INTERNAL AUDIT AND RISK MANAGEMENT IN PUBLIC SECTOR ENTITIES, BETWEEN TRADITION AND ACTUALITY

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ABSTRACT: The deep transformations which have marked the public sector, generated by the European Union extension, the decentralization process, the increase of complex activities, the ascendant trend of current agreements and the descendant trend of future resources require redefining the role of internal audit and risk management in the public sector entities.

By the undertaken study we define the risk concept, identify the typology and indubitably divide the involvement of public internal audit and risk management into the equation of risks within the public sector entities. The research takes into account a synthesis of the ideas published on the topic, the regulations issued by the national and international accounting regulators, and by bodies of the accounting profession.

Key words: public internal audit, risk, risk management, activity consistency, performance

JEL codes: M42

Introduction

The public sector entities have to answer the users' continuously increasing demands for various and quality public services, requests for higher public and social responsibility, as well as strictness related to performance and transparency. The limitations act tridimensionally: existing regulations, descendant trend of public resources, and respectively, limitation of expenses, the process being subject to a portfolio of different risks.

In this respect, redefining the role of internal audit and managing risks by implementing and developing a device of risk management are considered essential processes for each entity of the public sector, which has as objectives the activity consistency and performance. Thus, by the undertaken research, we explain the concept of risk and clearly divide the role of public internal audit and risk management in the public sector entities, from the current economic crisis view.

Research methodology

Our research has as objective to develop the concepts of risk and risk management in the public sector entities in Romania, in respect of the current economic situation and international directions on the field.

The basis of the study consists in a synthesis of the ideas published on the the topic, the regulations issued by the national and international accounting regulators, and by bodies of the accounting profession.

In order to achieve the proposed objectives we will use a fundamental research method to identify risk and risk typology in the public sector, to explain the concepts of internal audit and risk management as well as to analyse the public internal audit process and risk management regarding the risks of the public system entities.

We will also refer to inducible research mechanisms demanding collection and analysis of

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certain qualitative information in order to redefine the role of internal audit and implement and develop the risk management in the public sector entities.

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Conceptual approaches of the risks in the public sector entities

Risk is unavoidable and it is permanently present in the activity of all entities, both in public and private sector.

Generally, risk is defined by the combination of the probability of an event occurence and its consequences. Therefore, risk means a series of challenges to face when taking some major decisions, due to the fact that it diminishes concentration on success and prevents achieving the estimated results.

Literature, national and international accounting regulators, and accounting bodies give various meanings to risk.

In economic terms, risk is an uncertain and probable event or a process which can cause loss into an economic activity, operation or action (Angelescu et al, 2001).

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, 2008) states that risk represents the threat for an event or action to have unfavourable impact on the capacity of the entity to successfully accomplish its objectives. Another approach presents risk as the possibility for a problem to appear and have fatal consequences, affect the plans of the entity or make less probable its objectives achievement (Daykin, 2005).

The public sector perceives risk as an event or situation of exogenous or endogenuous nature of a public entity which can interfere with the accomplishment of its missions, it can affect its patrimony or image as well as its staff's safety (Ernst & Young , 2008).

In accordance with the guidelines on risk management in the public sector from Australia and New Zeeland, risk shows the possibility for an event to occur and affect the objectives of the entity. Risk is measured in terms of consequences and probability.

The Canadian Accounting Institute defines risk as the possibility for one or many persons to bear with the unfavourable consequences of an event or circumstance.

The Internal Audit Standards describe risk as the possibility for an event to occur and have impact on the achievement of objectives.

The couple internal control – internal audit defines risk as an assembly of occurences which could have negative consequences on an entity whose internal control and internal audit mission is to ensure a good control on them.

For the public internal audit, risk means any event, action or conduct with unfavourable impact on the capacity of the entity to accomplish its objectives.

Although various, the above definitions have something in common, i.e. uncertainty and negative impact on the results of the entities.

