RISK MANAGEMENT'S IMPORTANCE AND ROLE IN AUDIT

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The importance of treating this theme is proved by the current situation that economy and the entities activating on the market are confronted with.
Risk is present in all the actions and event of humanity. Risk is in a permanent change, it evolves in complexity, among the traditional exposures to hazard other risks are added: operational, financial, strategic, market, country, legal, human, fraud risks and its complex character can be attributed to a range of factors that are grouped by the specialized literature in macroeconomic factors, also called extern, and microeconomic factors, also called intern.
In the last few years, the importance of the corporate governance involvement in risk management is more and more recognized. The organizations are under the pressure of identifying all risks that it is confronted with starting with social risks, ethical and environment risks to those financial and operational, and also to the way it manages them at an acceptable level. In the same time, using integrated risk management procedures and politics at enterprise level (ERM-Enterprise Risk Management) has extended, in this way organizations are admitting the risk management approach advantages.
The internal audit, in both his roles of providing assurance and consultancy, contributes to risk management in various ways, its importance being increasing due to the current financial crisis.
For the financial auditor the term of risk has other senses, meaning that risks are regarded through the mission type and objectives. But still, identifying and measuring audit risks during the mission's planning are strong connected to the existing risk management of the entity. In this way, if the audited entity has an implemented risk management that is proved to be efficient, this will represent a starting point for the auditor in evaluating the risks connected to his engagement, meaning that the general audit risk will be lower and the assurance level will be higher. More than that, an efficient enterprise risk management determines a higher level of trust in the internal audit department's activity.

Key words: Risk, risk management, internal audit, audit risk, efficiency

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Introduction

While liberalization, globalization and fast development of informatics technology generate new business opportunities, financial and economic entities are exposed to more diverse and complex risks then before. Risk identification, measurement and control have never been more important for organizational and strategic management then they are today.
The paper treats issues such as the existing risks for an entity, the efficiency and advantages of implementing a risk management, the internal auditor's play in risk management functioning and its connection with the audit risk determined by the financial auditor during his engagement.
The importance of treating this theme is proved by the current situation that economy and other entities on the market are confronted with. Since the financial crisis started and up until now we

could assist to the effects apparently produced by this situation, but even more by an inefficient management and by unreliable strategic plans.

Under these conditions, the entities that had developed an efficient risk management in the past had been capable to survive this period, and some of them even more, they managed to maintain profitable. It is also true that past can't be changed, but learning from it, some cautions can be taken, some decisions and plans that haven't been implemented can be reviewed.

Treating risk management and its impact in all aspects it becomes relevant for the entities which can still learn from mistakes and from other positive examples and also for those who analyze and study the market, being a subject of real interest and present.

1. About the risks

Risk has various definitions in the specialized literature. It can be defined as: "the possibility to get into danger, to face a mess or to support a damage".(I.Mihut & co.,2003:6), "the risk is practically the threat of an event to affect the ability of a company to function and to accomplish its strategic goals. The risk generally appears not from the probability that nothing is going to happen, but from the probability that something bad is going to happen" (I. Mihut & co., 2003:8). Also, "the economic life is governed by incertitude and any other view of further events is, by definition, susceptible not to fit in the predicted parameters" (I. Mihut & co., 2003:8).

The risk exists permanently and he produces or not depending of the created conditions. Risk is present in all humanity's actions and events. Risk is in a permanent change, it develops in complexity, beside traditional exposure to hazard, adding operational, financial, strategic, market, country, legislative, human, fraud risk, and the complex character of the risk can be referable to more factors that in the specialized literature are grouped in macroeconomic factors, named external factors and microeconomic, named internal factors.

Internal factors are:

- Economic, determined by: changes in interest rate, inflation, insurances, taxes, economic changes.
- Political, determined by: the ambiguous and changing legislation, some protective politics, regulations and respecting them, area political priorities.
- Competitive, determined by: the changes of the market, the pressure of big companies , the types and services offered, fashion trends, using the mass-media, the demanding and the expectations of the clients, contract requests.

Internal factors may be considered:

- Social determined by: employees' ethic and faith, individual culture of the involved people concerning risk, the pressure claimed by the employees for their compensation rights or performing inadequate activities, frequent employees' changes, to close relationships between employees.
- Economics, determined by: the changes in data processing , the material substitution, a better security for the new products and technology, a better system regarding the procedures and the new operating methods, the need to reduce the loses, the investors' and shareholders' expectations, the adopted strategy.
- Physical determined by: buildings' damages, the fraud made through the acts or intentions of the employees or clients employees.

