AUDITING THE RISK MANAGEMENT PROCESS

K.H. SPENCER PICKETT

John Wiley & Sons, Inc.

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This publication includes extracts from AS/NZS 4360:2004 *Risk management*; HB 436-2004 *Risk management guidelines* and HB 158-2002 *A guide to the use of AS/NZS 4360 Risk management within the internal audit process*, all published by SAI Global Ltd, Sydney, Australia. *www.riskinbusiness.com*. Reprinted with permission.

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Published simultaneously in Canada.

Library of Congress Cataloging-in-Publication Data:

Pickett, K.H. Spencer.
Auditing the risk management process / K.H. Spencer Pickett.
p. cm.
Includes index.
ISBN 0-471-69053-8 (cloth)
1. Auditing, Internal. 2. Risk management—Auditing. I. Title.
HF5668.25.P529 2005
658.15′11—dc22

2005000043

Printed in the United States of America

10 9 8 7 6 5 4 3 2 1

About the Institute of Internal Auditors

The Institute of Internal Auditors (IIA) is the primary international professional association, organized on a worldwide basis, dedicated to the promotion and development of the practice of internal auditing. The IIA is the recognized authority, chief educator, and acknowledged leader in standards, education, certification, and research for the profession worldwide. The Institute provides professional and executive development training, educational products, research studies, and guidance to more than 80,000 members in more than 100 countries. For additional information, visit the Web site at *www.theiia.org*.

This book is dedicated
to the memory of Jenny Topham

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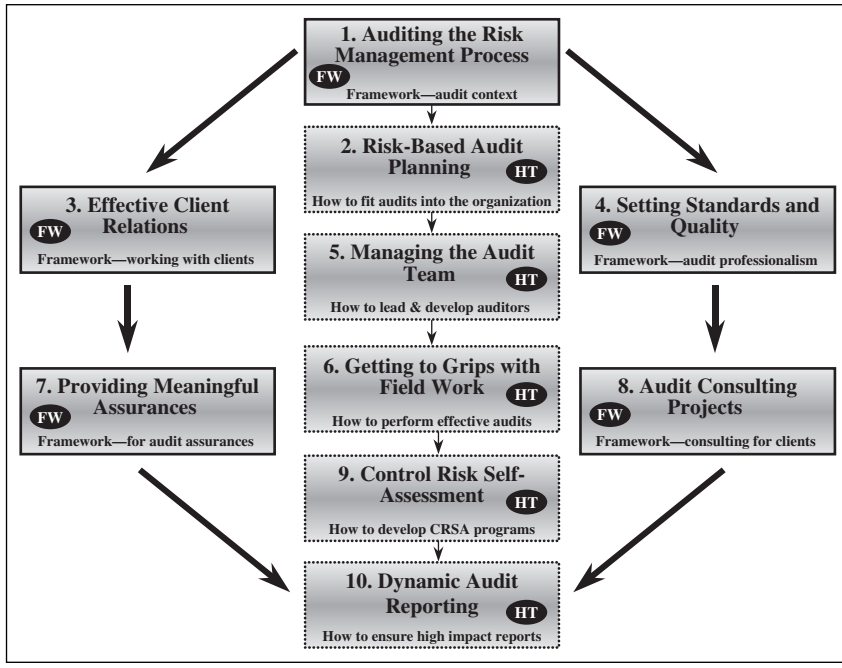
PREFACE

Auditing New Horizons is a new series of short books aimed primarily at internal auditors, but which will also be useful to external auditors, compliance teams, financial controllers, consultants, and others involved in reviewing governance, risk, and control systems. Likewise, the books should be relevant to executives, managers, and staff as they are increasingly being asked to review their systems of internal control and ensure that there is a robust risk management process in place in all types of organizations. Each book provides a short account of important issues and concepts relevant to the audit and review community. The series will grow over the years and

Figure P.1 The Auditing New Horizon Book Series



John Wiley & Sons, Inc., is working alongside the Institute of Internal Auditors, Inc., to ensure that each new title reflects both current and emerging developments. The framework for Auditing New Horizons is illustrated in Figure P.1.

