RISK MANAGEMENT FROM THE PERSPECTIVE OF INTERNAL AUDIT

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Abstract:

The existence of a wide range of risks with actual or potential impact on business entities is a certainty, as well as their influence on company results. In this context, the increase of the economic performance and the implementation of effective activities is strictly related to implementing a risk management system, allowing to define the principal risks of the entity, to identify and assess the risks it faces, and the creation of effective strategies to reduce them.

Key words: *entity, risks, risk management, internal audit, performance.*

JEL code: M42

1. Introduction

The current economic environment, in which uncertainty and instability are risks that have the tendency to become generalised, causes entities to adapt to these conditions by implementing efficient and effective methods and techniques to ensure the management of threats at an increasingly higher level.

Risk identification is not always the easiest action undertaken by the entity because the changes occurring at all levels of aggregation of the economy cannot be entirely anticipated (Țenovici C. O., Ducu C. M., 2012).

Implementing internal audit is probably the most important way in which the management of the entity can ensure an effective risk management process since internal audit can provide the objective assurance of the fact that there is both an effective risk management method and an effective internal control system.

The counselling achieved through internal audit in the field of risk management can also occur through offering support in the risk analysis processes or in their control processes, as well as in identifying the methods of diminishing the risk production effects.

"Risk management is increasingly being considered a general function of the entity's management whose objective is to identify, analyse and control the causes and effects of uncertainty and risks within an entity. The main purpose of risk management is to support the entity in making progress towards achieving its goals and objectives in the most direct, efficient and effective manner"(Williams A. C., 1995).

The faster the management's reaction is when faced with the risks identified, the more likely is the reduction of the risks, respectively the correction of violations.

To carry out the two activities represents a contribution to optimising the entity's performance, through the specific methods, techniques and strategies developed and implemented to reduce the threats an entity faces.

2. Research methodology

The research approach aims to describe risk management, both in terms of the entity, presenting the action of the process in reducing the threats that the entity is faced with and in terms of internal audit, presenting the importance and influence of the function within the process.

The study has a predominantly theoretical character and the scientific research methodology focused on an analysis of the national and international regulations in accounting, auditing, of the various articles published in the literature and the reports made by the regulatory bodies.

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In order to achieve the objective set we used the basic research by expanding the theory related to the risk management process and the internal audit function.

Although the study is theoretical, it is a source of ideas applicable in the practice of entities interested in reducing the risks arising from the activities carried out.

3. Enterprise Risk Management

ERM - Enterprise Risk Management is considered a continuous process that enables managing the threats that affect the achievement of the set objectives.

The Committee of Sponsoring Organisations (COSO) defines ERM as “a process carried out by the members of the Board of Directors, of senior management, as well as by the persons who are involved in establishing the enterprise’s strategy, designed to identify the potential events that could affect the enterprise and to manage risk in order to provide reasonable assurance for the management”.

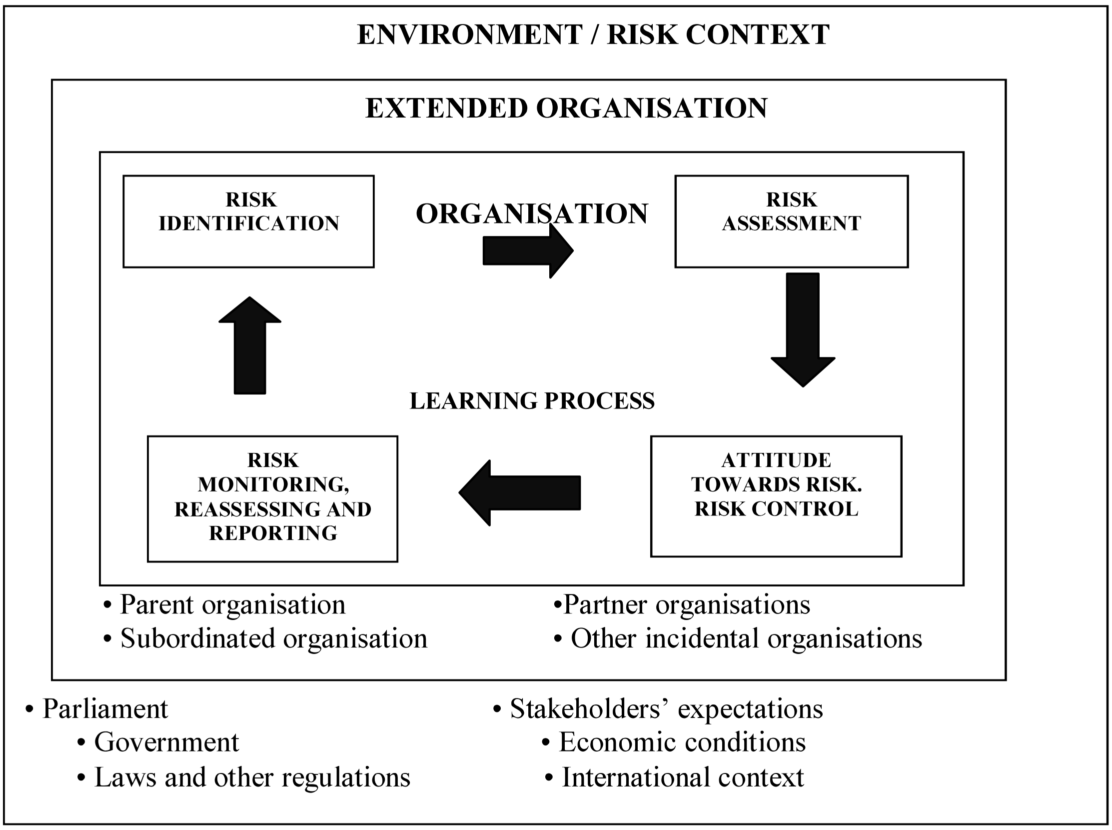
Risk administration or management refers to all the processes defined and implemented by an enterprise whose primary purpose is to reduce the existing or potential risks.

