

POSSIBILITIES OF INITIAL ESTIMATION AND FURTHER VALIDATION OF INSIDE CONTROL RISK

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Abstract: The approach option of the theme of this essay had in mind the distinguished importance of the objective of inside control regarding the segmentation with maximum exigency of the risks which can disadvantageously influence the fulfillment of the entity objectives. We considered essential the use of adequate procedures regarding the estimation and documentary validation of inside control risk. Regarding the initial estimation we analyzed the phases that are justified to be followed (four) and the proper steps which are followed (ten), starting with the assessment of audit objectives on types of operations and ending with reporting to the competent institutions. Regarding initial risk validation we examined the subsequent circumstances of this operation which are influencing the forecasted risk level, like: adjourning of control mechanisms applications, the apparition of new legal procedures, the alterations of the entity's politics, etc.

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Key words: critical; inside control, initial risk estimation, subsequent risk validation, risk estimation procedure.

1. INTRODUCTION

As we know, during the phases of planning and execution of the inside control are being utilized many procedures, which are called data collection techniques and they refer to the projection and integration of inside control in the current activity of the entity. Moreover, the projection and the functioning of the inside control lead to the use of complex set of relevant information, which allow the estimation of the risk that can be generated and the testing of the mechanisms which are adopted. On the other hand, it is imposed to mention that the ending of those operations can be materialized in a document which contains the analysis of the way in which the obtained results are affecting the detection risk.

2. THE INITIAL ESTIMATION OF THE INSIDE CONTROL RISK

The planning of an audit mission presumes following the learning and understanding phase and the initial estimation of *the control risk* with the purpose of using its resources in an efficient way, there where these things are of interest for the entity. For the realization of an initial estimation of the inside control risk we follow **four mandatory phases** which **allow the identification of some essential elements** like: established of the **auditable character** of the entity; **the estimation of the control risk**, while learning and understanding the inside control system; **the justification of the estimated control risk**; the determination of the **adequate risk level**.

- In the in the stage of *setting of the auditable character of the entity* two factors are most important: the integration of the management and the adequate character of the documentation. Regarding the first factor, it is told that the audit procedures are based, in many situations, on the declarations of the management staff. This declarations *can be correlated* with other declarations of staff or can be strengthened with documents like decisions, a situation in which the procedure of finding of the integrity *will contain an active formed by affirmations or negations of the management staff and a passive which contains information from documents or certifications of other people*.

The adequate character of the accountancy or no accountancy evidence is found by the auditor using *the procedure of inventory of the forms of evidence existent in the said entity*. The nonexistence of a part of this evidence cannot be an impediment in the founding of the auditable character of the entity, if this can be reconstructed or moved to another place (in the case of entities which assure financial services) or an alternative information source can be identified. The latter can be materialized in electronic evidences, in which case professionals should be called. This professionals should be able to exploit the copies of the databases to satisfy the need of information and finally, to be able to collect reliable evidence. *The affected integrity and inadequate evidence are factors which will justify the auditor decision to appeal to the sole appeal: the entity is not auditable*.

- The estimation of the control risk presumes its determination on the basis the resulted elements from the learning and understanding of the system. This determination represents an initial estimation which tells how much is expected that mechanisms (the inside control instruments) used inside the system components will not prevents the apparition of important errors or not to detect or correct them. It is mentioned that the *estimation is done at the level of each audit object*, and then at the level of the activity an global estimation is realized. *The highlights of the estimations can either be realized through subjective expressions* like: low, medium, high or by using percents, according to the population included in the sample. If the sample is low and the probability of the circumstances of the risk is high, then the estimation might be overrated. This is why, in the initial estimation it is taken in consideration the management staff attitude over inside control, identified like a position over control forms applied over the activities and operations. The initial estimation is completed only if all the components of the inside control system and all the relevant mechanisms are taken into consideration.

- The initial estimation of the inside control risk represents a fixing phase of the risk profile and initiation of the determinations regarding the fact that *there is a possibility to justify a smaller control risk*, like a precursory phase of the establishing of the adequate risk. *The determinations are realized by inventory control instruments attached to an activity*, case in which it will be expressed the possibility of

identification a higher or lower number than the one stability by the initial estimation. This situation permits the auditor to lower or heighten the initial risk level, because he has sufficient arguments regarding the inside control mechanism.

