

Financial risk insights for all sectors



All organisations need financial capital to operate; without it headlines emerge such as ‘Northampton County Council cash crisis’ and ‘Thomas Cook has ceased trading.’ Credit and liquidity risks are not exclusive to the financial services sector.

The Institute’s **Risk in Focus 2020** survey identified financial risk as a top five risk for 30% of chief audit executives with 40% saying it is one of the key areas for internal audit focus.

Financial risk is a complex area but one that internal audit should not avoid. We have included ideas in this thought leadership piece to inspire confidence that audit leaders can apply the same principles of governance, internal control and risk management assurance to these risks as for any other part of the organisation.

This piece will ask you to consider your own audit plan and whether the issue of financial risk is sufficiently addressed. It is written for a non-financial services audience.

What is financial risk?

Financial risk addresses the ability of an organisation to manage its money, particularly in light of changes in interest rates, foreign exchange rates and the creditworthiness of counter-parties.

Audit leaders will be familiar with auditing financial controls. These controls help an organisation to mitigate its financial risks so the impact of exposure in the event of a failure is reduced.

Financial risk is a very broad category and the specific details can vary according to sector and business model. At its core is sustainability, the availability of funds to enable the organisation to meet its strategic vision as well as its basic financial obligations to stakeholders; investors, suppliers, clients and customers.

Financial risk encompasses everything from working capital management to the treasury function, pension liabilities to cash flow forecasting, debt management to cost control.

The risks are split between those that are outside the organisations control, systematic risks such as interest rates and currency fluctuations, and those that only affect the organisation, unsystematic risks, such as those relating to investment and funding decisions. This terminology is different to systemic risk which auditors will be familiar with that refers to the breakdown of an entire system rather than simply the failure of individual parts within it, such as the systemic issues with diesel emissions in the motor industry.

The vast majority of these risks are relevant to all organisations. We have included all of the risks categories for completeness although some (shaded in the diagram) are more theoretical and complex than others. An [explanation](#) of all the terminology is included at the end of the piece.

External audit do this....don't they?

Yes and no. External audit are principally concerned with the accuracy of the reported accounts, the going concern of the organisation and its longer-term [viability](#). They operate at high materiality thresholds and with limited time to undertake detailed testing outside specific areas which leads to the possibility of assurance gaps.

How comprehensive is the financial risk assurance your audit committee receives?

Think for a moment about the scope of the last external audit report and its findings and also the activities of your second line of defence.

Audit leaders should consider providing assurance over financial risk in addition to financial controls when planning their activities. This should be clearly explained to the audit committee as experienced non-executive directors may have expectations based on what they see elsewhere; all organisations are different including the nature of financial risk and the skills of the internal audit team.

Audit planning

The key to planning audits of financial risk is effective liaison with the external auditors to understand their audit coverage. A shared, comprehensive understanding of the key financial risks for the organisation is vital together with how assurance will be provided. The audit committee may benefit from an assurance map specific to these risks as it would also highlight gaps between the activities of the two parties. Financial risk assurance is not exclusive to external audit.

CAEs may also want to consider embedding assurance over financial risk into other audits. For example some operational risks that involve cash, expenses and cost efficiency may include controls that also impact on the management of financial risk.

| Risk | Example Audit Areas |
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| Systematic Risk <i>(outside own control)</i> | <ul style="list-style-type: none"> • Interest Rate Risk • Market Risk • Inflationary Risk | <ul style="list-style-type: none"> • Hedging process (forex) • Investment strategy/management • Treasury function • Cash forecasting • Cash flow management • Pension liabilities modelling • Working capital management |
| Unsystematic Risk <i>(within own control)</i> | <ul style="list-style-type: none"> • Liquidity Risk • Credit Risk | <ul style="list-style-type: none"> • Accounts receivable • Credit limit setting and compliance • Debt management • Capital structure strategy • Financial strategy/management • Transaction processing |

Finance culture and risk appetite

The culture of the financial services sector came under intense scrutiny following the 2008 financial crisis for excessive risk taking by having short-term focus and suffering from group think that they were too big to fail.

Might these traits have also been found in board meetings at Carillion, Thomas Cook or Bury Football Club in the months before their demise? Financial viability is the lifeblood of any organisation.

CAEs may wish to consider auditing finance culture, including attitude to risk, governance, regulations, accounting standards and relationships with external audit/third parties (such as investors, funding providers, lenders etc). Is decision-making robust or led by a strong individual? Are options debated or closed down?

What financial risk assurance does your second line of defence provide? Is it proportionate to the size of the organisation and nature of the risks?

Before undertaking specific audits related to financial risks, it would be prudent to provide assurance over the maturity of risk management within the finance function - identification, measuring, monitoring and reporting of financial risks - to ensure it is of sufficient quality to be relied upon. Financial risk management could also be an audit in its own right depending on the size of the organisation and its complexity.

Establishing an organisation's financial risk appetite is of critical importance not only for effective board governance but for internal audit to perform risk based audits. The process of setting and communicating risk appetite should be included in any audit of finance culture or financial risk management. Auditors should ensure they understand the financial risk appetite of the organisation before beginning any audits in this space.

Reducing the fear factor

Audit leaders may feel hesitant about adding financial risk assurance to their plan if it has not been done before. The subject matter can be intimidating to non-accountants and even to those whose training is a distant memory. Just like auditing marketing, logistics or procurement there will be jargon and specialists who will know more than the auditor, but there will also be processes, controls and management information that form the basis of what goes on.

