Presentation on

Risk Assessment

ICAI Seminar on Internal Audit

1st Feb 2014

Why Risk Based Audit Plan

Definition of Internal Audit

- Internal Auditing is an independent, objective assurance and consulting activity designed to **add value** and **improve an organization's operations.** It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of **risk management, control and governance processes.**

- **Source: The Institute of Internal Auditors 1999 (IIA)**

Evolution of Internal Audit

Business consultancy approach

Business process based audits

Transaction based audit

Evolution of Internal Audit

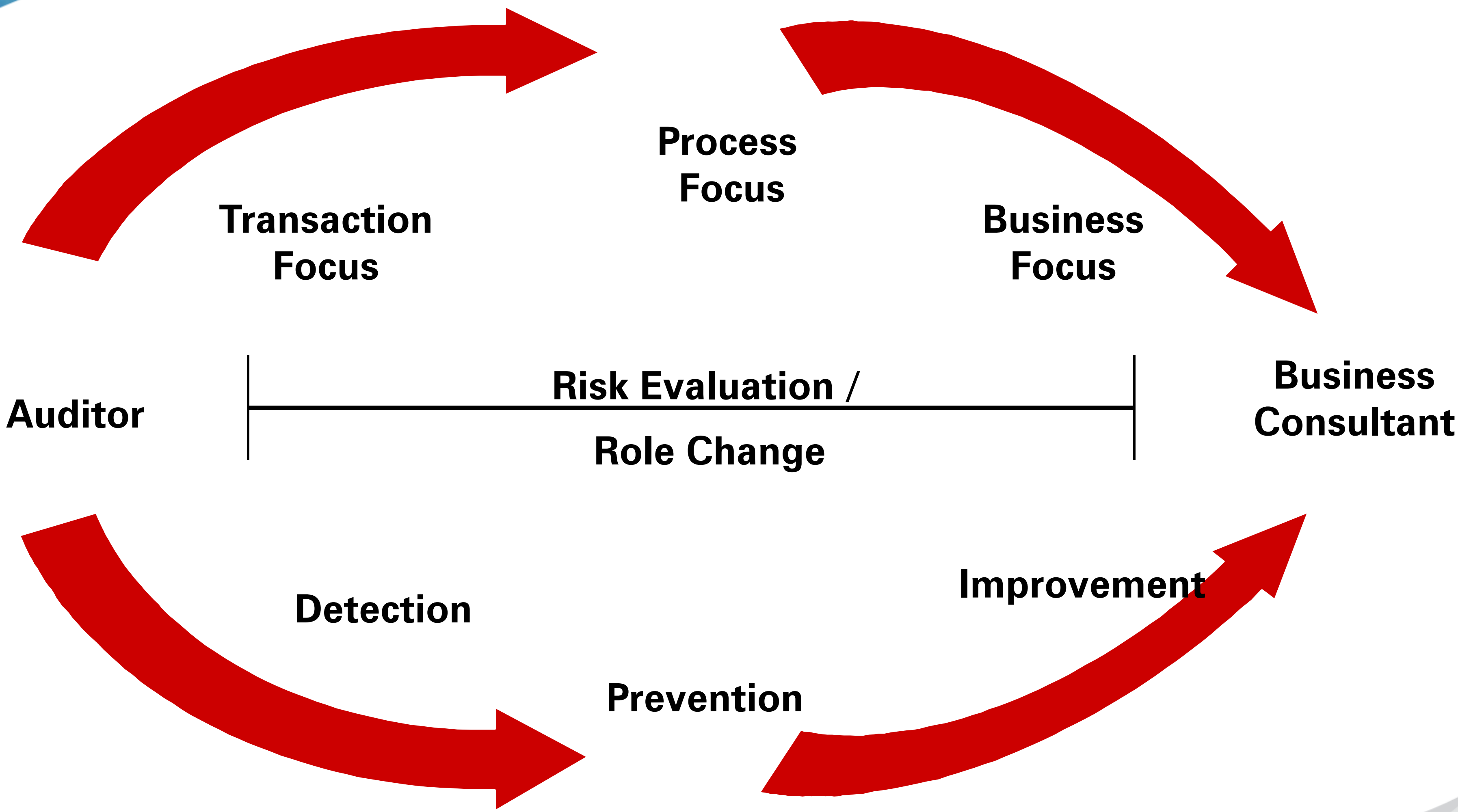
- **Transaction Audit :**
  - Aim to find out accuracy of specific transaction.
  - Gives 100% assurance.
  - Requires huge resources.
  - Does not improve the process

- **Process Audit:**
  - Aim to improve process.
  - Emphasis on "What can go wrong" in process
  - Requires good understanding of processes
  - Useful for repetitive transactions e.g.: Purchase, Sale, Expenses, Accounts Payable, Accounts Receivables etc.

