Risk Management Issues–States and State Auditors

New England Intergovernmental Audit Forum

June 2018

What is Risk?

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Risk

- **There is no single definition of risk**
- ***Risk* is the "effect of uncertainty on objectives" and an *effect* is a positive or negative deviation from what is expected. (1)**
  - Risks can produce positive or negative results.
- **We all face many risks everyday**

(1) Source: **ISO 31000**

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Risk

- **Risks come in all shape and sizes**
- You cannot change a risk –
- You can change the probability of the effect of the risk
  - Avoid
  - Embrace
  - Manage
- Risk is relative

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Risk is Relative

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Risk

- **What is the skateboarders risk? Reward?**
- **Does the positive effect of the risk outweigh the negative?**
- **How might our skateboarder change the probability of the effect of the risk?**
  - Common responses:
    - Avoid – Eliminate exposure to the risk and its effects
    - Embrace – Throw caution to the wind. Go for it - YOLO!
    - Manage – Take steps to change the probabilities – wear a helmet and other protection, start farther down the hill, buy life insurance.

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Risk

What does all this mean?

- **For any risk - you identify, evaluate and take steps to control the effects of the risks you encounter.**
  - States and other organizations do as well!
- **In other words, each of us manages risk each and every hour of the day, so……..**

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Risk

You are already pros at the process of risk management!

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Risk Management

Just like 'risk' there is no single definition of risk management.

- ***Risk management*** **refers to a coordinated set of activities and methods that is used to direct an organization and to control the many risks that can affect its ability to achieve objectives.**

Or in simple terms

- ***Risk management*** **is the identification, evaluation, and prioritization of risks followed by coordinated and economical application of resources to minimize, monitor, and control the probability or impact of unfortunate events or to maximize the realization of opportunities.**

Source: ISO 31000

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Risk Management

Just like ‘risk’ there is no single definition of risk management.

- ***Risk management*** **also refers to the architecture that is used to manage risk. This architecture includes risk management principles, a risk management framework, and a risk management process.**

Source: **ISO 31000**

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State Risks

How does all this relate to States?

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States

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State Risks

States officials are exposed to a countless number of risks from very small risks to very large risks

- **Common risks**
  - Project failures – construction, IT, etc.
  - Credit risk – Bond rating and ability to borrow
  - Safety - OSHA
  - Legal Compliance – Compliance with State and Federal statutes (including Grants)
  - Fluctuations in the Stock market
  - Budgetary Risk

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State Risks

States officials are exposed to a countless number of risks from very small risks to very large risks

- **Less Common Risks**
  - Natural disasters – floods, hurricanes, volcanoes
  - Terrorist attacks

What is the State responsible for?

How do State Officials deal with all the risks they face?

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State's responsibilities

Oversight Group/Legislature/Executive Branch

—**Primary** responsibility for risk management – not the auditors

- Group should work at an **Enterprise Wide Level** to create an effective control environment including a culture of honesty and ethical behavior
  - —setting the proper tone;
  - —creating a positive workplace environment;
  - —identifying, prioritizing and responding to entity wide risks;
  - —creating entity wide risk policies – litigation, harassment, insurance, etc.;
  - —hiring, training and promoting appropriate employees; and
  - —moving down the Enterprise Risk Management continuum

—**If leadership establishes and enforces a strong internal control environment the impact of identified risks will be reduced**.

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State's responsibilities

Agency/Department Level Management

- Management should place a strong emphasis on internal controls over the business processes within their Department/Agency including those that focus on risks
  - —identifying, prioritizing and responding to Agency/Department risks;
  - —identifying, prioritizing and responding to process level risks;
  - —commitment to a linking risks to controls/control processes;
  - —implement appropriate controls/control procedures
    - Consider cost/benefit of controlling individual risks
      - —Fraud controls
      - —Compliance controls – allowable grant expenditures
      - —Reconciliation controls – financial reporting.

—**If a strong system of internal controls is established and the system is tested adequately by internal and external auditors, the strength of the system will help reduce the effects of identified risks.**

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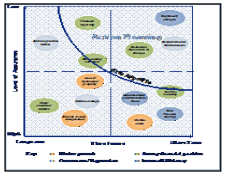
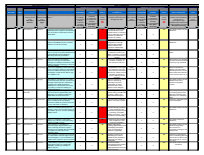
Levels of Risk Management and Information

	Detailed Risk Information related to Level	Detailed Risk information supports
 Enterprise Level	 Enterprise Risks are included in the Priority Risks of the Government	Risk information supports: ■ Strategic plan initiatives ■ Decisions regarding financial priorities, capital allocation and program initiatives ■ Monitoring and reporting of risk information to management and the Oversight Board
 Agency, Department, or Functional Level	 Next level of risks specific to business unit or functional level, but mapped and linked to priority enterprise risks	Risk information supports: ■ Identification and understanding of agency/departmental/functional specific risks ■ Agency/Departmental/Functional focus on gaps, mitigation and action plans to remediate ■ Internal Audit Plan and focus on processes
 Process Level	 Process level risks may be identified as part of the following: Compliance, Privacy, Security, etc.	Process Risk supports: ■ Understanding operational risks in the process, or application level. Status and mitigation of gaps ■ More efficient co-ordination of Internal Audit and External Audit testing

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State's Responsibilities

So what's all this mean?!?