Practice in the field of the public sector has shown the existence of various risks the entities incur. Their acuity and importance differ from one period to another in accordance with the status of economy, as well as the changes occuring in the society as a whole. Thus, the following risks are considered prevailing risks: global risks, risks generated by the regulation environment, risks concerning the non-compliance with the budgetary accounting or financial rules, risks determined by the deficiencies of the services in the operational and support processes, risks related to the ownership of state joint accounts and to the control of entities acting on behalf of the state, risks related to delegation of management, risks concerning the persons' safety, risks concerning the public control, risks of internal and external fraud, risks generated by poor public governance from point of view of policy and public law, risks regarding the services deficiency in managing the assets.

Currently, the analysis of the economic situation emphasizes a slow-down of the economic growth, simultaneously with the increase of differences regarding the revenues. The economic imbalance is reflected at the level of public sector entities in all domains, individually or cumulatively, by the diminution of public financing resources, the poor quality of public services, and the contraction of the institution activity. Therefore, the entities will look for new financing methods. For example, 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 take loans, negotiate the rates of interest and the financial conditions of the debt. The principle of free administration does not prevent the financial investment of the public local collectivities and institutions strictly regulated by law, prohibiting any exposure to risk. 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 structural products comprise in the same contract a loan and more derived products, usually, under cover of sale of options towards the borrower, and they offer the borrower in the first year of contract an interest inferior to the market, and in some cases of 0%. The alarming increase of the local public entities debts, and implicitly their cost, simultaneously with the expected degradation of the financial situation are considered the consequences of the absence of a strategy to use the financial instruments to diminish the debts, the models to measure uncertainty and exposure to risk, the forecast of financial risk and subsequently of deficient risk management. In the countries which have recently got the quality of European Union card-carrying member, the financing by accession of EU non-refundable financial resources has augmented the public entities exposure both to financial risks and fraud and corruption risks. Of course, the risk area can be enlarged but no matter what the stage of economy development should be, the public sector remains one of the greatest risks.

Internal audit and risk management in the public sector entities in terms of the current economic crisis

Namee & Selim (1998) consider that the emergence of the risk concept has influenced also the concept of internal audit whose development consists of three stages: identification and analysis of risks, systems of internal control, audit of activities with emphasis on risks.

Generally, internal audit is an independent function of control, a component of the entity, having the aim to evaluate and examine its activities, being considered a valuable service for the entity.

Morris (quoted by Renard, 2008) approaches the internal audit in terms of its esential role and the support granted to the managing board, "in order to handle the internal control". This opinion consolidates the the role of the internal audit, that is to ensure the quality of the existing internal controls, the manner they are applied, the correctness and effectiveness of the implemented strategy, giving courage and confidence to the internal audit.

From point of view of management, the internal audit encompasses all that a responsible should do in order to be sure that he has a good control on the business if he had time, or if he knew how to act (Renard, 2008).

A complete definition of the internal audit is given by the Institute of Internal Auditors through the International Standards of Internal Audit, adopted at national level as the Internal Audit Standards: an independent and objective activity giving ensurance to an entity on the degree of control of its operations, guiding it in order to improve its operations and contributing to plus value addition. The role of the internal audit is to support the entity in achieving its objectives, assessing by systemic and methodic approaches its processes of risk management, control and governance of the organization, and coming up with proposals to consolidate their effectiveness.

The concept of internal audit in the public sector, called public internal audit, is the activity functionally independent and objective giving ensurance and counseling to the managing board for a good management of public revenues and expenses, improving the activities of the public sector entity; it helps the public entity in achieving its objectives through a systemic and methodic approach evaluating and improving the efficiency and effectiveness of the management based on risk, control and process management (Law no.672/2002).

The thorough examination of the last two definitions, relatively similar, shows clearly that risk management is the responsibility of the managing board of the entity, which, in order to achieve its objectives, has to make sure that the risk management processes are implemented and they function well.

The concept of risk management does not have a generally accepted definition. In literature, risk management is approached from point of view of the developed financial-banking markets, capable to ensure the means required for the reinstatement of equilibrium if risks generate negative effects. The Standards of Internal Audit define risk management as the process of identification, evaluation, and control of potential events or situations in order to give reasonable assurance in respect of the achievement of objectives. From COSO point of view (Comittee of the Sponsoring Organizations of the Treadway Commission), risk management is the process in which the managing council, general management and the entire staff are involved and it is intended to give reasonable ensurance in terms of the achievement of objectives; this process is intended to identify the potential events which could have effects on the entity and to manage the risks within the limits of its aversion to risk, and it is taken into account when drawing up the entity strategy and its activities.

