

ROLE OF INTERNAL AUDITING IN CORPORATE  
GOVERNANCE: TWO CASE STUDIES FROM TURKEY

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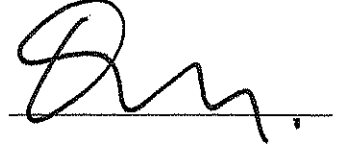
ROLE OF INTERNAL AUDITING IN CORPORATE GOVERNANCE : TWO CASE  
STUDIES FROM TURKEY

Ph.D. Thesis by  
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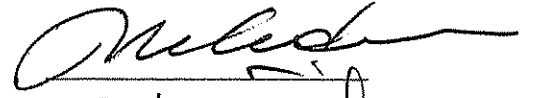
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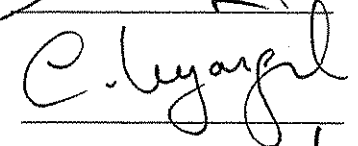
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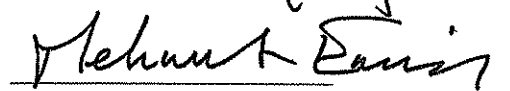
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# ROLE OF INTERNAL AUDITING IN CORPORATE GOVERNANCE: TWO CASE STUDIES FROM TURKEY

## **Abstract**

Corporate governance can be defined as a process whereby business organizations take decisions. Corporate collapses that have been experienced undermined the trust in corporate sector. Corporate governance emerged as a system which can make companies stronger against the crises and increase the trust of investors.

Internal auditing is an independent and objective assurance and consulting activity which adds value and improves the operations of an organization and evaluates the effectiveness of risk management, control and governance processes.

Internal auditing is an important function for the establishment of sound corporate governance. Internal audit activity assesses and makes recommendations for improving the governance process in its accomplishment of promoting appropriate ethics and values, ensuring effective performance management and accountability, effectively communicating risk and control information to appropriate areas of the organization and communicating information among related parties.

In this thesis corporate governance, internal control, internal auditing and the role of internal auditing in corporate governance have been studied in the theoretical framework. For the applied section, case studies have been conducted in two commercial banks in order to reach conclusions about internal audit applications of commercial banks that operate in Turkish national banking system.

At the end of the literature review and the case studies, it has been found that internal auditing has an important role in corporate governance. Moreover, the case studies indicated the profile and applications of internal auditing in commercial banks in Turkey.

# İÇ DENETİMİN KURUMSAL YÖNETİMDEKİ ROLÜ: TÜRKİYE'DEN İKİ VAK'A ÇALIŞMASI

## Özet

Kurumsal yönetim, organizasyonların karar aldıkları bir süreç olarak tanımlanabilir. Yaşanan kurumsal yıkılmalar sektörlerdeki güven ortamının sarsılmasına sebep olmuştur. Kurumsal yönetim, şirketleri krizlere karşı daha güçlü hale getirebilecek ve yatırımcıların güvenlerini arttıracak bir sistem olarak ortaya çıkmıştır.

İç denetim, işletme faaliyetlerine değer katan, bir işletmenin organizasyonel faaliyetlerini iyileştiren ve risk yönetimi, kontrol ve yönetim süreçlerini değerlendiren bağımsız ve tarafsız güven ve danışmanlık faaliyetidir.

İç denetimin, sağlam bir kurumsal yönetim ortamının oluşturulmasında önemli bir fonksiyonu bulunmaktadır. İç denetim faaliyeti, etik ve değerlerin teşvik edilmesi, etkin performans yönetimi ve hesap verebilirliğin sağlanması, risk ve kontrol bilgilerinin organizasyonun uygun kademelerine iletilmesi, yönetim ve denetçiler ile olan ilişkilerin koordinasyonunun sağlanması gibi hususlarda değerlendirmelerde ve önerilerde bulunarak yönetim sürecinin iyileşmesini sağlamaktadır.

Bu tezde, teorik çerçeve açısından kurumsal yönetim, iç kontrol, iç denetim ve iç denetimin kurumsal yönetimdeki rolüne ilişkin çalışmalar yapılmıştır. Tezin uygulamaya yönelik olan kısmında ise Türk ulusal bankacılık sektöründe faaliyet gösteren bankaların iç denetim uygulamalarına yönelik sonuçlara ulaşmak amacıyla iki ticari bankada vak'a çalışması yapılmıştır.

Literatür taraması ve vak'a çalışmalarının neticesinde, iç denetimin kurumsal yönetim içerisinde önemli bir rolünün olduğu tespit edilmiştir. Bunun yanı sıra, vak'a çalışmaları vasıtasıyla Türkiye'deki ticari bankaların iç denetim profilleri ve uygulamaları ile ilgili bilgiler edinilmiştir.

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To my parents and my wife

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## **List of Abbreviations**

ACC	: Australian Criteria of Control
AICPA	: American Institute of Certified Public Accountants
ALCO	: Asset and Liability Commission
AUS	: Australian Auditing Standard
BCBS	: Basel Committee on Banking Supervision
BIS	: Bank of International Settlements
BRSA	: Banking Regulation and Supervision Agency
CAAT	: Computer Assisted Audit Technique
CAE	: Chief Audit Executive
CEO	: Chief Executive Officer
CFE	: Certified Fraud Examiner
CFO	: Chief Financial Officer
CIA	: Certified Internal Auditor
CISA	: Certified Information Systems Auditor
CMB	: Capital Market Board
COSO	: Committee of Sponsoring Organizations
ECIIA	: European Confederation of Institutes of Internal Audit
GNP	: Gross National Product
IAA	: The Institute of Internal Auditors
IAPC	: International Auditing Practices Committee
ISE	: Istanbul Stock Exchange
ISS	: Institutional Shareholder Services
IT	: Information Technology
NACD	: National Assessment of Corporate Directors
NBER	: National Bureau of Economic Research
OECD	: Organization for Economic Co-operation and Development

PCA	: Parliament of the Commonwealth of Australia
PWC	: Price Waterhouse Coopers
SAS	: Statement on Auditing Standards
SEC	: Securities Exchange Commission
SME	: Small and Medium Size Enterprise
SMOFM	: State of Michigan Office of Financial Management
SOX	: Sarbanes Oxley
TCE	: Transaction Cost Economics
TUSIAD	: Turkish Industrialists' and Businessmen's Association
UK	: United Kingdom
US	: United States

## **Chapter 1**

### **Introduction**

Corporate governance is a new but important term for all sectors. As a result of globalization and rise of international investments, companies began looking for a common language and the name of this common language was corporate governance. It is necessary for the survival of companies, governments and countries; as well as for the benefits of owners, shareholders and stakeholders of corporations.

Financial scandals that have been recently experienced especially by the American companies undermined trust in corporate sector and sent shockwaves through stock markets all over the world. Corporate governance evolved as a result of the damaging effects of systemic crises, corporate failures and scandals, which damaged economies, investors and stakeholders. Because those crises and failures had destabilizing effects on economies and harmed both the investors and the stakeholders, it was necessary to promote a good corporate governance system in order to make companies stronger against crises and increase the trust of investors (Silva and Gomes, 2003).

Liberalization of markets and rise of competition from national to international level are the main characteristics of international economic order. Today, private sector has obtained greater importance as a result of the importance of economy and rule of liberal thoughts in economic order. Because of the effects of liberalization and globalization, corporate failures and scandals that occur in one country affect the economic order of other countries or the world economic order. So, central authorities began to work on setting of internationally accepted common main

principles that demonstrate the ways to answer the question “how corporations should be managed?” (Mallin, 2004).

According to several researchers one of the major causes for Asian financial crisis was poor corporate governance. Prowse (1998) and Rajan and Zingales (1998) reached to the conclusion that poor corporate governance on top of concentrated ownership structure accelerated the way to the crisis. Johnson *et al* (2000) concludes that agency problem is more serious facing economic downturns in case of poor corporate governance environment. So, the markets are more vulnerable to unfavorable economic situation.

Investors look at annual reports, accounts and other information released by corporations in making their investment decisions. Annual reports give a reasonably accurate picture of the activities of the corporation and show its financial position. Although they are useful in making investment decisions, some information can not be obtained effectively from these reports and accounts. In the last decade, world economy has experienced corporate failures, which could not have been estimated by examining the annual reports or accounts. These corporate failures had adverse effects on shareholders, stakeholders, national and international economies. The main reason behind those corporate collapses was lack of effective corporate governance. Good corporate governance can help economies to prevent these kinds of collapses, restore the confidence of investors and attract new investments (Mallin, 2004).

It is important for banks to have a strong corporate governance system. Because, banks are critical elements of the economy, they are extremely important engines of economic growth, they provide financing and basic financial services for the economy, some banks are expected to make liquidity available in difficult economic conditions and banks have access to government safety nets (BCBS, 1999).

In banking system,

corporate governance involves the manner in which the business and affairs of institutions are governed by their boards of directors and senior management affecting how banks (BCBS, 1999):

- Set corporate objectives,
- Run the day to day operations of the business,
- Consider the interests of recognized stakeholders,
- Align corporate activities and behaviours with the expectation that banks will operate in a safe and sound manner and in compliance with applicable laws and regulations,
- Protect the interest of depositors.

Boards of directors should establish strategies in order to direct ongoing activities of the bank and establish and approve corporate values. Values should emphasize the importance of clear and timely discussion of problems and prohibit bribery and corruption in corporate activities (BCBS, 1999).

IIA (1999) defines internal auditing as follows:

Internal auditing is an independent, objective assurance and consulting activity designed 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.

Internal auditing profession is a continuing contributor to the development of corporate governance. It is recognized as a strong international player in corporate governance system (D'Silva and Ridley, 2007).

Internal audit is a fundamental function for sound corporate governance. An objective internal audit function is important for proper discharge of the responsibilities of directors. Corporate governance has an increasing importance around the world in recent years. Expectations of communities about an independent review of operations of organizations and financial accounts have been raised. Governments and the regulatory authorities began improving corporate governance standards, strengthening corporate governance principles and improving transparency. In such an environment boards of directors and senior management of organizations need objective and independent reviews and advice from reliable

sources. These needs are mainly met by the work of internal audit function (Laker, 2004).

Internal auditors provide management with reasonable assurance that (Bailey *et al*, 2003):

- Risks are identified and monitored effectively.
- Organizational processes are effectively controlled.
- Organizational processes are efficient and effective.

In this structure, internal audit function plays a unique role. It helps organizations implement, assess and conceptualize risk processes of risk management and control. It plays an active role in the implementation of effective governance and control mechanisms (Bailey *et al*, 2003).

The research questions of this study are,

- Why corporate governance matter for banks?
- Why corporate governance problem in banks might be more serious than in other firms?
- What are the special problems facing banks in promoting sound corporate governance?
- What are the objectives and tasks of the internal audit function within banks?
- What are the principles of bank internal audit?
- What is the role of internal auditing in corporate governance?
- What are the internal audit applications of commercial banks that operate in Turkish national banking system?

This thesis consists of seven chapters. First chapter is the introduction. In the second chapter, principles and essential elements of corporate governance which is a special direct and control system concerning corporations are examined, theoretical structure of this system is determined. It is decided that every kind of governance of

corporation is not called corporate governance. Only governance based on fairness, transparency, accountability and responsibility can obtain this peculiarity. Such governance is useful for corporations, shareholders and stakeholders.

In the third chapter, corporate governance in banking system is discussed. Banks are considered to be special compared to other firms. They have some unique features. In this chapter, unique features of banks that distinguish them from other institutions, essential elements of corporate governance of banks, corporate governance mechanisms at banks and the role of banks in corporate governance are studied.

In the fourth chapter, internal controlling and internal auditing are explained. In this chapter, types of internal auditing, international standards for the professional practice of internal auditing, internal auditing in banking institutions and the role of internal auditing in corporate governance are discussed.

In the fifth and sixth chapters, case studies are conducted in commercial banks that operate in Turkish national banking system. With the help of these case studies, conclusions are derived about internal auditing practices of commercial banks that do business in Turkish national banking system.

In the last chapter, results of the case studies are discussed and conclusions and recommendations about internal audit applications of banks in Turkey are derived.

## **Chapter 2**

### **Governance and Corporate Governance**

#### **2.1 Governance**

At general level governance can be defined as a process whereby organizations and societies take decisions. In this process, leaders are selected, powers are conferred, strategic decisions and directions are set, important relationships are maintained and performance is monitored. This process may take place in businesses (corporate governance), governments, communities and non-profit organizations (Plumptre, 2004).

Governance is a structure, which appears as a result of the interactions of all parties within a social system. It refers to societal steering and it is a process of coordination within networks (Kooiman, 1993). It can be defined as the corporate structure that determines how resources will be used in order to obtain economic and social development. So, governance is concerned nearly all areas of economic and social life (Yücaoğlu, 2000).

Governance can also be defined as the ability to manage a country, city or a region and to solve the problems that may occur in these areas. This concept covers mechanisms, processes and associations in which both individuals and groups can explain their demands and expectations, they can easily use their legal rights and parties fulfill their responsibilities. It refers to the decision-making processes in the administration of an organization. It includes all systems, processes, procedures and controls that are used to safeguard and grow assets. It affects the whole organization and looks at why the organization is there, what its values are, who its stakeholders are and the way it does business (Tuzcu, 2004).



Governance has mainly three dimensions. It encompasses policy instruments (policy), institutional properties (polity) and actor constellations (politics). (Treib *et al*, 2005) In politics dimension, Rhodes (1997) describes governance as a process of policy formulation in which state actors share power with private actors. Thus, policy formulation takes place within interorganizational networks characterized by interdependence and resource exchange. The main criterion used to distinguish different types of governance is the relationship between private and public actors in policymaking process. This places the concept in context of terms like public-private relations and interest intermediation (Treib *et al*, 2005).

In polity dimension, governance is defined as the system of rules, which shapes the actions of social actors. Different modes of governance are situated on a spectrum which is delineated by two opposing types of market and hierarchy. Between these types, a set of modes of governance can be identified, like community, associations, etc (Treib *et al*, 2005).

Governance can be defined as mode of political steering, which refers to its policy dimension (Heritier, 2002). Policies are distinguished depending on their steering instruments. These instruments define the ways by which policy goals could be achieved. In order to achieve certain social outcomes such as information, command and control, incentive and supply, forms of social influence and control, state can apply different types of instruments (Baldwin and Cave, 1999).

Heritier (2002) makes a broad definition of governance:

Governance implies every mode of political steering involving public and private actors, including traditional modes of government and different types of steering from hierarchical imposition to sheer information measures.

## 2.2 Corporate Governance

### 2.3 Definition of Corporate Governance

There is no globally accepted definition of corporate governance. Each country has its own priorities in achieving sound corporate governance based on the particular weaknesses and strengths of different systems. For example, Sarbanes Oxley law concentrates on fraud and white collar crimes and it mainly focuses on efficient monitoring and quality of accounting-auditing. On the other hand Russia's corporate governance code of 2002, aims to improve transparency and to ensure ethical and fair relationships between companies, shareholders, communities and governments (Mallin, 2004).

Sir Adrian Cadbury who was a pioneer in raising awareness on corporate governance defines corporate governance as the following:

Corporate governance is holding the balance between economic and social goals and between individual and communal goals. The governance framework is there to encourage the efficient use of resources and equally to require accountability for the stewardship of these resources. The aim is to align as nearly as possible the interests of individuals, corporations, and society. The incentive to corporations is to achieve their corporate aims and to attract investment. The incentive for states is to strengthen their economies and discourage fraud and mismanagement. (Cadbury Code, 1992).

Management structure should support efficient use of resources and make the directors accountable for the losses that occur from not using the resources in the proper way. The aim of the management should be setting the balance between individuals, corporation and the community (Cadbury, 1999). As it can be understood, Adrian Cadbury explains the concept of corporate governance as a management structure, which has main objectives and purposes.

Corporate governance deals with increasing the value of the corporation, which fulfills financial, legal and contractual obligations. In order to achieve sustainable long term increase in the value of the corporation, this definition requires the boards of directors balancing the interests of shareholders and stakeholders (Iskander and Chamlou, 1999). In public perspective, corporate governance enables accountability

responsibilities of directors, to support the corporation in operating in an efficient and effective manner and as a result of this to contribute to national economy. Public offices should protect interests of the parties related to the corporation and minimize the difference between private and social returns (Bockli, 1991). Shareholders, stakeholders and in general the national economy benefit from this situation.

Corporate governance is the system that deals with the management of corporations. Instead of the topics related to day to day activities of the corporation, corporate governance states inspection and accounting for responsibilities of the executive directors (Ireland, 1999).

Gregory and Lillien (2000) make a broad and a narrow definition of corporate governance. In their broad definition, corporate governance is defined as a mixture of laws, codes and practices, which enables the corporation to operate efficiently, to show respect to its shareholders and stakeholders and in the long term to increase the value of the shares of the corporation. On the other hand, in a narrower perspective, they say that corporate governance explains the roles and operations of the board of directors, managers and shareholders (Gregory and Lillien, 2000).

Corporate governance enables the continuation of operations of corporations based on the signals coming from the markets. It is a system of management, which tries to make secure that the demands of shareholders and stakeholders will be realized (Berglöf and von Thadden, 2000).

OECD's definition is consistent with the definition of Sir Adrian Cadbury. Corporate governance is defined as the system by which business corporations are directed and controlled.

Corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as the board, managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs. By doing this, it also provides the structure through which the company objectives are set, the means of attaining those objectives and monitoring performance (OECD, 1999).

Corporate governance is a field in economics, which tries to investigate the ways to secure efficient and effective management of corporations with using incentive

mechanisms, such as contracts, legislation and organizational designs. This is often limited to the question of improving financial performance, for example, "how the corporate owners can secure or motivate that the corporate managers will deliver a competitive rate of return?" (Mathiesen, 2002).

According to Shleifer and Vishny (1997), "corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment". It can be narrowly defined as the relationship of a company to its shareholders and in a broader sense it can be defined as the relationship to the society (Financial Times, 1997).

In its broadest sense, corporate governance is the organization and management of a modern institution established for a specific goal (TUSIAD, 2002). It consists of a set of relationships between management, board, shareholders and stakeholders of a company. It enables the corporation to construct a structure and with the help of this structure corporate objectives are set, means to attain these objectives and monitoring performance are determined (OECD, 1999).

Some of the writers take a narrow view and see corporate governance as a way by which auditors and directors handle their responsibilities towards shareholders of the corporation. Corporate governance is a new topic importance of which has recently risen. It can be thought as a subject, an objective or a regime to be followed for the benefits of shareholders, employees, customers and for the survival of the country and its economy (Maw *et al*, 1994).

The definitions made about corporate governance are concerned with internal and external aspects of corporate governance. These can be described as internal control and relationships between shareholders and stakeholders. Corporate governance is a mechanism with the help of which, corporations can attain their corporate objectives by monitoring performance (Mallin, 2004).

The goal of corporate governance is to maximize business performance, market value and share value. Sound corporate governance mechanisms enable to select

competent business executives, ensure an effective management and checks and balances system over managerial rights (Kang, 2005).

## **2.4 Studies Conducted About Corporate Governance**

Studies about corporate governance still continue all around the world. Although they have some common points, their rules may change from nation to nation as a result of national conditions. But with the help of these rules, the ultimate point, which is aimed to be reached, is the same. That is fair and efficient management of corporations depending on institutionalization base (Mallin, 2004). Some of the main studies conducted about corporate governance are explained below.

Shleifer and Vishny (1996) can be thought as a good starting point for the studies about corporate governance. They provided a survey of research and a theoretical structure on corporate governance. Their structure was based on the agency problem. Agency problem was derived from the separation of ownership and control and it was focusing on aligning the incentives of managers with the incentives of shareholders. They state legal protection of shareholder rights, large shareholders and takeovers, debt finance as possible solutions to governance problem. In their survey they account for different governance models across countries. They conclude that the UK and US have a governance system characterized by a strong legal protection of investors and lack of large investors. In Continental Europe and Japan, corporate governance relies more in large investors and banks to monitor managers and legal protection for investors is weaker. They state that all successful governance models are characterized by protecting the investors efficiently.

Shleifer and Vishny (1997) asserts that as a result of stronger legal protection in US and UK systems and more concentrated equity ownership in German and Japanese systems, systems in these countries can be characterized as good corporate governance systems. They state that while there is some room for variation in legal protection, there is a reservation level for legal protection, which is not met in many of the economies but required for an effective system of corporate governance.

In their survey, Coombes and Watson (2000) asked major international fund managers to estimate the premium they are willing to pay for high quality corporate governance. The results for selected countries are given in table 2.1 below.

Table: 2.1 Average Premium Investors are Willing to Pay for Good Governance

Country	Premium (%)
Venezuela	28
Indonesia	27
Thailand	26
Malaysia	25
Italy	22
Japan	20
Germany	20
United States	18

Source: Coombes, P. and Watson, M. (2000), "Three Surveys on Corporate Governance", *McKinsey Quarterly*, 4.

Size of the premium reflects the extent to which fund managers believe there is room for improvement in the quality of corporate governance. The size of premium in countries like the United States, with highly developed corporate regulation, suggests investors remain dissatisfied with standards of corporate regulation (Coombes and Watson, 2000).

Compers *et al* (2003) constructed a governance index to provide a measure of shareholder rights at about 1,500 large firms during the 1990s. Firms with stronger shareholder rights have higher firm value, higher profits, higher sales growth and lower capital expenditures. They state that an investment strategy that bought firms in the lowest decile of the index which indicates strongest rights and sold them in the highest decile which means weakest rights would have earned abnormal returns of 8.5 percent per year in the sample period.

Gillan and Starks (2003) examined the relationship between corporate governance and ownership structure. They primarily focused on the role of institutional investors. They concluded that, institutional investors had the potential to play an important role in many markets. They expected from institutional investors to play a constructive role. According to their study, presence of institutional investors leads to

more informative prices and lower monitoring costs. And, this situation leads to better monitoring of managers and more sound corporate governance system.

Brown and Caylor (2004) created measure of corporate governance based on data which was provided by Institutional Shareholder Services. They stated that better governed firms are more profitable, less risky, more valuable and pay out more of their cash to shareholders compared to other firms. They also found that a governance committee that meets annually and the independence of nominating committee are crucial factors associated with performance. They concluded that the two most important governance categories were board of directors and executive and director compensation. On the other hand the two least important categories were state of incorporation and by-laws.

Farber (2005) indicated that fraud detected firms that took actions to improve their corporate governance had superior stock price performance. The study used a sample of 87 firms as fraudulently manipulating their financial statements. Fraud firms had poor governance, fewer numbers and percentages of outside board members, fewer Audit Committee meetings, fewer financial experts on the Audit Committee, a smaller percentage of big 4 auditing firms, and a higher percentage of CEOs who were also chairmen of the board of directors compared to other firms within the sampling period. After improving their governance within a time period of three years, fraud detected firms achieved similar corporate governance characteristics as the control firms. Also, they concluded that investors value corporate governance improvements because fraud detected firms that made changes achieved better stock performance.

Chhaochharia and Grinstein (2005) study the effect of the announcement of the Sarbanes-Oxley Act on firm value. Also they tried to find out whether the market response to governance reforms differs across larger and smaller firms. They state that announcement of the governance rules positively affected the value of large firms. On the other hand, they did not find a correlation between better corporate governance and firm value in smaller firms. These results concluded that if governance rules are applied to larger firms, they are more effective than they are applied to smaller firms.

Although the subject of corporate governance has received attention in the literature, corporate governance of banks has almost been ignored by the researchers (Caprio, and Levine, 2002). The main studies conducted about corporate governance in banks are explained below.

Ciancanelli and Gonzales (2000) argue that financial regulations have structural consequences on the individual firm and on the sector as a whole. According to them corporate governance of banks are different from a typical firm. The reason of this situation is that, regulation imposes constraints on market forces and the regulator acts on behalf of the public to share risks with the owners. They conclude that in banks, governance problem is more complex, principal-agent relationship is unique because an external force mediates it and the owners are the most important source of moral hazard.

Macey and O'Hara (2001) argue that a broader view of corporate governance should be adopted in banking institutions. They state that because of the peculiar contractual form of banking, corporate governance mechanisms for banks should encapsulate depositors as well as shareholders. They conclude that special nature of banking requires a broader view of corporate governance. Also government intervention should be in place in order to restrain the behaviour of bank management.

Caprio and Levine (2002) stated two features of banks, which affect corporate governance. First one is the opaqueness of banks. This situation intensifies the agency problem. It is difficult for equity and debt holders to monitor managers because of the information asymmetries between outside investors and insiders within the banking system. On the other hand, exploiting the private benefits of control instead of maximizing value is easier for managers. They argue that second feature is the heavily regulated structure of banks and it is seen as an obstacle for natural corporate governance mechanisms.