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State's Responsibilities

Risk management **is the identification, evaluation, and prioritization of risks followed by coordinated and economical application of resources to minimize, monitor, and control the probability or impact of unfortunate events or to maximize the realization of opportunities.**

- **Identification of risks**
- **Prioritization of Risks**
- **Response to Risks**
  - Avoid
  - Embrace
  - Manage

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Identification of Selected Risks

Strategic

Planning & Resource Allocation
- Organizational structure
- Strategic planning
- Budgeting and forecasting
- Capital planning
- Cost management
- IT planning
- Resource planning

Reputation with Stakeholders
- Taxpayers
- Businesses
- Community/Citizens
- Vendors – Pay to Play

Revenue Enhancement
- Tax limitations
- Fees. Fines, etc.
- Proprietary activities/Gambling
- Strategic partnerships (P3)
- Technology Transfer

External Dynamics
- Public Pressure
- Crime/Guns
- Illegal Immigration
- Economic factors
- Interest rates
- Opioid Crisis

Operations

Facilities
- Disaster preparedness
- Maintenance and condition
- Construction/Infrastructure
- Safety and security

Service Provision
- Education
- Health/Social services
- Transportation
- Colleges/Universities
- Health Care Facilities

Information Technology
- Information Security
- Data Privacy
- Change management
- System implementation
- Automated application controls
- Management reporting

Student Services
- Student Wellness
- Student rights and responsibilities
- Financial aid
- Organizations and activities
- Recreational and athletic centers
- International and immigration

Financial & Compliance

Governance
- Legislature oversight
- Ethics
- Conflicts of Interest
- Code of conduct
- Fraud

Colleges/Health Care Facilities
- Sexual litigation
- Enrollment/Tuition
- Graduation Rates
- Healthcare Reform
- Patient care / quality
- Health information & HIPAA
- Medical Malpractice

Financial and Accounting
- Budgeting
- Cash management
- Investments
- Debt management
- Collections
- Risk management and insurance – Self-insurance
- Procurement
- Payroll
- Grant accounting
- Unfunded Pension/OPEB

Legal & Regulatory Activities
- Privacy and confidentiality
- Security
- Federal/State
- Contract
- Environmental
- Labor
- Securities and Exchange (SEC)
- IRS

Human Resources
- Succession Planning
- Hiring and termination
- Unions
- Ability to retain key talent
- Compensation and benefits
- Performance evaluations
- FLSA, OSHA compliance

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Identification of Overarching Risks

Media/Press Risk

What will the Headlines say?

- Risk of bad press
- Spinning the story
- Short or long term news cycle

Re-election Risk

How will this impact the election?

- Risk of job loss/support
- Campaign contribution impact
- Impact on party candidates

Political Risk

How much blowback will I get?

- Risk of overwhelming heat
- My party's reaction
- The other party's reaction

How will this impact other initiatives/plans I have?

- Risk of damage to other priorities
- Impact on negotiations on other initiatives

