RISK ASSESSMENT OF INTERNAL AUDIT OF PUBLIC ENTITY

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Abstract: *In the last years it is becoming increasingly actual the recognition of corporate governance involvement and the risk management in public entities, the importance of approaching this issue is evidenced by the current situation faced by internal auditors. The entity is a body constantly changing which evolves in complexity, besides traditional exposure to the hazard, thus adding operational, financial, strategic, legal, human, and fraud risks. The complex nature of the risk can be attributed to several factors. Internal auditors have an important role in the risk assessment, processes, systems, and addressing or providing recommendations is the result of everything that happens and what can it lead to. Planning the internal audit activity implies a broader evaluation of operational risks and the environment in which it works. The topic approached in this article refers to the risk assessment and internal audit work plan in order to assist an entity in achieving its objectives by implementing a systematic and disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes.*
Keywords*: risk, internal audit, public entity, management, internal control.*
JEL Classification*: H83, G32, G34.*

1. Introduction

"There is no risk equal to zero. A good auditor does not exclude any risks."
Marcel Ghiță

Risk management is the art of taking decisions in a world governed by uncertainty, which is a complex scientific approach to the risks that use material, financial and human resources to achieve the objectives aimed at reducing exposure to losses.

Assessing risk exposure in an entity pressuposes not just damage caused to top manager but also to employees, customers and beneficiaries. From this regard, the objective of "social responsibility" must belong to both category of goals such as pre and post event.

The assessment of operational and strategic risks represents one of the most important and complex stage of implementation and monitoring of financial management and control, which allows identification of potential hazards that exist within the entity, which may have a negative impact in achieving its objectives and and which have the finality of highlighting, as possible, all existing risk. The advantage of the assesment is the planning of internal audit activity and the planning of prevention measures in order to minimize risk and achieve the entity's objectives, which are aimed at increasing of efficiency and credibility

2. The planning of internal audit activity

Control activities of operational managers serve as a lever for attenuating inherent risks and those that are not identified or mitigated represent the residual risks, accepted and potentially supported by the public entity. The purpose of internal audit is to assess residual risks of internal control system by providing recommendations for its improvement, thus it will help improving its operational activity, but it won't assume any responsibility for risk management. In this order of ideas, it is very important for internal auditors to understand that managers are responsible for the efficient and effective function of the risk management system.

In first phases of the planning process of audit activity, it is carried out an objective analysis of the pre and post event which functions in an entity, as well as the operations characteristics. In this context, it is established whether the organizational culture of risk is predominantly opponent or it is not by the help of (Book of Internal Audit, 2013):

- Veracity and integrity of financial and operational information;
- Effectiveness and efficiency of operations and programs;
- Security of the assets;
- Agreement with legislation, normative and domestic regulations.

In order to assess residual risks of operational managers, the auditor uses professional judgment to estimate numerous factors, examples of which are:

a) Examines whether all significant risks have been identified, afterwards have been evaluated by managers and have been taken into consideration in the planning process;

b) check whether mitigation measures (control activities) are implemented and operates in the established manner;

c) evaluates if risk management system involves monitoring, updating and reporting of risks faced by the entity;

d) assesses the probability of fraud risks.

Thus, internal auditors contribute to the improvement of risk management processes by evaluation of the effectiveness and functionality of the system of risk management to the extent that:

- the employees manage the risks (culture, responsibility, awareness, training, capacity);
- the attitude to risk is incorporated into processes (context, organization, identification, assessment, evaluation criteria, control, review, monitoring and reporting);
- the risks are under control and their management contribute to the reach of the goals (better predictions, better decisions, review and insurance, better planning, better financial management).

Methodological Norm number 10 of the internal audit in the public sector establishes the following techniques and tools to assess risk management:

- the interviewing of managers and staff;
- the analysis of policies and procedures documentation;
- the evaluation questionnaires;
- the assessing of the effectiveness and efficiency of processes / control activities

In a world of uncertainty, the major risks have a significant impact because they generate a cost, known as the risk cost. The internal auditor should obtain a sufficient understanding of control procedures to ensure that the risk is reduced to an acceptably low level.

Due to the fact that internal control procedures are integrated into internal control environment, the auditor develops such an activity based on risk. According to national standards, the internal audit will demonstrate professional care regarding the adequacy and effectiveness of the risk management, control and governance of the public entity and the probability of errors, fraud, irregularities or significant nonconformities.