The role of corporate governance in corporate performance in banks was studied by Macey and O'Hara (2003). They indicate that commercial banks have special corporate governance problems for managers, investors, regulators and depositors.



They argue that the directors of banks should be held to a broader set of standards than nonfinancial firms. It is recommended to top bank executives taking into account solvency risk explicitly and systematically in decision making.

Adams and Mehran (2003) examined the governance practices of bank holding companies, which are regulated institutions and unregulated manufacturing firms. They studied with a sample of thirty-five bank holding companies over ten years period, constructed governance variables and compared those variables with the variables achieved in other studies about manufacturing firms. In this study, their main focus was on internal governance structures and shareholder block ownership. They found systematic differences between the governance of banking and manufacturing firms and reached the conclusion that governance structures may be industry specific. It is argued that these differences are results of the differences in investment characteristics and the presence of regulation. Ultimately, they concluded that industry differences should be taken into account in conducting corporate governance reforms.

Crespi *et al* (2003) examines the effectiveness of governance mechanisms in Spanish banking sector. Their analysis considers three forms of ownership: independent commercial banks, dependent banks and savings banks. Four control mechanisms that they analyze can be stated as changes in the board, removal of the chairman, CEO dismissal and mergers or acquisitions. Their results show that each governance mechanism is used by different types of banks with different intensity. Chairman turnover and mergers are more frequently used among savings banks, CEO replacement is more frequently used in independent commercial banks. They also corroborate the hypothesis that governance intervention is more likely when firms are poorly managed and their economic returns are low.

Arun and Turner (2003) discussed the key concepts and issues about corporate governance of banks. They state that corporate governance of banks in developing economies is affected by political considerations. They reach to three basic conclusions. Firstly, in developing economies there is a trend of privatization of state owned banks. It is suggested that the managers of these banks should introduce the corporate governance practices of private sector prior to divestment. Secondly, it is

suggested to developing economies partially open up their banking sector to foreign banks. Because, limited entry of foreign banks causes increased competition and domestic banks are encouraged to emulate corporate governance practices of their competitors. Lastly, in case of partial divestment and lack of any control of other shareholders, it is difficult to divest further ownership stakes if corporate governance is not strengthened.

Berger and Udell (2004) examine how capital impact agency problems in banking. They conclude that between 1990 and 1995, banks with lower capital levels had smaller agency problems after controlling for ownership structure.

## **2.5 Theories Associated with the Development of Corporate Governance**

Many theoretical frameworks evolved in order to explain and analyze corporate governance. They use different terminology and view corporate governance in different perspectives (Mallin, 2004).

Theories associated with the development of corporate governance date from much earlier and drawn from disciplines such as economics, finance, sociology, management, organizational behaviour and law. Some theories may be more appropriate to some countries, and some of them may be more relevant to other countries depending on the stage countries are at. Main important point is whether the company operates in a shareholder framework and aims to enhance shareholder value or whether it has a broader stakeholder approach and emphasizes the interests of the stakeholders such as employees, customers, creditors, suppliers and the local community (Mallin, 2004).

There are mainly six theories associated with the development of corporate governance. These are agency theory, transaction cost economics, stakeholder theory, stewardship, class hegemony and managerial hegemony. Table 2.2 below summarizes the theoretical perspectives on corporate governance.

Table: 2.2 Theoretical Perspectives on Corporate Governance

Dimension	Theoretical Perspective				
	Agency and Transaction Cost	Managerial Hegemony	Class Hegemony	Stewardship	Stakeholder
Board Role	Ensure match between managers and shareholders	Board “a legal function”	Perpetuate elite and class power	Ensure the stewardship of corporate assets	Inclusive pursuit of stakeholder interests
Theoretical Origin	Economics and finance	Organization theory	Sociology	Organization theory	Politics, law and management theory

Source: Stiles, P. and Taylor, B. (2002) *Boards at Work: How Directors View Their Roles and Responsibilities*, Oxford: Oxford University Press.

### 2.5.1 Agency Theory

Governance arrangements center around principal-agent relationships. Shareholders (principals) who invest in the company select the board of directors (agents). These directors are set responsible to ensure that management of the corporation behaves responsibly and executives carry out their duties (Plumptre, 2004).

The studies conducted by Jensen and Meckling (1976) and Fama and Jensen (1983) are important in the area of principal agent framework. It views the modern corporation as a nexus of contracts between principals and agents (Aguilera and Jackson, 2003). Agency relationship is a contract under which principal engages agent to perform some service on their behalf, that is involving to delegate decision making authority to the agent. In case of corporations, owners are the principals and directors are the agents. But there is possibility that the agent may act partially in the best interests of the principal or does not act in the best interests of the principal. The agent may misuse his power for an advantage; he may not take appropriate risks in pursuance of the principal’s interests because the agent may not see those risks as appropriate to take. There is also the problem of asymmetric information in which the principal and the agent have access to different levels of information. This means

that the principal is at a disadvantage, as the agent will have more information (Fama and Jensen, 1983).

Much of agency theory as related to corporations is set in the context of the separation of ownership and control as described in the work of Berle and Means (1932). In this context agents are the managers and principals are the shareholders. In the corporate governance context this is the most commonly cited agency relationship. It is useful to be aware that the agency relationship can also cover various other relationships such as that of company and creditor, and employer and employee (Mallin, 2004).

The work of Berle and Means (1932) provides one of the fundamental explanations of investor and corporate relationships. Berle and Means' work highlighted that as countries industrialized and developed their markets, ownership and control of corporations became separated. However in many countries, protection of minority shareholders is not effective, and as a result of this situation there has been less impetus for a broad shareholder base. La Porta *et al* (1999) highlighted this situation and concluded that family firm or controlling shareholders rather than a broad shareholder base is the most common form of ownership around the world.

Silva and Gomes (2003) argues that there is a conflict between owners, managers and directors of banks. Goals of the owners, who are the principals, can be significantly different from the goals of the managers and directors, who are the agents. Agents can implement policies that are not consistent with share value maximization. These conflicts of interests can be addressed by contractual solutions. They state that because of high transaction costs contracts do not cover all deviations from value maximizing behaviour. As a result, corporate governance procedures are instituted to address gaps in contractual specifications of rights and obligations of claimants on firm value.

In case of banking sector opaqueness of banks intensifies the agency problem. Because there are information asymmetries between outside investors and insiders in the banking system, it is important to monitor managers for equity holders and debt

holders. On the other hand, exploiting the private benefits of control instead of maximizing value is easier for managers (Caprio and Levine, 2002).

According to agency theory boards of directors are essential in corporate governance mechanisms because of their monitoring role in ensuring that any problems that may be brought about by the principal-agent relationship are minimized. Managers can be thought as the agents of a corporation's owners, but they should be monitored in order to provide evidence that they do not abuse their power. Costs of monitoring and disciplining managers to prevent their abuse and costs resulting from misuse of their positions are agency costs (Blair, 1996).

As a result of the corporate collapses, scandals and abuses which caused shareholders losing their investments and wiping out corporate pension funds, there has been an increasing pressure on shareholders to act more as owners of corporations and to be more effective. With the help of improved transparency and disclosure, which came into place with corporate governance codes and international accounting standards, investors have been better informed about activities of corporations. As shareholders act as owners they will exercise more influence on companies. Boards will be more accountable for their actions and ownership will be returned to the shareholders (Mallin, 2004).

In summary, agency theory states that human behaviour is opportunistic and self-serving. So, it prescribes strong director and shareholder control. It advocates that the main function of the board of directors is controlling managerial behaviour and ensuring that managers act in the best interests of the shareholders (Fan, 2004).

### **2.5.2 Transaction Cost Economics**

Transaction cost economics is studied by Williamson (1975, 1984) and views the firm as a governance structure. Choice of an appropriate governance structure helps to align the interests of directors and shareholders. As firms grow in size their capital needs from capital markets raise and they establish a wider shareholder base. As a result, problems of the separation of ownership and control and corporate governance issues arise (Mallin, 2004).

Transaction cost economics studies the firm behaviour through a contractual or exchange based approach. It focuses on transactions and the costs of transactions by one institutional mode rather than other. According to this theory there are two main dimensions of transactions. These are asset specificity and uncertainty. Uncertainty can be defined as the inability of to specify a complete decision tree by decision makers. When the level of transaction uncertainty increases, information amount that an organization has to process also increases and it causes higher cost (Jiang, 2006).

Asset specificity can be defined as “the degree to which the assets used in support of the transaction can be redeployed to alternative uses without sacrifice of productive value.” Williamson (1985) states three types of asset specificity. These are site specificity, physical asset specificity and human asset specificity.

Site specificity is the situation where successive production stages that are immobile in nature are located close to one another. Physical asset specificity refers to transaction specific capital investments that tailor processes to particular exchange partners. Human asset specificity refers to transaction specific knowhow accumulated by transactors through longstanding relationships (Jiang, 2006).

Hart (1995) states that there are a number of costs to writing a contract between principal and agent which include the cost of thinking about and providing for all the different eventualities that may occur during the course of the contract, the cost of negotiating with others and the costs of writing the contract in an appropriate way. These costs tend to mean that contracts are apt to be incomplete in some way and contracts will tend to be revisited when any omissions or required changes come to light.

In a world of incomplete contracts (where agency problems are also present), governance structure does have a role. Governance structure can be seen as a mechanism for making decisions that have not been specified in the initial contract (Hart, 1995).

Stiles and Taylor (2001) point out that:

Transaction cost economics and agency theory are concerned with managerial discretion, and both theories assume that managers are given to opportunism (self interest seeking) and moral hazard, and that managers operate under bounded rationality...(and) both agency theory and TCE regard the board of directors as an instrument of control.

In this context bounded rationality means that managers will tend to satisfice rather than maximize profits.

### 2.5.3 Stakeholder Theory

According to the stakeholder theory, relationships of the firm with stakeholders determine the capacity of a firm in generating sustainable wealth over time and its long-term value (Post *et al*, 2002). Stakeholder theory defines a corporation as “a socio-economic organization built to create wealth for its multiple constituencies.” The stakeholders of a firm are usually quite diverse, but the relationship between the firm and its stakeholders has common features (Mitchell *et al*, 1997).

Instead of focusing on shareholders, stakeholder theory takes into account a wider group of constituents. A consequence of focusing on shareholders is that the maintenance of shareholder value is paramount, whereas when a wider stakeholder group such as employees, credit providers, customers, suppliers, government and the local community is taken into account, the overriding focus on shareholder value becomes less self-evident. Many companies both try to maximize shareholder value and take into account the interests of wider stakeholder groups. One rationale for effectively privileging shareholders over other stakeholders is that they are the recipients of the residual free cash flow (being the profits remaining once other stakeholders). This means that the shareholders have a vested interest in trying to ensure that resources are used to maximum effect that in turn should be to the benefit of society as a whole (Mallin, 2004).

For Phillips (2003), stakeholder theory is a theory of management and ethics and it is distinct because it addresses morals and values explicitly as a central feature of managing organizations. He also points out that managing for stakeholders involves attention to more than simply maximizing shareholder wealth. Attention to the interests and well being of those who can assist or hinder the achievements of organization’s objectives is the central admonition of the theory.

The critical point for contemporary management is to recognize the mutual interests among the firm and its stakeholders. Jones and Hill (1992) developed a stakeholder

agency model and concluded that managers should act as agents for stakeholders. Jensen (2000) states that if stakeholder theory is widely adopted it reduces social welfare. The reason is that it increases agency costs. He also states that long-term market value of an organization can not be maximized if any important constituency is ignored.

#### **2.5.4 Stewardship**

Stewardship theory has its roots in psychology and sociology and aims at explaining situations in which agents, as stewards, are motivated to act in the best interests of their principals. The main rationale in stewardship theory is that there are no conflicts of interests between agents and principals; there is consensus (Alberti, 2001). Stewardship theory invokes the notion of a company and its governance based on the applicable company law. It is based on the belief that the directors to whom authority is delegated will exercise stewardship (Tricker, 1994).

Agency theory has been criticized in recent years because of its inability to explain sociological and psychological mechanisms inherent of the principal agent interactions (Hoskisson *et al*, 2000). Stewardship theory sets an alternative perspective to agency theory. It assumes that managers are good stewards of the firms and they work diligently to attain high shareholders' returns and profit. They can work closely with principals (Davis *et al*, 1997). Directors are regarded as the stewards of the company's assets and will be predisposed to act in the best interest of the shareholders.

Stewardship theory is grounded in a human relations perspective and starts from opposite assumptions to agency theory. It assumes that managers want to do a good job and will act as effective stewards of an organization's resources. As a result senior management and the owners of the organization are better seen as partners. Hence, the main function of the board is not to ensure managerial compliance or conformance, but to work with management to improve organizational performance. The role of the board is primarily strategic, to add value to top decisions. In this context it is not surprising that management ideas and practices should be applied to governance. From this perspective board members should be selected on the basis of



their expertise and contacts so that they are in a position to add value to the organization's decisions; boards and managers should receive proper induction and training and they should know how to operate effectively as a team (Williamson, 2002).

### **2.5.5 Managerial Hegemony**

The managerial hegemony theory addresses itself to the board, which it describes as a de jure governing body of the organization. Corporate management assumes the real responsibility of running and controlling the organization (Scott, 1997). The board of directors is a legal fiction that is dominated by management. So, the board becomes an ineffective organ for supervising and exercising control over management. This theory points to the paradoxical position of the board in that the power delegated to it by shareholders is actually exercised by management (Demb and Neubauer, 1992).

Agency theory and managerial hegemony theory differs in their perspectives of board of directors-CEO interactions. Managerial hegemony theory argues that:

While board of directors are designed to protect the interests of organizational stockholders several different practical circumstances regarding board of directors operation and member selection serve to limit the board of directors eventual effectiveness as a control function. Examples of forces that serve to limit board of directors' activities as a control function include the ongoing trends regarding the dilution of corporate ownership into smaller stockholder blocks, increased CEO duality which means the CEO also serves as the chair of the board of directors, increased CEO participation in board of directors member selection, compensation determination and dismissal, board of directors dependence on the CEO for accurate and timely information regarding the firm operations and short-term decision making processes (Adams, 2004).

According to this theory these trends serve to increase board of directors' reliance and dependence on the CEO for its composition and continued operation. As a result of this, it limits the board of directors' ability to function in the best interests of stockholders. So, board of directors is viewed as another management tool and as a rubber stamp for management decisions and strategic plans (Kosnik, 1987). In managerial hegemony theory, the boards of directors are seen as organizational entities with little power of their own (Adams, 2004).

According to the managerial hegemony theory:

The board is constrained in its ability to control abuses by management because management inevitably controls them. The theory states that management's significant influence on the board stems from their influence on the nomination process, access to information and the weak incentives for outside directors to actively monitor management. Managerial hegemony theory relates to the thesis that although shareholders may legally own and control large corporations they no longer effectively control them, control having been effectively ceded to a new professional managerial class. From this perspective the board ends up as little more than a rubber stamp for management's decisions. Its function is essentially symbolic to legitimise management's actions (Cornforth, 2002).

### **2.5.6 Class Hegemony**

The class hegemony theory is based upon power shared by an elite class at the head of large corporations. It states that board of directors is a mechanism by which this elite class seeks to perpetuate itself as well as strengthening itself through interlocking directorates (Clarke and Clegg, 1998).

Directors view themselves as elite at the top of the company and will recruit and promote to new director appointments taking into account how well new appointments might fit into that elite. It views the board of directors as a means of perpetuating the power of the ruling capitalist elite (Ricart *et al*, 2004).

Class hegemony theory views governing bodies as a way of perpetuating the power of one elite and therefore its composition is ruled by the will of having members only from one class. By this exclusion of other stakeholders the interests of one and only one group is protected (Alberti, 2001).

Interlocks emphasize upper-class participation in business. The model argues that an upper class elite exists that has cohesiveness, self-consciousness and a consensus on social issues. The unity of this class is promoted through common life experiences, of which membership to a corporate board is an example. Since the size of this elite class is small, a number of members must fill multiple positions, hence the interlocking directorate (Useem, 1980).

## **2.6 Perspectives on Corporate Governance**

There are mainly two different perspectives on corporate governance. These are the liberalist perspective and the communitarian perspective (Bradley *et al*, 1999).

### **2.6.1 Liberalist Perspective**

Liberalist perspective states that the rights and interests of individuals are superior to the societies'. The interests and rights are projected at the corporation level and they should be protected. The main point in the liberalist perspective is that it assumes human beings are selfish and they try to maximize their personal satisfaction. The entrepreneur negotiates with firms' stakeholders and has rights to sell or disband the organization (Bradley *et al*, 1999). Entrepreneur is a self interested individual. Since the entrepreneur pursues his economic interests by the firm, the liberalist perspective holds an instrumental perspective of the firm. Instrumental perspective means that the corporation has no use beyond its functional use as an instrument through which wealth may be maximized (Fischer and Lovell, 2003).

The liberalist perspective states that economic activities are coordinated by the invisible hand and it enables the maximization of social welfare. Invisible hand works more efficiently in free markets where there is minimum government intervention. Free markets provide possibilities to exercise individual choice to achieve maximum individual utility (McKenzie and Johnson, 2004). Some of the definitions of corporate governance within liberalist perspective are as the following:

- Corporate governance refers to institutions including laws, regulations and acceptable business practices which, in a market economy, govern the relationship between corporate managers and entrepreneurs on the one hand and those who invest resources in a corporation on the other (Oman *et al*, 2003).
- Corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment (Shleifer and Vishny, 1997).
- Corporate governance is an umbrella term that includes specific issues arising from the interaction among senior management, shareholders, boards of directors and other corporate stakeholders (Cochran and Wartick, 1988).

### **2.6.2 Communitarian Perspective**

The main distinguishing feature of the communitarian perspective is the inclusion of different constituencies in decision making processes of corporations. Managers should take into account the interests of stakeholders in decision making process. Stakeholders include customers, employees, suppliers, creditors, etc. (Melyoki, 2005). The managers are considered as stewards of corporate assets for the benefits

of stakeholders rather than as agents working for the interests of shareholders as in the liberalist perspective (Tricker, 1994). In this perspective, an important challenge is the inadequacy of stakeholder participation in governance process. This causes the use of power by some stakeholders as they attempt to exert influence over decision making processes (Weimer, 1995).

Some of the definitions of corporate governance made by the authors of the communitarian perspective are the following:

- The exertion of influence by stakeholders on the managerial decision making processes (Weimer, 1995).
- The process by which, corporations are made responsive to the rights and wishes of stakeholders (Demb and Neubauer, 1992).
- The total of structures, arrangements and conventions that is determinant for the manner in which and the effectiveness with which a corporation, by means of interaction between stakeholders, characterized by stimuli and deterrents is managed and supervised (Pape, 1999).

## **2.7 Internal Corporate Governance Mechanisms**

### **2.7.1 Board of Directors**

Board of directors represents the interests of shareholders. It hires, monitors and compensates management and tries to maximize shareholder value. In general, management has strong power in the selection process of board members. The main issues about the board of directors are board composition and executive compensation. Board composition includes size of the board, the structure of the board, number of directors and whether the CEO and chairman is the same individual. On the other hand, executive compensation concerns if managers are compensated in a way that aligns shareholders' interests (Denis and McConnell, 2003).

En Bai *et al* (2004) states some issues derived from studies related to board composition and firm performance.

- Firms the boards of which contain majority of independent directors do not perform better than the other firms.

- An acceptable number of inside directors is associated with greater performance and profitability.
- In some countries there is a strong negative relationship between CEO turnover and firm performance.

### 2.7.2 Ownership Structure

Ownership structure is an important element of corporate governance. Greater overlap between ownership and control reduces conflicts of interests and ensures higher firm value. Ownership by a company's management can serve to better align the interests of managers with those of the shareholders. On the other hand, higher equity ownership provides managers greater freedom to pursue their own objectives. So, effects of managerial ownership on the value of the firm depend on the trade-off between the alignment and entrenchment effects (Denis and McConnell, 2003). Concentrated equity ownership can distort corporate governance of the firm. Because it gives the largest shareholders more discretionary power to use the firm's resources in a way that serve their own interests at the expense of shareholders' (En Bai *et al*, 2004).

Shareholders can influence the actions of management. The main problem in widely dispersed ownership structures is that individual shareholders have small fractions of shares and have little or no incentives to monitor or influence managers. On the other hand, individual shareholders who have significant fractions of ownership have more incentives in monitoring and influencing management. Government ownership is a common practice both in corporations and banks in many countries. If government is viewed as a single entity government ownership corporations have concentrated ownership. State ownership is funded by money that belongs to government, not to individuals within the government that influence actions of the firm. In this perspective, ownership of state owned companies is quite dispersed (Denis and McConnell, 2003).

### **2.7.3 Executive Compensation**

Third internal corporate governance mechanism is executive compensation. Executive compensation can be linked to stock valuation and accounting based performance. Empirical studies state that there is a positive relationship between executive pay and performance (En Bai *et al*, 2004).

### **2.7.4 Transparency and Disclosure**

Transparency and information disclosure are important in all countries. Managers should provide sufficient, timely and accurate information about the financial position and operations of the organization (En Bai *et al*, 2004).

## **2.8 External Corporate Governance Mechanisms**

### **2.8.1 Market for Corporate Control**

A market for corporate control is important for efficient allocation of resources. It ensures replacement of inefficient managers who can control large amounts of resources (En Bai *et al*, 2004). There is incentive for outside parties to take control of the organization when the internal control mechanisms fail significantly. Changes in the control of the firm occur at a premium and create value for shareholders. Change in the control of the organization may provide management incentives to increase or keep firm value high. As a result, the value gap is not large enough to warrant an attack from outside. So, the takeover market is an important governance mechanism (Denis and McConnell, 2003).

### **2.8.2 Legal and Regulatory System**

Legal system is an important corporate governance mechanism. The extent to which investor rights' are protected by laws and these laws are enforced are important determinants of corporate governance system within a country. It is found that in countries with common law tradition, governance standards are higher and minority

shareholders are better protected. On the other hand, in countries where there is continental law systems governance standards are lower and minority shareholders are less protected (La Porta *et al*, 1998).

### **2.8.3 Product Market Competition**

Product market competition is another external corporate governance mechanism. If managers waste the resources of the firm, the firm can not compete against its competitors as intended. Competition reduces efficiency losses and reduces managerial slack (En Bai *et al*, 2004).

## **2.9 Principles of Corporate Governance**

### **2.9.1 Disclosure and Transparency**

Disclosure of accurate and timely information enables investor confidence and market efficiency. Disclosed information should be clear, consistent and comparable. If this is the case investors can make educated decisions concerning the allocation of their assets and it enables high performing corporations with lower cost capital (Millstein *et al*, 1998).

Disclosure is not effective if investors do not rely on the credibility of the information that is disclosed. The most straightforward way to assure credibility of disclosure is to mandate disclosure by law, and impose penalties. Different information about the organization may be important to different users. The form of disclosure allows users to restructure the information as they see fit. The critical concept is that hidden should not be attached to any disclosure (Gilson, 2000).

Investors try to protect their capital, so they demand transparency and disclosure. While making their investment decisions, investors rely on the information they receive from companies. It is the fiduciary duty of management to provide full disclosure on financial statements and the accuracy of this information is of great significance (Darman, 2004).

Disclosure ensures the improvement of the public understanding of the structure and activity of the company, corporate policies and performance. A strong disclosure is important for monitoring and is important for shareholders' ability to exercise their voting rights. A strong disclosure can attract capital and enhance confidence in capital markets. Insufficient information hampers the ability of markets to function, increases the cost of capital and causes inefficient allocation of resources (McKenzie and Johnson, 2004). With the help of this principle, investors can actually examine companies, can understand their real market values, compare their performance and can take the best investment decisions (Dunlop, 2001).

According to OECD principles of corporate governance, disclosure should include the financial and operating results of the company. Audited financial statements are the most widely used source of information about companies. OECD principles highlight the timely and cost efficient access to relevant information concerning related party transactions (OECD, 2004).

Disclosure should cover the material matters of the corporation. They include ownership and voting rights, material risk factors, issues regarding employees and other stakeholders, government structures and policies. Transparency enables the financial markets, depositors and other stakeholders to form a fair view of the value of the company and they trust in the quality of the company and its management (OECD, 1999).

Corporate governance should ensure accurate and timely disclosure of material matters about performance, financial situation, ownership and governance structures of the company. Strong disclosure attracts capital and ensures confidence in the markets. On the other hand, weak disclosure causes unethical behaviour and loss of market integrity. Shareholders and investors need regular and reliable information in making their decisions. Insufficient and unclear information hinders efficient functioning of markets, increases the cost of capital and causes misallocation of resources (OECD, 2004).



