An Analysis of the Role of Internal Audit in Implementing Risk Management - a Study of State Corporations in Kenya

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Abstract
The study analyzed the role of internal audit in Enterprise Risk Management (ERM) by providing empirical Evidence on the Kenyan public sector firms. The study examined the impact of Involvement in ERM by auditors and internal auditors' willingness to report a breakdown in risk procedures and whether a strong relationship with the audit committee affects willingness to report. The study also investigated the use of ERM and the role of internal audit in ERM. The study was carried out as a cross-sectional survey where the study population was 99 respondents from nine state corporations operating under the State Corporations Act. From the findings, the study concluded that management of State Corporation needs to create an environment that will harness commitment and support to internal audit if it is to effectively perform its responsibility of giving assurance that organizational risks are managed effectively. This will only be possible if individuals within organizations are aware of the role and importance of internal audit function in implementation of enterprise risk management. The study made the following recommendations; the process regarding internal audit and regulatory compliance certification should be amended to ensure the corporations' trust in them. This will have the desired effect of their wide-scale adoption that, in turn, leads to stronger internal controls and standardization of operations. The study suggested further research should be carried out to find out how the auditors themselves contribute to the effectiveness of internal audit function, for example factors such as competences, education status and others.

Keyword: Internal Audit, Corporate governance, enterprise risk management

Introduction

Internal Audit and Enterprise Risk Management

Internal auditing is an independent, objective assurance and consulting activity. Its core role with regard to ERM is to provide objective assurance to the board on the Effectiveness of risk management. Indeed, research has shown that board of directors and internal auditors agree that the two most important ways that internal auditing provides value to the organization are in providing objective assurance that the major business risks are being managed appropriately and providing assurance that the risk management and internal control framework is operating effectively. Enterprise risk management (ERM) can be viewed as a natural evolution of the process of risk management. The Committee of Sponsoring Organizations of the Treadway Commission (COSO) defines enterprise risk management as: “a process, effected by an entity’s board of directors, management and other personnel, applied in strategy setting and across the enterprise, designed to identify potential events that may affect the entity, and manage risk to be within its risk appetite, to provide reasonable assurance regarding the achievement of entity objectives.”

The history of ERM has been marked by the Introduction of several standardized frameworks. One of the earliest of these was the Australian/New Zealand Risk Standard which was first introduced in 1995. An updated version of this standard (ASNZ 4630) was subsequently introduced in 2004.

People undertake risk management activities to identify, assess, manage, and control all kinds of events or situations. These can range from single projects or narrowly defined types of risk, e.g. market risk, to the threats and opportunities facing the organization as a whole. The principles presented in this study can be used to guide the involvement of internal auditing in all forms of risk management but we are particularly interested in enterprise-wide risk management because this is likely to improve an organization’s governance processes.

Enterprise-wide risk management, or ERM, first emerged as a recognized new approach to risk management in the 1990s, ERM is a natural evolution of the process of risk management, and represents a more advanced and sophisticated approach to managing risk. Some sources have referred to ERM as a new risk management paradigm.

Currently, many organizations still continue to address risk in “silos,” with the Management of insurance, foreign exchange risk, operational risk, credit risk, and Commodity risks each conducted as narrowly focused and fragmented activities. Under ERM, all risk areas function as parts of an integrated, strategic, and enterprise-wide system. While risk management is coordinated with senior-level oversight, employees at all levels of the organization using ERM are encouraged to view risk management as an integral and ongoing part of their job.

