THE POSITION OF CONTROL ENVIRONMENT TOWARDS AUDIT

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Abstract: *control and audit are two commonly used terms in professional language. Although a part of modern researchers refer to audit, or confuse them, we have tried to prove that audit is an element that refers to control. The key features of internal control were presented from the perspective of the control environment and from the perspective of internal and external audit. The results of the control environment analysis, within an entity, justify the attitude of the top managers towards control and audit processes as well as the significant influence on their structure and efficiency. Finally, it has been proofed that these are two terms that work in parallel. Control helps the entity's leadership in achieving strategic objectives, and audit aims to ensure the efficiency, reliability and compliance of financial statement data.*
Keywords: *control environment, internal control, audit.*

ПОЛОЖЕНИЕ ВНУТРЕННОЙ КОНТРОЛЬНОЙ СРЕДЫ В СВЯЗИ С АУДИТОМ

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Аннотация: *контроль и аудит - это два часто используемых терминов на профессиональном языке. Хотя некоторые из современных ученых сосредоточены на аудите или путают их, мы попытались доказать, что аудит является элементом контроля. Основные особенности внутреннего контроля были представлены с точки зрения среды контроля, внутреннего аудита и финансового аудита. Результаты анализа контрольной среды предприятия демонстрируют отношение топ-менеджеров к процессам контроля и аудита, а также значительное влияние на их структуру и эффективность. Таким образом, было продемонстрировано, что это два термина, которые используются параллельно. Контроль помогает руководству предприятия в достижении стратегических целей, а аудит направлен на обеспечение эффективности, надежности и соответствия данных финансовой отчетности.*
Ключевые слова: *среда контроля, внутренний контроль, аудит/*

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I. Introduction

The research area of the present article focuses on issues related to the relationship between control and audit. Some argue that there are some similarities between these two terms, while others confuse them. In this context, we consider it necessary to consider these relations from the perspective of the following structure: internal and external control, internal and external audit. Although the concept of "*internal"* generates certain dilemmas, we specify that the elements of the classification mentioned above refer to the control and audit performed within the entity.

The history of audit is much more recent than that of control; it appeared in the early twentieth century. A great part of corporate financial statements in the U.S. before 1930 were not audited and had a different structure from one society to another. Investors could not compare the financial statements, questioning the quality and transparency of earnings per share data. At that time, there was no large-scale body to implement certain regulations on financial-accounting reports. There were no requirements for corporate financial information to be audited or verified by third parties. Financial statements in the UK began to be audited in 1900, and in the U.S., the Congress passed such a law in 1914 [1, pp.196-211]. The above situation justifies the need to introduce external (financial) audit to ensure that the data in the financial statements objectively reflect the economic reality and are prepared in accordance with the applicable laws and regulations.

Finally, we want to make it clear that audit and control are two notions with distinct functions within the entity. The study process was initiated with the analysis of the control environment within the entity, in order to justify the fact that the attitude of the top managers towards the control and audit processes has a significant influence on their structure and efficiency. The use of an overwhelming number of regulations demonstrates the degree of evolution of these concepts and their importance for the entity success.

II. Control environment

The entity's control system is designed by the executive management under the supervision of the board of directors. Its assessment is conducted in strict accordance with the principles of the COSO 2013 Conceptual Framework and National Standards for Internal Control (NSIC). The control environment is part of the five necessary steps to be followed, along with risk assessment, control activities, information and communication, and monitoring of activities. The COSO integrated framework helps clarify the responsibilities of the board of directors and top management through the five control principles (P1-P5) presented in Figure 1.