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Prioritization of Risks

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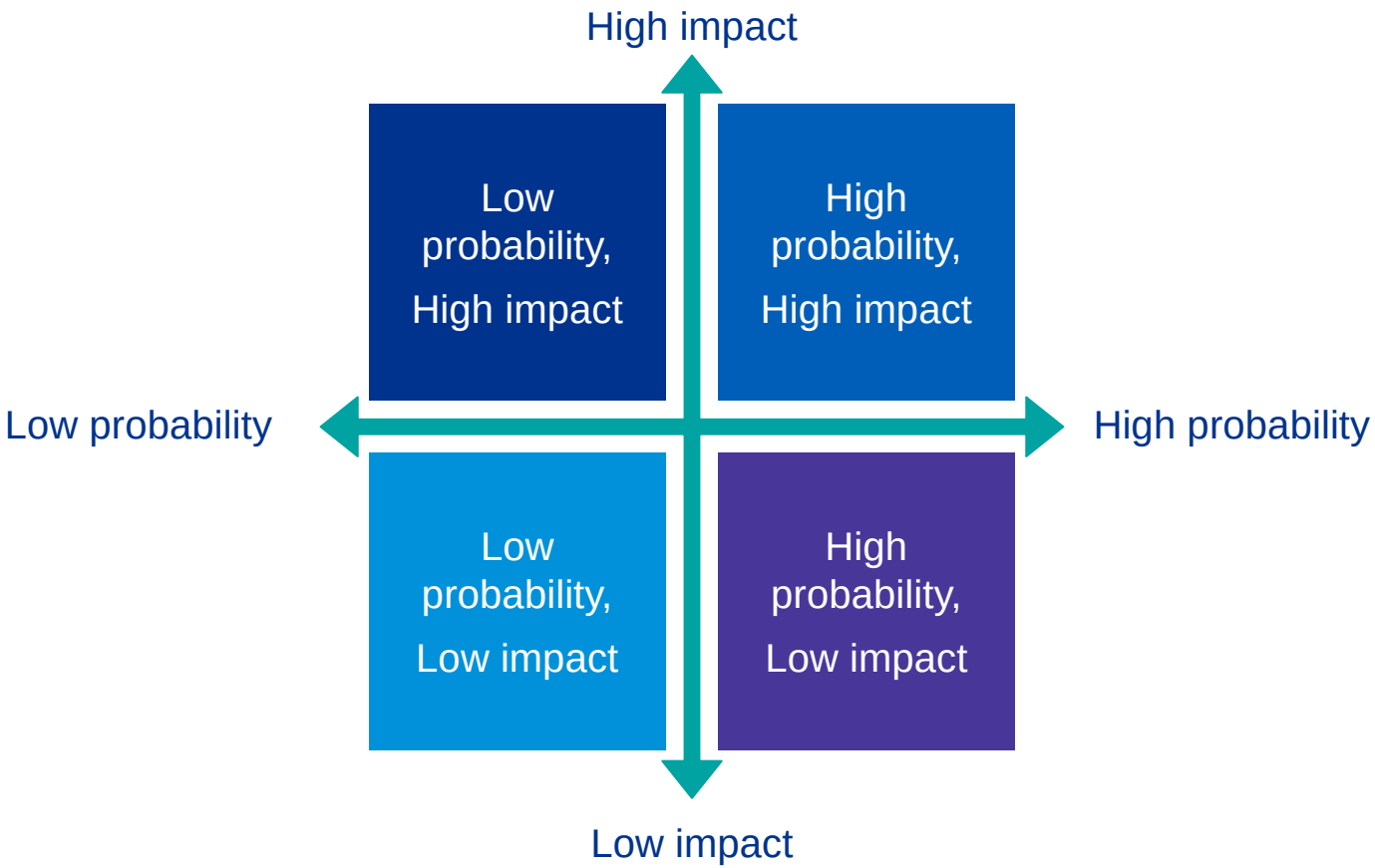
Prioritization of Risks - Mapping

Probability and Impact



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Example Probability Description

Almost certain	— Event is expected to occur in most circumstances — Probable of occurring in any year
Likely	— Event will probably occur in most circumstances — High likelihood of occurring in any year.
Moderate	— Event should occur at some time — Likely of occurring in any year
Unlikely	— Event could occur at some time — Unlikely of occurring in any year
Rare	— May occur but only in exceptional circumstances — Remote chance of occurring in any year

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Example Impact Description

Critical	— Catastrophic impact on financial condition ***[quantitative]*** — Extremely negative publicity ***[qualitative]*** — Impact on reputation of State/State Officials — Impact on re-election chances — Assigned to the Executive leadership for resolution
Major	— Major impact on financial condition — Serious negative impact on reputation due to long term bad publicity — Delegated to Senior Management for resolution
Moderate	— Moderate impact on financial condition — Short-term impact on reputation — Delegated to Middle Management for resolution — Consequences can be absorbed in the short-term
Minor	— Minor impact on financial condition — Potential short-term impact on reputation — Delegated to Junior Management for resolution — Consequences can be absorbed under normal operating conditions
Insignificant	— Minimal impact on financial condition — No impact on reputation — Junior Management/line staff to resolve

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Response to Risks

- **Avoid – Effectively eliminate possibility of a risk and its impacts**
  - Don’t do the activity from which the risk flows
    - Don’t Skateboard
    - Don’t invest in the stock market
- **Embrace – Gain an understanding of the risk and its impact and accept both**
  - Do nothing

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Response to Risks

- **Manage - Gain an understanding of the risk and its impact and take action to balance the risk, its impacts and the costs of the action**
  - Wear a helmet when skateboarding
  - Buy car, life, health insurance
  - Implement internal controls and risk reduction (fraud) programs

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Analysis of Inherent Risks

Inherent Risks - Risk of doing business

- **Identification:**
  - Lawsuits
  - High Profile Transactions – P-3, Lease-Buyback, Interest Rate Swaps
  - Related Party transactions
  - Public scrutiny
  - Buildings

