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Internal auditing and its role in risk management in commercial banks: A field study of the Algerian Popular Credit Bank, Batna Agency

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Abstract---This study aimed to identify internal auditing and its role in activating risk management in commercial banks, as it plays an important role in enhancing risk management. To address the research problem, we conducted a survey at the Algerian Popular Credit Bank in Batna province by distributing a questionnaire to employees of Batna Agency. This was done to understand the role of internal auditing in activating risk management in banks. The study reached a set of findings, the most important of which are: the contribution of internal auditing to analyzing and understanding bank risks and how to manage them; risk management requires an effective administration to develop a strategy through which risks faced by banks are diagnosed; there is coordination between the internal audit department and risk management at the Algerian Popular Credit Bank through information exchange, with the aim of reducing the severity of banking risks so that the bank can achieve its objectives of continuity; there is an effective and positive contribution of the internal audit function to the risk management process in the bank.

Keywords---Internal Auditing, Risks, Risk Management, Commercial Banks.

JEL Classification: M420

1. Introduction

Commercial banks play a crucial role in the national economy and are consequently exposed to the same risks faced by other economic institutions. As such, banks rely on all departments to manage these risks and seek to both mitigate and avoid them. Internal auditing is responsible for identifying, evaluating, and disclosing these risks, in addition to predicting the quantitative and qualitative risks that the bank will face in the future. This allows users of financial data to assess the bank's capabilities in risk management and control. Based on the above, we can pose the following main research question:

Research Problem: The problem is encapsulated in the following question: What is the role of internal auditing in risk management in commercial banks?

From this main question, the following secondary questions arise:

- What is the reality of internal auditing in risk management in commercial banks?
- To what extent do commercial banks recognize the importance of risk management?
- To what extent does internal auditing contribute to risk management in the Algerian Popular Credit Bank?

Study Hypotheses: The main hypothesis of the study is "Internal auditing plays an important role in activating risk management in commercial banks." From this hypothesis, the following sub-hypotheses are derived:

- The internal audit function is of great importance in commercial banks;
- Commercial banks place great importance on risk management;
- Internal auditing contributes to risk management in the Algerian Popular Credit Bank.

Study Objectives: The main aim of this study is to understand the role of internal auditing in risk management in commercial banks. Additionally, it seeks to achieve the following objectives:

- To identify the internal auditing procedures in recognizing risks and their importance;
- To determine the extent to which adherence to professional standards of internal auditing affects the activation of risk management;
- To examine the reality of commercial banks' application of internal auditing;
- To identify the most significant risks faced by banks.

Study Methodology: To address the research problem and test the validity of the hypotheses, the study employs a descriptive analytical approach. This method aims to facilitate understanding and in-depth analysis of the components of the subject.

Study Structure: This study consists of three main sections:

- Commercial banks and banking risk management
- Internal auditing in commercial banks and its relationship to banking risk management
- Field study

2. Commercial Banks and Banking Risk Management

2.1. Introduction to Commercial Banks:

2.1.1 Concept of Commercial Banks:

A commercial bank has been defined as: "A banking and credit institution that manages the flow of various financial and monetary balances to and from economic units. The commercial bank is considered a special type of institution that accepts different types of liabilities, which represent financial resources, and then uses these financial resources to obtain a diversified portfolio of assets that achieve returns for the bank. These returns enable the bank to meet its obligations, cover administrative costs, and then achieve a competitive return on capital." (Mahmoud, 2017, p. 13)

Commercial banks are also considered the second type of entity in monetary theory, coming in second place after the central bank. They are the most widespread banking institutions, unlike central banks, which date back to the late seventeenth century. Commercial banks were known before this date, with the first banking activity in the world said to date back to 1700 BC in Babylon. (Shih, 2010, p. 7)

2.1.2 Objectives of Commercial Banks:

Commercial banks seek to achieve three main objectives: profitability, liquidity, and security:

- **Profitability:** Bank management always seeks to achieve the highest possible profit for its clients and increase the value of the owner's wealth by investing the funds obtained from various sources. The basic criterion for the bank's efficiency is the volume of profits it achieves. Achieving the greatest amount of profits gives the bank a reputation and competitive advantage that ensures it attracts or draws the largest volume of deposits, and vice versa. (Najjar, 2014, p. 21)

