

Dear Q&A

Should 'likelihood' be a primary consideration when rating an observation in an internal audit report?

Risk management is built around likelihood and consequence of something happening. My internal audit function has recently been challenged on how we rate audit observations. There is a view that likelihood should not be a primary consideration when rating an observation in an internal audit report. The logic seems to be that an observation has occurred and is therefore an issue (something that has happened) so likelihood is absolute and consequence (impact) should be the only consideration. They are therefore suggesting an 'impact only matrix' that does not include likelihood within the matrix. As an internal auditor, I have always used likelihood as a key component when assessing risk severity of an audit observation.

#### Answer

When we rate our audit observations, we are signalling to management how important we think it is that action to resolve the issue should be taken. Ratings are considered by the 'International Standards for the Professional Practice of Internal Auditing' as a way of expressing the results of an engagement, but they are not mandatory and the 'International Professional Practices Framework' (IPPF) does not tell us how to express them. There is some advice in Internal Audit Standard 2410.A1 'Criteria for Communicating' – ".....An opinion [ratings are considered one way of expressing an opinion] must take into account the expectations of senior management, the board [audit committee], and other stakeholders.....".

For management and the audit committee, there are two things that drive action:

- › Addressing a matter of strict liability, for example matters arising from work health safety breaches.
- › The benefit to be gained opposed to cost of the solution.

Our focus as internal auditors as stated in the 'Core Principles for the Professional Practice of Internal Auditing' is to promote organisational improvement.

It is helpful to senior management and the audit committee if internal audit report ratings can be compared in some way to the risks of the organisation.

If an identified weakness is generating consequences for the organisation, then risk rating makes little sense. The cost / accumulating cost to the organisation should be estimated instead. The dollar value of accumulated consequences over a 12-month period may be a good basis on which to rate or rank an observation. The proposed solution can then be costed and compared to this figure. Admittedly, the dollar value of some consequences may be difficult to estimate, although risk modellers can probably even value things like reputation or customer satisfaction.

If the identified issue is not currently generating consequences, then we are trying to quantify a risk. If the measure of likelihood is based entirely on estimation, there is a strong possibility it will be inaccurately estimated – human beings have a propensity to allow personal experience to influence their assessment of likelihood, rather than the real world as a whole. So, whenever it can be applied, use real world data to make estimates.

We are much better at estimating the worst conceivable case, but this does not necessarily make things any easier for us. If the worst conceivable case is extremely serious, for example injury / death or complete loss of a computer system, we must deal with it regardless of likelihood. If the worst conceivable case is not in the class of 'catastrophic' we are left with asking ourselves how likely it is – or we need to

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think about what the most likely consequence is. None of this is easy. Once again, use of real world data is best wherever possible.

The risk estimation process was addressed to some extent in HB 158:2010 'Delivering assurance based on ISO 31000:2009 Risk management – Principles and guidelines'. This was a joint publication between the IIA and Standards Australia – it has not been updated to reflect the ISO 31000 update in 2018.