INTERNAL AUDITING - PUBLIC SECTOR OF THE SARAWAK STATE GOVERNMENT

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Kota Samarahan
2002
INTERNAL AUDITING – PUBLIC SECTOR OF THE SARAWAK STATE GOVERNMENT

By

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A Research Paper Submitted in Partial Fulfillment of the Requirement For the Degree of Corporate Master in Business Administration Faculty of Economics and Business Universiti Malaysia Sarawak 2002
I certify that I have supervised and read this study and that in my opinion it conforms to acceptable standards of scholarly presentation and is fully adequate, in scope and quality, as a research paper for the degree of Corporate Master in Business and Administration.

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Supervisor

This research paper was submitted to the Faculty of Economics and Business, UNIMAS and is accepted as partial fulfillment of the requirements for the degree of Corporate Master of Business and Administration.

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DECLARATION AND COPYRIGHT

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I hereby declare that this research is the result of my own investigations, except where otherwise stated. Other sources are acknowledged by footnotes giving explicit references and a bibliography is appended.

Signature : ----------------------------------------
15th April 2002
Date : ----------------------------------------

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DEDICATION

This project paper is for
my wife, Siti Zaiton Hj. Jahidin with love and affection
and also to my handsome and beautiful children, Shazrul Jizan
Jeman,
Effa Nurfasya Jeman, Fatin Nadzirah Jeman and Faiz Nurhan Jeman
To whom I promised five years ago that I could obtain this
prestigious Corporate Master Of Business Administration (CMBA)
on a part time basis and on a constraint budget.

To all of you knowledge is power and never stops learning!

Menuntut ilmu adalah taqwa
Menyampaikan ilmu adalah ibadah
Mengulang-ulang ilmu adalah zikir
Mencari ilmu adalah jihad
‘Al-Ghazaly’
ACKNOWLEDGEMENTS

This project paper is truly the synergistic product of a team of people. Without their tireless, wholehearted, unique contributions it never would have come about. I express my deep appreciation to them:

-my supervisor of this project paper, Associate Professor Dr. Sazali Abu Mansor, the Dean Faculty of Economic and Business for his remarkable judgment and counseling on many key issues, invaluable advice, guidance and support that enable me to complete this project paper on time.

-The Honorable State Secretary, Yang Berhormat Datuk Amar Abdul Aziz Hussein for his support of government servant to pursue further education as well as the Sarawak State Government for the scholarship that enable me to finance this CMBA program.

-my immediate head Encik Ien Talif Salleh who is our Acting General Manager,STIDC for his patience in handling and understandings the problems faced by part time student like us.

-my Brother-in-law, Yang Berhormat Encik Abdul Wahab Aziz, for his lifelong loyalty and friendship, his inspiration to me in the development of the ideas in this project paper.

-to the happy memory of my late father who brought up all the nine children.

-my mother, Hajjah Mordiah Ekram, who taught me to keep learning all these years in time of sorrow and happiness.

-my internal audit friend Tuan Hj. Yusuf Bin Hj. Bujang, the internal auditor attached to the State Internal Audit Unit to whom I seek for comment and advice.

-all the lecturers that had taught me through this master degree course in CMBA.

To all of you, may Allah bless you always.
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ABSTRACT

The main area of concerns or problems to investigate are whether the public sector of the Sarawak state government are moving toward a more professional approach in the current practices of internal auditing and simultaneously to find out the reason why the Institute of Internal Auditor, Malaysia (IIAM) are not eager to organize courses or seminars in Sarawak.

The method of collecting primary and secondary data respectively was by distributing questionnaires and by telephone interview as well as through books, magazines and through the Internets. All the fourteen government departments and statutory bodies are chosen as 100% sampling area. The statistical method used is based on frequency and percentages with the assistance of the SPSS software.

The main results are that the internal audit units in the public sector of the Sarawak state government are moving toward a more professional approach in the current practices of internal auditing based on the reasons that they are practicing risk management, corporate governance, internal controls and fraud investigations which are good practices of internal auditors. The use of audit software proved that the internal auditors have upgrade their talents and skills in the use of latest technology as well as attending the latest seminars and courses to keep abreast of the current situations. The cooperation of the Sarawak District Society of the Institute of Internal Auditors, Malaysia, The Centre for Modern Management and the various Associations-Association of Business Scholars (Unimas) and UiTM Alumni Associations of Sarawak (MITSA) are needed to promote the internal auditing profession in Sarawak.
ABSTRAK

Masalah utama yang dihadapi ialah samada unit-unit audit dalam di sektor perkhidmatan awam kerajaan Negeri Sarawak telah menuju kearah pendekatan yang profesional didalam mempraktik ilmu-ilmu pengauditan yang terkini dan juga untuk mengetahui mengapa Institut Juruaudit Dalam Malaysia tidak boleh untuk mengadakan kursus atau seminar di Sarawak.