- **Liquidity:** The primary feature of commercial banks is the acceptance of deposits of all types, including current or demand deposits. Deposits comprise the largest part of commercial banks' liabilities, necessitating that the bank meet these obligations, especially demand deposits, without delay when requested. This means that commercial banks must maintain appropriate liquidity to meet demand deposit requests at any time. However, this means that the amounts the bank holds as cash are frozen, and the bank loses the interest on investing them. Shareholders seek to obtain cash whenever they wish, and these are conflicting interests that commercial bank management must balance. Therefore, commercial banks resort to investing part of their cash in short-term investments that can be converted to cash without incurring losses to meet withdrawal cases and employ what exceeds the liquidity amount in profitable investment opportunities where the risk size is directly proportional to the size of profits. The central bank obliges commercial banks to keep a certain percentage of deposit amounts as legal reserves with it to face cases of high demand on banks, especially in abnormal circumstances. At the same time, banks keep amounts in the form of reserves under several names to face deposit withdrawal cases. (Al-Jajawi, 2013, p. 57)

· **Security:** The capital is characterized by its small proportion compared to all the assets deposited with it, which means a small safety margin for depositors. The bank cannot bear losses exceeding its capital ratio. If losses increase, they may consume part of the depositors' funds, resulting in the bank declaring bankruptcy.

2.1.3 Functions of Commercial Banks: The functions of commercial banks have evolved over time with the needs of markets and individuals, allowing all parties to deal with them towards achieving common goals and achieving the well-being of societies. The following figure illustrates the most important functions of commercial banks:

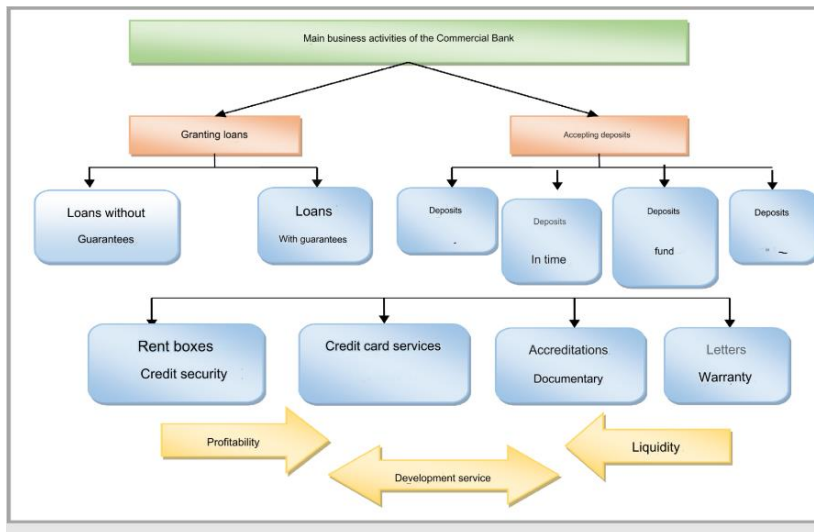


Figure 1: Functions of Commercial Banks
Source: (Al-Sayrafi M., 2014, p. 25) with adaptation

2.2. Banking Risk Management:

2.2.1 Definition of Risk Management: There are several definitions of risk management, including: It is defined as "a set of systematic and effective scientific methods that must be taken into account when making any decision related to risk in order to prevent or reduce potential material losses." (Kallash & Bahloul, 2021, p. 439)

Banking risk management has also been defined as "an integrated organization that aims to confront risks with the best means and lowest costs, by discovering, analyzing, and measuring risk, determining means to face it, and selecting the most appropriate of these means to achieve the required objective." (Ahmed Mili, 2020)

2.2.2 Preventive Methods to Avoid Banking Risks: Some methods and means to face risks with the aim of overcoming them and reducing their expected

negative effects on the results of the credit decision regarding granting debit credit facilities can be addressed as follows:

