

## INTERNAL FINANCIAL ACCOUNTING CONTROL OF PRIVATE ENTITIES

**Radu Dorin Lenghel**

***Abstract:** Internal control is an integrated process carried out by the management and staff of the entity, designed to approach risks and to provide a reasonable assurance in the exercise of the entity's mission, by the fulfilment of the following objectives: realization of functions and assignments in an economic, efficient and effective manner; observance of legal regulations and management orders; protection of resources against abuses, losses or frauds; development, maintenance and supply of accurate and complete financial information for the substantiation of management decisions. The activity of financial accounting control is exercised by the accountant in chief and heads of offices from the financial accounting department.*

*The internal financial accounting control of the entity applies for the assurance of an accounting management and a financial follow-up of its activities, in order to achieve the objectives defined. The financial accounting internal control is a major element of internal control. It targets the totality of processes for obtaining and communication of accounting and financial information and contributes to the realization of reliable information in compliance with the legal requirements.*

*The internal control organized at entity level is the responsibility of management and represents the totality of measures taken by the management and implemented by the whole staff regarding the organizational structure, the procedures, instruments and techniques applied for the purpose of achieving the objectives of the entity.*

***Keywords:** internal control; internal financial accounting control; internal control components, control activities; objectives of internal financial accounting control, correction of errors.*

### **1. Purpose and objectives of internal control**

The purpose of internal control is to assure the coherence of objectives, to identify the key factors of success and to communicate in real time to entity leaders the information regarding performances and perspectives. Regardless of the nature or size of the entity, the efforts

made for the application of a satisfactory internal control are related to the application of good practices.

Internal control is an integrated process carried out by the management and the staff of the entity, designed to approach risks and to provide a reasonable assurance in the exercise of the entity's mission, by the fulfilment of the following objectives: realization of functions and assignments in an economic, efficient and effective manner; observance of legal regulations and management orders; protection of resources against abuses, losses or frauds; development, maintenance and supply of accurate and complete financial information for the substantiation of management decisions.

The internal control organized at entity level is the responsibility of management and represents the totality of measures taken by management and implemented by the whole staff regarding the organizational structure, the procedures, the instruments and techniques applied, for the purpose of achieving the objectives of the entity.

The internal control system represents the totality of policies and procedures adopted by management, which contribute to the fulfilment of management objectives, to the prevention and detection of frauds or errors, to the accuracy and exhaustiveness of accounting entries and to the preparation in due course of financial accounting information.

The role of internal control can be summarized as follows: limitation of uneconomical and inefficient operations; assurance of patrimony integrity; assurance of a thorough and efficient management of activities; observance of orders given by the management; observance of legal provisions; reality and accuracy of accounting information.

In accordance with the legislation in force<sup>1</sup>, the internal control represents the totality of policies and procedures elaborated and implemented by the management of public entity in order to assure: the achievement of entity objectives in an economic, efficient and effective way; the observance of rules specific to the field, policies and decisions of the management; protection of goods and information, prevention and detection of frauds and errors; quality of accounting documents and the provision in due course of reliable information for the management.

In the meaning of legal regulations, the internal control of the entity aims at assurance of:<sup>2</sup> conformity with the legislation in force; the application of decisions made by the management of the entity; the

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<sup>1</sup> Law no. 672/2002 regarding internal public audit, republished in 2011.

<sup>2</sup> OMFP no. 1802/2014 for the approval of accounting regulations regarding the annual individual financial statements and the annual consolidated financial statements.

good operation of internal activity of the entity; the reliability of financial information; the effectiveness of entity's operations; the efficient use of resources; the prevention and control of risks of not achieving the objectives set etc.

Therefore, the internal control procedures have the objective:

- on one hand, the follow-up of integration of the entity's activity and staff behaviour in the framework defined by the applicable legislation, the values, norms and internal rules of the entity;
- on the other hand, checking whether the accounting, financial and management information communicated reflects correctly the activity and situation of the entity.

The internal control applies throughout the operations carried out by the entity as follows:

- prior to the realization of operations, on the occasion of drawing up the budget, which will allow the budgetary control after the realization of operations;
- during the operations, such as the determination of percentage of physical realization of production in progress of execution or the percentage of scrapings recorded;
- after the completion of operations, in which case the checking is designed, for example, to analyse the profitability of operations and to note the existence of conformity or possible anomalies which must be corrected.