- **Prioritization based on impact/probability:**

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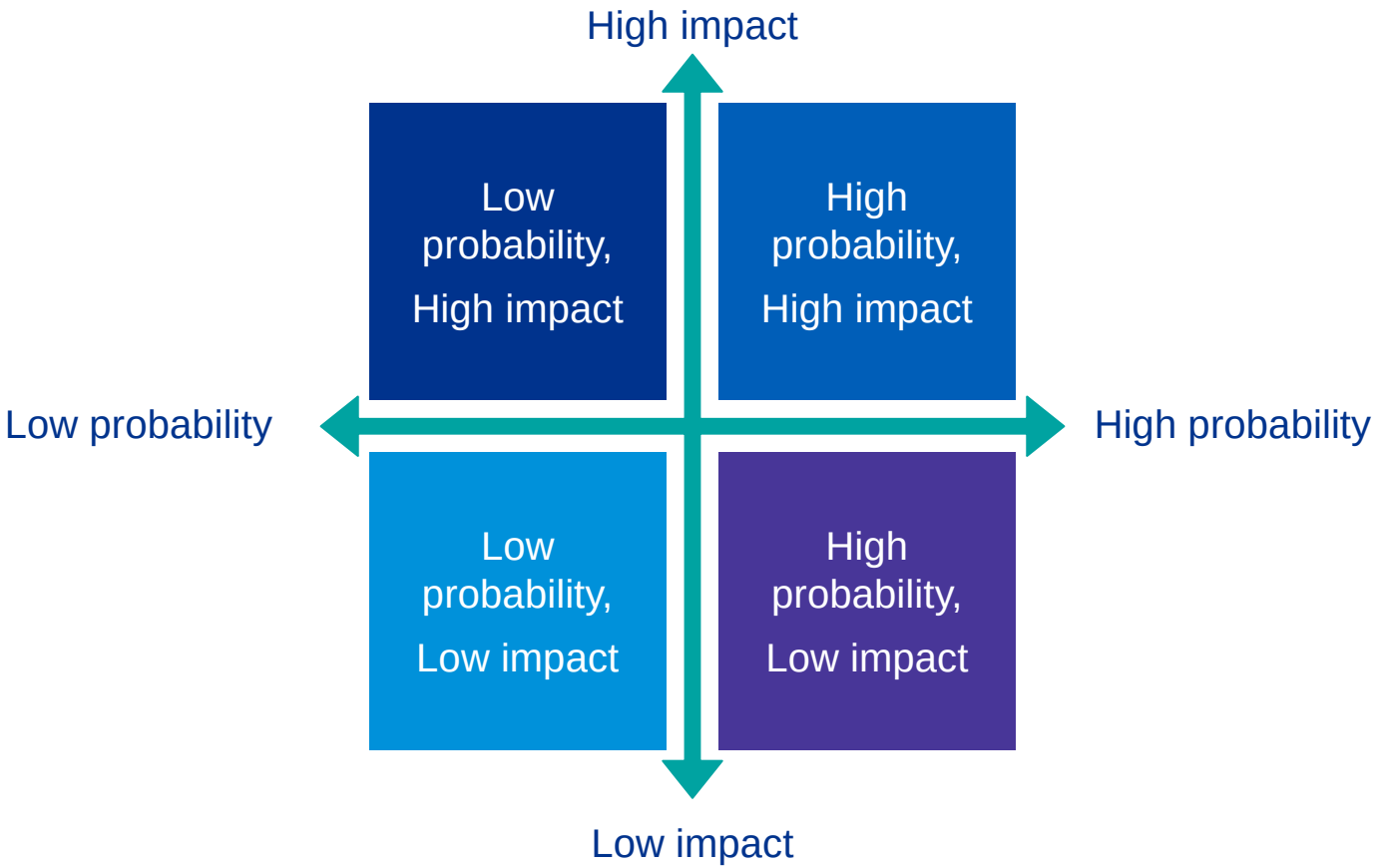
Prioritization of Risks - Mapping

Probability and Impact



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Analysis of Inherent Risks

Inherent Risks - Risks of doing business

- **Responses:**
  - Insure against selected risks
  - Accept risk: Self-Insure = no insurance
  - Avoid High Profile transactions/mitigate risk through use of specialist/experts
  - Control and scrutinize Related Party Transactions
  - Employ/consult specialists in analyzing risks

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Analysis of Internal Control Risks

<u>Internal Control Risk</u> – risk that controls are not in place or not adequate to effectively manage identified risks

- **Identification: risks related to day to day operations that have no corresponding control points**
  - Lack of/ineffective control over
    - Budgets – statutory compliance
    - Segregation of duties - fraud
    - Account Reconciliation reviews – financial operations/reporting
    - Theft of cash/assets - fraud