- Distributing risk or transferring it to other parties by sharing risks with others, especially in large-scale or high-risk facilities, where more than one bank is invited to participate in granting these facilities;
- Proper application of specific controls grants each type of credit facility and follows up on the granted credit to avoid the risks resulting from it;
- Dealing with several clients and financing different activities and sectors to avoid what might happen if financing was focused on limited clients and on distributing loans to some activities over others;
- Benefiting from the services of specialized bodies in insuring and guaranteeing banking credit operations; (Khedraoui, 2009, p. 22)
- Monitoring risk by providing an information system capable of identifying and measuring risks and monitoring significant changes;
- Reviewing and following up on risks and control procedures, and conducting periodic review procedures for policies and examining their compatibility with agreed standards;
- Risk management provides a clear approach to identifying, measuring, and determining risk tools in order to take appropriate measures to reduce losses. The practice of risk management does not prevent risks from occurring but reduces them. (Bouskar, 2017, p. 420)

In addition to the above, the bank takes guarantees that suit each credit category, and for other areas, the bank resorts to hedging and securitization methods to reduce risks.

2.2.3 Indicators for Measuring Banking Risks: There are many indicators for measuring risks that can be illustrated in the following table:

Table (1): Indicators for Measuring Banking Risks

Type of Risk	Indicators Used in Measurement
Credit Risk	- Net loan charges / Total loans - Provision for doubtful debts / Loans that are due and unpaid - Provision for doubtful debts / Total non-performing loans - Securities (non-government) / Total assets
Liquidity Risk	- Total equity / Total assets - Core deposits / Total assets - Volatile liabilities / Total assets - Financial investments for trading purposes / Total assets - Net loans / Total assets - Short-term financial investments / Total deposits - Maturity ladder
Interest Rate Risk	- Interest rate sensitive assets / Total assets - Interest rate sensitive liabilities / Total liabilities - Sensitive assets - Sensitive liabilities
Exchange Rate Risk	- Open position in each currency / Capital base - Total open positions / Capital base
Operational Risk	- Total assets / Number of employees - Labor expenses / Number of employees - Net income / Number of employees
Capital Risk	- Total equity / Total deposits - Total equity / Risky assets

Source: (Hamad, 2003)

3. Internal Auditing in Commercial Banks and Its Relationship with Banking Risk Management

3.1 Concept of Internal Auditing in Commercial Banks:

Before addressing internal auditing in commercial banks, we review the concept of internal auditing:

According to the Institute of Internal Auditors (IIA), it is defined as: "An independent evaluation activity established within the organization to review accounting, financial, and other operations as a service to management. It is a means of administrative control that works to measure and evaluate the effectiveness of other control methods." (Boukhrouba & Douah, 2019, p. 309)

The French Institute of Audit and Internal Control (IFAC) defines internal auditing in an organization as a function responsible for periodic auditing of the means and possibilities available to management and administrators at all levels, for the purpose of managing and controlling the organization. This function is provided by a department subordinate to management and independent from other departments. Its main objectives within the framework of periodic auditing are to verify that procedures include adequate safeguards, information is correct, operations are legitimate, regulations are effective, and structures are clear and appropriate. (Oucif, 2017, p. 159)

Through this, it can be said that internal auditing is a partially independent function in the organization that seeks to verify the accuracy of information and operations and evaluate the effectiveness of the organization's internal control.

As for auditing in commercial banks, it has been defined as:

A function established within banks for the purpose of examining the financial, accounting, and administrative activities they undertake. It also involves analysis, evaluation, and providing guidance and consultations in all bank operations and functions. (Mouissi, 2017, p. 259)

The internal bank auditor is often required to submit special purpose reports to the higher supervisory bodies of the bank and to other regulatory authorities. The following are the objectives of internal auditing in commercial banks:

Optimal use of available resources in the bank; · Evaluation of the internal control system, systems, and procedures; · Identification, assessment, and monitoring of risks; · Facilitating compliance with corporate governance laws and independent reporting to the audit committee; · Reviewing and monitoring compliance with policies, procedures, laws, and regulations within the bank; · Increasing the reliability of financial statements. (Al-Madhoun, 2011, p. 23)

3.2 Internal Auditing Procedures in Commercial Banks:

The auditor studies the system and completes the data that affect the issuance of judgment regarding the financial condition of the bank; · Collecting data and documents related to the financial institution: basic law, organizational structure, bank account guide, balance sheets and financial statements for several years, decisions and minutes of the board of directors and general assemblies; · Evaluating the internal control system and expressing an initial opinion on the soundness of this system and the degree of control over it, as well as the

efficiency of the internal audit function and the extent to which bank management relies on it; · Studying all financial incidents that the bank has experienced (their causes and consequences), with reference to the measures taken to prevent their recurrence.