<table>
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<th>Old Paradigm</th>
<th>New Paradigm</th>
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<td><strong>Fragmented</strong></td>
<td><strong>Integrated and enterprise-Wide</strong></td>
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<td>Departments management risk</td>
<td>Coordinated with senior-level oversight, risk management culture</td>
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<td>Independently (Silos)</td>
<td>Continuous</td>
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<td>Ad hoc</td>
<td>Ongoing process</td>
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<td>Narrowly focused</td>
<td>Broadly focused</td>
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<td>Risk management done when thought appropriate</td>
<td>Addresses all business risks and Opportunities</td>
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<td>Addresses primarily insurable risk and financial risks</td>
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Source: Mark, Richard and Dana, 2005

State Corporations are state owned entities established under the State Corporations Act, chapter 446 of the laws of Kenya. They were formed to provide strategic and essential services to the Kenyans such as electricity, railway transport and port services. Included here also are statutory bodies formed for the purpose of regulating various sectors. They are partially or fully government owned or controlled entities.

The initial thought of setting up these organizations was noble, but most of the political leaders at the time were capitalists and the vision got lost along the way. Influential individuals turned to these enterprises with a single desire to reap maximum personal benefits at the expense of the rest of the public. This led to mismanagement and therefore massive losses. To stem some of these losses, an attempt was made to shed off some of the government shareholding to private investors by issue of shares through the Nairobi Stock Exchange. However, as it is seen in the management of such firms, as National Bank of Kenya and Kenya Commercial Bank, the government still maintains a substantial shareholding, this creates avenues to reward loyalty by political elites of the day.

A case in point is the Kenya Meat Commission (KMC), which collapsed in the early 1990s and it was only in 2006 that it was revived by the government which pumped in KSH 500 million. For instance in 1988 and 1999 financial years, a total of KSh. 8 billion was injected to 18 state corporations. Further capital injection has been made through time and some recent cases can be cited.

Another corporation which was on the verge of collapse until the government came to its rescue is Agricultural Finance Corporation (AFC) whose mandate is to facilitate the development of the agricultural sector by giving loans to farmers at interest rates as low as 5% p.a.
Again due to mismanagement, AFC went down to a point where, by the end of the 1990s it was not able to give loans to farmers, neither was it able to recover loans given to farmers, as a result of which the portfolio of non-performing loans continued to increase year after year and by the close of the financial year 2004/2005 the corporation had a provision for bad and doubtful debts amounting to KSh. 3,295,563,000 against a loan balance of KSh. 3,718,361,000.

Besides, the government extended KSh. 900 million grant to AFC to lend to farmers. Effective utilization of this grant lies in good governance. In 2003, the government injected funds into Kenya Power and Lighting Company by converting loans to the corporation into preference non cumulative shares. Corporate governance malpractices have made Telecom Kenya to be unable to fulfil its mandate. Despite its monopolistic status until the coming in of Safaricom and Cetel companies, Telecom has been unable to supply landlines to many customers who have applied for connection. It has reached a point where the government want to privatize the corporation, which, apart from being unable to provide the much needed telecommunication services, it is a drain to the Exchequer.

The Kenya Railways (KR), which is a key player in the transport sector and very Critical as far as economic development of Kenya is concerned has been going through internal financial and operational problems. But how can such a monopoly in a lucrative transport sector find itself in such financial and operational problems? The Answer is found in corporate governance. The problems in KR were so great that the Government had to engage a private company, the Rift Valley consortium to run this Railway transport giant. Most of the state corporations have been receiving funding from the exchequer, but their financial statements indicate that they have continuously reported deficits. Taking into account that most of these state corporations are monopolies in their respective sectors, it is difficult to understand why they continue to report deficits. Part of the reason for these deficits is corporate governance failures.

**Statement of the Problem**

Companies in the 21st century face a formidable array of risks. Driving forces like Technology advances and the Internet, global competition, complex financial Instruments, mergers, downsizing, deregulation and increased consumer demands all create a riskier operating environment for organization. Interest in enterprise risk management (ERM) has continued to grow in recent years.

