The Independence of Banks Internal Auditors from Banks' Executives

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Abstract

Are internal auditors independent of banks' executives? In the reality, what happens to the activity of auditors is described as "isolated activities" or at least "unobservable" for the rest of the organization except bank executives. Banks' internal auditors operate based on a legal framework that is always improving, but in the meantime, the concern of their independence continues to be present evidenced even through interviews conducted with them for this paper. Internal Auditors have weakened their independence from Banks' Executives because of being under pressure of keeping their job position. The point is that threats to independence are indirect and difficult to identify and measure. Subsequently, the control of the movement and autonomy of internal auditors can't be founded uniquely on consistency with legitimate and administrative acts. This paper infers that autonomy in the dynamic of inward examiners ensure the monetary soundness of banks and thus their customers and different partners. In the end, there are some conclusions and recommendations for enhancing the independence of internal auditors.

Key words: internal auditor, bank, independence, regulation
J.E.L. classification: A10, D70, D82, H11

1. Introduction

Taking into account the work of the Internal Auditor based on International Accounting Standards (IAS-ISA) 610, internal audit is defined as: "An assessed activity located within an entity in the form of service to the entity. Its functioning includes, among others, the examination, evaluation and monitoring of the adequacy and effectiveness of the accounting system and internal control". Internal auditors in banks, who are liable for inspecting also the operations and executive management decisions of the bank in light of a legitimate concern for the shareholders and other stakeholders must play out their obligation with high expertise and individual moral principles. The two basic audit concepts that indicate the volume of work that auditors do are Risk and Materiality, but both of them should go together with Independency of a professional internal auditor from bank's executives. We will focus on this relation on a commercial bank in Albania. The organizational aspects of risk are very broad, but risk from an audit perspective is described by International Auditing Standard ISA (400) - Risk Assessment and Internal Control define audit risk as to the risk that auditors give an inappropriate opinion.

While, Materiality is defined in International Auditing Standard SNA 320 - Audit Materiality. It states that: "Information is material if its absence or anomaly affects the economic decisions of users taken based on financial statements." And finally, according to CIPFA in the guide "Standards of professional practice on ethics" the objectives of the professional auditors by their very nature must meet three basic needs: Credibility - of information and information systems; "Quality of services - they need to ensure that all services provided by CIPFA members are delivered to high standards"; Confidentiality - service users by members should feel confident that there is a framework for

professional ethics and technical standards that guide the provision of these services and that cannot be compromised. The CIPFA guideline sets out six fundamental principles: Integrity, a member must be trustworthy and honest in the performance of professional service; Objectivity, A member must be fair and objective in his or her conduct; Competence and Care, a member during the realization of the professional service must be competent to provide these services; Confidentiality, A member must respect confidentiality; Proper Action (Realization), a member must act in the same way while maintaining the good reputation of the Institute and curb any action which may harm the Institute or itself; Technical and Professional Standards, a member must perform services within the relevant technical and professional standards. The guide also sets out some other detailed principles that apply, such as Corporate Governance; Conflicts of interest; Hospitality and Gifts.
Mr. Stefan Ingves, Chairman of the Basel Committee on Banking Supervision and Governor of Sveriges Riksbank, Sweden's national bank, noticed that "an internal audit function, independent from management and composed of competent auditors, is a key component of a bank's sound governance framework. The Committee's document lays out expectations that should help banks and their supervisors strengthen professional practices in this area" (BIS, 2012).

2. Literature review

The purpose of internal controls is to ensure that: All transactions and information that should have been recorded are recorded; Errors or irregularities in information processing will be highlighted; Assets and liabilities that are recorded in the accounting system exist and are recorded with the correct amounts. In this way, notwithstanding the obligation to keep up legitimate bookkeeping records, the executives are likewise answerable for the adequacy of the internal audit framework. "The minimum obligation of banks is to comply with all laws and regulations that are commonly tailored to each country to ensure the sustainability of operations and to increase the bank's trust" (Ribaj and Illollari, 2019).

