EVALUATING THE RISKS OF THE PUBLIC ENTITIES THROUGH AUDIT AND THROUGH THE MANAGEMNT OF THE AUDIT RISK

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Abstract

Amid the increasing complexity of the public entity's tasks, the continuous development and modification of the legal framework, the decentralization of liability, the risk tends to install itself in the central of the concerns of the entities. For a long time, specialists have argued that we are living in a civilization of risk, that the benefits of any action are proportionate with the assumed risk. Therefore, decisive in making a performance achievement of the activities of any public entity is represented by controlling the risks. This fundamental problem faced by public entities strongly involves the internal audit work.

The paper presents the risks from two perspectives: aspects regarding risks faced by public entities and also the risks faced by auditors in their work – the audit risk.

Keywords: risk, internal audit, public entities.

JEL classification: G29, H0, M42.

1. Introduction

In practice, entities face *a wide variety of risks*, both internal and external, with certain forms of materialization that produce effects from the most diverse as a method of manifestation and amplitude. For the management of the entity, it is important to identify as many risk-related aspects as possible, based on its generating factors, in order to provide the correct basis for the types of risk.

Internal auditors have the obligation to report to the management the results of the activity, as well as the significant deficiencies discovered during

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the course of an audit mission. In conducting their work, auditors face their own risk: *the audit risk.*

2. Typology of risks faced by public entities

There are many risk classifications in the literature, but there is no well-defined typology.

In order to analyze and evaluate, the risks faced by the public entities can be classified according to several criteria:

A. *From the point of view of the possibility of the risk occurring,* (Boulescu, M., Ghiţă, M., Mareş, V. , 2001) there are:

- *potential risks* that may occur if there is no effective control that prevents, detects and corrects them. They are recorded at the level of all economic entities.
- *possible risks,* represented by that part of the potential risks for which the management has not taken effective measures to limit them. As a result, there is a high probability that errors will occur without being detected and corrected.

B. *By their nature* (Ghiţă, M, 2004) the risks are:

- *strategic risks,* related to the implementation of wrong actions related to organization, resources, environment, IT endowment, etc.;
- *informational risks,* related to the adoption of unsafe or non-performing systems for information processing and reporting;
- *financial risks,* related to the loss of financial resources or the accumulation of unacceptable liabilities.

C. *From the point of view of the specific nature of the entities*, the risks may be:

a) *entity-specific general risks* arise from the entity-specific characteristics and include:

- risks related to the economic situation of entities, which differ according to the existence of the financial difficulties;
- risks related to the organization of the entity are determined by several factors, from which we mention: risks related to the nature and complexity of structures and rules, risks related to the quality of

management, risks related to the accounting and internal control system, risks related to the absence of some procedures;
- risks related to the attitude of the management, which are influenced by the reaction of the entity management. Thus, risks increase when executives put pressure on the employees, asking them to mask certain situations against banks, external control bodies, etc.

b) *risks related to the nature of the transactions treated*

In the accounting, the existing data is presented in several forms, which in turn present different types of risk:

- repetitive data resulting from the entity's usual activity. For this type of data, the risk of errors is determined by the reliability and quality of the accounting system practiced;
- punctual data, complementary to the repetitive ones, are reflected in accounting at different time intervals, more or less regularly (data from annual inventories, depreciations, provisions, etc.). These data may be risk-taking if their collection is not organized in a reliable manner.
- exceptional data that occur in exceptional operations (mergers, liquidations, etc.). For these data, the risk of producing errors or even the risk of not being detected is greater, especially if the entity does not have highly trained staff.

c) *risks related to the design and operation of the systems*

I have here in mind both the data collection and processing system, which must present the possibility of preventing, detecting and eliminating errors, as well as the reliability of the internal control system that significantly reduces the risks within the entity.

D. In accordance with *the General Rules concerning the exercise of the public internal audit activity (*HG No.1086/2013 - General Norms concerning the application of the public internal audit), the risks are classified as follows:

a) *Organizational risks*, such as: the lack of precise responsibilities; insufficient organization of human resources; insufficient, not updated documentation, the non-formalization of procedures;
b) *Operational risks*, such as: non-recording in the accounting records, inappropriate archiving of the supporting documents, and lack of control over the high-risk operations;

c) *Financial risks*, such as: unsecured payments, non-detection of financial risk operations;
d) *Other risks* such as those resulting from legislative, structural, managerial changes etc.

