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THE FIRST OF TWO ARTICLES INTRODUCING ISLAMIC BANKING AND FINANCE CONCEPTS

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Also in this issue

BASEL SETS THE STANDARD...IS YOUR BANK INTERNAL AUDIT FUNCTION UP TO IT?

Peter J Hughes, Head of Risk & Internal Audit at Risk Reward Ltd, (former Head of Internal Audit, ChaseManhattanBanco, Brazil), is a risk-based bank internal auditor co-sourcing and training in emerging markets. Two recent assignments, one for a Gulf bank and one southern Africa bank led him to suggest here it is worth investing in a high quality, modern risk-based audit function as one major positive step towards meeting Basel requirements and preventing the next financial crisis.

In October 2006 the Basel Committee on Banking Supervision issued its Core Principles Methodology which sets the standards for the prudential regulation and supervision of banks. Among its 25 principles is Principle 17 that addresses internal audit and control. Specifically, with respect to Internal Audit, supervisors will need to conclude whether a regulated bank:

- "has sufficient resources and staff that are suitably trained and have relevant experience to understand and evaluate the business they are auditing;
- has appropriate independence, including reporting lines to the Board and status within the bank to ensure that senior management reacts to and acts upon its recommendations;
- has full access to and communication with any member of staff as well as full access to records, files or data of the bank and its affiliates, whenever relevant to the performance of its duties;
- employs a methodology that identifies the material risks run by the bank;
- prepares an audit plan based on its own risk assessment and allocates its resources accordingly; and
- has the authority to assess any outsourced functions."

Apart from setting high expectations, Principle 17 expects Internal Audit departments to have a methodology that identifies material risks and an audit plan based on its own risk assessment. In other words, there is an expectation that banks will have adopted risk-based audit approaches.

So what is risk-based audit? In his book Phil Griffiths[1] describes risk-based auditing as, 'a process, an approach, a methodology and an attitude of mind rolled into one'. This may seem a little vague. But there's a good reason for this vagueness because there's no standard risk-based 'one-size-fits-all' audit template. Quite simply, it's about being totally professional.

The best analogy for risk-based audit is to be found in a doctor's surgery. The good, professional doctor is highly trained to recognise and interpret the symptoms of ill health, makes enquiries to understand what the patient is suffering or potentially could suffer, conducts an examination to identify and assess the causes of the suffering, decides on a course of treatment to remediate the causes and monitors the patient to ensure that the course of treatment is being adhered to and having the desired effect.

This doctor analogy applied to banking is what risk-based auditing is. Gone are the standard audit checklists and audit programmes that are applied systematically and repetitively and, sometimes mindlessly. Gone are the audit reports that only discuss what the auditor did and found with the accompanying exception statistics. Gone is the auditor who sits in judgement of management and staff to declare them 'satisfactory' or 'unsatisfactory' or even 'marginally satisfactory'.

Instead we have a new breed of auditor who has in-depth understanding of the business, knows how to identify and assess the risks inherent in the business, is able to apply expertise and creativity to suggest and agree with management how identified risks can be most effectively mitigated and writes audit reports that explain the risks with appropriate quantification, the actions agreed to mitigate the risks to acceptable levels and details of the cost benefit of such actions and their risk reduction impact.

Many banks now perceive a need to modernise their internal audit function. Indeed, Risk Reward is advising a number of clients on audit modernisation programmes and providing immediate solutions through co-sourcing[2] and training.

It's a moot point whether higher standards of auditing would have prevented the current financial crisis and the concomitant failures, bailouts and nationalisations that affected banks of all sizes. But one thing is for certain... it's probably worth investing in a high quality, modern audit function as one major positive step towards preventing the next financial crisis.

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[1] *Risk Based Auditing* by Phil Griffiths, published by Gower Publishing Limited

[2] Refer to the article in the Risk Update Q1 2009 *'Co-Sourcing or the New Way to Ensure Audit Excellence'*