were analyzed, to conduct this research on the control procedures used by unlisted entities. The sample entities were selected from the category of entities which, according to Romanian laws, are not obliged to implement internal audit and a regulated process of internal control. Further on we will present the results of the research on unlisted entities, grouped in: particularities of internal control on unlisted entities and the signification of internal control in financial reports.

**1. Particularities of internal control in unlisted entities**

In the regulation process of the internal control, an element is considered to be a decisive factor in dealing with practices and processes of control, which is risk. In our opinion, the financial reporting system is threatened by the control risk, with impact on

[1] International Manual of Standards for Quality Control, Audit, Review, Other Insurance Services and Auxiliary Services, IAASB, Bucharest, pages 263 to 277.


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noncompliance risk. The control risk means the possibility according to which "a significant error in the turnover or account balance may not be discovered and corrected by the internal control system"[2]. The noncompliance risk refers to the possibility that the financial reports may not be in compliance with the applicable regulations[3]. Due to these threats, we used the analysis of some internal control methods which were applied to unlisted entities compared to established models such as COSO, COCO and COBIT. The identification of the similarities and distinctions between the control processes present inside the studied entities and the ones mentioned above was important because during the implementation of internal control, the studied entities did not choose any of those models.

We must take note that the studied entities are small and medium entities in which management can adequately and efficiently supervise the control process, so we started this research knowing that recognized models such as COSO and COBIT can be very well adapted to the internal control process of these entities[4].

We considered even the habit of contracting the financial reporting services with accredited accountants, this action intervening in the internal control process and management supervision process, changing the control environment of financial reports. In our opinion, this action does not increase the possibility of risk. The processes from small and medium entities can be supervised more easily by the management, as stated in the ISA[5] standards, however in this case there is a risk, the elusion of controls, while in case of contacting an financial statements service provider, the contracting entity will be responsible for property managing the risk of noncompliance and control.

According to the conducted study we remarked that from the COSO model, the process of evaluation of internal control in various moment, is not found in the unlisted entities internal control procedures, in our opinion this leads to an inclination towards the COCO model which implies a constant process of adaption. Also the management of the entities tends to adapt an internal control, during the financial reporting process, based on law changes and entity necessities, without evaluating the results. There is a possibility that state authorities, as a result of financial checks on unlisted entities, thought the penalties awarded,

[2] Danescu Tatiana, Procedures and Techniques of financial audit, Publisher: Irecson, Bucharest, 2007, pag. 91.
[3] Dănescu, T., Prozan, M., Dănescu, A. (2014), Non-conformity risks–theoretical and practical connotations, Conference on Emerging Markets Queries in Finance and Business (EMQFB), Tg Mures, 24-27 October 2013, Procedia Economics and Finance, vol 15, pag. 993-1001.
[4] International Manual of Standards for Quality Control, Audit, Review, Other Insurance Services and Auxiliary Services, Bucharest, 2014, pages….. ISA 315
[5] International Manual of Standards for Quality Control, Audit, Review, Other Insurance Services and Auxiliary Services, Bucharest, 2014, pages…..


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to indirectly establish an evaluation note on internal control. The risk identification and evaluation component from the COSO model is absent from the internal control process of the sample entities because their identification was realized late, mostly after making an error.

Another approach in the internal control conducted in the unlisted entities towards the COCO model is realized by accent on the employee engagement unlike the COBIT model that focuses on control processes.

According to our information, we tend to conclude that in the internal control applied, the unlisted entities implement a series of elements from acknowledged models, but mostly elements of the COCO model.

## 2. Considerations on internal control of financial reports at unlisted entities.

The internal control can offer a reasonable insurance regarding the conformity and credibility of financial reports, realizing this objective through its components.[6] The internal control of financial reports, defined in theory as a component of the internal control system, consists of procedures adopted and implemented by entities with the aim of faithful representation of economic activity, according to an applicable financial reporting framework, for the achievement of established objectives.

In the past some acknowledgements of internal control of financial statements were given under the terminology of financial control, even if financial control unlike internal control of financial reports is limited to the verification process of the financial information.

Financial reports control, can be classified based on the moment when it takes place, as it follows: preventive control, detective control and directive control.[7] Also the verification component from the internal control process of financial reports is divided, based on the moment of taking place, in other three types which are: preventive verification, concomitant verification and verification after the publishing of the financial reports. In case of the entities which made the object of this study, we observed a focus on preventive and concomitant

[6] Dănescu, T., Prozan, M., Dănescu, A. (2012) The role of the risk management and of the activities of internal control in supplying useful information through the accounting and fiscal reports, Conference on Emerging Markets Queries in Finance and Business (EMQFB), Tg Mures, Procedia Economics and Finance, Volume 3, pp.1099-1106.

