CONSIDERATIONS ON THE PRACTICAL APPLICATION OF INTERNATIONAL AUDITING STANDARDS REGARDING THE ENVIRONMENT OF CONTROL

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Abstract: : In the research contract, no.60C from 21.12.2009, concluded between the University of Craiova and EURO TYRES MANUFACTURING LTD. from Drobeta Turnu Severin, in the section *International Auditing Standards regarding the Environment of Control*, the aspects of how auditors approach the environment of control within the audit mission were analyzed. The responsibilities of top management include maintaining some adequate accounting and internal control systems, selecting and applying accounting policies and preserving safe the entity's assets. To achieve these objectives auditors apply the provisions of the International Standard on Auditing 315, "Knowing and Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement" that became effective after December 15, 2004 and was restated in December 15, 2008 as "Identification and Assessment of Risks of Significant Misrepresentations by Knowing and Understanding the Entity and its Environment." The financial auditor's responsibility is to identify and assess the risks of material misstatement, whether due to some frauds or errors, in the financial statements and in the declarations, by understanding the entity and the environment in which he operates, including the entity's internal control. Internal control is the process designed and put in practice by those charged with governance by the top management and other personnel, so to provide a reasonable assurance about achieving the entity's objectives regarding the credibility of financial reporting, the effectiveness and efficiency of operations and the compliance with applicable laws and regulations.

JEL classification: M41, M42

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1. INTRODUCTION

In the task of auditing the annual financial statements, the auditor would consider whether the information obtained during the phase of client's acceptance or continuation of work is relevant to identifying the risks of material misstatement. When there is a mission partner, there will be considered whether he has performed other engagements for the entity audited and whether the information obtained is relevant to identifying the risks of material misstatement. If he intends to use observations obtained from his previous experience with the respective entity and the audit procedures performed in prior audits, the auditor will determine whether changes have occurred since the previous audit that can affect their relevance for the present audit.

The partner or another key member of the team will discuss the susceptibility of material misstatements in the entity's financial statements and the application of the legal framework in view of the facts and circumstances specific for the entity. He will determine what matters shall be discussed with the team members who were not involved in activities developed within the entity whose annual financial statements are audited.

2. METHODOLOGY

The purpose of this research is to disseminate the results obtained by carrying out the Research Contract 60C/21 December 2009, concluded between University of Craiova and EURO TYRES MANUFACTURING LTD., whose object is the "Organization, implementation and evaluation of internal control”. Research team is formed of academics with a rich theoretical and practical experience and members of professional accountancy organizations: CAFR, CECCAR, CCF and ANEVAR.

The research methodology that we used for elaborating this article was to study the specialized literature, national accounting legislation, European directives in accounting and international accounting and audit standards, as well as to document ourselves at the contracting entity, Romanian legal person with foreign capital. The scientific instruments used for elaborating the article belong to the quantitative and qualitative methods: document analysis, mathematical and statistical processing of financial-accounting information, synthesis, interpretation of data, professional reasoning. The method of questionnaires was also used for data collection.

3. UNDERSTANDING THE ENTITY, ITS ENVIRONMENT AND INTERNAL CONTROL

For *understanding the entity and its environment* in which it operates, the auditor will obtain information on the following aspects**:**

(a) the relevant sector of activity, the regulatory framework and relevant external factors, including the applicable financial reporting framework.

(b) the nature of the entity, including :

- its operations;
- structures holding the voting and governance rights;
- the types of investments that the entity makes;
- the manner in which the entity is structured and it is financed.

(c) the selection and application of accounting policies, including the reasons that led to their change. The auditor will evaluate whether the entity's accounting policies are appropriate for its business and in accordance with the applicable accounting-financial reporting framework and the accounting policies used in the relevant activity sector.

(d) the entity's objectives and strategies and those related to business’s risks that may result in risks of material misstatement;

(e) the measurement and review of the entity's financial performance.

(f) the internal control.

For understanding the entity's internal control the auditor should first acknowledge the components of internal control: environment of control and risk assessment process.

The auditor will obtain an understanding of the environment of control by evaluating:

- The leadership which, under the supervision of those charged with governance, created and maintained a culture of honesty and ethical behavior;
- The strengths of control environment's elements taken together providing an appropriate basis for the other components of internal control.