The nature and extent of internal audit controls vary from bank to bank and from department to department within the same bank. Among other things, internal audit controls will depend on several other factors, such as Nature, size and volume of transactions; The degree of control that the management can exercise itself; Geographical spread of the bank; The expense of working controls versus the advantages expected of them. A significant element will be the size of the bank. A small bank with a large shareholder involvement as bank executives involved in day-to-day operations is unlikely to need formal internal controls like those of a large bank in which shareholders do not participate in operations. of the bank.

Internal auditors are responsible only to the bank's governing body (not executives) and their targets change as per the board necessities. Internal audit should generally look for the possibility of such abuses and should seek to identify serious deficiencies in internal control that may allow these events to occur. An internal auditor who discovers evidence or suspects misconduct should report the evidence found or reasonable doubt to the appropriate management level. Management has the obligation to figure out what further advances should be taken. Internal audit has to distinguish the control targets inside every framework, to analyze these controls and, using tests, to guarantee that they work and are satisfactory. When conducting these examinations, the internal auditor should be vigilant about potential misconduct, but it is not his responsibility to identify all fraud and irregularities within a system; and also, auditors are not expected to provide such assurance or assurance to management. However, the tests performed by internal auditors should be designed in such a way that they ensure, as far as possible, the detection of any underlying irregularities and those that occur consistently. Banks Board of Directors have the essential obligation regarding guaranteeing that adequate controls are set up to forestall or distinguish misrepresentation and defilement; while Internal Auditors are responsible to the executives for a few duties to advice them in their job of forestalling and recognizing extortion and debasement. "The Audit process is made responsible for "collecting and interpreting reports of selected business facts" enabling executives to keep track of significant business developments, activities and outcomes from diverse and voluminous transactions" (Cinaj, Meçe, Ribaj and Kadrimi, 2020).

Unlike many goods, an audit is not a "good" that can be noticed in advance. An audit is referred to as the 'good experience' (Craswell & Francis 1999). This means it is a 'good', the qualities of which cannot be respected before the purchase. Essential qualities are often not foreseen until the moment it is best experienced. This makes auditing choice decisions more difficult than in many other commodity markets. Furthermore, even after the audit has been taken and experienced, it is not always possible to observe all the relevant qualities of an audit. It would be rare for anyone other than those involved in more detail in the audit to be able to observe key audit features. Even those close to the audit (e.g., those involved in the financial function or audit committee) are more likely to have an opportunity to observe aspects of competence. Most of what happens are unobservable by anyone other than those involved in the process. In a 2003 Houghton and Trotman review, this process was described as a 'secret audit business'.

Some argue that the best way to move forward in terms of audit quality (including auditor capability and independence) is to expand legislation and/or market regulations for audit services (e.g., Ramsay 2001). Internal Audit is an independent activity that provides an objective assurance and provides management advice designed to add value and improve the operation of the public entity (Listed Company). Internal audit encourages the public body to accomplish its goals, through a restrained and methodical movement, to evaluate and improve the adequacy of corporate governance.

A professional internal auditor should not only be familiar with the definition but should also be able to explain it to other stakeholders, even those who are not internal auditors. This explanation can also be used to overcome the misconception that internal auditors are the "police of the organization". "The level and quality of financial inclusion has a significant impact on opportunities for further progress that will support and facilitate a greater degree of stability of the financial stability and sustainable growth of the Albanian economy" (Ribaj, Meçe, Çinaj, and Kadrimi, 2020). The interests of various stakeholders, such as shareholders, customers, and employees, do not necessarily match. Bankers ethical behaviour is estimated to be at the forefront of ethical banking, which means that an institution offers and facilitates easy access to transparent information for customers and the public (Ribaj, Ilollari, Scalera, 2019).

