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ADVANCED AUDIT AND ASSURANCE

CORPORATE LEVEL

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INTERNAL AUDITING – (PART 02)

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INTERNAL AUDIT – (PART 02)

Risk Management Framework

A) Introduction

Every business organization has its own objectives to achieve. Uncertainty of the future is the main problem faced by the organization. Business organizations may fail to achieve their pre-set targets because of the unexpected future events.

For a business organization, risk is the ***possibility that actual results will differ from what was expected, and that will affect the ability of the organization to achieve its objectives.*** Some risks are significant and cause considerable losses and even have the ability to threaten the going concern of the organizations.

Therefore, business risks should be managed well as organizations can not completely avoid risk. For that purpose, organizations should have a well-defined mechanism to identify risks pertaining to organization.

Therefore, Risks can be segregated into two main segments

1) Internal Risks
2) External Risks

1) Internal Risks

Internal Risk generates within the organization. As a result, management has more control over internal risks. These risks are generally connected with the operational risks of the organizations. Therefore, Internal Risks can be mainly divided into 04 segments

a) Operational Risk

These are the uncertainty and hazards a Company face when it attempts to do its day-to-day business activities within a given field or industry.
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b) Fraud Risk

These are the risks of possible losses due to fraudulent activities by an employee or an external party. These risks occur mainly due to the lack of internal controls
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c) Compliance Risk

The risk of failure to comply with an important law or regulation. A consequence of noncompliance with regulations may be losses from the cost of fines. There are some industries which are bound by specific regulations due to the significant risks involved in that industry. Therefore, an organization that operate in such a industry, always has to comply with the rules and regulations imposed by the authorities.

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d) Reputational Risk

The risk of losing the reputation the organization has in the public due to an unfavourable incident or series of actions.

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2) External Risks

Some risks arise from events outside the company and are beyond its influence or control. As external risks cannot be prevented, their management must focus on identification and mitigation. There are various tools which can be used by companies to identify their external risks.

External Risks can be divided into two main segments

a) Risk in the general business environment
b) Risks in the industry environment

Risks in the General Business Environment
This includes the unfavourable impacts coming from external environmental factors as follows.

1) **Political and Legal Environment**
Eg: Change in Government Regulations in the areas of taxation, labor laws, interest rates, international trade, new trade agreements etc.
Eg: Instability in the country resulting from changes in government policies

2) **Economic Environment**
Eg: Change in inflation rate, interest rate and exchange rates
Eg: Economic recessions

3) **Social and Cultural Environment**
Eg : Change in attitude of majority of the population which adversely affect the business
Eg: Religious beliefs which adversely affects business opportunities

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4) **Technical Environment**
   Eg: Introduction of new technology which organizations cannot afford or compete with
   Eg: Products become obsolete due to latest technology in industries such as mobile phones

Risks in the industry environment

This refers to industry specific risks affect the organizations in that particular industry.
Eg: Banks are facing high regulatory compliance requirements specific to its industry

B) Risk Management Framework.

Risk Management Framework consists of Three Main Sectors.

1) Risk Assessment
2) Risk Response/Risk Treatment
3) Monitoring and Review

Risk Assessment
Risk Assessment Segment is further sub-divided into three components, such as Risk Identification, Risk Analysis and Risk Evaluation,

Under the Risk Identification, the business organization should identify each and every risk and to segregate in between Internal and External risks

Upon the identification of the risks, those risk should be analysis in detail depending on the Impact of the Risk and the Possible Occurrence of the Risk, which is referred as the Risk Analysis. The main objective of the Risk Analysis is to establish the potential impact to the organization and the achievement of the organization objectives.

Upon Identification and Analysis of the Risk, the Business Organization should decide which risk is more important than others and identify those which should be treated or managed. This is referred as Risk Evaluation.

Risk Response/Risk Treatment

For each identified significant risk, business organization should make appropriate responses to manage the risk. The response is depending on the risk appetite, which is referred as the "Willingness to Accept the Risk". Business organization should decide the most appropriate way of managing the risk and implement risk treatment measures

Monitoring and Review.

Under the monitoring and review segment, business organization should revisit the entire process at regular intervals, to check whether the implemented actions/responses are effective or not.

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ABC Company is a Company which operates in the apparel industry and the Managing Director (MD) of ABC, devoted the attention for the following key points in the recent Board Meeting.

a) As a result of the economical policy which as been taken by the government, the prices of the apparel which the Company currently exporting to the European Market is increased significantly and further MD stated that, at present the Company prices are much higher than the its competitors which is located at India and China. Further MD stated that, as a result of the prices increase, the Company is experiencing a significant decrease in the current export quantities, compared to previous quarters.

b) Company IT system faced several breakdowns during the last three months and the system has been repaired by the system vendor and they have provided a warranty period of 2 months.

c) A local competitor is trying to attract Company's most senior and experience employees while providing a higher salary and MD further stated that, the replacement of these vacancies are much more difficult in the current business context

d) A minor supplier who supplies material to the Company has requested a price increase and the Company is having the ability to accept the price increase. Further, MD stated the Company is in the position to find new suppliers as well, if it wanted.

e) Few of the Minor Employees are already resigned from the Company and several employees are going to resign as well in the near future. However, as per MD, the Company is having the ability to recruit new staff under that capacity if the situation demands.

Assume, you are the Finance Manager of ABC Company and based on the above mentioned senarios, you are expected to carry out the Risk Identification and Risk Response from the Risk Management perspective.