Banking risks are considered a real barrier, which prompts the auditor to focus more on assessing the degree of control and mastery over these risks. Risks can be distributed across the most important banking activities, according to their degree of severity. After a comprehensive understanding of the specificities of the banking system and the surrounding risks, the auditor conducts appropriate tests and examinations according to the audit program. (Radwan, 2012, p. 28)

3.3 The Role of Internal Auditing in Activating Risk Management and the Relationship Between Them

3.3.1 The Role of Internal Auditing in Risk Management: Internal auditing plays an important role in activating risk management, and is considered as providing objective assurances to the board of directors regarding the effectiveness of risk management activities. The importance of internal auditing in banking risk management is highlighted through the roles it plays regarding risk management, which can be mentioned as follows:

Providing assurances regarding the progress of the risk management process; · Providing assurances regarding the accuracy of risk assessment; · Evaluating the process of reporting on key risks; · Reviewing key risk management processes. (Hajjaj, Zaabat, & Saadaoui, 2019, p. 138). The role of internal auditing in risk management can be illustrated according to the following figure:

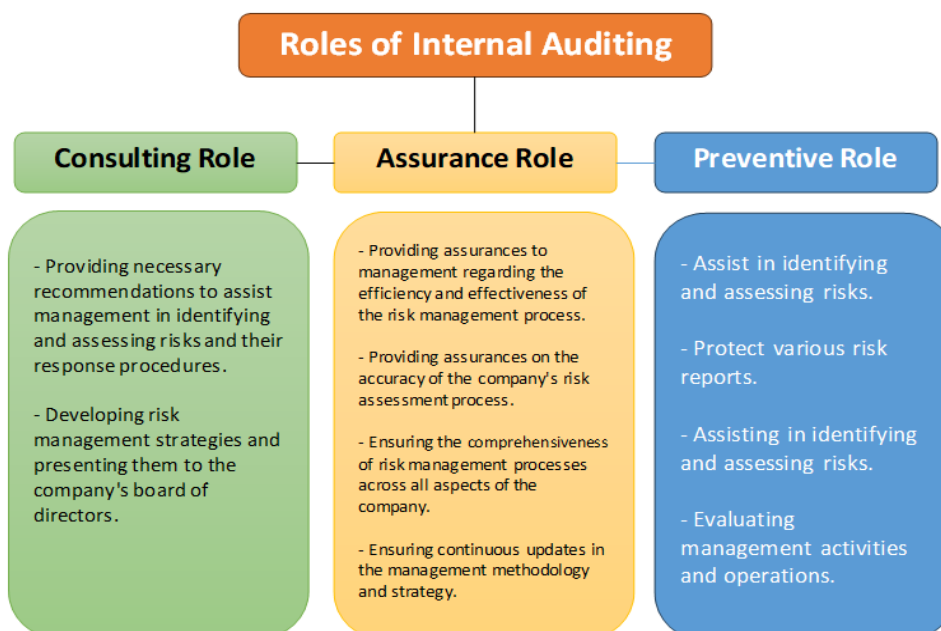


Figure 2: The Role of Internal Auditing in Risk Management
Source: (Chikhi, Mahaouat, & Fakir, 2018, p. 57)

4. Field Study:

In the field study, the Statistical Package for Social Sciences (SPSS) program was used to process the data derived from the questionnaire distributed to the sample individuals, represented by bank employees including administrators, auditors, accountants, and financial managers, to know their opinions regarding the application of internal auditing and its importance in risk management in the bank.

4.1 Overview of the Bank Under Study: The Algerian Popular Credit was established by Decision No. 66/336 dated 26/12/1966 with a capital of 15 million DA. Its laws were defined by Order No. 67/78 dated 11/5/1967. It was established based on the banking structures that existed during the colonial era, and it is an integration of the following banks:

- The Popular Commercial and Industrial Bank of Algeria;
- The Popular Commercial and Industrial Bank of Oran;
- The Popular Commercial and Industrial Bank of Constantine;
- The Popular Commercial and Industrial Bank of Annaba;
- The Popular Commercial and Industrial Bank of Algiers.