The following are stated in OECD (2004) about disclosure and transparency:

- Disclosure should include material information on financial and operating results, company objectives, major share ownership and voting rights, remuneration policy for board members and key executives, related party transactions, foreseeable risk factors, issues about stakeholders, governance structures and policies.
- Information disclosure should be made in conformance with accounting standards, financial and non-financial disclosure.
- In order to ensure that financial statements fairly represent true financial position and performance of the company, independent auditors should conduct annual audits.
- External auditors should exercise due professional care and should be accountable to the shareholders.
- Equal, timely and cost efficient access to relevant information by users should be provided.
- An approach that promotes analysis or advice by analysts, rating agencies, etc. should be included in corporate governance framework. Since they are free from material conflicts of interest, they are important for the integrity of the analysis of investors.

In order to determine the scope of information to be disclosed, materiality concept can be taken into account. OECD (2004) defines materiality as “information whose omission or misstatement could influence the economic decisions taken by users of information”. So, it is important to ensure regular and timely disclosure of material information to shareholders and investors.

Among the key elements of Accounting Industry Reform Act 2002 (Sarbanes Oxley Act) is increased disclosure requirements. So, as a part of the disclosure and transparency principle of corporate governance, Sarbanes Oxley Act is discussed below.

### 2.9.1.1 Accounting Industry Reform Act 2002 (Sarbanes Oxley Act)

Corporate scandals and collapses led to the passage of Accounting Industry Reform Act 2002, widely known as the Sarbanes-Oxley Act. Any company, registered with the US Securities and Exchange Commission (SEC) is subject to Sarbanes Oxley Act.

The main categories covered in Sarbanes Oxley Act are the following:

- Establishment of a Public Company Accounting Oversight Board,
- Provisions concerning the composition of Audit Committees, including the independence of members and their responsibility for appointing auditors,
- Prohibition of personal loans to executives,
- The banning of auditors from providing non-audit services,
- Forfeiture of directors' bonuses if these were based on misleading accounts,
- Assignment of responsibility to CEOs and CFOs to certify the accuracy of the financial and other information in company reports,
- Penalties for misleading auditors,
- Protection of whistleblowers.

One of the most important aspects of the Sarbanes Oxley Act was the requirement for CEOs and CFOs to certify that quarterly and annual reports are fully compliant with applicable securities laws and present a fair picture of the financial situation of the company. The penalties for not complying with the requirements are monetary fine, imprisonment or both.

The Sarbanes Oxley Act aims to strengthen auditor independence and the company's Audit Committee. Listed companies, for example, must have an Audit Committee comprised only of independent members, and must also disclose whether it has at least one Audit Committee financial expert on its Audit Committee. The Audit Committee financial expert should be named and the company should state whether the expert is independent of management.

The Act establishes a new regulatory body for auditors of US listed firms, the Public Company Accounting Oversight Board, with which all auditors of US listed companies have to register, including non-US audit firms. Correspondingly the Securities Exchange Commission (SEC) has issued separate rules, which encompass the prohibition of some non-audit services to audit clients, mandatory rotation of audit partners and auditors' reports on the effectiveness of internal controls. The SEC implementation of the Sarbanes Oxley Act prohibits nine non-audit services that might impair auditor independence (Mallin, 2004). These nine areas cover:

- Book-keeping or other services related to the accounting records or financial statements of the audited company,
- Financial information systems design and implementations,
- Appraisal or valuation services, fairness opinions or contribution-in-kind reports (where the firm provides its opinion on the adequacy of consideration in a transaction),
- Actuarial services,
- Internal audit outsourcing services,
- Management functions/ human resources (an auditor should not be a director, officer or employee of an audit client nor perform any executive role for the audit client such as supervisory, decision making or monitoring),
- Broker or dealer, investment adviser, or investment banking services,
- Legal services or expert services unrelated to the audit,
- Any other service that the Public Company Accounting Oversight Board decides is not permitted.

According to Sarbanes Oxley Act, companies are required to disclose in their annual report the fees paid to the independent accountant for each of audit, audit-related, tax and other services. The auditor is required to report to the Audit Committee information that includes critical accounting practices and alternative accounting treatments.

There are some requirements about audit partners. It is required that the lead audit partner should rotate every five years, and then subject to a five year period when it can not be the audit partner for that company. Other partners not acting as the lead partner are subject to a seven-year rotation period followed by a two-year bar. Also it is prohibited for any member of the audit team to accept a certain job in a company that he has audited in the last one-year period.

### **2.9.2 Fairness**

Fairness can be defined as equal treatment of shareholders, protection of minority interests and protection of shareholder rights and interests of foreign shareholders. Minority shareholders and other stakeholders are treated fairly and their interests are taken into account. In case of fairness, decisions and their implementation will not be allowed to create unfair advantage to any party (Millstein, *et al*, 1998).

OECD (2004) states that the corporate governance should ensure treatment of all shareholders in an equitable way. Shareholders should be able to obtain effective redress for violation of their rights. There is the possibility that boards, managers and shareholders can engage in activities that may be benefit of their own interests at the expense of non-controlling shareholders. OECD (2004) makes a distinction between ex-ante and ex-post shareholder rights. Examples for ex-ante rights can be preemptive rights and qualified majorities for certain decisions. On the other hand, ex-post rights allow the seeking of redress once rights have been violated.

OECD (2004) supports equal treatment of foreign and domestic shareholders. It states the equal treatment of shareholders under three main headings as listed below.

- All shareholders of the same series of a class should be treated equally.

All shares within any series of a class should carry the same rights. Investors should be able to obtain information about the rights attached to all series and classes of shares before they purchase. Changes in voting rights should be approved by the classes of shares that are affected negatively. There should be protection for minority shareholders from abusive actions of controlling shareholders. Controlling

shareholders can reduce the agency problem by monitoring management. But, on the other hand weaknesses in legal and regulatory framework can cause the abuse of other shareholders in the company.

- Insider trading and abusive self-dealing should be prohibited.

In the case of abusive self-dealing, persons have close relationships with the company and use these relationships to the disadvantage of investors and the company. Because of manipulation of capital markets in insider trading, it is prohibited in most OECD countries.

- Board members and key executives should disclose to the board if they have a material interest in any transaction or matter, which directly affects the corporation.

Board members and key executives should inform the board about their business and other relationships out of the company, which can affect their judgments about the operations of the company. If there is a material interest, the person should not be involved in the decision making process involving the matter.

### **2.9.3 Accountability**

Accountability means clarifying governance responsibilities and ensuring the alignment of managerial and shareholder interests (TUSIAD, 2002). The board of directors is positioned as the internal corporate governance mechanism for holding management accountable to shareholders. Board oversight enables to reduce the potential for divergences between management and investor interests. Accountability principle is generally based on internal checks and balances. In corporate context they include sound audit practices. Sound audit practices include board selection and reliance on an independent auditor and they should be encouraged (Millstein *et al*, 1998).

Management is accountable and must answer to the board of directors for achieving plans and implementing approved policies that ensure the safeguarding of assets and

the financial viability of the organization. On the other hand, the board of directors is accountable to the shareholders and stakeholders (Kimberly, 1995).

Accountability is inherently linked to corporate governance and aims to hold responsible the management of an organization for its performance and entails making judgments on proper use of executive power. It ensures that the behaviour is consistent with the purpose of the company's undertaking (Bavly, 1999). Accountability provides objective criteria for executive and consulting performance. Accountable individuals are aware of that they must defend their decisions that they have accepted responsibility and will have to take the blame for their wrong choices (Kimberly, 1995).

Corporate governance is concerned with processes associated with decision making, production and controls within an organization. Accountability considers the company's operating procedures and also recognizes the shareholders' right to know (Hsieh, 1999). It focuses on efficiency and productivity and proving that the results claimed were actually accomplished. It also implies a relationship where the corporate officers are accountable to the board and the board is accountable to shareholders. It gives responsibility to an institution, corporate officers or individuals and mandates full reporting of that responsibility (Bavly, 1999).

#### **2.9.4 Corporate Social Responsibility**

According to the OECD, "corporate social responsibility involves the search for an effective fit between businesses and the societies in which they operate" (OECD, 1999). The fit helps to foster mutual trust and predictability, which enhance economic, social and environmental welfare. The core element of corporate social responsibility concerns business activity and involves corporations' relationships with the society as a whole (Darman, 2004).

It states that companies should also take into account the interests of the groups other than the shareholders in decision-making process and cooperate with them. They should notice the social impacts of their activities. The main objective here for the company is to fulfill its responsibilities against the society and to achieve sustainable

development of performance. It forces the managers of corporations to take into consideration the benefits and wishes of the stakeholders such as employees, customers, suppliers and government (Gregory, 2002).

Corporate social responsibility enables companies to set desirable policies by themselves, considering the goals and values of the society make a decision and put them into practice (Drucker, 1984). It means to unfold business activities in a comprehensive way for the aim of sustainable development (Kang, 2005). There are both positive and negative perspectives against corporate social responsibility. Neo-classic economics takes a negative perspective. According to their view, companies contribute to society by maximizing their profits, improving efficiency and reducing costs (Lee, 2004).

Stakeholder theory takes a positive perspective against corporate social responsibility. As a result of the development of capitalism in 20<sup>th</sup> century, influence of companies has increased. Companies should serve their own role as members of society. When they avoid any social demands, such avoidance turns out to be the cost of the society and expand the spending of business costs. Development of society will be beneficial to corporate development as well (Carrol, 1999).

Business confidence serves an important role in consumers' decision-making. If companies lose confidence of the consumers, it affects their share prices and profits and also threatens the long term existence of the organization. If companies fulfill their social responsibilities, market and brand values of companies can be enhanced (Kang, 2005).

#### **2.10 Development of Corporate Governance Codes**

Desire for more transparency and accountability and increase investor confidence within the markets fastened the introduction of corporate governance codes. Development of corporate governance codes has often been affected by corporate failures, scandals or crisis (Mallin, 2004).

Cadbury Report influenced the development of many corporate governance codes globally. Similarly the OECD principles are reviewed in detail as they have also formed the cornerstone of many corporate governance codes.

### **2.10.1 Cadbury Report (1992)**

As a result of the financial scandals and collapses and a general lack of confidence in the financial reporting of many UK companies, the Financial Reporting Council, the London Stock of Exchange and the accounting profession established the Committee on the Financial Aspects of Corporate Governance in May 1991. Sir Adrian Cadbury chaired the Committee and when the committee reported in December 1992, the report became widely known as the Cadbury-Report (Mallin, 2004). The Cadbury Report recommended a Code of Best Practice with which the boards of all listed companies registered in the UK should comply, and utilized a “comply or explain” mechanism. This mechanism means that a company should comply with the code but if it can not comply with any particular aspect of it, it should explain why it is unable to comply. This disclosure gives investors detailed information about any instances of noncompliance and enables them to decide whether the company’s noncompliance is justified (Cadbury, 1992).

Recommendations in this report are divided into four main categories. These categories are the board of directors, non-executive directors, executive directors and reporting and controls. Recommendations based on these four categories are listed below (Cadbury, 1992).

#### The Board of Directors

- The board should meet regularly, retain full and effective control over the company and monitor non-executive management,
- There should be clear division of responsibilities at the head of a company. This will ensure a balance of power and authority, such that no one individual has unfettered powers of decision. In the case that the chairman is also the Chief Executive Officer (CEO) of the company, there should be



a strong and independent element on the board, with a recognized senior member,

- The board should include non-executive directors of sufficient qualification and number,
- The board should have a formal schedule of matters specifically reserved to it for decision in order to ensure that the direction and control of the company are under its control,
- It is necessary to have a procedure for directors in the furtherance of their duties to take independent professional advice if necessary,
- The directors should be able to access to the advice and services of the company secretary, who is responsible against the board in order to ensure that procedures, rules and regulations are complied with.

#### Non-Executive Directors

- Non-executive directors should bring an independent judgement in order to bear on issues of performance, strategy, resources and standards of conduct,
- Majority of the non-executive directors should be independent of management and free from any business relationship that could materially undermine their independent judgments, apart from their fees and shareholding,
- They should be appointed for specified terms and their reappointments should not be automatic,
- They should be selected by a formal process and their selection and appointment should be a matter for the board as a whole.

#### Executive Directors

- Executive directors' service contracts should not be longer than three years without the approval of shareholders,
- There should be a clear disclosure of directors' total emoluments and those of the chairman. Separate figures should be given for salary and

performance related elements and performance measurement basis should be explained,

- Remuneration committee's recommendations should be taken into account when determining the pay of executive directors,

#### Reporting and Controls

- It is the board's duty to present a balanced and understandable assessment of the company's position,
- The board should ensure that there is an objective and professional relationship with the auditors,
- An Audit Committee which consists of non-executive directors should be established by the board of directors,
- The directors should report on the effectiveness of the company's internal control system,
- It should be reported that the business is a going concern, with supporting assumptions or qualifications as necessary, by the directors.

#### **2.10.2 OECD Principles of Corporate Governance (1999/ 2004)**

OECD principles of corporate governance were published in 1999 and updated in 2004. According to OECD there is no single corporate governance model that can be applied to all countries. So, the main principles established by OECD states common characteristics that are essential for good corporate governance. OECD principles are organized under six headings: ensuring the basis for an effective corporate governance framework, the rights of shareholders, equitable treatment of all shareholders, the role of stakeholders in corporate governance, disclosure and the responsibility of the board of directors. OECD principles of corporate governance can be explained as the following:

✓ Ensuring the Basis for Effective Corporate Governance Framework

Countries should promote transparent and efficient markets and clearly describe the division of responsibilities among different supervisory and regulatory authorities. This principle requires the development of a corporate governance framework with a view of its impact on the overall market participants. It encourages accountability among institutions that have a bearing on corporate governance.

✓ The Rights of Shareholders and Key Ownership Functions

Corporate governance framework should protect shareholders' rights. Good corporate governance principles recognize and explain the property rights of shareholders, obtain relevant information timely and regularly, rights to secure methods of ownership transfer or convey shares, vote at general meetings and elect members of the board of directors. However, there is a weakness in this principle. It is that mentioning extensive rights is not the same as effective corporate governance (Frederick, R., 1999). So, it is not special to specify rights and it is required to establish actual mechanisms for realizing these rights (Melyoki, 2005).

✓ Equitable Treatment of Shareholders

Corporate governance framework should ensure equitable treatment of shareholders, minority shareholders and foreign shareholders. Shareholders should be able to obtain effective redress for violation of their rights.

✓ The Role of Stakeholders in Corporate Governance

Stakeholders play an important role like the shareholders for the survival of the corporation. Corporate governance framework should recognize the rights of stakeholders and encourage active cooperation between corporations and stakeholders.

#### ✓ Disclosure and Transparency

Corporate governance framework should ensure that timely and accurate disclosure is made regarding the financial situation, corporate objectives, performance, ownership, issues involving other stakeholders and governance of the company. The importance of applying high quality accounting and auditing standards is also emphasized under this principle.

#### ✓ The Responsibilities of the Board

Corporate governance framework should ensure strategic guidance of the organization, effective monitoring of management by the board and accountability against shareholders and stakeholders. This principle requires directors to be effective overseers of management performance and provide accountability to shareholders and other organizational constituencies. This principle outlines key board functions in effective monitoring of management performance (Melyoki, 2005). They are the following:

- Reviewing corporate strategy, major action plans, risk policy, annual budgets and business plans,
- Setting objectives, monitoring implementation and performance, overseeing capital expenditure, acquisitions and divestitures,
- Selecting, monitoring, compensating and replacing key executives and overseeing succession planning,
- Reviewing board and executive remuneration, establishing a formal and transparent board nomination process,
- Managing conflicts of interest of management, board members and shareholders,
- Ensuring the integrity of financial reporting and accounting systems, independent audit, systems of control in particular systems for monitoring risk, financial control and compliance with the law,
- Monitoring the effectiveness of governance processes and overseeing disclosure and communications process.

### 2.10.3 World Bank

The World Bank's corporate governance activities mainly focus on the rights of shareholders, the equitable treatment of shareholders, disclosure and transparency and the duties of board members. Clearly the OECD principles are very much in evidence in this approach (Mallin, 2004).

The World Bank utilizes the OECD principles to prepare country corporate governance assessments which detail and assess the corporate governance institutional frameworks and practices in individual countries. These assessments may then be used to support policy dialogue, strategic work and operations, and aid in determining the level of technical assistance needed in given countries in relation to their corporate governance development. In addition the IMF produces reports on the observance of standards and codes, which summarize the extent to which countries observe internationally recognized standards and codes. Sections on corporate governance, accounting, and auditing are included in these reports (Mallin, 2004).

## Chapter 3

### Corporate Governance in Banking System

#### 3.1 Bank Corporate Governance

Banks play critical roles in the economies. They are extremely important engines of economic growth, they provide financing and basic financial services for the economy, access to payments systems, and some banks are expected to make liquidity available in difficult economic conditions (BCBS, 1999). On the other hand crises that occur in the banking system destabilize both economic and social situations of countries. As a result, corporate governance of banks arises as an important issue. Banks which are properly governed will be more efficient compared to other banks (Levine, 2003).

Good governance is an important concept for banks and also because of the unique characteristics of banks and their regulated condition it is different from the other firms. One of the major causes of bank collapses is the failure of boards of directors and management of banks. If banks are governed better, it will be helpful in preventing bank failures and in decreasing the costs derived from bank failures (Busta, 2004).

In banking system,

corporate governance involves the manner in which the business and affairs of institutions are governed by their boards of directors and senior management affecting how banks (BCBS, 1999):

- Set corporate objectives,
- Run the day to day operations of the business,
- Consider the interests of recognized stakeholders,

- Align corporate activities and behaviours with the expectation that banks will operate in a safe and sound manner and in compliance with applicable laws and regulations,
- Protect the interest of depositors.

Boards of directors should establish strategies in order to direct the ongoing activities of banks and establish and approve corporate values. Values should emphasize the importance of clear and timely discussion of problems and prohibit bribery and corruption in corporate activities (BCBS, 1999).

### **3.2 Differences Between Banks and Other Firms**

Universal banking can be divided into basically three functions. These are retail banking, investment banking and asset management. Retail banking can also be divided into two main categories: commercial banking and private banking. Private banking deals with the management of the portfolios of wealthy individuals. On the other hand commercial banks collect deposits, manage accounts and banking transactions and lend money to customers. Investment banking deals with mergers and acquisitions, underwriting of securities and asset management is responsible from institutional assets and savings instruments (Busta, 2004).

Banks are different from other firms in the economy because of the nature of their businesses (collecting deposits and making loans), their crucial roles in the economy, their roles in economic growth and healthy functioning of financial system (Busta, 2004). Llewellyn (2001) and Macey and O'Hara (2003) pointed out some factors that affect corporate governance in banks and make corporate governance of banks different than other companies:

- Regulation in banking system has an important impact on bank governance. Regulation in banking contains information disclosure, reserve requirements, monitoring lending policies of banks and deposit insurance in order to ensure sound functioning of the banking system.
- Monitoring and supervision of banks by official agencies is an important factor. Some authorities provide monitoring and supervision which influence incentives of depositors and shareholders to exercise control.

- Different than the other sectors, existence of the fiduciary relationship between banks and their customers.
- Banks should present a less concentrated ownership structure than manufacturing firms, since regulation means subsidized monitoring by the government.
- Banks have a more leveraged capital structure. Debt may account for 90 percent of the funding of a banking institution; whereas in manufacturing firms this proportion is generally below 50 percent.
- Banks are fragile institutions. Their liquidity production function which includes the mismatch in the term structure and liquidity of their assets and liabilities, together with the high debt ratios make bank runs an important and serious risk.
- Banks present higher risk of failure to fraud and self-dealing as a result of deposit insurance reducing the incentive for monitoring within the firm.
- Boards of directors of banks are larger and more independent (higher proportion of outside directors) than the other firms.
- Investment opportunities in banking sector might be different than in other sectors of the economy.

Because of the special characteristics of banks listed above, it is different to enhance corporate governance of banks than other non-financial firms. The mechanisms that have been developed in banks should not serve the interests of shareholders only and risk management and internal control mechanisms of banks should be strengthened (Nam and Lum, 2006).

Understanding the corporate governance in banks is important for many reasons. In case of efficient allocation of funds by banks cost of capital to firms decreases, economic growth is stimulated, as a result of the stability in financial system economic development can be achieved and negative effects of bank failures can be prevented (Levine, 1998).

Banks are regulated more than the other firms. Regulation in banks can also influence the role of corporate governance. Also, banks are more opaque than the



other firms and there is greater information asymmetry between insiders and outsiders of banks. Because of this information asymmetry it is more difficult for stakeholders to monitor managers (Caprio and Levine, 2002).

Development of the financial system is important for the development of the economy as a whole. Banking system is a crucial component of the financial system of countries and for many developing countries it is the dominant component of the financial system. Banks are financial intermediaries that extend credit and administer the payment system and they are important components of the economy. Banking industry is seen as a key actor in causing and preventing financial and economic crises (Barth *et al*, 2004).

Banks and other financial intermediaries exert corporate governance on firms, both as creditors of firms and, in many countries, as equity holders. As Caprio and Levine (2002) point out, in many developing countries where banks dominate as financial intermediaries, banks are among the most important sources of governance for firms. To the extent banks are well-managed; there will be efficient allocation of capital in an economy. If there is poor corporate governance of banks, bank managers may induce managers of the firms to behave in ways that favor the interests of bank managers. But this can hurt overall performance of the firm and the economy (Macey and O'Hara, 2003).

In governance literature, very little attention has been paid to corporate governance of banks. But, as a result of recent governance scandals that took place in many of the economies, interest in corporate governance practices of banks have started to rise. Since the liabilities of banks, especially to depositors, play an important role in the economy, bank directors should owe fiduciary duties to fixed and equity claimants (Macey and O'Hara, 2003). According to Caprio and Levine (2002), governments, debt holders, equity holders and competitive discipline of output markets have important roles in effective functioning of corporate governance mechanisms of banks.

Transparency is an important dimension of corporate governance mechanisms both in banks and non-financial organizations. When the operations of banks are

transparent, it is easier for shareholders and stakeholders to monitor activities and performance of managers (Caprio and Levine, 2002). In their studies, Caprio and Levine (2002) present some factors that contribute to effective transparency of banks. These are the effectiveness of external audits, transparency of accounting practices, evaluations by external rating agencies and incentives for creditors to monitor the performance of banks (Caprio and Levine, 2002).

### **3.3 Banks and the Governance Problem**

When funds are efficiently allocated by banks cost of capital to firms decreases, capital formation and productivity growth are positively affected. On the other hand, weak corporate governance in banking system causes negative effects both on the banking system and economic development. So, governance of banks plays a crucial role in an economy. If sound governance mechanisms have already been established, bank managers will allocate capital more efficiently, will act on the interests of both shareholders and debt holders and exert sound governance over firms that they fund. But if bank managers act in their own interests, savings of society will be allocated less efficiently, interests of shareholders and stakeholders will not be taken into account and banks will less likely exert sound governance over firms which they fund. Many of the banking crises are as a result of weak corporate governance mechanisms. Because of poor governance, banking crises occur, there exists poverty, economy destabilizes, economic growth and productivity are negatively affected (Levine, 2003).

Macey and O'Hara (2003) states some reasons why banks are considered to be special. These are the following:

- Banks heavily rely on deposit receipt. So they have a high debt-equity ratio and their balance sheet structures are different from other non-financial institutions. Banks issue liquid liabilities while holding illiquid assets and there is a maturity mismatch between both assets and liabilities sides of their balance sheets. These features make banks very vulnerable to shocks.
- Banking sector has a large positive externality. Governments have particular interests about the stability of banking sector. Because, bank

failures can cause erosion of public confidence in the banking sector, they cause runs on solvent banks and have a crucial impact on the economy as a whole.

- As a result of government deposit guarantees, banks' risk taking increases and depositors have less incentive to monitor banks. This insurance function makes governments as important stakeholders of banking institutions. It also encourages banks to take a risky business strategy. Since banks do not need to rely on large uninsured depositors who might have strong incentives to monitor banks, they are not interested in improving their corporate governance.

Macey and O'Hara (2003) argue that the directors of banks should be held to a broader set of standards than nonfinancial firms. It is recommended to top bank executives taking into account solvency risk explicitly and systematically in decision making. The duties and obligations of bank directors and officers should be expanded to ensure soundness and safety of banks.

Caprio and Levine (2002) states the main factors that make corporate governance problem more serious in banks than other non-financial institutions. First of all, information asymmetry and agency problems are more serious in banks than other firms because of their opaque structures. The quality of loan portfolios of banks is difficult to evaluate and it is easy to hide problems from outsiders. As a result of opaqueness and information asymmetries, insiders in banks have strong incentives to act in their own interests rather than the interests of stakeholders.