During the *risk assessment process*, the auditor will be able to understand whether the entity has procedures for:

- identifying risks for the financial reporting objectives;
- estimation of risks' significance;
- assessment of the likelihood of their occurrence;
- deciding on the necessary actions for approaching these risks.

If the entity has established such a process, referred to as "the entity's risk assessment process", the auditor shall obtain an understanding of it and its results**.**

4. INFORMATION SYSTEM, FINANCIAL REPORTING AND COMMUNICATION

The auditor shall obtain an understanding of the information system, enterprise's processes relevant to financial reporting, including the following domains:

- ♦ classes of transactions of the entity's operations that are significant to the financial statements;
- ♦ procedures, both those in the field of information technology (IT) and the manual systems through which some of them are initiated, recorded, processed, corrected, and, if necessary, transferred to the general ledger and reported in financial statements;
- ♦ related accounting records, supporting information and specific accounts in the financial statements used to initiate, record, process and report transactions, that can be done either manually or in electronic form;
- ♦ how the system captures events and conditions, other than transactions, significant to the financial statements;
- ♦ financial reporting process used for the elaboration of entity's financial statements.

The auditor shall obtain an understanding of how the entity communicates the roles and responsibilities of financial reporting and the significant matters related to financial reporting, including:

- o Communications between management and those charged with governance;
- o External communications, such as those with regulatory organizations.

5. CONTROL ACTIVITIES RELEVANT TO THE AUDIT

The auditor shall obtain an understanding of control activities relevant to the audit, more precisely those about which the auditor, based on its reasoning, believes should be understood in order to assess the risk of material misstatements in the statements and to design future audit procedures responding to the assessed risks.

To understand the entity's control activities, the auditor shall obtain an understanding of how the entity responded to risks arising from information technology (IT).

6. MONITORING CONTROLS

The auditor shall obtain an understanding of the major activities the entity uses to monitor internal control over financial reporting, including those related to those control activities relevant to the audit and how the entity initiates corrective actions for its controls. The auditor shall obtain an understanding of the sources of information used in the monitoring activities by the entity and how high management considers that basic information is sufficiently reliable for their purpose.

7. IDENTIFYING AND ASSESSING RISKS OF MATERIAL MISSTATEMENT

The auditor will identify and asses the risks of material misstatements:

- ♦ in the financial statements;
- ♦ in the statements for classes of transactions, account balances and representations in order to provide a basis for designing and performing further audit procedures.

To this end the auditor:

- Identify risks throughout the entire process of obtaining an understanding of the entity and the environment in which it operates, including relevant controls that relate to risks;
- Evaluates the identified risks and seeks to determine whether they are generally related to financial statements, as a whole that can affect several evaluations;
- Makes the connection between risks and what may arise unexpectedly in the evaluation.

Following risks' evaluation by the auditor, it shall be determined whether any of the risks identified represents, in his view, a significant risk. In the exercise of reasoning according to which risks could be significant, the auditor should consider at least the following aspects:

- ▪ Whether the risk in question is a fraud;
- ▪ Whether the risk is related to economic, accounting or other evolutions, therefore requiring a special attention;
- ▪ Complexity of transaction;
- ▪ Whether the risk involves significant transactions with the involved parties;
- ▪ The degree of subjectivity to the extent that financial information is related to risk, especially those measures that imply a wide range of uncertain analysis;

Whether the risk involves significant transactions that are outside the normal course of making business used by the entity, or seems unusual.

The auditor will communicate, during the audit, the significant weaknesses in internal control to the entity's management, in accordance with the ISA 260 "Communicating with those charged with governance".

8. RESPONSIBILITIES AND LIMITS OF INTERNAL AUDIT

Internal audit is meant to contribute to the implementation of total quality, to train the entire staff in achieving managerial objectives and to optimize all systems (supply, production, retail etc.) but also the accounting and internal control systems. Internal audit is an exchange of ideas that leads to enriching the information available, and the management obtaining reasonable assurances of achieving the objectives set. Methodical reasoning and internal audit actions are based on the triplet "findings – analysis - recommendation". For reasons of efficiency and time, internal audit is not done in an absolute manner, it does not aim to detect all anomalies (errors or frauds), because such an approach would result in costs that exceed the benefits they generate.