- The last phase of the control risk estimation is the determination of its adequate level. This phase is about the auditor's decision regarding the control risk estimation, decision which is based on a logic cycle: *attitude, initial estimation, justification and in the end adequacy*. The decision is an economic one, based on the relationship between the auditor's effort (the costs of risk taking) and the impact (the added value introduced in the entity).

The approach of the inside control risk problem, as it results from the estimation phases presented before, need to apply some procedure, which *suppose to follow next ten steps: the setting of the audit levels; the identification of the specific control mechanisms; the identification of the flaw regarding the inside control mechanisms*; in this essay requires applying some procedures which assume following this ten steps: *the identification of the existing inside control mechanisms; the identification of the relevant and absent mechanisms; the determination and estimation of the potential errors which can appear; the analysis of the possibility that certain inside control instruments can compensate the absence of others; correlating the identified elements with the affected operations or activities; the estimation of the inside control risk; reporting the conditions to the competent institutions*.

The identification of the audit objectives requires an approach based on professional logic expressed while analyzing the operations included in the activities or in an operation cycle. In this case, the auditor will identify and approach each major operation type for setting the control risk generating circumstances; this helps him to identify the audit objectives. The expressions are realized only in general terms regarding each major category linked to a certain activity or cycle of operations.

The identification of the specific control mechanism is realized while analyzing the information from the entity system. The relevant information are obtained while identifying the politics and the procedures that are applied over the activities or cycle of operations which usually assure the management integrated operations controls. The auditor must assure a compatibility between the different types of control which should exist and those which could exist, while validating their existence. To complete this step, it is specified that the auditor needs to find clear answers to questions like: "Is the task separation realized?", "Are the documents adequate to this operation?", "Is the information access authorized?". In the realization of the information analysis the key mechanisms of the inside control are include because, the good practice shows that they are enough for completing the audit objectives.

The identification of the flaws regarding the inside control mechanism represent a ascertaining operation; this means that a flaw its given by the lack of an inside control mechanism which can generate additional risks. The practice in this field shows that the flaw identification problems implies that the auditor should use a different approach that will include the specified steps or approach them separate, like a follow-up of the identification operation. Regardless of the approach, **the importance of the steps** remains.

The identification of the existing control mechanism is being realized by correlating them with the mechanisms specified in the inside control picture, operation which ends with their certification as being functional in the entity.

The identification of the relevant and absent mechanism is being realized through the analysis of the answers given by the staffs which responsible with the inside control charts, corroborated with analysis criteria realized over the sequential diagrams.

The determination and estimation of the potential errors which could result is a mandatory step. As shown before, the lack of certain instruments is directly proportional with the magnitude of the flaws or the generation of important problems (i.e. fraud).

The analysis of the possibility that certain inside control instruments can compensate the absence of others is a prudential step in the setting activity of the inside risk, because there can be the possibility that the entity could have compensated the lack of a mechanism by implementing another which has the purpose of annihilating the impact.

Considering those presented above, states that the identification of the flaws must be formalized in a document which has a content that follows a logic cycle: flaw – compensating control mechanism – potential error - significance - the implication on the future audit activities.

Correlating the identified elements with the affected operations or activities assumes that the auditor must use a support instrument of the control risk estimation. This instrument is known in the specialized works under the name of *the control risk matrix* and its being used because of some expressions which appeared out of the analysis, which show that the lack of a certain mechanism affects many operation related objectives. This matrix can be presented in this way:

Inside Control		Audit Objectives			
		The analysis is correlated with the real solicitations	The operations are written in the registry	The analysis justify the use of reactives	Serviciile sunt încasate în totalitate
Key Mechanisms	The solicitations are made by the hospital	C	C		
	The requests are authorized	C	C		C

Flaws	The reactive reception is not being realized			Unconf ormed	
	There is no information regarding paid amount				Nec.
Estimated Risk		Low	Low	Medium	Medium

The estimation of the inside control risk, as it is observed from the presented matrix, is realized for every audit objective while taking into account the level of usage of the inside control mechanisms or the identified flaws.