If risk identification, evaluation and monitoring are the responsibilities of the management, which is the role of the internal audit within this process? Given the emerged confusions in respect of the internal audit integration into the equation of risk, by the undertaken research we clearly state that the internal audit process depends on risks. Risks and exposures to risk are an instrument of planning for the internal audit. Therefore, the internal audit is approached in accordance with the risks because the assessment carried out by the auditor means that this one has examined the areas having weaknesses. The role of the internal audit is to offer information to the management in order to diminish the negative consequences generated by risks in achieving the objectives of the entity and risk management efficiency.

The role of the internal audit within the risk management is an issue under debate in literature and practice. In their study, Gramling and Myers (2006) have proved that internal audit has a moderate role within risk management by means of its five components, on a scale from 1 to 5, according to the assigned importance: 1- no responsibility ; 2- limited responsibility; 3- moderate responsibility; 4- great responsibility; 5- total responsibility (Table no.1):

Table no. 1

Main roles of the internal audit in the risk management process of the economic entities

Activities related to risk management	Actual responsibility	Ideal or desired responsibility
Gives assurance within the risk management process	3,10	3,80
Gives assurance that risks are correctly evaluated	3,00	3,60
Evaluates the process of risk management of the entity	3,17	3,82
Evaluates the reporting of the main risks	3,09	3,70
Reviews the management of the main risks	3,19	3,76

Source Gramling & Myers (2006)

The shy involvement of internal audit into the identification and evaluation of the risks from the local public entities and public institutions is also supported by the study carried out by Ernst& Young, on a sample of 400 local collectivities and 125 public institutions. The questionary submitted to these entities consists of questions related to public sector governance, the organizations major tendencies regarding the risks and identification of significant domains, status of internal control implementation by references generally adopted. The answers to the question regarding the responsibilities of the internal audit were the following (Table no.2):

Table no.2

The activities of the internal audit function in the local public sector entities and the world public institutions

Type of activities /Repondents	Public institutions		Local public sector	
	Systematic (%)	Frequent (%)	Systematic (%)	Frequent (%)
Assessment of internal control	47	32	20	44
Testing the effectiveness of procedures	40	30	17	44
Mapping of risks	**32**	**16**	**6**	**27**
Audit of financial information	26	42	15	43
Audit of informatic systems	25	38	8	22
Audit of subordinate entities	13	31	41	38
Writing of procedures manuals	5	26	25	43
Evaluation of public policies	-	6	21	36
Constituence of internal control	-	21	6	26

Source: Ernst & Young (2008)

The survey shows that the issue of identification and evaluation of weaknesses from point of view of risks is subject to systematic internal audit missions in a percentage of 32% into the public institutions and 6% in the local public sector entities. Also, testing the procedures effectiveness, auditing the informatic systems, and the financial informations are rarely subject to the internal public audit missions, and the missions with indirect function of internal audit (writing of procedure manuals, constituence of internal control) are frequently subject to it. The assessment of internal audit and auditing of subordinate entities, systematic and frequent responsibilities of the internal audit within most of the public entities (79%, 64%; 42%, 79%), prove that the missions of internal audit are still traditional.

The traditional role of the public internal audit is also sustained by the survey carried out by Steunpunt Bestuurlijk Organisatie Vlaanderen, Instituut voor de Overheid (KULeuven), University association of research of public action, at public sector level in Belgium (Table no. 3):

Table no.3

The activities of the internal audit function in Belgium

Type of activities	Actual responsibility
Risks and control systems	**4,87**
Process reengineering	4,22
Specific to the public sector	4,09
Performance assessment	3,78
Finance and accounting	3,52
Legal problems	3,32
IT	3,22
Change management and human resources management	3,00
Health, safety, environment	2,26

Source: Steunpunt Bestuurlijk Organisatie Vlaanderen (SBOV) – Instituut voor de Overheid (KULeuven), Association universitaire de recherche sur l'action publique (AURAP – UCL), (2008)

The results of the survey, assessed in accordance with the importance of the activities of the internal audit function on a scale from 1 to 5, place as very important, with 4,87 the activity regarding risks and internal control.