Increasing numbers of organizations have implemented or are considering ERM Programs unlike traditional risk management where individual risk categories are separately managed in risk “silos” or “stovepipe”, ERM enables firms to manage a wide array of risks in an integrated, holistic fashion (Liebenberg & Hoyt, 2006). ERM Also seeks to strategically consider the interactive, effects in various risk events with the goal of balancing an enterprise’s entire portfolio of risks to be within the stakeholders’ appetite or tolerance for risk (Beasley, 2006). In the face of major scandals leading to the collapse of big corporations, especially state owned ones, with disastrous social and economic consequences, it is inevitable that the wider society would start questioning how organizations in Kenya and the world at large were run. Most state corporations have performed poorly since inception and large amounts of money have been injected by the government to meet operating and capital expenses. In the 1990s many state corporations collapsed and closed shop due to mismanagement, conflict of interest by members of the Board, including the board chairmen.

The studies established whether necessary guidelines which give them capacity to identify the risk areas in the organization have been issued. Therefore, the study established the role of internal audit as a cornerstone to all other pillars of corporate governance in efficient implementation of enterprise risk management.

**Research Objectives**

i. To analyze the role of internal audit in implementing enterprise risk Management in state corporations in Kenya

ii. To identify the risk management practices adopted by state corporations in Kenya

**Hypothesis**

Ho- The risk management practice adopted by a corporation does not significantly affect Enterprise risk management
Empirical Review

Development of Enterprise Risk Management

D’Arcy (2001) has postulated that the origin of risk management was developed by group of innovative insurance professors i.e. Robert and Bob in 1950s. In the 1960s, the first risk management text titled ‘Risk Management and the Business Enterprise’ was published. The objective of risk management at that time was to maximize the productive efficiency of the enterprise. At that time, risk management was specifically focused on pure risks and speculative risks. In the 1970s, when Organization of Petroleum Exporting Countries (OPEC) decided to reduce production in order to increase the price, financial risk management became an interesting issue highlighted by firms because the increment in oil price has affected the instability in exchange rates and inflation rate (D’Arcy, 2001; Skipper and Kwon, 2007).

Later in 1980s, political risks attracted more attention from multinational corporations as a result of different political regimes in different countries, for example, when the Government announced a new policy, investors and corporations must make decision to reduce risk (Skipper & Kwon, 2007). According to D’Arcy (2001), during this era, organizations did not properly apply risk management because they did not apply the risk management tools and technique such as options. Therefore, it had increased the cost of operations to the organizations. During this era, the silo mentality still remains (Skipper & Kwon, 2007).

In the 1990s, the use of financial tools such as forwards and futures were widely practiced in the United States, in addition, pressure from shareholders and stakeholders to take more action rather than buying insurance to fight against uncertain loss or financial crisis, influenced managers to mitigate risks more proactively. It demanded managers to retrieve better risk information and risk management techniques. During this time, risk management was closely related to financial, operational and strategic risks, not only hazard risks (Skipper & Kwon, 2007). Hazard risk refers to any source that may cause harm or adverse effects such as equipment lose due to natural disasters for example, the Hurricane Katrina that happened in United States in 2005.

There are various risks that can occur. These include financial risk, strategic risk and Operational risk, financial risk refers to any loss due to economic conditions such as Foreign exchange rates, derivatives, liquidity risks and credit risks. Apart from the corporate scandals in Enron, WorldCom, Polly Peck and Parma, the last decade showed how serious the financial scandal was in corporations and banks (Jones, 2006; Benston, 2003). Another example was in 1994, the Orange County’s Investment Pool lost USD1.7 billion from structured notes and leveraged repo positions, while in 1995, Barings Bank and Daiwa Bank lost USD1.5 billion and USD1.1 billion respectively due to losses in futures and options trading and unauthorized derivatives trading. The same financial disaster occurred in 1996 when Sumitomo Corp. lost USD1.8 billion as a result of the actions of its head copper trader, Yasuo who secreted his activities in unauthorized copper trading on the London Metal Exchange (Holton, 1996; D’Arcy, 2001).

