

VALENCES CONSIDERING THE IDENTIFICATION OF RISKS IN TERMS OF PUBLIC INTERNAL AUDIT

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Abstract: *Risks get new valences into the public sector within an economy characterized by resource limitation, increase of public exigency regarding services and diversification of the activities in the public sector entities. By carrying out this fundamental research we consider the problem of classification of risks from point of view of public internal audit. This study is based on a synthesis of the ideas published by national and international accounting regulators, accounting bodies and works put forward on the matter. We define the concept of risk, identify the types of risks in terms of public internal audit at European and national level, we determine the correlation between the audit risk optimization and the expedience of public financing use and propose a model to evaluate risks.*

Keywords: audit risk, public internal audit, risk.

1. Introduction

The public sector entities are exposed to a lot of risks within an economy dominated by uncertainty. In this respect, the public internal audit becomes the bond between risks and objectives of the entity, giving information to the managing board in order to diminish the negative consequences which risks could bring in the accomplishment of objectives.

The undertaken research identifies the internal audit actions regarding the risks within public sector entities. In this respect, we define the concept of risk, identify the types of risks from point of view of public internal audit, as well as the risks discovered by internal audit into the sensitive fields of the public sector in the member states of the European Union having a long tradition in implementing the function of internal audit, as well as in the ones in process of consolidating this function.

The research takes into consideration a synthesis of the ideas published by national and international accounting regulators, accounting bodies and works put forward on the matter.

The complexity of public internal audit missions can be sometimes retrieved in setting wrong or unrealistic recommendations and conclusions regarding the audited entity. As a result of the research, we determine the correlation between the audit risk optimization and the expedience of public financing use, and we propose a model to evaluate the risks of the public internal audit activity.

In order to achieve the proposed objectives, we will use a fundamental research method. We will also appeal to inductive research mechanisms, which imply collecting and analysing certain qualitative informations in order to define the general model of assessment of risks by the public internal audit.

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2. Conceptual assertions on risks in the public internal audit

In general terms, risk is the combination of the probability of the event occurrence and its consequences.

Cohen (2005) defines risk as all that can interfere with achieving objectives, being to some extent the cause of failure and, from financial point of view, loss. Vicenti (quoted by Renard, 2006) states that risk is the threat of an event or action to have undesired impact on the capacity of the entity to successfully achieve its objectives. In another approach risk is described as a future event and its occurrence could probably generate certain loss (Kirişescu & Dobrescu, 1998). For the public sector, risk is an event or a situation of exogenous or endogenous nature of a public entity which can interfere with the accomplishment of its missions, it can affect its patrimony or image, as well as the safety of its staff (Ernst & Young , 2008).

The definition given by the International Standards of Internal Audit states that risk is the possibility for an event to occur and have impact on the achievement of objectives. From point of view of the couple internal control – internal audit, risk is an assembly of circumstances which could have negative consequences on an entity whose internal control and internal audit have as a mission the ensurance of a good control on them. In terms of the public internal audit, risk is any event, action, situation or conduct with negative impact upon the entity's capacity to achieve its objectives.

Although various, the definitions presented above have as a convergence point the uncertainty and the negative impact of risk on the performance of the public sector entities. In his missions, the internal auditor must identify and analyse the significant risks which keep going after applying the internal control procedures and can affect the achievement of the public entity's objectives, but they also face the audit risk, specific to any audit mission. Although the audit risk is an external audit concept, by the current research we demonstrate that it also appears into the public internal audit. Our study is based on the consequences that risks, remained undetected in the internal audit, have on the public sector entity, consequences presented in Table 1:

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Table 1

The correlation of risks remained undetected by the public internal audit and consequences of non-detection

