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# THE IMPACT OF INTERNAL AUDIT ON THE FINANCIAL RISK MANAGEMENT OF SMES IN ROMANIA IN THE CONTEXT OF FISCAL HARMONIZATION

## Abstract:

The study has the following objective:
The analysis of SME behaviour in the management of the risk, of the risk appetite, as factor of impact on the process of planning and performance of the internal audit within the context of internationalization of the Romanian accounting and of harmonization of tax legislation with European norms in the field.
The premises of this work are meant to be a starting point for a systematic analysis of the current knowledge level concerning the integration of the internal audit for the risk management in order to reach the optimum risk balance of the entity's results.
The international financial environment is affected by the new exposures generated by the European sovereign debt crisis, concerns caused by the slowing down of world economy.
Having been politically and culturally influenced by the countries of European Union, Romania represents an interesting environment for research, in order to raise awareness that the internal audit and the risk management bring additional value to the entity and they are integral part of the risk equation.
For the recent years the use of the procedures and policies of integrated risk management at entity level (ERM-Enterprise Risk Management) has extended, the entities thus acknowledging the advantages of risk management approach.
The internal audit has the purpose of providing safety and consultancy while contributing to the risk management.
The relationship between the internal audit and the risk management starts from the presentation of the global economic context where they act and manifest themselves, following the influences that define their mutual relationship, from the national perspective anchored in the European perspective.
The general research area is given by the sciences of management accounting, taxation and integration of the internal audit in the risk management process, respectively, so that at the level of the theoretical research, a deductive type of approach is observed, based on the existing concepts, in order to singularize them at the level of SMEs.
Research is fundamental, deductive-inductive, aiming at measuring the awareness of the need to apply risk management, its management in terms of the economic efficiency of the entity, by explaining the current national and international legislative context of the analyzed interdisciplinary phenomenon.
It is envisaged that information will be acquired in what concerns the status of the analyzed phenomenon, anchored in the national economic reality, the capitalization of the information available in the analyzed field of interest, the exchange of experiences and good practices.

**Keywords:**

risk management , management accounting, internal audit,planning and performance of the internal audit

**JEL Classification:** A10, D03, H32

## Introduction

The international financial environment is marked by the new exposures arising from Europe's sovereign debt crisis, unrest caused by a slowing down in the world economy and by political tensions in the Middle East.

Romania, being strongly influenced politically and culturally in the recent years by EU Member States through the EU accession and post-accession, is an interesting research environment of awareness that internal audit and risk management bring added value to the entity and are integral part of the risk equation.

Entities face various risks: social, ethical, financial, operational, as well as risk in their management.

Information providers must find the balance between the listed quality features (understandability, relevance, reliability, comparability) in Romania’s process of economic convergence (real and nominal) with the European Union, in order to meet the objective of financial statements and to make them useful for a certain environment.

To create a safe environment for stakeholders, data transparency and quality play a dominant role, being pre-condition for accountability and internal discipline in the decision-making process of entities.

*Transparency enhances responsibility, while liability enhances transparency.*

1. **Regulation of Internal Audit at national and international level:**

Nationally, the main legal regulations include:

- Law 31/1990 on trading companies;
- Emergency Ordinance no.75 / 1999, republished, on Financial Audit;
- Order of the Ministry of Finance No.1802 / 2014 dated 29 December 2014 approving the Accounting Regulations on individual annual financial statements and consolidated annual financial statements
- Internal audit rules

Internationally, norms (standards) of internal audit professional practice were issued, recommended to internal auditors, based on which they develop their own standards for the implementation of internal audit.

## 2. **Impact of Internal Audit in Risk Management**

The emerging economy of Romania, part of the emerging Europe, creates the environment favorable for the choice to develop a business.

The implementation of a Risk Management System is required to meet legal obligations, to ensure internal and external transparency.

The essential component in management to meet objectives is given by Internal Audit performed in different, heterogeneous entities of various sizes, structures and goals.

The legal obligation to implement risk management in company is set out by:

2.1. **Professional standards of Internal Audit**, MPA, MPA 2010-2, Consideration of risk exposures in developing an audit programme which includes:

- conclusions on risk management;
- recommendations aimed at reducing risk exposures;
- audit reports will highlight the importance and consequences of exposure to risk on meeting audit mission program objectives conducted based on the assessment of the main risks;
- the need to define priorities in the decision-making process on resource allocation depending on the importance of risks and risk exposures.