Cara untuk mendapatkan data asli dan data yang sedia ada ialah dengan mengagihkan borang scalselidik dan juga menerima buku-buku, majalah-majalah dan juga menerima internet. Kesemua empatbelas buah badan kerajaan dan badan berkalan diambil sebagai contoh kajian. Kaedah statistik yang digunakan ialah perulangan dan peratus dengan penggunaan perisian SPSS.

Kajian menunjukkan unit-unit audit dalam di sektor perkhidmatan awam negeri Sarawak telah menuju kearah pendekatan yang profesional dengan mempraktikkan cara pengauditan yang terkini seperti risiko pengurusan, penyiasatan penyelidikan, tadbir us us koperasi (corporate governance) dan kawalan dalam yang baik dan juga menghadiri kursus dan seminar bagi memperbaiki kemahiran. Juga terdapat penggunaan perisian audit yang menunjukkan unit audit dalam menggunakan teknologi terkini didalam kerja sehari-hari mereka. Akhir sekali, Pertubuhan Kawan Sarawak bagi Institut Juruaudit Dalam Malaysia dengan kerjasama Centre for Modern Management (CMM) dan juga persatuan-persatuan-Association of Business Scholars (Unimas) dan Persatuan Alumni UiTM Sarawak (MITSA) perlu memain peranan yang penting bagi mengembangkan profesi ini di Sarawak.
CHAPTER 1

1.0 INTRODUCTION

1.1 Background study.
Internal auditing is not new especially for the public sector of the Sarawak state government. Way back to the 1970s, Internal Audit Units have been set up in the state statutory bodies such as the Sarawak Economic Development corporation (SEDC), Sarawak Land Development Board (SLDB) and other state government agencies. However, not much studies have been carried out to determine how effective the units are in carrying out the internal audit practices in confronting the complex changing of the present day business activities. Internal audit unit was set up in 1992 under the state financial secretary office.

In the year 2000, the unit was placed under the state secretary office in order to promote greater transparency and accountability of financial and operational matters. (Rakan Sarawak, December 2000). This move hopes to see more focus and attention to improvements of system efficiency and financial disciplines by controlling officers and heads of departments.

Currently, all government Ministries and agencies have put in place many elements of good corporate governance, including corporate objectives and strategies; corporate planning; internal audit and audit committee; performance standards and measurement; evaluation, review and reporting mechanisms; values and code of ethics, benchmarking, risk management, etc.

The government has introduced various reform programmes in the public sector in its effort to introduce good principles of governance to promote a greater sense of responsibility and transparency in the government's operations and decision-making process. So far, the government has introduced and implemented programmes such as systems and procedures improvement, establishment of Internal Audit Unit; the Inspectorate Unit, the formation of specific committee to tackle various issues on management integrity, financial management and accounts. These initiatives here taken to uphold
structures and this will serve as the main defense against fraud, corruption, and mismanagement within the public sector.

These reforms were brought about after conducting studies and review on the overall government's operations, including systems, procedures as well as rules and regulations. National Audit Department has been the prime mover towards these reforms as can be seen from the issue; observations and recommendations raised in the audit reports. Apart from that, Audit Department has also been playing an active role in several high level committees, particularly the Special Cabinet Committee on Financial Management, which is headed by the Deputy Prime Minister. This committee deliberates on all issues, including issues, which are of public concern brought about outside the formal mechanism available within the government.

The problems faced by the internal auditing profession in Sarawak were as follows:

The Institute of Internal Auditors, Malaysia was not eager to organize courses or seminars in Sarawak due to poor response from the participants. It should be noted that in running such courses or seminars the participants were the most important factor.

The Sarawak District Society of the Institute of Internal Auditors, Malaysia was not active in promoting the internal audit in Sarawak. Ever since the set-up of the District Society few years ago, the activities of this Society were not seen in the local newspaper.

Internal audit carry out their auditing work more on compliances rather than on risk management, control self assessment and other best internal audit practices.