Deficiencies unidentified by the internal audit	Consequences of non-identification
Health	
<ul style="list-style-type: none"> ▪ There is no evidence of the tax payers who have the obligation to present statements, calculations and transfer of contributions for medical leaves; ▪ There are received, registered and certified statements that are not accompanied by the proof of payment; ▪ Offset of allowances for medical leaves without checking the carrying out of the stage of insurants' contributions; 	<ul style="list-style-type: none"> ▪ Occurrence of financial risk by: not cashing the amounts representing debits to the health social insurance fund for the medical leaves prior to foreclosure; payment of certain allowances for medical leaves to persons who do not meet the legal conditions; not cashing the due contributions for leaves and medical allowances.
Public procurement (acquisition)	
<ul style="list-style-type: none"> ▪ Lack of technical facilities required to carry out the activity of public procurement; ▪ The informatic applications do not meet the criteria imposed by the legal regulations regarding the electronic acquisitions; ▪ Non-existence of market prospect study and of an owned complete database listing the representative suppliers providing an appropriate tender; ▪ Lack of the Annual Programme of Public Procurement; ▪ Preparation of the Annual Programme of Public Procurement on prior experience years and not on a rigorous foundation; ▪ The awarding documentation, half-prepared and not published in the Electronic System of Public Acquisition (SEAP), has reduced competition, requiring repetition of procedure and conclusion of a contract with one competitor; ▪ Defective information of potential competitors by non-publication of documentation for awarding contracts in SEAP. 	<ul style="list-style-type: none"> ▪ Not purchasing some goods and services compulsory for the current activity instead, buying others which were not strictly necessary; gathering oversupplies and locking up financial funds; ▪ Possibility to spend more money on the acquisition, non-complying with the principle of efficient use of public funds; ▪ Breaking the principle of transparency; ▪ Wrong disqualification of a tenderer can lead to the award of public acquisition contract to a higher price; ▪ Limitations for tenderers; ▪ The selection of tenders is done on a smaller scale, diminishing the possibility to ensure a better price/higher performance for the subject of procurement.

The above list of non-identified risks can be completed with the corruption and fraud risks, which are frequent in the public sector entities. Not detecting and preventing these risks by the internal audit generally affects the manner of usage of public resources, the accomplishment of the proposed objectives, the image and credibility of the entity and the public sector. The analysis of the correlation of risks remained undetected by the public internal audit and their consequences, performed for health and public acquisition domains, emphasizes a common denominator for the

consequences: inefficient, ineffective, uneconomic usage of public resources and even their fraud.

By this study we demonstrate that partial identification or non-detection of existing risks and possible risks by the public internal audit, regardless of the type of public entity and audited field, lead to wrong or incomplete and unrealistic recommendations which do not add plusvalue to the entity, do not support it in improving its processes of control, risk management and governance to achieve the proposed objectives. This is the confirmation of the hypothesis of our research, that is the existence of audit risk into the missions of public internal audit whose definition is the following: the risk for the internal auditor to formulate wrong or unrealistic recommendations and conclusions concerning the audited entity/structure. The approach of the audit risk implies also the definitions of the following risks: inherent risk, control risk, non-detection risk.

The inherent risk is the susceptibleness that a statement should be significantly distorted, either individually or combined with other distortions, assuming that there have not been relevant internal controls.

The control risk is risk perceived as distortion, which can be significant, either individually or combined with other distortions, and cannot be prevented or detected and corrected in due time by the internal control system of the entity.

The non-detection risk is the risk that the procedures applied by the auditor should not lead to detection of distortion which can be significant, either individually or combined with other distortions.

By analysing the correlation of risks remained undetected by the public internal audit and their consequences, using an inductive research mechanism, we determine the bond between the optimization of audit risk and the effectiveness of using the public resource financing.

3. Valences regarding the risks identified by the internal audit into the public sector entities at European level

In order to emphasize the major role of the internal audit into the public sector entities, we further analyze the significant risks discovered by the internal audit in France and Great Britain, two of the European Union founding countries, with great experience in the field.

