Using Risk Assessment in Multi-year Performance Audit Planning

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Introduction

Public sector audit entities should have the independence and responsibility to select which areas of public administration they will audit and which performance audit topics they will select.

Audits entities have limited resources and should ensure that their multi-year performance audit plan is effective, will address the key risks that could hinder the government's ability to achieve its objectives and will lead to improved public administration.

Audit entities can take a number of factors into account when they select audit topics for inclusion in their audit plans. This paper discusses and provides a brief overview of some examples and better practices for using risk assessment in multi-year performance audit planning—aligned with the following steps:

1. Establishing a clear purpose and objectives
2. Defining the audit universe
3. Identifying and assessing risk in the audit universe
4. Creating a multi-year performance audit plan

Auditors can balance the application of better practice principles with the use of their own professional judgement on their operating environments and jurisdictions. Auditors should be supported by these approaches and better practices—not bound by them.

1. Establishing a clear purpose and objectives

An audit entity should ensure it has established a clear purpose and objectives before it begins the process for creating a multi-year performance audit plan. The purpose and objectives of an audit entity should relate to its mandate. The mandate of an audit entity depends on its jurisdiction, model and institutional arrangements and whether or not it is an external or internal audit entity.

1.1. Mandate of external audit entities

The mandate and primary purpose of a supreme audit institution (SAI) is to fulfil the independent public sector external audit function for the national government and to oversee and hold government to account for its use of public resources. SAIs promote good governance and provide the supreme law-making body (such as the parliament or the legislature) with independent assessments of selected areas of public administration and assurance about public sector financial reporting, administration, performance and accountability. An independent and professional SAI is an important actor in a country’s accountability chain and its public sector integrity system. The audit mandate of an SAI should be embedded in clear legislation clarifying its independence, role, powers and responsibilities. The same basic principles apply to external audit bodies at other levels of government.

1.2. Mandate of internal audit bodies

The mandate and primary purpose of an internal audit body is to provide independent, objective assurance to add value and improve an organisation’s operations. An internal audit body helps an organisation accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes. The internal audit activity provides assurance that internal controls in place are adequate to manage the risks, governance processes are effective and efficient, and organisational goals and objectives are met. (The Institute of Internal Auditors, 2018[1])

1.3. Clear purpose and objectives

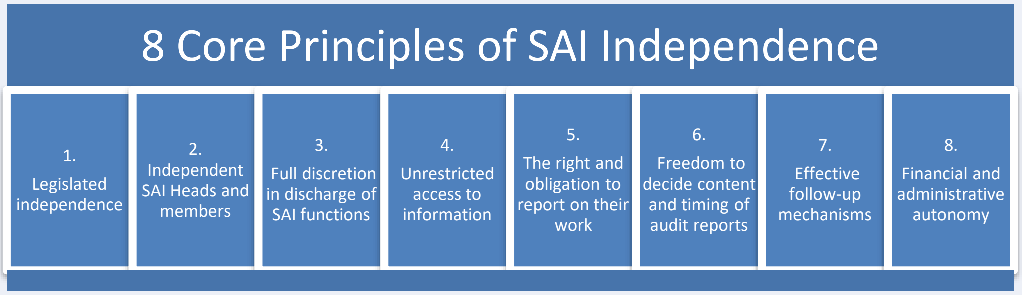
An audit entity’s purpose and objectives should be based on its legislative mandate and clearly articulated. A purpose statement should also reflect the key principle of audit independence. For example, the mission of the supreme audit institution of Australia (the Australian National Audit Office, ANAO) is as follows: The purpose of the ANAO is to improve public sector performance and support accountability and transparency in the Australian Government sector through independent reporting to the Parliament, the Executive and the public.

The ANAO delivers on its purpose under the Auditor-General's mandate in accordance with the Auditor-General Act 1997 (Australian National Audit Office, 2018[2]). Further information on the importance of audit entity independence from the International Organization of Supreme Audit Institutions is outlined in Box 1.1.

Box 1.1. International standards for ensuring independence of audit institutions

Ensuring audit institutions are free from undue influence is essential to ensure the objectiveness and effectiveness of their work, and principles of independence are therefore embodied in the most fundamental standards concerning public sector audit. The International Organization of Supreme Audit Institutions (INTOSAI), for example, has two fundamental declarations citing the importance of independence. Specifically, the *"Lima Declaration of Guidelines on Auditing Precepts"* (ISSAI 1) states that SAIs require organisational and functional independence to accomplish their tasks.