Second, banking sector has a heavily regulated structure to safeguard the stability of the financial sector. This makes governments responsible against customers when banks are in trouble. Also, banks have access to governments' safety nets. Government regulations require diffused ownership structures which cause continuous government intervention and weak governance structures in banks.

Third, usually competition in banking sector is not as intense as it is in other sectors. While competition can be seen as a factor that disciplines the behaviours of managers, it can distort corporate governance mechanisms of banks. Inadequate

competition is attributable to government regulations such as government ownership of banks, entry barriers, restriction of services, etc. in order to stabilize the banking sector and thus the financial market.

Fourth, financial institutions have started to face higher risks and their corporate governance mechanisms are weakening as a result of globalization and deregulation. They are involving with activities that consist of increasingly complex instruments and they face with intense competition. Also, decision making and risk taking decisions are delegating from top management to down. In order to struggle with those risks corporate governance and risk management mechanisms of banks should be strengthened.

Fifth, corporate governance of banks also have an important role in governance of other corporate clients. Banks can periodically monitor their corporate clients and are able to review their creditworthiness regularly. If performances of their clients are going bad banks may intervene in the management and governance of their clients. This is an efficient alternative for corporate control in Anglo-American corporate governance model.

### **3.4 Opaqueness of Banks**

#### **3.4.1 Implications for Governance by Equity and Debt Holders**

In banks, it is difficult for equity and debt holders to monitor bank managers because of information asymmetries between insiders and outsiders. Debt holders do not concern upside potential from risk taking but they take into account the downside if the bank may not service its debt. So, it is difficult for debt holders to control banks from this risk shifting because of their opaque structures (Levine, 2003).

Managers find it easier to manipulate payoffs from compensation packages when outcomes are not easy to measure. Bank managers, who are concerning to increase their compensations, can be interested in increasing their interest revenues by giving high interest loans to troubled borrowers. In case of opaque structure, managers can

benefit from compensation packages that can have negative consequences on the long term health of the bank (Levine, 2003).

### **3.4.2 Implications for Governance by Competition**

Product market competition is relatively less intense in banking compared to other firms. Opaque structure of banks impairs competitive forces in banking sector, whereas in other sectors, helps disciplining managers through the threat of takeover. There are long term relationships between banks and their clients and these relationships constitute barriers to competition. Because of opaque structure of banks, insiders have better information than outsiders and purchasers. So, takeovers become less effective in opaque structures. Also, in industrialized countries, hostile takeovers are rare (Prowse, 1997).

Anderson and Campbell (2000) states that in 1996 despite serious problems of Japan banks there were few takeovers and there is a very low relationship between bank performance and manager turnover. Takeovers in baking system are observed rarely in banking systems of developing countries. But, takeovers are observed more frequently after bankruptcies of banks. The main reason behind this problem is the opaque structure of banks which distorts corporate governance mechanisms (Anderson and Campbell, 2000).

Inefficient and undeveloped securities markets hamper takeovers and distort corporate governance. If banks' shares do not trade actively in developed and efficient equity markets, takeovers will be hindered as effective corporate governance mechanisms. Also absence of efficient securities markets means that financial instruments such as debentures, which are used to limit managerial discretion do not exist (Levine, 2003).

## **3.5 Bank Regulation**

### **3.5.1 Implications for Governance by Shareholders and Competition**

Concentration of ownership and ability of outsiders purchasing a substantial percentage of a bank's stock without approval is restricted by many of the governments. Governments put these restrictions in order to prevent concentration of power and people controlling a single bank. So, in many of the countries it is required to take government approval if stock purchasers reach above a certain level (Levine, 2003).

Barth *et al* (2003) studied bank regulation and supervision in 107 selected countries. They found that governments of 41 countries put a percentage limit on bank capital ownership by a single organization which is less than 50% and governments of 38 countries put a limit which is less than 25%. Also there are some constraints to bank ownership such as prohibition of bank ownership by insurance firm, securities firms or non-financial institutions. In another study conducted by Caprio *et al* (2003), it is found that 75% of banks have a single owner that holds more than 10% and more than half of these owners are families. They concluded that government restrictions about share purchases do not prevent family ownership; they defend existing owners from competition for control.

### **3.5.2 Implications for Governance by Depositors**

Deposit insurance obstructs corporate governance in a way that it reduces incentives of depositors to monitor banks. It also ensures banks to rely more on insured depositors who have no incentives to monitor banks rather than uninsured depositors. Also with the role of central banks as lender of last resort, banks produce lower capital-asset ratios compared to other firms. As this ratio falls, controlling owners of banks begin to think of increasing the riskiness of banks (Levine, 2003). As a result of deposit insurance, bank owners increase the risks because of lower capital asset ratios and incentives of depositors not to monitor banks. Thus, in countries which

apply higher deposit insurance there is a more probability of banking crises to occur (Demirguc-Kunt and Detragiache, 2002).

### **3.5.3 Implications for Competition**

In most of the countries governments set limits and restrictions about ownership structures and concentration of banks. Government regulations and restrictions distort competition in banking system. As an example of reducing competition in many countries there are restrictions to banks on conduct of insurance businesses, real estate businesses or take ownership in nonfinancial institutions (Barth *et al*, 2003).

Also in banking systems of most of the countries there are restrictions or regulations about liquidity requirements, limits on interest rates and commissions, portfolio restrictions and minimum limits about capital adequacy ratios. While there are positive effects of those government regulations, they restrict competition and distort corporate governance mechanisms (Levine, 2003).

## **3.6 Essential Elements of Corporate Governance of Banks**

Banks have characteristics that differentiate their corporate governance mechanisms from other non-financial institutions'. Nam and Lum (2006) defines essential elements of bank corporate governance mechanisms as protection of depositors, financial safety nets, role of prudential regulation and supervision, disclosure and transparency.

### **3.6.1 Protection of Depositors**

In order to prevent depositors from the effects of bank failures, many countries impose depositor protection systems. But, policymakers do not pay enough attention to the effects of those systems on bank behaviour and stakeholders. When deposit insurance systems are in place, depositors are less likely to monitor banks and banks are less interested in relying on large depositors and creditors that are interested in

monitoring banks. As a result of less monitoring of banks they are encouraged to take more risks (Gropp and Vesala, 2004).

Deposit insurance systems vary from country to country and they may have some aspects such as public or private management of insurance agency, a maximum monetary limit of deposit insurance for a single customer's deposits, coinsurance, etc. Deposit insurance systems generally cover small depositors. As a percentage small depositors are included in the majority of the population. But their deposits account for the minority of total deposits compared to large depositors. While this situation encourages large depositors to monitor banks more carefully and more frequently than small depositors; it is difficult in such a deposit insurance system to avoid banking system crises (Nam and Lum, 2006).

Efficiency of a deposit insurance system depends on three main factors. Those factors relevant to efficient functioning of deposit insurance system can be classified as the following (Kane, 2000):

- Relevant information provided by financial institutions should be in transparent manner.
- Deterrence which means the ability of bank supervisors and creditors protecting themselves on the basis of disclosed information.
- Ensuring the accountability of insurers to taxpayers.

These factors should be taken into account in the design and implementation phases of deposit insurance systems. Also governments should specify the weaknesses of the financial system in deterrence, transparency and accountability while adopting a deposit insurance system (Kane, 2000).

Deposit insurance system causes lower required interest rates, make interest rates less sensitive to bank risks and reduce market discipline. Strong market disciplines in countries can be established by both private and public joint management of the insurance, also covering foreign currency deposits and coinsurance (Demirguc-Kunt and Huizinga, 2000). Demirguc-Kunt and Kane (2001) states mainly four features of



deposit insurance systems which decrease moral hazard and enhance market discipline:

- Coinsurance or low insurance coverage in order to provide monitoring incentives to certain parties.
- Mandatory membership is required in the insurance system to enlarge the size of the insurance pool.
- Both public and private joint management of insurance to increase the incentives to monitor the banking system.
- Targeting surviving banks to cover losses.

### **3.6.2 Financial Safety Nets**

Governments provide some financial safety nets for banks and financial institutions such as the lender of last resort function of the central bank, guarantees and resolution procedures for insolvent banks. These safety nets, prudential regulation and supervision increase the incentives of stakeholders to monitor banks and also affect corporate governance of banks. In many countries governments do not let large banks to fail in order to prevent bank panics. In such a situation market participants become insensitive about the soundness of banks. There should be efficient regulatory frameworks that ensure efficient restructuring and exit of troubled banks. Those frameworks should enable that shareholders, depositors and creditors of troubled banks bear the full extent of losses (Nam and Lum, 2006).

With the role of central banks as lender of last resort, they provide liquidity through open market operations and discount window to prevent bank failures and crises that can occur as a result of liquidity shortages in the banking system. This role gives central banks the ability to lend to solvent but illiquid banks at penalty interest rates. In order to fulfill their lender of last resort function efficiently, central banks should have timely information about the solvency of banks and the nature of the crisis (Goodfriend and King, 1988). Lender of last resort function is used to finance deposit outflows that resulting in larger losses. Bank failures have important economic and social costs. So, it is important to rescue troubled banks. In achieving this objective,

lender of last resort function should be in coordination with deposit insurance in ensuring stability of the financial system (Nam and Lum, 2006).

### **3.6.3 Prudential Regulation and Supervision**

Governments undertake prudential regulation and supervision over banks in order to limit their excessive risk taking behaviours. Monitoring of banks may be transferred from depositors to the state as a result of providing of deposit insurance to obtain banking sector stability. Nam and Lum (2006) states that because of the following reasons, public supervision of banking system can not be as effective as private sector supervision:

- Since public regulators and supervisors do not have personal stakes in banks, their monitoring practices would not be as efficient as the monitoring of private supervisors.
- Public supervisors do not have necessary incentives to follow changes in the market and rapid innovation compared to private supervisors.
- They are more susceptible than private supervisors to political interference using banks for political objectives.

Excessive regulation and supervision reduce incentives of bank managers and market participants to monitor banks. This situation weakens internal corporate governance. Private monitoring of banks increases stability and performance in banking system. More government regulation and supervision cause corrupt ties between banks and firms (Barth, 2003). One of the most important elements of prudential regulation and supervision is minimum capital requirements. These are determined depending on the riskiness of the portfolios of banks. Internal systems such as risk management and internal control practices also have crucial importance. Prudential regulation and supervision work more effectively in the cases where they reward complying banks and are market compatible (Bossone and Promisel, 1998).

Prudential regulation and supervision will be more effective if they are undertaken by regulatory agencies which are independent from political interference and free

from capture by the industry. Quintyn and Taylor (2002) identify four dimensions of independence.

- **Regulatory Independence**

It is the autonomy to set rules and regulations. It is needed to respond to rapidly changing financial environment quickly and flexibly.

- **Supervisory Independence**

It ensures safeguarding the integrity of supervisory function and includes on site inspections and off site monitoring.

- **Institutional Independence**

It means being separate from the branches of government with independence in the appointment and dismissal of the senior personnel and governance structure.

- **Budgetary Independence**

It signifies relying less on government branches when determining the size and use of the budget of the agency.

### **3.6.4 Disclosure and Transparency**

Accounting and auditing standards are important components of disclosure and transparency. Disclosure and transparency determine the quality of information available on banks. They enable the stakeholders to monitor banks in an effective manner and they are essential for market based monitoring. Because of information asymmetries, banks have opaque structures and quality of their disclosed information is inadequate. Regulatory authorities can have better access to bank information but

governments can be accountable for the consequences of monitoring. So, enhancing disclosure and transparency should take the priority (Nam and Lum, 2006).

Basel Committee on Banking Supervision (2001) emphasizes promotion of market discipline in encouraging safe banking practices by requiring banks to disclose more information on their risks and capital. Also Sarbanes-Oxley Act of 2002 requires publicly-held corporations to significantly enhance their corporate governance. In case of banks, banks with more than USD 500 million in total assets are subject to this act. Sarbanes-Oxley Act put the following standards on independence of audit processes and financial disclosure:

#### **3.6.4.1 Independence of Audit Processes**

Sarbanes-Oxley Act of 2002 states the following issues about independence issues:

- External auditors should not be directly or indirectly misled, manipulated, coerced or fraudulently influenced by officers or directors of the firm.
- They can not provide specified non-audit services contemporaneously to the client companies.
- They can not serve the audit function more than five consecutive years.
- They should not have employed the client's CEO, controller, CFO, chief accounting officer, or equivalent officer for the audit of the client during the one-year period before the current audit.

The Sarbanes-Oxley Act aims to strengthen auditor independence and the company's Audit Committee. Listed companies, for example, must have an Audit Committee comprised only of independent members, and must also disclose whether it has at least one Audit Committee financial expert on its Audit Committee. Audit Committee financial expert should be named and the company should state whether the expert is independent of management. Members of the Audit Committee can not accept any consulting, advisory or compensatory fee from the company other than the fee for director service. They must establish procedures for processing complaints and confidential submissions by employees about accounting, internal

control and auditing matters. The members of the Audit Committee are also responsible for the appointment, compensation, and oversight of the work of external auditors (SOX, 2002).

#### **3.6.4.2 Enhanced Financial Disclosure**

Publicly-held companies are prohibited from extending loans to any director or executive officers and senior management. Principal stockholders should disclose changes in securities ownership within two business days (Nam and Lum, 2006). Financial reports filed with the SEC or annual reports should include:

- All material off-balance sheet transactions and contractual obligations that may entail a material effect on the company,
- Management assessment of internal controls over financial reporting,
- Whether the company has established an ethics code for its principal executive, financial, accounting officers and controller,
- Whether the Audit Committee has at least one financial expert member.

#### **3.7 Internal Corporate Governance Mechanisms at Banks**

The Basel Committee on Banking Supervision (1999) states that directors and senior management of banks are primarily responsible for good corporate governance. The nature of banking industry is different than other industries mainly because of being exposed to risks in a changing environment. So, it is important to ensure operation of strong internal control systems in banking industry. Internal corporate governance mechanisms in banks can be classified as the board of directors, compensation of bank executives, internal control and risk management, board and senior management oversight of risks, adequate risk management policies and procedures and risk measurement, monitoring and control.

### 3.7.1 Board of Directors

Board of directors has the duties of monitoring and providing guidance to management. It is the central corporate governance mechanism (Nam and Lum, 2006). About the effectiveness of the board of directors there are several aspects that can be considered. These are board structure and independence, functions of the board, board committees' activities, director compensation and liability (Nam, 2004).

The board of directors of a bank should have a right mixture of executive and non-executive directors. It should consist of enough non-executive directors in order to ensure independence and full time executive directors with required experience. If the board of directors is too large its activities can be in an ineffective manner and there may be the free rider problem among the directors. On the other hand, when it is not large enough, it may not be able to bring enough expertise to the board (Nam and Lum, 2006).

Corporate governance of banks should ensure the strategic guidance of the bank, monitoring of management by the board and ensuring the safety and soundness of the organization by the board of directors. Board members of a bank should act in the best interests of depositors and stakeholders, with care and in good faith. Main functions that should be fulfilled by the board are the following (McKenzie and Johnson, 2004):

- Setting corporate strategy, risk policy, major plans of action and performance objectives, monitoring implementation and corporate performance.
- Selecting, monitoring, compensating and replacing key executives.
- Review of key executive and board remuneration and ensuring a transparent board nomination process.
- Monitoring and managing conflict of interests of board members, shareholders and management.

- Ensuring the integrity of financial reporting and accounting systems and ensuring that appropriate systems of control are in place.
- Monitoring the effectiveness of governance practices.
- Overseeing disclosure and communication processes.

Separation of board chairman and CEO helps to enhance the checks and balances function of the board. There should be a clear definition of the roles of the board and the management. Proper mechanisms of interaction between the board, management and the auditors should be established. There should be strong internal control systems in order to avoid conflicts of interest. In order to make non-executive directors to undertake their tasks they should be compensated adequately. Non-executive directors should be able to obtain relevant information when they need it. Also, remuneration for directors should be adequate and may include stock based compensation to align their interests better with those of shareholders (Nam and Lum, 2006).

### **3.7.2 Compensation of Bank Executives**

Executive compensation is an important tool in determining the incentives of corporate executives. There are mainly three different mechanisms of giving executives compensation. The first one is the base salary, bonus and new equity gains. Second one is capital gains on their portfolio of stocks and options. Last one is the market's assessment of their human capital. Equity incentives and stock based compensation are important in aligning the interests of executives with those of shareholders. And, this ensures lowering monitoring costs (Nam and Lum, 2006).

Stock options or other incentive contracts can be inefficient because of the serious information asymmetries in banking. Earnings and other short-run performance outcomes can easily be manipulated at the expense of the long run health of banks. Also, there is the possibility that incentive contracts may be designed inefficiently by poorly motivated boards of directors without adequate attention to the performance of the corporations (Aboody and Kasznik, 2000).

In the case of family controlled firms, they are not expected to give much stock based compensation to their executives, since if they are not family members they will be monitored closely by controlling families. So, equity based executive compensation is more prevalent in banks with dispersed ownership. Nam and Lum (2006) identifies three main reasons which makes equity based compensation in banking not as strong as it is in other industries. First of all, banks have more opaque structures than other firms. In banks it is difficult to design compensation contracts properly because the bank managers find it easier to manipulate the pay-offs. Second, banks are heavily regulated institutions and they are subject to heavier monitoring than other firms. Since, regulation can be thought as a substitute for other mechanisms of corporate governance, there may be less need for equity based executive compensation for banks. The last reason is that, since banks mobilize funds more from deposits than from equity, the rationale for aligning executive interests with those of shareholders may not be strong for banks.

### **3.7.3 Internal Control and Risk Management**

Banks should ensure that goals are pursued in the operation of the internal control system. Establishing internal controls is the responsibility of management. Their primary aim is setting the tone of risk taking and ensuring that risk exposures do not threaten the organization. Internal control is supported by accounting, internal audit, risk management and compliance which independently monitor the effectiveness of the control process (Nam and Lum, 2006). The Basel Committee on Banking Supervision (1998) identifies five main areas where control breakdowns occur in the evaluation of internal control systems of banks.

- Accountability, management oversight and development of a strong control culture within the banking organization.
- Risk assessment of the certain banking activities including off balance sheet activities.
- Setting control activities such as segregation of duties, verification, approval, reconciliation and operating performance reviews.



- Communication of information between certain levels of management within the bank.
- Internal and external audit programs and other monitoring activities.

According to the British Revised Combined Code on Corporate Governance (2003), the board should maintain a sound internal control system in order to safeguard the assets of the company and shareholders' investment. The board should conduct a review in order to determine the effectiveness of internal controls within the organization and report the findings of this review to shareholders including financial, operational and compliance controls and risk management systems.

Risk management is an important concept for the stability, continuity and prosperity of the organization. Riskiness of financial institutions is affected by some factors such as globalization, competition, new products, new markets, etc. Banks should identify, monitor and control liquidity, credits, changes in interest rates and exchange rates and exposures in order to ensure soundness in their operations. Establishing an effective risk management system is important for a sound corporate governance mechanism (Nam and Lum, 2006). The Basel Committee on Banking Supervision issued the principles and sound practices of managing certain risks faced by banks that emphasize mainly three points. These points can be classified as the following:

### **Board and Senior Management Oversight of Risks**

The boards of directors of banks should be responsible for approving and reviewing the strategy and policies on managing credit risk, operational risk and interest rate risk. Senior management should be responsible for implementing frameworks, developing strategies, procedures, processes and policies in order to establish an effective control environment and limit those risks that banks can face with.

### **Adequate Risk Management Policies and Procedures**

Adequate risk management policies and procedures can be identified under three types of risks within the banking system. According to the Basel Committee on

Banking Supervision these are credit risk, interest rate risk and operational risk (BCBS, 2003)

- Credit Risk

There should be sound credit granting practices, credit limits, credit granting criterias, processes for approving credits at different phases and rules on credits to related parties within the banks.

- Operational Risk

Basel Committee on Banking Supervision (2003) defines operational risk as “the risk of loss inadequate or failed internal processes, people and systems or from external events”. The most important elements of operational risk framework include a strong operational risk culture, internal control culture, effective internal reporting and contingent planning.

- Interest Rate Risk

There should be clearly defined policies and procedures about interest rate risk within the banks. These policies and procedures should be consistent with the nature of their activities.

### **Risk Measurement, Monitoring and Control**

Risk measurement, monitoring and control can be classified by risk type as the following (Nam and Lum, 2006):

- Credit Risk

Banks should be able to monitor individual credits, their composition and quality of their credit portfolios and ongoing assessment of their risk management processes. They also need information systems and techniques in order to measure credit risk

and they are encouraged to develop an internal risk rating system to manage credit risk.

- **Operational Risk**

Banks should develop adequate procedures, policies and processes in order to monitor operational risk profiles and exposure to losses. They should also develop contingent and business continuity plans to limit losses in case of a business disruption.

- **Interest Rate Risk**

Banks should be able to measure their interest rate risks and their vulnerability to loss under stressful market conditions. They should establish limits that contain exposures within tolerable limits and have adequate information systems in order to measure, monitor and report interest rate exposures.

### **3.8 Governing of Banks**

Canoy *et al* (2001) presents four main classifications in the case of how banks themselves are governed.

#### **3.8.1 Externalities**

Banks have crucial roles in efficient functioning of the financial system. So, ineffective governance mechanisms of banks can lead to serious consequences than it is in the case of non-financial firms. In non-financial firms, if there is weak supervision it is bad for the wealth of shareholders and it will hardly cause to serious effects outside the firm or the industry in which the firm operates. On the other hand, if this situation exists in banks it can cause more serious problems because of contagion effects (Canoy *et al*, 2001).

### 3.8.2 Managerial Compensation and Risk Taking

In case of banking, performance based and incentive compatible remuneration policies can provide senior managers and loan officers to take higher risks in order to increase the volume of transactions and business. Also, in banking institutions there exists the principal-agent problem. Shareholders (principals) who invest in the company select the board of directors (agents). These directors are set responsible to ensure that management of the corporation behaves responsibly and executives carry out their duties (Plumptre, 2004).

If managers are also owners of banks, they will be more cautious to take more risks (Canoy *et al*, 2001). Saunders *et al* (1990) found that risk taking in US banks both decreases and increases by managerial ownership. In the direction of this relationship intensity of banking regulation plays a crucial role. Anderson and Fraser (2000) found out that in 1980s US banking system was less regulated and banks which were classified as higher equity holdings by bank managers had higher bank specific and total risks. On the other hand, in 1990s there was more tightened bank regulation in US banking system. In this period, the relationship was inverse (Anderson and Fraser, 2000).

### 3.8.3 Capital Structure

In the banking system, stakeholder interests are more important than it is in non-financial institutions because of the riskiness of business in banks compared to other non-financial firms. The main source of financing assets of commercial banks is their liabilities in the form of customer deposits. As a result, depositors can be thought as the main stakeholders. When banks are compared to other non-financial institutions, it can be concluded that they are more leveraged and smaller portion of their total capital consists of equity (Canoy *et al*, 2001).

As a result of this discrepancy there exist adverse incentives for both bank owners and managers. In the case of low deposit rates, bank depositors prefer low risk and the bank has an incentive to undertake riskier projects in order to obtain higher returns. It is a kind of moral hazard behaviour that is also in the interest of

shareholders who are waiting to gain, especially when owners' liability are limited. Limitation of liability raises the value of equity relative to the value of debt (Canoy *et al.*, 2001).

#### **3.8.4 The Public As Residual Claimant and Banking Supervision**

Free-rider and collective action are crucial problems that should be solved in order to establish effective functioning of corporate governance mechanisms in banking system. Since, it is for the benefit of the public, public is the residual claimant and ultimate controller of banks. Banking supervision has an important role in this case. Corporate governance conflicts that occur in banks can be detected and corporate governance systems can be improved with the help of effective supervision mechanisms (Llewellyn, 2000).

#### **3.9 The Role of Banks in Corporate Governance**

Banks function as intermediaries between investors and savers. They pool the risks of lending and provide depository for savers. Mainly, banks are different than other financial and non-financial institutions. Difficulty in one bank can cause sudden withdrawals of deposits from banks. If depositors panic it can spread quickly through all the banking system and cause illiquidity and instability (Patrick, 2001).

Banks are important components of sound corporate governance systems. With the help of their functions of monitoring of their clients, evaluation of projects, monitoring ongoing performance of customers and assisting firms which are in distress; they can contribute to sound corporate governance. In order to fulfill their effective monitoring functions, banks should be independent from borrowers and government pressures, make their lending decisions in an objective manner and able to obtain sufficient information about performance of the borrowers. Also, by transparency and disclosure rules banks themselves must engage in corporate governance practices (Patrick, 2001).