In addition to these five banks, three foreign banks were integrated since 1967:

- Marseille Credit Company (SMC) in 1968;
- The French Company for Credit and Banks (SFCR) in 1972;
- The Mixed Bank of Algeria: Algeria-Egypt in 1968.

In 1975, the Central Popular Bank joined the Algerian Popular Credit. The Algerian Popular Credit Agency -307- Batna, which was established on April 24, 1984, is considered one of the most successful agencies. The geographical location of the agency (in the city center on Larbi Tebessi Street) has contributed to facilitating direct interaction with current customers and attracting new ones through the services offered by this agency and the good treatment by its employees. The agency employs 31 permanent staff distributed across various departments according to the nature of their work and specialization.

4.2 Risks Faced by the Bank Under Study:

- **Operational Risks:** These include professional errors, system processing errors (automated systems), and technical issues.
- **Market Risks:** This refers to changes in key market factors (market prices, interest rates) and the funding of productive projects for materials that are not in demand in the market.
- **Default Risk:** The debtor's inability to repay their debts.
- **Liquidity Risks:** The bank's inability to appropriately allocate funds. For instance, during the period of civil unrest, false rumors spread about the closure of banks, including the Batna branch of the **Algerian Popular Credit Bank**, and about currency exchanges, prompting a large number of customers across the country to withdraw their funds.

- **Interest Rate Risks:** These risks involve a decline in revenues due to movements in interest rates on deposits and loans, which are linked to inflation.
- **Foreign Exchange Risks:** Since banks play an active role in stimulating and facilitating foreign trade, they are exposed to risks related to foreign exchange. Foreign exchange risks refer to the risks of converting foreign currency into local currency when exchange rates are unpredictable.

4.3 Methodological Framework of the Study:

4.3.1 Study Methodology: The descriptive method was used, focusing on a precise scientific description of the phenomenon being studied, either quantitatively or qualitatively, in order to explore solutions and interpretations. This approach was based on the results produced by the data and information collected.

4.3.2 Study Population and Sample: The study population and sample were limited to the employees of the National Algerian Popular Credit Bank in the Batna province. A questionnaire was distributed to the employees, and 40 questionnaires were retrieved.

4.3.3 Study Tool: This study relied on the questionnaire as one of the primary tools used to collect the necessary data directly from the targeted sources. The questionnaire was divided into two main sections. The first section covered personal information about the study sample, including (gender, educational qualifications, professional experience). The second section included three main topics related to the study's subject and hypotheses. The topics of the questionnaire were divided as follows:

- **First Section:** The current state of internal auditing in commercial banks.
- **Second Section:** The institution's awareness of the importance of risk management.
- **Third Section:** The contribution of internal auditing to risk management in the **Algerian Popular Credit Bank**.

The variables of the second and third sections were measured using a three-point Likert scale, as it is one of the most suitable scales for measuring the respondents' perception of the questionnaire's content, as shown in the following table:

Table (2): The Three-Point Likert Scale.

Agree	Neutral	Disagree
3	2	1

Source: Walid Abdel Rahman Al-Farra, *Analysis of Questionnaire Data Using the Statistical Program SPSS*, 1430 AH, p. 26.

4.3.4 Tools Used in Processing the Questionnaire:

The statistical methods available in the Statistical Package for the Social Sciences (SPSS) were relied upon for descriptive analysis of the sample's responses and to

determine their level of response to the themes included in the study tool. Additionally, Microsoft Excel was used to organize the data into tables and figures.

4.3.5 Validity and Reliability of the Study Tool:

The reliability of the study questionnaire was verified using Cronbach's Alpha, which yielded a value of 91.3%. This indicates that if the questionnaire were distributed under the same previous conditions, 89.5% of the sample would give the same responses, demonstrating high reliability of the tool used in the study. This also shows the credibility of the results that can be achieved, and it confirms that the correlation between the items is good and acceptable.

4.3.6 Characteristics of the Study Sample:

4.3.6.1 Gender:

Table 3 and Figure 3 show the results of the distribution of the study sample according to the gender variable.