Li & Liu (2002) define strategic risk as the uncertainty of loss of a whole organization and the loss may be profit or non-profit, while Mango (2007) points out that there is no specific definition of strategic risk due to the inability to well-define and understand it. Strategic risk may arise from regulatory, political impediments or technological innovation. For example a specific guide titled Risk Management Principles for Electronic Banking was produced to ensure banks follow the 14 guidelines in providing internet banking services like electronic fund transfers as proposed (The Basel Committee, 2001). The Basel Committee (2001) define operational risk as the risk of direct or indirect loss resulting from inadequate or failed internal processes, people and systems or from external events. Operational risk is more related to internal problems, such as employee fraud, corporate leadership, and segregation of duties, information risk and product flaws for example, Marc Dreier was found guilty and charged for 20 years of imprisonment due to fraud of fictitious promissory Notes, which was valued at approximately USD700 million (Weiser, 2009).

Organizations face risks and the risks depend on many factors. For example operational risk, strategic risk, political risk, technology risk, legal risk, financial risk, reputational risk and human capital risk. Most of the literature mainly concern on four types of risk i.e. financial risk, hazard risk, operational risk and strategic risk (D’Arcy, 2001; CAS, 2003; Cassidy, 2005).

Cassidy (2005) found that Enterprise Risk Management existed in planning, Organizing, leading and controlling organizations activities in order to minimize firms’ major risks such as financial, strategic and operational risks.
As argued by Lam (2000), practicing Enterprise Risk Management should be observed upon three perspectives: globalization; changes in the role of risk managers; and regulatory. From the globalization perspective, it created multiple risks perceptions, fast growing technologies and interdependency of risks. From the role of risk manager, risks should not only be treated as a trouble, but also as an opportunity. Finally from the regulatory oversight factors perspective, appointing Chief Risk Officer (CRO) and the establishing Risk Management Committee (RMC), the adoption of ERM will become a reality.

ERM is important in many perspectives. There are four main reasons why US Companies exercise ERM (KPMG International, 2006). These are: the organization desire to reduce potential financial losses (68 percent); the organization desire to improve business performance (64 percent); due to the regulatory compliance requirements (58 percent); and the organization desire to increase risk. Accountability (53 percent), on the other hand, (PricewaterhouseCoopers, 2008) found that firms in Finland are motivated to implement ERM because of the following reasons: over 96 percent of the users want to adopt good business practice; more than 81 percent due to corporate governance pressure; 42 percent stated it gives them a competitive advantage; and more than 30 percent comes from regulatory pressure and also investment community pressure.

A New Era of Risk Management and the Internal Auditors’ Role

Wangai (2006) the Principal Auditor in the Ministry of Trade and Industry in his article ‘The role of internal audit in risk management in the Kenya trade and industry ministry’ quarterly publication observes that risk management is not just the responsibility of management. For risk management to be effective it must be implemented by every person in the organization. Risk management must become an integrated part of the organizations culture. Risk makers and risk takers must be risk managers. This is because we all manage risks consciously or unconsciously but rarely systematically. He further goes on to elaborate how the internal audit function would fit in this whole ERM through risk based audits. He notes that risk based audits will focus on the objectives of the ministry. The methods applied in developing the plan include identification of auditable entities; identification of risk factors in terms of both impact and likelihood; then ranking them and deciding on the audit profile depending on the risks identified.

In their Quality Assurance Review of the internal audit function paper, KPMG noted that, today, more than ever, there is increased demand for the internal audit function to add value to the organisation. Executive management is relying more on internal audit to identify, measure and control business risks. Audit committees are asking tough questions about the quality and effectiveness of their internal audit functions. The regulatory authority including Capital Market Authority, central government Regulations and Central Bank of Kenya expect internal audit to be the eyes of the Audit Committees. There is increased scrutiny of the function (KPMG-Kenya 2006). The changing business environment and ever-changing stakeholders’ expectations are not making the work of the internal audit any easier. Globalisation, organisational downsizing, new technologies, development of e-commerce and changes in executive management are a few examples of the forces driving change in internal audit.