### 3.10 Ownership Structure of Banks and Monitoring by Shareholders

Shareholders have interests in monitoring their banks and react negatively to excessive risk taking. Despite government regulations and safety nets weaken the incentives of creditors to monitor banks; shareholders of banks should be more concerned about the possibility of bank failures. Ownership structure of banks has a role in determining the care of shareholders in monitoring their banks. The quality of corporate governance is likely to be different depending on bank ownership structure (Nam and Lum, 2006).

State ownership of banks is pervasive around the world and state owned ownership of banks is associated with less financial development and lower productivity. State ownership reduces competition in banking sector and it is associated with the level of nonperforming loans and policies that restrict bank activities. Also, in some studies it is found that greater state ownership increases the probability of banking crises (La Porta *et al*, 2000). Bonin *et al* (2003) states that on the basis of individual bank data, government banks are less efficient than private banks.

In state owned banks, managers are usually do not have strong incentives to perform and they are subject to political influence or their own bureaucratic interests. The stakeholders do not have interests to monitor the management of state owned banks. On the other hand, depositors and creditors think that their credits are guaranteed (Caprio and Levine, 2002). As a consequence of these factors, information disclosure and monitoring is weakened and there exists corruption and inefficiencies.

Although private sector participants have incentives to monitor private banks, with state owned banks there is no doubt that the government is providing a guarantee. Thus, private sector creditors have fewer incentives to monitor state owned banks. Quality of governance in state owned banks depend on whether they are subject to the same set of regulations as private banks, the degree of government intervention in banking operations and the independence and effectiveness of the board of directors. State owned banks may also obtain information about government policy changes. This situation gives state owned banks an unfair advantage compared with private banks and cause conflicts of interests. Also, in diffused ownership structures, small

shareholders have little incentives to monitor banks due to the free rider problem. So, they are not able to exert much influence on decision making despite their rights (Nam and Lum, 2006).

### **3.11 Bank Committees**

The boards of directors of banks establish committees to ensure proper management of the bank. Most of the banks have at least an Audit Committee. Besides Audit Committee, some banks also have a risk management committee, a compliance committee, an executive committee, a corporate governance committee, etc. The types and number of committees depend on size, structure and supervisory needs of banks. Boards of directors should define responsibilities of committees and give them appropriate guidance (McKenzie and Johnson, 2004). Main committees that can exist in banks are described below.

#### **3.11.1 Audit Committee**

It should be composed of external board members or members of the board who are not part of management. The Sarbanes Oxley Act states that listed companies should have an Audit Committee. It should be comprised of independent members and should disclose whether it has at least one Audit Committee financial expert. The Audit Committee financial expert should be named and the company should state whether the expert is independent of management. If the bank engages in complex activities, establishment of Audit Committees is important. Financial Reporting Council Report (2003) states five main functions of Audit Committees.

#### **Financial Reporting**

- Reviewing financial reporting issues and judgements related to company's preparation of financial statements, interim reports and other formal statements. It should also review completeness and clearness of disclosures in the financial statements of the bank.
- Focusing on changes in accounting practices, adjustments resulting from the audit and compliance with accounting standards. The Audit Committee

should be satisfied that financial statements represent accurate picture of company's performance and position.

### **Internal Financial Controls and Risk Management Systems**

- Reviewing and monitoring the internal financial system of the bank and reviewing the risk management system in the absence of a risk management committee.
- Reviewing reports from management about financial and non-financial risks, corporate governance and internal control.
- Reviewing bank's risk analysis and control system and ensuring that they are working and cost effective.
- Requiring confirmation from management that they have maintained a sound financial reporting system and obtaining reasonable assurance from auditors.

### **The Internal Audit Function**

- Monitoring and reviewing the internal audit activities within the bank. In the cases where there is no internal audit function, the Audit Committee should consider if such a need exists and make recommendations to the board.
- Monitoring and reviewing the internal audit process consist of the following functions carried out by the Audit Committee:
  - ✓ Ensuring the direct access of the internal auditor to the Audit Committee and board chairman.
  - ✓ Reviewing and assessing the internal audit work plan.
  - ✓ Receiving reports about the results of the internal auditors' work.
  - ✓ Reviewing responsiveness of management to the findings and recommendations of internal auditors.
  - ✓ Meeting with the head of internal audit without the presence of management.



✓ Monitoring and assessing the role and effectiveness of internal audit function within the organization.

- In the case of an outsourced internal audit function, ensuring that internal audit function is operating effectively.

### **The External Audit Function**

- Making recommendation to the board of directors about appointment and removal of external auditors.
- Ensuring that the external auditors possess the necessary qualifications, expertise and independence.
- Approving the engagement terms and remuneration to be paid to the external auditors.
- Reviewing the audit plan and ensuring that it is risk based, appropriate and addresses the major concerns of the bank.
- Reviewing the recommendation letter of external auditors and management's response.
- Overseeing the relations of bank with the external auditors.

### **Whistle Blowing**

The Audit Committee should ensure that there are arrangements for employees who have concerns about the activities of the bank. These concerns especially include violations of legal rights of shareholders, depositors and stakeholders. Also, the Audit Committee should be confident that there is necessary legislation to protect employees from adverse actions of employers.

### **3.11.2 Risk Management Committee**

The risk management committee monitors activities of management about controlling bank's risks such as credit, operational, legal, market and reputational risks. If the bank has no risk management committee, risk management can be

accomplished by the Audit Committee. Scope of the risk management system depends on the size and complexity of operations of a bank. Large banks with more complex operations and greater risk exposures tend to develop a risk management process with detailed guidelines (McKenzie and Johnson, 2004). Credit risk is the major risk categorization that banks face with. Charkham (2003) states main functions of risk management committee as the following:

- Ensuring that the risk management system is functioning as intended.
- Ensuring that board's procedures for granting loans and determining the creditworthiness of borrowers have been observed.
- Ensuring that the loan applications are complete.
- Ensuring that the managers are responsible for collecting loans and maintaining credit information on borrowers.
- Obtaining periodic reports of credit facilities and reviewing large amounts of loans in detail.
- Ensuring that the credit facilities do not exceed legal and regulatory limits.
- Ensuring that the directors of the bank seek approval for letters of credit and require the necessary confirmation that the circumstances of parties to whom letters of credit has been granted have not materially changed.

### **3.11.3 Corporate Governance Committee**

Corporate governance committee is responsible from election, invitation and orientation of the board members. It determines the number of board members according to the company needs. Main responsibilities of the corporate governance committee are monitoring the functioning of the board of directors, ascertaining whether corporate governance principles are practiced by the board of directors, taking note of shareholder criticisms and concerns and periodically reviewing all the systems and policies (TUSIAD, 2002).

### **3.11.4 Nominations Committee**

The Nominations Committee is responsible to make recommendations for the appointment of new board members and members of the various committees established within the bank. It is composed of both executive and non-executive members. The Nominations Committee ensures that the appointment process is transparent and impartial. It should evaluate expertise, knowledge and skills on the current board and determines the required resources before recommending an appointment. It should ensure the existence of processes and plans for succession of appointments to the board and senior management (McKenzie and Johnson, 2004).

### **3.11.5 Remuneration Committee**

The role of remuneration committee is reviewing and advising the board about compensation policies, goals and standards for the board, senior management and other management staff. It should be composed of non-executive directors in order to promote autonomy. It should be in coordination with nomination committee to ensure that incentives and employment packages are consistent with the requirements of the appointment (McKenzie and Johnson, 2004).

### **3.11.6 Compliance Committee**

Compliance Committee monitors activities of senior management in order to ensure that the operations of the bank are in compliance with regulations, laws, ethical standards and regulatory and supervisory requirements (McKenzie and Johnson, 2004).

### **3.12 Basle Committee**

The Basle Committee Report (1999) guidelines are related to enhancing corporate governance in banking organizations. The guidelines have been influential in the development of corporate governance practices in banks across the world. Sound corporate governance practices stated in the Basle Committee Report (1999) are the following:

- Strategic objectives and corporate values that are communicated throughout the banking organization should be established,
- Clear lines of accountability and responsibility should be set throughout the organization,
- It must be ensured that the board members are qualified for their positions, have a clear understanding of their role in corporate governance and they are not be subject to undue influence from management or outside concerns,
- There should be appropriate oversight by senior management,
- Work of internal and external auditors should be effectively utilized in recognition of the important control function they provide,
- It should be ensured that compensation approaches are consistent with the bank's ethical values, objectives, strategy and control environment,
- Corporate governance should be conducted in a transparent manner.

Corporate governance is essential in order to have a well functioning banking supervision. It makes the work of supervisors easier and contributes a collaborative working relationship between bank management and bank supervisors. It states that boards of directors and senior management of banks are responsible for promoting good corporate governance (BCBS, 1999).

According to BCBS (1999), other ways by which corporate governance can be promoted are the following:

- Governments: through laws and regulations,
- Securities regulators and stock exchanges: through disclosure and listing requirements,
- Accounting standards: through audit standards on communications to board of directors, senior management and on publication of sound practices,
- Banking industry associations: through initiatives related to voluntary industry principles and agreement on publication of sound practices.

The Basle Committee Report (1999) states four forms of oversight that should be included in the organizational structure of any bank in order to ensure appropriate checks and balances. These are:

- Oversight by the board of directors or the supervisory board,
- Oversight by individuals not involved in the day-to-day running of the various business areas,
- Direct line supervision of different business areas,
- Independent risk management and audit functions.

### **3.13 Regulation on Corporate Governance Principles of Banks**

Regulation on Corporate Governance Principles of Banks was issued in official gazette in November 1<sup>st</sup>, 2006. The aim of this regulation is to design structures, processes and principles of banks related to their corporate governance. It is prepared with respect to Basle Committees report of “Enhancing Corporate Governance in Banking Institutions”. This regulation defines the following seven main principles about corporate governance of banks (BRSA, 2006).

1. Corporate values and strategic goals should be established within banks. The board should define the mission and vision of the bank and disclose them to the public, evaluate the activities and performance of the bank, monitor conformity of activities to laws, regulations, legislation and internal regulations and take corrective action when necessary.
2. Authorities and responsibilities within the bank should be clearly defined and applied. Authorities and responsibilities of the board, board members and senior management should be identified and actions of senior management should be monitored. Corporate governance committee should be established in order to monitor the accordance of bank to corporate governance principles, make amendment actions and make suggestions to the board of directors. Heads of the committees should be selected from non-executive members of the board.

3. Members of the board should have adequate competencies to perform their duties effectively, should be conscious about their duties of corporate governance and be able make independent evaluations about bank operations. They should fulfill their duties in loyalty against the bank and its shareholders, understand their duties in bank supervision, not give defective or partial information and have sufficient knowledge about regulations and legislation. The board should fulfill their duties in fairness, transparency, accountability and responsibility, interrogate senior management and be able to obtain sufficient information and have enough number and mixture of members.
4. Senior management should have adequate competencies to perform their duties effectively and be conscious about their duties of corporate governance. They should fulfill their duties in fairness, transparency, accountability and responsibility. They should ensure that the business of the bank is in line with bank's mission, vision, goals and policies.
5. Work of bank internal auditors and independent external auditors should effectively be utilized. Senior management should comprehend the importance of risk management, internal control and internal audit processes in order to determine defects in these processes and ensure that financial reports of the bank reflect the true position of the organization. Senior management should use the findings of internal auditors and internal controllers in a timely and effective manner.
6. It should be ensured that bank's compensation policies are compatible with ethical values, strategic goals and internal balances. This is the responsibility of the board of directors. Also, senior management should establish objective criterias in employment and promotion processes compatible with overall policies of the bank.
7. Transparency should be provided in corporate governance. Sufficient information should be provided to shareholders, depositors and the public

about the structure and goals of the bank. This information should be accurate, timely, complete, objective, understandable and accessible.

### **3.14 Corporate Governance in Banking Law No. 5411**

Banking Law No. 5411 gives special attention to corporate governance in the third part of the law. According to this act Banking Regulation and Supervision Agency (BRSA) determines structures, processes and principles regarding corporate governance. Corporate governance part of the law consists of four main parts. These parts and their main contents in accordance with the law are explained below (Banks Association of Turkey, 2005).

#### **3.14.1 Management**

The board of directors of banks should consist of at least five board members one of which is the general manager. In the absence of the general manager the deputy general manager becomes the member of the board of directors. The law states that the general manager and the chairman of the board of directors can not be the same person. The main responsibilities of the board of directors are stated as ensuring the establishment, adequacy and appropriateness of internal control, internal audit and risk management systems compatible with existing legislation, securing financial reporting systems and specifying responsibilities and power in the bank.

Board of directors of banks should establish Audit Committees to execute audit and monitoring functions. Audit Committee should consist of at least two non-executive members of the board. According to the law the main responsibilities of the Audit Committee are supervision of the adequacy and efficiency of internal audit, internal control and risk management, ensuring the functioning of these systems and integrity of information produced, conducting necessary evaluations for the selection of independent auditors, monitoring activities of independent auditors, ensuring that reports of risk management, internal audit, internal control and independent auditors include reliable execution of the activities of bank, etc. In fulfilling its duties, the Audit Committee is authorized to receive information and documents from all units of the bank and independent auditors.

### **3.14.2 Internal Systems**

According to the law, banks should establish adequate and efficient internal control, risk management and internal audit systems. Internal control system should ensure execution of bank's activities in compliance with legislation, internal regulations and ethics, secure integrity and reliability of accounting and reporting systems and timely accessibility of information, ensure distribution of duties and identify and evaluate risks.

In case of risk management system, banks should establish, implement and report risk policies. These practices should be performed by risk management department. Also, the law states that banks should establish internal audit systems covering all of their units and branches. Internal auditors should investigate banking activities according to internal regulations, legislation and banking principles.

### **3.14.3 Authorized Institutions**

If independent auditors detect any matter that endangers the existence of the bank or points out the violation of the law they should notify the BRSA. According to the law, this notification does not mean the violation of the professional confidentiality principles and agreements or the obligations pertaining to confidentiality.

### **3.14.4 Financial Reporting**

It is requested by the law that banks should ensure uniformity in accounting systems, record all of their transactions and prepare their financial reports timely and correctly. If it is determined that the financial statements are misrepresented the BRSA shall be authorized to take necessary measures.

Financial reports of the bank should be signed by the chairman of the board of directors, the members of the Audit Committee, general manager, deputy general manager responsible for financial reporting, declaring that the financial reports are in compliance with the accounting records of the bank and the legislation pertaining to



financial reporting. Also the annual reports of the banks shall be approved by independent audit firms. The board of directors is responsible for setting the policies, duties, powers and responsibilities related to financial reporting system, including the accounting of activities, preparation, approval, audit, submission to relevant authorities and the publication of financial statements.

## **Chapter 4**

### **Internal Control, Internal Auditing and Role of Internal Auditing in Corporate Governance**

#### **4.1 Controlling**

Controlling can be defined as a form of management improvement which is used to ensure the effectiveness, efficiency and consumption of financial funds by collecting and processing information for the use of management. Its function is to attract the attention of governance bodies about efficiency and effectiveness of their decisions. Also, controlling function reports about the effectiveness, efficiency and financial needs and measures that should be taken in order to correct or eliminate deficiencies (Peess, 2000).

It is a process which ensures that the activities of an organization are carried out according to the plan, they are accomplished according to predetermined objectives or standards and corrective action is taken when necessary. Basically, it means that what is happening compared to standards. The purpose of controlling process is giving warnings to management about existing or potential problems (Rue and Byars, 2003).

Comparing the results with predetermined standards is a key element of controlling. Description of what has happened is important for developing a plan in order to improve performance. Controlling function provides an important feedback to the planning function of management (Isaacs and McAllister, 2002).

Management of an organization defines goals and objectives, makes business and organization planning, lead people by delegating activities, communicating plans and

motivating people and conduct the controlling function. Controlling can be defined as process of auditing the behaviour of an organization and achievements (Klemencic, 2006).

Koskela and Howell (2004) divides the process of controlling into two sub processes. These are performance reporting and overall change control. In case of performance reporting, corrections are prescribed for the execution of processes. On the other hand, in overall change control process, changes are prescribed for the planning processes.

#### **4.2 Internal Control**

Committee of Sponsoring Organizations (COSO) (1992) defines internal control as a process which is effected by the board of directors, management and all other personnel of an organization. Its objective is to provide reasonable assurance in the effectiveness and efficiency of operations, reliability of financial reporting and compliance with procedures, laws and regulations.

According to the definition of BIS (1998) internal control is a process that is effected by all levels of personnel within an organization. It operates continually at all levels within the organization. It is not a policy or a procedure which is performed at a certain time. Boards of directors and senior managements of banks are responsible to establish an effective internal control process and to monitor its effectiveness continuously. Also, each individual within an organization should participate in this process.

Internal control is the responsibility of everyone within the organization. It helps an organization in achieving operating, financial, reporting and compliance objectives. It provides reasonable assurance in case of achievement of the objectives of an organization. It can not ensure absolute assurance because of cost-benefit realities, collusion among employees and external events beyond the control of the organization. Understanding internal control enables employees of an organization identifying and assessing operating controls, financial reporting and compliance

processes and guides the organization in taking actions in order to strengthen needed controls (SMOFM, 2005).

### **4.3 Components of Internal Control**

There are mainly five components of internal control. These are control environment, risk assessment, control activities, information and communication and monitoring (BIS, 1998).

#### **4.3.1 Control Environment**

Control environment can be defined as the environment in which people conduct their activities and perform their control responsibilities. In an effective control environment people within the organization are aware of their responsibilities, are knowledgeable, understand the limits to their authority and try to do the right things. Technical competence and ethical commitment are main components of a control environment. It is an essential factor for enhancing effective internal control. Management of the organization is responsible in establishing a control environment that encourages the following (SMOFM, 2005):

- Highest levels of personal standards, professional standards and integrity,
- Operating style and leadership philosophy to enhance internal control within the organization,
- Authority and responsibility assignment.

Policies and procedures enhance the control environment of an organization. Individuals within the organization should recognize that they are accountable against policies and procedures. These organizational policies and procedures should include hiring, training, orientation, compensation and disciplinary actions. If individuals do not comply these policies and procedures there should be appropriate disciplinary actions in order to establish an effective control environment (Sampson, 1999).

### 4.3.2 Risk Assessment

Risk assessment contains the identification, analysis and management of an organization's risks. In the achievement of an effective internal control environment the first and the most fundamental step is the identification of risks. Setting goals and objectives have important priority in this respect. Parts of the organization should understand main risks that they face with and they must set objectives regarding their activities to enable the operation of the organization in a coordinated manner and to identify, analyze and manage the risks (SMOFM, 2005).

First phase of risk assessment is to determine goals and objectives. The main objectives within the internal control process according to BIS (1998) are operational, information and compliance objectives.

- Operational Objectives

Operational objectives for internal control contain using assets and resources in an efficient and effective manner and protecting the organization from loss.

- Information Objectives

Information objectives include completeness and reliability of financial and management information. Information provided both to external and internal parties to be used in their decision making processes should be in sufficient integrity, quality and reliability.

- Compliance Objectives

Compliance objectives ensure that the business is conducted in compliance with laws, regulations, policies and procedures.

Second phase of risk assessment is identifying risks. Risks should be identified both at the process and department level for each department's objectives. The last phase is the risk analysis. In risk analysis frequency of risks should be assessed, potential

impact of risks should be estimated and necessary actions in order to manage those risks should be determined (Sampson, 1999).

#### **4.3.3 Control Activities**

Control activities are actions that are used to manage or reduce risks. They are supported by control policies and procedures. They ensure that actions of management, which are necessary to address risks, are effectively carried out. Managers are responsible to identify the financial and compliance risks, design, implement and monitor the internal control system. Some of the main control activities are approvals, authorizations, verifications, segregation of duties, performance reviews and information system controls (SMOFM, 2005).

There are mainly three types of controls. These are preventive controls, detective controls and corrective controls. Preventive controls prevent an error or happening of an undesired event. They help to prevent loss. Some of the preventive controls are segregation of duties, proper authorization and proper documentation. Detective controls are used to detect undesirable events. They alert management about errors and problems. They do not prevent a loss from occurring but they provide assurance that a loss has already been occurred. Audits, physical inventories and reconciliations are main types of detective controls. Corrective controls are used with detective controls in order to recover from the results of undesired events. An insurance policy is a type of corrective control (Moeller, 2006).

#### **4.3.4 Information and Communication**

Organization's plans, risks, control activities and performance should be communicated across the organization. Reliable information obtained from internal and external sources should be identified and communicated to the people who need that information. Information systems support management to control an organization by producing reports that contain information about compliance and operational and financial activities (SMOFM, 2005).

There are basically two types of information and communication systems. These are formal and informal systems. Formal systems provide data related to operational, information and compliance objectives. Examples of formal information and communication systems are computer technology and staff meetings. In case of informal systems; informal interviews with customers, employees, suppliers and regulators can provide information which is useful in identification of opportunities and risks (Sampson, 1999).

#### **4.3.5 Monitoring**

Monitoring is used in the assessment of internal control over time. The main objective of monitoring is to understand whether internal control is effective and adequately designed. It ensures that control activities are carried out properly and in a timely manner and there is effective control within the organization. There are separate evaluations and ongoing monitoring activities of internal control. Ongoing monitoring activities can be stated as activities that evaluate and improve the design and effectiveness of internal control. On the other hand internal audits and self assessments are periodic evaluations of the components of internal control (SMOFM, 2005).

#### **4.4 Frameworks for Internal Control**

There are a number of frameworks for internal control. The most popular ones are as the following (Deloitte&Touche, 2003):

##### **1. COSO – Internal Control Integrated Framework**

It is developed by the Committee of Sponsoring Organizations of the Treadway Commission and sponsored by the American Institute of Certified Public Accountants (AICPA), the IIA, etc. It is the dominant framework in the U.S. The guidelines were published in 1991 and it is chosen by the majority of U.S. based public companies.

## 2. COCO – The Control Model

It is developed by the Criteria of Control Committee of the Canadian Institute of Chartered Accountants. It focuses on behavioral values as the main basis of internal control rather than control structure and procedures.

## 3. Turnbull Report

It is developed by the Committee on Corporate Governance of the Institute of Chartered Accountants in England & Wales. The guide was published in 1999. This report requires companies identifying, evaluating and managing their risks and assessing the effectiveness of the internal control system.

## 4. ACC – Australian Criteria of Control

It was issued by the IIA – Australia in 1998. It emphasizes competencies of employees and company management in developing and operating the internal control framework. According to ACC, attitudes, behaviours and competency constitute the most cost effective approach to internal control.

## 5. The King Report

It was released by the King Committee on corporate governance in 1994. King Report aims to promote high corporate governance standards in South Africa. It addresses social, ethical and environmental concerns and goes beyond regulatory and financial aspects of corporate governance.

### **4.5 Auditing**

Auditing is a process which provides collection and assessment of evidence in order to support statements which are made by the management of an organization. Audits are conducted on many subjects. Mainly, audits include the assessment of (PCA, 2002):



- Financial statements or reports
- Effectiveness and efficiency
- Administrative and legal compliance
- Prospective financial information
- Any agreed-upon procedure

An audit is described in Australian Auditing Standard (AUS) 106 – Explanatory Framework for Standards on Audit and Audit Related Services as:

A service where the auditor's objective is to provide a reasonable level of assurance through:

- The issue of an opinion that enhances the credibility of a written assertion(s) about an accountability matter; or
- The provision of relevant and reliable information and an opinion about an accountability matter where the party responsible for the matter does not make a written assertion.

Wilschut (1994) indicated the elements that should be included in the general theory of auditing. According to him, there should be an assignment, the subject should be derived from the assignment, audit objectives should be defined, audit criteria should be established, there should be a formula to come to a conclusion, methods and techniques should be used, a risk analysis approach should be used, interrelationships between the subjects should be analyzed.

Auditing suggests a variety of ideas. It can be viewed very narrowly, such as the checking of arithmetical accuracy or physical existence of accounting or other business records, or more broadly, as a review and appraisal at the highest organizational level (Moeller, 2006).

Auditing can be conducted by internal or external personnel. Audits conducted by external auditors are usually performed by outside accountants and normally deal with financial matters. Most of these kinds of audits are conducted to express that the accounting methods of an organization are fair, reliable and consistent with existing practices (Rue and Byars, 2003).

The Ramsay Report (2002) states that audits:

- Add value and improve the reliability of financial statements,
- Add value to capital markets by enhancing the credibility of financial statements,
- Enhance effectiveness of capital markets in allocating resources by improving the decisions of financial statement users,
- Assist to lower the cost of capital for the groups which are using audited financial statements by reducing information risk.