Reporting the significant conditions towards the competent institutions is being realized according of the information content and their usage competency. This way, the information afferent to the learning, understanding and estimating the inside control risk are being communicated towards the audit committee in a written (a letter)

or spoken (communication and the presentation of the work sheets) way. The less important aspects of the inside control or regarding the existence of certain opportunities of improvement of the inside control are being reported, even if this is not mandatory, towards the managers. The auditors write this report as an added value service, and the information give to the management or the audit Committee will be used in the setting of the audit objectives, sizing resources and staging of the applied procedures. The process of risk estimation is complex, the auditor being obliged to follow every phase mentioned before.

3. THE VALIDATION OF THE INITIAL ESTIMATED INSIDE CONTROL RISK

The inside control risk is usually estimated and founded using the correlation between the flaws and the qualities regarding the mechanisms or instruments used with audit objectives afferent to the economical forecasted operations. In this situation, we should decide if the estimated level is justified or not, and the auditor will signal relevant aspects of the functioning inside control mechanisms. This analysis is mandatory to be realized because, even if the estimated level is founded, the auditor, in the end, has to present the mitigation of the recommendations. In the audit activity, the problem of the level, the substantiation and recommendations are being analyzed on the basis of the specific evidence regarding the efficiency of the applies on the whole period that is subject to auditing obtained through the testing of the inside control mechanisms. *When the obtained results confirm the expectations of the inside control mechanism the risk level remains unchanged, while in the situation where flaws exist, the level should be corrected (lowered or heightened).*

It is important to remember the fact that the *efficiency of applying inside control risk initial estimation mechanisms is affected by circumstances like:* interruptions of applying following a temporary lack of responsible people, the routine in the application of the procedures, the application of new legal procedures, the modification of the politics, etc, which, as we can see, have the probability equal with one (they already happened). As a consequence, the risk exposure is high and this circumstances will be validated and will become solid arguments regarding the modification of the risk level (heightening), and, in the end, in the adequate identification of the recommendations. In this sense, we can use several specific procedures which are presented below.

- *The testing of functioning of the inside control mechanisms* (mechanisms which presented flaws, as it was presented in the control risk matrix) assumes redoing certain procedures specified while **stabilire** risk level or applying certain analytical validation procedures. This is why, through testing, according with forecasted results, the auditor can redo the questioning procedure of the responsible employees and the reexamination or extension of report, evidence and documents examination procedure. It is told that redoing these procedures is mandatory for the mechanism in which were found flaws and those affected by risk generating events.

- Moreover, it is mandatory that the auditor make a call to the ***observing and exminating of the inside control activities procedure***. This activites should be integrated in the management line, especially for the activities which ask for an hierarchic control, auto control, mutual control or other forms of specialized control (patrimonial control, financially preventive, authorizations, etc). For these cases, the auditor makes a list and specifies the type of examination and observation, including the obtained results. According with the relevance of the results, the initial estimated control

risk will heighten or be maintained at the same level, and the results will be used as evidence which justify the well functioning or syncops of the applied control mechanisms.

- Another procedure used in testing the inside control mechanisms, that had good results, which can guarantee a certain level of inside control risk is **remaking the operational procedures** for the mechanism in which flaws were found. In this case, we do not talk about following the used procedures, but of using one made by the auditor, applied and the compared to first one. Using this procedure, we can identify the errors in the operational steps, including the results and such can be establish the exactly their causes.

4. CONCLUSIONS

Regarding the procedures applied with the purpose of knowing the risk level of the inside control, it is seen that firstly, they have a temporary finality, because this first operation needs a validation, and then a subsequent justification. These activities require applying certain testing procedures of the corresponding mechanisms and extension of the procedures, and the finality of the activity will be materialized through determination the planned detection risk and projecting the imposed tests.

The analysis of the estimation and testing activates highlights aspects which will be presented below:

- ✓ The existence of significant overlap between the corresponding procedures of the two activities: observing, documenting and questioning.
- ✓ The essential differences between using this procedures, meaning that in the estimated risk determination phase, the procedures are applied to all inside control mechanism, and in the testing phase the procedures are applied only when the estimated risk is under the maximum level, but even the they are applied only to the key mechanisms of the inside control
- ✓ Selective application of the risk estimation procedures for one or more operations, while for testing the functionality of the inside control mechanisms it is used a greater sample of operations which contains periods selected after signal-criteria
- ✓ Reconstruction procedures are applied as a continuation to the activity reconstruction ones, with the purpose of more efficient resource usage and obtaining a correct understanding of the control system

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