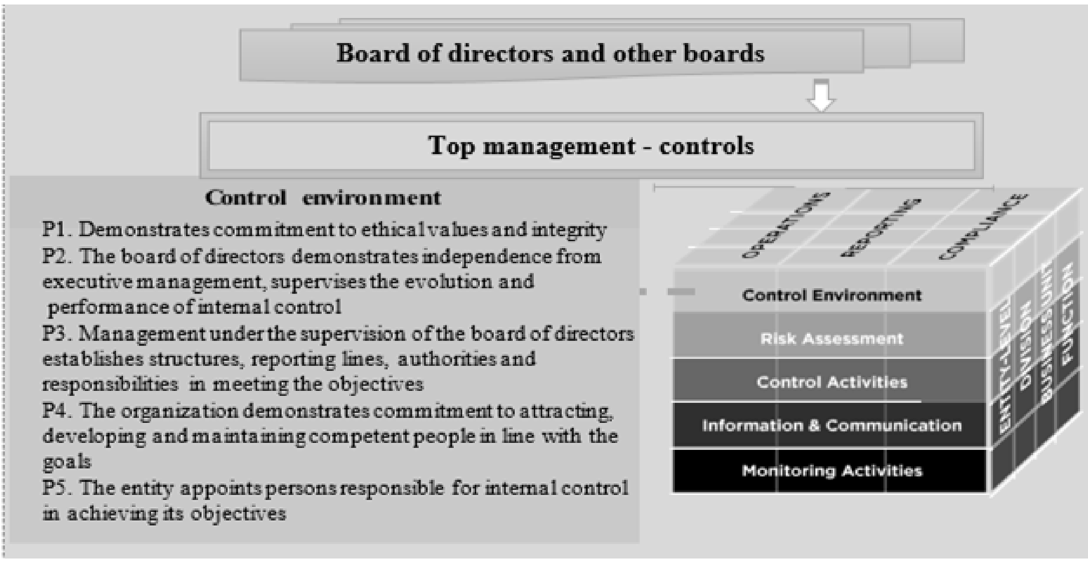

Fig. 1. Control environment elements

Source: [2, p. 4], [3].

As shown in Figure 1, top management and board of directors are primarily responsible for the control environment of an entity. The five principles guide the entity's leadership in organizing risk management and control. The content of these principles demonstrates the correlation with strategic objectives, with emphasis on ethical values, accountability and performance evaluation system. In this context, we ask ourselves: What is the link between the COSO 2013 principles on control environment, the provisions of the International Standards on Auditing (ISA) and the National Standards for Internal Control. Table 1 has been developed to provide an answer to this question.

Table 1. Comparative analysis of the regulations regarding the internal control environment

No.	Name of the regulatory act	Control environment elements
1.	ISA 315 "Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment"	**1. Communicating and applying values of integrity and ethics** **2. Commitment on Competence** **3. Participation of governance responsible** **4. Philosophy of leadership and style of work** **5. Organizational Structure** **6. Assigning authority and responsibility** **7. Human resources policies and practices**
2.	National Internal Audit Standards	**NIAS 1. Ethics and integrity** **NIAS 2. Functions, roles and tasks** **NIAS 3. Commitment to Competence** **NIAS 4. Approach and style of operation of management** **NIAS 5. Organizational Structure** **NIAS 6. Delegated mandates**

Source: developed by author based on regulations [4], [5].

As can be seen in Table 1, the first element of the control environment refers to ethics and integrity and is present in all three sources. The division of responsibilities between the board of directors and the executive management was foreseen only in the COSO conceptual framework, while the insights on the organizational structure are only recommended by ISA and NSIC. The idea of human resources policies and practices for achieving the entity's objectives is found in all three sources. While National Internal Audit Standards provide additional explanations in relation to the delegation of powers, although other rules also mention the need for authorization levels and hierarchies.

Having questioned top managers from the Republic of Moldova and Romania, regarding the question: Does the control environment depend on the attitude of the top management towards the internal audit and the internal control processes? The answers are presented in Figure 2.

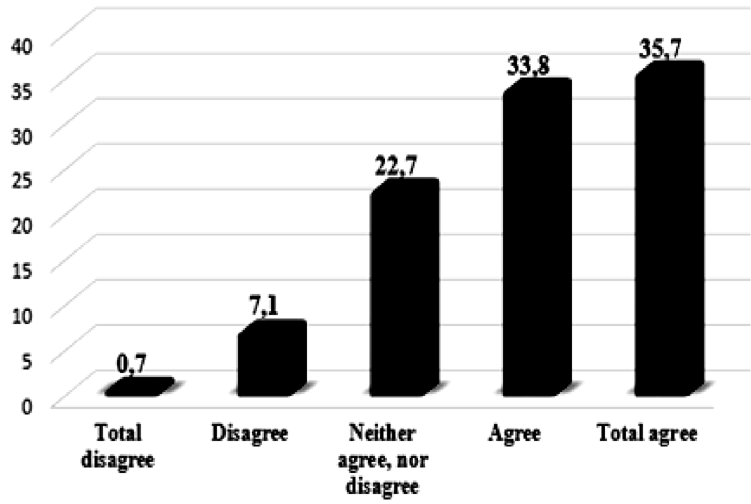

Fig. 2. Distribution of answers regarding the relations between top management, internal audit and internal control, %

Source: author's processing based on [6], [7].