- **Prioritization based on impact/probability:**

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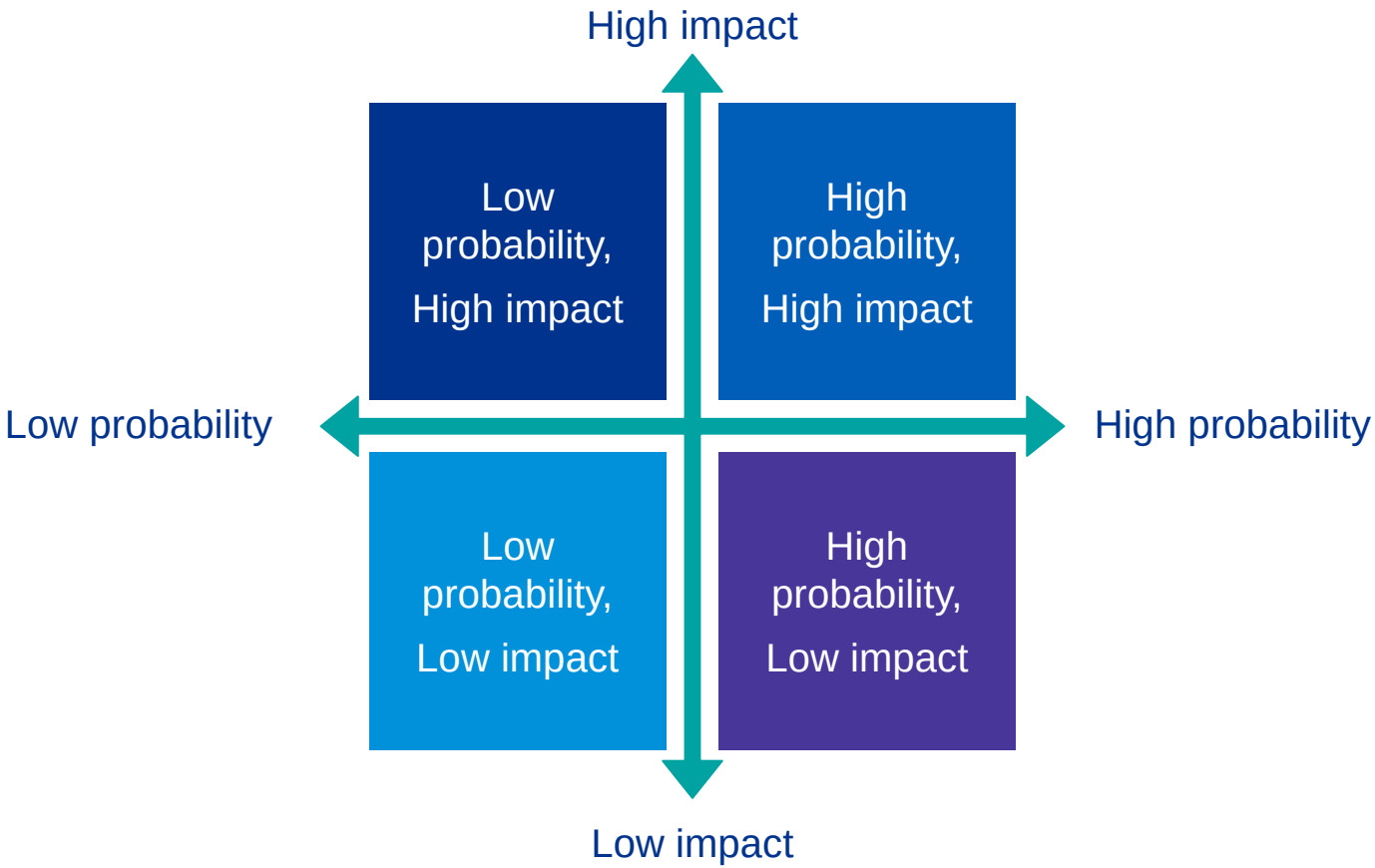
Prioritization of Risks - Mapping

Probability and Impact



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Analysis of Internal Control Risks

Internal Control Risk – risk that controls are not in place or not adequate to effectively manage identified risks

- **Responses:**
  - Hard to avoid risks at this level – except to get out of business segments
    - Stop taking cash for payments (but creates other risks to be addressed)
  - Implement IT/manual controls linked to selected risks – where benefit exceeds cost
  - Accept impact of risk – where benefit exceeds cost
  - Involve Internal Auditors to refine risk and response

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Analysis of Compliance Risks

<u>Compliance Risk</u> – risk that controls are not in place or not adequate to effectively manage compliance risks

- **Identification: compliance risks have no corresponding control points**
  - Lack of/ineffective control over
    - Federal laws and regulation – statutory compliance
      - Financial (IRS, SEC) and non-financial (OSHA)
    - Federal grants
    - IRS, DOL
    - Union Contracts
- **Prioritization based on impact/probability:**