1.2 Objectives of the study.

The main objective was to investigate the level of internal auditing in the Sarawak State Government, Statutory Bodies and Local Authorities.
Other specific objectives include:
- To find out the various components in internal auditing as regard to risk management, fraud, control self-assessment and internal controls.
- To determine the professional competency of the internal auditors in executing the internal auditing activities.
- To know whether the head of internal audit units as well as their supporting staff receives the required level of training.

1.3 Significance of the study and limitation.
This paper could reveal the current practices of internal auditing in the public sectors of the Sarawak State government. The paper could determine the strength and weaknesses of the present internal audit teams in the public sectors of the Sarawak State government.

In respect of the limitations, major obstacles would be the secondary data on internal auditing for the Sarawak State Government as the matter was highly confidential and would not be disclosed to the publics.

1.4 The scope of this study
The scope of the study will cover only the Sarawak State Government Department, Statutory Bodies and Local Authorities.

1.5 Organization of the chapters
Chapter One touched on major issues in respect of the importance of internal auditing, about the internal auditing itself as well as the technology in internal auditing. Chapter Two would cover on the literature review on risk management, the assessment of risk, the type of risks as well as its implication. The element of corporate governance in the public sector as well as touching a little bit on the
private sector. Chapter Two also stressed on fraud. The major reasons why fraud occurred as well as the internal controls needed. Other than that the aspect of an Audit and outsourcing were also being looked into. Chapter Three would cover on the topic of research methodology on how the data were collected and the procedure for the analysis of data. Chapter Four was on the findings that was in respect of the analysis of problems statements, objectives and hypothesis. Finally, Chapter Five focused on the conclusions and recommendations.
CHAPTER 2
2.0 LITERATURE REVIEW

2.1 The Importance of Internal Auditing
Lawrence B. Sawyer (1993) in his Article of "Why Internal Auditing" appeared in the December Issue of the Internal Auditor Magazine posed a number of reasons why Internal Auditing was a very important function. Auditing—both internal and external—has its roots in antiquity. In about 3600 B.C., according to records of an early Mesopotamian civilization, scribes used to prepare summaries of financial transactions. Tick marks, dots, and circles indicated a painstaking comparison of one record with another. The Greeks, and the Romans after them, had an abiding regard for control over finances. The suspicious Greeks preferred slaves to keep records because they reasoned that a slave under torture could be considered more reliable than a freeman under oath.

The function of checking figures has survived to this date. The Internal Auditors provide service to their organization to ensure proper internal controls, risk management and good governance processes. The General Manager would like to see whether their operating personnel done their jobs according to established standards, procedures and instructions and also to make sure costs were reduced at level of operation. This is where the service of the Internal Auditors is highly demanded. The other reason is the counsel the auditors can provide objective views on highly technical matters.

In the acquisition of a company internal auditors were called to determine the reliability of the financial data whether true information were given and the internal auditors job were to check and make final decision whether to proceed with such acquisition or otherwise.

On the other hand, the shareholders of the company need internal auditors to act as a watchdog over the operation and running of this company. Internal Auditors will review the established policies for example on the management of fixed assets whether proper controls were established in the acquisition and disposal of assets.

In the case of the Cooperative Society, internal auditors were established to monitor the financial records as well as the operation to
ensure procedures and policies were adhered to at all level of operations.

In the government sector, the internal audit units as well as the internal audit committees were set up to ensure resources were fully utilized. Stories were heard about the mismanagement of resources such as the purchase of fertilizers whereby purchases exceeded usage causing the stocks to spillage and rotten at the warehouse.

The Board of Directors also needs internal auditors. Beataguered board members, subject to legal action for failing to carry out their responsibilities, desperately reach out for reliable information.

Gregg R. Maynard (1999), in his Article Embracing Risk, which appeared in the Internal Auditor Magazine stated that Internal Auditing as a function of Risk Management. He stressed that management in many types of organizations is now evaluated not only by its performance record, but also by the adequacy and effectiveness of its risk management activities.

2.1.1 Internal Auditing
Internal auditing is an independent, objective assurance and consulting activity designed to evaluate and to add value and improve an organization’s operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes.

The standards for the Professional Practice of Internal Auditing (SPPIA) at Appendix II formulated by the Institute of Internal Auditors Inc is a global attempt to look at internal audit objectives from a holistic management approach (Ruin, 2001:51). According to the SPPIA guidelines, the spectrum of internal audit objectives would be:

(i) To determine whether results of operations are consistent with established objectives and goals and whether the operations are being carried out as planned. Mission accomplishment, and making the audittee feels good—the stark contrast between the ‘traditional audit attestation’ and ‘modern internal auditing’.