The treasury function has a key role in managing financial risk. They are often responsible for cash management, advising on capital structure, managing market risks in relation to interest rates and foreign currency together with developing strong relationships with banks and other funding partners.

Invite them to talk to the team about financial risk and the work they do, notwithstanding that they may well be the subject of assurance audits!

There are some key points that audit leaders should consider:

- Invest time for all auditors to understand financial ratios; particularly the analysis of the ratios between assets and liabilities will help identify areas of improvement and opportunities to take calculated risks. The Institute offers members an on-line [introduction to accounting ratios course](#).
- When auditing financial risk, internal audit can leverage their knowledge of the IT systems and accounting systems together with understanding of key stakeholders, pressure points and risks to deliver added value to the organisation.
- It is important to stay abreast of major changes to accounting standards. For example in January 2019 the reporting of liabilities changed under IFRS 16 to include operating leases in addition to finance leases. This represents a major shift on the balance sheet and associated debt pressures for organisations with significant property and operating equipment leases eg retailers, airlines, construction and energy companies.
- Many financial risks are inter-related and care should be taken when scoping engagements. We have separated out the risks in this paper although audit leaders will recognise that there is overlap between the activities of treasury and the management of individual risks such as liquidity and working capital management.
- Good relationships and communication with stakeholders (external audit, chief finance officer and senior finance managers) are key to establishing internal audit as a credible partner in providing assurance over financial risk.

While the ideas below are not exhaustive, they indicate some practical ways to think about auditing financial risk.

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| <p style="text-align: center;">Financial reporting</p> <p>All organisations produce management information: financial performance reports, analysis for decision-making, estimates and assessments. In our digital age, auditing spreadsheets is not enough with the use of algorithms and artificial intelligence. Both management and internal audit must recognise that it is unacceptable to have blind faith in the "black box" that is used to calculate and manage financial risk.</p> | <p style="text-align: center;">Liquidity risk</p> <p>Every organisation carries this risk. Liquidity is essentially ensuring that cash is on hand when needed to meet liabilities such as paying employees and suppliers. It is cash flow management. Assurances can include the robustness of liquidity stress testing, cash flow forecasting and modelling used for pension liabilities through to the cash banking processes in the case of retailers. Assurance can also be provided over the financing strategy.</p> |
| <p style="text-align: center;">Working capital management</p> <p>This is about assets that could be easily sold to meet liabilities as they fall due. It explains why some organisations value regular assurance over the financial controls and tight management of accounts payable, accounts receivable and stock/inventory. The balance of assets to liabilities is referred to as a working capital ratio. It is an indicator of financial and operational efficiency, as assets may be able to produce higher returns if used in other ways.</p> | <p style="text-align: center;">Credit risk</p> <p>This is the strategic element of accounts receivable - the risk that money owed is not recovered. Economic uncertainty and a slowdown in the domestic and global economy heightens the risk defaults from debtors. It is why some Thomas Cook customers were asked to pay their room charges as hotels feared unpaid bills. Exposures may vary across the geography of complex supply chains.</p> |
| <p style="text-align: center;">Debt management</p> <p>Internal audit can provide assurance that accounting standards are being met to prevent misstatement. At a compliance level, walkthroughs of debt transactions providing completeness, such as checking documentation, covenants and segregation of duties, for example. The administration of multiple covenants should also be considered to ensure conflicts are identified and managed.</p> | <p style="text-align: center;">Market risk</p> <p>The volatility of exchange rates (market risk) is an important aspect of financial risk for organisations with overseas activities, particularly sales and supply chains. Assurance over the hedging process (forex), derivative transactions and associated banking procedures are some of the potential internal audits that could undertake of activities within the treasury function where market risks is often identified.</p> |

Occupational Pension schemes

One of the specific financial risks highlighted by CAEs in **Risk in Focus 2020** was pension liabilities.

Many organisations have legacy or ongoing commitments from defined benefit schemes. The CAE of a UK food retailer commented that "if the pension scheme is not delivering the targeted level of returns, we have to put more money in."

Whether pension funds are managed externally or in-house, periods of low return as experienced in recent years puts pressure on revenue targets, operational costs and the ability to effectively finance projects.

UK legislation sets out a number of statutory requirements for the auditing of financial statements by external

audit firms. Internal audit however can provide assurance over the governance of the trustees, decision-making processes, communications with members, contribution collections etc.

CAEs should consult with appropriate stakeholders such as the company secretary, chief finance officer or chair of pension trustees before proposing audits in this space as there may be other means by which assurance can be gained over their key controls and which should be taken into account.

The pensions regulator introduced new requirements in January 2019 which go further than the adequacy of internal controls into risk assessment and appropriate governance. Related to this, the ICAEW has produced a useful assurance [guide](#) for auditors.

Closing Thoughts

Audit leaders should not see this as a backward step into more auditing of financial controls; elevate the audit scope to financial risk management. These risks are fundamental to an organisations long-term success. When internal audit resource is scarce which assurances are really valued by the board - a warning about petty cash controls and low level personal expenses fraud or that cash forecasting models are inaccurate? Make sure the right financial audits are on your plan.

"Accounting is the language of business"

Warren Buffett

References

Auditing liquidity risk - IIA Global [guidance](#)