2.2. **Order No.1802 /2014** dated 29 December 2014 approving the Accounting Regulations on annual individual financial statements and annual consolidated financial statements, Section on Internal Control in companies. In the meaning of these regulations, the entity's internal control aims at ensuring:

- prevention and control of the risks of not achieving the objectives set etc.
- compliance with the applicable law;
- implementation decisions made by management;
- proper operation of entity’s internal activity;
- reliability of financial information;
- effectiveness of the entity's operations;
- efficient use of resources.

Entities prefer whatever is measurable, logically and precisely defined. Currently, the everyday physical world is affected by subjective influences, reality is no longer rational, decisions can no longer be backed by complete information as it is expensive and difficult to obtain in a timely manner.

Acceleration of economic processes starting with that of innovation, going through the renewal of products and sales methods and ending with decision-making, generates a "formidable detonator irrational" (Le Saget M. 1999).

Starting from the idea that management is both art and science, by analogy, risk management is the balance between art and science, estimation and modeling of risks with essential role in decision-making.

Moreover, the risk of an entity is determined by the actions and decisions of its employees.

In the activity of any entity, especially in small and medium-sized entities, assessment and pursuit for stability and economic security have imposed a variety of methods and techniques for the evaluation of potential risks and to take preventive measures to avoid their negative effects.

Corrective measures were also created to minimize adverse effects.

Thus, the need for an Integrated risk management system - Risk management system at the enterprise level (EWRM - "Enterprise Wide Risk Management") has emerged, which must actively pursue the identification, analysis, evaluation and management of all risks (*market and financial, operational and strategic risks*) to minimize their impact on entity’s cash flows up to an acceptable level agreed as risk appetite.

*Market risk* has a central strategic importance within the entity's risk profile and its medium-term liquidity. The market risk afferent to entity's traction able products must be carefully analyzed - being quantified, evaluated and reduced when necessary, in order to guarantee the expected revenues according to entity's objectives

Hedging instrument of the swap-type risk, hedging strategy, etc. may be engaged to protect entity’s cash flow.

In terms of *operational risk*, high potential event-type risks associated to the operational activity must be identified and incident scenarios need to be developed and evaluated for each of them. Where deemed necessary, making specific risk management plans..

Credit risk management refers to the risk of default of one counterparty in contractual obligations resulting in financial loss to the entity. The main credit risks need to be assessed, monitored and managed at entity level using predetermined credit limits for each business partners and suppliers. Based on their creditworthiness, all counterparties are allocated a maximum (ceiling type) exposure in terms of credit limit (amounts and maturities) and creditworthiness revaluations and limits granted must be reviewed at regular intervals.

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Risk awareness, understanding of entity's risk profile and risk management skills must be enhanced according to entity's risk appetite.

In this respect, the entities need to implement an internal control system (internal audit), which includes activities to prevent or detect unwanted events and risks, such as fraud, errors, damage, noncompliance, unauthorized transactions and distortions in financial reporting.

Based on various models of activities, a number of steps in the evaluation and quantification of risk management have been taken and their further influence on the planning process and implementation of internal audit. In this respect, the National Bank of Romania, the Insurance Supervisory Commission and the Chamber of Financial Auditors of Romania played an important role, imposing the approach of internal audit based on risk management at entity level and identifying the internal audit function within the organization of the entity by various rules / orders issued.

Internal audit contributes to risk management in a variety of ways.

Entity's Board of Directors has overall responsibility to make sure that key risks are managed to an acceptable level. In its support, the role of internal audit on ERM is to give these objective assurances and consulting role.

Internal audit evaluates the effectiveness and efficiency of an entity's applicable policies, procedures and systems designed to provide:

- correct identification and risk management,
- reliability and integrity of information,
- compliance with laws and regulations,
- asset protection, economic and efficient use of resources,
- meeting the intended objectives.

Internal audit should conduct entity's regular audits to establish a high-quality financial reporting process.

Entity's internal audit must cover all its operations, with objectives such as:

- compliance with laws and internal regulations;
- reliability of financial reporting (accuracy, completeness and fair presentation);
- prevention and detection of fraud and error;
- effective and efficient business operations.