(ii) To ascertain compliance with plans, policies, procedures, regulations or laws. Stretching further from verifying
compliance, auditors should determine whether those regulations and rules are acceptable and relevant for the operations in relation to current changes and competitions in the market place. This encompasses issues like ‘not only doing things right but also doing the right things’ (effectiveness vs. efficiency).

(iii) To review the integrity and reliability of both operating and financial information, and how much such data are classified, reported, identified and measured.

(iv) To assure that organizational assets as well as other resources are used and deployed economically and efficiently. This audit exercise includes verifying that assets are in existence and adequately safeguarded.

The Institute of Internal Auditors (IIA) was formed in Florida, USA in 1941. Consequential to the Malaysian needs, a Chapter was established in 1977 in Kuala Lumpur, Malaysia. Growth in size and stature in internal auditing in Malaysia was eminent resulting in the conferment of a National Institute Status by IIA Inc. in January 1988. The institute stood independently as Institute of Internal Auditors Malaysia. Development was continuous, growth was vigorous and the strategic move for corporatisation of the Institute took form in July 1994, thus giving birth to a new entity, the Institute of Internal Auditors Malaysia, a company limited by guarantee and not having a share capital. The membership of IIAM has grown from strength and strength. Individual membership increased from 562 in 1998 to 800 in 2001 and Corporate membership has grown steadily from 31 members in 1996 to 127 in 2001 as shown in Figure 1.1 below.
2.1.2 Objectives of IIAM
The objectives for which the institute is established are as follows:

- To advance the theory and practice of internal auditing in all its aspects.
- To recruit, educate, train and assess by means of examination or otherwise a body of members skilled in these areas.
- To preserve at all times the professional independence of internal auditors in whatever capacities they may be serving.
- To maintain high standards of practice and professional conduct by all its members.
- To do all such things as may advance the profession of internal auditing in relation to industry, commerce, education and the public service.
- To provide practicing internal auditors with a forum for exchanging ideas and expertise on matters of common interests, to develop their professional skills and to enhance their contribution to the organizations they serve.
- To enhance the professional status of internal auditing in Malaysia.

Source: IIAM Annual Report 2001
• To create an awareness in interested parties on the benefits of professional internal auditing.
• To develop courses and conduct examinations for the continued professional development of the members.

2.1.3 The many facets of audit
(i) Value for money auditing (VFM)
Government activities in developing countries have increased manifold over last three decades. They are no longer confined to defense and maintenance of law and order. The size of government departments and agencies has increased enormously. In most of the countries large public sector corporations have been established to pursue the policy objectives of the governments.

These public sector corporations or state-owned enterprises (SOE) draw large chunks out of the national budgets. But are the taxpayers getting value for their money for every rupee spent by these SOEs? Probably no one knows for sure. “Value for money Auditing” or “Performance auditing” is an approach for carrying out audits of SOEs activities and passing judgment on the economy, efficiency and effectiveness of their operations (Javed, 1988).

While financial and operational audits have long been recognized as integral parts of successful management strategies for many companies, the Management Audit has been welcomed enthusiastically by enterprising executives to evaluate their company’s efficiency and effectiveness in clear and objective terms (Alexander Hamilton Institute, 1983).

(ii) The management audit
The management audit will:
• Uncover unprofitable operations before they drain company resources.
• Focus energies on productivity improvements that yield immediate results.
• Coordinate production schedules on purchasing policies and inventory practices into smooth running operations.
• Pinpoint personnel problems that lead to low morale, high turnover and general employee malaise.
• Create profitable new marketing and merchandizing strategies.
• Identify and fulfill the management information needs of the corporation hierarchy.

For a public sector organization to achieve the maximum benefit from the activities of internal audit, it is essential that the auditor should not be engaged in any system, which he normally review and appraise (Buttery et al, 1989).

Internal audit activity should be unrestricted and auditors should have full rights of access to records, assets, and personnel, and should receive such information and explanations, as they consider necessary for the performance of their duties.

The Institute of Internal Auditors has developed the Internal Auditor’s Handbook (Heeschen et al, 1984) and a toolkit (Tarr, 1991) for those who are going to establish an internal audit department for the first time and for those who are new to the responsibilities of internal audit.

Management at all levels is absorbed with operations and rarely can spare the time required to make detailed study of any procedure or system (Fonerow, 1989). To obtain an objective, analytical review of specific operations, management turns to the professional trained in the art of analyzing records, controls and procedures—the internal auditor.