Table (3): Distribution of the Study Sample by Gender Variable

Category	Frequency	Percentage
Male	22	55.00%
Female	18	45.00%

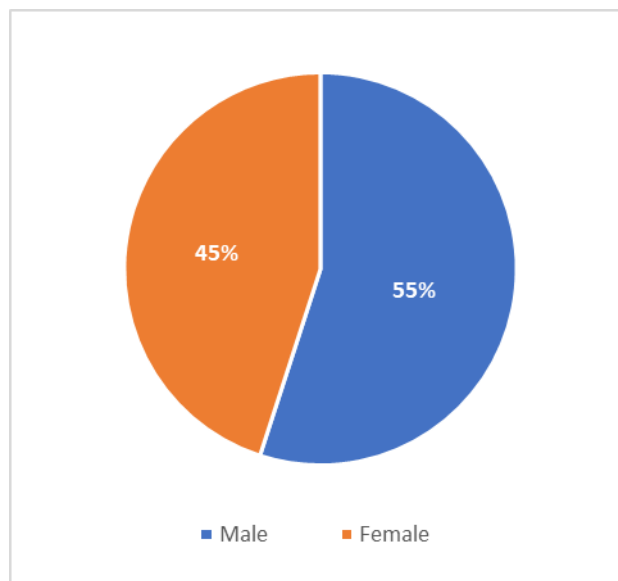


Figure 2: Distribution of the Sample by Gender Variable
Source: Prepared by the researchers using Excel and SPSS outputs

4.3.6.2 Educational Qualification:

Table 4 and Figure 4 show the results of the distribution of the study sample according to the educational qualification variable.

Table (4): Distribution of the Study Sample by Educational Qualification Variable

Category	Frequency	Percentage
Secondary	07	17.50%
Bachelor's	11	27.50%
Master's	17	42.50%
Other Degrees	05	12.50%

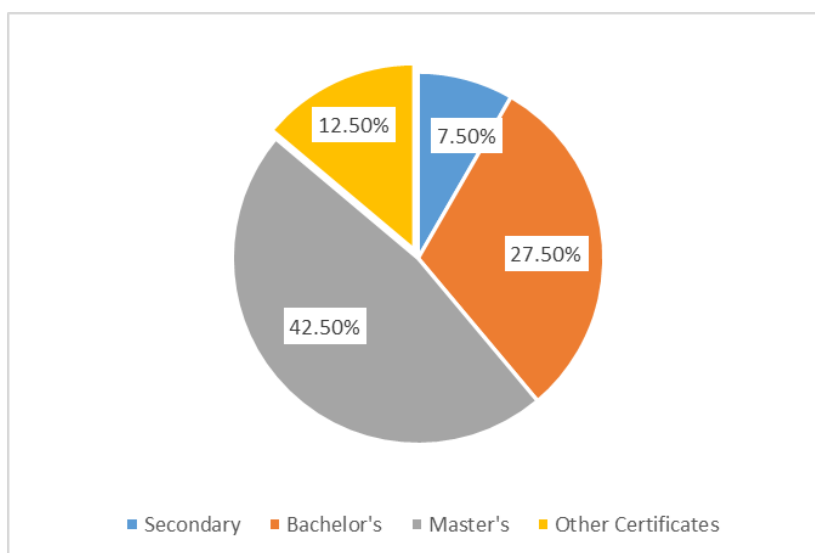


Figure 3: Distribution of the Sample by Educational Qualification
Source: Prepared by the researchers using Excel and SPSS outputs.

4.3.6.3 Professional Experience:

Table 5 and Figure 5 show the results of the distribution of the study sample according to the professional experience variable.