Further, the scope of internal audit has expanded to include review of risk management and governance processes. Considering all these challenges, the demand to assess, benchmark and report on internal audit performance has increased (KPMG-Kenya, 2006). There are a number of questions that can help you determine whether your internal audit function is adding value to your organization, among them: Is the internal audit plan risk-based? Does it cover the right risks, thus supporting the organization in achieving its corporate objective? Is the function focused on a wide view of risks that go beyond business processes and focus on environmental factors (e.g. competitor, political, regulatory) for decision making? Is the function seen as the first part of call for advice or resource in the event of a problem in a business area? Is the function perceived as a business partner – helping management achieve their objectives in a controlled manner? Is internal audit appropriately sponsored to allow it to deliver the service required? Is it appropriately positioned on Management’s agenda? Does the internal audit develop effective communication strategies which impel management and employees to take action? Does internal audit report to an independent Audit Committee and is this done frequently (Kamau, 2006). These value adding question serve to point out the changing focus of internal audit to emphasis on risk management as seen from an enterprise wide point of view.
Internal Auditors Role in ERM

Internal auditors have the training and experience to identify and assess risk, and they have a broad view of their organization. This group is in an ideal position to take a key role in the ERM process. What exactly is that role, and what ERM activities can internal audit undertake while maintaining its independence and objectivity?

To address these questions, the Institute of Internal Auditors (IIA) issued a position paper titled ‘the Role of Internal Audit in Risk Management’ (2009). The IIA emphasizes that the board and management are responsible for actual risk management, and that internal audit’s role is to provide assurance on the process that management uses and to consult on ERM, provided the activity does not jeopardize internal audit’s independence and objectivity. To further clarify, the IIA provided examples of various roles that internal audit may and may not undertake in ERM. There are considerable opportunities for internal audit to broaden its traditional scope and add value to their organization’s ERM program.

Internal auditing may provide consulting services that improve an organization’s governance, risk management, and control processes. The extent of internal auditor’s consulting in ERM will depend on the other resources, internal and external, available to the board and on the risk maturity of the organization and it is likely to vary over time. Internal auditor’s expertise in considering risks, in understanding the connections between risks and governance and in facilitation means that the internal audit activity is well qualified to act as champion and even project manager for ERM, especially in the early stages of its introduction.

As the organization’s risk maturity increases and risk management becomes more embedded in the operations of the business, internal auditor’s role in championing ERM may reduce. Similarly, if an organization employs the services of a risk management specialist or function, internal auditing is more likely to give value by concentrating on its assurance role, than by undertaking the more consulting activities. However, if internal auditing has not yet adopted the risk-based approach represented by the assurance activities, it is unlikely to be equipped to undertake the consulting activities.

Some of the consulting roles that the internal audit activity may undertake are: Making available to management tools and techniques used by internal auditing to analyze risks and controls, being a champion for introducing ERM into the organization, leveraging its expertise in risk management and control and its overall knowledge of the organization, providing advice, facilitating workshops, coaching the organization on risk and control and promoting the development of a common language framework and understanding and acting as the central point for coordinating, monitoring and reporting on risks and supporting managers as they work to identify the best way to mitigate a risk.

The key factor in deciding whether consulting services are compatible with the Assurance role is to determine whether the internal auditor is assuming any management responsibility. In the case of ERM, internal auditing can provide consulting services so long as it has no role in actually managing risks - that is management’s responsibility and so long as senior management actively endorses and supports ERM.

Internal auditing may extend its involvement in ERM provided certain conditions apply. The conditions are: It should be clear that management remains responsible for risk management, the nature of internal auditor’s responsibilities should be documented in the internal audit charter and approved by the audit committee, internal auditing should not manage any of the risks on behalf of management, internal auditing should provide advice, challenge and support to management’s decision making, as opposed to taking risk management decisions themselves, internal auditing cannot also give objective assurance on any part of the ERM framework for which it is responsible. Such assurance should be provided by other suitably qualified parties. Any work beyond the assurance activities should be recognized as a consulting engagement and the implementation standards related to such engagements should be followed.