The *"Mexico Declaration on SAI Independence"* (ISSAI 10) and INTOSAI's Strategic Plan 2017–2022 outline eight related principles of independence:


8 Core Principles of SAI Independence
1. Legislated independence
2. Independent SAI Heads and members
3. Full discretion in discharge of SAI functions
4. Unrestricted access to information
5. The right and obligation to report on their work
6. Freedom to decide content and timing of audit reports
7. Effective follow-up mechanisms
8. Financial and administrative autonomy

In relation to Principle 3 on **functional independence**, ISSAI 10 states that an SAI should have a sufficiently broad mandate and full discretion in the discharge of its functions, and SAIs should be empowered to audit the: use of public monies, resources, or assets; collection of revenues owed to the government or public entities; legality and regularity of government or public entities accounts; quality of financial management and reporting; and economy, efficiency, and effectiveness of government or public entities' operations. Further information is provided in INTOSAI's *Guidelines and Good Practices Related to SAI Independence* (INTOSAI, 2007[3]) .

SAIs should be free from direction or interference from the Legislature or the Executive in the: selection of audit issues; planning, programming, conduct, reporting, and follow-up of their audits; organisation and management of their office; and enforcement of their decisions where the application of sanctions is part of their mandate.

Sources: (INTOSAI, 2017[4]; INTOSAI, 2007[3]; INTOSAI, 2007[5]; INTOSAI, 1977[6]).

2. Defining the audit universe

Defining the audit universe is a fundamental step in preparing a multi-year performance audit plan. The audit universe is the totality of auditable processes, functions, and entities (Internal Audit Community of Practice, 2014, p. 14[7]). It includes the jurisdiction(s) in which the audit entity has the authority to carry out its purpose and achieve its objectives; as well as the public sector entities, topics and types of audits it has the power to conduct. Some audits may be legislatively mandated, while others may be at the discretion of the audit entity. In order to create an effective multi-year plan, the audit entity needs a good overview of its audit universe, including its mandate, its jurisdiction and the organisational structures and operating environments within this universe.

A common approach to represent the audit universe is by organisational structure, presenting each public sector entity with its subdivisions and programme areas—a "top down" approach. This approach works well for data collection, as entities often provide information in line with its internal structures, programmes and subdivisions. This is a good place to start. However, the audit universe could also include many cross-functional activities that should be considered, such as human resource management and procurement (Internal Audit Community of Practice, 2014, pp. 14-15[7]).

Programmes, policy objectives and issues that are the responsibility of multiple entities should also defined. For example, cyber security is relevant across government—even if one or more actors play a stronger role in its management. The French Cour des Comptes and its regional courts' approach includes dividing its audit universe into regional areas. Each regional court delivers a separate annual plan, while working closely with the Cour des Comptes (Cour des comptes de France, 2018[8]).

Establishing a comprehensive view of the audit universe requires access to accurate information. Some possible information sources include: corporate plans, performance statements, annual reports, organizational charts, budgets and previous audit plans (Internal Audit Community of Practice, 2014, p. 16[7]).

3. Identifying and assessing risk in the audit universe

Once the audit universe has been defined and there is a clear overview of all potential areas of audit, the audit entity needs to choose where it will devote its limited time and resources. This is where risk assessment can be incorporated to assist an audit entity with making the best use of its resources to have the greatest impact and to most effectively achieve its purpose and objectives.

The outline of the audit universe can serve as the initial structure to create the risk map, including the development of risk criteria. The audit entity should consider what data and information is needed to develop the risk map and to identify and assess the risks within its audit universe. To develop the risk map and risk criteria, different sources of information should be used. Budgets, corporate plans, performance statements, risk management frameworks and other governance documents can provide a good starting point. Information from past audits and reviews by other oversight bodies can also be useful.

According to the *ISO 31000:2018 Risk Management Guidelines*, risk is the effect of uncertainty on objectives. An audit entity has the mandate of providing assurance on the state of public administration—whether to the legislature or parliament in the case of the SAI, or to management, in the case of an internal audit body. Audit entities can be more effective at achieving their mandates if they focus their limited resources on areas of key risks—areas where there is a greater possibility that the full achievement of objectives could be hindered by uncertain internal and external factors (ISO, 2018[9]).

Risk criteria

According to *ISO 31000:2009 Risk management: Principles and Guidelines*, risk criteria are the terms of reference against which the significance of a risk is evaluated, and they are based on organisational objectives and external and internal context. Risk criteria can be derived from standards, laws, policies and other requirements (ISO, 2009[10]).