As can be seen from Figure 2, answers of *agreement* and *total agreement* predominate, demonstrating that top management is aware of the importance of control environment. However, if analysing each answer separately, it is seen that 69, 5% of respondents support the idea that control is a function of the entity's management attitude and control processes with the efficiency of the internal audit.

III. Relationship between audit and internal control

The business supervision mechanisms are designed to reduce the entity's total costs and expenses. Researchers noted that there is no single form of monitoring or merging that dominates the others. Instead, managers and owners can use a variety of variants and means of combining. Each method is used until its marginal cost is equal to marginal benefit. To a great extent, the intensity of using such a method usually decreases when it begins to be occupied by others. From this perspective, the internal costs are a function of the major differences between incentives for top managers and lower-level employees within the entity, while external costs arising from differences in incentives of top management and capital providers. The role of internal and external audit lies in monitoring internal and external costs made by managers and employees [8, pp. 57-58].

At European level, control is analysed from a systemic perspective of Internal Control Standards, which includes the following elements:

Internal Control = Internal Audit + Financial Management and Control

As can be seen from this formula, internal audit is an element of internal control, with the role of assessing the financial management and control system [5]. However, noteworthy is the fact that these are specific to public sector entities, while those in the private sector use them as needed.

Generally viewed, the internal audit has the role of helping the entity to achieve its objectives by bringing added value to stakeholders and contributing to the efficiency and effectiveness of governance, risk management and internal control processes. In this regard, internal audit, as external audit, examines control in a systemic manner alongside corporate governance and risk management. Thus, point A1 of ***ISA 610 "Use of the Work of Internal Auditors"*** states that *the internal audit function may be assigned specific responsibilities for reviewing controls, assessing their performance, and making recommendations for improvement.* [4]. Thus, as seen from the external audit standards, internal audit has the function of assessing the effectiveness of internal control, and, unlike the external audit, it only refers to the reality and legality of the data in the financial statements.

National Internal Audit Standards (NIAS) 2130 "Control" is part of the functional standards category and provides that internal audit assists the public entity in maintaining an effective financial management and control system by assessing its effectiveness and effectiveness, and by promoting continuous improvement [9]. Although NIAS has control through financial management, it still retains system value and efficiency and effectiveness attributes. If we compare with the ***International Standards for the Professional Practice of Internal Auditing 2130 "Control"***, then it is noted that the national version of the standards has replaced *"effective controls"* by *"effective financial management and control system"* [9], [10]. From this perspective, we confirm that the Republic of Moldova is using the variant adapted by the European Union in order to consolidate public finance management.

Unlike ISA, which operate with the notion of “internal control”, NIAS uses the notion of “control” by relying on the veracity of the information in the financial statements, the effectiveness and efficiency of the operations performed. In this context, the *ISA 210 “Agreeing the Terms of Audit Engagements”* (A16-A20) states: *management maintains such an internal control as it determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error* [4]. As can be seen from ISA 200, the entity’s management is the one that decides the structure of internal control processes. And their purpose is to provide a reasonable, but not total, assurance that the financial statements do not contain significant errors or frauds. From this perspective, additional explanations are provided by: *an independent audit conducted in accordance with ISAs, it does not replace the maintenance of internal control necessary for management to prepare financial statements.* The role of this point is to emphasize that in assessing the effectiveness of internal control, the work of financial auditors cannot be considered equivalent to management. The audit must provide justification and ensure that the entity’s management or management is aware of its responsibility for the financial statements. It is up to the management to determine the structure of the control procedures required to provide information in the financial statements. Finally, the internal control of an entity, in particular the accounting system, is designed and implemented according to management needs, complexity of the business, the nature of the risk to which the entity is subject and the relevant laws or regulations [4].