Audit risk assessment is the central concern of auditor in the analysis of the audit process.

When evaluating the overall audit risk in a mission, the three risk components which make up the audit risk are considered separately, namely the Audit risk = inherent risk x control risk x non-detection risk.

The risks for the financial audit are seen through the audit mission and objectives. Identification and quantification of audit risk in mission planning is in correlation with the existing risk management in the entity.
In case the audited entity has implemented a risk management proven as effective, the overall audit risk will be lower and, thus, the level of assurance provided by auditor shall be high. An effective ERM causes a greater confidence in the work of the internal audit department which leads the auditor to:

- reducing the number of tests and procedures performed;
- less conclusive evidence collected;
- carrying out the mission in a shorter time;
- focus on some important aspects to be tested;
- a high cost / benefit ratio both for the tested entity and for the auditor.

Starting from today's reality, it is easily seen that the activity of an entity is held under the influence of some variables of state and development.

The resilience capacity and growth capacity of entity's system depend on the level of control of these variables.

In its turn, this ability is the result of interaction between information obtained and its processing capabilities and decision-making.

When continuity prevails in this causal chain, certainty can be invoked. Fixed costs, prices, payment obligations based on a contract, quantities of products to be delivered and deadline, the date of payment and salary level etc. can be known.

Once the processes, phenomena and characteristics of the real economy have become more complex, the Laplacian determinism no longer meets the rationality requirements of economic entities. Their current status is no longer the result of determinations caused by its previous stances, but of multilateral influences, measurable or immeasurable acting in the past, present and future, which are little known about, although the current society is one of information.

The increase of complexity of economic activities is found easily in any field.

## Conclusions

Economic entities have gradually acquired the characteristics of non-balance systems that are no longer able to self-regulate based on its own mechanisms and he intervention of the management unit runs uncertain, primarily because technology has surpassed science to such point that states and subsequent parameters of the activity of an economic entity cannot be known with precision.

The faster development of production possibilities than science and of international economic exchanges than processes for collecting and processing necessary information

Economic entities acting on larger markets have accentuated the feeling of insecurity and vulnerability.

The risk in business is normal. Its disappearance would create confusion, inefficiency and would generate unnatural behavior of economic entities, as found in totalitarian systems. Then, the risk decreased, often even disappeared, because the economy was run by administrative-type control levers.

Thus, Romania has opted for the introduction of a distinct system for small enterprises in order to reduce administrative burdens on entities and, thus, the costs, including those related to accounting and financial reporting, objectives contained in various communications and resolutions adopted at the EU level.

So, in the road to refining the professional judgment, internal audit must be qualitatively in order to maintain its social role in front of its users, even if the emotional states generated by the growing stress and insecurity, by the emotional involvement all the more pronounced in the various problems an economic entity faces with today, aiming to impose on the market, makes non-logical elements, such as intuition, have an incredible expansion.

It takes a number of logical steps to maintain the economic entity within the efficiency range. Like any other resource, the emotional element should also be managed. In other words, risk management is a matter of balance between procedures and people. An entity can survive and even thrive if it has people of quality, even given circumstances when it has poor management methods and processes. The converse is not valid.

Therefore, we can say that there is dialectical relationship (based on contradictory phenomena) between rational (internal audit) and irrational (uncertainty risk): in current circumstances, the penetration of irrational, in economy, in the economic entity is an inexorable reality (relentless).

Maintaining a balance between components and functions of economic entities requires the presence of rational in it, not as much as to block the manifestation of stress, of subjective, of emotion, but to overcome them and steer them in a creative direction.

There is no difference in plan between rational and irrational in economy, namely whichever comes first or second, but in the ratio relating to time, place, and particular solution. The rational prevails in the beginning stages, such as the statement of mission, vision, business plan, income and expenditure balance and, in the end, in the form of balance results, which cannot be entrusted to random or emotional factors.

In the other cases, the task of rational is to ensure growth and balancing of processes and relations with third parties, to prevent distortions and deviations between thinking and logical and analytical actions, on one hand, and judgment and intuitive procedures, on the other hand. Intuition (operational risk) must make its way beside it, so that screenings based on such a release base be able to confront and balance with mathematical-type approaches, that is measurable approaches.

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