

Risk or Opportunity — The Choice Is Yours

Risk is always getting a bad rap — when in fact, it is simply a measure of uncertainty, the chance that some event will have an impact on objectives. Risk is most commonly thought of as having negative consequences — harm, loss, danger, and hazard — when in fact it may just as easily involve opportunities. However, according to The IIA book, *Business Risk Assessment*, a decision system that incorporates uncertainty, even in a flawed way, may well outperform a system that ignores it.

Although organizations use the term risk management frequently (and it is used here for lack of better terminology), it too is misleading, because risk is never actually managed. It is the organization that is managed in anticipation of the uncertainty (and opportunities) presented by risk in the environment.

However stated, risk is the new driver of organizational activity.

RISK MANAGEMENT: ARE YOU A KEY PLAYER?

According to David A. Richards, CIA, manager of the internal audit department for FirstEnergy Corporation, and The IIA's 2001-2002 chairman of the board, "Boards and audit committees play a vital oversight role in determining that risk management processes are effective, and forward thinking boards actively involve their internal audit departments in this process."



Richards and his team of 18 auditors are active in the risk management process at FirstEnergy, a \$7 billion-a-year investor-owned electric, gas, and facilities services company.

Richards sees a major change in the area of risk during his 20 years in auditing. "There is now greater involvement by line management in ensuring that sound processes are in place and functioning. This includes identifying key business risks, evaluating their impact on the organization, estimating the probability of the risk event's occurrence, and determining the appropriate response to the risk."

"The shift in 'ownership' of the risk management process from an internal audit tool to a management responsibility — and ultimately that of the entire board — is a dramatic change from the past," Richards explains.

Internal auditors assist both management and the board/audit committee by examining, evaluating, and reporting on the adequacy and effectiveness of management's risk processes and by recommending improvements when necessary. The chief audit executive (CAE) should seek direction from management and the board as to internal auditing's role in the risk management process.

Responsibilities and activities should be coordinated among all individuals and groups involved in the organization's risk management process. For example:

- Setting strategic direction may reside with the board or a committee.
- Acceptance of residual risk may reside at the executive management level.
- Efforts should be coordinated with appropriate legal counsel.
- Ownership of risks may be assigned at the senior management level.
- Identifying, assessing, mitigating, and monitoring activities on a continuous basis may be assigned at the operating level.
- Periodic assessment and assurance to others should reside with the internal audit activity.

All of the responsibilities and activities above should be appropriately documented in the organization's strategic plans, board policies, management directives, operating procedures, audit committee and audit activity charters, and other governance-type instruments.

AUDIT COMMITTEES TAKE CONTROL

According to The IIA's new handbook, *Audit Committee Briefing — 2001: Facilitating New Audit Committee Responsibilities*, new pronouncements and guidelines issued by regulatory bodies give evidence of the trend toward increasing the number and breadth of tasks assigned to audit committees. Audit committee responsibility for risk management practices in the organization is one of the major guidelines.

The Public Oversight Board Panel on Audit Effectiveness (United States) reiterated the need for audit committees to receive formal annual evaluations of business risks and related internal controls. Professional bodies in the United Kingdom and Canada have also issued recent statements augmenting the emphasis audit committees should give to risk evaluation and mitigation and related controls. In effect, these statements outline new audit committee responsibilities for oversight of risk and control.

“Audit committees desperately need help in carrying out their oversight responsibilities.”

More than half of the business leaders attending a 1999 Financial Executives International/Arthur Andersen symposium on the changing roles of audit committees held the belief that management’s ability to identify and manage business risks is

not keeping up with the accelerating pace of change. According to The IIA’s *Audit Committee Briefing* author Curtis C. Vershoor, “They are afraid that systems for identifying and controlling business risks may not always be strong enough to cope with the increasing severity and scope of those risks and the rapidity of changes in today’s business environment.”

Research shows that audit committees are increasing their emphasis on oversight of the systems their organizations use to assess, analyze, and mitigate business risks. A 2000 KPMG Audit

KEY FACTORS IN SUCCESSFUL RISK MANAGEMENT

- *There must be a method to understand the business process. Without understanding the process, there is an incomplete appreciation of the business risk for that process.*
- *There must be a framework and a common language to discuss business risk among all stakeholders.*
- *There must be methods to stimulate and open up the imagination about the source of business risk. Unless the risk can be identified and assessed, it cannot be managed.*
- *The chief audit executive (CAE) should participate in strategic risk management issues.*
- *The CAE should keep the internal audit process aligned with the goals and objectives of the organization.*

Committee Institute survey shows that 61 percent of audit committees are provided a current assessment of the organization’s significant business risks at every meeting.

Managing Risk in the New Economy, a recent publication by the American Institute of Certified Public Accountants and the Canadian Institute of Chartered Accountants, states that current best practices in risk management include:

- Identifying risk from all sources.
- Analyzing and assessing risks in terms of a common measure.
- Designing strategies for managing risk.