Risk assessment

According to the *ISO 31000:2018 Risk Management Guidelines*, risk assessment is a three-step process that starts with risk identification and is followed by risk analysis, which involves developing an understanding of each risk, the likelihood of these risks occurring, and the risk's severity. The third step is risk evaluation, which includes prioritising each risk (ISO, 2018[9])

Risk assessment can be qualitative and descriptive, such as a report, or quantitative, such as data analysis with numerical values for likelihood and impact of risk. The way in which risks are assessed and the form of the output should be compatible with entity-defined risk criteria. There are various risk analysis techniques that may be used, such as those outlined in *IEC/ISO 31010:2009 Risk management: Risk assessment techniques*:

- Bow-tie analysis;
- Hazard analysis and critical control points (for assessment of health safety risks);
- Strengths-Weaknesses-Opportunities-and-Threat analyses;

- Failure modes and effects analysis (FMEA);
- Hazard and operability (HAZOP) studies which involves identifying potential deviations from the design intent;
- Scenario Analysis;
- Structured what if technique (SWIFT); and
- Layers of protection analysis (LOPA) analyses that assesses whether a risk is controlled to an acceptable level (IEC & ISO, 2009[11]).

All of these risk assessment techniques involve the basic principles of risk identification, risk analysis and risk evaluation.

3.1. Identifying risks

The first step in a risk assessment is risk identification. Within the audit universe, there are different types of risks that could be identified. For example: risks facing the entire public sector; risks facing individual entities; and emerging risks.

Risks facing the public sector

To identify the risks facing the public sector, an audit entity should consider:

- strategic and operational risks facing public sector entities, including changing priorities of the government; and
- social, cultural, political, legal, regulatory, financial, technological, economic and environmental factors—whether international, national, regional or local.

Risks facing individual entities

The process of risk identification at the individual entity level will depend on whether or not the risks have already been identified within the public entities. High level and strategic risks are usually identified by the entity’s senior management and linked to the entities’ objectives and the government priorities.

If the audit entity has access to internal risk assessments for each entity and these are developed and credible, these could be considered. If the risks within the entities are not clearly identified and documented, the audit entity can conduct its own risk identification exercise based on the documentation available, past audits and consultation with key internal and external stakeholders.

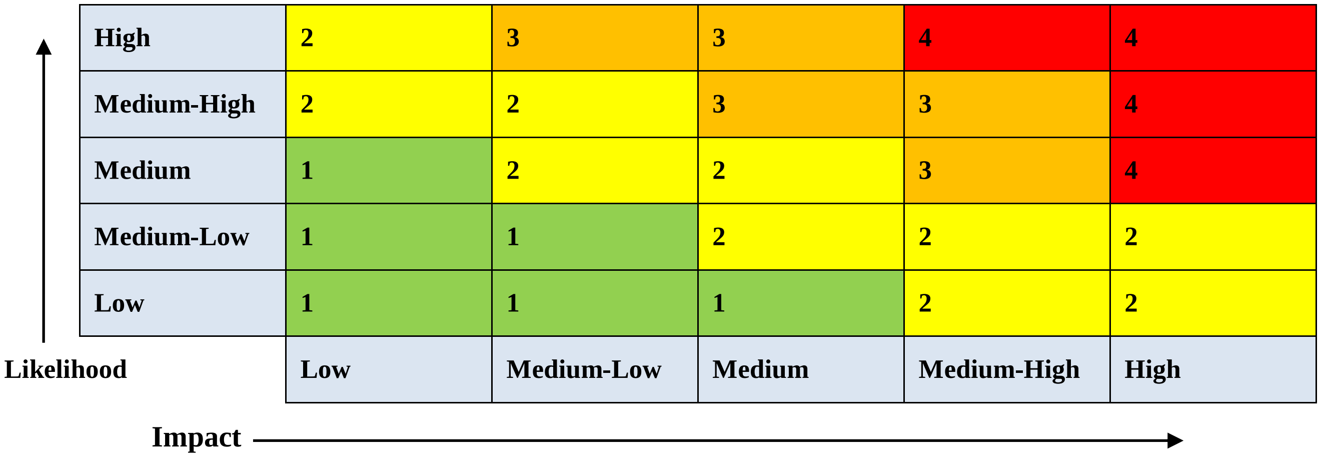
Emerging risks

Audit entities should also consider emerging risks related to changing circumstances and environments within the audit universe, leaving some flexibility in their audit plans to enable a response to emerging risks as they eventuate.