2. Risk management's importance for internal audit

In the last few years, the importance of the corporate governance involvement in risk management is more and more recognized. The organizations are under the pressure of identifying all risks that it is confronted with starting with social risks, ethical and environment risks to those financial and operational, and also to the way it manages them at an acceptable level. In the same time, using integrated risk management procedures and politics at enterprise

level (ERM-Enterprise Risk Management) has extended, in this way organizations are admitting the risk management approach advantages.
The internal audit, in both his roles of providing assurance and consultancy, contributes to risk management in various ways, its importance being increasing due to the current financial crisis. People carry on activities of managing risk in order to identify, evaluate, manage and control all types of events or situations that might affect the organization. These may vary from individual projects to defining the types of risk, for example, the market risk, in order to measure the threats and opportunities that organization as a whole is confronting with. The principles presented in this statement can be used to guide the internal audit's involvement in all risk management processes, but we are especially interested in risk management at enterprise level, because this is the one able to improve the governing processes in an organization. Enterprise Risk Management is a continuous process, structured within the organization as a whole, which allows identification, evaluation, decision upon the answers and reporting regarding the opportunities and threats that affect accomplishing the its objectives.
The Board of Directors has the general responsibility to make sure that risks are properly managed. But, in practice, the Board delegates the risk management functioning frame to the management team. Within the team, a separate function may exist, that coordinates and manages these activities and contributes through competences and knowledge.
The benefits of implementing an Enterprise Risk Management include:

- a higher probability of accomplishing the organization's objectives;
- improving the key risk understanding and their implications;
- a management that pays attention to the real important meters;
- less unpleasant surprises or crisis situations;
- the capacity of taking a higher risk for a higher reward/benefit;
- extended informing about risks and making decisions regarding risks.

Any decision regarding the accomplishment of a new objective, developments and restructures, involves a risk in obtaining the estimated results due to the influence of changes that take place all the time in the technical, economical, social, internal and external environment. The incertitude conditions influence the events that concur to obtain some indicators that can be used to evaluate the versions of realizing a project and the decisions' fundamentals.
Risk evaluation is necessary starting with the highest levels of making strategic decisions - for example, in al cases regarding of: what type of activities to be carried on, what assets to be bought or what markets to take in count- and continuing with the operational decisions- from accepting foreign currency payments to assuring a proper level of safety for the working place. Evaluation of risk plays a role even if an organization is or is not conscious of risk management (Likierman A., 2008).
Despite its complexity, risk management is actually a managerial instrument which helps the organization to hold the most proper control politics of the unfavorable results (Internal Audit Standard 1130). Even though, the general opinion saying that a good corporate governance determines management tot make the best decisions in risk conditions – meaning, well informed decisions are opposed to avoiding risk. Some specialists consider that in the current climate an attitude of adversity against risk once with the increasing importance of conformity, determined by the reactions of the regulators around the world regarding the corporate crushes (cases of Enron, Parmalat, Worldcom).
A good risk management has as a purpose the improvement of organizational decisions. This does not only refer to avoid or to minimize loses, but also to treat the opportunities in a favorable manner.
One of the key requests of the Board is to obtain the assurance that the risk management process is efficient, and key risks are managed at an acceptable level. It is possible that assurance may come from different sources, but from all of them the assurance provided by management is the

most fundamental. This aspect should be complemented by providing objective assurance for which internal audit is a key source. Other sources include external audit and specialized independent reviews.

Internal audit will normally provide assurance on three areas:

- risk management process, both for process projecting and process's good functioning;
- classified risks' management as "key-risks", including controls efficiency and other response to that;
- adequate and reliable risk evaluation and reporting upon risks' status and control.

Internal audit is an independent and objective activity of assurance and advisory. Its main role regarding ERM is to provide objective assurance to the Board regarding risk management efficiency. Research has shown that Board directors and internal auditors agree upon the fact that two of the most important ways through which internal audit adds value to organization consist in providing objective assurance that major business risks are managed in a proper way and providing assurance that risk management and internal control work efficiently. One of the consultant role in which internal audit engages involves:

- Making available for management some instruments and techniques used by the internal audit to analyze risks and control performing;
- directing the process for introducing ERM in an organization due to accumulated experience;
- providing advisory, facilitating work-shops, preparing the organization for risk area and promoting the development of a common language for understanding this area;
- supporting managers that have as an objective the identification of the best ways to minimize risks.

Any time the internal audit supports the managerial team in creating or improving the risk management process, its working plan should include a well defined strategy regarding the responsibility migration for these activities to the members of the managerial team.

If within the organization exists a management risk function, that works properly, then the work volume of the internal auditors will be substantially reduced. If this function is missing, the internal auditors may support and advice the superior managers upon risk identification, their evaluation and establishment of risk appetite.

3. The connection between risk management and financial audit

In analyzing the audit process, risk evaluation takes a very important place. In some authors' opinion (I. Graz & S. Manson, 2000), risk evaluation should be the main concern of the auditor. Shortly, risk audit could be defined as the risk that an auditor assumes to give an inadequate audit opinion regarding the audited financial situations. Audit Standards mention the following definition for audit risk: "the risk that the auditor attributes to an inadequate audit opinion, when financial situations contain information significantly misstated".

For this reason, the auditors especially follow, starting with the moment they accept the engagement, but also during the whole mission, the risks that might occur that might lead them to opinions that do not reflect reality as it is. After identifying the risks, the auditors establish their procedures depending on the risk areas.