3. Research methodology

In addition to the literature analysis for this paper, we analyzed the regulatory framework approach with EU Directives and BCBS principles. To conduct the application analysis in the Albanian reality we rely on a survey conducted with internal auditors of banks. The data obtained refer to data valid for the reality of internal audit in the banking system in Albania. The identity of the interviewees remains discreet about maintaining their privacy. Responded are 20 internal auditors in Albanian banks. The time to complete the questionnaire and the interview was on average 20 minutes. Open-ended, closed-ended and alternative questions were applied. They are built in such a form and order to obtain professional opinions regarding the independence of banks' internal audit from the bank management (CEO and executive management) and their transparency towards bank stakeholders.

4. Findings

4.1. Analyses for compliance of banks internal audit with EU Directives and BCBS

The Directive 2006/43/EC "On statutory audits of annual accounts and consolidated accounts", distributed by the European Commission in 2006, set assessment panels on the way to turning into a vital component of the corporate administration system of all EU Member States. The part of the control board, as needed by the Directive, was extensively predictable with that set out in some since quite a while ago settled corporate administration codes, to: … screen the viability of the organization's internal audit and danger the executives' frameworks; screen the adequacy of the organization's inside examination work; and so forth. (European Commission, 2006)

According to the 8th Company Law Directive of the European Union, Article 41 appoints an obligation for checking the viability of danger the executives and control frameworks by every "public-interest entity", which will have an audit advisory group also. The definition of "public interest entity" varies across the EU, but generally, one of them is considered the activity of banks.

It should be noticed that Albania, an EU competitor nation, is moving toward the EU directives and Basel principals using enactment and administrative system. Identified with the bank's internal control system, its structure and obligations, Albania has taken occasionally the method of obliging the prerequisites of EU orders and Basel standards inside the law no. 9662, dated 18.12.2006. "On Banks on the Republic of Albania", amended; regulation no. 63 "On core management principles of banks and branches of foreign banks and criteria on the approval of their administrators", dated 14.11.2012 and lately the new regulation no. 67, dated on 02.09.2015 "On Internal Control System" (Bank of Albania, 2006). This last one has given the requirements for setting up an effective internal control system and supporting arrangements by the three lines of defence model; a strong internal control system, including independent and effective internal audit functions, as part of sound corporate governance; the findings of internal audit to be followed and bank's management to take appropriate and timely corrective action in response to internal control weaknesses; the internal audit to provide vital assurance to bank's board of directors and supervisors; etc.

Article 37, point 2 of "Law on Banks" the bank's board of directors has the ultimate responsibility for ensuring that executive management/bank's directorate/bank's senior management establishes and maintains an adequate, effective and efficient internal control system, supporting arrangements by the three lines of defence model, and, accordingly, the board should support the internal audit unit in discharging its duties effectively (Bank of Albania, 2006). In addition to article, 45 and article 46 of "Law on Banks", the internal control system and internal audit unit should have independence, objectivity, professional competence and care in accordance with best practices and international standards of internal control (Bank of Albania, 2006). In addition to article 38, point 3 of "Law on Banks", the audit committee should: oversee the bank's internal audit system; monitor the effectiveness of the internal audit unit; ensure that the internal audit unit carries out its responsibilities independently and based on internal control standards; ensure that the bank's executive management has established and maintains an adequate and effective first and second line of defence; may propose the appointment or dismissal of the employees and head of internal audit unit; ensure regular open dialogue between the external/statutory auditor, bank's executive management, supervisory authority and internal audit.

Each bank should have a permanent internal audit function that must be independent of the audited activities, which requires the internal audit function to have sufficient standing and authority within the bank, thereby enabling internal auditors to carry out their assignments with objectivity. Internal audit must have adequate resources available, supporting both efficient and effective audit planning and management. The internal audit function should be accountable to the board of directors, on all matters related to the performance of its mandate as described in the internal audit regulatory framework, which articulates the purpose as well, standing and authority of the internal audit function within the bank in a manner that promotes an effective internal audit function.

4.2. Implemented independence of internal auditors of banks in Albania

Over time, many of the changes implemented in the regulatory framework have increased the quality of internal audit. However, no matter how well the audit is implemented and how well the audit regulation is implemented, bank failures continue to occur. This is seen by some as a sign that the audit process is not capable of providing a product that has value for the financial information market. In recent years, this perception of the lack of "distribution" of the audit product has been described as an 'expectations gap'. It is reasonable to conclude that, at least in part, what is expected of some market participants is not achievable.