#### **4.6 Generally Accepted Auditing Standards**

Generally accepted auditing standards which are formed by AICPA deal with measuring of the quality of the performance of procedures by the auditors. Generally accepted auditing standards concern themselves with professional qualities of auditors and the judgment which is exercised in engagements and reports. Auditing standards adopted by AICPA are classified in three categories. These categories are general standards, fieldwork standards and reporting standards. The main components of these standards are stated below (AICPA, 1974):

##### 1. General Standards

- Auditors conducting the internal audit activity should have adequate training and proficiency.
- Auditors should maintain their independence.
- Auditors should exercise due professional care in performing their work and preparing the report.

##### 2. Field Work Standards

- The work should be planned adequately and assistants should be supervised properly.

- Auditors should obtain an efficient understanding of internal control in planning the audit and should determine the extent, timing and nature of tests to be performed.
- Sufficient and competent matters should be obtained by inspection, examination, observation and confirmations in order to obtain an opinion regarding the financial statements under audit.

### 3. Reporting Standards

- It should be stated in the audit report that the financial statements of the organization are presented in accordance with the generally accepted accounting principles.
- The circumstances in which these principles have not been observed consistently in the current period compared to previous periods should be identified.
- Informative disclosures of financial statements shall be regarded as reasonably adequate unless otherwise stated in the report.
- An opinion regarding the financial statements or an assertion to the effect that an opinion can not be expressed should be contained in the report. The reasons should be stated if an overall opinion can not be expressed.

## **4.7 Types of Auditing Based on the Status of the Auditor**

### **4.7.1 External Auditing**

External auditing is an auditing method used to give an independent reasonable assurance that the accounts of an organization accurately and fairly reflect its true position. It is important for public and private sectors, for accountability to shareholders, stakeholders and taxpayers (Reinstein *et al*, 2002).

In modern sense, external auditing was initially performed in England at the beginning of the nineteenth century. As a result of the industrial revolution, production capacity and diversity and the volume of transactions have tremendously

increased. So, there existed a need of an independent examination of companies' records (Castle and Renshall, 1982).

Independence of external auditors is important to the reliability of their work in their reports and for public trust. It is important that investors rely on the financial statements of organizations. External auditors give investors reasonable assurance that these financial statements reflect the true position of an organization by an independent and impartial examination of statements. So, the investors can rely on the financial statements because of the auditors' assurance. If investors do not believe the independence of an auditor they do not fully rely on the work of auditors and be less likely invest on the company's securities. External auditors should avoid situations that lead the outsiders to doubt about their independence (PCA, 2002).

External auditing is an independent auditing activity which is conducted by independent auditors by examining the fairness of financial statements according to generally accepted accounting standards (Kepekci, 2000). The following are expected from external auditors (Johnson, 1964):

- Examination of financial statements and financial position of an organization fairly, prudently and by reflecting their professional judgment,
- Trying to find out errors and noncompliance,
- Reporting the results of engagements to appropriate parties.

Independent auditing separates ownership and control from each other. This separation leads to the agency theory. Auditors decide the nature and scope of their services and report directly to the board of directors. In this case auditors take the role of agent and the board of directors takes the role of principal. Independent audit function was established making agents more accountable to principals (Reinstein *et al*, 2002).

#### 4.7.2 Internal Auditing

The Institute of Internal Auditors (IIA) (1999) defines internal auditing as the following:

Internal auditing is an independent, objective assurance and consulting activity designed 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.

In the definition of the IIA the term internal signifies the work carried by employees who are directly part of the organization, independent means the work of internal auditors is free from any restrictions which limit their scope and decrease effectiveness of their work (Moeller, 2006).

Internal auditing activities are performed in organizations which vary in size, purpose, complexity, and structure; operate in different environments and by persons from inside (own personnel of the organization) or outside the organization (IIA, 2004).

Objectivity and impartiality do not exclude the possibility that board of internal auditors is invoked in consulting and advising. Advising senior management in the development of internal controls, ensuring that management makes an informed decision; examining and evaluating the internal control systems such as controls over financial reporting are the main forms of advising and consulting which are the basic functions of internal audit (BIS, 2001).

Internal audit activity supports the board and management in fulfilling an essential component of their governance mechanisms. Internal audit activity makes analysis, appraisals and recommendations about the activities under its review. It makes suggestions for reducing costs, enhancing revenues and improving profits (Adukia, 2005).

Internal auditing also evaluates and measures the effectiveness of other controls within the organization. An organization's implementation of its plans in terms of

operations should be monitored and evaluated. There should be a control process over these operations. Besides the control role of internal audit activity which evaluates and measures controls; there are other types of controls within organizations. Internal audit activity should be aware of its role within this control environment and also understand the scope and nature of other types of controls (Sampson, 1999).

Internal auditing supplies one of the most important information to managers of organizations in both private and public sectors. Its main purpose is to review and assess independently financial, operating and administrative areas and make recommendations for improvements. These reviews enable managers to identify opportunities and risks and to increase both efficiency and effectiveness within the organization (Williams, 2005).

An effective internal audit function can strengthen the internal control environment within an organization. So, it is important for companies evaluating the need of internal audit function. The following factors should be taken into account when determining the need for and the size of the internal audit function within organizations (PCA, 2002):

- Stakeholders' expectations
- Risk levels
- Size and complexity of the organization including the volume of activity and number of operating facilities

Laker (2004) states the following as the main features of the internal audit function:

### 1. Structure and Resources

Internal audit function's structure should be established and an assessment about internal audit personnel, their roles, responsibilities and skills should be made.

## 2. Independence

Boards of directors should ensure the independence of internal audit function. Independence of internal audit function may be compromised if internal audit function is directly involved in operational processes and risk management. If internal audit function is outsourced there should not be any conflicts of interest such that internal audit activity should not be a source of referral business for the organization.

## 3. Approach

The approach of internal audit activity should be one of the following or a combination of them.

- Risk-based approach – the focus is on high-risk areas
- Review-based approach – the focus is on reviews of various parts of the institution, chosen randomly or according to the internal audit plan
- Compliance-based approach – the focus is on compliance with policies and procedures.

## 4. Internal Audit Plan

Internal audit plan usually shows the internal audit work for the next one year period. It should be endorsed and documented by the board. The plan should be adequate for the scale of the organization's operations and consistent with the type of approach. The following should be taken into account in assessing the robustness of the plan:

- There is a dedicated planning process for the development of the internal audit plan. The board of directors, Audit Committee and management must ensure the plan reflects the needs of the institution.
- The plan clarifies the objectives, scope and cycle of internal audit function.

- The external audit function has highlighted areas of weaknesses in the internal control environment which require the review of the internal audit function.
- Progress against the plan is monitored by the Audit Committee and reported to the board of directors of the organization.

## 5. Reporting

The Chief Audit Executive (CAE) should regularly report the findings to the Audit Committee. Issues should be monitored in order to ensure that appropriate action is taken to manage risks and mitigate possible loss. There should be a clear flow of reporting from internal audit activity to the Audit Committee and the board of directors. Reports should show the frequency of reporting, focus on internal audit work and clarify whether the work is in line with the plan.

### **4.8 History of Internal Auditing**

The demand for auditing is sourced to reduce record keeping errors, asset misappropriation and fraud within organizations by an independent review. The roots of auditing are described by historian Richard Brown as follows (Mautz and Sharaf, 1961):

The origin of auditing goes back to times scarcely less remote than that of accounting. Whenever the advance of civilization brought about the necessity of one man being intrusted to some extent with the property of another, the advisability of some kind of check upon the fidelity of the former would become apparent.

As a result of the growing volume and complexity of transactions, managers became distant from the sources of those transactions and there existed a need for a technical expertise to review independently the activities of organizations and give reports to management. This situation basically fastened the establishment of internal audit departments within organizations. In its early days internal auditing function focused primarily on loss of cash and other assets and payroll fraud. But later its scope widened and moved from an audit for management view to audit of management (Reeve, 1986).



After the founding of the IIA, Brink and Cashin (1958) made the following operational auditing oriented definition of internal auditing:

Internal auditing thus emerges as a special segment of the broad field of accounting, utilizing the basic techniques and method of auditing. The fact that the public accountant and the internal auditor use many of the same techniques often leads to a mistaken assumption that there is little difference in the work or in ultimate objectives. The internal auditor, like any auditor, is concerned with the investigation of the validity of representations, but in his case the representations with which he is concerned cover a much wider range and have to do with many matters where the relationship to the accounts is often somewhat remote. In addition, the internal auditor, being a company man, has a more vital interest in all types of company operations and is quite naturally more deeply interested in helping to make those operations as profitable as possible. Thus, to a greater extent, management services comes to influence his thinking and general approach.

In 1947 the IIA's Statement of Responsibilities of the Internal Auditor was issued. In this statement, it was stated that operating matters also are in the scope of internal auditing as well as accounting and financial matters. In 1957, this statement was broadened and included the following services (Bailey *et al*, 2003):

- Reviewing the adequacy and soundness of accounting, financial and operating controls,
- Ascertaining compliance with policies and procedures,
- Ascertaining the reliability of data within the organization,
- Appraising the quality of performance.

In 1978, the IIA approved the Standards for the Professional Practice of Internal Auditing. These standards have the following purposes (IIA, 2004):

- State basic principles of internal auditing practice,
- Provide a framework in order to perform value added internal audit activities,
- Establish an appropriate basis for evaluating the performance of internal auditing activity,
- Achieve improvements in organizations' operations and processes.

These standards define and set the objectives of internal auditing. Internal auditing is an objective and independent appraisal activity. It examines and evaluates the effectiveness and adequacy of controls. Main objective of internal auditing is to ensure effective discharging of the responsibilities of the members of an organization. Internal auditing provides the members of the organization analyses, information, appraisals and recommendations about their activities. Its objective includes promoting effective internal controls at reasonable cost (IIA, 2004).

Today, the reporting relationship between the internal audit function and the Audit Committee is considered as one of the best practices in enhancing governance structure. Audit Committee can be considered as a bridge between the board of directors and both internal and external auditors. Members of the Audit Committee should be properly informed on auditing matters in order to fulfill their responsibilities. Management became aware of the necessity to protect itself through adequate attention to effective audits and internal controls (Mautz and Neumann, 1977).

In the early 1990s internal auditors worked in many areas such as compliance audits, fraud audits, evaluating operational efficiency, measuring and reporting risks, assurance activities and consulting activities. Internal auditors performed a combination of financial, operational, management and compliance audits. They performed those activities with a risk based and controls focused approach. They also began more extensively using technology applications in their audits. Internal auditors began gradually to specialize in specific industries. They also began to come from no accounting backgrounds and became more internationally oriented (Bailey *et al*, 2003).

#### **4.9 New Roles, Responsibilities and Definition of Internal Auditing**

In recent years, internal audit activity started to respond to new regulatory and legislative mandates as a result of some international reports such as the Report of the National Commission on Fraudulent Financial Reporting (Treadway Commission Report, 1987); the Report of the Committee of Sponsoring Organizations (COSO) of the Treadway Commission (1992), Cadbury Committee Report and changes in the

New York Stock Exchange rules such as the requirement for all publicly listed companies to have an internal audit function and Sarbanes-Oxley Act of 2002. Business environment has been experiencing rapid growth and because of increased competition there existed a need for increased risk management initiatives, processes and greater accountability. All these situations require timely and reliable information for decision makers. Also organizations are trying to establish more effective governance systems. As a result of these, internal auditing appears as a key function to monitor controls, support governance processes and evaluate operational effectiveness (Bailey *et al*, 2003).

Ratliff and Reding (2002) states skills and responsibilities of 21st century auditor as the following:

Auditors of the 21st century must be prepared to 'audit' virtually everything - operations (including control systems), performance, information and information systems, legal compliance, financial statements, fraud, environmental reporting and performance, and quality. Auditors must master analytical and critical thinking skills; an efficient method to gain an adequate understanding of any auditee - individual, organization, or system, new concepts, principles, and techniques of internal control; understanding of risk and opportunity; development of audit objectives; selection, collection, evaluation and documentation of audit evidence; reporting audit results in a variety of formats; audit follow-up; professional ethics and audit technology applicable across a variety of types of audit reports. In addition, auditors must understand the concepts of auditor independence and objectivity as these concepts relate to different types of audits by different types of auditors. They must fully understand cost and materiality implications of risk; opportunity, and audit evidence.

Birkett *et al* (1999) stated that internal auditors should possess a wide range of skills and competencies to handle change and complexity in operations of the organizations. In such situations, internal audit activity adds value to the organization by providing assurance about organizational governance, risk exposures and operational activities.

GTF Report (1999) carried out a review of professional standards, the code of ethics and definition of internal auditing. According to this report, the old terminology can not reflect the evaluation of practice or it can not promote the internal auditing profession in the marketplace effectively. According to the GTF Report the new Professional Practices Framework has the following purposes:

- Provide a framework in order to support and promote value-adding internal auditing activities,
- Specify basic principles that represent internal auditing as it should be throughout the world,
- Foster improved organizational operations and processes,
- Request for a quality assurance mechanism in order to ensure compliance with the standards.

Internal auditing's new definition aims to accommodate the profession's expanding roles and responsibilities:

Internal auditing is an independent, objective assurance and consulting activity designed 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 (IIA, 1999).

There are mainly six images of this new definition of internal auditing (Chapman and Anderson, 2002):

1. This definition permits internal auditing which is an objective activity and not necessarily established within the organization, to be obtained through outsourcing.
2. The new definition designs internal auditing as customer focused and proactive and it is concerned with key issues in risk management, control and governance processes.
3. It highlights the contribution of internal auditing by explicitly stating that it adds value and improves an organization's operations.
4. It perceives the aims of internal auditing more broadly, charging it with helping the organization accomplish overall objectives.
5. It assumes that controls exist to manage risks of an organization and to promote effective governance. This perspective widens working domain of internal auditing to include control, risk management and governance processes.
6. It accepts that internal auditing is a standards based profession and rigorous standards provide the basis for crafting a documented, disciplined, and

systematic process that assures quality performance on internal audit engagements.

Internal auditing activity had a remarkable evolution in the last sixty years and reached to an important position within organizations. Today, internal auditing function contributes to organizational governance by conducting assurance and consulting services and has more responsibility against the organization, shareholders and the stakeholders. Information provided by internal auditors enhances decision making and efficient and effective use of economic and organizational resources (Bailey *et al*, 2003).

#### **4.10 Assurance and Consulting Services**

There are basically two types of services that internal audit activity performs. These are the assurance and consulting services (IIA, 2004).

##### **4.10.1 Assurance Services**

The IIA defines assurance services as “the internal auditor’s objective assessment of evidence to provide an independent opinion or conclusions regarding a process, system or other subject matter”. Internal auditors determine the scope and nature of assurance services. There are three parties in an assurance engagement (IIA, 2004):

1. The process owner which is a group or person involved with the system or the process,
2. The internal auditor that is responsible to make the assessment,
3. The user of the assessment.

Assurance services involve evaluating evidence in an objective manner with a systematic process, require an established criteria and communication of results to appropriate parties (Bailey *et al*, 2003).

There are mainly three types of assurance services. These are financial auditing, performance auditing and quick response auditing. Financial auditing includes

examination of financial results of organization, compliance attestations such as audits of expenditures, audit of financial statements with external auditors. Performance auditing or operational auditing is the traditional form of internal auditing. The aim of this type of auditing is to minimize risk with constrained audit resources of internal audit activity. Performance auditing gives reasonable assurance about the effectiveness and efficiency of operations and make recommendations to management. Quick response auditing consists of activities which are conducted by special requests of management. They can be seen like consulting engagements but they are different in the sense that management requests them for a third party review for assurance. The typical engagement example of this type is fraud investigations (Bailey *et al*, 2003).

#### **4.10.2 Consulting Services**

Consulting services are advisory services which are usually conducted by request of an engagement client. Internal audit activity and the engagement client determine the scope and the nature of the consulting engagement together. In case of consulting services, the internal auditor should not assume management responsibility and should maintain his objectivity. The CAE is responsible for determining the function and form of consulting engagements (IIA, 2004)

There are two parties involved in a consulting engagement (IIA, 2004):

1. The internal auditor who offers the consulting engagement,
2. The person or the group taking the consulting engagement from the internal auditor.

There are three types of consulting services. These are assessment services, facilitation services and remediation services. In assessment services the auditor examines present, past and future aspects of operations and by this way assists management in decision making process. These engagements do not include specific recommendations for management. An example of assessment service is evaluating the effectiveness of internal control in an accounts payable system. Facilitation services assist management in examining organizational performance to promote

change. In this type of service, the auditor identifies organizational strengths and weaknesses and guides management. On the other hand, he does not judge organizational performance. These types of engagements include benchmarking and business process reengineering support. In case of remediation services, the auditor assumes direct role to prevent problems on behalf of the client. Such engagements include augmenting of operating personnel, in which the auditor actually performs operating functions for a period of time or on a permanent basis (Bailey *et al*, 2003).

Bailey *et al* (2003) makes two main distinctions between assurance and consulting services:

1. Assurance engagements require an opinion about the results but consulting engagements make recommendations. If needed there can be formal reporting in consulting engagements.
2. The internal audit function can not decide not to conduct assurance engagements, if it is identified as an area of need. Assurance engagements are mandatory in nature.

#### **4.11 Types of Internal Audit**

The main types of internal audit can be categorized as financial audit, compliance audit, operational audit and management audit.

##### **4.11.1 Financial Audit**

Financial audit is a type of audit the objective of which is to evaluate the reliability of accounting system and information in the financial results of the organization (Dumitrescu, 2004). It deals with financial data and statements. Reporting framework is international standards or national laws. The aim of financial audit is to establish the reliability of accounting system, accounting information and financial reports of the organization (BIS, 2001).

In the case of financial audit, auditors review the records and reports of a department or the entire organization to evaluate if assets and liabilities of the organization are

properly recorded and the financial statements show the true financial position of the organization. In financial audits significance is usually defined in monetary terms. This type of audit covers the examination of balance sheet, income statement and statement of cash flows of an organization (Adukia, 2005).

#### **4.11.2 Compliance Audit**

Compliance audit assesses the appropriateness and quality of the systems within the organization in order to ensure compliance with stated regulations, procedures and processes (BIS, 2001). Compliance audit includes collecting information about procedures, laws and regulations assessing the risk that noncompliance could occur, providing reasonable assurance to detect significant noncompliance (Adukia, 2005).

#### **4.11.3 Operational Audit**

Operational audit assesses the appropriateness and quality of systems and procedures. It examines and evaluates organizational structures and gives opinions about the adequacy of resources and methods (Dumitrescu, 2004). Operating procedures and internal controls of a department are examined and evaluated under compliance audit. It concerns if the resources are managed in an efficient and effective manner. It includes the elements of financial audit and compliance audit (Adukia, 2005).

#### **4.11.4 Management Audit**

Management audit aims to evaluate the quality of management's approach to risk and control in the framework of the overall goals of the organization (Dumitrescu, 2004).

All of the activities of an organization are under the scope of internal audit activity. So, internal audit activity does not use a single type of audit. Instead it chooses the best type depending on the objectives of the engagement and the area under consideration (BIS, 2001).



## **4.12 Dimensions of Internal Auditing**

Internal audit function can be organized along four dimensions. These are; centralized, decentralized, hybrid and decentralized with guidance dimensions (Gupta, 2001).

### 1. Centralized

In a centralized internal auditing structure, only one internal audit department handles all of the auditees.

### 2. Decentralized

Each organizational sub unit or division has its own internal audit function and there is no corporate internal audit department.

### 3. Hybrid

Each sub unit or division has its own internal audit department which reports to the corporate internal audit department. Corporate ~~internal~~ internal audit function exercises centralized control with regional auditing offices at major business units.

### 4. Decentralized with Guidance

Overall guidance is provided by the corporate audit department. But, day to day operations are decided upon and managed locally or regionally through the world.

## **4.13 Internal Audit Approaches**

There are mainly three approaches about internal audit. These are traditional approach, integrated audit team approach and fully integrated audit approach (PWC, 1991).

### 1. Traditional Audit Approach

In traditional audit approach, internal audit function of the organization is divided into autonomous groups such as operational audit, information technology audit and financial audit groups. These groups report to the director of audit. Each group of activity is independent and performs its own planning, training, reporting, etc.

### 2. Integrated Audit Team Approach

In integrated audit team approach, a set of audit objectives is defined for operational, information technology and financial audit considerations. The lead auditor may be from any of the specialties. Auditors who have the necessary skills are on the audit team and report to a single audit manager.

### 3. Fully Integrated Audit Approach

In fully integrated audit approach there is no differentiation between functional areas of audit. Internal auditors are trained in various specialties and all of the auditors are capable of handling routine control and audit areas.

## **4.14 International Standards for the Professional Practice of Internal Auditing**

The IIA is an association the aim of which is to ensure continuous development of both individual internal auditors and the internal audit profession. IIA sets some standards for the professional practice of internal auditing. These standards are classified under three broad categories such as attribute standards, performance standards and implementation standards (IIA, 2004).

IIA (2004) states the purposes of these standards as to,

- State basic principles of internal auditing practice,
- Provide a framework in order to perform value added internal auditing activities,

- Establish an appropriate basis for evaluating the performance of internal auditing activity,
- Achieve improvements in organizations' operations and processes.

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#### **4.15 Attribute Standards**

In attribute standards the characteristics of organizations performing internal audit activities are addressed (IIA, 2004). Attribute standards described in the IIA's International Standards for the Professional Practice of Internal Auditing are as the following.

##### **4.15.1 Purpose, Authority and Responsibility**

Internal audit activity's charter should be approved by the board and should include the purpose, authority and responsibility of internal audit activity. The nature of assurance and consulting services should also be defined in the audit charter.

##### **4.15.2 Independence and Objectivity**

In a general sense being independent means a person or a group unwilling to be under obligation to others (PCA, 2002). Internal auditors should be objective and they should have an independent status in performing their work and communicate their findings. Internal audit activity should be free from interference in doing its work and the attitude of internal auditors should be unbiased and impartial. If independence and objectivity of internal audit activity are impaired, this situation should be communicated to appropriate parties.

##### **4.15.3 Proficiency and Due Professional Care**

Proficiency means that internal auditors have sufficient knowledge, skills and competencies to be able to perform their duties. In case of fraud examinations internal auditors should be able to identify fraud indicators, but they are not expected to have expertise in detecting and investigating fraud. If internal auditors lack

competencies to perform a consulting engagement, the CAE should decline these kinds of consulting engagements.

In case of due professional care, it is expected from internal auditors that they apply the skills and care expected from a prudent and competent internal auditor. Due professional care should be exercised by considering the following:

- The extent of work,
- Materiality, complexity and significance of matters,
- Effectiveness of risk management, control and governance processes,
- Probability of noncompliance and irregularities,
- Cost of the services compared to potential benefits.

#### **4.15.4 Quality Assurance and Improvement Program**

It is the responsibility of the CAE to develop quality assurance and development program that monitors the effectiveness of internal audit activity. This program includes internal and external quality assessments and monitoring. Internal assessments include ongoing monitoring and periodic reviews by other persons within the organization. External assessments include periodic reviews conducted by an independent reviewer outside the organization.

#### **4.16 Performance Standards**

Performance standards describe internal audit activities' nature and set criteria to evaluate the performance of those activities (IIA, 2004). Performance standards described in the IIA's International Standards for the Professional Practice of Internal Auditing are described below.

##### **4.16.1 Managing the Internal Audit Activity**

It is the responsibility of CAE to manage the internal audit activity and to ensure that it adds value to the organization. The main responsibilities of the CAE in managing

the internal audit activity are stated in the IIA's International Standards for the Professional Practice of Internal Auditing as the following:

- Establishment of risk based plans consistent with organizational goals,
- Accepting consulting engagements to improve organization's operations and add value to the organization,
- Communicating the plans of internal audit activity to board of directors and senior management for review and approval,
- Ensuring that internal audit resources are appropriate and sufficient,
- Establishing procedures and policies in order to guide the internal audit activity,
- Coordinating activities and sharing information with other internal and external assurance and consulting service providers,
- Reporting periodically to the board of directors and senior management about the purpose, authority, responsibility and performance of internal audit activities,
- Reporting to the board of directors and senior management significant risk exposures, corporate governance and control issues.

#### **4.16.2 Nature of Work**

Internal audit activity within an organization should examine and do work for the improvement of risk management, control and governance processes. In case of risk management, internal audit activity should identify and evaluate significant risk exposures and try to improve risk management process. It should monitor and evaluate the effectiveness of risk management system. Internal audit activity should also evaluate the effectiveness and efficiency of controls. In case of governance, internal audit activity should improve the governance process by promoting ethics and values, ensuring effective organizational performance management and accountability, communicating risk and control information with appropriate parties and communicating information among the boards of directors, management, internal auditors and external auditors.