Depending on the moment when it is exerted, internal control can be: *preventive* (ex-ante), made before the approval of operation and with a diversity of concrete forms, among which the most known are preventive financial control and the authorizations issued by the legal department or another specialized department; *hierarchical-operative* (*concomitant*), executed by persons with management positions during the process flow; *subsequent* (ex-post), made post-factum, usually by the management control department and by heads from different levels of the company.

## **2. Internal control components and activities**

### **a. Internal control components**

In order to achieve its objectives internal control has the following components closely related as follows:

- a clear definition of responsibilities, resources and adequate procedures, information methods and systems, adequate instruments and practices (control environment);

- internal dissemination of pertinent, reliable information whose knowledge allows each person to carry out his/her responsibilities (information and communication);

- a system which aims, on one hand, at the analysis of the main identifiable risks regarding the objectives of the entity and, on the other hand, the assurance of existence of risk management procedures (evaluation of risks);

- adequate control activities for each process designed to reduce risks which may affect the accomplishment of entity's objectives (control activities);

- a permanent supervision of internal control device and an examination of its functioning (monitoring of controls).

### **b. Control activities**

Control aims at the application of internal control norms and procedures at all hierarchical and functional levels: approval, authorization, checking, evaluation of operational performances, reporting, supervision, securitization of assets, separation of functions.

Apart from the control activities integrated in management line (self-control, mutual, hierarchical), specialized controls can be organized carried out by structural components specially created (commissions, control departments etc.), whose activity is carried out based on a plan designed by taking into account risks.

The internal control system must be developed and implemented by the manager up to the level which allows him a better control over the operation of all activities in order to achieve the objectives set.

Internal control is found in the structure of each activity, being a process made by all the employees, so it is not a distinctive department in the entity.

The control activities are carried out in the whole entity, at all its levels and positions.

The management of the entity establishes for each activity which are the most adequate forms of internal control in view of limitation of risks.

Internal control is found in the structure of each activity and must be formalized by procedures, based on the job descriptions and check questionnaires.

As far as it concerns the method of implementation of control activities, in most entities they are not formal (there are not specific procedures).

### 3. Objectives of internal financial accounting control

The internal financial accounting control activity is carried out by the accountant in chief and heads of offices from the financial accounting department.

The internal financial accounting control of the entity applies in view of assuring an accounting management and a financial follow-up of its activities in order to achieve the objectives defined.

The internal financial accounting control is a major element of internal control. It aims at the totality of processes for obtaining and communication of financial and accounting information and contributes to the realization of reliable information compliant with the legal requirements.

Just like internal control in general, it is supported by a system which comprises especially the elaboration and application of policies and procedures in the field, including the supervision and control system.

The internal financial accounting control aims at the assurance of:<sup>3</sup>

- conformity of accounting and financial information published, with their applicable rules
- the application of instructions elaborated by the management in relation to this information;
- protection of assets;
- prevention and detection of frauds and accounting and financial irregularities;
- reliability of information disseminated and used at internal level for control purposes, to the extent that they contribute to the elaboration of accounting and financial information published;
- reliability of annual financial statements published and other information communicated to the market.

The internal financial accounting control has the following objectives to check:

- organization and updated running of accounting;
- whether all the operations made the object of a registration (exhaustiveness);
- whether any entry is justified by an operation (reality);
- whether there are errors in the accounting of amounts (accuracy);

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<sup>3</sup> OMFP no. 1802/2014 for the approval of accounting regulations regarding the annual individual financial statements and annual consolidated financial statements.

- organization and running of accounting of fixed assets, inventory items, materials;
- establishment and payment of money rights owed to staff;
- establishment and transfer of company contributions and salary tax;
- establishment and transfer of taxes and duties;
- establishment and performance of deductions with third parties;
- existence of cash and other valuables in cash register according to the cash book and accounting;
- the method of keeping operative records and the agreement with accounting records;
- whether the results of annual inventory were correctly revaluated;
- control of accounting correlations (correspondence of accounts, between synthetic and analytical accounting, trial balance and annual financial statements);
- the method of drawing up trial balances and annual financial statements.

#### **4. Settlement of errors noticed after financial accounting control**

The errors noticed in accounting can refer either to the current fiscal year or to the previous fiscal years. Such errors include the effects of mathematical mistakes, errors in the application of accounting policies, ignorance or wrong interpretation of events and frauds. The correction of errors noticed on the occasion of internal financial accounting control is made at the date of acknowledgement depending on the moment of acknowledgement, their size and significance threshold.

