RISK ANALYSIS AND INTERNAL CONTROL ASSESSMENT - PREMISES FOR IMPROVING MANAGEMENT AT THE LEVEL OF ROMANIAN PUBLIC ENTITIES

CRISTINA MARIA VOINEA, VIOLETA STATE [*]

ABSTRACT: *Romania, as a European Union member state, has undergone, in recent years, a complex process of reform in all activity fields. This includes the current process of public administration reform, which aims to improve the management, the administrative capacity and the manner in which the entire Romanian public sector is organized. In this study, we intend to portray the manner in which the internal control system and the internal audit structure of a Romanian public entity are shaped into form. For exemplification, we chose the internal audit mission titled "The Accounting System and Its Reliability". We will identify the risks, we will assess them and we will also propose measures through which the entity's management may mitigate these risks by correcting registered deviations.*

KEY WORDS: *risk, analysis, probability, impact, internal control, assessment, internal audit.*

JEL CLASSIFICATION: *M42, M48.*

1. INTRODUCTION

The community *acquis* in the field of internal control consists predominately of general principles of good practice accepted internationally and within the European Union. The manner in which these principles are integrated into management systems and/or internal control systems is particular to each country, taking into account the specific constitutional, administrative, legislative and cultural conditions. Thus, Romania has adopted the Internal Control Code (O.M.F.P. nr. 946, 2005),

[*] *Lecturer, Ph.D., Valahia University of Târgovişte, Romania, voinea_cristina_maria@yahoo.com*
Assoc. Prof., Ph.D., Valahia University of Târgovişte, Romania, viostate@yahoo.com

encompassing management and internal control standards for the public entity and for developing managerial control systems. According to these regulations, the internal control system is aimed at providing reasonable assurance for achieving the objectives of the public entity in an economic, efficient and effective manner, for compliance with external rules and management policies and rules, for protecting assets and information, for prevention and detection of fraud and errors, as well as for the quality of accounting documents and producing timely and reliable information concerning the financial and management segments.

Internal control is associated with a much wider sense, being regarded as a management function rather than a verification operation. Using the control function, the management identifies the deviation of results compared to objectives, analyzes the causes of said deviations and decides on the corrective or preventive measures required. Internal control is one coordinate of the public management that "seeks to identify general and specific principles and legalities for the public sector in general and especially for public institutions, which by their content should ensure the necessary fundamentals to satisfy the public interest" (Guţă, 2013).

2. REDEFINING THE INTERNAL CONTROL MANAGEMENT FUNCTION

Exercising the management process calls for performing specific tasks that can be grouped under five mandatory functions for the manager of an entity, regardless of hierarchical level, these being planning, organizing, leading, staffing and controlling, with the latter implying supervision and guidance in order to comply with set norms, rules and standards.

Due to redefining internal control (switching from a control with strong financial and accounting connotations to one based on policies and procedures, whose structure includes the internal audit), there is a widening of its objective, in that it is seen as a function of the management process, alongside the other established management functions.

As a consequence, a significant mutation has taken place, with the controlling function of management becoming the internal control function, which also includes the internal audit activity. Considering the fact that "internal control standards envision the internal control as a process and recommend its dissipation on workflows within the organization, the internal control function at management level is basically represented by the internal audit, that assesses internal control functionality" (Ghiţă, et al., 2009).

The internal audit is "the functionally independent and objective activity that offers assurance and counsel to management, for the proper administration of public revenue and expenditure, improving the activities of the public entity" (Law. nr. 672, 2002). The internal audit does not exercise any of the forms of internal control, but rather analyzes and assesses the risk management process and the internal control system, in order to provide: reasonable assurance on risk mitigation and internal control system functionality; counseling meant to generate added value and improve the activities of entity management, risk management and internal control.

As mentioned earlier, through the internal control function, the management evaluates the level at which the objectives have been reached, identifies the deviations from these objectives, analyzes the causes that have determined them and decides the corrective measures required.

Reaching the objectives requires carrying out activities that represent the result of staff efforts. Each activity involves certain ***risks***. Knowing these risks facilitates the efficient and effective reaching of the entity's objectives. It is evident that if we know the threats, we can construct a hierarchy based on their probability of occurrence, extent of impact on objectives and costs associated with the measures aimed to reduce their chances of occurrence or to limit their undesirable effects. The lower the probability of risk occurrence, the less significant their impact is if they do occur; the activity with which the risk was associated would be more "healthy" and safer to implement.

The internal control system of an entity must have a key role in the risk management process, in order to reach the objectives. In this regard, an implemented internal control activity is carried out in order to reach the objectives, manage the risk and maintain the balance at entity level.

