

Inherent risk and auditor's decisions: Government internal auditing.

Khalid Suidan Al Badi

Head of Internal Audit Department, Ministry of Health, Oman

A faculty Member, Al Buraimi University College, Oman

Abstract:

Government internal auditing in recent times has increased greatly in terms of importance and responsibility; it has become an official observer in the eyes of both managers and the public. Most decision-makers in government organizations make their decisions based on the internal audit function (IAF) which is supported by internal auditor's reports. It is necessary to find a clear mechanism to ensure that the internal auditor's decisions are highly credible and reliable. Hence, the issue of the three inherent risks (IR) appears, which can affect the internal auditor's decisions. This paper investigates the government internal auditing process and the inherent risk which affects the internal auditor's decisions in the public sector; it focuses on the main three factors of competence, objectivity and performance.

The high quality of the internal auditor's decisions can improve opportunities and explore threats to the achievement of organizational goals, identify operation management improvements, and reduce the impact of risk.

However the management of government organizations should accept a level of what is called “residual risk” (RR). RR is the risk that remains after organizational management takes action to decrease the possibility of undesirable events, in conjunction with internal control activities, as a way of dealing with risk.

Key words: Government audit, public sector, internal audit, inherent risk, internal auditor’s decisions, competence, objectivity, performance.

Introduction:

Although few publications deal with government internal auditing, it has become increasingly important because its presence has become closely linked in terms of reliability and effectiveness to government activities (administrative and financial), and its key role goes far beyond the financial focus.

Recently it has appeared that governments rely on internal auditing in order to measure public service performance. In this context, some talk about an ‘audit explosion’. Power stated that we are involved in an ‘audit society’ and that internal auditing plays a significant role in the ‘reinvention of government’ (Power 1994; 1997). It is obvious that internal auditing has a vital role to play in current government strategy for achieving integrity, performance and responsibility in the public sector (Humphrey *et al.*, 1998).

In relation to the virtuous role of internal auditing as a central part of the 'reinvention of government' (Power, 1994, p.17), arguments have arisen about the issue of inherent risks and how they affect the auditor's decision in terms of integrity, performance and accountability.

The Auditing Standards Board (United States) has pointed out that there is a lack of profession guidance with regard to internal auditor's decisions in respect to inherent risk (SAS No. 65, AICPA 1990).

Many researchers into internal auditing have generally delineated that the three internal auditing factors identified in the internal audit professional standards — objectivity, competence and performance — have a significant impact on the internal auditor's reliance judgments. Margheim (1986) states that internal audit competence and work performed factors have a significant effect on the auditor's decisions and reliance judgments. This is consistent with Schneider's (1984;1985) result which found that the three variables seriously affected the evaluations of internal audit quality and the auditor's decisions in the audit-planning engagement. Finally the study by Brown (1983) emphasized that the three internal audit variables had an effect on the internal auditor's decisions.

The scope of internal auditing activity in government has grown considerably. As part of the normal sequence, most financial and administrative decisions are built upon the reports of internal auditing functions. It is very important to examine the

inherent risk which is involved in the context of internal auditing functions. This paper analyses the three internal auditing factors in terms of inherent risk.

The role of government auditing:

Government auditing (public auditing) is presently enjoying a high political profile and local public interest. Walker (1996) states the reason for this attention is the growth in corruption and sleaze accusations which have resulted in an erosion of public confidence in the managers of public services. This issue has resulted in talk of the significant role of internal auditing functions. These are based on internal auditors' decisions as a solution to revealing the extent of corruption and sleaze. The internal auditing function has become responsible, not only in the eyes of decision makers but also in terms of public opinion. All of these virtues have come together to emphasize that the internal auditors' decisions must deal with inherent risk in a professional way.

The internal auditing function (IAF) is different in various public organizations. In some countries such as Australia, many organizations do not operate any type of internal auditing function at all (Goodwin and Kent, 2006; Carey et al., 2000). On the other hand, in Saudi Arabia, traditionally the internal auditing function has concentrated on the credibility of transactions and accounting only, and up to 2004 there was no legal support for such a function (Alzeban and Sawan, 2013)

In the Sultanate of Oman, a government internal audit has been introduced incrementally. The first Internal Institute (IIA) Chapter was founded in 2002 within Oman Air Aviation. The main purpose of this IIA Chapter was to increase the number of IIA members and to provide courses for Certified Internal Auditors (CIA) as well as conducting examinations to allow applicants to gain a CIA qualification (IIA Chapter, Oman, 2002).