As any management activity, risk management is also based on key management processes such as:

- definition;
- identification;
- analysis and assessment;
- establishing management procedures;
- monitoring and reassessment;
- communication and counselling;
- reporting.

A general risk management model is presented in Figure 1.

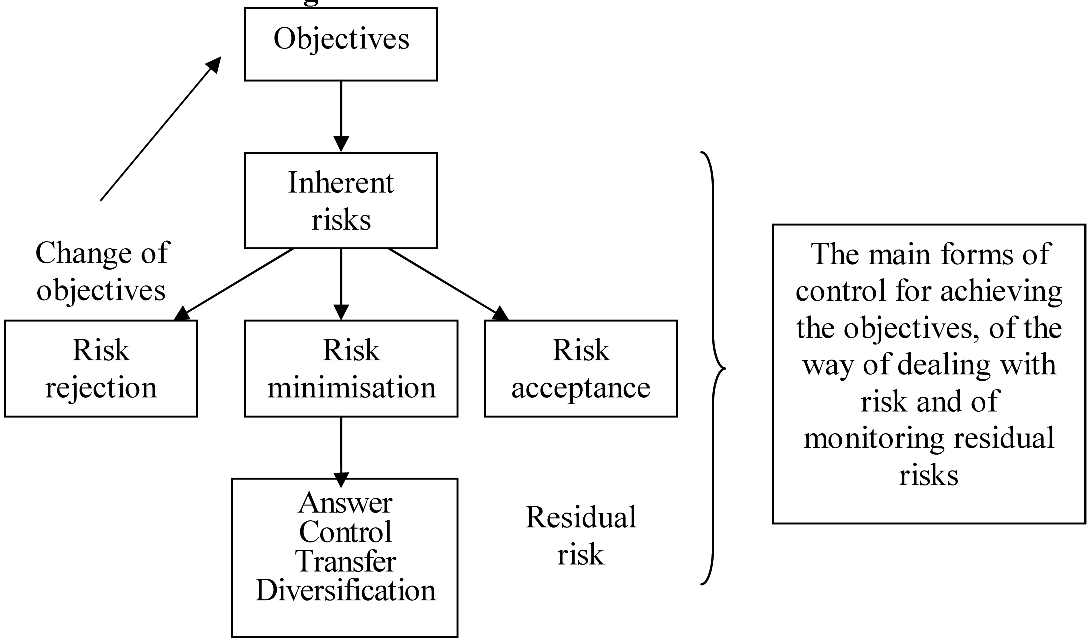
Figure 1. Risk Management Model



Source: Ministry of Finance (2007), Implementation methodology of the Risk Management internal control standard, p. 16

Identifying the risks relating both to the risks involved in the management process and also to the other risks that may have a significant influence on them. The focus at this stage should be directed mainly towards the distinction between risk, whose nature is potential and the problems that already exist within the enterprise, as well as on the quantification of the effects of the risks identified. At this point it is also important to identify the residual risks (risk exposure after implementing the reduction measures), which in addition to the inherent risks (risk exposure before establishing certain reduction measures) can have a major impact on the enterprise's activity. It is also now that the controlled or uncontrolled nature of the risks identified must be analysed.

Figure 2. General risk assessment chart



Source: Hubbard L. (2009), Skip the Numbers: Assessing Risk is not a Math Game!, p.1, available at http://www.lhubbard.com/pubs/Making-It-Work-Risk-Assessment-is-not-a-Math-Game.pdf, accessed on 06 January 2013

The next step is to analyse and assess the previously identified risks, which must aim at quantifying both the extent to which they can occur and the consequences of their occurrence. Within this process a comparison must be carried out between the level of risk exposure and the level of tolerance.

In order to minimise the potential effects of risks or of changing their effects into benefits the risk control process must be exercised by managing them. Thus, the risks can be accepted, avoided, partly or entirely transferred or their production probability can be diminished. Also within the process of risk management a series of control tools can delimited, namely (Vasile E., Coritoru I., Mitran D., 2012):

- preventive control instruments;
- corrective control instruments;
- directive control instruments;
- detective control instruments.

