RISK MANAGEMENT IN THE FINANCIAL AND ACCOUNTING ACTIVITY

Ph.D. **Emilia VASILE**
"Athenaeum" University Bucharest

Ph.D. Student **Ion CROITORU**
Ph.D. **Daniela MITRAN**
"Athenaeum" University Bucharest

Abstract

The financial and accounting activity represents an important function of the organisation, through which measurement, evaluation, knowledge, management and control of assets, liabilities and equity can be performed, as well as the outcomes of the economic activity.

Risk management process ensures that risk management is regularly monitored and that there are mechanisms that alert the management of the entity about arising risks or changes in already managed risks and that the appropriate control devices in order to minimize them are identified.

The role of the internal audit is to conduct assessments on all components and financial and accounting activities or activities with financial implications and to track how public funds are used, namely if they are used efficiently and effectively and weather the financial information given to the management is appropriate and can contribute to achieving the planned results.

Keywords: business financial accounting, internal audit, risk assessment, risk identification, risk management, risk monitoring, risk tolerance.

Jel Classification: M00; M41; M42

The importance of financial and accounting activities within the organisation

The financial and accounting function represents a specialised activity within the organisation through which the measurement, evaluation, knowledge, management and control of assets, liabilities and equity can be performed, as well as the outcomes obtained from the economic activity of an organisation. Financial and accounting activities ensure chronological and systematic recording, processing, publication and preservation of information regarding financial position, financial performance and cash flow for both the domestic needs of the organisation as well as for external users.

Information provided by the financial and accounting system refers to the performance of income and expenditure budgets, budget execution outcomes, assets under management, asset outcomes and cost of approved programs.

Also, financial and accounting operations present the situation concerning propriety and assets, namely inventory, calculation, analysis and control of assets denominated in currency, it provides control of operations, processing procedures as well as the accuracy of accounting data provided to users.

The content and range of the financial and accounting activities include:

- the existence of material and financial means;
- movement and transformation of material and financial means within the economic operations and processes
- determination of the final outcome of movements and transformations in a value expression.

Carrying out any economic activity by an organisation or entity imposes the preparation and existence of *financial and book-keeping records* which represent the consignment made in a specific order, based on set principles, of any conducted economic activity or operation. According to the nature of the data and the manner in which they are obtained, processed and represented, financial and book-keeping records take three distinct forms: *technical and operational records, accounting records and statistical records*, which reflect the overall situation of the organisation.

Activities carried out within the financial and accounting function can be grouped as followed:

- *financial activities* which refer to the establishment and use of financial resources;
- *accounting activities*, which relate to preparation of accounting records that reflect the existence, movement and transformation of assets in a value expression. These ensure the integrity of the assets and give a foundation to management decisions.

Finance and book-keeping performed within an organisation is key because it reflects any asset operation and in the same time provides a series of data which are used by the management in decision making, as well as a series of users, depending on concerns.

Under these conditions ensuring effective management of financial and accounting hazards is essential for limiting errors and fraud, waste and uneconomical activity. Implementation of an effective risk management system on financial and accounting activities contributes to increasing business performance and overall performance across the entire organisation, given the interfering of this function with all other functions within the organisation

The need for risk management in financial and accounting activities

Why risk management is required? The answer is that, achieving business objectives or obtaining expected results is burdened by the uncertainty of the nature of the threats, which may become both performance barriers and opportunities. At any time, events or situations may arise, actions or inactions, which result in failure of targets or which can become opportunities to be exploited.

The need for risk management stems from the fact that uncertainty is a reality and a reaction to this uncertainty is a permanent preoccupation. Therefore, the acquisition of a risk management system, widely accepted across the organisation, becomes indispensable to financial and accounting activities.

Implementing a risk management system in the financial and accounting activity is necessary due to the following:

- *Risk management requires change in management style* – managers must deal with both the consequences of events that occurred and to devise and implement measures that are likely to reduce risks so that the organisation can carry out it's activities in good conditions;
- *Risk management facilitates effectiveness and efficiency in terms of achieving objectives* – knowledge of threats enables risk rating based on the probability of materialisation, the magnitude of the impact and the costs necessary for implementing measures for reducing or limiting unwanted effects.
- *Risk management provides appropriate conditions for a healthy internal control* – ensuring the functioning of internal control involves a complex set of management measures in order to obtain reasonable assurance that objectives will be achieved.

Risk management involves identifying risks associated to developed activities and establishing means to respond to them, by putting into practice adequate internal control devices to mitigate the possibility of them occurring or the consequences in case the risk already materialised. The process must be coherent and convergent, integrated to the objectives, activities and operations carried out under the financial and accounting structure.