In France, local collectivities, their subordinate entities and hospitals have the freedom to borrow and choose the manner of loan, fact which led to the significant increase of debts. Based on their autonomy, they can contract loans, negotiate the rates of interest and the financial conditions of the debt. The emergence of structural products (loans), a hybrid form of the financial derived products but non-comprehensive for the potential borrowers, was successful among these entities, which were convinced of the total absence of risk or of the fact that an ascendant evolution of the interest rate would be surely favourable for them. The alarming increase of the debts contracted by local public entities, and implicitly their cost, simultaneously with

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the degradation of the financial situation are considered the consequences of the following risks identified by the internal audit (Table 2):

Table 2

The significant risks identified by the internal audit into the public sector in France

Typology of the domain	Significant risks
Structured debts	Defective procedures of debts and treasury management
	No strict delimitations of local authorities' competences related to loans
	Privation of a department of risk management
	Ambiguous conditions for contracting structured debts
	The structured products are not enough defined and described
	There are no delimitations in the respect of criteria for choosing the creditor
	Privation of procedures of choosing the typology and conditions of loan
	There are no methods of measuring uncertainty and exposure risk
	There is not an accounting distinct approach in comparison with the other debts
	Lack of forecasting of the financial risk
	There is not a complete reflection of the gains, risks and latent losses which are normally induced by the structured loans
	There is not a strategy of usage of the financial instruments to diminish debts

The study carried out into the public sector from Great Britain set out the national defence domain where each credit manager identifies its own risks, administrates them, and registers them into the risk registry; the major risks which cannot be controlled by the credit manager are submitted to the Audit Committee of Defence. The types of risks identified by the internal audit into the public sector entities of defence are the following (Table 3):

Table 3

The significant risks identified by the internal audit into the public sector in Great Britain

Typology of the domain	Significant risks
Infrastructure	<i>External</i>
	Facilities regarding infrastructure (personnel transportation, power supply, utilities, third parties contractual relationships, internet and e-mail connections)
Economic	Objective factors (interest rate, exchange rate, inflation rate)
Environment	Exhaust gas or pollution of the atmosphere
Political	Political constraint (government replacement)
Market mechanisms	Competitional environment or procurement of goods
Force majeure	Unforeseeable events (fires, floods, earthquakes)
	Financial

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Typology of the domain	Significant risks
Budgetary	Availability of financial resources or their manner of assignment
Insurances	Premises for the appearance of certain losses which can be covered by concluding person or material insurance policies
Capital investment	Decisions regarding the capital investment
Legal accountability	The right to start legal action or to be brought in court in certain circumstances
	<i>Specific to the activity</i>
Internal decisions	Opportunity and quality of the internal decisions
Reputation (fame)	Structure image and the effects it generates
Technological	Usage of certain technologies for achieving the established objectives
Innovation	Exploitation of all opportunities creating benefits to the organization
Personnel	Availability or maintainance of the qualified personnel within the structure
Health and safety	Physical stage of the people

The experience of the European Union founding states was borrowed by the newer members, among them being Hungary (2004).

By our research we have discovered that within the entities in Hungary the internal audit is focused on fighting against corruption, improving performance, as well as proving responsibility within the public sector. The analysis of the risks identified by the internal audit into the public sector places risks related to corruption on top of the following fields: public acquisition, internal control functions, financing of political parties (Table 4):

Table. 4

The significant risks identified by the internal audit into the public sector in Hungary

Typology of the domain	Significant risks
Public acquisition/ procurement	Deficiencies of internal regulations, set up to facilitate the application of local laws
	Defective training of personnel and material conditions
	Limitations of the financial control or steadiness in protecting business secrets do not diminish corruption risks
Internal control	Inappropriate function of the internal control
Financing of political parties	Legislative deficiencies
	Lack of transparency of the activities performed by companies and their partners – founded by the political parties, as well as of the "fund raising" activities organized by the foundations of the private sector in order to offer political support
	Deficiencies of the internal control regarding the elective campaign

Romania has entered the process of implementation and development of the internal audit function into the public sector as a result of entering the obligation of compliance with the community acquis within the domain of public financial control,

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as a candidate to the status of European Union member having full rights. In a relatively short period of time, the new member state of the European Union (2007) has concentrated on the settlement of structures and national regulating framework, and also on the cognitive means within the domain of public internal audit.

The undertaken research underlines the fact that the risks identified by the internal audit into the public institutions represent the consequence of the positive trend of consolidating the internal audit function so that it should accomplish its role of value creator. The public sector vulnerability and its exposure to diversified risks generate difficulties in choosing a domain or an entity, considered relevant in terms of the risks identified by the internal audit.