E. Intervening in previous opinions, *I consider* that the most enlightening classification of the risks faced by public entities is the one that is based on *the origin of the risk*, as follows:

- **risks within the entity;**
- **risks outside the entity.**

The risks inside the entity (internal) are as follows:

a) *The economic or exploitation risk* arises from the entity's inability to adapt in time and with the lowest cost to environmental variations. More specifically, it reflects the volatility of the economic result to the exploitation conditions. The exploitation risk consists in the existing possibility of not recovering all the expenses incurred (Işfãnescu, A., Stănescu, C., Băicuşi, A., 1999).

By the nature of the activity and its position in the economic environment, the results of the entity are more or less influenced by a series of economic and social events: rising energy prices, wage growth, technological innovation, etc.

The economic risk depends not only on general factors (sales price, cost, turnover, etc.), but also on the structure of costs, respectively on their behavior towards the volume of activity of the entity. In this respect, a rigorous analysis of the cost-volume-results relationship, as well as the analysis of the profitability threshold of the economic entities, is imposed.

b) The financial risk is that risk which is generated by the way the entity is financed, taking into consideration the sensitivity of the result towards the changes in the financing conditions. Within the financial risks we can distinguish the interest rate risk, the financing risk, the liquidity risk, etc.

c) Bankruptcy risk (Bogdan, I., 2004) represents a sum of the economic and financial risks (as well as some conjunctural causes) and is due to the periodic or definitive financial deficits caused by insolvency (Explanatory Dictionary).

The risks from outside the entity (external) include a variety of types of risks. Among these, we consider that the main categories of external risks are as follows:

a) Risks related to the legislative and regulatory framework - reflects the fact that entities must operate in view of the existing legal context, in compliance with their specific internal regulations.

b) Legal risks often represent the consequence of a conflict of interest, resulting from a transaction and it causes the issuing of an unfavorable sentence to the parties involved.

c) The country risk is triggered when events such as: revolutions, regime changes, civil war or changes across borders are taking place.

d) The political risk is influenced by the future attitude of the governors. This type of risk is often confused with country risk.

e) Risks related to natural factors – earthquakes, fires, floods etc.

f) The market risk is the result of price variations and takes the following forms: interest rate risk and exchange rate risk.

3. The relationship between the fraud risk and the public internal audit

Distortions found in the financial statements prepared by public entities are based on errors and frauds. Of course, there is a clear distinction between the two notions, respectively, while the "error" refers to an unintentional misstatement of the financial statements, "fraud" represents the illegal actions intentionally committed by individuals from the management of the entity or among other employees, in order to obtain some advantages. In the explanatory dictionary of the Romanian language, fraud is defined as a deception, an act of bad faith committed by someone, usually in order to gain a material profit from the attainment of the rights of another.

It should be noted that in Romania the responsibility for dealing with frauds when they arise falls within the competence of the authorizing officers who, according to the law (Law on Public Finances no. 500/2002), have the responsibility to ensure the legality of the patrimony and the expenditures within the limits of the approved credits and with the established budget destination.

Therefore, the internal audit work is not responsible for managing and taking action in terms of the risk of fraud which is the responsibility of the management, but given that frauds occur in different areas of the audited domains, auditors should act towards prevention and detection of this phenomenon with unfavorable financial implications for entities. The internal audit should have the task of helping the management to ensure that the fraud risks faced by the entity have been identified and that there have been established measures in order to ensure that they do not materialize. Throughout the entire audit mission, the internal auditors should maintain an attitude of professional skepticism, recognizing the possibility that there are some misstatements in the financial statements due to fraud. The risk of not detecting a significant misstatement of the financial statements caused by fraud is high because any fraud involves well-organized actions such as: the use of false declarations or documents, the deliberate non-registration of some transactions, etc. If it is found that the leader of the audited field is likely to be involved in fraud, it is immediately necessary to bring this negative working situation to the hierarchical superior so as not to lose the opportunity to investigate it.

The fraud auditing should consist in performing thorough checks and evaluations in order to determine whether or not fraud has been committed. Research has shown that international practice in this field is quite different.

In the UK, for example, before deciding on fraud, the internal auditor consults with a legal specialist in order to avoid risking being sued for harming the professional interests of those concerned.