3.2. Analysing risks

After risks are identified, they should be analysed. During this step, risks are analysed in terms of the likelihood (possibility) of the risk occurring and the severity or impact on objectives, should the risk occur. A risk matrix can be used to conduct this analysis and to chart the likelihood that a risk might occur and the impact it might have on the entity’s ability to deliver on its mandate and objectives. An example risk analysis matrix is provided in Figure 3.1.

Figure 3.1. Five-by-Five Risk Analysis Matrix



High	2	3	3	4	4
Medium-High	2	2	3	3	4
Medium	1	2	2	3	4
Medium-Low	1	1	2	2	2
Low	1	1	1	2	2
Likelihood	**Low**	**Medium-Low**	**Medium**	**Medium-High**	**High**

Source: OECD, based *ISO 31000:2018 Risk Management Guidelines*.

The following are examples of risk analysis questions that may be used in conducting a risk analysis.

Likelihood (Possibility)

What criteria will be used to determine the likelihood of the identified risks?

- Is the risk internal or external?
- What is the history of occurrence?
- Has an event occurred recently?
- What are the predictions for occurrence in the future?

According to the responses to the questions, assess the likelihood of risk as:

- High (Almost certain): expected in almost all circumstances within a timeframe;
- Medium-High (Likely): will probably occur;
- Medium (Possible): could occur at some time;
- Medium-Low (Unlikely): not expected to occur; and
- Low (Rare): exceptional circumstances only.

Severity (Impact)

What criteria will be used to determine the severity or impact of the identified risks?

- What could go wrong? What could go right?
- What are the opportunities associated with the risk? What are the threats?
- Who will be affected? How will they be affected? How will they react?
- Will the impact enhance the entity’s ability to achieve its objectives?
- Will the impact threaten the entity’s ability to achieve its objectives?

What responses are in place to prevent or minimize the risks?

- Are there too many risk responses for low risks?
- Are there too few, or no, risk responses for high risks?

According to the responses to the questions, the severity of the risks can be analysed as:

- High;
- Medium-High;
- Medium;
- Medium-Low; and
- Low.

Once a risk has been analysed for likelihood and severity, it can be plotted according to the risk analysis matrix and given a risk rating.

The National Audit Office of Finland conducts risk analyses of the central government and the national economy every four years, which includes:

- auditability analysis in which the levels of identified risk areas are assessed and in which it is determined whether the risk areas can be audited from the perspective of the powers, competence and other resources of the National Audit Office and which audit type is suitable for auditing any particular risk; and
- effectiveness analysis in which it is assessed, which audit types or forms of monitoring can be used for tackling the auditable risk identified in the risk analysis (National Audit Office of Finland, 2015, p. 33[12]).

In other years, the general picture produced by the risk analysis of the central government finances and the national economy, the auditability analysis and the effectiveness analysis are updated as part of the preparation of the annual audit plan of the National Audit Office (National Audit Office of Finland, 2015, p. 33[12]).

3.3. Evaluating risks

After risks have been analysed and rated, risks can be evaluated and given a priority ranking. Generally, there are three major approaches to ranking risks:

1. Professional judgment on the part of subject matter experts;
2. Decision-making based on historical precedent; and
3. Application of modelling to select the most significant risks.

At the Office of the Auditor General of Canada (OAG), strategic audit planning begins with identifying significant risks—both internal and external—facing government departments and agencies and the government as a whole. It then uses risk analysis and evaluation to propose audits that ensures OAG resources are focused on the areas of greatest significance. These plans provide assurance to the Auditor General and to the Parliament of Canada that the OAG is exercising due diligence in applying the discretion provided in the *Auditor General Act* for selecting matters for audit. When this evaluation has been undertaken and strategic audit plans are completed, the results, including a proposed list of audits for the next few years, are presented to the Auditor General for review and discussion (Office of the Auditor General of Canada, 2017[13]).

4. Creating a multi-year performance audit plan

Once risks have been identified and assessed, an audit entity can use this information to prepare a strategic performance audit plan that covers multiple years—often audit entities prepare plans on a three-year or five-year basis and refresh these plans each year. There are a variety of approaches for creating a strategic audit plan.

4.1. Risk-based approach

As outlined in the previous section of this document, the risk-based approach involves focusing audit capacity and efforts on key risk areas in the audit universe. This method optimises the allocation of resources and addresses main issues. For audit entities with limited resources, the risk-based approach is highly valuable for achieving the greatest impact. A risk map with identified risks and risk ratings and rankings can provide a good overview of the risks in the audit universe.