Evolution of Internal Audit

- **Business Consultancy Approach:**
  - Pro-active approach
  - Feedback on Operations
  - Prediction of current & future challenges
  - Recommendation on measures to tackle challenges
  - Help organization in achieving business objectives
  - Considers both "Process Risks" & "Business Risks"

Changing Role of Auditor

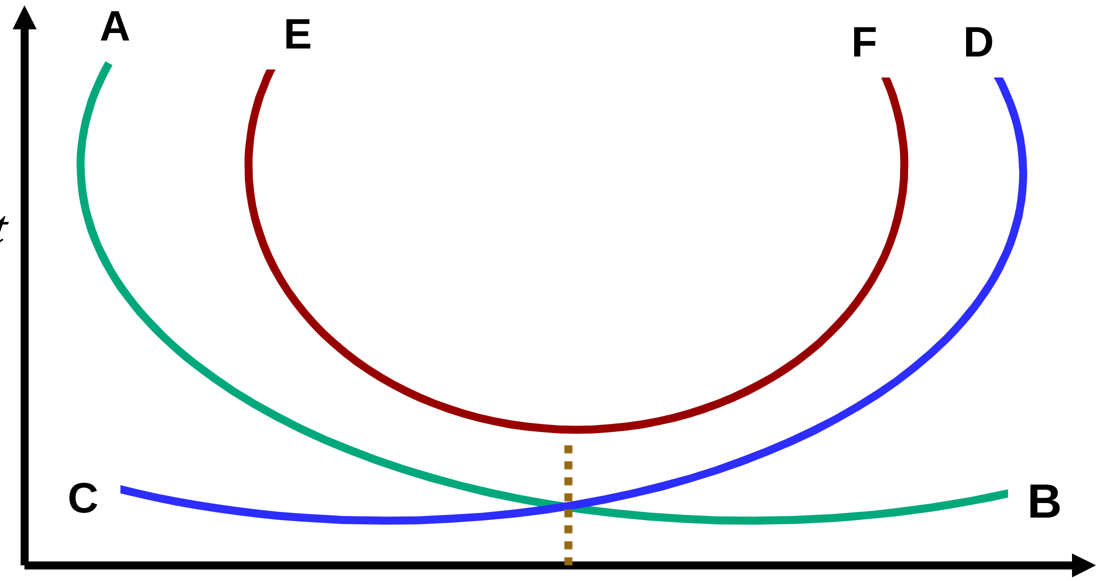


Management Expectation from IA

- Pro active approach, i.e. no last minute surprises
- Business oriented audits
- Value Addition in form of Cost Reduction
- Feedback on operations instead of processes
- Act as consultant
- Contribute in Risk Management Framework
- Limited resources / Low cost

Audit Planning & Resource Rationalization

Risk of losses due to non-audit / Cost of Internal Audit resources



Frequency of internal audit

A — B **'Costs due to risk of losses' curve**

C — D **'Cost of Internal Audit resources' curve**

E — F **'Total Cost' Curve**

The more number of audits IA function undertakes, the more is the cost of resources and the less the number of audits, the more the risk of losses.

What is Risk Based Audit Plan

Risk

- Any issue / threat which affects organization's ability to achieve its objectives.