FrameWork (FW) books set out various models, supported by reference material that can be employed to ensure best practice pointers can be assessed for their impact on current practice. HowTo (HT) books use similar models but focus more on checklists and worked examples that can be employed to implementing aspects of relevant underlying frameworks. Each book is immersed in the Institute of Internal Auditor's Professional Practices Framework in terms of their published standards, advisories, and assorted guidance. Because the books are fairly succinct, reference to other sources will need to be limited. There are no detailed case studies taken from well-known companies in this book series because of the fast-changing pace of business, where current material quickly falls out of date. The books do, however, refer to many short examples of what happens in different organizations as a way of illustrating important points. The dynamic nature of the governance, risk, and control context means that some new book titles for the Auditing New Horizons series may change over the coming years. We hope that readers find the series both interesting and stimulating and that this series will provide a reference source that adds value to internal auditing, external auditing, and other review functions.

LIST OF ABBREVIATIONS

BASEL: Committee on Banking Supervision

CAE: Chief Audit Executive

CEO: Chief Executive Officer

CFO: Chief Finance Officer

COSO: Committee of Sponsoring Organizations

CRO: Chief Risk Officer

CRSA: Control Risk Self-Assessment

CSA: Control Self-Assessment

ERM: Enterprise Risk Management

H&S: Health and Safety

IIA: Institute of Internal Auditors

IS: Information Systems

IT: Information Technology

KPI: Key Performance Indicators

OECD: Organization of Economic Cooperation and Development

PPF: Professional Practices Framework

PR: Public Relations

RA: Risk Assessment

RI: Risk Identification

RM: Risk Management

RO: Risk Owner

SEC: Securities and Exchange Commission

SIC: Statement on Internal Control

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WHY RISK MANAGEMENT?

> The internal audit activity should assist the organization by identifying and evaluating significant exposures to risk and contributing to the improvement of risk management and control systems.
>
> IIA Standard 2110

INTRODUCTION

Internal auditing has grown tremendously over the years to reflect its new high-profile position in most larger organizations. It has shifted from back-office checking teams to become an important corporate resource. The focus on professionalism and objectivity has driven the new-look auditor toward high-impact work that can really make a difference. The key development that has underpinned this change relates to the shift from enforcing controls on employees to using an assessment of risk to empower management and their staff to establish meaningful controls over their business. This move from must-do to want-to control cultures has allowed employees more scope to innovate and experiment.

Unfortunately, in the past, robust risk management processes have not always been in place. The rapid change programs of the 1980s and '90s meant that many organizations were likened to speeding trains that would leave behind anyone who was not bold enough to jump on board and hang on for dear life. Investors expected quick returns, while competition was about being the first to bring new or improved products to the marketplace—or at least give that impression. The resultant crashes and scandals that rebounded throughout the last decade underpinned the lack of clear direction or ethical values that could be described as the much-needed rail signals and brakes—to continue our train analogy.

Reckless trading against the backdrop of the cutthroat competition of the 1990s continued into 2000 and beyond, before the regulators started to get tough. The old governance models of a select board of high achievers

gathered around a powerful CEO, whose only accountability was to publish financial accounts that had been reviewed by a friendly auditor, could not cope with the new business dynamic. In this type of environment, regulations were seen as obstacles to be sidestepped. Corporate lawyers were often used to design roadmaps to allow the executive teams to weave a path through legal provisions and industry-specific regulations. Societal concerns came to a head in 2002, with the publication of the Sarbanes-Oxley Act, to enshrine personal responsibility at the top of each company to adhere to the rules and demonstrate that this is the case. The link between risk management and corporate governance has been explored by the Institute of Internal Auditors (IIA):

> Risk management is a fundamental element of corporate governance. Management is responsible for establishing and operating the risk management framework on behalf of the board.[1]

In the past, control frameworks have helped in setting standards, but they often acted as basic benchmarks to be checked off against and often ended up as just checks in the Compliance Box, something that is done and then filed away—until the same time next year. Nowadays, the new focus is firmly on risk—to the business, executives, and stakeholders. Several societal concerns appear at the forefront of this idea of risk, including the risks that:

- Published accounts are misleading.
- Performance information is fudged.
- Regulatory disclosures are not supported by sound evidence.
- Senior executives are making uninformed assertions about the adequacy of controls over financial reporting and compliance procedures.
- The corporate asset base is not properly protected from waste, loss, attack, or natural disaster.
- The corporate reputation militates against customer loyalty.
- Operations and processes are inefficient and inflexible.
- The wrong people are being promoted and recruited.
- The organization is failing to meet the changing expectations of customers, the marketplace, and stakeholders generally.

Attempts to address these issues have led organizations in the direction of Enterprise Risk Management (ERM). That is a wholesale approach to identifying and managing risk across all aspects of the business—from a strategic standpoint. As each risk changes in impact and urgency, so