Taking into account the audit risk establishment's importance, the audit standards contain very few indications regarding the technical manner for establishing this risk. In this way, the professional judgment of the auditor is almost exclusively used.

The main objective that the auditor considers consists in projecting and implementing some audit procedures to allow risk reduction at an acceptable level. Audit risk has to be very well evaluated, because not only a superficial audit, but also too detailed applied audit procedures can have negative effects on the audit process. The issue for the auditor is that, if he is not aware of the risks he assumes, if he simply doesn't consider these risks, he might get some severe professional sanctions or payment for some significant material damages, as a consequence of being accused of bad-faith and negligence in accomplishing his attributes. All these explain the auditor's tend to allocate a substantial part of his time during the engagement to identify the risks involved in exercising his mission.

When the general audit risk is evaluated within the engagement, it divides in three components, measured separately: inherent risk, control risk and detection risk. The relationship between the three components is the following:

Audit risk = Inherent risk x Control risk x Substantive risk or AR=IRxCRxSR

Audit risk and its components can be established both in quantity (percents) and quality (low, moderate, high) terms. In practice the most used are the quality methods of measurement for risk levels.

a) Inherent risk represents the susceptibility that the closing balance of an account or of a category of transactions to contain misstated information that might be individually significant or when misstated information are cumulated from other closing balances or transactions, supposing that there weren't effectuated side internal controls (RCFA, 2000:123).

b) Control risk represents the risk of misstated statement, that might occur in the clogging balance or in a category of transactions and might be individually significant or cumulated with other information, and can not be detected, prevented or corrected in due time by the internal control and accounting systems (RCFA, 2000:124)

External auditors base their work on the internal auditors' work by using the audit risk model. When the activity of the internal auditors is efficient, external auditors significantly reduce the control risk, reducing at the same time the quantity of substantive tests and implicitly the improving the quality of the given opinion.

c)Substantive risk represents the risk that a substantive procedure performed by the auditor might not detect misstated information in the closing balance of an account or of a category of transactions, that might be individually significant, or cumulated with other misstated information from other closing balances or other categories of accounts (RCFA, 2000: 124). Substantive risk's level is strongly connected to the substantive audit procedures performed.

As we could observe, for the financial auditor the concept of risk has another sense, meaning that risks are regarded through the engagement type and objectives. But still, identifying and measuring audit risks within the engagement planning coexists in strong connection with the existent risk management within an entity. In this way, if the audited entity has implemented a risk management that has proved its efficiency, this aspect represent a starting point for the auditor in evaluating the risks connected to his engagement, meaning that the general audit risk will be lower and the assurance level provided by the auditor will be a higher one. More then that, an efficient ERM determines o bigger trust in the activity of the internal audit department that leads the financial auditor to:

- reducing the number of tests and procedures;
- less audit evidence to be collected;
- shorter period of time for the engagement;
- concentration upon really important elements to be tested;
- higher cost/benefit report both for the audited entity and for the auditor.

4. Efficient risk management – a solution for crisis situations

The entities that knew to apply at the right time an efficient risk management are those which now look with lucidity to the market an which can take advantage of the existing crisis. Those who let themselves carried out by the increasing economy wave, and who had lost from sight the elementary risk management measures, must redirect.

The financial crisis that we are passing through is like a coin with its two faces. So managers can let themselves influenced by negative news and by the general state of pessimism, and they can concept their future plans depending on these or they can act in a way to take advantage of the situation.
Within the market, everything works on the domino principle: the increasing of the credit cost will bring the disappearance of some companies, but will consolidate the position of others, negative examples will create tensions, and, potential investors will reorient to other geographical areas.
If a company will win or not upon this situation depends of how well did it know to evaluate its business and the impact of an unwanted event, of how well did it know to develop a plan that assures upon the business continuity. And this means exactly risk management.
After this period that we are crossing might have to win the enterprisers who knew to correctly quantify the money value, the ones who will manage to balance the expenses and revenues. Up until now the consequences of the inexistence of such a balance had been seen through extreme measures as: disposals, activity interruptions, relocation.
The entities which accumulate reserve funds or the entities which increase these funds and are leading for bay markets, professionalism in serving the clients, added value, will be the winners in the current situation. Risk management represents the art ok making decisions in a world governed by incertitude. More exactly, risk management represents a process of identification, analysis and answer to the risks that an organization is exposed to. The costs of implementing a risk management within a company depend on the methods of unpredictable events' managing.

Conclusions

It can be conclude that changing means insecurity, and insecurity means risk. The future belongs to the businesses based on an efficient risk management. The obtained results deserve the effort, because efficient risk administration brings important benefits for the company through: increasing the shareholders' trust, improving the company's image and the moral of the employees, increasing productivity.
The basic play that the internal audit has in connection with risk management should be providing assurance for the executive management and for the Board of Directors upon the efficiency of risk management. In the context of an extended role assumed by the internal auditor, additional protection measures should be applied.
There also is a strong relationship between the risk management's efficiency and the risk level and assurance level measured by the financial auditor. So, a risk management proved to be efficient leads the external auditor to establish a lower level for the general audit risk.

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