By means of the overall analysis of the public sector in Romania we stated that public acquisitions had always been a high risk field. In this respect, Table no. 5 shows the significant risks identified by the public internal audit:

Table 5

The significant risks identified by the internal audit into the public sector in Romania

Typology of the domain	Significant risks
Public acquisition/procurement	Lack of an information system to ensure assistance to the activity of public acquisition
	Lack of database listing the suppliers of products, services and practicable prices
	Lack of regular updating of the database with the suppliers of products, services and practicable prices
	The acquisition activity is not carried out in accordance with an annual programme
	Defective correlation between the Acquisition Programme and the policy of achieving the objectives of the public entity
	Lack of reports of necessity on acquisitions
	Exceeding the assigned budget
	Wrong estimation of the value of services and works contracts
	The procedure of awarding the public acquisition contract is established without compliance with the foreseen certified thresholds
	Dividing the public acquisition to obtain lower part thresholds

The examination of the accession process and further implementation of projects financed by structural funds shows that in Romania the public internal audit will have to focus on risk factors having as effect the low absorption (non-absorption) of structural funds such as: the defective presentation of the general framework of fund accession, the defective information of potential beneficiaries on the preparation and carrying-out of projects, and their fiscal policy, the public and beneficiaries mistrust in fund accession.

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The analysis of risks identified by the internal audit into the public sector entities from the European Union member states having experience in the implementation of this function, as well as from the states integrated afterwards, shows the various risks to which the public sector entities are exposed, no matter what type of audited sector and domain, as well as the relation in direct ratio between the progress of the society as a whole and the types of risks.

For a comprehensive presentation of the relationship of public internal audit – risks, by our research we propose the preparation of the risk map in terms of integrity, in respect of the public sector typology, and generally, at the public sector level. This map allows the identification of the vulnerable public sectors, setting up recommendations, foregrounding the investigation efforts, and comparatively monitoring and assessing the plus value added by the internal audit during years.

4. General model of risk measurement into the public internal audit

Risk is for the internal audit a planning instrument, due to the fact that the planning stage must be based on the evaluation of risks and exposures to risk, which could affect the entity. In this respect, we show the sequence (points a – f) of the internal audit regarding risks, from point of view of the internal audit mission for contracting medical and pharmaceutical services, considering the checking in terms of form and content of the concluded contracts, out of the auditable objectives:

a) Identification of auditable objects:

Objectives	Auditable Objects
Checking in terms of form and content of the concluded contracts	Checking of the form conditions
	Checking of the content conditions

b) Identification of risks for the auditable objects:

Objectives	Auditable objects	Identified risks
Checking in terms of form and content of the concluded contracts	Checking of the form conditions	Lack of documents required for the conclusion of contracts
		Inappropriate documents
		Non-usage of a contract model required by regulations
		Incomplete writing of contract
		The data within contract are not appropriately completed
	Checking of the content conditions	Lack of all authorised signatures and seals;
		Lack of CFP visa
		Lack of legal visa
		Lack of registration of contracts, additional agreements or other documents from the registry book

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c) Setting-up the risk factors and assessment of risk weight and levels

Risk factors (F _i)	Risk weight (P _i)	Assessment of risk level (N _i)		
		N 1	N 2	N 3
Internal control assessment - F 1	P 1 – 50%	There are procedures and they are applied	There are procedures, they are known but they are not applied	There are no procedures
Quantitative assessment - F 2	P 2 – 30%	Very weak financial impact	Medium financial impact	High financial impact
Qualitative assessment – F 3	P 3 – 20%	Very low vulnerability	Medium vulnerability	High vulnerability