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C) Risk Management Strategies /Techniques used to mitigate the Risks

The following techniques are used by the Business Organizations to mitigate the risk

a) **Risk Avoidance**
Risk avoidance is the elimination of hazards, activities and exposures that can negatively affect an organization's assets. Whereas risk management aims to control the damages and financial consequences of threatening events, risk avoidance seeks to avoid compromising events entirely.

b) Risk Acceptance

Risk acceptance or risk retention means the fact of accepting the identified risk and not taking any other action in order to reduce the risk because we can accept its impact and the possible consequences. This strategy is mainly using;

1) When the potential impact of the risk is low
2) The likelihood of an adverse risk is low
3) The residual risk is within the organizational risk tolerance level

c) Risk Transfer

Risk transfer is a risk management and control strategy that involves the contractual shifting of a pure risk from one party to another.

d) Risk Reduction

Management may decide that a risk should be reduced because it is currently too high and so unacceptable. Methods of reducing the risk depend on the nature of the risk. The following methods are used to reduce the risk to an acceptable level.

1) Implementation of proper Accounting and Internal Control System within the organization
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2) Operational Diversification
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3) Business Contingency Plan
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4) Risk Sharing.
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Internal Audit and Enterprise Risk Management (ERM)

Internal auditors will be involved in monitoring risk management systems and feeding back suggestions for improvements

Internal audit will play a significant part in the organisations risk management processes, being required to assess and advise on how risks are countered.

Internal audit's work will be influenced by the organisation's appetite for bearing risks. Internal audit will assess:

a) The adequacy of the risk management and response professes for identifying, assessing, managing and reporting on risk.
b) The risk management and control culture
c) The appropriateness of internal controls in operation to limit risks
d) The operation and effectiveness of the risk management processes, including the internal controls

Where the risk management framework is insufficient, auditors will have to rely on their own risk assessment and will focus on recommending an appropriate framework. Where a framework for risk management and control is embedded in operations, auditors will aim to use management assessment of risks and concentrate on auditing the risk management processes.

The risk management function will be responsible for building a risk aware culture throughout the organisation by information provision and training. Risk management will provide guidelines on overall risk policy and coordinate the various functional activities that deal with risks.

Risk management will also be responsible for designing risk, analysis procedures and risk response processes. They should ensure not only their recommendations for improvements, but the recommendations of the board, board committees and internal audit functions are implemented

Independence of Internal Audit

Internal Audit should be independent from the operational management. Even though an internal audit department is part of the organisation, it should be independent of the line management.

The Concept of Independence involved a number of key qualities

Objectivity	Judgements are made in a state of detachment from situation or decision
Impartiality	Not taking slide. In particular not being influenced by office politics in determining the work carried out and reporting
Unbiased Views	Avoiding the perception that the internal audit is biased to individuals or department

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Valid Opinion	The Audit Opinion should be based on all relevant factors
Sensitive Areas to be audited	Internal Audit must have the ability and skills to audit complex areas effectively
Senior Management Also Audited	Internal Audit must cover the Management process and not just the operational areas
No Backing Off	Audit Objective must be pursued fully in a professional manner and auditors must not allow aggressive managers to deflect from doing necessary work and issuing valid opinions

Threats to Independence

A) Involvement in System Design

If the internal audit has been involved in the design of systems, it is very doubtful that they can audit what they have recommended

B) Overfamiliarity

As a result of working for the same organisation, and being involved with the same issues, internal auditors may develop close professional or personal relationships with the managers and staff they are auditing. This may well make it very difficult to achieve independence. This particularly applies to staff who come into internal audit from operational departments. There may also be the risk of self-review - that they review work that they have previously done for operational departments. An organisation's culture and informal networks of staff can have a big influence on individuals' attitudes to ethics.

C) Reporting relationships

The principle that internal audit should be independent of the line management whose sphere of authority it audits ideally should extend to internal audit being independent of the finance director.

The reason for this is best seen by thinking about what could happen if the internal audit department reported some kind of irregularity to a finance director without realising that the finance director was actually involved. The director would take the report and decide that it was all very interesting, but not worth pursuing. A very different line might be taken by another, independent director!

Dealings with Threats to Independence

a) The department should report to the board or to a special audit committee and not to the finance director.
b) Management should ensure that staff recruited to internal audit internally do not conduct audits on departments in which they have worked.
c) Where internal audit staff have also been involved in designing or implementing new systems, they should not conduct post-implementation audits.

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d) Internal auditors should have appropriate scope in carrying out their responsibilities, and unrestricted access to records, assets and personnel.
e) Rotation of staff over specific departmental audits should be implemented.

Review and consultancy

Consultancy projects (one-off projects designed to address ad-hoc issues) are playing an increasing role in the work of internal audit. Taking on these projects enables internal auditors to extend their skills and the organisation to draw om the knowledge of Internal Auditors.

However, it has the following draw backs as well.

A) Internal audit staff may be diverted to consultancy projects, and the regular audit reviews may be inadequately resourced.
B) Taking on consultancy projects, and suggesting solutions internal audit could be getting too involved in operational concerns. There is a serious potential lack of independence if internal audit has to review solutions that internal audit staff have provided
C) Management is relying on internal audit to solve problems instead of having operational staff and managers solve or preferably prevent them.

Certain steps therefore need to be taken in order to avoid these problems:

1. The terms of reference of the internal audit department (the main responsibilities) should draw a clear distinction between regular audit services and consultancy work.
2. Enough resources for regular work should be guaranteed. Consultancy work should be separately resourced and additional resources obtained if necessary.
3. If managers are concerned about improving controls, reviewing these improvements can legitimately be included in the work of internal audit.
4. Regular audit reviews and consultancy projects can be undertaken by different staff.
5. If consultancy work identifies serious control weaknesses, these must be incorporated into internal audit reviews as high risk areas.

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