

CHAPTER THREE

ABC BANK AND ITS INTERNAL AUDIT DEPARTMENT

3.1 Brief Description Of The Organization Concerned

ABC Bank was established in 1960 and the parent institution, operating as a commercial bank, is both the holding company and major operating entity of the financial services group. Through subsidiary companies, the organization is also involved in merchant banking, general finance, discount houses operations, stockbroking, general insurance, leasing, factoring, trustee and nominee services and fund management. ABC Bank also has an offshore bank subsidiary operating in Labuan offshore financial centre.

ABC Bank has more than 290 branches staffed by approximately 13,000 staff, making it one of the largest banking groups in the country's banking fraternity. The bank itself has representative offices in Myanmar, Vietnam, Phnom Penh and the People's Republic of China. Additionally, ABC Bank has a wholly owned subsidiary in Papua New Guinea with two branches, a majority-owned subsidiary in Philippines and a joint-venture bank in Indonesia.

3.2 ABC Bank's Risk Profile

Among the major risks faced by ABC Bank are credit risk, market risk, liquidity risk, operational risk, competitor risk as well as customer satisfaction risk. Credit risk is the risk of non-payment due to the inability or unwillingness of a customer or a counterparty to meet its financial obligations with ABC Bank. Exposure to credit risk arises primarily from lending, trade finance and treasury activities. Additionally, market risk encompasses price and interest rate risks, all of which arise in the ordinary course of the Bank's business. Price risk is the risk to earnings

that arises from changes in interest rates, foreign exchange rates, equity and commodity prices, as well as in their correlations and volatilities. Liquidity obligations arise from withdrawal of deposits, repayments of purchased funds at maturity, extensions of credit and working capital needs. ABC Bank needs to manage its liquidity risk across all classes of assets and liabilities to ensure that even under adverse conditions, it has access to funds at a reasonable cost. On the other hand, operational risk is the potential exposure to financial or other damage arising from inadequate or failed internal processes, people and systems, including disruption of business. Actions of competitors or new entrants, including newly merged entities that threaten ABC Bank's competitive advantage or even its ability to dominate the market is defined as competitor risk. These actions include introducing of new products to the market, improve product quality, increasing productivity and reducing costs. Customer satisfaction risk is a result of lack of focus on customers which threaten ABC Bank's ability to meet or exceed customer expectations. The consequences of dissatisfied customers are severe which could lead to permanent loss of repeat business, declining revenues and loss of market share.

3.3 The Internal Audit Department

The overall vision or strategy of ABC's internal audit department is to be on par with the rest of the world. It intends to achieve the vision through benchmarking itself against best, global practices especially guidelines or standards espoused by the Institute of Internal Auditors. In addition, being a financial institution, ABC Bank Bhd would also consider guidelines suggested by the Basle Committee as well as Bank Negara Malaysia.

The internal audit department of ABC Bank believes that with RBA approach, it would provide better value-added service to the organization by being able to detect weaknesses, and improve these areas by

recommending controls to manage such weaknesses. In order to do that, the internal auditors should have the competency and skills to be able to balance the role between auditor and consulting activity besides providing assurance on the operations of the bank. Additionally, nowadays, the banking industry is very competitive and one of the management's initiatives is to reduce cost without compromising on quality. Every body is concerned with the bottom line in order to stay ahead. Therefore, another objective of implementing the RBA approach is to reduce the number of auditors without sacrificing the quality of audit work.

Under the traditional auditing approach, the audit plan is based on the audit cycle of 18 months as well as audits required under the statutory requirements, for example, Bank Negara Malaysia or the Kuala Lumpur Stock Exchange rules and regulations. However, the internal audit department realized that with the traditional method, more manpower will be required to ensure that all auditable areas identified in its audit universe are eventually audited rather than focusing on auditable areas which are rated as extremely high risks. This is because as one of the anchor banks of the country, ABC Bank had recently merged with two other banks thus resulting in an increase in the number of branches to be audited. Furthermore, in line with its expansion plans, ABC Bank is planning to open a branch in Bahrain.

Although there was some form of risk assessment in the past, the audit plan was designed firstly, by the audit universe and secondly, by the risks of the location. Using the risk based auditing methodology, the audit planning takes into consideration the risks prevalent in the organization and locations rated with high risks are given higher priority as compared to locations which are rated with low risks.