Taking into account that the manager of the public entity tends to get insurance that the strategic plan and annual plan addresses the identified risks by operational managers, the internal auditor plans the internal audit (audit engagement) based on the repeated assessment managers high risks.

The premise of an audit mission must take into account the extent that it can improve the risk management process, as well as all of the entity's operations by following the strategic plan period and the frequency with which each system / process will be audited, where the professional judgment is applied.

The strategic plan is based on a risk assessment, taking into account the provisions of NIAS, the identification and definition of risks are part of the strategic planning of the public institution that will provide the necessary visibility and strategic focus, because, basically, this plan "invent" the future, it is a road map that sets out future directions which the organization leads to. In these circumstances, entities that have developed an effective risk management, in the past they have been able to maintain an effective internal control or to develop it. It is true that the past cannot be changed, but one can draw on his account alarm signals, one can return to some decisions and plans that have not yet been implemented.

Strategic plan requires more frequent auditing systems / processes with high risks to provide assurance that they are kept under control. During the first missions, there are identified elaborately the control activities, which are being particularly emphasized. Within the following mission, these control activities are further tested after confirmation that the objectives of the system / process and control objectives remain unchanged.

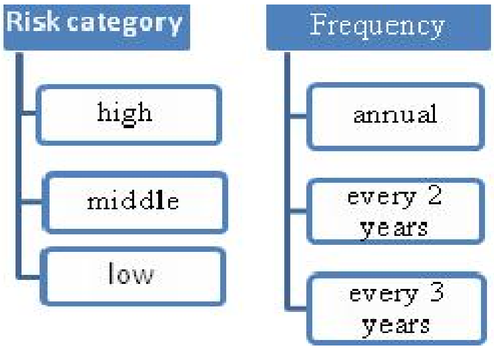

Figure 1. Reference model of a strategic plan for three years

Source: Book of Internal Audit, 2013.

Systems / processes with medium risk require less frequent missions, because even if they are not audited in a particular year, risk exposure is relatively small. Subsequently, the internal auditor takes into account the results of previous missions, as that collected information and evidence will later confirm that there have been few changes.

In the case of systems / processes with reduced risks, tasks can be performed less often, every mission providing minimal additional security requirements. Periodically reviewing of the systems / processes with reduced risks provides insurance that the risk exposure has not changed.

Planning is not a separate phase of the audit, but rather a continuous process that runs parallel with the execution of the audit. Adequate planning helps the auditor to organize work efficiently and effectively, its efforts being focused on important areas. According to NIAS the auditor should plan their tasks so as to ensure achievement of business in an effective manner to define their scope, its timing, and direction.

Methodological norm number 3 of internal audit in the public sector provides clear instructions for dealing with risks from strategic planning and annual internal audit activity.

Also at the planning phase of the mission it is carried out a risk assessment associated with audited units, and then this assessment will be reflected in mission’s objectives. In case the public entity manager accepts an intolerable level of residual risk, there take place rational discussions upon the causes of risks with the top-manager.

Thus, internal audit at different stages of the activity approaches risks differently (Book of Internal Audit, 2013):

a) *The strategic and annual planning:*

- Analysis of the risks related to public entity's objectives;
- Assessing inherent risks at each level (strategic risks, financial risks / performance, risks, operational risks and compliance);
- Determining the priority areas to be covered by future missions;

b) *Planning missions*:

- Determining the mission objectives
- Examination of the potential risks related to the mission's objectives;
- Assessment of inherent risks connected with the objectives of the audited unit (operational risk) and knowledge about the effectiveness of controls (risk compliance);
- Selection of areas for analysis and testing to achieve the objectives of the mission;

c) *Carrying the tasks (insurance and counseling):*

- Examining the risks objectives of the system / process audited;
- Assessing the risks involved in the control objectives / control activities (operational and compliance risks);
- The identification and selection of control activities to be examined / tested;
- Testing of control activities;
- Determining the level of residual risk;
- Examining other information related to inherent and residual risks;
- Updating the annually and / or strategic plan as a result of risk assessment;
- Announcing the public entity's manager about high unacceptable identified risks;

d) *Reporting*:

- Reporting audit findings and conclusions at the level of residual risks;
- Providing audit recommendations about approaching unacceptable residual risks.

Strategic planning approach based on risk offers the next advantages (Book of Internal Audit, 2013):

a) ***a comprehensive audit*** - methodology based on top-down approach enable them to provide insurance systems such that all major systems are included;

b) ***an effective audit*** - channeling resources to areas where resources are most needed;

c) ***the added value of internal audit*** - operational managers increased awareness of the objectives, systems, processes and risks.