An argument of inappropriate management of risks within the public sector is the survey carried out by Deloitte (2009), in 200 government departments from 28 states, according to which, 48% of the world public officials consider that the inappropriate management of risks is one of the many challenges incurred by the financial departments of the public entities.

The redefinition and reinforcement of the role of risk management into the public sector entities are imposed by the examination of the results of the undertaken surveys and the deep transformations in the public sector, generated by the extension of the European Union, the processes of decentralization and those of compliance with the European practices, the augmentation of the complexity of the activities and environment as a whole, the ascendant trend of current agreements and descendant trend of future resources, as consequences of the economic crisis.

The focus of internal audit mainly on activities related to the internal control system and less on risks (tables no. 1, 2, 3) does not represent a diminution of its role in the public sector. There are the diversification and multiplication of risks into the public sector, mainly the financial risk, fraud risk, and the complex of risks they generate, which bring the anticipation of risks and their management. In this respect, we clearly set out the internal audit and risk management regarding the risks within the public system:

Table no. 4

Tri-dimensional concept determinations: internal audit – risk – risk management into the public sector entities

Risk management	▪ It is applied at each level of the entity and in each subordinate entity and it allows a panoramic view of the entity exposure to risks; ▪ Identifies potential events capable of affecting the entity; ▪ Manages risks within the entity disposition to risks; ▪ Oriented towards accomplishment of the entity's objectives.
Internal audit	▪ Risks represent a planning instrument ▪ It helps the entity by identifyiny and evaluating the exposures to significant risks ▪ It supervises and evaluates the effectiveness of the risk management system ▪ It contributes to the improvement of the risk management systems

Unlike public internal audit, risk management helps the entity to identify and prevent significant risks, makes for the decisions concerning the manner to handle these risks, monitors the progress of their management and teaches the entity to improve the way of handle risks. Also, risk management focuses on the increase of benefits and decrease of costs of activities involving a degree of uncertainty. The permanent concern for risk management represents for the public sector entities their obligation in respect of the care for the public. On the other hand, risk management contributes to the improvement of the decisional process in uncertain situations.

In order to achieve its objectives, risk management implies following the stages below:

- The identification of risks consists in a global approach of the entity in order to identify risk diversity, both new risks and potential ones, to estimate the effect a risk event could have on the entity's activity;
- The aim of the evaluation of risks is to determine the entity's exposure to the identified risks, taking into account their probability and incidence, risk classification in terms of tolerance to risk on the basis of the existing criteria or on the basis of new ongoing ones;
- The answer to risks is the stage whithin which there are determined the objectives and expected results regarding the priority of risks set up on short and long term; there are identified and analysed the options; it is chosen the strategy based on the decisional criteria focused on results or oportunities; it is implemented the chosen strategy;

- The monitoring of the effectiveness of risk management has a major role for the existence of the relationship feedback-learning-improvement.

The analysis of the integration of internal audit and risk management within the equation of risks of the public sector, shows that entities can achieve their objectives and improve their performance only by the two complementary actors. Thus, the internal audit evaluates the correctness of the measurments of risk management in association with the exposures to risk, supervises and evaluates the effectiveness of the risk management system and contributes to their improvement to add plus value to the entity.

Conclusions

The complex activities of the public sector entities, the autonomy of certain entities, the increase requests regarding the quality of service demands, the public resource limitation as an effect of the economic crisis, and at the same time, the variation of the financing alternatives, the difficulties of performance measurement into an uncertain environment amplifies and diversifies the risks of the public sector both at national and international level. Therefore, the responsibilities of the actors involved in the risks matter become more complex, too.

The research underlines the fact that risk anticipation and management into the public sector entities become neccesity. Thus, risk management brings its contribution to the improvement of the decisional process of the public entity in uncertain situations. Additionally, the public internal audit supervises and evaluates the effectiveness of risk management system and contributes to its improvement, for plus value addition to the entity. Thus, each of the actors involved in this process needs the other one, and together offer the public entity the appropriate framework to better answer the public's strict requests.

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