- 2 components :
  - **Probability** of occurrence
  - **Impact** on organization

- **Risk Based Audit Plan:** Audit plan which links audit areas with risk profile of business processes

Audit Methodology

- Annual Audit Plan
- Selection of Audit Area
- Preliminary discussions with the Business Head
- Preparation of audit checklists
- Audit Execution
- Audit report discussions
- Reporting to Audit Committee - Key Audit Findings
- Follow up for compliance

- **Now Top of it : “Risk Assessment”**

Different ways –
Example : 1

Risk Based Internal Audit Approach

Stage1: Assess the risks

Request Management to rate inherent risks in audit units

Stage 2: Evaluate controls

Based on parameterised breach / error levels for each process in an audit unit

Stage 3: Control Score

Aggregate control score of all processes

Stage 4: Compute RR

RR Score indicates risk not covered by the existing controls. It is average of inherent risk and controls

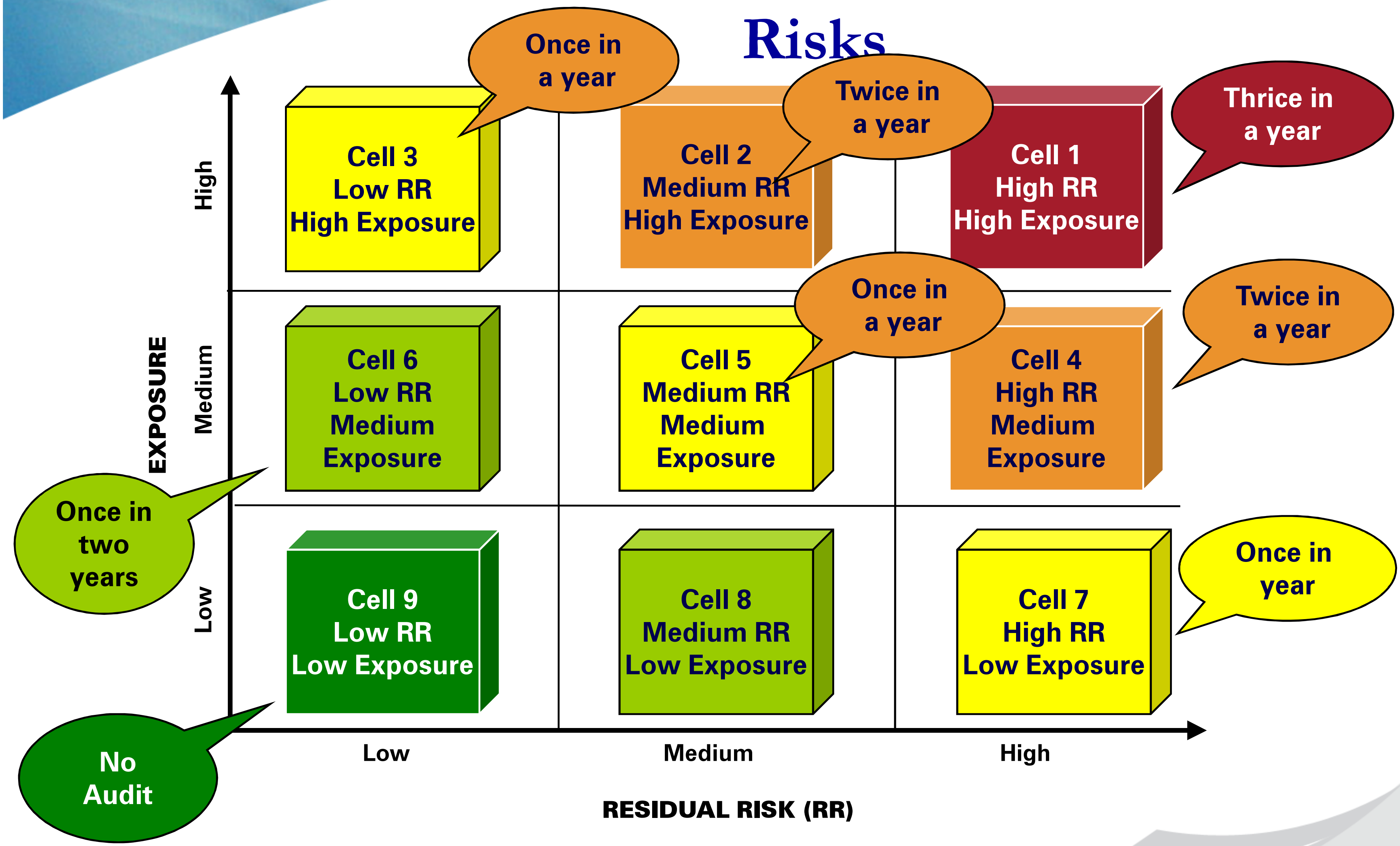
Stage 5: Relate to Exposure

Compare RR with volume/ size of business unit

Stage 6: Risk Map

Used for determining frequency of audits in the Annual Audit Plan

Risk Matrix- Illustrating Significance of Risks



Risk Based Audit Plan

- Considers net risks (i.e. inherent risks and controls) for preparation of plan
- Frequency of audit
  – Based on net risk and impact
- Priority for allocation of resources
- Risk matrix for transaction testing
  – High Magnitude and High Frequency
  – High Magnitude and Medium Frequency
  – Medium Magnitude and High Frequency
  – High Magnitude and Low Frequency
  – Medium Magnitude and Medium Frequency
- Extent of testing
  – Sampling techniques
  – 100% checking

Cautions

- Complicated approach
- It is more of subjective than objective.
- Depends on persons assessing inherent risk
- No flexibility to accommodate time constraints
- Not useful for new businesses, new locations, new internal audit dept.

Example : 2

Risk Based Audit Plan

- Risk Assessment:
  - Done Location-wise
  - Done at 2 levels, i.e. Business Risks & Control Risks
  - Rating on a scale of 1 to 5 for both the risks

Business Risk

- Based on values i.e. reflects “Impact”.
- Taken Location-wise financial statements of last year
- Created groups for common accounts e.g. Fixed Assets, Bank Accounts Loans & Advances, etc.
- Rating done based on values of each group

Rating	Criteria
1	< Rs. 1 crores
2	> 1 crores < 5 crores
3	> 5 crores < 25 crores
4	> 25 crores < 125 crores
5	> 125 crores

Control Risk