Carrying about risk management and its impact on all levels becomes thus relevant for entities that can still learn from mistakes and examples of others and equally for those who study and analyze the market, as topical and interest issue.

3. The methods of risk assessment

The opportunity of adoption of any managerial decisions in which nature originally persists a certain degree of risk, can be justified only by analyzing and evaluating them. To plan efficiently the activity is not enough to know the type of risk that can influence the activity of subdivisions of entity; it is also necessary to calculate its size, namely to assess the consequences that may arise from its influence.

The internal auditors develop methods for risk assessment based on the value of transactions, budget, staff turnover, materiality, organizational structure, the complexity of the regulatory framework, the findings of previous audits etc. There are used various techniques for performing relatively systematic and objective analysis in order to have a less subjective approach. By the use of these techniques it is supported an auditing professional judgment regarding the priority and frequency of missions. At present, public entities face the following risks:

a) political instability;

b) frequent changes in legislation;

c) conflicts of interest;
d) insufficient and incorrect accounting;
e) negative image and reputation damage;
f) fraud, corruption;
g) use against destination, wastage and loss of property;
h) incorrect planning and wrong decisions;
i) inadequate information systems.

In providing reasonable assurance regarding the strategic planning of internal audit activity one should analyze risk factors through multiple methods.

A. The method of establishing the risk level based on the assessment criteria.

At the initial stage, it follows a meeting with the top manager where there are analyzed the main risks to be attributed to each system / process category of risk (for example, high, medium, low), thereafter the systems / processes that internal auditors assess primarily are being classified, namely (Book of Internal Audit, 2013):

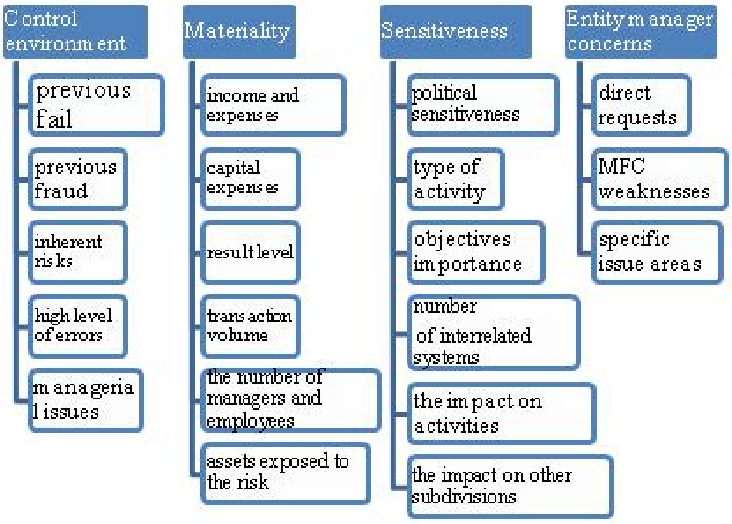

Figure 2. General criteria of risk assessment for its counting score
Source: The book of internal audit

Risk score calculation will be carried out based on indicators:

Table 1. Award procedure for the risk factor score

Criteria	Description	Parameter
A. Materiality	The system / process has a weight less than 1% in the annual budget	0
	The system / process has a weight of 5-10% in the annual budget	2
	The system / process has a weight of 25-50% in the annual budget	3
	The system / process has a weight over 75 % in the annual budget	5
B.Control environment/ vulnerability	System / process well controlled, with a low risk of fraud or error	0
	System / process relatively well controlled, with some risk of fraud or error	3
	System / process ineffectively controlled, with high risks of fraud or error	5
C. Sensitiveness	The system / process has minimal contact with the external environment	0
	Certain complications with the external environment are possible, if the system / process is not effective	3
	Major legal problems, if the system is not effective	5
D. Manager concerns	System / process with a reduced role in the activity of the public entity that has little impact on the achievement of its objectives	0

	System / process with a leading role in the activity of the public entity in the recent past, involving some concerns due to repeated failures	5

Source: *The book of internal audit*

Thus, according to this method there are used four risk criteria which are assigned with specific index between 1 and 5, and each risk criterion is assigned with a certain weight using the reasoning of its relative significance. These weights vary depending on the type of public entity. The following is an example of applicable weights:

Table 2. The way of assigning weight for risk factor

Criteria	Weight
A. Materiality	3
B.Control environment/ vulnerability	2
C. Sensitiveness	2
D.Manager concerns	4

Source: *The book of internal audit*

The index and weights are combined into one formula which is used for the calculation of the risk score:

Risk score = ***(A x 3) + (B x 2) + (C x 2) + (D x 4)***

Table 3. The risk score in accordance with category

Risk score	Risk category
Over 49	High
30 – 49	Medium
Less than 30	Low

Source: *The book of internal audit*

The formula is applyed to calculate the risk score for each system / process. After that, the systems / processes are classified under the following matrix, assigning them following scores: high, medium, low - very high, high, medium, low, very low.