Low risk: 1,00 – 1,70 points

Medium risk: 1,71 – 2,20 points

High risk: 2,21 – 3,00 points

d) Setting-up the risk level and total score

Objectives	Auditable objects	Identified risks	P 1 50% F 1	P 2 30% F 2	P 3 20% F 3	Total score
Checking in terms of form and content of the concluded contracts	Checking of the form conditions	Lack of documents required for the conclusion of contracts	2	3	2	2,30
		Inappropriate documents	2	3	2	2,30
		Non-usage of a contract model required by regulations	2	2	2	2,00
		Incomplete writing of contract	2	2	2	2,00
		The data within contract are not appropriately completed	2	2	2	2,00
	Checking of the content conditions	Lack of all authorised signatures and seals;	1	3	1	1,60
		Lack of CFP visa	1	3	1	1,60
		Lack of legal visa	1	3	1	1,60
		Lack of registration of contracts, additional agreements or other documents from the registry book	2	2	2	2,00

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e) Risk range

Objectives	Auditable objects	Range
Checking in terms of form and content of the concluded contracts	Checking of the form conditions	Medium
	Checking of the content conditions	Low

f) Strength – Weakness points table (S/W)

Objectives	Auditable objects	Identified risks	S/W	Degree of trust
Checking in terms of form and content of the concluded contracts	Checking of the form conditions	Lack of documents required for the conclusion of contracts	W	Low
		Inappropriate documents	W	Low
		Non-usage of a contract model required by regulations	W	Low
		Incomplete writing of contract	W	Low
		The data within contract are not appropriately completed	W	Low
	Checking of the content conditions	Lack of all authorised signatures and seals;	W	Low
		Lack of CFP visa	W	Low
		Lack of legal visa	W	Low
		Lack of registration of contracts, additional agreements or other documents from the registry book	W	Low

By analysing the mission of the internal audit regarding the contracting of medical and pharmaceutical services, having as auditable objective the checking in terms of form and content of the *concluded* contracts, we observe the involvement of audit in the following directions: it identifies the risks representative for concluded contracts and the extent to which the internal controls or the entity's procedures can prevent, eliminate or diminish these risks; it evaluates the internal control structure which is representative for contracts; it makes the hierarchy of the operations to be audited.

By the research carried out, on the basis of the inductive algorithm, we identify the stages of the Risk Analysis procedure, used by the public internal audit to

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ensure the identification, priority and selection of the activities to be audited, regardless the type of audited public sector or field:

a) Identification of the auditable operations/activities, auditable objects, by means of which there are analyzed and identified the activities/operations, as well as the interactions between them, setting up the area of analysis;

b) Identification of possible threats, inherent risks, associated to these operations/activities, by means of the determination of their financial impact;

c) Establishing the criteria of risk analysis as it follows: internal control assessment, quantitative assessment and qualitative assessment;

d) Establishing the risk level of each criterion by using a scale of values on three levels, such as internal control assessment, quantitative assessment and qualitative assessment;

e) Establishing the total score of used criterion by awarding a weight factor and a risk level to each criterion, on the relation:

$$T = \sum_{i=1}^n P_i \times N_i$$

T – total score of the criterion

P_i – risk weight for each criterion;

N_i – risk level for each criterion used.

f) Classification of risks, on the basis of overall prior scores, into the following categories: low risk, medium/average risk, high risk;

g) Establishing the table of strenght and weakness points, which synthetically presents the result of each evaluating each analyzed activity/operation and allows the hierarchy of risks for the purpose of orienting the activity of public internal audit. In this manner there is made an hierarchy of the operations/activities to be audited.

By this approach, the public internal audit accomplish its objective of providing the managing board with information to diminish the the negative consequences which risks could bring in the accomplishment of the entity's objectives, as well as in the efficiency of risk management process.

Conclusions

This research shows the significance of risk for the public internal audit. Regardless the types of risks, partial identification or non-detection of the existing risks and of the possible ones by the public internal audit, they generate wrong or incomplete and unrealistic recommendations, which do not add plusvalue to the entity, do not support it in improving its process of control, risk management and governance, in order to achieve the proposed objectives.

In this respect, this research based on the inductive research mechanism shows that, by means of an existing general model of risk assessment, the internal audit gives ensurance to an entity on the degree of control of its operations, guides it in order to improve its operations and contributes to plusvalue addition. Also, the internal audit

supports the entity in achieving its objectives, assessing by systematic and methodic approaches its processes of risk management, control and governance of the organization, and coming up with proposals to consolidate their effectiveness.

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