The Ministry of Health in the Sultanate of Oman is a good example that can be used to illustrate a government audit, as it was one of the first non-for-profit organizations to establish an internal audit department in 1999 (*Resolution No 20/1999 in respect of the Internal Audit Department*). This was consistent with Royal Decree No. 56 which established a Directorate-General at the Health Ministry called "The Directorate-General of Internal Audit" (*Official Gazette, 2006*). The Ministry of Health is the only one which has a decentralized and self-administering system for all of its units in all regions of the Sultanate of Oman (Oman Daily Newspaper, 2103).

From 1999 until 2002, the role of the Internal Auditing Department was very limited, and did not exceed the documentary audit in the headquarters of the Ministry of Health located in Muscat. It should be noted however that the Ministry of Health had branches spread all over the Sultanate. However, the department lacked training materials and expertise in the field of internal auditing, and until 2002, there were no more than 10 employees (Ministry of Health, 2002).

With the establishment of the IIA Chapter in 2002, the Ministry of Health in the form of the Internal Audit Department started to collaborate with the IIA Chapter by sending some staff on professional training courses related to procedures for internal audit. With the development that has occurred in terms of systems of internal audit, in line with the important role of internal auditing, the Ministry established new staff consisting of bachelor degree holders and upgraded the internal audit function to become the Directorate-General of Internal Audit (DGIA). This entity performing the internal audit function (IAF). It is now fully independent and is directly answerable to the Head of the Unit (Minister of Health). This is consistent with international standards of internal auditing. On the other hand, the DGIA has set up internal audit departments in health institutions in areas that are remote from the capital (Oman Daily Newspaper, 2103).

Inherent risk (IR):

Risk, as defined by the Institute of Internal Auditors (IIA) is "...the possibility of an event that will have an impact on the achievement of objectives and it measured in term of impact and likelihood" (IIA, 2006). Mario (1993) stated that existing internal audit pronouncements define inherent risk as "...the risk of an account of class of transactions to material error irrespective of the system of internal controls". Consistent with these issues, Libby et al. (1985) emphasized that if there is a change in internal audit test strength, it will have an effect on the internal auditor's judgments in an environment high on inherent risk.

The IIA's guidance system defined the three factors of inherent risk as follows:

- 1- Competence; “Internal auditors should have the knowledge, skills, and experience needed in order to perform an internal auditing activity”.
- 2- Objectivity; “...an unbiased mental attitude that allows internal auditors to perform engagement in such a manner that they have an honest belief in their work product and that no significant quality compromises are made”.
- 3- Performance; “...the internal audit activities and criteria for their evaluation” (IIA, 2006)

Internal auditor’s decisions:

The decisions of the internal auditor in terms of government auditing used to be linked to the three factors of inherent risk. Internal auditing is “...an independent, objective assurance and consulting activity designed to add value and improve and organization’s operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes” (IIA 2006). In order to achieve the high internal quality which is a function of the three factors of inherent risk, the IAF (Internal Audit Function) in Ministry of Health in Oman applies this definition of internal auditing.

In this context, the filling of an internal auditing position should be in accordance with the appropriate criteria established by the IAF in the Ministry of Health (Ministry of Health, 2013). In terms of the competence concept there are some variables that affect the internal auditor’s decisions such as: proficiency, understanding and appreciation. However, the internal auditors should have

adequate knowledge to identify and monitor any lack in control, but they are not expected to have the experience of a person whose major responsibility is to detect and investigate this issue (IIA, 2006)

Objectivity is one of the main points associated with the international standards of internal auditing (1100) states that “Internal audit activity should be independent and internal auditors should be objective in performing their work” (IIA, 2006). Objectivity is achieved through organizational status and independence, which permit internal auditors to make impartial and unbiased decisions.

The last factor of inherent risk is performance. The internal auditors should identify, analyze, assess and trace information to achieve the organization’s goals (IIA, 2006). The purpose and the scope of the work associated with the internal auditing activity affects the decisions of the internal auditor in terms of authority, responsibility and accountability.

Conclusion:

The current policy on government audit should enhance the role of the internal auditor in order to measure administrative and financial performance within the public sector. The quality of the internal auditing function (IAF) is based on the internal auditor’s decisions and, as a consequence the auditor’s decision quality is markedly dependent on the effect of inherent risk. Government organizations

should limit uncertainty in terms of inherent risk and misstatements in the auditor's decisions. The three factors associated with inherent risk can be managed by the promotion and the spreading of awareness and information with reference to internal auditing and subjects related thereto. The internal auditors' decisions should be supported by the necessary competencies. A continuing learning system is necessary to allow staff to possess the knowledge and skills needed to achieve proficiency and an appreciation of the existence of actual problems or potential problems. Organizational status and independence ensures that the internal auditors' decisions are unbiased and impartial, and achieve a high degree of objectivity. Any impairment of performance on the part of the internal auditors may result in limitations in terms of their scope, purpose and authority which would restrict the internal audit activity and preclude the public services from accomplishing their plans and objectives.

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