- Implementing risk management processes.
- Integrating risk management within the organization’s management processes.
- Measuring and monitoring changes.
- Reporting to appropriate parties.

INTERNAL AUDIT AT THE ONSET

Study findings reported in The IIA Research Foundation’s *Audit Committee Effectiveness: What Works Best, Second Edition* indicate that significant opportunities exist for forward-looking internal auditors to provide greater value-added service to their organization’s audit committee. According to principal author Rick Steinberg from Pricewaterhouse-Coopers, the internal auditor must:

- Serve as a key resource to management in shaping information for the audit committee.
- Serve as a key resource to the audit committee by providing data and analysis as needed.
- Support management/audit committee interaction.

Steinberg believes that many audit committees “desperately need help” in carrying out their oversight responsibilities effectively. Professionally staffed and certified internal auditors are uniquely aligned to be the team-oriented objective arm the committee needs.

Risk Management and the Value Added by Internal Audit, issued by the Audit Faculty of the Institute of Chartered Accountants of England and Wales (ICAEW), notes that internal auditors assist the board and management by examining the processes for identifying, prioritizing, managing, controlling, mitigating, and reporting risks.

The ICAEW Audit Faculty states that what is most relevant about internal auditing’s value is the internal auditor’s knowledge of the organization and its systems, processes, and culture. The internal auditor brings further value by:

- Systematically analyzing business processes.
- Objectively assessing the efficiency of business processes.
- Independently reporting findings and making recommendations for improvement.
- Supporting the spread of best practices organization wide.

Essentially, the internal auditors can bring significant value to the process of organizational risk assessment, evaluation, and mitigation; and should be in a position to assist management in providing the audit committee with a periodic, overall evaluation of business risks and related controls.

Although it is clear that the internal auditors can facilitate or enable risk management processes, they should not “own” or be responsible for the management of the risks they identify. That responsibility is yours.

Visit www.theiia.org and enter RISK in the search box for additional IIA resources for effective risk management.

Changing the Risk Paradigm

The IIA Research Foundation report, *Risk Management: Changing the Internal Auditor's Paradigm*, proposes a new paradigm for thinking about risk.

Characteristics	Old Paradigm	New Paradigm
Internal audit focus	Internal control	Business risk
Internal audit response	Reactive, after-the-fact, discontinuous observers of strategic planning initiatives	Coactive, real-time, continuous monitoring participants in strategic planning
Risk assessment	Risk factors	Scenario planning
Internal audit tests	Important controls	Important risks
Internal audit methods	Emphasis on completeness of detail, controls testing	Emphasis on significance of broad business risks covered
Internal audit recommendations	Internal control: <ul style="list-style-type: none"> • Strengthened • Cost-benefit • Efficient/effective 	Risk management: <ul style="list-style-type: none"> • Avoid/diversify risk • Share/transfer risk • Control/accept risk
Internal audit reports	Addressing functional controls	Addressing process risks
Internal audit role in organization	Independent appraisal function	Integrated risk management and corporate governance

According to the researchers David McNamee, CIA, and Georges Selim, Ph.D., “There are definite indicators that many, if not all, of these characteristics are in the process of changing to the new paradigm in leading organizations.”

Enterprise Risk Management (ERM) Moves Into Practice

Add the term “enterprise” in front of risk management, and you change the definition from “dealing with uncertainty,” to “a rigorous and coordinated approach to assessing and responding to all risks that affect the achievement of an organization’s strategic and financial objectives. This includes both upside and downside risks.”

This definition of ERM is taken from the new IIA Research Foundation report *Enterprise Risk Management: Trends and Emerging Practices*. This forward-thinking publication was prepared for The Foundation by Tillinghast - Towers Perrin with the assistance of the Conference Board of Canada.

Corporate interest in ERM is a function of regulatory and oversight factors and market factors.

Since 1994 there has been increasing pressure on corporations to improve their governance mechanisms and fully disclose key risk factors and issues. The Committee

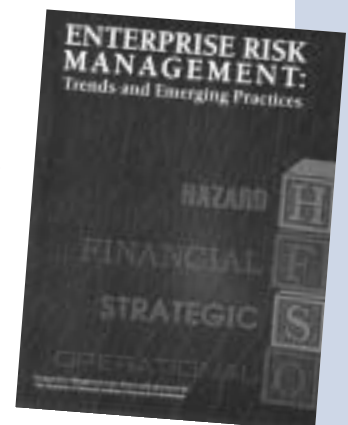
of Sponsoring Organizations of the Treadway Commission (COSO) intends to publish an ERM conceptual framework and application guidance in 2002.

ERM is destined to become an integral part of the management process for organizations of the 21st century.

Visit www.theiia.org and enter RISK in the search box to learn more.

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To provide executive management, boards of directors, and audit committees with concise, leading-edge information on such issues as ethics, internal control, governance, and the changing role of internal auditing; and guidance relative to their roles in, and responsibilities for the internal audit function.

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