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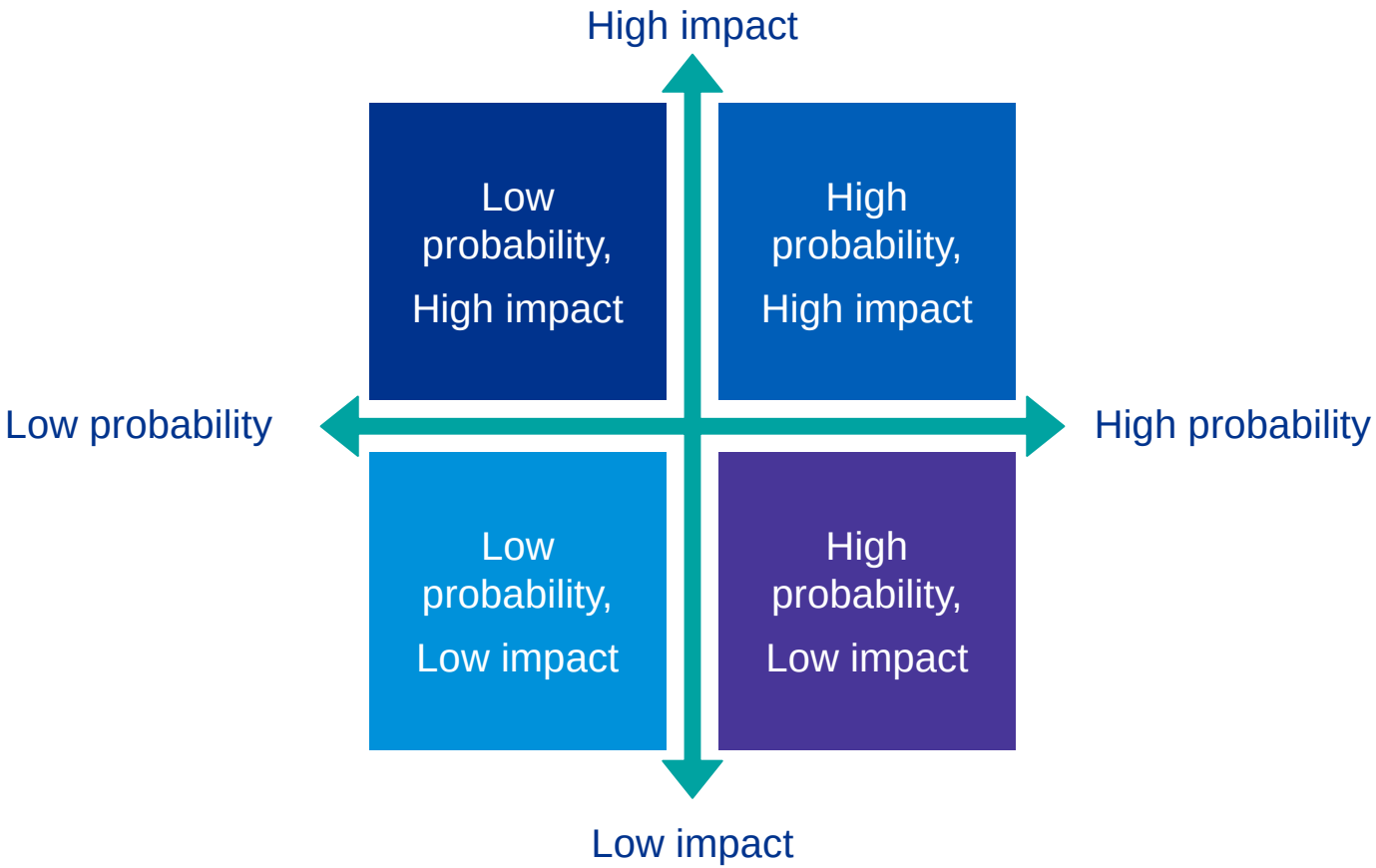
Prioritization of Risks - Mapping

Probability and Impact



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Analysis of Compliance Risks

<u>Compliance Risk</u>– risk that controls are not in place or not adequate to effectively manage compliance risks

- **Response - Combination of higher level and process level controls**
  - Hard to avoid risks at this level – many are inherent type risks
    - Higher Level Controls
      - Implement Compliance Policy
      - Establish Compliance Department
      - Schedule Internal Audit Reviews
      - Involve experts – often specialized legal resources
        - Bond attorneys, OSHA experts, Union contract resources
      - Accept risk where cost exceeds benefits

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Analysis of Compliance Risks

<u>Compliance Risk</u>– risk that controls are not in place or not adequate to effectively manage compliance risks

- **Response - Combination of higher level and process level controls**
  - Process Level Controls
    - Implement IT/manual controls linked to selected risks – where benefit exceeds costs
      - Payroll compliance – employee use of cars, other perks
      - Grant compliance – allowability, reporting
      - Bond Arbitrage – IRS compliance
      - Investment policy compliance – authorized investments

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Analysis of Fraud Risks

<u>Fraud Risks</u> - controls are not in place or not adequate to effectively manage potential fraud risk

- **Identification - risks related to potential fraud have no corresponding control points**
  - Lack of consideration of controls to prevent
    - Employee Theft
    - Fraudulent time/expense reporting
    - Fraudulent reporting to federal government
    - Fraudulent External Financial reporting
    - Medicaid Fraud