The range of risk management tools will thus be differentiated according to the stage where they are used (Ducu C., 2013).

Risk management also involves continuous monitoring as well as reviewing risk management strategies. The regular review of risk management strategies is imposed by the fact that in time the level of risk may undergo changes, the previously identified risks may disappear and new risks may arise, the enterprise's priorities may change and the effects of these changes have significant influences on the effectiveness of the risk management strategies.

It takes communication to conduct an efficient and effective risk management process as well as consultation with the stakeholders to disseminate information to all levels. Furthermore, ensuring effective risk management requires the existence of written procedures.

The main opportunities offered by the practice of risk management within the enterprise brings benefits related to (IIA, 2004):

- a greater likelihood of achieving the enterprise's objectives;
- improvement in understanding the key risks and their implications;
- a management that pays more attention to important issues;
- fewer surprises or crises;
- more information about risks and making decisions about the risks.

4. The role of internal audit in risk management

One of the important tools of risk management is internal audit which can have a significant contribution to supporting the enterprise in its approach to overcome the difficulties it has to face, arising from risks, or to support it in order to achieve and overcome the objectives or to increase performance.

Thus, the importance of internal audit within entities becomes increasingly higher and risk management is becoming increasingly necessary. Internal audit through risk management not only prevents the risks but it also makes an entity operate effectively as a result of a structured and organised approach.

Establishing the importance of internal audit in risk management must start from the definition of internal audit "which is an independent process, which provides an objective assurance, as well as consulting activity aimed at adding value to an organisation and improving its operations" (IIA, 1999).

The role of internal auditing is to provide support to the enterprise to achieve its objectives through a systematic approach in order to assess and improve the effectiveness of risk management, control and governance process.

The International Standards for the Professional Practice of Internal Auditing state that internal auditing activities should assess effectiveness and contribute to the improvement of the risk management process.

According to Standard 2120, the internal auditing activity must assess the risk exposure in relation to:

- "reliability and integrity of financial and operational information;
- effectiveness and efficiency of operations;
- asset protection;
- compliance with laws, regulations and contracts.

As shown above, internal audit plays an important role in managing risks, but nevertheless, in Table 1. we present the main roles that internal audit should or should not take, in terms of overall risk management.

It is obvious that between internal auditing and risk management there is a complementary relationship and the structure of the two activities can be done in several ways (Dickinson A.(2010):

- risk management and internal auditing can be considered two separate functions reporting to different parts;
- considering risk management and internal auditing as separate functions but which report to the same party;
- integration of risk management and internal auditing under the responsibility of a single person;
- combining the functions of risk management and internal auditing in a single department and reporting to the entity's management.

Table 1. Internal auditing roles in relation to risk management

Basic roles of internal audit	Legitimate internal audit roles	Roles that internal audit should not undertake
- providing assurances regarding the risk management process; - providing assurances regarding the correct risk assessment; - assessment of the risk management process; - assessment of how the key risks are reported.	- facilitating risk identification and assessment; - involvement of management in terms of how it responds to risks; - coordination of risk management activities; - preparation of consolidated reports on risks; - maintaining and developing a general risk management framework; - development of a risk management strategy.	- setting the appetite for risk; - enforcement of risk management processes; - managing risks insurances; - preparation of decisions on how to respond to risks; - implementation of risk response measures on behalf of the management; - taking responsibility for risk management.

Source: IIA - Risk Management and Internal Audit: Forging a Collaborative Alliance, p.4

Moreover, the interdependency between the two activities occurs as follows:

- related to internal auditing, if the responsibility of risk identification and management rests with the management, the key role of internal auditing is to ensure the management that these risks were managed properly. Therefore, the fulfilment of the internal auditing mission occurs when the stability of the entity’s functioning is ensured in the context in which its shares position it in the area of risk management;

- regarding the link between risk management and internal auditing, the latter should not encourage risk-taking, but facilitate taking decisions on the actions to be taken in order to diminish risks.

The existence of functional interdependencies between internal auditing and risk management leads to alleviating the economic difficulties faced by entities and even to the increase of the financial performance.

Therefore, achieving the goal of enterprise risk management aims both at the implementation of the risk management process and of the internal auditing function and their interaction as a result of their common goals.

5. Conclusions

The current financial and economic turbulence that we are in has given special connotations to the risks generated by the activities performed within an entity, suggesting the importance of implementing measures to reduce them.

From this point of view we consider important a pro-active approach to the risk based on identifying the ways to prevent and diminish their negative effects.

The presentation of the risk management process has revealed the methods underlying the threats management, threats emerging within an entity as a result of the activities carried out. The effectiveness of these methods is provided by their continuous assessment and the suggestion of measures to improve them through the internal auditing function.

The implementation of internal auditing linked to the risk management considers the interdependencies between the two activities and contributes to a correct approach to the risks by the enterprise’s management, realising the need to decrease them to an acceptable level.

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