Table (5): Distribution of the Study Sample by Professional Experience Variable

Category	Frequency	Percentage
Less than 5 years	11	27.50%
5 to 11 years	14	35.00%
11 to 16 years	10	25.00%
More than 16 years	05	12.50%

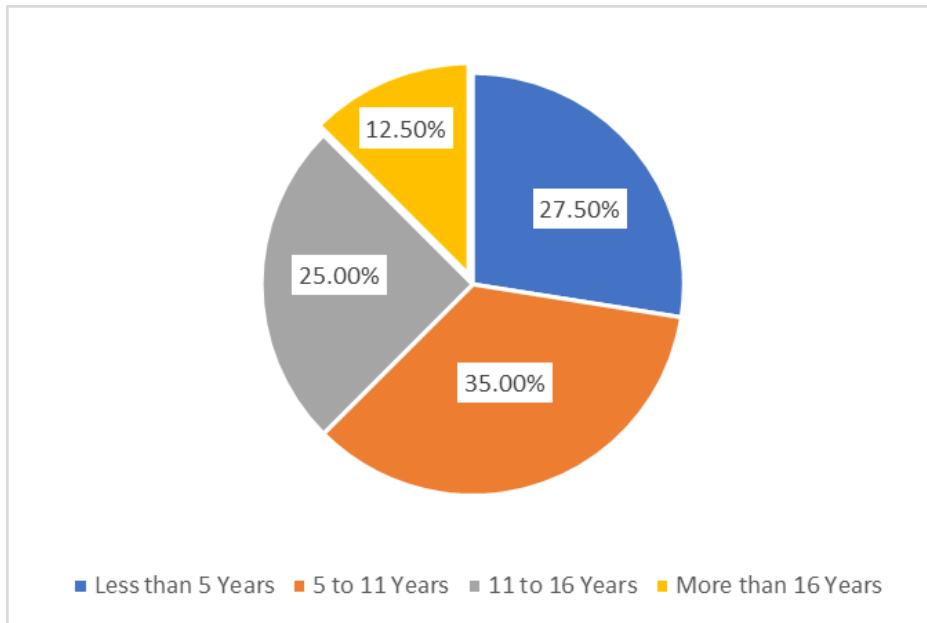


Figure 4: Distribution of the Sample by Professional Experience
Source: Prepared by the researchers using Excel and SPSS outputs.

4.3.7 Results Analysis:

The data presentation and analysis were conducted using the Statistical Package for the Social Sciences (SPSS V28). Some tests were used along with descriptive and analytical statistical methods, including graphical representations, calculation of the mean, and standard deviation. These methods were used to identify how much the responses of the sample deviated regarding each statement and to determine the dispersion in the responses of the sample. Hypotheses related to each section were also tested.

4.3.7.1 Testing the First Sub-Hypothesis, which States: "The Importance of Internal Auditing in Commercial Banks."

Table (6): Means and Standard Deviations of the Study Sample's Responses Regarding the Importance of Internal Auditing in Commercial Banks

No.	Statements	Mean	Standard Deviation	Rank	Agreement Level
1	The bank has a department responsible for conducting audits.	2.63	0.740	02	High
2	The bank provides the necessary resources and information to implement the audit plan.	2.72	0.640	01	High
3	The internal audit department prepares an annual audit plan across different units based on	2.45	0.749	04	High

No.	Statements	Mean	Standard Deviation	Rank	Agreement Level
	risks and classification criteria.				
4	The audit committee is informed of internal audit plans and requirements and gives its approval.	2.25	0.707	06	Medium
5	The bank's operations require the management to improve the internal audit team.	2.35	0.736	05	High
6	The bank defines the scope of internal auditing in line with its objectives.	2.47	0.716	03	High
7	Internal auditing activities are subject to intervention by internal and external parties when defining the audit scope.	2.25	0.742	07	Medium
Reality of Internal Auditing in Commercial Banks		2.44	0.563		High

Source: Prepared by the researchers using SPSS outputs.

From the previous table, it is clear that the mean of the sample's responses to all the statements in the first section, "The Reality of Internal Auditing in Commercial Banks," reached 2.44, with a standard deviation of 0.563, which is greater than the hypothetical mean. Therefore, we reject the null hypothesis and accept the alternative hypothesis, which states: **The internal audit function is of great importance to commercial banks.**

4.3.7.2 Testing the Second Sub-Hypothesis:

This sub-hypothesis states: **"The extent to which banks recognize the importance of risk management."**

Table (7): Means and Standard Deviations of the Study Sample's Responses Regarding Banks' Recognition of the Importance of Risk Management

