

CHAPTER ONE

INTRODUCTION

Risk-Based Audit Approach In The Internal Audit Department Of A Financial Institution (A qualitative study)

1.1 Introduction

Internal auditing is an independent appraisal function to examine and evaluate organizational activities. Internal auditors assist the management and the Audit Committee of the Board of Directors to meet the organization's objectives by promoting effective controls at a reasonable cost. Internal auditing furnishes top management with analyses, recommendations, counsel and information concerning the activities they have reviewed. Working in partnership with the Audit Committee of the Board and management, internal auditors can provide a thorough assessment of the risks and implications of business decisions and ultimately contribute significantly towards the success of an organization.

In the past, the internal auditing approach had been very much procedures or process driven. However, lately, there is increased emphasis on the risk-driven approach for achieving higher effectiveness and efficiency in internal auditing. Although historically, internal auditors have used some form of risk assessment in their annual audit planning, the concept of focusing on business risk as the basis for conducting the entire internal audit process is rather new. This emerging internal audit paradigm focuses on business risk rather than internal controls, establishes "partner" relationships as a critical component of the internal audit methodology and fully embraces a proactive (and even coactive) internal audit vision. In the traditional audit, the internal auditor focuses on internal controls, and controls after controls are recommended and built

into the existing processes to further strengthen the control environment with hardly any consideration given to the business risks.

A Risk-Based Audit (RBA) goes one step further and focuses not **only** on audit risk, but also on the organization's business risks – those risks **which** can affect a company's profitability and which hold the key to its **survival**. In order to analyse the business risk of a particular organization, the auditor must look into the business processes of the organization to understand how it operates as well as the short and long term **business** risks that the company faces. In this way, the auditor can **provide** management with an independent assessment based on all the risk factors affecting a particular business.

1.2 **Objectives of the Study**

The objectives of the study are:

- a) to evaluate the differences between the traditional audit approach and risk based auditing approach
- b) to review problems in relation to the implementation of the RBA methodology in a financial institution including the issues and challenges involved in the transformation from a traditional audit approach to a risk based auditing approach
- c) to provide some recommendations and solutions to **smoothen** the transformation process from the traditional audit approach **to** the risk based auditing approach.

1.3 **Research Methodology**

The approach used for this research is that of a case study method. This method is defined as a comprehensive description and analysis of a situation relating to the research problem. In this paper, the case study

approach involves an in-depth consideration of the issues and challenges faced by the internal audit department of a financial institution in transforming its traditional auditing approach to the risk-based auditing approach including the implementation strategy adopted by the internal audit department. The financial institution shall henceforth be referred to as ABC Bank Bhd.

The information and data in relation to this research were obtained through the following methods:-

- a) interviews with the project management team and staff of the internal audit department
- b) observation on auditing activities
- c) review of reports, manuals and other related documentation
- d) review of journal articles relating to risk-based auditing approach.

1.4 **Significance of Study**

There has been little research done to review the implementation strategies of internal audit departments that had successfully transformed their traditional way of auditing to the RBA approach. This study analyses and evaluates the issues and challenges faced by an internal audit department of a local financial institution in implementing the RBA methodology in their audit process. It is hoped that it will provide a source of reference and possible solutions to practitioners who intend to transform their traditional auditing approach to the RBA approach.

1.5 **Organization of Report**

The report consists of 7 chapters. Chapter 1 discusses the objectives of study, significance of study, research methodology and relevant literature on the subject concerned.

Chapter 2 presents the scope of work of an internal auditor, definition and concept of risk-based auditing approach and provides comparison between the traditional auditing approach and risk-based auditing approach. Furthermore, it explains the reasons/motivations world organizations are transforming or have changed from a traditional auditing approach to one of a risk-based approach.

Chapter 3 briefly describes the background of ABC Bank Bhd and its internal audit department including the organizational structure of the department, its people and the infrastructure. The background information is to provide a preliminary understanding of the issues and challenges faced by the internal audit department of the Bank in implementing the risk based auditing approach, which is the subject of the case study. The chapter also explains the functions and objectives of the internal audit department, its reasons and motives to embark on the risk based auditing approach.

Chapter 4 describes the risk based auditing (RBA) methodology that has been adopted by the internal audit department of ABC Bank.

Chapter 5 discusses the issues and challenges and the practical problems faced by the internal audit department including the training and enhancements to be made on the existing infrastructure. The chapter also explains the key success factors for the success of its implementation.

Chapter 6 discusses the stages in the implementation of the RBA methodology planned for the internal audit department.

Chapter 7 summarizes and presents the conclusions of the study.