In conclusion, 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. Enterprise-wide risk management (ERM) brings many benefits as a result of its structured, consistent and coordinated approach.
Executive Leadership and Top Management Involvement in Risk Management

During the forum "Internal auditing in the public sector: a consultative forum in Nairobi, Kenya, shore up best practices for government audit professionals in developing nations" held in 2005, six main themes—perception and ownership, organization and governance framework, legislation, improved professionalism, a conceptual framework, and resources—were identified as crucial in building an effective internal audit function in the participating countries. Key among these themes is perception and ownership. The organization's leadership sets the tone by establishing governance, risk Management, and control systems and consistently applying sanctions, forum participants agreed. The internal audit function assesses that these systems work effectively and efficiently, internal audit function will assist management in decision-making, and thus will fill a more proactive and forward-looking role. It is seen as vital that the internal audit function establish priorities for effective and efficient service delivery. Management will then view the internal audit function not as "nit-picking" and a burdensome over-head cost, but as truly adding value to the organization's objectives.

Indeed, strong, active leadership support to improve governance is the over-whelming prerequisite for successful reform of internal auditing in the public sector. Buy-in and active involvement are needed from the head of internal auditing, senior management, audit staff, accounting officers, and senior operational management. For sustained change, internal cooperation is not enough. External relationships must be cultivated as well. Stakeholders and policy- and decision-makers must be kept aware of changes, reforms, and improvements in internal auditing, so they will take into account the contributions internal auditing can offer.

Research Methodology

This study was carried out through a survey of different respondents in the Kenyan public sector. It was carried out as a cross-sectional survey focusing on the state corporations operating in Kenya between January and July 2013. The target population was comprised of Chief Executive officers, financial officers, Directors, Operational Management, Corporate Planners or Heads of Internal Audit in 9 state corporations in Kenya. Data was collected using a standardized questionnaire.

The study used Pearson’s Product Moment Coefficient to show the relationship between the variables. An empirical model was built by applying logical regression on determinants of the enterprise risk management. The empirical model is as follows (Walker, 2006), Enterprise risk management = f (role of internal audit, risk management practice, staff capacity, management and staff commitment).

Empirical of Findings and Recommendations

The study found out that the core role of internal audit in relation to ERM is to provide assurance to the organization about the effectiveness of risk management. When internal auditing extends its activities beyond this core role, it should apply certain safeguards, including treating the engagements as consulting services and, therefore, applying all relevant Standards. In this way, internal auditing will protect its independence and the objectivity of its assurance services. Within these constraints, ERM can help raise the profile and increase the effectiveness of internal auditing. The results on first hypothesis on role of internal audit in implementing enterprise risk Management at 0.05 level of significance indicate a moderately strong positive and Significant correlation between role of internal audit and implementation of enterprise risk management (r=0.586, p= 0.000).

The null hypothesis is therefore rejected. This meant that role of internal audit positively and significantly affected implementation of enterprise risk management in State Corporation. From the study, state corporations do not carry out an enterprise-wide management of risks, even though effective risk management is critical in achieving the goals and objectives of their organizations. The reason for this is that risks curtail achievement of an organization’s goals and objectives.

It was evident that most state organizations’ current risk management practices support strong corporate governance. The COSO-Integrated Control Framework is the most widely used risk management framework. In line with the findings and conclusions arrived at, the study recommends that: Enterprise risk management strategies employed by state corporations should support strong corporate governance. This will ensure effective and responsible management of these entities as required by the public. State corporations should ensure effective strategic risk management since this is critical in achieving the goals and objectives of their organizations.
There is need to establish measures that will encourage every individual to be committed to the achievement of organizational objectives. In this way they will render their commitment and support to internal audit function. Enough resources should be provided for personnel to carry out effective risk management and internal controls. These personnel should also be well equipped to carry out current and proposed activities of the institution.

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