The independence and objectivity of internal auditors are the first to be mentioned in the definition to emphasize their importance. Independence does not simply mean that the internal auditor is independent in the structure of the public entity, but that he/she has immunity from the power exercised by various actors and carries out activities in the interest of the organization. An objective internal auditor bases his judgment and works on factual and impartial information. Personal interest or perspective on different things or people should not affect the work of internal auditors under any circumstances. The analysis of the main results of the questionnaires and interviews of 20 internal auditors are as follows:

1. About 39% of respondents state that they as internal auditors were free to perform their duties without interference from individuals outside the audit department, while 38.3% did not agree. While the rest hesitated to answer this question.

2. The majority of respondents (67%) state that they feel free to include their materials in the draft reports they draft. While following this question, they state that the final report had changed from the interventions made by the head of the internal audit department, mainly affecting the reduction of findings and their materiality by arguing that they were addressed.

3. The majority of respondents (82%) state that they as internal auditors had never made a presentation of their audit reports to their banks' boards of directors. The audit reports were delivered to the bank's CEO (or Vice CEO) and usually they discussed findings with the Head of Internal Audit Department. Following the discussion on this question, they state that the board of directors could ask the head of the internal audit department to report to them, if they want.

4. Almost all respondents (91%) stated that they had not gone through a recruitment process through the bank's board of directors, but the same process was followed as for other positions in the bank. Record interviews with the bank's Human Resources Department as well as with the CEO or CFO.

5. About 79% of respondents state that they do not audit the activities for which they were responsible for their functioning before being promoted to this position.

5. Conclusions

1. The challenges arising from the economic situation, and changes in regulatory framework, increase the pressure for banks to adopt a robust governance framework keeping an effective communication between structures.

2. Risk management, internal control and audit functions provide reliable information channels for the bank's board of directors to monitor the effectiveness of risk management and internal control system. With regard to risk management, the bank's board and/or the audit committee needs to receive, at least yearly, an evaluation of the bank's risks and its internal control system. They need to have appropriate information to know how the business model is impacted by major risks, and how value generation could be enhanced by opportunities or reduced by vulnerabilities of external environment or particular risks inherent to the activity of the bank and what strategies to be chosen for achieving the bank's mission.

3. Independence of the audit is vital for the bank life. But internal auditors are not truly independent because they are employed by the bank executives.

4. The final audit reports are finalized and presented to bank executives (maybe to Audit Committee as well) only by Head of Audit Departments, and not by internal auditors. Head of Audit Departments have the power to decide for final and material findings identified by internal auditors.

6. Recommendations

1. The bank's culture, code of conduct, human resources policies and performance reward systems are critical components of the internal control system. Critical for this system to work is the protection of the people who "blow the whistle".

2. Internal auditors of banks should be provided with clear and consistent incentives or penalties to promote their independence. The monitoring and supervision of Internal Auditors Independence should be 360 degrees, more qualitative than quantitative focusing on essential issues (risk-based) for the independence of the auditors. The supervisors might be appointed by Central Bank or IEKA as audit experts who have not had a business relationship in the last 5 years and who are legally committed not to have in at least the next 3 years with this bank and the supervised auditors. The audit expert should have a broad scope of the inspection to examine the full corporate governance of the bank, its organizational culture and the ethical behaviour of the internal auditor. The assessment

report should be distributed on the website of the Central Bank, IEKA, just as on the website of the bank itself.

3. The bank's audit committee has to evaluate the reports from these multiple sources and advice the bank's board of directors to determine the measures to be taken for problems identified for independency of internal auditors. Internal audit function should have the right to attend or observe executive committee meetings and to have timely access to relevant management information and committee materials. Internal audit function should ensure that its internal audit reports are provided to the board of directors or the audit committee without banks executives filtering.

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