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# INTERNAL AUDIT AND RISK MANAGEMENT

Theoretical  
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Internal audit  
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M10, M42

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## Abstract

*The existence of risk in economic activity can not be denied. In fact, the risk is a concept which exists in every activity, the term of risk being identified with uncertainty, respectively the (un)chance to produce an undesirable event. Internal audit and risk management aim at the same goal, namely the control of risks. Internal Audit performs several roles in risk management plan. The objectives of the internal audit function varies from company to company, but in all economic entities internal audit department aims to improve performance management, enterprise performance and thus improve the internal control system. This paper aims to demonstrate, among other things, that any event that may result in failure is unquestionably classified as risk.*

## 1. Risk perception

The existence of risk in an economic activity cannot be denied. In fact, the risk is a notion integrated in any type of activity, the term “risk” identifying itself with uncertainty, respectively the (lack of) opportunity of an undesirable event to occur.

In the neoclassical theory supporters’ vision, the risk is described as a possibility to deviate from a proposed objective, where the proposed objective makes reference to the economic entities’ objectives. Thus, any event that can lead to the failure of proposed objective is undeniably classified as risk.

In the assessment of the economic entity’s associated risks, it is important to identify the general risk factors that can also be synthesized as in figure 1. *Factors that influence the risk management.*

The perception of risk is influenced by emotions; therefore four risk images are being differentiated in public’s perception (Caroll and Webb, 2001):

I. Imminent peril (the Sword of Damocles)

Presenting risk as a threat that can take place any moment, being characterized by the impossibility of prediction.

II. Invisible risk (Pandora’s box)

Risk appears as an invisible threat to the public’s health or wealth, and its effects are belated but not catastrophic.

III. Cost – benefit report (the Scale of Athena)

The risk identifies with the difference between what is earned and what is lost; the perception is limited to financial gain or loss.

IV. Voluntary Risk (The Myth of Hercules – Risk for the risk’s sake)

Risk is desired and exploited; therefore the perception of the capacity to control risk exists.

## 2. Risk management and internal audit

A patrimonial entity consists of a system formed of multiple distinct sub-systems, which are also inter-conditional. Three

main subsystems are worth being mentioned here: the operational subsystem, the decision-making subsystem and the informational subsystem. The enterprise may be itself considered a subsystem, a part of a global system represented on the economic – financial market and that has the prominent characteristic of complexity and dynamism. Therefore, the economic entity, as feedback to the complexity of the environment where it activates, builds a protection system made up of elements placed at the level of the organizational structures. The company’s defense system is called internal control and makes reference to the set of rules, procedures and techniques, which are being applied for its convenience and in order to ensure the entity’s protection and performance.

Modern management of economic entities, irrespective of the society’s nature and regardless of the fact it has the status of public or private entity, cannot be conceived without a rigorous and flexible control. Steering a company implies a permanent and systematic control of the activity.

The patrimonial entity whose activity is developed in a dynamic and aggressive business environment, must be flexible. It must have the capacity to easily and rapidly adapt to these changes, in order to survive, to develop an efficient activity, namely, to ensure the compliance with the going concern principle.

Patrimonial entities carry on their activities in an aggressive, competitive, full of risks climate and their final target being to obtain profit. To reach their target, managers must master and control their business in order to effectively appropriate the resources for profit gain and for ensuring a permanent and efficient development of the entity.

Internal audit is a profession shaped throughout time as an answer to entities’ economic needs. Entities’ economic needs roughly have the same characteristics as human needs have, such as:

- they are unlimited: although the primordial need that identifies itself with the major objective of any enterprise is that of maximizing profit, the economic entity has many more needs/ necessities that, once met, congregate towards meeting the primary need;

- they are complementary: entities' economic needs are numerous and complementary, they complete each other; the need for capital, human resources, material resources, the existence of a legislative and normative framework, etc., all these elements can be classified within the category of needs the economic entity has and without the fulfillment of which it cannot function;

- The regeneration capacity (needs currently disappear when they are met, but they reappear in time): the need for personnel: a vacant job may exist at one given point. Once occupied, the need is considered to have been fulfilled, but the company's development can lead to the emergence of new jobs, therefore the need for personnel will be topical all over again. We can also look upon profit from this perspective. Any company wants to obtain profit at the end of the fiscal year. If this happens, the company's need for the respective year shall be fulfilled, but along with the beginning of the financial year, this need will become again the company's major objective. However, the profit gain can be rather seen as a permanent need because it is never extinguished.