4.2. Cyclical approach

The cyclical approach to forward audit planning is also common. This approach involves auditing all entities within the audit universe during a cycle of a specified time period—often three to five years. This approach ensures a total coverage of the audit universe over a certain timeframe.

According to The Institute of Internal Auditors Australia (IIA Australia), this cyclical approach was the long established method for developing longer term audit plans. This approach may have used some risk factors, but the correlation between risk rankings and the audit plan was often weak. IIA Australia purports that while the cyclical approach has its merits, contemporary audit planning should involve the identification of audit topics on a more strategic and cross-organisational basis, drawing on risk management information (The Institute of Internal Auditors–Australia, 2016, p. 3[14]). However, the cyclical approach can be viewed as a more balanced method by some, as covering all significant areas of government—regardless of the likelihood of non-compliance or mismanagement, results in an audit programme that give a more accurate picture of the government as a whole—with audit reports that contain both negative and positive findings. This can reinforce the entity’s reputation for being apolitical and independence, as it provides both supporters and opponents of the government with audits they can use for their purposes. This could also result the relevant oversight committee giving greater attention to audit reports than if only opponents found the reports of interest (Canadian Audit & Accountability Foundation, 2016, p. 14[15]).

4.3. Incident-based approach

Another approach is incident-based, where stakeholder requests and concerns are taken into account and audits are conducted where incidents have occurred or issues have already been identified. In some countries, such as Australia, the SAI takes into account the views of Parliament during its audit planning, but the Parliament is not able to *direct* the SAI to conduct any specific audits—as this would go against the principle of SAI independence. *ISSAI 12: The Value and Benefits of Supreme Audit Institutions* recommends that stakeholder concerns be taken into account: "SAIs should engage with stakeholders, recognizing their different roles, and consider their views, without compromising the SAI's independence". In some cases, audit entities may reserve a certain percentage of their resources to respond to issues and concerns or to respond to emerging risks (INTOSAI, 2013, p. 9[16]).

4.4. Multi-faceted approach

These three approaches are complementary and are often used together to create a multi-faceted risk-based, relevant audit plan with comprehensive audit coverage. Combining the risk-based approach, cyclical approach and incident-based approach can be highly effective. Audit entities also need to use professional judgement to ensure that audit topics are significant, auditable and its approach and topic selection is in line with its mandate, objective and purpose.

According to *ISSAI 300: Fundamental Principles of Performance Auditing*, auditors should select audit topics through a strategic planning process that includes the identification and analysis of risks and the consideration of topics that are in keeping with the audit entity's mandate. Although it advocates using formal techniques, such as risk analysis to help structure the process, it emphasises the need for the process to be complemented by the professional judgement of auditors. Auditors can contribute in their respective fields of expertise, which helps ensure that the overall process is balanced (INTOSAI, 2013, pp. 13-14[17]).

An example on how the Australian National Audit Office incorporates risk into a multi-faceted planning process is provided in Box 4.1.

Box 4.1. Australian National Audit Office

The Australian National Audit Office (ANAO) has a six-step process for developing their multi-year performance audit work program: environmental scan, topic development, coverage review, consultation, final review and audit selection. The ANAO's selection of audits is also informed by the following criteria:

- **Risk:** risk coverage at the whole-of-system level that has the potential to impact on public sector administration more broadly and also at the individual program level;
- **Impact:** the outcomes or potential benefits that might flow from performance audit coverage, including improved administrative effectiveness, greater efficiency, or improved program/service delivery performance;
- **Importance:** the importance of the area proposed for audit coverage to key stakeholders;
- **Materiality:** the significance of the program, including the financial and non-financial materiality;
- **Auditability:** the extent to which the area of proposed audit coverage is able to be audited; and
- **Previous coverage:** the extent to which the area of proposed audit coverage has been subject to previous audit coverage.

The planning process also brings together the knowledge and insights gained from the ANAO's financial statements audit work and the program of performance audits to inform the identification of topics for inclusion in each year's program. In its consultation phase, the ANAO takes into account the views of the Parliament, as presented by the Joint Committee of Public Accounts and Audit, relevant stakeholders, and the public.

Source: (Australian National Audit Office, 2018[18]).

The incorporation of risk assessment into the selection of audit topics and the creation of a multi-year performance audit plan helps an audit entity to ensure that it is using its limited resources to audit the areas of highest risk and priority with the public sector. This increases the audit entity's ability to be relevant, dynamic and effective.

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