Unfortunately, in Romania, the Law on Public Internal Audit no. 672/2002 and the General Norms concerning the application of the public internal audit, approved by HG no. 1086/2013, do not specify the relationship between the internal audit and fraud, if the audit investigates or not the phenomenon of fraud, although the International Standard of Internal Audit foresees this. Thus, the internal auditing standards (Standard 1210.A2-1 „Identifying fraud” and Standard 1210.A2-2 „Responsibility for detecting fraud”) *provide that "internal auditors should contribute to discouraging fraud by assessing the pertinence and effectiveness of the internal control system, taking into account the specific risks of each domain of the organization, and at the same time states that" with regard to fraud detection , the purpose of the internal audit is to help the members of the organization perform their functions effectively by providing them with analyzes, evaluations, recommendations, advice and information concerning the activities under review."*

As a result, it is necessary to complete the Romanian legal framework in the field of internal audit, by assigning the competence for detecting fraud at the level of public entities. In case of identifying a potential fraud, separate reports should be drafted, containing indications of fraud and proposals for further investigations. In this way, the tests performed by internal auditors associated with other controls applied by management, improve the chances of detecting possible frauds, thus ensuring the legality when using the state and administrative-territorial units' financial resources.

4. The audit risk

4.1. The significance of risk in public internal audit

In the literature, there are various definitions given to the audit risk, but its essence is limited to the possibility of being issued inaccurate audit opinions or that do not reflect the specific reality of the audited entity.

Thus, according to the opinion of specialists in the field (Boulescu, M., Ghiţă, M., Mareş, V., 2001), "the amount of audit evidence required to prove compliance with a given evaluation criterion is directly proportional to the risk that the auditor may issue the opinion concerning compliance with that criterion, but in fact there exists a strong derogation (deviation) from that criterion, which will be covered by the importance for users of the audit report. This risk is called global audit risk."

Other definitions given to the audit risk define it as "the possibility of making, materially, recommendations and conclusions which are false or non-conforming with reality over the audited entity " (Ghiţă. M, 2004) or "the risk that an auditor assumes when issuing an audit opinion which is inappropriate in terms of the financial statements audited" (Dobroţeanu, L., Dobroţeanu, C., 2002).

For this reason, the auditors specifically follow, from the beginning of an audit mission, the risks that may arise and which may lead them to issue erroneous audit opinions.

The internal auditor, from the moment when the preparatory activities of an audit mission are triggered and until it is completed, will address the issue of risks. "Because of the insistence on identifying, analyzing and the evolution of risks, throughout the process, the internal auditor is perceived by many as the Mister Risk." (Ghiţă. M, 2004)

The main objective of the internal auditor is to implement some audit procedures that would allow him to reduce the audit risk to an acceptable level that relates to the extent to which the auditor is willing to accept that the financial statements are erroneous, after the audit mission has been performed. It is appreciated that establishing the audit risk at a reduced level is largely due to the professional judgment of the auditor.

In practice, the internal auditors do not analyze all the risks, but focus on analyzing the risks characterized by medium and high levels of their likelihood of occurrence and their impact, if they occur. This does not mean that auditors accept minor weaknesses, but that it is only logical and normal to focus primarily on avoiding major weaknesses. Hence the audit risk and from the fact that the internal auditors evaluate and monitor the significant risks of the entity by comparing them with their own list of risks and with the risks associated with the internal control activities.

The factors that can determine the risks in the audit (Dascălu, D., Nicolae, F., 2006) are:

- the particularities of the investigated matter derived from the specifics of the processes of the public entity in which the audit is conducted;

- the quality of the definition / delimitation of the entity under investigation;

- the quality of the design / operation / control process of the data collection / processing systems during the documentation;

- misinterpretations of some aspects / elements / problems that are part of the investigated entity;

- the procedures / methodologies applied in the audit research, by the expert, according to his / her experience and professional training.

Risk measurement in the internal audit activity depends on the following important elements:

- ➢ probability of occurrence of risks;
- ➢ the level of impact in the case of the risk occurring, meaning the severity of the consequences and the duration of the risk.

