RISK ANALYSIS - SPECIFIC PROCEDURE OF THE INTERNAL AUDIT

GEORGE CALOTĂ, TRAIAN IANA *

ABSTRACT: *During the stage of Preparation of the mission of internal audit for intervention on the spot, Internal audit program must be prepared, which shall be based on a specific risk analysis procedures. The Standard „ 2200 - Mission Plan recommends that „when planning the mission, internal auditors should take into account: the audited business objectives and how this activity is under hand; significant risks related to business, its objectives, resources used and operational tasks and the means by which the potential impact of risk is maintained at an acceptable level; pertinence and effectiveness of risk management and control of business systems in relation to an appropriate control framework or model; opportunities for significant improvement of risk management systems and control of business. Practice in internal audit field in Romania, adapted to the requirements of International Standards on Internal Audit, requires that the Elaboration of the internal audit program procedure, to be preceded by Risk analysis procedure and followed by the Opening meeting procedure.*

KEY WORDS: *risk, probability, risk register, risk analysis, internal audit program*

Risks, as inherent elements in the conduct of any activity, can lead to different effects. In the literature there are found many definitions of the risk. Thus, one of the recognized experts in the French environment, Dominique Vicente, quoted in the literature in Romania [3], considers that: „risk is a threat in the purpose that an event or action to have an adverse impact on the company's capacity to fulfill its objectives successfully". In another publication in the area, Risk Management: Changing the Internal Auditor's Paradigm, two renowned experts, David Mcmanee and George Selim, argue that „risk is a concept used to express uncertainty about the event and / or their results, which may have a significant effect on the objectives of the organization".

* *Ph.D. Student, Internal Auditor - Central Unit for Public Internal Audit Harmonization, Ministry of Finance, Romania, gcalota2003@yahoo.com*
Lecturer, Ph.D., „Titu Maiorescu" University of Tg.Jiu, Romania, traian.iana@mfinante.ro

International Standards on Internal Audit (Standard 2200 - Planification of the mission) define risk as „the probability of producing an event that may impact on the achievement of the objectives". Internal audit rules applicable to public sector entities [9] define risk as being „any event, action, situation or behavior with negative impact on the public entity's ability to achieve its objectives". Analysis of such definitions points out that *risk is a problem* which has not yet occurred but could occur in the future, where it constitute a threat to the entity regarding the achievement of the objectives set by the multiannual and annual plans and those concerning each function of the enterprise; the risk should be seen as a combination of probability and impact.

Considering the volume on the impact, there may be strategic or operational risks (in some approaches appear intermediate risks or program risks as well). Also, some risks have their origin in the external environment of the organization (external risks), and others are risks of the organization itself (internal risks). However, risks can be seen in the light of nature of the activity, in which case they may be risks: legal, judicial, financial, professional, social, commercial, informational, operational, environmental, image (goodwill), property. For illustrating different types of risks that may affect the activity of an entity, *we consider* as representative the table shown below including the categories of risks, conducted by the resort ministry of the United Kingdom - *Hight Majesty Tresury*, equivalent institution of the *Ministry of Public Finance of Romania*, in order to support entities to determine whether they have taken into account the full range of risks involved.

According to *General rules regarding the exercise of public internal audit activity*, the main categories of risks are: *organizational risks* (unformalized procedures): lack of clear responsibilities, insufficient organization of human resources, inadequate documentation, outdated; *operational risks*: not recording in the accounts, improper archiving of justificatory documents, lack of control on high-risk operations; *financial risks*: unsecured payments, not detecting financial risk operations; - *other risks*: risks arising from legislative, structural changes or managerial changes.

From the above it results that the risks must be **identified** and **evaluated** in terms of the combination of its two components namely, **the probability** that something (the risk) may occur and **the impact** (the consequence in the objective) that the materialization of such probability will have:

a) Measuring the probability means determining the likelihood of occurrence probability of a specific result. We would like to recall that the risk is a problem (situation, event) that may occur (to materialize), case that leads the objectives to be affected. In other words, there is uncertainty in the occurrence of the situation or event that may affect the achievement of the objectives. The probability is a measure of uncertainty. The probability of risk's advent varies from impossibility to certainty and is expressed on a scale of values on three levels: low probability, average probability, high probability.

