The Role of Internal Audit in Controlling the Business Risk

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Abstract. The enterprise nowadays is confronted with a variety of internal and external pressures which can substantially affect the financial results, with consequences upon the profit for the invested capital and the additional capital investment necessary to extend and to continue the activity. The audit of the business risks involves several aspects regarding the strategy in business, the assets control, the financial capacity to absorb the risks. The business risks measurement and identification as well as the establishment of optimum solutions to prevent and to diminish the effects of their producing, make the audit become the indispensable instrument of a good economic and financial control for any enterprise. The paper presents the main business risks identified and estimated in an audit mission of the enterprise performance.

Key words: internal audit, risk, audit mission, audit test, control by means of audit

1. Introduction

Starting from the authority which the legislative and regulatory framework gives to internal audit, it can be said that, in reality, the internal audit function shall be exercised within professional norms binding and unanimously accepted by the international community of the internal audit.

The Economic situation of a company at a certain time, the prospects for business continuity, the satisfaction of the shareholders, the customers and also the employees, are forms of response, how the internal audit is organized and works in a company. It is known the fact that every company resists in business as long as it takes risks provided to identify and manage them better to get bigger profits. Their management responsibility is the management of each organization and specialized structures for this purpose. In this context, the audit is required to strengthen its supervisory role over the management of business risks and the professional judgments applied by management in accounting, over the internal control system and comply with legislative requirements

2. The internal role of the audit in enterprise risk management

Professional standards show that internal audit performs assurance and advisory missions, that its areas of responsibility are the risks, internal control , the management of the company and its goal lies in the added value of organizations. In the process of risk management, internal audit management supports putting a number of roles such as: observation, diagnosis, counseling, insurance, incentive.

The role of audit observation is fundamental and requires analysis of phenomena, processes, operations and activities from a critical position, and the quantification and interpretation of their performance in terms of legal regulations or standards.

The role of diagnosis is the most difficult of all the audit roles but is also necessary for the economic management. In this role internal audit examines relevant observations collected so that they can reach conclusions about the changes that the management must perform. For this purpose, methods ,techniques and instruments are used as well as experience and communication skills of internal auditors, in order to formulate solutions and proposals aimed at making organizational changes in terms of independence regarding the management.

The role of counseling is done in the form of advice given to managers, employees, and by organizing lectures and seminars for training. During consulting the engagements, internal auditors address the significant risks in accordance with the objectives of the mission and pay attention to the existence of other significant risks. The role of insurance provides confidence in both the need for management changes and in terms of impact and results of them or those already implemented.

The audit provides the correct conclusions regarding the priorities in the field, designing and implementing quality change, especially as the level of performance which must be achieved, which was reached or will be achieved. When impairments are identified, internal audit proposes management solutions of change, modification, improvement and completion of some documents and procedures for compliance with strict legal requirements in current standards and objectives of the organization.

Stimulating role is the least understood of the role of internal audit. It is the most evolved, but also the most difficult. Internal audit fulfills the role of incentive by proposing the best solutions for the organization to meet its objectives. Internal audit, through the recommendations for improving management of the business risks, stresses, in fact, the roles it manifest in the audited entity.

3. Categories of risks that affect business

In the specialty literature we find various classifications of risks affecting the organization, which derives from the two broad categories of risks: potential and possible. A good risk management must prevent, eliminate, or reduce the effects of potential risks turning them into potential risks.

- Strategic risks affecting the organization's strategic objectives in the long and medium term;
- Operational risks that are generated by the current development activities of the enterprise;
- Financial risks, which may cause loss;
- Information and IT related risks are risks arising from changes in the information;
- Risks related to personnel, covering the selection, training, remuneration

Business risk, according to many experts is normal. There is no risk-free economic activity, but not all risks, generate negative effects on the economic performance of the company.

The multitude of risk factors that generate business, make it manifest in different ways:

- The risk of market instability generated by the application, offer size, the sales price
- The operational risk due to factors such as:

The demand of fluctuation that influences the volume of returns payment options and providers to expand the business.

Price fluctuation of raw materials, materials, services whose evolution can influence the cost and the size of the profit. The competent managers, the effectiveness of decisions taken on which business success depends. Risk due to changes in technology. Every technology development or acquisition of the most appropriate technology can bring significant damage.

Financial risk is associated with financial activities of the enterprise and can be generated by loans that the company makes, and by the company's revenue and expenditure which can fluctuate causing difficulties in securing financing activity. Financial risk is defined as (variability of results indicators under the company's financial structure) (I.Stancu-Finanţe, Editura Economică, Bucuresti, 1996. pag.376). It is determined by the policy of the company through equity financing or loans. (T.Hada-Finanţele agenţilor economici din Romania, Editura Intelcredo,Deva,1999,pag.207).Typically, companies use for finance both equity and business loans. The measure in which they reach these two funding sources is expressed by the concept of financial leverage. Regarding the loan capital, the indebtedness represents an importan risk throughout the loan. Indebtedness has two important features : on the one hand the payment obligation that means financial costs, which will reduce the results, and on the other hand, the resolting to loans that may determine a return surplus. The profit obtained appears as a reward for the risk taken in contracting loans. The Increasing interest costs adversely affect profitability, if the economic rate of return (Re) is less than the interest rate (Rd). The financial leverage (Elf) highlights the increase in pay equity (SPC) as a result of the influence of fixed costs consisting mainly of medium and long term debts (D) on the company's profit.