- They are conditioned both objectively (according to the economic development degree, the progress degree), and subjectively (each company having its own needs, others than those common to all entities – such as profit gain).

A series of human activities among which the internal audit is part of, was developed in order to ensure the fulfillment of the economic entities' needs/ necessities.

The internal audit and the risk management aim the same objective, that is, the control of risks. The internal audit fulfills many roles in the risk management

field. The objectives of the internal audit position differs from a company to another, although within all economic entities, the internal audit department has the purpose to improve, enhance the management performances, implicitly the enterprise's performances and to improve the internal control system.

We consider appropriate to mention the objectives of the internal audit:

- providing an assurance concerning the appropriate character of the internal control system;

- providing an assurance concerning the appropriate character of the activities carried on inside the company;

- management counseling.

Starting from the objectives of the internal audit, we can state that, from a conceptual point of view, a visible lack of correlation between managers' intentions towards an efficient management and the means used for its achievement is being manifested in practice. This disagreement concerns the management instruments (especially the internal audit) that have not evolved accordingly in relation to the structural and functional transformations of the patrimonial entities, although such evolution would have been natural.

Internal auditors find themselves in that position that offers a significantly important support in the company's transition process, from the previous state to the implementation of a viable, efficient and effective control model. The companies that offer higher importance and value to the internal control, have the same tendency also in respect of the internal audit.

At the internal audit level, risks associated to the already mentioned above objectives can be registered, such as:

- insufficient testing in order to offer a reasonable assurance;

- incorrect management counseling.

Among others, risk management can be defined as the activity related to the efficient management of opportunities and adverse effects. The economic entities'

management has in view the selection of a risk strategy, the definition of the appetite for risk and the choice of an adequate risk treatment. (Figure 2. Risk management)

The appetite for risk refers to the company's availability to risk, respectively how much the company is willing to risk in order to achieve its objectives.

The risk treatment refers to choosing adequate options in order to reduce risks, correspondent to each type of risk.

The existence of a risk management has the following benefits:

- a high significance to achieve objectives;
- a reduced cost of risk;
- assuming certain calculated risks.

The main strategies that aim the risk management are (Ciobanu, 1998):

I. Avoiding the risk generating activity. It is a good, applicable strategy where the risk cannot be controlled, but not always risk generating activities can be identified or separated. This greatly depends on the entity's activity field.

II. Reducing risk concerns ensuring against risk, fact that will lead to the reduction of the financial impact.

III. Accepting risks, supposing a good concentration from the management and the risk dimension acknowledgment.

The internal audit position has different roles and responsibilities in relation to the risk management process in an organization.

Corporate failures and growing of the risk management programs determined the internal auditors to get actively involved in the efforts to manage the organization's risks.

It is important to clarify the manner in which the internal audit can evaluate the appropriateness and efficiency of an organization's efforts to manage risks. Nevertheless, it is important to underline that the risk management falls under the management's responsibility.

In this sense, the internal auditors' role is to assist the management by providing risk related counseling. In those organizations

that have an internal audit position and the risk management process, it is vital to make sure of the fact that there is no work overlapping. Therefore, it is essential that the roles of each position be clearly limited in order to avoid an unjustified overlapping and more importantly, in order to avoid the conflict of interest.

The role of the internal audit in the evaluation of the risk management process can be identified through:

The assessment of risk management processes at a strategic and operational level;

The assessment of implemented policies and processes;

The participation of internal auditors in committees;

Managers' objective counseling;

Both the entity's management and the internal auditors can use, as assessment model, the fishbone diagram, also called the Ishikawa diagram (Ishikawa, 1986) or the Cause – Effect diagram. By means of this diagram, a profound analysis of an issue that requires a solution is required within a brainstorming meeting.

This method is used in order to identify the basic causes of the problem. The fundamental structure of the diagram is presented in figure 3. The Fundamental Structure of the Fishbone Diagram.