In practice, for the probability of risk's advent measurement, two criteria are used: ***a.1. vulnerability assessment of the entity.*** To make the assessment, the auditor will examine all the factors that could have an incidence on the vulnerability of theexisting technical means. The vulnerability is expressed on three levels: low vulnerability, average vulnerability, high vulnerability.

a.2. assessment of internal control. The assessment of internal control is based on an analysis of the entity's internal quality control on three levels: appropriate internal control, insufficient internal control, deficient internal control.

Table 1. Types of risks

No.	Risk categories
1.	**External -** arising from the external environment and can not be fully controlled by the entity, but for which mitigation measures can be taken: 1.1. Political; 1.2. Economic; 1.3. Socio-cultural; 1.4. Technology; 1.5. Legal; 1.6. Environment.
2.	**Operational -** related to current operations, meaning the current mode of developing the activities, creation and maintenance of the capacity and capability as well: 2.1. Progress in: 2.1.1. Ability to provide a product / service; 2.1.2. Running activities / projects. 2.2. Capacity and capability: 2.2.1. Resources (assets, human, financial, information); 2.2.2. Relations; 2.2.3. Operations (results); 2.2.4. Reputation. 2.3. Method and capability of risk management: 2.3.1. Governance (regular and fair); 2.3.2. Exploration (ability to identify risks and opportunities); 2.3.3. Flexibility and adaptability; 2.3.4. Security (active, social, informational)

b) Measuring the severity of the consequences of the event (at impact level). The impact represents the consequence on the expected objectives (outcomes), which may be, depending on the nature of the risk, positive or negative. In some situations, especially when it comes to strategic objectives and the organizations are complex (alike, complex projects, complex activities), the assessment of impact becomes a difficult problem that requires impact studies. But, in an organization, most risks are not of the above mentioned the nature and their impact can be measured with considerably less effort. The impact of any risk is characterized by the consequences of different natures. Besides qualitative consequences, expressed in a descriptive way, can be identified and consequences can be expressed in terms of budget (costs), effort (work time) and time (possible delays in the allocated period to achieve the objectives).

Generally speaking, the impact can be decomposed as follows:

I → **IC** - qualitative component (which may include quantitative indicators)
→ **IB** - budgetary and / or patrimonial component
→ **IE -** effort component
→ **IT** - time component

We consider as necessary to mention the fact that, the impact assessment is not required to be made by all its components. Sometimes this thing is not possible, and sometimes it is not relevant. For example: the impact produced by the risk of non-availability of the justificatory documents:

- ***Ic*** - untrue financial statements, damage credibility in front of the partners (problems regarding the receipt of funding by onerous title or not), increased frequency of external audits. Internal audit rules applicable to public economic entities from Romania require that measuring the level of the impact of a risk to be done using a scale of values with three levels: low impact, moderate impact, high impact.

Performing risk analysis in accordance with the rules of internal public audit, supposes crossing the following phases:

A. Identify the risks associated activities. Identifying the risks associated to the objects that may be audited, has as its starting point, the analysis of the objects and / or the operations covered by the *Centralized list of objects that may be audited.* For this purpose, the auditors collect information about the objects that may be audited, information which are then examined in order to determine their impact on the mission.

Regarding the information that the auditors need at this time of deployment of internal audit activity, reviews the literature points out that these concerns: business objectives and goals; rules, plans, procedures, legal and contractual regulations which may have significant impact on the operations;audited entity / structure: number and names of the employees, employees who occupy key positions, job descriptions, changes in the organizational structure, changes in information systems;the income and expenditure, turnover and financial data regarding the audited activity;working documents of previous internal audit assignments;results of other missions, including external auditors, completed or under development;correspondence files to detect important problems;information on the technical reference documentation for the activity being audited;technical reference documentation for the activity concerned.

However, in order to achieve *the analysis of risks,* the auditors should assess the processes of risk management. Regarding these issues, *The International Internal Audit Standards* (Standard 2100 – Nature of activity) states: „We must distinguish between the assessment of risk management processes and risk analysis tha tthe auditors must make, in order to plan their activities. However, the information resulting from a full risk management process and in particular from the identification of the subjects of interest to the managers and the Council may help the internal auditor to plan audit activities”. In such conditions and requisitions *we consider as necessary* the following presentation of several issues that may be considered as useful in terms of the auditor's awareness of the situations they may encounter in practice.

