

## **INTERNAL AUDIT, RISK DETECTION TOOL FOR CONTEMPORARY CRISIS**

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### ***Abstract:***

*The current economic and financial crisis appeared without the anticipation of audit and control organizations, without objecting its manifestation or denouncing the practices that triggered it, that's why the limits and the potential were highlighted. To maximize the internal audit function, to expand the spectrum of risk management, to protect business and to deliver measurable values at world level, have been made a number of studies that have contributed by solving the fundamental causes of the emergence of the recession.*

*In this sense, our research aims to discover the extent in which the scope of internal audit has expanded and strengthened along the current economic and financial crisis manifested globally and based on the recent large national and international studies regarding the state function of internal audit and its role in detecting risks. At the same time we want to highlight the opportunities for value creation by internal audit as well as opportunities to improve risk management process leading to the implementation of corrective and constructive solutions.*

**Keywords:** internal audit, internal control, risk management, organization, economic and financial crisis.

**JEL Classification Codes:** M4.

### **Introduction**

The current economic and financial crisis, considered the worst economic crisis since the interwar period 1929-1933, was initiated in autumn 2008 on the

background of major disturbances occurred in the banking area. In the context of mortgage market collapse the entire financial sector has suffered a number of situations generating in chain: inflation, bank failures, a gradual slowdown in economic activity, tighter credit conditions, reduced consumption, lower investment. These unwanted manifestations of financial crisis led to the creation of an uncertainty framework for business continuity that has undermined some organizations activity, especially for business operations. Since risks cannot be avoided, any organization, regardless of its specific activities developed, must be conducted so that to insure against risk by undertaking all of those necessary measures in order to achieve that level of risk which the organization is willing to accept [Vintilescu Belciu A. et al, 2010].

About the effects generated by the current economic and financial crisis affecting the global economy have been raised a number of questions relating to the governance, risk management, as well as the control in some organizations. Thus, knowing the significant progress made in governance, development of new control techniques, extend the spectrum of risk management as well as the strengthening of internal audit, there was arisen a double question:

1. *if the organizations have implemented adequate systems of internal control, risk management and internal audit, and if the organizations' internal control, risk management and internal audit have made known their diagnoses;*

2. *if management have made appropriate recommendations.*

The answers, of course, were given on both sides of the parties involved, and a lot of studies recalled that organizations are not checked only by persons entitled thereto within organizations but are subject to all sorts of controls in the external environment that could report any non-compliances. We note, however, as a general conclusion on the background problems of the global financial and economic crisis, that a strong internal control and internal audit performance can be seen as a solution to streamline companies.

### **I. New challenges for internal audit profession**

Willing to support managers, the international specialized bodies have decided to use their own experiences to guide and advise governing bodies highlighting the advantages that internal audit can provide in assuming their responsibilities. They also have proceeded to define a framework for the relationship between internal audit and the organizations governing bodies. These

steps were helping organizations to provide, with the same care, in the moment of a new added-value creation as well as in the case where there is a risk of damaging the already made added-value, by: 1) taking actions for identification and risk assessment; 2) by a thorough analysis of their control; 3) by seeking and implementing constructive solutions and remedies recommended by the internal audit.

In this aim, at the end of 2009, the PricewaterhouseCoopers Global State of the Internal Audit Profession conducted a study involving more than 2,000 people, CFO and internal audit committee members of 55 countries with the following main objective [Sima, 2010]: an overview of the internal audit profession; highlighting the deficiencies and the most important changing trends in the audit function; providing the relevant data for organizations in order to facilitate comparisons between processes and audit procedures; setting a reference' threshold necessary to identify continuous changes that occur in the internal audit function. In this study, people participating have agreed that to strengthen its position and support the requirements of all the responsible factors involved, internal audit must know a significant development and should deliver more value.

In this respect, it is necessary that the current role of the internal audit function to be expanded and also to be maintained at a high level of performance. But to achieve these objectives, considered to be a real challenge, internal auditors are required to continually develop skills and knowledge with a continually improvement. Following this study, it was launched a new stage of development of the internal audit entitled "Internal Audit 2.0", concept based on best practices, on the expectations for internal audit activity which must be ready at all times to practice and improve a higher level of standards through alignment, collaboration and acceleration. The study also aimed to providing concrete actions to monitor and manage risk and actions to mitigation critical risks.

To streamline and maximize the internal audit function, protecting business and delivering measurable value, the new audit concept introduced is considering implementing the following key attributes [PwC, 2010]: *aligning operational business processes, focusing on risks, management of all beneficiaries, efficiency in terms of cost, model of human resource management, customer-oriented culture, quality and innovation, an adequate technology.*

It was also identified three critical areas to which the internal audit departments should turn its attention to improve, namely: *risks and critical issues, values align with the expectations of internal audit stakeholders and a staff*

*correlation with the values promoted.* These eight attributes in conjunction with the three risk areas identified are regarded as elements for building up a new standard [PwC, 2012]. These, however, are essentially conditioned by an audit plan constructed as part of a comprehensive and risk top-down organization assessment, taking into account the entire system of risk management, including operations and joint defense lines.