Also, staff members, regardless of their hierarchical level, should be aware of the importance of risk management in achieving their objectives and implement monitoring and control based on principles of efficiency and effectiveness.

Financial and accounting officers must periodically analyze the risk of their activities, develop appropriate plans in order to limit the possible consequences of such risks and determine actions necessary for implementing the objectives of the plans.

The process of risk management specific to the financial and accounting activity

Risk management is a process designed and established by management and implemented by the entire staff within the finance and accounting department. This process consists of: defining the risk strategy; identifying and evaluating risks; cost control; monitoring; reviewing and reporting situation of the risks.

The process should not be linear, risk management may have impact on other risks as well and measures identified as being effective in limiting a risk and keeping it within acceptable limits may prove beneficial in controlling other risks.

The main steps in risk management specific to financial and accounting activities can be identified and characterised as follows:

a. Identifying the risks is the first step in establishing a risk profile for analysis and includes the following situations:

- *initial risk identification* typical for new organisations or organisations that have not previously identified risks
- *permanent risk identification* is typical for organisations that have strengthened their risk management. Knowledge regarding the risks that have not yet manifested and their changing circumstances is necessary.

Risks should be identified at any level where there are consequences regarding objectives and where specific measures may be taken to resolve the issues raised by these risks. They can only be identified and defined in relation to the goals that are affected by their materialisation.

Approach for identifying business risks can be achieved by:

- *self-assessment of risks by staff members involved in achieving these objectives and activities, on hierarchic levels by diagnosing risks they take daily;*
- *identifying risks carried out by a specially designed compartment within the entity or an accountable team to evaluate all financial and accounting*

operations and activities in relation to the objectives and to attach appropriate risks.

In the process of identifying and defying risks there should be taken into consideration a ser of rules, namely:

- *the risk must represent an uncertainty*, it should be analyzed weather it is a possibility or an existing situation, which means existing problem and not a risk;
- *difficult issues must be evaluated*, in repetitive situations they can become risks;
- *problems that do not occur are not risks*, their analysis leads to waste of resources;
- *problems that certainly appear are certainties and measures must be taken*, having certainty as a reference point;
- *risk should not be defined by it's impact on objectives*, the impact is the result of the materialisation of the risk;
- *risks are identified by correlation with the objectives*, the aim is to identify those problems that could lead to the non-fulfilment of the objectives;
- *risks have a cause and effect*, the effect (result) is the impact and the cause is a situation that exists (circumstance) and which favours the appearance of the risk;
- *making a distinction between inherent and residual risk*, inherent risk is the specific risk related to the objective without interfering with mitigation measures. Residual risk is the risk that remains after they have put into practice measures to mitigate the inherent risks.

In order to identify significant risks, the organisation must organise its activity systematically, establish acceptable levels for the significant risks and it must ensure that appropriate measures are taken for the evaluation and control of the risks.

The process of identifying significant risks must be made by taking into account internal factors and external factors that may influence the achievement of the financial and accounting activities, and also by including into the analysis both the manageable risks as well as the uncontrollable ones. In the case of controllable risks it is necessary to determine weather they are undertaken or provided to be reduces and in the case of uncontrollable risk it is necessary to determine the extent to which they must be reduced or eliminated.

b. Risk assessment is realised by assessing the probability of risk materialisation and the impact of the risk if it materialises and then risk classification on three levels: high, medium or low, based on a risk analysis.

The purpose of risk assessment is to establish a hierarchy of risks within the organisation and to establish the most appropriate ways of dealing with risks. In this sense, the risk assessment process involves assessing:

- *likelihood of risk materialising* in the finance and accounting department. Analysis of the causes that favour risks leads to a assessment regarding the level of their materialisation;
- *risk impact on the objectives*, namely consequences in case the risk materialises;
- *exposure to risk*, namely the extent to which the risk can be accepted;
- *determining the specific outcome*, namely if the risk is an inherent risk or a residual risk, depending on the existence or inexistence of implemented control devices which keep risk within certain limits.

Risk assessment process should cover all risks, measurable and immeasurable, identified and which are specific to financial and accounting activities. However, the risk assessment process involves some problems related to the fact that, new regulation occur, new people appear, activities change, objectives are periodically reviewed as necessary, conditions that change constantly alter the map of risks.

c. Risk tolerance represents the extent to which risks are acceptable without the need for taking any action. Establishing this level is the responsibility of management represents the limit of consequences the organisation is willing to endure in case of risk materialisation.

d. Risk control is achieved in order to transform uncertainty into an advantage by limiting the threats and it consists of measures of internal control, namely control devices identified and implemented for risk limitation.