ISA 210 “Agreeing the Terms of Audit Engagements” also states that *in some jurisdictions, law or regulation may refer to the responsibility management for the adequacy of accounting books and records, or accounting systems. In some cases, general practice may assume a distinction between accounting books and records or accounting systems on the one hand, and internal control or controls on the other* [4]. This distinction is made to demonstrate the importance of internal control in ensuring the reality and legality of data that for the most part is recorded and processed by accounting but should not be considered as accounting due to the fact that accounting or accounting systems are an integral part of internal control [11].

The position of external audit related to internal control in small entities that are not subject to mandatory audit is presented by: *when a third party contributed to the preparation of the financial statements, it may be useful to remind the management that the preparation of the financial statements in accordance with the applicable financial reporting remains its responsibility* [4]. Finally, the conclusion is clear, no matter who draws up the annual report, the employees of the entity or certain external individuals or natural persons, the responsibility for the entity’s information remains on the management of the reporting entity.

In the research of the **relationship between control and audit**, it is also important to take into account the practitioners’ opinion. Thus, the administrators’ reports for the year 2015 were analysed on the web site of the Bucharest Stock Exchange (BSE) within the regulated market. Of the 50 entities with available information, those in the financial sector were excluded, so, 39 entities remained. Content analysis has served as a method for collecting information, and the resulting categories are shown in Figure 3.

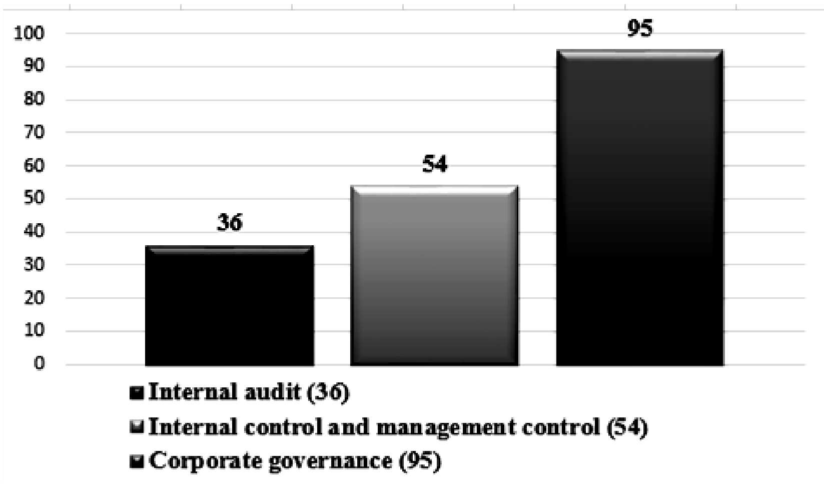

Fig. 3. Interdependence between control and audit (%)

Source: author’s processing based on [12, p. 50], [7].

Information in figure 3 suggests that 14 entities out of the 39 (36%) included in their annual reports information on internal audit. Position on *internal control and / or management control* holds the highest share of 54%, and facing it with corporate governance has led us to affirm that both control and audit are elements required by the Corporate Governance Code. The share of 95% means that 37 of the 39 entities included information on the top management structure. In this regard, we mention that audit and control are elements of corporate governance, and the management of entity uses them in combination because each one has different objectives.

IV. Conclusions

The theoretical, legal and pragmatic analysis of the relationship between control and audit leads us to mention that these are two parallel terms that serve to help the entity's management achieve strategic goals. Although most modern researchers are focusing on auditing or confuse them, it should not be neglected that audit is a controlling element.

The financial audit has been created to build confidence that the data in the financial statements reflect objectively the economic reality and are prepared in accordance with the legal and normative acts in force. The idea about the third pair of eyes refers to both types of audit. Thus, internal audit is a function within the entity, and, due to its independence from executive management, it checks the efficiency of economic activity and internal control procedures. External control is unexpected and is carried out by public institutions. The discovery of non-compliance with the legislative and normative acts in the audit is finalized by indicating various recommendations by internal and external auditors, while external controllers usually apply various fines, penalties, or warnings.

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