Entities must define clear objectives and subsequently assess the specific risks inherent in reaching them, purpose for which they will elaborate ***control strategies*** (measures to achieve tasks) that would provide reasonable assurance that assets would be protected and operations would be "crowned" as successful.

Risk analysis activity aims to identify risks within the audited entity associated with the auditable field and to assess them, to evaluate the internal control and to select the audit mission objectives. Risk assessment depends on the likelihood of their occurrence and impact. The criteria for analysis are (H.G. nr. 1086, 2013):

1. Probability assessment – a qualitative element, achieved by evaluating the likelihood for risk occurrence, by taking into consideration the occurrence factors specific to the auditable field and that can be expressed on a value scale, with three levels: ***low probability***, ***medium probability*** and ***high probability***;
2. Impact assessment – a quantitative element, achieved by assessing the effects of the risk in case of occurrence, by taking into account the criteria specific to the auditable field and that can be expressed on a value scale, on three levels: ***low impact***, ***moderate impact*** and ***high impact***.

The specific criteria weighed when assessing both the probability and the impacts are characteristic to the auditable field.

3. RISK ANALYSIS AND INTERNAL CONTROL ASSESSMENT WITHIN THE INTERNAL AUDIT MISSION "THE ACCOUNTING SYSTEM AND ITS RELIABILITY"

In general, carrying out an internal audit mission involves setting objectives and within these objectives, setting activities (actions) that will be subject to auditing. In order to exemplify the execution of the internal audit mission titled "The Accounting System and Its Reliability" in a Romanian public institution, we set the objective *Accounting organizing and leading*. We chose this mission because accounting information is "specific economic information produced from the processing through methods, processes and instruments appropriate to accounting data. representing the dashboard, the support of economic, financial and management decisions taken by managers" (Epuran, et al., 2004, p. 24).

The quality of information influences the quality and the sustainability of decisions made by managers, in other words "the information represents the support of decision making by those managing the economic entity, helping them take the right decision for them to achieve set objectives" (Sabău, 2012).

For the objective mentioned, two activities are to be taken into account:

- Activity 1: Setting the objectives of the accounting department;
- Activity 2: Risk management at department level.

We associated the following potential risks with these identified activities:

Table 1. Identified risks associated with the objective "Accounting organizing and leading"

Objective	Activities/Actions	Identified risks
Accounting organizing and leading	Setting the objectives of the accounting department	There are specific objectives that do not meet the SMART requirements package*
		Lack of correlation between established objectives and the activities that these objectives are based upon
		Lack of correlation between established objectives and allocated resources
	Risk management at department level	Lack of identification of risks specific to activities executed within the department
		Lack of risk management measures
		Risk register not completed/ updated

* The SMART requirements package is provided by the Standard for management/internal control of public entities no. 7 "Objectives" and stipulates that objectives must be defined in such a manner so as to meet the following requirements.
S – specific, precise, concise;
M – measurable, verifiable;
A – attainable, necessary;
R – realistic;
T – with a term for completion.

Source: Author's research

Once the risks are identified, we proceed with their analysis by assessing the two criteria: probability and impact. The combination between the estimated level of probability and the estimated level of impact represents the ***risk exposure***, based on which the risk profile is elaborated. The purpose of risk assessment and analysis is to establish a hierarchy of the entity's risks in order to associate corresponding internal controls, to evaluate these controls and to select activities to be audited.

Risk analysis involves assigning scores on a three-level scale, as follows:

Table 2. Probability prioritization criteria

Probability	Criteria
Low (1)	The normative framework has been in effect for three years without modifications
	Activities and actions have a low complexity level
	Staff has at least 5 years of experience
	High level of staffing
	The risk has no prior occurrences etc.
Medium (2)	The normative framework is relatively new or has suffered some modifications
	Activities and actions have a medium complexity level
	Staff has at most 3 years of experience
	Medium level of staffing
	The risk has rare prior occurrences etc.
High (3)	The normative framework is relatively new or has suffered numerous modifications
	Activities and actions have a high complexity level
	Staff has under 1 year of experience
	Low level of staffing
	The risk has frequent prior occurrences etc.