The criteria used to measure **the likelihood** of occurrence of the risk are: *the appreciation of the vulnerability of the public entity and the appreciation of the internal control.*

The measurement scale of risk probability starts from impossibility and reaches certainty, with three levels of expression as follows:

- *small probability;*
- *medium probability;*
- *high probability.*

Depending on the assessments of the entity's vulnerability and on the control activity, the severity of the event's consequences can be determined. **The effects of the risk** in the event of its production can be expressed on a three-tier scale:

- *low impact risk;*
- *moderated impact risk;*
- *high impact risk.*

Depending on the combination of the likelihood of occurrence of risk with its impact, several situations may arise, which may be treated by management as follows:

- if the risk measure shows a *high impact,* but *a low probability* of occurrence of the risk, then there is the *possibility of intervention* by the management of the entity;

- if *the impact of the risk and the likelihood of its occurrence are low,* then the risk can be ignored;

- if *the impact is low, but the probability is high,* then *control procedures* are required in order to avoid the risk;

- if both *the impact is high* and *the likelihood of the risk occurring is high,* then it is mandatory to *organize the internal control procedures* and possibly *to use the possibilities for intervention in order to eliminate the risk.*

4.2. Components of audit risk

Inherent (essential) risk = the risk of some significant errors being present in the audited situations

The inherent risk (RI) represents a measure of the auditor's judgment about the likelihood of significant misstatements (mistakes or frauds) happening, in a segment subjected to audit, before estimating the effectiveness of the internal control mechanisms (Arens, A.A., Loebbecke, J.K, 2003). In other words, this risk reflects the vulnerability of the financial statements towards the occurrence of errors, in the absence of internal control. If the auditor concludes that there is a high probability of error without taking into account the internal control, then it means that he considers a high level of inherent risk.

Control risk = the risk of non-discovery/non-detection of some errors due to malfunctioning of the internal audit of the audited entity

The control risk is the risk that an offense is not prevented or detected in a timely manner by the audited entity's accounting and internal control system.

Therefore, the control risk arises when the entity's internal accounting and control system are not applied correctly or when they are insufficient.

Non-detection risk

The risk of non-discovery or non-detection lies in the fact that audits triggered by auditors fail to detect a significant error in the balance of an account or in a category of operations, isolated or together with other balances or categories of operations.

The risk of non-detection cannot be totally eliminated, regardless of the techniques and procedures used by the auditor, but the level of this risk is directly related to these substantive procedures applied by the auditor. The auditor's choice of the procedures used depends on his / hers experience and professional training.

Therefore, *the risk of non-detection is the only risk that can be controlled by the auditor.*

5. Methods (techniques) for determining the audit risk and the risk of audited entity in the activity practiced

In the practice of internal audit, a set of methods for determining the audit risk and the risk of audited entity are used.

5.1. Statistical survey method

A common and well-known method in the economic activity is, in general, the **statistical survey,** which involves *an estimation of a result calculated on the basis of an analytical examination of a sample from the total information (population) considered*. This estimation is based on two indicators:

- the *allowed deviation* represents a plus or minus error over the exact result. For example, a deviation of ± 5% actually means that 5 samples of the total of 100 information may be incorrect or inaccurate;

- the *accuracy of the result* represents the interval in which the result of the estimation is included. For example, the deviation of ± 5% for a score of 30 means a range of 25 to 35; in other words, there is a 95% chance that the expected outcome is between the interval 25 and 30, and 5% chances that the result is above these limits.

The audit risk can be determined both in quantitative terms (in percentages) and in qualitative terms (low, moderate or high risk). Although qualitative terms are often used in practice, we will use quantitative terms in order to illustrate the relationships between the components of the risk.

To determine the audit risk using the statistical survey, the following **mathematical risk model** is used:

$$\mathbf{R_a = R_i \times R_c \times R_n} \text{ where, } \mathbf{R_n = R_a / (R_i \times R_c)}$$

The audit risk model is a quantitative form of the relationships between the audit risk (Ra), inherent risk (Ri), control risk (Rc) and non-detection risk (Rn) (Court of Accounts of Romania, 2002).

In order to obtain relevant audit evidence to support opinions, the auditor must in fact obtain the *guarantee (confidence level)* that the financial statements analyzed are in line with reality.

As we have shown in the previous paragraphs, the opposite of the guarantee is *the risk of the audit,* which represents the risk that the auditor may reach erroneous conclusions regarding the financial situation.