This method can easily be changed, that means that there can be used more risk criteria, several categories of risk - very high, high, medium, low, very low. In this case (multiple risk criteria / multiple risk categories) it will be necessary to use other risk weights for each criterion and other values of the score for each risk category. Risk score is always expressed in whole numbers. It is important to keep in mind that many risk criteria are intuitive and not based on absolute values.

B. Method of guidelines

The model promotes uniform definition of the universe of internal audit or the audit field so audit risk on each compartment of the public entity can be compared with those of others compartments on an objective basis depending on the geographical distribution of risks and staff entity.

The scope determining of the audit is a prerequisite risk hierarchy, which will be based on the entity's strategic planning and activity.

Uniform approach of the risk analysis of internal audit universe, auditable respective areas can be based on the following risk factors, namely (Ghiţă, 2009):

• Previous audit findings;
• Sensitivity of the system as perceived;

• The control environment;
• Confidence in operational management;
• People or systems changes;
• Complexity.

The results from the review will be counted and multiplied by the "age factor" of auditing, namely:

Table 4. Age coeficient of the frequency of realized audits

Similar audit in the last 24 months	100 %
Similar audit in the last 25 – 36 months	125 %
Similar audit in the last 37 – 60 months	150 %
Audit older than 60 months	200 %

Source: Drafted by M. Ghiță, Internal audit

In this way the results of analyzes carried out will vary between 6 - 36, which will allow to group into four categories.

Table 5. Assignment category of the age factor and the frequency of performed audits

Category	**Type of risk**	**Proportion**
The layer of 10%	Maxim	100%
The layer of 20%	Sensitive	50%
The layer of 30%	Moderate	25%
The layer of 40%	Low	10%

Source: *Adopted by M. Ghiță, Internal audit*

The identification of the risk analysis factors and their levels of assessment is being carried out in accordance with the recommendations from NMAISP for the use of factors regarding: the assesment of internal control, the quantitative and qualitative assessment, where we can add other factors specific for the activity.

We mention that in order to establish the risk weight, there should be taken into account the importance and the weight of risk factor in the framework of that activity, and also the fact that the weight sum of risk factor must be 100 % (Ghiţă, 2009).

According to the criteria we set the following weights:

- Assessment of internal control 40%;
- Quantitative assessment 25%;
- Qualitative assessment 20%;
- Legislative changes 10%;
- Staff seniority5%.

The risk factor is the element used to identify the likelihood that events have a negative impact on an auditable activities and the level of assessment is the change produced by its impact on the auditing profession.

This stage is meant to focus by carrying out the table „ The situation regarding the analysis factors of risks and the levels of their assessment”. The level of the risk based on assessment criteria is being realized by adding a assessment level to each analysis factor of risk. Phase is achieved through preparation of the statement setting. The determining total score of risk is achieved by applying the weight level to assess each risk factor levels of risk in order to determine the total score based on the formula (Ghiţă, 2009):

Pt = ġPi* Ni

where:

Pt – total score;
Pi – risk weight to each factor;
Ni - the risk of each used factor.

The stage is achieved through determination of the total score, which takes into account the importance and weight of risk factors within that domain.

The methods employed in assessing residual risks of operational managers will provide a clearer view of its work in setting goals for a specified period and improve internal control system.

4. Conclusion

The basic role of internal audit in relations with risk management should be the provision for ensuring the implementation of financial management and control and risk management efficiency. The basic rule while planning the audit is the rigurous assessment of residual risks of the entity, in this regard the planning of internal audit activities assures a cooperation between the auditor and the auditee.

Internal audit provides assurance and independent and objective advisory services to help operational management to improve risk management and internal control. Its purpose is the prevention of major risks. The performance of an entity is based on the concept of continuity and stability of managers having responsibility for the effectiveness of the activity. The stability in function assures the continuity of current activity. Forecasting, organization, management, coordination and control activities are expected to be fulfilled in order to manage the entity. We can affirm that internal control system leads to an improvement of economic efficiency of the entity, by expanding the responsibilities of internal audit and internal control organization.

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