- **Prioritization based on impact/probability:**

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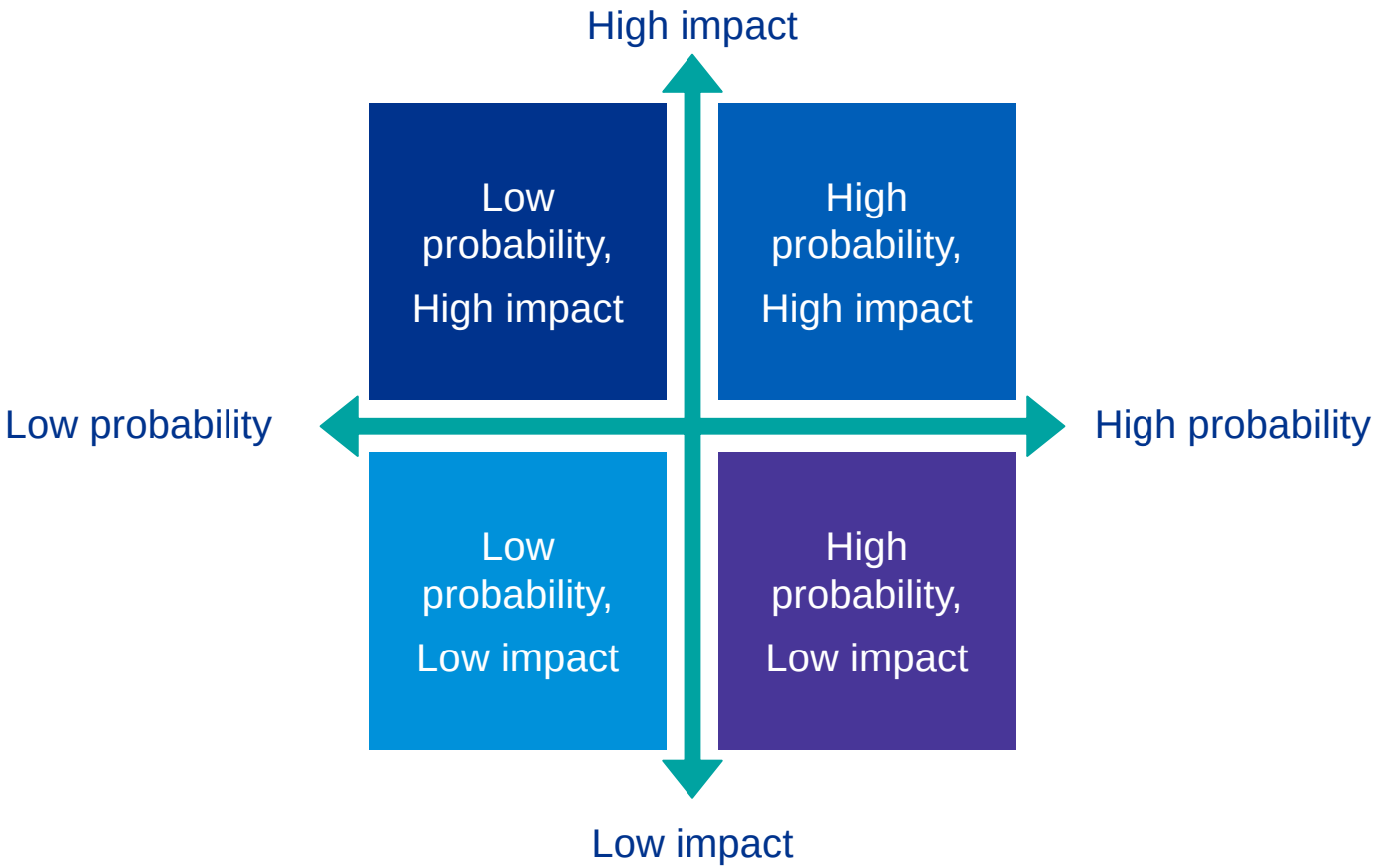
Prioritization of Risks - Mapping

Probability and Impact



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Analysis of Fraud Risk

Fraud Risk - controls are not in place or not adequate to effectively manage potential fraud risk

- **Response - Combination of higher level and process level controls**
  - Hard to avoid risks at this level
  - Higher Level Controls
    - Hotlines, e-mail boxes, web portals
    - Policy – required vacations
    - Internal Audit Reviews
    - Payroll/vendor set up controls
    - IT controls – access, passwords, etc.

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Analysis of Fraud Risk

Fraud Risk, continued

- **Response - Combination of higher level and process level controls**
  - Process Level Controls
    - Implement controls linked to selected risks – where benefit exceeds costs
      - Payroll/Vendor setup
      - Dual check signers/Wire transfers
      - Door Locks
      - IT application controls
    - Accept risk where cost exceeds benefit

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Auditor

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Auditor Responsibility

External Auditors are not part of the State's internal control system or its risk management program.

- **Auditors' Responsibility – "Our responsibility is to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement."**
- **Much more narrow than the State's responsibility for risk management.**
- **However, auditors do plan for and evaluate individual risks as they map to the overall objective – i.e. the risks associated with a specific balance or transaction.**

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Auditor Risks

Auditors should be planning the audit to assess risks impacting the State that could result in a material misstatement.