Accounting errors can affect both the balance sheet and the profit and loss account or only one of the two components relating to the annual financial statements. Accounting errors which affect only the balance sheet are due to: the omission of registration of fixed assets, material goods, use of inadequate accounts, registration of wrong amounts in accounts, errors which do not influence the registered results.

The accounting errors which affect the income and expenses accounts are more serious because they influence the profits of the company from current or previous periods, with implication on the taxable profit, which may lead to the payment of fines, interests, delay penalties and the value of dividends.

If the errors relate to the current fiscal year, their correction is made in the profit and loss account, therefore if the errors belong to the fiscal year which ends and are noticed until the closure of fiscal year (submission of balance sheet), their correction will be made in the current fiscal year.

The correction of insignificant errors related to the previous fiscal years is made either in the account of carried forward profit, I or in the profit and loss account, therefore, their correction will be made in the annual financial statements of the fiscal year which ends. The correction of significant errors related to the previous fiscal years is made in the account of carried forward profit.

Following the correction of errors from the previous fiscal years the financial statements of those fiscal years do not change, therefore it is assured the observance of intangibility principle, according to which the opening balance sheet must correspond to the closing balance sheet of the previous fiscal year. In case of errors in the previous fiscal years, their correction does not imply the adjustment of comparative information presented in financial statements. The comparative information regarding the financial position and financial performance, respectively the change of financial position, is presented in explanatory notes. In case of correction of errors which generate carried forward accounting loss, this loss must be covered before making any allocation of profit. Supplementary information regarding the errors noticed must be presented in explanatory notes (note 10) to financial statements.

## **5. Case studies regarding the settlement of errors noticed after the internal financial accounting control**

### **Exemple no. 1**

In a company it is noticed in August 2015, after the internal financial accounting control, that no delay interests were recorded in amount of 5.000 lei and the delay interests were acknowledged in the fiscal inspection report, and were calculated for the non-payment of budgetary obligations for the period April-June of the same year.

Solution:

Because the errors relate to the current fiscal year, their correction is made in the profit and loss account. Because the error was discovered in the same fiscal year, its correction will be made directly in the accounts of expenses with penalties by the following accounting formula:

$$6581 = 4481 + 5.000 \text{ lei}$$

**Exemple no. 2**

In a company, after the internal financial accounting control carried out in July 2015 it is noted that the company did not record an invoice representing services provided in amount of 20.000 lei, at its issue (30<sup>th</sup> April 2014). According to the accounting policies of the entity any error is significant if its value is higher than 1% of the total assets of the entity (significance threshold). According to the normative acts in force, the insignificant error related to the previous fiscal years is corrected in the carried forward profit account or in the profit and loss account.

Solution:

a. *The case when the insignificant errors are corrected at the expense of the carried forward profit:*

– according to the accounting policies of the entity, the significance threshold is 1% of total assets of the entity,  $1\% * 3.000.000 \text{ lei} = 30.000 \text{ lei}$ ;

– the error is insignificant because it is lower than the significance threshold;

– registration of omitted invoice in the carried forward profit account:

$$4111 = 1174 \quad 20.000 \text{ lei}$$

b. *The case when insignificant errors are corrected at the expense of the profit and loss account:*

– according to the accounting policies of the entity, the significance threshold is 1% of total assets of the entity,  $1\% * 3.000.000 \text{ lei} = 30.000 \text{ lei}$ ;

– the error is insignificant because it is lower than the significance threshold;

– registration of omitted invoice in the profit and loss account:

$$4111 = 704 \quad 20.000 \text{ lei}$$

**Exemple no. 3**

In June 2015, on the occasion of internal financial accounting control it was acknowledged the omission of registration of expenses invoiced by third parties in amount of 20.000 lei (the significance threshold is 18.000 lei). According to the accounting policies of the entity the error is significant (it exceeds 18.000 lei). According to the normative acts in force the significant error related to the previous fiscal years is corrected in the carried forward profit account.