The repercussions of these fixed costs on profit are similar to those of a lever:

$$Elf = (Re - Rd)\ xD/Cp$$

Where: D/Cp = levier = loan rate

$$Rcp = Re + (Re - Rd)\ D/Cp$$

From these equations it follows that the amount of leverage is directly proportional to the rate of indebtedness of the company, and with the difference between the average cost of capital and loan interest rate used. The efficiency of financial leverage on the equity return is dependent on the relationship between economic profitability and the percentage of the interest. The more the repot of the two funding sources is unbalanced in favor of the loan, the higher is its profit outlook and the risk assumed by shareholders is higher. Since borrowing firm performance deteriorates, the report D / Cp must be minimized. Difficulties in paying interest on loans and suppliers can lead to risk of insolvency. Financial risk occurs when loans are not generating financial efficiency, economic rate of return that is

obtained by using loans is lower than the interest rate of loan capital. The relation of leverage allows explaining the level and evolution of financial profitability by two main factors:
- company's debt
- economic profitability

The financial risk is one of the major risks of any company, that influences performance.

Identification and evaluation, is achieved by audit effectiveness.

The Audit of financial risk is regarding both the probability of its appearance and the influence that can have on economic and financial performance of the company. In performance audit, the conclusive evidences to express an opinion on business result and formulate recommendation for management system, are based on the performance indicators, expressed by:
- economic rates of profitability
- financial rates of profitability
- effect of financial leverage
- indicators of dividend policy

An interesting model to analyze the correlation between the company debt, expression of financial risk assuming and the company's economic performance is presented by Camelia Burja in her work "Indebtedness and economic performance" (Tribuna economică nr.3/2006). It is considered that the law of manifestation of financial risk can be expressed by the model:

$Rf = Re + (Re - Rd) \times Gi$

$Re = CA/Ae \times P/CA$

where:
Rf - financial profitability
Re - economic profitability
Re-Rd - the gap between economic profitability towards interest rate (Rd)
CA/Ae - rotation speed of economic asset
P/CA - Commercial profitability
P - profit
Gi - gearing = financial leverage

The model highlights the influence of gearing on the profitability indicators.

A high gearing rate points out the difficulties that the company may have in case of unfavorable events.

When the indicator trend is decreasing, the company may take into account the possibility of activity extension. In the audits of the company under study, was identified a high financial risk, due to contracted loans from the bank's current activity and investment, interest and expenses due to term services.

Based on financial indicators, we determined rates of return, of financial leverage:

Indicators	U/M		2009	2010	Difference	%
Turnover	RON	CA	323715	405120	81405	125,14
Equity	RON	Cp	67696	76928	9235	113,64
Active	RON	Ae	76497	95621	19124	125
Profit from operations	RON	P	10235	17318	7083	169,2
Financial liabilities	RON	D	50293	72925	22632	145
Interest expenses	RON	Ch.d	1380	3845	2465	278,6
Indebtedness	%	Gi	74,29	94,80	20,51	127,6
The interest rate	%	Rd	2,74	5,27	2,53	192,33
Economic Return Profit / Active	%	Re	13,38	18,11	4,73	135,35
Commercial Profitability Profit / Turnover	%	Rc	3,16	4,28	1,12	135,44
Financial own Return. Profit-Interest/Equity	RON	Rf	13,08	16,92	3,84	129.35
Leverage	%	Elf	7,85	12,17	4,32	155.03

The results allow the formulation of several conclusions, which highlight how financial risk was managed.

1. Loan resources have led to a considerable increase in the profit and interest expenses.
2. Increasing economic return is the result of a good management of the capital.
3. Economic profitability is higher than the interest rate, which gives loans financial leverage in both exercises.
4. The existence of a large balance unpaid invoices embarrasses providing funds for current activity, and increasing indebtedness generates interest expenses, negatively affecting profit.

In terms of damage the business environment, increasing indebtedness may cause financial loss. The effect of financial leverage express financial risk which may ultimately lead to bankruptcy risk by insolvency. In conclusion, economic and financial indicators have showed a good evolution and the economic profitability is higher than the interest rate, an increase will not lead to increased financial risk, which demonstrates an adequate business financing policy of the company. To maintain a good economic and financial situation in terms of business continuity, internal audit recommend to the management measures to reduce financial risk, as:

- The increase of the activity which lead to the increase of the turnover and to obtain a higher commercial profitability.
- The increase of the recovery of production through effective marketing policy.
- Continuous monitoring of the level of economic performance by reducing interest expenses.

By promoting an optimal report between the equity capital and the loan of indebtedness it may possible the use of the indebtedness as a way to increase performance.

4. Conclusions

Risk management is a major responsibility of management. The role of internal audit in risk management process manifests itself through a continuous and active support and participation in the risk management, especially in the surveillance and monitoring committees and issuing reports in this process. Findings of audits and recommendations for eliminating deficiencies and improve management activities. are the exclusive responsibilities of internal audit. If there isn't adopted a risk in management process, Internal Auditor advises the leadership on this issue and makes suggestions for the adoption of such a process . The extent to which internal audit recommendations are implemented by the management entity make from audit a value-creating structure.

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