Source: H.G. nr. 1086, 2013, for adopting General Norms concerning the exercising of the internal public audit activity

Table 3. Impact prioritization criteria

Impact	Criteria
Low (1)	There is no loss of assets (financial, staff, material)
	The entity's image is slightly affected
	Operational costs are not affected
	Quality of services provided is not affected
	There are no activity interruptions etc.
Moderate (2)	Minor loss of assets (financial, staff, material)
	The entity's image is moderately affected
	Operational costs increase is moderate
	Quality of services provided is slightly affected
	There are minor activity interruptions etc.
High (3)	Significant loss of assets (financial, staff, material)
	The entity's image is significantly affected
	High operational costs
	Quality of services provided is significantly affected
	There are significant activity interruptions etc.

Source: H.G. nr. 1086, 2013, for adopting General Norms concerning the exercising of the internal public audit activity

After applying these criteria for the public institution subjected to the study, the risk analysis for activities identified under the objective "Accounting organizing and leading" revealed the results presented in Table 4. Please note that in the risk hierarchy, the following levels were considered:

- Low risk, if the Total Score is between 1 and 2;
- Medium risk, if the Total Score is between 3 and 4;
- High risk, if the Total Score is between 6 and 9.

After completing the ***risk analysis***, the following conclusions can be drawn:

- Identified risks were estimated as being of medium and high level, which means that these activities will be audited;
- At the level of the objective "Accounting organizing and leading", there are two risks with high probability of occurrence, namely: *There are specific objectives that do not meet the SMART requirements package* and *Risk register not completed/updated*.

Table 4. Determining the total score for risks and establishing the risk hierarchy

Identified risks	Risk analysis criteria		Total Score	Risk hierarchy
	Probability	Impact		
Activity 1: Setting the objectives of the accounting department				
There are specific objectives that do not meet the SMART requirements package	3	2	6	High
Lack of correlation between established objectives and the activities that these objectives are based upon	2	2	4	Medium
Lack of correlation between established objectives and allocated resources	2	2	4	Medium
Activity 2: Risk management at department level				
Lack of identification of risks specific to activities executed within the department	2	2	4	Medium
Lack of risk management measures	2	2	4	Medium
Risk register not completed/ updated	3	2	6	High

Source: Author's research

Regarding the *first risk with high probability* of occurrence, we can state that the objectives specific to the accounting department were established, but do not meet the following characteristics: specific, measurable, attainable, realistic and with term. Also, it was not possible for all presented objectives to be associated with executed activities, which means there is no correlation between them and the department's activities/actions.

Concerning the *second risk with high probability* of occurrence, we observed that, although corresponding risks were associated with the identified activities, the risk register was not properly completed, since it did not meet the regulated minimal number of elements, and it was also not updated.

After the risk analysis and the identification of activities to be audited, we proceed to the ***internal control assessment***. The initial internal control assessment takes into consideration the risks associated with auditable activities/actions and involves the identification and analysis of internal controls implemented by the entity in order to manage these risks, with the purpose of discovering potential areas where there are signs that it does not exist, it does not work at all or it works inappropriately. *Depending on the results of the risk analysis and internal control assessment, the vulnerable activities/actions are selected for auditing*.

Initial internal control assessment involves going through the following stages (H.G. nr. 1086, 2013):

- Determining operating procedures for each identified activity/action;
- Identifying existing internal controls, based on the internal control questionnaire and collected documents;
- Establishing expected internal controls for each identified activity/action and risk;
- Establishing internal control conformity.

A three-level scale is used for the internal control assessment, as follows: ***conforming internal control, partially conforming internal control*** and ***nonconforming internal control.*** The separation criteria are (H.G. nr. 1086, 2013):

1. For establishing internal control as conforming:

- The internal/managerial control system is implemented, appropriate procedures that can prevent risk occurrence are developed;
- The entity's management has knowledge of the regulatory framework of the internal/managerial control system;
- The management and staff have a positive attitude towards internal/managerial control, manifesting preoccupation for anticipating and eliminating the identified issues;
- Internal/managerial control is integrated into the current activities of the audited entity/structure and it is not a separate activity or an activity conducted in parallel with them;
- The entity's risk management process ensures the identification of risks, their assessment, establishing risk management measures and monitoring of their effectiveness;
- The management systematically receives reports concerning activity execution and objective reaching and decides corrective measures in case of deviations from objectives etc.

2. For establishing internal control as partially conforming:

- The internal/managerial control system is partially implemented, appropriate procedures that can prevent risk occurrence are not sufficiently developed;
- The management and staff have a subjective attitude towards internal/managerial control, eliminating the issues identified only be certain audit or control teams;
- Internal/managerial control is partially integrated into the current activities of the audited entity/structure;
- The entity's risk management process ensures the identification of some risks, their assessment, but the risk management measures are not always appropriate and effective;
- The management receives certain reports concerning activity execution, but objective reaching is not monitored etc.