- Identified various processes relating to various account heads. For example: Preparation of fixed assets register, Addition of fixed assets, Capitalization, Disposal, Physical verification, Charging of depreciation, Impairment of assets and Capital spares treatment etc were identified for account group “Fixed Assets”.

- Rated processes based on our past audit experience.

- The scale of rating : 1 to 5. Rating of 1 for no audit observation while 5 for repeated control failures.

- Calculated average of all the processes in a given account group.

- It reflects “Probability”

Frequency of Audit

- Worked out Exposure = Business Risk x Control Risk.

- Rating scale : 1 to 25

- Frequency of audit based on Exposure.

Frequency	Exposure
No audits	< 5
1	>5 <10
2	>10 < 15
3	>15 < 0
4	>20

Audit Plan

- Calculate total man days required after considering frequency of audits.
- Compare man days available with man days required.
- Form strategy either to recruit or outsource
- Prepare Annual Audit Plan and Manpower Plan
- Prepare Quarterly / Monthly Plans and monitor Budget v/s Actual

Benefits

- Objective Risk Assessment. Very limited subjectivity.
- Frequency of audit based on Risk Scores .
- More frequency of audit for areas with High Risk High Impact as against current frequency of once in a year.
- Limited review for low risk prone areas.
- Better allocation of resources.
- Flexibility in modifying audit scope based on time availability

Caution

- Do not use this methodology for :
  - New organizations
  - New locations
  - New internal audit dept.
  - High value low volume business
  - 100% coverage required by Statute or Management

- For service industries (ex: Bank Branches, Retail Stores etc), this methodology requires modification.

- Method in case study shown is only one of method. Other methods can also be used.

Example : 3

Business Risk

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Control Risk

- Based on 5 factors influencing controls in each area.
  - People : Whether person is experienced or new.
  - Place: Whether activities are centralized or decentralized.
  - Inherent : Inherent risk in process / area.   E.g. Cash v/s HRC, Excise
  - Past : Past Audit observations.
  - Automation: Whether process is automated or manual.

- Rating given to each factor.
  - Rating of 1 if it can influence controls
  - Rating of 0 if there is no influence on controls

- Total up rating of all 5 components.

Frequency of Audit

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1	> 5 < 10
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Features

- Objective Risk Assessment. Very limited subjectivity.
- Allocation of resources based on risk score.
- Good for new organizations, new locations new IA Dept.
- Not to be used for high value low volume businesses.


THANK YOU!