[7] Schiek P, Vera J, Bourrouilh – Parage O, „Audit interne et référentiels de risques", Editura Dunod, Paris, 2010 pag 227-324



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verification but a reduced number of verification processes after publishing the financial reports.

The documentary control is one of the procedures which is applied in the internal control of the financial reports in all the studied entities. This is closely related to primary documents, accounting records and technical-operation registrations and accounting logs, having the purpose to prevent any human error in the process of financial reporting. In the documentary control process, the verification component appears in the form of a preventive and concomitant verification. We consider that the verification process after the publication of financial reports although it uses the documents which are the object of this control, it has an impact not on this documents or the processes included but on the financial reporting process itself.

Within the verification component, we discovered the use of systematic verification or problem targeted verification. This involves grouping the primary documents according to the registers in which they belong, for example: documents that appear recorded in the cash journals or the documents appearing recorded in the bank journals; and verification by comparison.[8]

Other procedures found in the conducted study, but on a lower scale were:

- Cross verification – which implies an exchange of accounting information between clients and suppliers by issuing account statements at a date later after the financial reports;
- Supervising – implies following and direct control by the management of the personal responsible with the financial reporting;
- Tracking calculations – represents verifying the correlations between the information present in the financial statements;
- The factual finding – is conducted occasionally and it consists of checking the factual existence of the elements presented in financial reports and the fact that these elements are used for the purpose of the entities operations ;
- Inventory – a concomitant control process, rarely found among studied entities, namely only when the regulations oblige in conducting it;

[8] Mircea Boulescu, Mircea Ghiță „Financial control and accounting expertise", Publisher: Mondo ,Craiova 1992, pag 58-61


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- Survey verification – is a concomitant control method, used in the process of financial reporting and it represents a selective checking of the documents, of relevant operations, of calculation ways, record keeping and payment of contributions.[9]

The principle of segregation of duties was used in all studied entities, even if in theory it is considered that this is rarely used in financial reporting control by small entities which do not have a large number of employees, in some entities this hindrance is removed by outsourcing some services.

In the process of analyzing the influence of internal control over the financial reporting system, the second must be structured in controllable components, which in our opinion are: the documenting and collecting component, making particular reference to economic operations and the registration of primary documents, the processing component, the verification component, the synthesis and report publishing component.

Each of these components, according to our research, may be the object of both preventive and subsequent verifications. Within preventive verification, these components are subjected to the survey verification technic to factual finding verification technic, of the activities and the verification for conformity of the legal documents.

From the subsequent verification perspective, it returns to the documenting component every time a discrepancy or error is found within the components.

Concomitant verification refers to the component of processing through the self-control of the responsible person regarding information processing and after that by supervising and comparing the processed data before making the financial reports.

The verification process of the final component of the reporting system, report publishing, cannot be but subsequent to the synthesis and communication component, which is the only stage weher the management is providing input as a supervisor, within unlisted entities.

Within the studied entities, the financial reporting control does not include management supervision but by the person responsible with the elaboration of financial statements, no matter the size of the studied entity. The only component identified which, in some cases, implies management supervision the synthesis component.

## 3. Conclusions and proposals

[9] Nadia Cerasela Aniței „Laws and regulations for financial and fiscal control institutions", Publisher: Lumen, Iași 2011, pag 78-81


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According to the results obtained in this study, in our opinion, the model which is most compatible with the used procedures by the unlisted entities is COCO, because there were many similarities between the particularities of internal control applied in the studied entities and the COCO model. Our recommendation is that unlisted entities should realize a combination of COCO and COSO procedures, especially by adopting the process of evaluation for internal control at a certain moment, including the internal control of financial reporting.

The management of unlisted entities tends to concentrate in the supervision process on the of internal control process which should ensure the accomplishment of the entity's economic and financial objectives, neglecting or commissioning most of its control of financial reporting attributes. In our opinion, this phenomena happens most often when a professional accredited accountant is contracted. Our recommendation for the management is to pay more attention to the supervising process focused on the conformity of financial reports and less on the financial image of the entity.

We conclude that the unlisted entities which do not resort to an internal audit or financial audit do not have a clear feedback on internal control efficiency, managing this process based on previous experiences and not on certified internal control methods or professional capacities. Contracting specialized entities to make the financial reports can offer a reasonable level of insurance regarding their conformity, because these entities are obliged to respect a professional ethics and deontology code which imposes the compliance to the professional international standards of financial reporting. Because of these reasons, we tend to believe that the entities which choose to contract independent professionals have a more efficient organization of the internal control on financial reports and also on the internal control components on which the management is focusing their attention.

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OFFICIAL MONITOR NR. 424 From 26 June 2012 „Public finance ministry no. 881/2012"



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