Therefore, given the new expectations and requirements of all interested parties, the internal audit must be constantly changing and has to redefine its role by expanding its competences. In parallel with this approach, the internal audit must take a leadership role and thus a powerful tool for decision while helping to align the organization's strategy on the identification, control and risk management.

## **II. The process of special risks identification for the present economical and financial crisis by the internal audit**

This economic and financial crisis has highlighted the need to implement the recommendations made by internal audit as a result of the findings of the auditors. Traditionally, the internal audit has a first responsibility to express an independent opinion on the financial statements of the organization while giving an assurance to all stakeholders (i.e.: shareholders, customers, suppliers, employees, banks) that they are sincere and gives a true and fair picture. In the current context, however, this approach is a precaution necessary but not sufficient.

In this regard, the National Company of Statutory Auditors (CNCC, abbreviation from French language) established in France, have provided the first track in this direction by publishing in 2008 a set of findings entitled "*crisis package*". The study conducted by CNCC is to highlight areas that require special attention from the audit as a consequence of economic - financial crisis. It was found that the first step the internal audit need to do in financial audit would consist of an upstream entity knowledge in order to evaluate in advance the areas where risks may arise for the auditor to focus on thereof.

It was also agreed that there can be no general methodology to address risk as not all organizations were affected by the crisis in the same way or with the same magnitude or intensity. The internal audit can even consider that for each entity audited accounts could have a certain kind of risk approach, adapted to the specific entity as a whole. However, globally, have been identified two classes of specific risks for the economical and financial crisis, namely:

1. *the first class* corresponds to the risk of further work and shall be based on the evaluation of the likelihood of continuation of activities grouped into three categories: *a criteria based on operations, a criteria based on financial statements and a quantifiable criteria based on data published in exceptional circumstances*

2. *the second class* corresponds to the risk of overstating the accounting result based on two aspects: *an increased risk of accounting irregularities and a measurement difficulties due to future uncertainties.*

Corresponding to the first class of risks, each of the three criteria for further work should provide warning signals to the auditor that there is a risk of liquidation of the organization' activity. Depending on the signals received, the auditor will assess more carefully exposed areas and its opinion will have a fundamental role to the entity.

The second class is related to overestimation of risk accounting result, the result will certainly overstated the company more attractive to stakeholders and that some managers to preserve the company are tempted to overstate the accounting. Suppliers will be more motivated to work with a company that generates profits, solvent and provides a guarantee of payment. To detect these irregularities internal auditors need to check more carefully any accounting irregularities regarding overstatement of assets and/or understatement of liabilities. On the one hand, the auditor will check if significant assets are recorded in the accounts in accordance with objective reality on the other hand will ensure that no element of liability was omitted from the accounting records.

The internal auditors will also consider checking the cash register and bank statements in order to detect possible non-compliance, based on the internal control procedures [Vasile, 2011]. There are, also, other forms of misconducting behavior, that may occur during the period of the financial crisis, as those referring to the exercise separation.

For example, when considering contracting an important service, which takes place in the period between the end of year N and the beginning of year (N +1), it is possible to assign costs only in the year (N +1) so that not to reduce too much profit of year N. Therefore, the auditor will need to be more vigilant about the composition and determining the result in the accounting balance sheet. The auditors will also dwell on how the provisioning judgment was implemented and due to fluctuations in financial markets they will pay more attention also to the assessment of the value for the financial instruments and /or the equity securities.

Therefore, the economic crisis creates favorable conditions for widening existing risks and the other risks arised, therefore this is making more difficult to assess the regularity and sincerity reflected in the accounts.

But, based on a series of principles and functions which outlines the internal auditors' courses of action, whether it is financial audit, system audit or performance system audit, by analyzing the risks, the auditor should become increasingly more a management consultant assessing financial management and control systems and providing solutions to improve all of these systems.

### **III. The new COSO revisions**

Given the problems of the current economic and financial crisis the Committee of Sponsoring Organizations of the Treadway Commission - COSO considered appropriate to review the internal control referential aiming to strengthen its concepts and ways to operating and to bring any improvements as well. Thus, as a continuation of this approach, in December 2011 the Committee of Sponsoring Organizations of the Treadway Commission (COSO) released a new version of the internal control referential in order to initiate a debate on this issue contributing to the final version of the referential. The new referential [PwC, 2012] has been prepared by PricewaterhouseCoopers (PwC) – one of the world largest professional in consulting and auditing services company, part of the four largest auditing firms in the world called the Big Four, Table 1. Its development took into account the significant changes in the economic environment, governance and organization as well as the new risks that have emerged after the first version in 1992.