#### **4.16.3 Engagement Planning**

A plan for each engagement which includes the scope, objectives, time plan and resource allocation should be developed by internal auditors. In planning an engagement; objectives, adequacy and effectiveness of risk management and control systems and improvement areas should be taken into account by internal auditors.

#### **4.16.4 Performing the Engagement**

When performing an engagement, in order to achieve the engagement objectives sufficient information should be identified, analyzed, evaluated and recorded by internal auditors. Management of internal audit activity should supervise engagements to ensure the achievement of objectives.

#### **4.16.5 Communicating Results**

Engagement results should be communicated by internal auditors to appropriate parties both internal and external to the organization. Communications should include objectives, scope, conclusions, recommendations and action plans.

#### **4.16.6 Monitoring Progress**

The CAE is responsible to monitor the disposition of results which are communicated to management. The CAE should also establish a follow-up system to ensure that actions of management are effectively implemented or management has accepted the risk of not taking action.

#### **4.16.7 Resolution of Management's Acceptance of Risks**

When the CAE believes that senior management has accepted an unacceptable level of residual risk, he should discuss this matter with senior management. If the decision is not resolved, the CAE and senior management should report this situation to the board of directors for resolution (IIA, 2004).

#### **4.17 Implementation Standards**

Implementation standards apply to specific engagements and there are multiple implementation standards for major internal auditing activities. They are established for assurance and consulting activities. The attribute and performance standards apply to internal audit services in general. On the other hand implementation standards apply the attribute and performance standards to specific types of engagements (IIA, 2004).

#### **4.18 Internal Audit in Banking Organizations**

Boards of directors of banks are responsible that management applies an effective internal control system. This system should be appropriate to evaluate banking risks and compliance with laws, regulations and internal bank procedures. Bank management is responsible to establish an organizational structure that clearly identifies powers and responsibilities. Also, it should develop policies and procedures in order to identify, monitor and control risks within the bank. Internal auditing is a part of monitoring of the internal control system of the bank. It gives feedback to both the board of directors and management about effectiveness of performance of their responsibilities (Dumitrescu, 2004).

Compared to non-banking organizations, special audit considerations arise in bank auditing because of the following factors (IAPC, 1990):

- The nature of business risks associated with the transactions undertaking within banks,
- The scale of banking operations and their resultant short-term exposures,
- Dependence on computerized systems in processing transactions,
- The effect of the regulations,
- Development of new banking practices and products that may not be in line with the development of auditing practices and accounting principles.

Internal audit activity in banks include a plan of the audit, examination and evaluation of information, communicating engagement results to appropriate parties both internal and external to the organization and giving recommendations in order to correct deficiencies. All of the activities of bank, its partnerships and branches fall within the scope of internal audit examination. Bank's records and all relevant information should be accessible by the board of internal auditors. Board of internal auditors should control the risk management system of the bank in order to assess bank's internal capital. It should make this evaluation on the basis of the relation of risk to the bank's capital and control the methods regarding the compliance of procedures. Risk assessment in relation to bank's capital is a part of risk management process. Individuals that are responsible for controlling the bank's capital evaluation process should be clearly identified and an independent evaluation of this control should be fulfilled by the internal audit activity. (Dumitrescu, 2004).

#### **4.19 Objectives and Tasks of Internal Audit Function Within Banks**

BIS (2001) states the objectives and tasks of internal audit function in banking organizations. These are the following:

First, boards of directors of the bank are ultimately responsible in ensuring that senior management establishes an effective internal control system in order to assess various risks, relate risks to the bank's capital level and set appropriate methods for monitoring compliance with laws, regulations and policies. Internal control system and capital assessment procedure of the bank should be reviewed at least once a year by the board of directors. Board of directors should ensure that the bank has established an adequate internal control system. Also board of directors should ensure that bank has processes for controlling the risks incurred in pursuing its business objectives, testing the reliability and integrity of financial information and for monitoring compliance with laws and regulations.

Second, senior management is responsible in developing processes in order to identify, monitor and control certain risks. Senior management should report to the board of directors about the scope and performance of the internal control system. Senior management should clearly assign responsibility, authority and reporting



relationships, develop risk management processes in order to identify, measure, monitor and control risks and monitor the adequacy and effectiveness of the internal control system.

Third, internal audit provides an independent assessment regarding compliance with established policies and procedures. By this way, internal audit function helps boards of directors and senior management in discharging their responsibilities in an effective and efficient manner.

#### **4.20 Principles of Bank Internal Audit**

BIS (2001) states seven main principles about internal audit function within banking organizations.

##### **4.20.1 Continuity**

According to BIS (2001) banks should have a permanent internal audit function. Senior management should ensure continuous reliance of bank on an adequate internal audit function. The structure of internal audit function should be appropriate to the size and the nature of the operations of the bank. In larger banks there are boards of internal auditors which are employed by full time staff. However in smaller banks which have less complex functions, internal audit activities may be outsourced.

##### **4.20.2 Independent Function**

BIS (2001) states that internal audit function within banks must be independent of the internal control processes and the activities audited. So, the internal audit activity can carry out its function in an objective and impartial manner. According to the independence function internal audit function should operate under the control of the board of directors or the Audit Committee. Head of the board of internal auditors should be able to communicate directly to the board of directors, Audit Committee or the external auditors.

Internal audit function should also be subject to an independent review. This can be conducted by external auditors or the Audit Committee of the board of directors. Independence of internal audit activity should be established by the Audit Committee by regularly reviewing and approving the internal audit charter (Adukia, 2005).

#### **4.20.3 Audit Charter**

All the banks should have an internal audit charter. According to BIS (2001) an internal audit charter establishes the following:

- Internal audit function's scope and objectives,
- Position, powers and responsibilities of the internal audit function within the organization,
- Head of the board of internal auditors' accountability.

Internal audit charter should be approved by senior management and confirmed by the board of directors or the Audit Committee of the board of directors. According to BIS (2001), in the charter, senior management of the bank gives the board of internal auditors the right of initiative, authorizes it to have direct access to any staff, records, files or data of the bank, examines any activity or entity of the bank whenever relevant.

#### **4.20.4 Impartiality**

Internal audit function should perform its duties free from bias and interference. According to this principle, internal audit function should not be involved in bank operations and in the implementation process of internal control measures. If it involves in these functions it has to assume responsibility for these functions.

For objectivity and impartiality concerns staff assignments of the board of internal auditors should be rotated periodically. It should be ensured that the internal auditors should not audit activities they performed within the last one year time.

#### **4.20.5 Professional Competence**

In order to ensure the effectiveness of the internal audit function internal auditors should have continuous training programs. Professional competence and experience must be established within the internal audit function and members of the internal audit function should be qualified in examining the areas in which the bank operates. In order to increase the competence of internal auditors BIS (2001) suggests rotation within the board of internal auditors.

#### **4.20.6 Scope of Activity**

Every activity of the bank falls within the scope of the internal audit function. Internal audit function should be able to obtain any information, access to records, files or data when it needs them. BIS (2001) classifies the functions that fall into the scope of internal audit as the following:

- Evaluation of adequacy and effectiveness of internal control systems of an organization,
- Review of application and effectiveness of risk management procedures and methodologies,
- Review of management and financial information systems,
- Examination of the reliability of accounting records and financial information,
- Evaluation of the efficiency of operations,
- Testing of transactions and the functioning of internal control procedures,
- Conducting reviews in order to ensure compliance with laws, policies, procedures and regulations,
- Testing the reliability and timeliness of financial reporting,
- Conducting special investigations.

Boards of internal auditors should be informed by senior management about operational changes and new developments in order to ensure identification of risks earlier (BIS, 2001).

#### 4.21 Internal Auditing and Corporate Governance

Internal auditing profession is an important contributor to the development of corporate governance. It is recognized as a strong international player in corporate governance system. In past fifty years, organizations established internal auditing functions in order to improve their monitoring activities. In its early years, internal auditing activity was related to accounting control and security over assets. Few internal auditors were involved in the achievement of objectives and strategic issues and in operating systems (D'Silva and Ridley, 2007).

Mints, F. (1972) classified internal auditing relationships into three broad categories: traditional (protection, compliance), current moderate approach (constructive, protective, problem-solving) and participative teamwork approach (providing assistance in achieving organization objectives, working with management). He defined the following hypothesis for the participative teamwork approach:

The establishment of participative auditee relationships would a) help to direct the audit effort toward more significant operating problems; and b) would help also to release the full potential of the audit process to make suggestions that would be of material assistance in accomplishing organizational objectives.

In 1999 the IIA revised its definition of internal auditing and emphasized the role of internal auditing in risk management, control and governance processes. It was the first time that governance was mentioned in the definition of internal auditing. The definition is as follows:

Internal auditing is an independent, objective assurance and consulting activity designed 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 (IIA, 1999).

Since the 1999 definition of internal auditing of the IIA, the Institute requires the knowledge and understanding of governance processes for internal auditors (D'Silva and Ridley, 2007).

The IIA-UK and Ireland (2002) described in their paper three main lessons learnt from corporate collapses. These are the role of the board of directors, loyalty to the right shareholders and serving the right interests and the internal audit activity. According to them, in order to fulfill its role effectively, internal auditing activity should have the profile, professionalism and independence. It should be able to provide an environment of transparency and accurate reporting. It should demonstrate an understanding of an organization's operations and should provide the focus on risks for the organization.

The Sarbanes-Oxley Act of 2002 had some effects on internal auditing. One of them was the measurement of the effectiveness of internal auditing at broad level would focus on the activity's quality assurance and continuous improvement. This attention can only improve an organization's corporate governance framework (D'Silva and Ridley, 2007).

European Confederation of Institutes of Internal Audit (ECIIA) (2005) describes the ways professional internal auditing can provide value to those responsible for governance as:

In summary there are two sorts of contribution – assurance and consulting. With regard to assurance, a professional internal audit activity will complement and support management assurance by providing objective assurance on the effectiveness of the processes for achieving good governance, risk management and internal control. As part of its work, such an activity will also provide consulting services, facilitating and advising on improvements in key areas.

The IIA-UK and Ireland (2003) states that as a minimum, the scope of internal auditing should review and report on the following issues:

- The control environment as a whole,
- Processes by which risks are identified, analyzed and managed,
- Controls over key operational and functional processes,
- Processes that deliver change and systems development initiatives,
- Reliability and integrity of management information systems,
- Safeguarding of assets
- Compliance with relevant laws and legislation.

#### 4.21.1 Role of Internal Auditing in Corporate Governance

Internal audit is a fundamental function for sound corporate governance. An objective internal audit function with skills to identify risk control problems is essential for proper discharge of the responsibilities of directors. Corporate governance has an increasing importance around the world in recent years. Expectations of communities about an independent review of operations of organizations and financial accounts have been raised. Governments and the regulatory authorities began improving corporate governance standards, strengthening corporate governance principles and improving transparency. In such an environment boards of directors and senior management of organizations need objective and independent reviews and advice from reliable sources. These needs are basically met by the work of internal audit function (Laker, 2004).

Internal auditors provide management with assurance that (Bailey *et al*, 2003):

- Risks are identified and monitored effectively,
- Organizational processes are effectively controlled,
- Organizational processes are efficient and effective.

In this structure, internal audit function plays a unique role. It helps organizations implement, assess and conceptualize processes of risk management and control. It plays an active role in the implementation of effective governance and controls (Bailey *et al*, 2003).

The IIA (1999) defines internal auditing as,

An independent, objective assurance and consulting activity designed 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 main function of internal auditing is an independent evaluation of internal controls of an organization including controls over financial reporting. It aims to review activities in order to ensure that they are carrying out as intended. An

important role of internal audit is to make recommendations on internal control and process improvements. On the other hand, risk management identifies and assesses inherent risks in activities and ensures that appropriate risk management limits, mitigation strategies and control mechanisms are in place. Internal auditing also plays an important role in evaluating whether the controls are in place and functional. The main distinction between internal auditing and risk management is that risk management function has the responsibility of understanding how risks facing the organization are changing and assessing if controls, limits and mitigations are needed to be updated. There should be cooperation between internal audit and risk management functions. When new procedures are in place, internal audit function should be informed and if internal audit activity finds out any weaknesses risk management function should be informed (Laker, 2004).

The role of internal audit in corporate governance is enshrined in international standards. In banking, the Core Principles for Effective Banking Supervision which was developed by the Basel Committee on Banking Supervision specifies that banks should have internal controls that are adequate for their business. These should include independent internal audit, external audit and compliance functions (Laker, 2004).

Basel Committee's essential criteria for the internal audit function are that the internal audit function should:

- Have access to all the bank's business lines and departments,
- Have appropriate independence within the organization,
- Have sufficient resources, staff and experience in order to be able to understand and evaluate the business under review,
- Employ a methodology in order to identify the key risks run by the bank and allocate its resources accordingly.

Basel Committee on Banking Supervision also issued a paper, Internal Audit in Banks and the Supervisor's Relationship with Auditors in 2001 to provide more

detailed guidance to bank supervisors. Two most crucial principles stated in this paper are the following:

- Internal audit function must be independent of the activities audited and the every day internal control process,
- Every activity and every entity of the organization should fall within the scope of internal audit activity.

Two fundamental governance activities of internal auditing function are monitoring risks and providing assurance regarding controls. The IIA defines risk as the “probability that an event or action, or inaction, may adversely affect the organization or activity under review.” In case of governance, key activities with respect to risk are identifying it, monitoring it and determining strategies in order to address risks. The IIA defines control as:

Any action taken by management to enhance the likelihood that established objectives and goals will be achieved. Management plans, organizes, and directs the performance of sufficient actions to provide reasonable assurance that objectives and goals will be achieved. Thus, control is the result of proper planning, organizing, and directing by management.

In case of governance it should be ensured that controls are in place to address organizational risks (Bailey *et al*, 2003).

Goals and accountability are important elements of governance process. Sufficient resources are required in order to monitor risks and controls for effective governance. These are important to help the organization in achieving its goals and objectives. If there is an internal control failure within the organization, this case exists as an obstacle in the achievement of goals and objectives. Effective governance activities aim to preserve the value of the organization. In case of accountability, because shareholders and stakeholders can not directly perform monitoring and assurance activities, they rely on the work of internal auditors (Bailey *et al*, 2003).

The IIA makes a summary of the role of internal auditing in corporate governance as the following (<http://www.theiia.org>):



Internal auditors' roles include monitoring, assessing, and analyzing organizational risks and controls; and reviewing and confirming information and compliance with policies, procedures, and laws. Working in partnership with management, internal auditors provide the board, the Audit Committee, and executive management assurance that risks are held at bay and that the organization's corporate governance is strong and effective. And, when there is room for improvement anywhere within the organization, the internal auditors make recommendations for enhancing processes, policies, and procedures.

To conclude, internal audit activity should assess and make recommendations in order to improve the governance process in its accomplishment of the following (IIA, 2004):

- Promoting ethics and values within organizations,
- Ensuring effective accountability and performance management,
- Effectively communicating information about risk and control to appropriate areas of the organization,
- Effectively coordinating the activities of the board of directors, management, external and internal auditors.

This definition enabled the internal audit function to take place in strategic management decisions and implementation of organizational policies. It is necessary for the internal audit activity to understand corporate governance principles and requirements. It is understood from the new definition of internal auditing that internal audit activity is deeply involved in corporate governance process (D'Silva and Ridley, 2007).

#### **4.21.2 Role of Audit Committees in Corporate Governance**

Audit Committee is a committee of the board of directors which is independent of management and consists of nonexecutive directors. Its members have access to any data and records of the organization and reports to the board of directors. Audit Committee reinforces internal control system, internal audit and external audit. For efficiency, the CEO or a member of senior management, the head of the board of internal auditors and the external auditor should attend to the Audit Committee meetings regularly (BIS, 2001).

The Audit Committee discusses (BIS, 2001);

- Functioning of internal control system,
- The activities of the board of internal auditors,
- The reliability and accuracy of financial information provided to internal and external parties,
- Material accounting and auditing concerns,
- Risk areas of the institution's operations,
- Compliance of the organization with legal and regulatory provisions.

Audit Committees strengthen internal control systems, internal audit and external audit. So, it is recommended for the banks to establish Audit Committees (Dumitrescu, 2004).

Corporate failures and accounting regularities that have been experienced in the world economy increased the crucial role of the internal audit function and the Audit Committees. Audit Committees assist in assuring the integrity of financial reporting system, strength of internal controls and adherence to policies and regulations (Freibert, 2000).

Audit Committees basically have three main roles. These are monitoring the financial reporting process, overseeing the internal control system and overseeing the work of internal auditors and external auditors. The primary role of Audit Committees is seen as the monitoring of the financial reporting process with the aim of ensuring reliable financial reporting. In case of overseeing the internal control system, Audit Committees ensure that organizational risks are assessed and mitigated and control weaknesses are addressed by management. In case of the oversight of internal audit functions, Audit Committees review the internal audit charter, receive internal audit reports, evaluate internal audit function's objectivity and monitor internal audit function's staffing issues. On the other hand, oversight of the external audit function includes discussion of certain issues with the external auditor, ensuring the independence of the external auditors and having the authority to hire and fire the external auditors (NACD, 2000).

Boards of directors of organizations rely on internal audit's knowledge of the risks, the control weaknesses and its recommendations for improvement. For the Audit Committee itself to be effective, it needs to (Laker, 2004):

- Understand the internal control systems used to monitor and manage risks,
- Consider whether internal control recommendations are being implemented by management,
- Require the board of directors to make the necessary changes.

Audit Committees play an important role in good corporate governance by managing and monitoring the external audit process. They provide a link between the internal audit function, the external audit function and the board of directors. They also provide comfort to directors on financial significance. They support the board by ensuring that the shareholders' interests are recognized and addressed (PCA, 2002).

## Chapter 5

### Case Studies on Internal Audit Applications of Commercial Banks

#### 5.1 Introduction

Banking crises that have been experienced in Turkish economy in the last years undermined the trust of both the public and investors. For that reason it became mandatory to establish a strict auditing environment within the banking system and within each bank itself.

First chapter was the introduction. Meaning, principles and essential elements of corporate governance are discussed in the second chapter. In the third chapter corporate governance in banking system is studied, corporate governance mechanisms at banks and the role of banks in corporate governance are discussed. In the fourth chapter, internal controlling and internal auditing are explained and differences between them are showed. Types of internal auditing, international standards for the professional practice of internal auditing, internal auditing in banking institutions and the role of internal auditing in corporate governance are discussed.

In this part of the thesis, case studies about internal audit applications of commercial banks that operate in Turkish national banking system are conducted and case study conclusions and recommendations are drawn.

This part begins with the research methodology, proceeds to the case studies and follows through with results, conclusions and recommendations.

## 5.2 Research Methodology – Case Study Approach

A case study approach gives more value to a study when there is little evidence about a phenomenon. Also it is valuable when asking questions of how and why about a set of events that the investigator have little or no control over. Case studies are useful when empirical evidence or theory base are weak and new perspectives and findings are necessary (Yin, 2003).

Using a case study approach focuses on understanding the dynamics within single settings. It can also include multiple cases and many levels of analysis. It combines the data collection methods such as interviews, questionnaires and observations. There may be qualitative or quantitative evidence. Case studies mainly have three aims. These are providing descriptions, testing theory or generating theory (Yin, 1994).

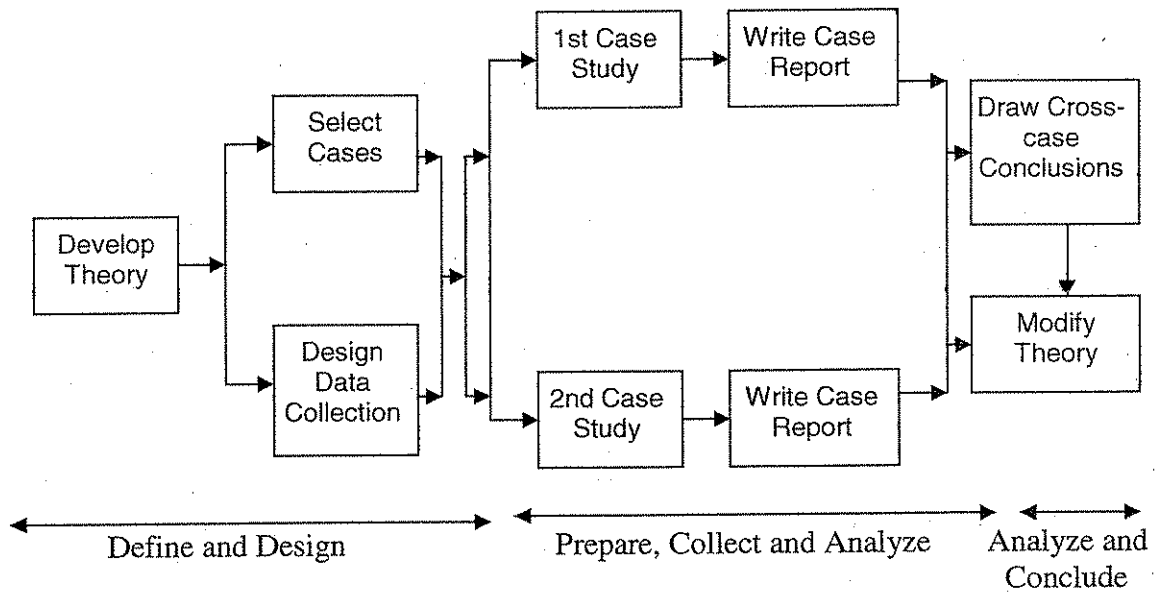
Case studies have some advantages. The main advantages of case studies are testibility, empirical validity arising from intimate linkage with raw data and the likelihood of generating novel theory. On the other hand, case studies have some disadvantages. The first one is that the use of empirical evidence in an intensive manner can lead theory that is overly complex. Another disadvantage is that results of the study may be too pinpointed, narrow and not sufficiently general (Eisenhardt, 1989).

In spite of the disadvantages of case studies they are widely used. The main reasons of using case studies despite their disadvantages are; they can be applied in any conceivable situation and they are flexible (Verschuren and Doorewaard, 1999).

Multiple case study approach is used in this study by conducting case studies in two commercial banks which do business in Turkish national banking system. Multiple case studies are considered to be more compelling and the study is considered more robust. But it also has some disadvantages. These disadvantages are more time and resource consumption compared to other types of studies (Herriot and Firestone,

1983) The approach which will be used in this study is illustrated in the diagram below (Yin, 1994).

Figure: 5.1 Case Study Approach



Source: Yin, R. (1994), "Case Study Research: Design and Methods" 2<sup>nd</sup> ed., Beverly Hills, CA: Sage Publishing.

Two commercial banks that operate in Turkish national banking system are chosen in order to make case studies. The reason for choosing two banks is to be able to make generalizations at the end of the study. Some criteria were used when choosing those banks. These are their willingness to cooperate, their willingness to share bank data, banks that have an internal audit function, both private and foreign banks in order to reach to a better insight.

### 5.2.1 Data Collection

The link between case study choice and data collection methods is illustrated in the table below (Yin, 1994).

Table: 5.1 Design Versus Data Collection: Different Units of Analysis

	<b>From an Individual</b>	<b>From an Organization</b>
<b>About an Individual if Case Study is an Individual</b>	<ul style="list-style-type: none"> <li>- Individual behaviour</li> <li>- Individual attitudes</li> <li>- Individual perceptions</li> </ul>	<ul style="list-style-type: none"> <li>- Archival records</li> </ul>
<b>About an Organization if Case Study is an Organization</b>	<ul style="list-style-type: none"> <li>- How organization operates?</li> <li>- Why organization works?</li> </ul>	<ul style="list-style-type: none"> <li>- Personnel policies</li> <li>- Organization outcomes</li> </ul>

Source: Yin, R. (1994), "Case Study Research: Design and Methods" 2<sup>nd</sup> ed., Beverly Hills, CA: Sage Publishing.

This study falls into the "from an individual-about an organization if case study is an organization" part of the table which is the lower left part of it. Since, it does not require direct observation of events, in conducting case studies in commercial banks, the following sources were used:

- Interviews with individuals who work within the banks such as the CAEs, deputy CAEs, internal auditors, etc.,
- Policies, procedures, records and data of the banks,
- Annual reports and some bank documentation,
- Sources from internet and intranets of banks.

### 5.2.2 Case Study Interviews

Some questions were developed and in light of these questions interviews were conducted mainly with some of the members of the boards of directors of banks, CAEs, deputy CAEs, internal auditors, external auditors and some experts in the field of internal auditing and corporate governance issues.