The main mission of internal audit is not directed toward the detection of frauds, but it can uncover fraud through the interventions made and the methods used or can put out the weaknesses of the accounting system and internal control system that may favor these frauds. To assess the quality of internal audit activity, in order to establish his responsibility, the audit procedures applied must be analyzed as well as the concordance between the results obtained from these procedures and the content of the report prepared for the entity's high management.

In our research we applied a ***Questionnaire for analyzing quality of the fair view in accountancy provided in the financial statements, from the financial auditors' point of view***, structured into 25 questions that aim at identifying the perception of professional accountants on the external financial audit on the annual financial statements.

The financial audit has as final purpose the expressing of an opinion on the extent to which the financial statements comply with the supreme goal of true and fair view and the compliance with the relevant rules of accounting. Given the subjectivity of the concept of "fair view", we can not say that there are relevant instruments for measuring the degree of fidelity in the financial statements. Although auditors are aware that there is no mathematical formula, or of any other nature, through which they can measure the degree of fidelity, they are aware that they have the ability and knowledge necessary to identify at least those situations where the fair view is not achieved, thus appealing to the professional reasoning to determine the degree to which the financial statements offers the desired true and fair view**.**

When asked "*Which of the following statements do you consider that best expresses the role of financial auditor*?"

- to provide reasonable assurance,
- provide independent verification of accounting information,
- provide increased reliability of annual financial statements.
  - 86% of respondents have showed that the financial auditor's role is to provide a reasonable assurance, by expressing an opinion on the degree to which the financial statements present a fair view, this response corresponding to the provisions of International Auditing Standards as well as Romanian regulations in audit, prepared by CAFR;
  - 10% of respondents have showed that the financial auditor's role is to ensure an increased reliability of the annual financial statements;
  - 4% of respondents have showed that the financial auditor's role is to provide independent verification of accounting information.

When asked *"Which do you think are the factors that could affect the financial auditor's independence and to what extent?":* (5 - to a very large extent, 4 - largely, 3 - in some way, 2 - in small measure, 1 - to a very limited extent). The responses were grouped as follows after the data processing:

What do you think are the factors that could affect the financial auditor's independence and to what extent? (5 - to a very large extent, 4 - largely, 3 – to some extent, 2 – to a small extent, 1 - to a very limited extent.)					
	(5)	(4)	(3)	(2)	(1)
Sanctions applicable				6%	
Auditor’s concern to keep his clients	40 %				
Size of auditing entities				12 %	
Competition of the internal auditing firms		28 %			
Competition of Big Four firms			10 %		
Auditor’s Responsibility					4%

- 12% of respondents believe that the auditor’s independence is influenced to a small extent by the size of entities audited;
- 40% of respondents consider that the auditor’s independence is to a very large extent influenced by the auditor’s concern to keep his clients;
- 28% of respondents believe that the auditor’s independence is largely influenced by the competition of the internal auditing firms;
- 10% of respondents think the auditor’s independence is influenced to some extent by the competition of international firms (Big Four);
- 4% of respondents believe the auditor’s independence is influenced to a very limited by the auditor's responsibility;
- 6% of respondents consider the auditor’s independence is influenced to a small extent by the professional sanctions applicable.

9. CONCLUSIONS

Following the research conducted, it was concluded that:

- financial statements of EUROTIRES MANUFACTURING LTD are subject to financial audit, external audit conducted by a company member of the CAFR;
- internal control is done within the entity in multiple domains: management control, preventive financial control, control of labor protection, occupational safety and health control, control of environmental factors, control of production’s quality, control of traffic security etc;
- since presently there is no specialist employed as internal auditor, the internal audit should be organized in a distinct department, as required by the regulations in force for companies whose annual financial statements are financially audited;
- control activity is recommended to be strengthened by creating the position of controller, who should be responsible for the economic and technical transparency of firm’s activity, a true "driver on the road to profit," and able to intercede coordination and informing of the manager so to make the best decisions still in the planning and launch of production phase.

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