2.1.4 Software in internal auditing
Audit technology has involved to the point where virtually every aspect of the internal audit process can now be facilitated by some form of software tool (Salerno, 2001). Data analysis, risk management, fraud investigation, work paper management and internal control evaluation, for example, are all processes that have entered the digital realm. Software applications increasingly are enabling audit shops to boost their efficiency and effectiveness and to broaden the scope of audit process.

In the Internal Auditor’s 2001 software survey it was revealed that the vast majority of respondents report that they are using data extraction and analysis software, and most indicate they are pleased with the results. The Survey results suggest that auditors who engage in computer-assisted fraud work are using their software more extensively—and more proactively—than in the past. Despite increasing
threats to information systems security over the last several years, few auditors report that they are using network security assessment software. When asked which type of software would increase most in importance to their audit shops over the next three years, the majority survey respondents cited data extraction and analysis tools.

This was especially true in 1996 when the same survey (Pratt et al., 1996) was carried out and accordingly the category of software that was increasingly importance over the next three years were as follows:

**Table 2.1: Software Category**

<table>
<thead>
<tr>
<th>Software category</th>
<th>Rank</th>
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<tbody>
<tr>
<td>Data Analysis/Extraction</td>
<td>1</td>
</tr>
<tr>
<td>Audit Management/Risk Analysis</td>
<td>2</td>
</tr>
<tr>
<td>Database</td>
<td>3</td>
</tr>
<tr>
<td>Spreadsheet</td>
<td>4</td>
</tr>
<tr>
<td>Utility/Other</td>
<td>5</td>
</tr>
<tr>
<td>Word Processing</td>
<td>6</td>
</tr>
<tr>
<td>Data Management/Groupware</td>
<td>7</td>
</tr>
<tr>
<td>Network Analysis/audit</td>
<td>8</td>
</tr>
<tr>
<td>Presentation Graphics</td>
<td>9</td>
</tr>
<tr>
<td>Systems/Control Audit</td>
<td>10</td>
</tr>
</tbody>
</table>


It was observed that Data Analysis, Risk Analysis and Database were the top three category of software to be used in the near future. Figure 2.1 below shows that in term of the product or the brand of software being used in the data extraction and analysis it was observed that 40% of the users were using ACL software, 21% using Spreadsheet Software, 14% using Database software, 4% using Internally Developed Software, 3% using IDEA and SAS respectively, 2% using Easytrieve Plus Report Writer Software, Focus Software and Monarch Software respectively and the rest totaling 9% were other brands.
2.2 Risk Management

Cassell English Dictionary, defined risk as 'a hazard, chance of harm, injury, loss. From the management’s mindset, risk is actually a concept. It is a measure of probabilities or uncertainties, a probability that an action or event might adversely affect an individual or an organization. The impacts or effects of risk could have political, economic, financial and regulatory implications.

Risk management is all about managing uncertainty; where the outcome is always an unknown, and at times a mystery like in gambling when you would either win an occasions but lose all the times (Ruin, 2001).

Risk management has been a subject of discussion ever since the IIAM organized the first annual conference on internal auditing in 1985. A topic on risk management and management audit technique (Shand, 1985) stated that proper assessment of risk and materiality is
The internal audit function is actually a value assessment function, and this process can help to determine the risk of any events that may occur. The management must ensure that the risk of any occurrence of harm, whether to the company or to the individual or an organization, is susceptible to political, social and economic pressures and the necessity to stay within the legal constraints. The risk management strategy is the risk that the control systems in operation will fail to prevent or detect errors in the information being audited. Control risk-the risk that the control systems in operation will fail to prevent or detect errors in the information being audited.

The subject of risk is intensified when the world is entering the new millennium. At this phase in the Y2K battle, some internal auditors are sweating over whether their organizations will enter the new millennium with a celebratory bang or a horrific crash (Figg, 1998). For this matter, to prevent a seemingly strong Y2K project from crumbling at last minute, internal auditors should systematically address several common risks, including the lack of management attention, poor project plan as well as vendor certifications.

Risk is the potential exposure to unexpected financial and non-financial damage arising from deficiencies in the management of the organization in pursuit of its business objectives (Chong, 2001).

Currently, some of the fundamental risk management challenges facing the organization were poor operational control, poor clarity in corporate governance, inadequate funding or capital, inadequate MIS, Risk management, lack of understanding of risk exposure and poor management of financial risk.

The management should:
- Identify and evaluate risks faced by the company for consideration by the board.