- **Identification**
- **Assessment**
- **Response**

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Auditor Risks

Inherent Risk - Risk that exists in the business due to its structure or operations

- **Identification:**
  - Control Environment/Tone at the Top
  - Application of technology – highly automated or manual
  - Management Integrity – Background checks
  - Higher risk operations/transactions – Convention centers, Sports Stadiums/Derivatives, Alternative Investments
  - Revenue Base/Liability Management (Pension, OPEB)
  - Establishment of fraud prevention programs

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Auditor Risks

Inherent Risk - Risk that exists in the business due to its structure or operations

Assessment:

- **Application of technology – highly automated or manual**
  - Automated bookkeeping
  - Technology drives business – Lotteries, POS systems
  - IT environment – On-site operations, cloud based, service provider
- **Higher risk operations/transactions – Convention centers, Sports Stadiums/Derivatives, Alternative Investments**
  - Management's ability to oversee operations
  - Management's familiarity with transactions
- **Revenue Base/Liability Management (Pension, OPEB)**
  - Management's ability to 'manage' major challenges

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Auditor Risks

- **Response:**
  - Adjust testing plan – timing, nature and extent of tests
  - Engage experts to assist in technical areas
  - Communication of Fraud programs

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Auditor Risks

Internal Control Risk - risk that a material misstatement could occur and not be prevented, or detected and corrected, on a timely basis by the State's internal control system.

- **Identification**
  - Management emphasis on strong internal controls
  - Integration of risk controls within the established system of internal controls
  - Specific controls over higher risk areas – liquid/movable assets
  - Implementation of fraud identification, prevention and reporting programs

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Auditor Risks

Internal Control Risk

- **Assessment:**
  - Management emphasis on strong internal controls
    - Control awareness/importance
    - Type and extent of documentation
  - Integration of risk controls within the established system of internal controls
    - Extent of process documentation/control narrative
  - Specific controls over higher risk areas – liquid/movable assets
    - Process documentation – commensurate with risks in areas
  - Implementation of fraud identification, prevention and reporting programs
    - Documentation demonstrating alignment with entity wide programs

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Auditor Risks

Internal Control Risk

- **Response:**
  - Assess adequacy of formal documentation/processes
  - Determine whether controls are designed and implemented
  - Test identified controls
  - Evaluate and conclude on effectiveness of controls
  - Adjust testing plan accordingly

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Auditor Risks

Detection Risk - risk the audit procedures would not detect a material misstatement in the financial statements or Federal program

- **Identification:**
  - Integration of risk detection controls within the established system of internal controls
  - Specific management review controls
  - Implementation of feedback controls – exception reporting follow up

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Auditor Risks

Detection Risk - risk the audit procedures would not detect a material misstatement in the financial statements or Federal program

- **Assessment:**
  - Integration of risk detection controls within the established system of internal controls
    - Formal documentation/inquiry and observation
  - Specific management review controls
    - Process documentation and observation
  - Implementation of feedback controls – exception reporting follow up
    - Process documentation, review of control operation

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Auditor Risks

Detection Risk - risk the audit procedures would not detect a material misstatement in the financial statements or Federal program

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Auditor Risks

Fraud Risk - risk that a material misstatement in the financial statements or Federal program resulted from potential fraud (intentional) as opposed to error (unintentional).

- **Auditor's direct responsibility for planning the audit relates only to**
  - Financial reporting process
  - Misappropriation of assets
- **Auditor has indirect responsibility if information comes to auditor's attention.**
- **The auditor's job is not to look for or catch immaterial fraud.**

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Auditor Risks

Fraud Risk - risk that a material misstatement in the financial statements or Federal program resulted from potential fraud (intentional) as opposed to error (unintentional).

- **Identification:**
  - Fraud risk controls within the overall system of internal controls
  - Specific controls over potential fraud risk areas – liquid/movable assets, payroll, overtime, receivables, payables
  - Consider Common Red Flags/fraud risk factors

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Auditor Risks

Fraud Risk - risk that a material misstatement in the financial statements or Federal program resulted from potential fraud (intentional) as opposed to error (unintentional)

- **Assessment:**
  - Fraud risk controls within the overall system of internal controls
    - Adequacy of design, implementation and operation
  - Specific controls over potential fraud risk areas – liquid/movable assets, payroll, overtime, receivables, payables
    - Properly designed and implemented to address identified risks
  - Consider Common Red Flags/Fraud Risk Factors
    - Have common items been considered in establishing system of controls

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Auditor Risks

Fraud Risk - risk that a material misstatement in the financial statements or Federal program resulted from potential fraud (intentional) as opposed to error (unintentional)

- **Response:**
  - Adjust nature, timing and extent of audit testing
  - Match higher level audit personnel with higher risk areas
  - Use stronger tests/obtain stronger evidence
  - Agree with client to report observations where fraud indicators are observed – inquiry and observation

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What Should Auditors Consider

Discuss Risk and the Responsibilities

- Oversight Group
- Management
- Internal Audit
- External Audit

Key Messages

— *Leaders must lead the effort*

— *Risks need to be identified at the appropriate level – entity wide, Agency/Department, process*

- *Appropriate internal controls linked to risks need to be established and implemented*

— *The risk identification and management process is time consuming, not a part time job and not static.*

— *Internal auditors should be part of the system of internal control and the risk management process*

— *External auditors are not part of an entity's system of internal control or risk management process*

- *But external auditors can be part of testing the process over and above the audit standard*

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Questions

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