The auditor's confidence is determined as a difference between 100% and the risk of non-detection. Since the guarantee is inversely proportional to the risk of non-detection, the lower the risk of non-detection, the higher the level of trust the auditor has. Similarly, the level of audit assurance corresponds to the difference between 100% and the audit risk.

In practice, auditors typically determine the risk by estimating and do not proceed to mathematically or statistically determination.

5.2 Matrix of risk components

This method is used when the audit risk is fairly easy to detect and assesses the relationship between the components of the audit risk, as shown in the following table:

Table 1: Matrix of risk components

The level of inherent risk appreciated by the auditor	The assessed level of the control risk			
	Maximum	High	Moderate	Low
The detection level of the audit risk				
Maximum	Very high	Very high	Low	Low
High	Very high	Low	Low	Moderate
Moderate	Low	Low	Moderate	High
Low	Low	Moderate	High	-

Source: Kell G. Walter; Boynton C. William – Modern Auditing, Fifth Edition, John Wiley & Sons Inc., New York în Boulescu, M., Ghiţă, M., Mareş, V.- *Fundamentele* *auditului [The fundaments of the audit]*, Didactic and Pedagogical Publishing House Bucharest, 2001, page 51.

Thus, for example, if the inherent risk is assessed by the auditor at a low level and the control risk at a moderate level, then the level of audit risk detection is high.

The matrix of the risk components can be used to determine the risk of non-detection both at the level of the audited entity and at the financial statements level, and within them on economic transactions and balance of accounts.

5.3 Matrix of risk synthesis

The matrix of risk synthesis is similar to the risk component matrix described above, but in this case the *audit criteria* are written on the column, and the *significant audit areas* on the line. At the intersection of the columns with the lines, are written the extent of the risks that are noted as follows: L - low risk; M - moderate risk; H - high risk.

For each significant area, the overall risk is estimated in the last column, depending on the evaluation criteria set. For each evaluation criterion, the afferent overall risk is estimated on the last line, reported in the significant domain.

You can also create a matrix on risk factors. The general risk assessment procedure is similar to that described in the risk synthesis matrix, also obtaining in addition a risk assessment on risk factors.

5.4 A risk analysis procedure is specified in the **General norms concerning the exercise of the public internal audit activity**

1. The identification of activities / actions and associated risks, which involve the following steps:

a) detailing for each general objective of the public internal audit mission the activities in successive actions, describing the process from the initiation of the activity to its registration;

b) defining the risks for each activity / action in part.

2. Establishing the risk analysis criteria - which are represented by the impact and probability of risk manifestation, being evaluated on a three-tier scale, as follows:

a) the probability assessment based on the analysis and evaluation of the established incidence factors;
b) impact assessment based on the analysis and assessment of the established risk factors.
Establishing the overall risk score, as the product between probability and the impact of risk, obtained on the basis of the formula:

TS = P × I, where:
TS = total score of the risk;
P = probability;
I = impact;

c) risk hierarchy - is done on the basis of the total scores obtained from the risk assessment and the auditable activities / actions are divided into small, medium and high risk activities / actions as follows:
d) for TS = 1 or 2, the risk is low;
e) for TS = 3 or 4, the risk is medium;
f) for TS = 6 or 9, the risk is high.

6. Conclusions

Any economic activity involves a number of risks, these being more or less serious, more or less known, easier or harder to anticipate and avoid. Before starting any type of activity, it is necessary to identify, analyze and assess the risks that may arise, mitigate or eliminate them as much as possible, accepting only those risks that only slightly affect the activity of the entity. Insufficient knowledge of the risk, its erroneous assessment or the lack of adequate protection against it will have a direct impact over the final outcome of the activity carried out.

In order to analyze and evaluate, the risks faced by the public entities can be classified according to several criteria presented in the first part of the paper, but in my opinion that the most enlightening classification of the risks faced by public entities is the one that is based on *the origin of the risk*, as follows: risks within the entity and risks outside the entity.

Unfortunately, in our country, the Law on Public Internal Audit no. 672/2002 and the General Norms concerning the application of the public internal audit, approved by HG no. 1086/2013, do not specify the relationship between the internal audit and fraud, so it is necessary to complete the

Romanian legal framework in the field of internal audit, by assigning the competence for detecting fraud at the level of public entities.

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