3. For establishing internal control as nonconforming:

- The internal/managerial control system is not implemented; appropriate procedures are missing, are not fully utilized or are improperly implemented;
- The entity's management does not have knowledge of the regulatory framework of the internal/managerial control system;
- The management and staff have a noncompliant or indifferent attitude towards internal/managerial control;
- Internal/managerial control is perceived as a separate activity or an activity conducted in parallel with the entity's other activities;
- The entity's risk management process does not ensure the identification of risks, and appropriate risk management measures are not established;
- The management receives some reports concerning activity execution and objective reaching, but the information is not reliable. These reports are not used in the decision making process and corrective measures in case of deviations from objectives are not implemented etc.

Returning to the case study presented above, following the initial internal control assessment for the objective "Accounting organizing and leading", we have found that the internal control system associated with all previously identified risks is *partially conforming*. This means that although there are a number of internal controls carried out, their number and scope are below expected levels.

For exemplification, we bring to your attention the identified situation concerning the risk with high probability of occurrence "There are specific objectives that do not meet the SMART requirements package".

1. Existing internal controls refer only to the presentation and analysis of general objectives.

2. As expected internal controls, we mention:

- Analysis of the entity's strategy in order to identify the general objectives;
- Analysis of the Internal Rules of Organization and Operation, in order to formulate the objectives specific to the accounting department/service;
- Adjusting the objectives in order to ensure compliance with the SMART criteria.

Elements such as these were individually identified and adapted to each activity and their associated risks.

Based on the findings of the initial internal control assessment, the auditor selects the activities to be audited, taking into account the following stipulations (H.G. nr. 1086, 2013); auditable activities become:

- Activities/actions with high risk level, regardless of the results of the internal control assessment;
- Activities/actions with medium risk level and partially conforming or nonconforming internal controls;
- Activities/actions with low risk and nonconforming internal controls.
- Taking into account, on the one hand, the regulations in this field, and on the other hand, the actual situation observed at the level of the public entity studied, we have reached the conclusion that the two activities, *Setting the objectives of the accounting department* and *Risk management at department level*, specific to the objective "Accounting organizing and leading", must be audited because they are

associated with high or medium level risks, while internal controls are partially conforming.

Moreover, regarding the initial internal control assessment for all activities identified at the level of the accounting department, we can ascertain that:

- The management and staff of the accounting department have a subjective attitude towards internal control, they do not get involved in this activity, motivating that they lack available time for additional activities;
- At department level, people lack the knowledge of legislation in the field of internal/managerial control;
- Internal/managerial control is partially integrated into current activities, especially under the form of self-control;
- Identified risks are not correlated with executed activities and as a consequence, the measures to be proposed are not appropriate;
- Procedures have been established, but the accounting department staff has little knowledge of them and thus, they are not utilized;
- Existing internal controls are insufficient, given the department's activity.

4. CONCLUSIONS

At the level of economic entity, internal control and internal audit must exist and be functional, in order to assist management in good activity organizing and in the decision making process.

Internal audit must be organized as a department under the direct subordination of the general manager, in order to maintain the auditor's independence and be of assistance to him.

In accordance with good practice in this field, internal control must reside within each activity and must be formalized through operational working procedures, based on job descriptions. Internal control must be present on all levels of the entity and manifest under the form of self-control, chain control (on process phases) and hierarchical control. From the perspective of the time of exercising, internal control can be divided into simultaneous control (operative control), ex-ante control (feed forward) and ex-post control (feedback).

As a result of the ***risk analysis***, conclusions can be drawn regarding:

1. Risk knowledge – facilitates efficient and effective reaching of the entity's objectives;

2. Threats knowledge – allows a reduction in the probability of their occurrence while limiting the manifestation of undesired effects.

Treating the consequences does not ameliorate the causes and thus, the risks already materialized will also manifest themselves in the future, with increased frequency and a more significant impact on objectives. The entity's management must adopt measures susceptible of attenuating the manifestation of the risk.

Following ***internal control assessment,*** the entity will proceed with:

- Identifying the general objectives and establishing objectives specific to each department, that meet the SMART criteria;

- Ensuring the correlation between the specific objectives, the Internal Rules of Organization and Operation and the job descriptions;
- Periodically updating the job descriptions;
- Elaborating procedures for each activity being executed and organizing meetings for disseminating these procedures for all staff;
- Stimulating participation to professional training, both internal and external to the entity, in order to ensure good knowledge of norms and regulations in this field;
- All these measures favorably influence the flow of activities and directly contribute to improving management and administrative capacity at the level of the public entity.

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