According to the audit manual of the ABC Bank, the primary functions of the internal audit department are to :-

- Determine the adequacy and effectiveness of the system of internal controls
- Review operations and programmes to ascertain whether performance meets established objectives
- Appraise the economy and efficiency with which resources are employed
- Determine the reliability and integrity of information and the means used to identify, measure, classify and report such information
- Determine the integrity of means for safeguarding assets and verify the existence of such assets
- Review the established systems to ensure compliance with policies, plans, procedures, laws and regulations.

These functions were already in existence in the internal audit department of ABC Bank Bhd prior to the adoption of the RBA approach. However, with the RBA approach, the internal audit department is able to play a more dynamic and proactive role in the organization by being more risk-focused. This is because the RBA methodology is a new approach that the internal auditors use in the performance of the audit functions to provide value add to the organization.

In order to fulfil these responsibilities, an audit plan outlining the areas to be audited is developed annually. The annual audit plan is a product of considerable planning and forethought. For example, the audit universe or all auditable units of the financial institution contains approximately 300 auditable areas. Each year, the internal audit department will determine which areas to audit. Using the rule of thumb, at least 75% of the audit universe needs to be audited by the internal audit department in a

particular financial year. However, the auditable areas chosen to be included in the audit plan should suit the following criteria determined by the management of the internal audit department with the Chief Internal Auditor's concurrence:

a) Statutory requirements.

As any other financial institution, ABC Bank Bhd is governed by the requirements espoused by the Bank Negara Malaysia. For the internal audit department, it is required to comply with the requirements stipulated in the Minimum Audit Standards for Internal Audit Departments of Financial Institutions issued by Bank Negara Malaysia. According to the Standards, areas which are deemed critical to the operations of the financial institutions such as funds transfers, derivatives operations, credit and lending operations and treasury operations are required to be audited at least once a year. In addition, under the KLSE requirements, the internal auditors of stockbroking companies have to audit the clearing accounts of the company. The internal auditors are also required to ensure that proper monitoring controls are in place in relation to the measurement of the capital adequacy ratio of the company and that the minimum capital adequacy ratio is complied with. Since one of the subsidiaries of ABC Bank is a stockbroking company, the internal audit department has to place cognizance to this KLSE requirement.

b) Period since last audited

If a particular area has not been audited at least for the past 18 months, it should be incorporated into the current year's audit plan.

c) Risk assessment analysis

Some form of risk assessment analysis is performed by the individual units/sections within the internal audit department. The

purpose of the risk assessment performed was mainly to arrange the sequence of the audits to be performed for the year as well as to determine which areas within the auditable areas that need to be audited and which areas could be excluded in the current year's audit. For example, the internal auditor planning an audit of a particular section in the financial institution such as the treasury department may decide not to audit the process of reconciliation of confirmation slips against original deal tickets. His or her assessment is based on the fact that the process was automated and that there were no particular significant findings relating to that process in the past audit reports.

3.4 Organization Structure, Size and Reporting Responsibilities of the Internal Audit Department

In ABC bank, the internal audit department reports directly to the Audit Committee of the Board (ACB). The ACB appraises the performance of the Chief Internal Auditor in conjunction with the performance/work performed by the internal audit department in the financial year. All reports are presented to the ACB and the Internal Audit Committee (which comprises senior management, for example, the Managing Director, Executive Directors, General and Assistant General Managers of the organization). The ACB assumes ultimate responsibility for the audit activities conducted in the organization and the annual audit plan is presented to the Committee for their endorsement and approval. Any strategic direction of the internal audit department is deliberated and approved at the Committee level. In fact, the move towards the RBA approach was initiated and driven by the ACB.

The internal audit department needs to coordinate and cooperate with the external auditors to ensure adequate audit coverage and to minimize

duplication of efforts. In addition, such co-ordination also prevents disruption of operations and optimizes the degree of reliance placed by the external auditors on the internal audit work performed. This co-operation promotes rationalization and optimization of the total audit exercise.

The organization structure of the internal audit department at ABC Bank is tabulated in Appendix 1. On the vertical boxes, the structure is very much determined by the main functions of ABC Bank Bhd, that is, banking, insurance, investment banking and asset management. Additionally, the banking group is divided into two sections, that is, Banking I which covers ABC Bank's branches whereas Banking II covers the head office departments and support centres of ABC Bank Bhd. The horizontal boxes are divided according to ABC Bank's major risks areas such as credit, information technology (IT), market, fraud risks sections. The motive behind such organization structure is to ensure specialization in the major risks encompassing ABC Bank such as credit default risk, collateral risk, market and liquidity risk, data integrity risk, access and security risk. However, the implementation was not really successful as the areas of coverage by the specialists are currently very much focused on the banking sector (due to historical reasons) rather than on other areas of ABC Bank such as insurance and investment banking services. Furthermore, although the abovementioned risks are some of the more major risks faced by ABC Bank, the organization structure did not encompass other equally or more important risks faced by the organization such as operational risks, strategic risks and human resources risks.