### 3. Conclusions

As already highlighted above, the responsibility regarding the risks management, lies in the management's task and not in the internal auditor's. There is a number of ways in which the internal audit could be involved in the risk management process, without its independence and objectivity being affected, as follows:

- organizing workshops destined to ensure personnel's training in what concerns the risk management process;
- ensuring expertise as members of teams, appointed to offer solutions for risk management;

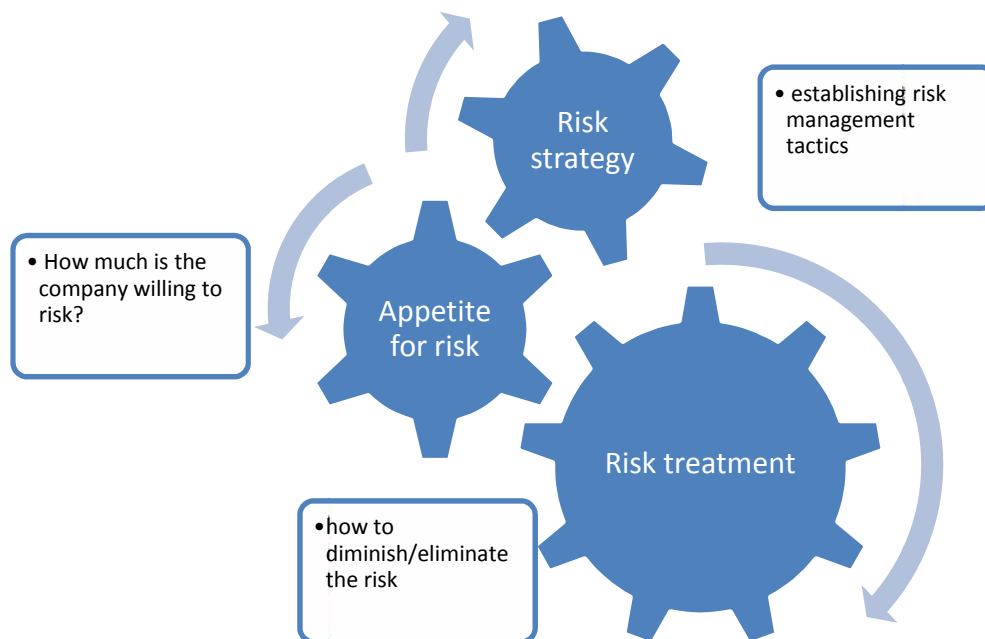
- the assessment of the risk management process and the issuance of recommendations in this field.
- Nevertheless, the fact that the internal audit shall not be responsible for the risks management efficiency, must be mentioned. This responsibility belongs to the top and operational management.

**Reference list:**

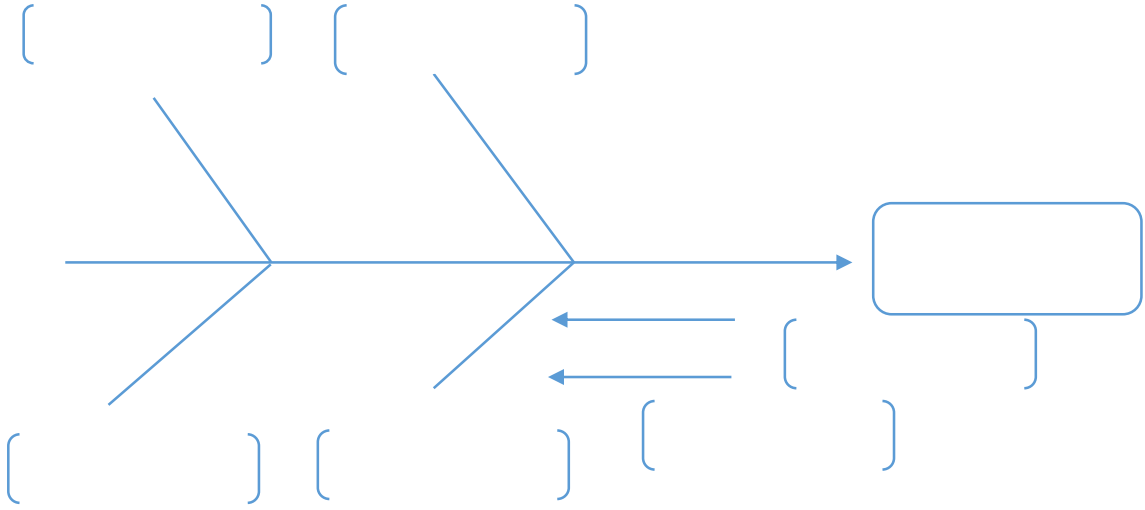
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*Figure 1.* Factors that influence the risk management  
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*Figure 2.* Risk management  
Source: processed data in personal manner



*Figure 3. The Fundamental Structure of the Fishbone Diagram*  
Source: processed data: [www.balancedscorecard.org/files/c-ediag.pdf](http://www.balancedscorecard.org/files/c-ediag.pdf)