Internal Control Guide & Resources

Section 4- How to Conduct a Risk Assessment

Performing risk assessments assists managers in prioritizing the activities where controls are most needed. Keep in mind that the objective of a risk assessment is to attain a "reasonable" level of assurance that the organization's financial and compliance goals will be achieved. Trying to attain an absolute level of assurance is not possible due to the following reasons:

- It is cost-prohibitive. The objective is to find an optimal level of control for an acceptable level of risk.
- Management can potentially bypass or override the internal controls.
- Employees may collude with each other.
- Human error may occur.

When conducting a risk assessment, the following steps should be followed:

1. Identify all significant activities or processes for which you are responsible. To simplify this task, we suggest grouping activities of the program or function into control cycles. A **control cycle** is a group of actions used to initiate and perform related activities. Control cycles provide the focal point for evaluating internal controls.

2. Make sure that the activities (or processes) for which you are responsible have clear and measurable objectives.

3. Identify the inherent risks for each activity/process.

a. Examples include complex programs or activities, cash receipts, providing services through sub-recipients or vendors, direct third party beneficiaries, and prior problems. Activities with inherent risk have a greater potential for loss from fraud, waste, unauthorized use, or misappropriation due to the nature of the activity or asset. Cash, for example, has a much higher inherent risk for theft than a stapler.

b. Determine if any of these situations apply to the activity/process:

i. *High Complexity*- Complexity increases the danger that a program or activity will not operate properly or comply fully with applicable regulations.

ii. *Third party beneficiaries* are more likely to fraudulently attempt to obtain benefits when those benefits are similar to cash (for example food stamps).
iii. *Decentralization* increases the likelihood that problems will occur. However, a problem in a centralized system may be more serious than a problem in a decentralized system because if a problem does exist, it could occur throughout the entire department.
iv. *A prior record of control weaknesses* will often indicate a higher level of risk because bad situations tend to repeat themselves.
v. *Unresponsiveness to identified control weaknesses* by prior auditors often indicates that future weaknesses are likely to occur.

4. Ask yourself the following questions:

- What could go wrong?
- How could we fail?
- What must go right for us to succeed?
- Where are we most vulnerable?
- What assets do we need to protect?
- How could someone steal from the department?
- How could someone disrupt our operations?
- What information do we rely upon the most?
- What do we spend the most money on?
- How do we collect money?
- What decisions require the most judgment?
- What activities are regulated?
- What is our greatest legal exposure?

5. Review changes. The risk to reaching objectives increases dramatically during a time of change. Consider various external and internal risk factors such as:

- Changing economic and political conditions
- New technology
- New accounting standards
- Changes in personnel, for example after a new administration
- New or modified information systems
- New programs or services
- Reorganization within or between state agencies
- Rapid growth
- Increased delegation of spending authority
- Moving to a new location

6. For each identified risk, evaluate the potential impact (minor, moderate, or severe) on your agency that would occur if such an event were to happen. Then estimate the likelihood (unlikely, likely, very likely) that such an event might happen.

7. Based on these two estimates, rank the risks so that you can identify which risks should be addressed first. Ask yourself how your agency can best manage the risks you have identified.

Risk Evaluation

		Impact		
		Minor	*Moderate*	*Severe*
Likelihood	*Very Likely*	Medium Risk	High Risk	Extreme Risk
	Likely	Low Risk	Medium Risk	High Risk
	Unlikely	Low Risk	Low Risk	Medium Risk