Solution:

– registration in 2015, of expenses invoiced by third parties for the fiscal year 2014 in the account of the carried forward profit:

1174=401 20.000 lei

– after the approval by the General Meeting of Shareholders of annual financial statements for the year 2015, we will record the allocation of profit for the coverage of the loss resulted from the correction of accounting error:

1171=1174 20.000 lei

#### **Exemple no. 4**

In June 2015, on the occasion of merchandise inventory it was reported a minus in inventory of 20.000 lei. Following the interrogations the inventory commission acknowledged that the merchandise was sold in December 2014, but the invoice was not recorded in accounting books (the value of invoice is 30.000 lei). The significance threshold is 20.000 lei. According to the accounting policies of the entity the error is significant (it exceeds 20.000 lei). According to the normative acts in force the significant error related to the previous fiscal years is corrected in the account of the carried forward profit.

Solution:

– the registration in 2015 of the invoice for sale of merchandise related to the fiscal year 2014, in the account of carried forward profit:

4111=1174 30.000 lei

– registration in 2015 of the discharge of management :

1174 = 371 20.000 lei

#### **Example no. 5**

A company incurs expenses with the modernization of a production shopfloor in 2014, in amount of 300.000 lei, which it records as fixed assets in December 2014 and decides their depreciation for a period of 10 years, starting from January 2015.

In August 2016, following the internal financial accounting control, it is noticed that these expenses were wrongly recorded as tangible assets because the recognition criteria was not observed and

they should have been recorded as expenses with repairs. The significance threshold is 1% of total assets (1%\*15.000.000 lei) =150.000 lei

Solution:

The correction of significant errors is done as follows:

– modernization works recorded in December 2014:

212 = 722 300.000 lei

– cancellation in the year 2016 of modernization works performed in the previous years, at the expense of the carried forward profit:

212 = 1174 – 300.000 lei

– cancellation in 2016, of the depreciation recorded in the year 2015:  
monthly depreciation:  $300.000 / 120 * 12 = 30.000$  lei

1174 = 2812 – 30.000 lei

– cancellation in the year 2016, of the depreciation related to the current fiscal year:  $300.000 / 120 * 7 = 30.000$  lei

6811 = 2812 – 17.500 lei

## 6. Conclusions

In relation to the method of organization and exercise of internal financial accounting control, we can draw the following conclusions:

- the activity of internal financial accounting control is carried out by the accountant in chief and heads of offices from the financial accounting department;
- the internal financial accounting control aims at the totality of processes for obtaining and communication of accounting and financial information and contributes to the realization of reliable information in compliance with the legal requirements;
- as far as it concerns the method of implementation of internal financial accounting control activities, it is noted that in most entities they are not formal (there are no specific procedures);
- the correction of errors noted on the occasion of internal financial accounting control is done at the date of

- acknowledgement depending on the moment of acknowledgement, their size and significance threshold.
- from the legal regulations (OMFP no. 1802/2014), it does not clearly result which are the procedures and policies for implementation of internal financial accounting control which apply to a private entity;
  - in the legal regulations only a certain form of internal control is developed, represented by internal accounting and financial control (financial accounting control) as if the other forms of internal control were inexistent;
  - as for internal control components, they are presented in another form, but similar to the already consecrated models of internal control (Coso and Coco );
  - as for the methods of implementation of internal financial accounting control only some general aspects are presented;
  - the general objectives of internal financial accounting control are presented also in the legal regulations;
  - the legal regulations do not present the procedures or specific techniques of checking the internal financial accounting control, they propose that they are represented by: inspection, observation, investigation (interview, interrogation), confirmation, calculation, analytical procedures etc;
  - as one can see, the legal regulations attribute a significant importance to only one of the internal control components, which is the internal financial accounting control, from where result the details of the general objectives of the internal control of financial and accounting function;
  - regardless of the way the internal control is organized, the manager in the fulfilment of managerial objectives, has to choose the most adequate forms, techniques or procedures of internal control;
  - in relation to the case studies we presented the methods of registration in accounting of the errors acknowledged as a result of internal financial accounting control.

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**NOTE ON THE AUTHOR**

**Lenghel Radu Dorin**, doctor in economics, reader at the Finance and Accounting Department from the Faculty of Economic Studies Cluj-Napoca. He is the author of many scientific works and specialized books in the field of accounting, financial control and financial audit. He has now the teacher tenure of bachelor's and master's degree courses in the following subjects: *Financial Control and Financial Audit, Auditing of financial statements, Internal Control and Internal Audit, Accounting of Public Institutions, Management Accounting.*  
*radulenghel@yahoo.com*