**Table 1:** The new referential

<b>The new referential</b>	
<b><i>Kept from the old referential</i></b>	<b><i>Changes brought by the new referential</i></b>
Internal control DEFINITION	A more precisely description of the ways for putting in effects for the five components of the internal control (i.e.: governance, risk response) based on the internal control principles.
The five internal control components: 1.control environment 2.risk assesment 3.controlling activities 4.informing and communicating activities 5.leading activities	Taking into consideration changes arised into the organizations functioning ways after the first COSO version (i.e.: development of informatique instruments, subcontracting activities).
Criteria used for internal control system efficacy assesment	A more clearly explanation of the internal control concept
Professional judgement used for internal control system assesment	Extension of the internal control application area with new reglementations and rules

**Source:** processed by the author

Even if the new referential is with not so fundamental changes in the internal control structure, by its reviewing, the Committee of Sponsoring Organizations of the Treadway Commission (COSO) has achieved the objectives for which it was initiated this endeavor.

#### **IV.Risk management in the new global economic perspective and the internal audit involvement for risk management process**

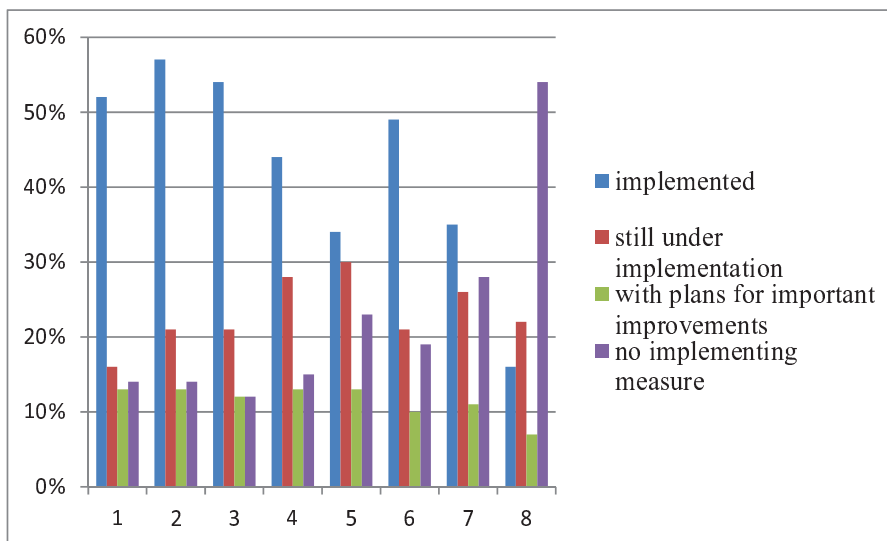
The economic and financial crisis led to a more careful assessment of risk management practices adopted by organizations. There are many voices that put current economic and financial crisis on account of risk management standards considering them as inadequate. In this context, managers from all economic sectors desire to improve the risk management system to have a profitable business [Bumbacea D., 2012]. According to the concept of some specialists, risk management process must be reviewed with a dynamic approach, aiming organizations to be able to achieve the objectives settled and to assure the highest level security of mitigating risk. On the current crisis can be drawn a number of clear lessons for measuring and managing risk. It emphasizes the need to develop more powerful tools for risk assessment and more sophisticated information systems to implement information exchange, for more efficient communication, for a new governance practices adoption and for improving earnings policies.

Therefore, it is necessary to use the best instrument for an accurately risk measuring, able to identify extreme events and to mitigate the cyclical trend occurrence of risks. Regarding the internal audit involvement into the risk management process in the current global crisis some specialists found necessary to be focus on the following aspects [Sima A., 2010]:

1. defining the general risk management and compliance policy;
2. establishing common rules and definitions for risk management;
3. development of a common methodologies for risk assessment;
4. revealing the assurance sources for the most important (key) risks;
5. balancing the risk assessment and the risk functions into the compliance behavior of each organization;
6. integration of the internal audit plans with the compliance audit;
7. integration of compliance reporting with the risk reporting activity;
8. a software implementation for risk and compliance functions.

Based on these issues evidencing, in order to know the state of their implementation, in 2009 PricewaterhouseCoopers conducted a study involving a total of 2021 people from 55 countries. Study revealed the following trends:

**Figure 1.** Stage for coordination and implementation of risk and compliance functions



Source: processed by author



From the above analysis, we can see that most audit functions have been planned or implemented, except software implementation risk and compliance function. This means that organizations should pay more attention to this issue by adopting advanced information systems to assist organizations to better assess the risks and identify their vulnerabilities.

### **Conclusions**

The current global crisis has highlighted a number of shortcomings in the internal audit and risk management components of internal control. It also creates an ideal context for the development of a creative accounting that reflects a fictive return, ignoring the principles of neutrality, ethics and fairness. In order to counter and reduce these practices there were made a number of studies and have been identified some specific risks to the economic and financial crisis. However, the undertaken concrete actions of the studies aimed providing critical risk management orientation and monitoring the risks in order to make mitigation actions. To streamline and maximize the internal audit function, protecting business and delivering measurable value, was introduced a new concept of internal audit - "**Internal Audit 2.0**" and the shaping of a new standard.

In conclusion, given the new expectations and requirements of all interested persons, i.e.: stakeholders, the internal audit should reposition itself as a key factor in an environment with multiple gaps, in areas such as process compliance, process management or financial risk. In parallel with this approach, internal audit must take a leadership role and thus a powerful tool for decision while helping to align the organization's strategy on the identification, control and risk management.

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