A first practical issue that can be incorporated, relates to the situation where the risk management process, as part of the organizational management process is well organized within the entity[1], in which case there is a *risk registry book*[2] that highlights the main risks, identified and assessed, associated with relevant objectives. Because the risks are constantly changing, the auditor will be interested to see whether the risks and

[1] The process of risk management or risk management - all processes on the identification, evaluation and risk assessment, establishing responsibilities and taking measures to mitigate or anticipate them, regularly reviewing and monitoring progress.

[2] Risk Registry book - integrating document for the risk management, which includes a summary of information and decisions taken on risk analysis.

their mitigation measures were reviewed regularly and recently. If this is evident in practice, the auditor will be interested to explore and validate the content revision, or if full, current and well-founded.

Finally, if the auditor concludes that *the risk registry book* is a good basis to guide the audit activity, he will focus on the higher risks involved, to ensure that control instruments are put with effectiveness in practice. Likewise, *it should be mentioned that* these risks are seen by the auditor on one hand as an "exposure" because the control instruments are not sufficiently consistent, and on the other hand as a potential for adding value based on the made recommendations.

Another relevant practical issue to this problem, is specific to entities that do not have organized such a *risk registry book* and the management does not have a clear idea on the most important risks they are facing. In these circumstances, the auditor should discuss with the management about the risks, their impact and probability. *This thing is recorded by the internal auditor as part of the audit trail.* If the management is not very concerned by these risks, the auditor should seek to identify and assess the risks on his own knowledge and experience and using all other sources of information that is available. This can be done only when all other options mentioned above have been already explored and considered as inappropriate. In practice this first phase of risk analysis procedure is completed by internal auditors through elaboration of the document called *Identification of risks.* Regarding this document, the internal auditing standards applicable in Romania do not provide a standardized templatet, leaving it up to the professionals to prepare this document as necessary.

B. Establishing the criteria, weightings and levels of risk assessment. On the subject of risk assessment, the internal auditor should develop an assessment methodology. Best practice in the field recommends that the structure of the internal audit to establish a set of criteria (factors), objectives for impact measurement and another set of instruments as targets for measuring the probability. In international practice, the impact criteria include financial criteria, operational criteria, reputational criteria, compliance criteria etc., and the probability criteria are often a combination of experience and insight sustained by information. The rules of internal audit in Romania, applicable to public economic entities, recommends for the risk analysis the following factors/criteria of risk: assessment of internal control, quantitative assessment, qualitative assessment.

Also, the general rules of public internal audit recommends the establishment of risk levels using a scale of values on three levels, such as (Table 2):

Table 2. Nivelurile de apreciere a factorilor de risc

Level of Assessment / **Risk factor**	**level 1**	**level 2**	**level 3**
assessment of internal control	appropriate internal control	insufficient internal control	deficient internal control
quantitative assessment	low financial impact	moderate financial impact	high financial impact
qualitative assessment	low vulnerability	average vulnerability	high vulnerability

After analyzing bibliographic resources and practical work in the manner of determining the share of risk factors, the following model ***can be retained:***

F1	- Risk assessment	……………………………..…..	50%
F2	- Quantitative assessment	……………………………….…...	30%
F3	- Qualitative assessment	…………………………………....	20%
Total	100%		

Another responsibility of the auditor, in this phase of risk analysis, is establishing the risk factor weighting within the audited activity. Practice recommends that the highest weight to be given to the criterion - *the assessment of internal control* and the amount of risk criteria assigned weightings to be 100%. The entire intercession of the auditor, in this phase of risk analysis, are materialized in the elaboration of a working document. The internal auditing standards applicable in our country do not provide a procedure for its preparation in this document template neither, which is why a study of literature in the related area was necessary. From the study performed, *we consider* that it justified to elaborate a document which will be called *The appraisal of factors, weights and risk assessment levels and which should* contain all the elements presented above.

C. Determination of risk level and determining the total risk score. Based on the risk factors described above in this phase of the risk analysis procedure, a risk assessment is carried out associated to the activities that may be audited which materializes in: *applying to the weights of the risk factors for assessing the level of risk, risk factors,* based on evaluations conducted by internal auditors*; determining total risk score* is achieved by applying the share of each risk assessment factor level to determine the total score, according to the formula:

$$T = \sum_{i=1}^{n} P_i x N_i \qquad (1)$$

where:
P_i - weight of risks for each criterion;
N_i - level of risks for each used criterion.