Risk control is achieved by the following:

- *Risk acceptance* represents the level to which risks are accepted without the need for taking any action. This measure is recommended for risks with low exposure, whose exposure is smaller then risk tolerance.
- *Risk avoidance* means that some risks may be eliminated or kept within reasonable limits only by reducing or abolishing their activities. The way to avoid risks is low for financial and accounting activities, keeping in mind

that these activities must be performed even if the associated risks are high, with no other choice or option for achieving them.

- *Risk transfer*, there are risk which can not be controlled for which the best solution is to transfer them. This option is beneficial especially for financial and property risks;
- *Risk treatment* represents the consequence of the fact that activities which have generated risks are necessary to conduct further, which requires the implementation of internal control devices in order to keep risks within acceptable limits.

Internal control devices concern all aspects of activities, being classified as: objectives, resources, information system, procedures, supervision.

The objectives group internal control measures put into practice through measures that aim: clear definition; adequate hierarchy, namely distorting them into a pyramidal system up to the jobs; measurability; association f measurable outcome indicators; monitoring the informational system.

The means represent the group of internal control measures designed to measure adequacy of resources against objectives.

The informational system groups operational internal control measures and follow the establishment of a reliable, complete, relevant, useful and opportune informational and steering system.

The organization groups internal control measures resulting from the application of measures aimed at correcting detected anomalies and which constitutes favourable circumstances for risk manifestation.

The procedures represent internal control measures which control risks arising from ignorance of the process and rules that should be respected in activities.

Supervision groups internal control measures which should keep under control risks arising from anomalies.

In practice, the following types of controls are used to treat risks:

- *Preventive control measures*, implementation of these measures is provided when it is intended that an undesirable outcome must not materialise or to limit the effects of unwanted risks.
- *Corrective control measures*, the goal of these measures is to correct unwanted results and represents a way of recovering damages or losses.

- *Directive control measures* are designed for achieving a particular result, they are essential when the effects of an unwanted risk are to be orientated towards a certain direction tolerated by the organisation.
- *Detective control measures*, the goal of these measures is to identify new unwanted situations.

e. Risk monitoring is require for periodic reviews of risks, following the regulatory change, humane resources turnover, activity or objective changes, as well as the need to obtain insurance on the effectiveness of risk management and identifying the need to take further measures.

Risk review processes are implemented to assess weather risks persist, weather there are new risks, impact and likelihood of risks have changed, and internal controls put into operation are effective or certain risks need to be redesigned at senior management levels.

The importance of managing the financial-accounting risk for the internal audit

The financial and accounting activity is characterised by all processes, procedures, inputs and outputs, resources (financial, material, human and informational) and technical means of management, recording, processing, transmission and storage of data and information on the activities and the environment the system works in.

Through internal control/management programs each accounting-financial compartment must identify the risks they face and by use of procedures and risk management policies to ensure their maintenance at acceptable levels.

Risk management is an ongoing structured process, which permits risk identification and evaluation and reporting on opportunities and threats that affect the achievement of its objectives. The advantages of implementing a risk management system include:

- it is more likely to achieve objectives;
- improvement in understanding risks and their implications;
- providing by the management a greater focus on important issues;
- limiting unpleasant surprises or crisis;
- taking, in some situations, a higher risk level;
- information on the wider risks and decisions regarding risks.

Management and staff perform risk management activities in order to identify, assess, manage and control all types of events or situations that may affect financial and accounting activities. Risk assessment is required from the highest levels of strategic decision-making and continuing with all operational decisions.

A good risk management means avoiding or minimising losses, as well as approaching opportunities in a positive manner. Under these conditions, one of the management requirements is to obtain assurance that risk management process is effective and significant risks are managed at an acceptable level.

This assurance is given by internal audit and represents a reasonable assurance on the effectiveness of risk management and it is performed:

- during the implementation of risk management process;
- further implementation by assessing how management monitors risks, watching how well it functions.

Internal audit, in reaching the general objective, namely in achieving assurance function, which means examination of evidence carried out in order to provide an independent view of risk management processes, control and governance, contributes to risk management by assessing how well risk is managed by the management team.

Also, we point out that two of the most important ways in which internal audit adds value to the organisation is to provide objective assurance that major risks are managed properly and to provide assurance that risk management and control system is operating effectively.