No.	Statements	Mean	Standard Deviation	Agreement Level
1	The environment in which the bank operates poses a source of risk	2.38	0.868	High
2	The bank takes risk studies into account	2.85	0.427	High
3	The bank is capable of predicting and anticipating potential risks	2.60	0.545	High
4	The bank uses methods to predict risks before they occur	2.40	0.672	High
5	The bank uses financial tools to detect	2.45	0.677	High

No.	Statements	Mean	Standard Deviation	Agreement Level
	risks			
6	The bank adopts an effective plan to deal with all risks	2.60	0.632	High
7	When a specific risk is identified, the bank allocates human and financial resources to confront it	2.58	0.675	High
Bank's Recognition of the Importance of Risk Management		2.55	0.375	High

Source: Prepared by the researchers using SPSS outputs.

According to Table 7, the overall mean of the sample's responses to the statements related to "The bank's recognition of the importance of risk management" was 2.55, with a standard deviation of 0.375, which indicates a high level of agreement. This suggests that the sample members agree that the bank places significant importance on risk management at a high level. Therefore, we reject the null hypothesis and accept the alternative hypothesis.

4.3.7.3 Testing the Third Sub-Hypothesis:

This sub-hypothesis states: "**The extent of internal auditing's contribution to risk management in the Algerian Popular Credit Bank.**"

Table (8): Means and Standard Deviations of the Study Sample's Responses Regarding the Contribution of Internal Auditing to Risk Management in the Algerian Popular Credit Bank

No.	Statements	Mean	Standard Deviation	Agreement Level
1	Internal auditing contributes to examining the bank's risk management system	2.78	0.480	High
2	Internal auditing helps develop new ways to collaborate with risk management	2.53	0.679	High
3	Internal auditing assists in gathering the necessary information used to determine the magnitude and likelihood of risks	2.60	0.632	High
4	Internal auditing evaluates work procedures, contributing to improving risk management	2.63	0.667	High
5	Internal auditing helps identify the causes of risk occurrence	2.63	0.628	High
6	Internal auditing provides sufficient guarantees about the effectiveness of the bank's risk management	2.45	0.714	High
7	The audit department proposes suitable	2.60	0.591	High

No.	Statements	Mean	Standard Deviation	Agreement Level
	methods and mechanisms for the bank to address various risk aspects			
	Contribution of Internal Auditing to Risk Management in the Algerian Popular Credit Bank	2.60	0.471	High

Source: Prepared by the researchers using SPSS outputs.

According to Table 8, the overall mean of the sample's responses regarding the contribution of internal auditing to risk management in the Algerian Popular Credit Bank reached 2.60, with a standard deviation of 0.471. This indicates that the sample's responses showed a high level of agreement with the third section. Therefore, the null hypothesis is rejected, and the alternative hypothesis is accepted.

5. Conclusion

Through this study, we aimed to explore various concepts related to internal auditing, commercial banks, and risk management, as well as the relationship between internal auditing in banks and risk management, and its importance in helping banks avoid and mitigate risks. To achieve the results and answer the hypotheses, we conducted a field study to gather specialists' opinions on the topic by preparing and distributing a questionnaire, based on which the conclusions were drawn.

Study Findings:

- The internal auditor is a key element in bank risk management, as they can access a vast amount of data and information that significantly reduces risks.
- The internal audit department prepares and develops an annual audit plan, setting objectives, timelines, and resource allocation across the bank's various units, based on risks and the classification of units.
- There is coordination between the internal audit department and the risk management department at the Algerian Popular Credit Bank (CPA) through the exchange of information, with the goal of reducing the severity of banking risks, enabling the bank to achieve its continuity objectives.
- The internal audit function plays a positive and effective role in the bank's risk management process.

Recommendations:

- Senior management must commit to enhancing and developing the internal audit activity among employees.
- Greater attention should be paid to the internal audit function, and its role should be activated, given its positive impact in supporting risk management.

- A relationship between risk management and internal auditing must be established to serve the bank's objectives and ensure their achievement.
- The bank's management is recommended to prioritize risk management and implement it practically, to help increase investor confidence and trust in the financial data.

Research Prospects:

Based on this study, several research topics can be suggested, including:

- The contribution of external auditing in detecting banking risks.
- The importance of internal auditing in reducing risks in economic institutions.
- Evaluating the internal control system in banking institutions.

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