Regarding the completion of this phase of the risk analysis procedure, internal audit rules applicable to public economic entities do not provide any document preparation.

D. Risk Ranking based on total scores. After the calculation, the phase of *Appraisal of the level of risk and determining the total risk score* is necessary to indicate to which level of risk corresponds numerical result of the calculation. To conduct this work, it is necessary to establish intervals which will indicate the level of risk, in fact the priority it gives a risk audit. Best practice in the field recommends that in establishing the size of the interval, to consider the available resources within the entity in order to carry out the mission of internal audit. Internal audit rules applicable to public economic entities in Romania, recommends sharing the risks - depending on the risk factors taken into analysis – on three risk levels: *low, medium, large*. At the same time, practice in the related area from our country, recommends for risk classification in the case of three risk factors, using the following intervals: *small risk from 1.0 to 1.8; average risk from 1,9 to 2,3; high risks from 2.4 to 3.0.* All activities developed by the auditors in this phase of risk analysis are summarized with a summary document - *Ranking objects that may be audited*, which the legislation has enabled the user to adapt to his needs.

E. Hierarchy of activities / operations depending on risk analysis. Prioritizing activities which are to be audited shall be based on previously prepared document. For the successful completion of this activity is necessary to take into account the number of staff, available time, other activities taking place within the structure of internal audit and risk analysis specifically identified in other areas of the entity.

This phase is materialized in the elaboration of *Table of strengths and weaknesses* document, through which analyzed operations to determine if they can be considered for the entity, *„strengths"* or, *„weaknesses".* In order to show how the identification of a strong point or a weak point, we consider as relevant the point of view of Mr Marcel Ghita who, in his publication The internal audit – second edition, Economic Publishing House, Bucharest, 2009, states: „A strong point or a weak point must be expressed depending on an objective internal control or a sought feature in order to ensure proper functioning of the audited structure". *Table of strengths and weaknesses* document presents schematically the result of assessment of each activity / operations / issues and contains the internal auditor's degree of confidence in the functioning of internal control as well as the consequence of operation / malfunction, which will lead to minimizing the risk, when the degree of confidence is large (strong point), and maximizing the occurrence of risk when the degree of trust is low (weak point). Operations identified as strengths are removed from risk analysis and will not be taken into account at the drawing up the detailed topic of the internal audit mission.

F. Develop the detailed thematic of the internal audit mission. The detailed thematic of the internal audit mission is that phase within the internal audit mission, which is done by selecting objectives that may be audited, having as starting point the Table of strengths and weaknesses document, which were assessed as weaknesses and will be considered further for auditing. Regarding the method of selecting objects that may be audited, we consider it appropriate to mention the view of experts [5] from Romania, respectively, „In practice usually there are considered all the objectives that were classified as weaknesses, but may be covered by the auditors and objectives that are qualified as strengths, if the auditor believes it necessary to investigate whether the internal control system is functioning". The results of this work are reflected in elaboration of the The detailed thematic of the internal audit mission document, for which the rules of internal audit applicable to public economic entities, do not recommend to use a formalized document, leaving it up to an auditor to use this document in accordance with his needs.

A distinct problem regarding The detailed thematic of the internal audit mission document is to locate this activity within The Preparation of the audit mission phase. Thus, the rules of internal audit [9] applicable in our country, for public economic entities, recommends the creation of this activity and thus develop the reference document, as a first step within the Elaboration of internal audit program procedure. In another train of thoughts, experts in the field of Romania [5][6] consider

The detailed thematic of the internal audit mission is the last phase of the risk analysis procedure, which is why the specific document of this phase should be developed within this procedure. From the analysis of the presented above *we can reckon* that for the smooth conduct of internal audit mission it is important the achievement of the activity itself namely, the correct elaboration of The detailed thematic of the internal audit mission document, which will compile The internal audit program. As for locating this activity within The Preparation of the audit mission phase, as the last phase of the Risk analysis procedure or the first phase of the Elaboration of internal audit program procedure, we consider that it is not very important as long as the activity was carried out in accordance with best practice in the related area.

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