In carrying out the counselling function of the internal audit may be involved in risk management process, regarding:

- providing management with tools and techniques used by the internal audit for risk analysis and implementation of control;
- involvement in the implementation of risk management;
- providing training for staff in risk and control and promoting the development of a common language for understanding the domain;
- helping managers identify the best ways to mitigate risks.

Internal audit involvement in limiting risks specific to financial and accounting activities includes:

- establishing which operations can be audited according to the scope of audit;
- the risk assessment, process which involves that for each identified risk the internal controls must be established;

- risk control, process that involves planned audit tests, appliance of specific audit methods and techniques and the internal controls that are unimplemented or don't work are identified;
- the recommendations help implement appropriate control devices that help minimize risk and maintain it within acceptable limits.

However, in carrying out its function, the internal audit evaluates the appropriateness and effectiveness of the control device, operations and information system, aims at the reliability and integrity of the financial and operational information, effectiveness and efficiency of the operations and asset protection and compliance with laws, regulations and contracts.

Within the audits mission of assessing the financial and accounting activity it is necessary to examine weather financial accounting system resources are managed in an economic, efficient and effective way which can lead to performance within the organisation.

Internal audit approach to optimization will have financial and accounting activities focused on assessing soundness of financial management systems, depending on the chosen subject as matter of the engagement and the risks involved, as follows:

- evaluating the management of expenditure and the measures taken on the best of use of resources. The review involves the evaluation and testing management process, namely managerial decision making and systems used in planning and spending.
- Evaluation of the achievement of objectives in a particular program or process and the performance achieved. The review involves an assessment of the objective and how it is reached, as well as an assessment of the amount of resources used to determine if there was used the minimum amount of resources in order to obtain a result.

In this sense, the internal audit establishes the organisations possibilities of *efficiently managing public resources* in order to meet growing public needs of citizens and to *obtain the best level of performance* by ensuring effective functioning of the financial and accounting system.

Also, a distinct issue is the performance of the financial and accounting activity. From this perspective, internal audit should review weather the criteria for achieving work objectives set in the financial and accounting activity are correct in evaluating the results and assess weather the results are consistent with the objectives.

In the evaluation of financial and accounting activity the internal audits main goal is the knowledge of both the accounting system, because this system produce audited financial statements, as well as the internal control system, because this system helps keep a better functioning of the accounting system.

Conclusions

Addressing financial and accounting activity in terms of risk management requires appropriate risk management so that risks that may affect the activity are identified and treated and that their level is acceptable.

Main features drawn from the assessment process of risk management are:

- risks related to the financial and accounting activity may involve a potential financial loss for the entity if internal controls are not functioning so as to prevent errors and to limit fraud;
- risk management represents a complex process that uses resources, financial and humane, in order to achieve objectives;
- risk management must ensure risk reduction at acceptable levels;
- effective strategies for the organisation and internal control exercise adapted to the entity.

Risk monitoring should ensure that threats specific to the financial and accounting activity are identified and evaluated regularly and mechanisms through which management is alerted about new emerging risks or changes in the identified ones are established.

Risk management aims to minimize risks and thereby the negative results that risks may cause to the activity. In this regard, management has the responsibility to identify risks, the causes that generate them and establish control devices to reduce its levels by involving minimum cost. This can be achieved by developing a risk management philosophy and awareness of the negative effects of risks at all levels of the organisation.

For good risk management it is important to have insurance that each employee understands their role properly, the risk strategy and the individual responsibilities that come in the process.

A sound and efficient control system can prevent, detect and quickly correct errors and fraud, thereby increasing the quality and relevance of management decisions, as well as user confidence in the information provided by the accounting system.

Lack of control or organisation lead in most cases to the emergence of conditions conductive for the manifestations of fraud, taking advantage of the weakness of the system.

Internal audit evaluates the internal control system established by the management, identifies nonconformities and bad functioning and proposes appropriate control measures that ensure good risk management and limiting the opportunities for errors.

The main role of the internal audit in risk management, are:

- *promoting the development of risk management*, through which the internal audit assists, examines and evaluates risk management processes implemented by the management and check weather they are sufficient and effective. In the consulting services, the audit helps the financial and accounting department to identify, evaluate and create risk management devices that allow risk control.
- *The use of risk management in planning the internal audit activity* involves that risk management process evaluation is, usually, the main objective of the audit.

Internal audit as a tool to optimize performance of the public activities contributes to identifying deviations and imbalances, and the recommendations offered make a significant contribution to strengthening stability, achievement, effective risk management and effective use of the financial resources available to the organisation.