3.5 **People**

The internal audit department is currently staffed by more than 300 personnel and these include the administrative, secretarial services and

training support staff as well as their Singaporean and Philippines counterparts. This is considered as a significantly large staff force by banking standards. Hence, one of the intentions of the Audit Committee of the Board (ACB) in embarking on the risk based auditing approach project is to reduce the size of the staff force.

Currently, the entry level for auditors in the internal audit department is not restricted to, university degrees or equivalent professional qualifications. As a result, the audit staff comes from rather diversified background such as marketing, agriculture, banking, accounting and finance. There is no requirement for the audit staff to undertake any specific examinations in order to attain a certain standard of auditing excellence. Furthermore, the majority of the more senior auditors are from the rank and file order, that is, from clerk to officers with minimum number of staff holding tertiary qualifications.

The majority of the audit staff are stationed under Banking I, where the focus is to audit a pre-determined number of branches nationwide of ABC Bank Bhd as required by ACB. As the branches are considered homogenous in their business and transactions, there is a standard audit programme which the auditors from Banking I are expected to adhere to. A review of the audit programmes revealed that it is more compliance driven, that is, its main objective is to assess compliance with the relevant policies and procedures of the financial institution rather than focusing on the areas of risk. On the other hand, for auditors in the Banking II section, investment banking and asset management and IT audits sections, there are some elements of risk assessment during the planning stage of the audit. This is due to the nature of the audits which are different from one auditable area to another. For example, the audit team leaders of these sections will propose the more high risk areas to be audited in the audit plan. Subsequently, the respective audit plan will be reviewed and

approved by the managers of the department. Upon approval, the appropriate audit programs will be drawn up according to the risk areas proposed by the audit team. However, the fallback of the current system is that it is more of a bottom up approach rather than top down approach in the risk assessment process. Most auditing literature propagates that the risk assessment stage should be a top-down process and it should be carried out by senior level auditors which includes not only the team leaders but also the managers involved in the audit assignment. The involvement of the managers is critical because they are more privy to internal on-goings of the organization as well as the direction of management as compared to the field auditors. Furthermore, the risk assessment process should be done upfront prior to execution of fieldwork audit to facilitate identification of locations to be audited based on risks rather than identification of the location and subsequently, a risk assessment performed on the audit location.

For the audit staff under the Investigation Department, their roles and responsibilities are more focused on investigating any irregularities as requested by management, for instance, bribery, illegal acts, cash shortages and employee or management frauds. There is no proper risk assessment mechanism in place to facilitate them in providing value-add information to the audit planning process of the department. For the staff under the Credit Risk section, their roles and responsibilities are to perform a quality assurance review of the credit papers approved by the Finance Committee of ABC Bank. This is required under the Bank Negara Malaysia guidelines, that is, to allocate independent staff to review the quality of the credit papers approved by management. Lastly, for the staff under the Market Risk Department, their functions are to perform research activities relating to market risks in ABC Bank and lend support to the field auditors performing the audits where market risks exist. As briefly explained above, although the organization structure depicts some form of

risk focused internal audit approach, the nature of the audit processes that are being carried out are more in accordance to the relevant statutory audits or requirements or what is considered as “putting old wine into new bottle.” There is no actual transformation in the way the audit is being carried out.

3.6 Technology

The internal audit department of ABC Bank is housed by a LAN system which allows multiple users to access the various application programs available and database of audit files, for example, audit reports and audit programmes. Working papers are still manually prepared and maintained in current and permanent paper and box files. For field auditors, each team leaders are supplied with a laptop that facilitates documentation of audit findings and audit report. Although there is some form of usage of the Computerised Assisted Auditing Techniques (CAATS) by the field auditors, the usage is not extensive and it is confined mainly to the insurance and the credit field auditors. The limited application of CAATS is probably due to the lack of on-the-job training and IT knowledge of the staff concerned.

Under the RBA approach, there is a need to enhance the existing technology so that working papers can be maintained electronically and relevant templates and the risk dictionary can be retrieved easily. Furthermore, the audit staff needs to be properly trained to use the CAATS more regularly and effectively in their audits.