The main objective of those interviews was to gain information about the functioning of the internal audit activity within Turkish national banking system and in the banks that have chosen for the case study. Also, another purpose of interviews was to

obtain information in order to corroborate certain facts which were established by documentation and certain records.

During the case studies conducted in banks, many documents were obtained and analyzed. These documents are Audit Committee charter, charter of the board of internal auditors, annual reports, internet and intranet sources, policies and procedures of the banks, etc.

### **5.2.3 Main Objectives of the Case Studies**

The main objectives of the case studies can be described as the following:

- Exploring whether theoretical applications are justified in practice by relating findings of case studies to the literature,
- Providing supportive data,
- Enriching and adding value to internal auditing and corporate governance theories,
- Getting a clear picture of internal auditing practices within chosen banks that operate in Turkish national banking systems,
- Reaching to conclusions about internal auditing practices of banks that do business in Turkish national banking system.



## **Chapter 6**

### **Case Studies**

#### **6.1 Information About Bank X**

Bank X is a real commercial bank which does business in Turkish national banking system. After its foundation, initially it conducted business in corporate and investment banking segments. But, after 1995 it started to do business in individual banking segment and now it is one of the ten biggest banks that operate in Turkish national banking system.

The mission of Bank X is to be a bank that exceeds its customers' expectations and of which shareholders and employees' are happy and proud to be members, a bank that is aware of its social responsibilities, inspires confidence and is profitable. Its vision is to set an example as a leading bank.

Bank X is operating in Turkey with about 410 branches and about 8.000 employees. In 2006, the bank achieved record growth in terms of the number of its branches. This growth process was aimed at establishing a broader network that will offer closer and uninterrupted services to a growing clientele, and its growth process still continues. As of August 2006, Bank X was active in ten countries: Turkey, Switzerland, the Netherlands, France, Germany, Belgium, Russia, Romania, Ireland and Bahrain.

Bank X has the Board of Directors; Risk Management, Board of Internal Auditors and Internal Control Department which are directly linked to the Board of Directors and the following departments which are linked to the general manager:

- Consumer Banking
- Small Business Banking
- Corporate and Commercial Banking
- Private Banking

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- Credits
- Information Technologies
- Treasury
- Human Resources, Quality System and Process Management
- Operations
- Purchasing and Technical Services
- Financial Control and Planning
- Legal

In order to ensure the effective working of the bank activities the following committees make some meetings in specific periods.

#### Corporate Governance Committee

Bank X has set up a corporate governance committee consisting of three members of the board of directors. The main objective of corporate governance committee in Bank X is to ensure compliance with, improve and advise the board of directors on the corporate governance principles. Corporate governance committee is responsible for verifying whether the corporate governance principles are complied with and, in the case of noncompliance, describing the reasons for and the problems arising due to such noncompliance, and offering corrective actions to the board of directors to ensure compliance.

#### Asset and Liability Committee (ALCO)

The head of this committee is the general manager. Also, CAE, deputy general managers of corporate banking, small business banking, treasury, credits and financial control and planning are included in the committee. In this committee asset

and liability structure of the bank is monitored and its investment, liquidity and borrowing policies, risks of interest, exchange and maturity are discussed.

#### Human Resources Committee

Head of board of directors, members of the board of directors and deputy general manager of the human resources, quality system and process management department are the members of the human resources committee. The members of the committee meet every month. Topics related to human resources are discussed in this committee.

#### Discipline Committee

There are four permanent members of the discipline committee: CAE, deputy general managers of human resources, quality system and process management, operations and legal departments. The head of the committee is the CAE. In discipline committee actions and behaviours of employees which are contrary to policies, procedures, laws and regulations are discussed.

#### Credit Committee

Members of the credit committee are head of board of directors, duly authorized member of the board of directors, general manager, deputy general managers of credits and corporate banking. The members of the committee meet twice a week and discuss credit proposals.

#### Corporate Banking Legal Committee

Members of the committee are head of board of directors, duly authorized member of the board of directors, general manager, deputy general managers of legal and corporate banking departments and head of the problematic credits department. These members meet once a week and discuss credits which have already liquidated.

## Purchasing Committee

Purchasing committee consists of general manager, deputy general manager of operations department and head of the internal services division. Purchasing needs and attributes of properties and services that are needed to be purchased are discussed in this committee.

### **6.2 Some Figures of Bank X**

In the third quarter of 2006, Bank X's total assets increased by 36% in real terms over the beginning of the year, reaching 16,768 million YTL. Also, the loan growth continued. In the third quarter of 2006, total loan volume increased by 33% compared to the beginning of the year, and reached 10,128 million YTL. Loan growth was mainly driven by consumer loans, followed by small and medium enterprise loans. Consumer loans other than credit cards increased by 86% and small and medium enterprise loans 54% in the first three quarters.

In 2006, Bank X significantly expanded its loan portfolio without compromising profitability. By the end of the third quarter, the net interest income of the bank increased by 11% over the same period in 2005 and reached 687 million YTL.

During the same period, net income from fees and commissions of the bank increased by 40% and reached to 294 million YTL. The bank continued to expand its branch network rapidly. Total number of branches increased from 208 at the beginning of 2006 to 334 by March 2007. Beginning to reap the benefits of this growth, YTL deposits of the bank have increased by 29% and reached to 7,758 million YTL.

At the end of this successful period, Bank X's net profit in the third quarter of 2006 increased by 157% over the same period in 2005 and reached to 700 million YTL. As a result of this improvement in profitability, total equity of the bank increased by 42% over the end of 2005 and reached to 1,984 million YTL. This equity growth increased the bank's capital adequacy ratio from 11.33% in the second quarter to 17.21% in the third quarter.

### **6.3 Internal Audit and Internal Control System of Bank X**

In Bank X, internal audit system is established with the aim of maintaining stability and trust in the financial sector, increasing transparency and ensuring a banking system in which there is efficiency, effectiveness and competition. Internal audit system is responsible from the establishment of such an environment within the bank by applying certain standards and procedures and conducting audits and examinations about the processes.

In order to be able to reach its goals, internal audit system in Bank X aims to coordinate its activities with risk management and internal control system. It is expected that internal audit, risk management and internal control departments share their findings, in order to ensure efficient functioning of internal audit system within the bank. Also, these departments are linked to Audit Committee of the board of directors of the bank and thus are able to communicate with the members of the Audit Committee about the problems or obstacles that they face with.

In Bank X, education of employees within the internal audit system and functional departments and branches has priority in order to inform and educate them about internal auditing system. In the bank, there are both horizontal and vertical reporting systems to be able to take risks under control more effectively.

Senior management of the bank is responsible from;

- The regulation and control of the internal control strategies, policies and processes,
- Determination of risks within the bank and development of methods to measure, monitor and control those risks,
- Arrangement of authorities and responsibilities and fulfillment of authorities and responsibilities in an effective manner.

The internal audit system of Bank X is working connected to the Audit Committee and it is independent from all of the functional departments of the bank. Audit

Committee of the bank consists of two non-executive members of the board of directors and is responsible from the activities of both internal audit and internal control departments against the board of directors of the bank.

Internal control system of Bank X is responsible from financial, operational and other control systems within the bank. Internal control system organizes control functions in order to prevent undesirable events, corrective control activities regarding undesired events which have already occurred and guidance activities regarding intended activities. Internal control system works according to the internal control code which is approved by the board of directors of the bank. Organizational structure, job definitions, scope and standards of internal control system are described in this code.

Activities of the board of internal auditors in Bank X include examination of records, documents, personnel, facts that may affect the financial position of the bank, conducting engagements in branches and divisions of the bank, conducting investigations when necessary and commandeering to documents and information. Board of internal auditors also conducts engagements in partnerships of the bank. Internal audit system continues its activities according to the code of board of internal auditors which is approved by the board of directors of the bank. The code consists of the authorities and responsibilities of the board of internal auditors, objectives and scope of auditing and position of the board of internal auditors within the organizational structure of the bank.

Audit system of the bank consists of the board of internal auditors and internal control department. Board of internal auditors represents the internal audit system and internal control department represents the internal control system. These systems come together and form the audit system of Bank X. In case of the following activities there is sharing of duties between the board of internal auditors and internal control department.

### Basic Control Areas of the Internal Audit System

The following basic control areas are under the responsibility of the internal audit system and audits are made by the internal auditors of Bank X in these areas.

- Controls including the preparation of reports and other information requested by the BRSA,
- Controls about compliance with policies, procedures, regulation and legislation,
- Controls related to credit provisions,
- Controls related to financial accounting system,
- Controls related to internal control and risk management systems.

### Basic Control Areas of the Internal Control System

Internal control system of Bank X is responsible from the day to day activities of the bank. The following areas are under the responsibility of the internal control system.

- Conducting controls and examinations in special functional areas of the bank (authorization and approval systems, controls related to accounts and records, controls related to segregation of functions, etc.),
- Controls related to the prevention of money laundering.

#### **6.4 Internal Control System of Bank X**

In the internal control system procedure of Bank X, there are the principles related to the internal control system which are necessary to ensure a control environment that is efficient, effective and in conformance with laws, regulations, policies and procedures.

Internal control system includes all of the financial, operational and other control systems fulfilled by internal control employees for the purpose of execution of all

activities of the bank in accordance with the policies, methods, implementation instructions and limits.

Internal control function in Bank X includes all of the control activities that are pursued within the scope of the management style and organization structure created by the bank's board of directors and senior management. These should be complied with and implemented by personnel ranking at all levels to ensure that the activities of the bank are pursued within the framework of the existing legislation and rules in a regular, efficient and effective way. They should be in compliance with the management strategy and policies, that accounts and records order is integrated and reliable, that data in the data system are accessible in time.

Internal control department is the structure designing, administering and ensuring coordination of the internal control activities of Bank X. Internal control employee is the personnel of Bank X apart from internal auditors of the board of internal auditors authorized by the bank management to perform constant monitoring, examination and control on the activities.

Activities of the internal control system include the following:

- Control activities related to undesired events,
- Corrective control activities regarding undesired events which have already occurred,
- Guidance activities regarding intended activities.

Internal control activities in Bank X are executed by the following personnel:

- Board of directors
- Internal control personnel
- Personnel chosen from functional divisions
- Personnel working in functional divisions



#### **6.4.1 Basic Principles of the Internal Control System in Bank X**

Basic principles of the internal control system in Bank X are as the following.

##### Internal Control Strategy

Internal control strategy of Bank X relies on site and distant examinations of functions of the bank in a continuous process. Main objective of the internal control process is making day to day controls and by this way ensuring that the operations of the bank are in accordance with bank's strategies, policies, legal laws and regulations. Becoming widespread of the control culture and inclusion of personnel at every level is the main strategy. The document related to the strategy, functions and facts of action are approved by the board of directors.

##### Responsibilities Against the Regulatory Authorities

Bank employees should have information about laws and regulations and should obey them.

##### Establishment of Appropriate Systems

A reliable information technology system which will support both internal and external reports should be established. With the help of this system every document and information can be obtained while conducting control activities. In internal controls in order to make a risk based controlling, analyses and selection of sampling methods are made with the help of internal control programmes.

##### Ensuring the Perfection of Internal Control Employees

Training and educations should be arranged in order to increase professional skills of employees who are working in the internal control process. These educations and training both can be from inside or outside the organization.

## Congruity to Professional and Moral Standards

All of the employees of the bank which are included in the internal control process should obey to professional and ethical standards. Banking ethical standards are as the following:

- Honesty
- Impartiality
- Reliability
- Transparency
- Benefit to the society and respect to the environment
- Struggling against money laundering

Also, internal control personnel should not share the information of the bank and its customers with third parties other than official authorities. They should evaluate their control results in an objective manner, should recommend corrective actions and make the follow up of their corrective actions.

### **6.4.2 Duties and Responsibilities of Internal Control in Bank X**

#### Board of Directors

Duties and responsibilities of the board of directors related to internal control in Bank X are as the following:

- Forming strategies and policies related to the control activities of the bank and renewing them when needed,
- Determining working procedures and principles of internal control department,
- Taking actions related to the procurement of internal control personnel and their quality,

- Examining the evaluations of senior management, internal control department, board of internal auditors and external auditors related to internal audit system and internal control process within the bank,
- Determining the responsible personnel from internal control process within the functional departments of the bank,
- Evaluating the attributes and objectivity of the internal control personnel.

#### Board of Internal Auditors

Responsibilities of the board of internal auditors related to internal control in Bank X are as the following:

- Monitoring the effectiveness of internal control process,
- Making effectiveness evaluation of internal control process and preparing a report to the board of directors.

#### Senior Management

Responsibilities of the senior management related to internal control in Bank X are as the following:

- Executing the internal control process and controlling its effectiveness,
- Ensuring development of methodologies, tools and applications in order to identify, measure, monitor and control risks,
- Arranging authorities and responsibilities clearly and monitoring their implementation,
- Ensuring that corrective action has been taken according to the control results.

### Personnel Executing Internal Control in Functional Divisions

In order to establish an effective internal control environment every personnel should fulfill their responsibilities and inform management about activities which are contrary to bank's policies and procedures and legal laws and regulations.

### Personnel Chosen from Functional Divisions

Responsibilities of the personnel who are chosen from the functional divisions in order to monitor the internal control process are as the following:

- Monitoring work processes within the division,
- Reporting evaluations about the effectiveness and quality of the internal control process to the board of internal auditors and internal control department,
- Conducting follow up and enhancing the quality and effectiveness of internal control.

### **6.4.3 Working Principles of Internal Control Department in Bank X**

Board of directors of Bank X establishes the working principles of the Internal Control Department. These principles can be stated as the following:

#### Determination of Internal Control Points

Internal Control Department determines internal control points by coordinating with the board of internal auditors.

#### Execution of Internal Control

In Bank X, internal control function is executed by chosen personnel and on site and distant examinations of internal control department staff. If there exists an on site examination as a result of distant examinations, internal control personnel conduct on site examinations in the related branches or departments.

## Reporting Control Results

Internal control personnel prepare reports regarding their findings at the end of control activities. Reports are prepared in both on site and distant examinations and findings should be shared with related branch or department. Internal control personnel prepare reports and send those reports to internal control department. Internal Control Department checks those reports and sends them to the Audit Committee and senior management. Beside findings, reports include recommendations of internal control personnel. Senior management and the board of directors take action related to the findings.

### **6.4.4 Control Techniques Used in Bank X**

Internal Control Department of Bank X uses basically two control techniques. These are on site controls and distant controls.

#### On Site Controls

Main objective of the on site control is to examine original documents. Internal control personnel examines whether the documents are conformable to internal policies and procedures of the bank. Documents which can not be reached by distant controlling fall in the scope of on site controlling. On site controlling takes place in branches or departments of the bank. On site controlling consists of the following controls:

- Control of physical assets, documents and records,
- Control of assets which are hidden on behalf of the customers,
- Control of hiding methods.

#### Distant Controls

In distant controls, internal control personnel accesses to transactions of a department or branch. Samples are chosen according to the scope and attribute of the controlling

activity. Findings are sent to the interested department or branch personnel and replies are requested. Depending on the replies internal control personnel prepares a report related to the findings. Distant controls include the following topics:

- Controls of records and accounts,
- Controls related to authorization and approvals,
- Controls related to segregation of duties and avoidance of money laundering.

#### **6.4.5 Basic Control Areas in Bank X**

Basic control areas that are used in Bank X are as the following:

##### Control of the Authorization and Approval System

- Control of activities and applications that contain risk,
- Control of limits related to activities and risks,
- Control of authority limits related to persons, committees and departments,
- Controls related to approval of separate liabilities, transactions and payments.

##### Controls Related to Account and Record Control Process

- Controls related to true and immediate recording of approved transactions,
- Controls related to fictitious transactions and errors that appear during recording process,
- Controls related to correct recording of income and expense accounts,
- Controls related to reconciliations of transactions and records.

##### Controls Related to Material and Physical Elements

- Control of documents, records and own assets of the bank,
- Control of assets which are hidden on behalf of the customers,

- Control of hiding methods.

#### Controls Related to Segregation of Duties

- Starting of operations
- Authorization and approval
- Making payments
- Recording
- Confirmation
- Hiding
- Monitoring
- Development of information technology systems
- Daily operations related to information systems
- Control of personnel that does not go on a vacation

#### Controls Related to Avoidance of Money Laundering

Controls that are conducted according to the laws and regulations about money laundering.

### **6.5 Internal Audit Process and Structure of the Board of Internal Auditors**

Internal audit is a systematic process independent from the daily activities of the bank, in the form of audit of the financial activities and compliance audits as per the bank's structure, within the scope of internal control function in an independent manner, realized by the internal auditors. It covers all activities and units of the bank, particularly the course of the internal control system and risk management system, and ensuring evaluation where findings are obtained as a result of reporting, monitoring and examination.

Board of internal auditors of Bank X is made up of one CAE, one deputy CAE, one unit auditor, senior internal auditors, internal auditors, senior assistant internal

auditors, assistant internal auditors, other audit staff and sufficient administrative staff. The number of staff employed in the board of internal auditors of Bank X is 81.

Specific units might be established in the board of internal auditors organization to execute special engagements that need expertise. Experts within the bank or from other institutions might be hired to work for board of internal auditors. Instructions for the working principles and procedures of those units are prepared by the unit auditor and approved by CAE with the opinion of the Audit Committee.

#### **6.6 Position of the Board of Internal Auditors in Bank X**

To execute the internal audit function in an objective, unprejudiced manner and to be away from intervention of senior management, board of internal auditors in Bank X is subordinated to the board and executes the audit engagements in the name of the board. Since the board delegates the responsibilities on this issue to the Audit Committee, board of internal auditors carries out its function under the supervision of the Audit Committee. Board of internal auditors is the sole authority to carry out the audit function in Bank X.

The Audit Committee's activities are carried out under the board of directors, for the purpose of performance of the undertaken duties and responsibilities in an unbiased and imbalanced manner as independent from all kinds of interferences. The board of directors has adopted the arrangements for the purpose of ensuring that audit function is in a respected status within the bank in terms of paying strict consideration on the requests and suggestions of the internal auditors.

Preparation of the policies, principles and procedures to be formed for guidance within the scope of internal audit function of the Audit Committee should be realized within the framework of the knowledge and approval of the member of the board of directors authorized as in charge of maintenance of the internal audit function.



## **6.7 Administrative Structure of the Board of Internal Auditors in Bank X**

In Bank X, the authority and responsibility areas of the board of internal auditors are included within the internal audit system, its administrative structure; number of employees and provision of personnel are specified by the board of directors.

The powers to regulate and execute the receipts regarding recruitment, training and intra-board promotion of the members of the board of internal auditors are awarded to the CAE of the board of internal auditors by the board of directors. The CAE has the authority to put in effect the decisions he may reach for execution of such activities without necessity to obtain the approval of the board of directors. Appointment of the members of the board of internal auditors in other departments of the bank should be realized upon the suggestion of the CAE having obtained the approval of the board of directors and the opinion of the human resources department. In decisions to be taken in relation with appointment to a position and promotions, it is essential that the banking experience and skills of the board of internal auditors' members are taken into consideration, and the office subject to appointment is consistent with the development of the board members.

The process of workforce planning for the purpose of determination of the employee needs and recruitment resulting there from within the scope of the activities of the board should be carried out with the approval of the board of directors being organized by the board of internal auditors' directorate. The board of internal auditors' staff consists of personnel at a number suitable the needs of the board employed upon the approval of the board of directors through examinations held by the board of internal auditors every year.

It is under the authority of the board of directors to set the fundamentals for the payment orders such as salary, travel allowance and subsidy, and realization of expenditures such as travel, representation expenses etc. of the members of the board of internal auditors.

In the event that the board members commit a disciplinary crime as a result of their actions violating the bank legislation, general banking principles, customs and

instructions, then the proceedings of handling the breaching actions and deciding upon the penalty corresponding to such actions under the instruction on disciplinary penalties of the bank should fall within the province of the board of directors.

Directorate of the board of internal auditors in Bank X consists of:

- CAE of board of internal auditors,
- Deputy CAE of the board of internal auditors,
- Unit head of branch audits and special investigations,
- Senior internal auditors, internal auditors, senior assistant internal auditors, assistant internal auditors and service personnel of various titles.

Also there is a board of internal auditors directorate service to carry out the daily works of the board of internal auditors directorate. Personnel at a required number and title are employed in that service.

### **6.8 Principles Related to Internal Audit Operations in Bank X**

The team chief, who is the most senior internal auditor of a team consisting of two or more internal auditors, is commissioned to ensure timely concluding in the best manner of the work. The team chief arranges the works of the internal auditors in a way to ensure their highest efficiency. The team chief determines the best method of audit, monitors progress of the works, and takes measures to ensure acquisition of positive results as a result of meetings to be held while starting work with the members in his team, and during the works. He arranges the works of the assistant internal auditors and ensures their best training. The members employed in the team are obliged to assist the team chief, follow and apply his suggestions and advice to ensure that the task is held completely in the shortest time. The team chief is responsible for complete fulfillment of the duties awarded to the team and ensuring the harmony and order the teamwork may require.

The investigation reports issued as a result of the investigations held by the internal auditors indicate the subjects, reasons, people concerned and degree of fault of the

concerned people of the incidents. Examination reports provide their opinions and suggestions on the deficiencies in application of the banking legislation and rules, and ways to correct them, and rules and methods to be reimposed, issues that are considered as not necessary to be bound to audit reports, financial and economic conditions of the markets, their opinions on various subjects examined by the board of internal auditors directorate, and the results of occupational studies of the internal auditors. Attention should be paid that the reports are short and to the point, repetitions are avoided, the essence is expressly provided with an open and simple writing style. The period necessary for reply by the branch or division to the audit reports should be set by the internal auditor.

Internal auditors should complete the works awarded to them within the periods set in the program. The audit periods may be revised within the year as per the progress of the program. Works which are found out that can not be completed in time should be notified to the directorate in time, and the period of the program can be extended when necessary. The internal auditors should be notified to the board of internal auditors directorate on the same date of commencement and end of their office for audit, examination and investigation in the departments.

It is essential that the departments in the audit program are audited in the programmed order. It is possible to change the order provided the approval beforehand of the board directorate is received. Not only short-term programs may be arranged, but also commissioning at places not included in the program of the internal auditor can be made and his program may be changed where deemed necessary by the directorate.

The board of internal auditors should pursue its internal audit activities in accordance with the internal audit standards included in the legislation in effect on internal audit. Where such standards are not set by the legislation, the IIA's Standards for the Professional Practice of Internal Auditing should be taken into consideration.

## **6.9 Duties and Responsibilities of the Board of Internal Auditors in Bank X**

The objectives of the audit function within the scope of internal audit system for Bank X and its partnerships within the country and abroad controlled by the bank within the scope of consolidation are as the following:

- To check execution of the transactions and liabilities as based on general or special powers,
- Ensuring defining of risks and taking of necessary measures to minimize risks arising from infraction of rules and errors,
- In relation with the bank activities, to ensure that the board of directors secure the assets of the bank and control the liabilities,
- To ensure that the board of directors is capable of orderly and timely monitoring of bank's capital adequacy, liquidity, quality of assets, profitability performance suitable for its budget and compliance with the legislation provisions related to banking,
- To ensure that risk management system is operated effectively for the board of directors in terms of defining of the risk of incurring loss, regular reviewing and digitalizing if possible.

The board of internal auditors is authorized to audit all activities and departments such as head office departments, branches of the bank, particularly the operation of the internal control system and risk management system and all activities and departments within the scope of consolidation of the partnerships controlled by the bank.

At the time of such audits, the board members should have the authority to examine at place all material issues of the bank and its partnerships, accounts and records, documents, personnel and all other factors that may affect the security of the bank in addition to the powers to pursue activities of examination and audit from the center in view of the characteristics of all departments and activities, to conduct

investigations where necessary, to hear, require defense, to seize documents and information and to dismiss from office personnel in charge where deemed necessary.

The board of internal auditors directorate and board members are authorized by the board of directors to realize the works specified above. The board of internal auditors' members should perform such works upon the instructions from the board of internal auditors directorate or ex officio in obligatory cases.

All activities and units of the partnerships of the bank with majority shares, audited upon the decision of the bank and the board of directors are pursued within the framework of the principles and procedures of Bank X. After the audit activities, reports containing the facts and examination or audit results are issued by the board of internal auditors' members, and are conferred upon the bank's board of directors or top executives in the order of significance and priority.

Also among the powers of the board of directors is establishing of intra-bank communication mechanisms in a way considering the requests and suggestions of the board of internal auditors and the internal auditors and informing them on the practices toward solution by the concerned executives.

Faults and deficiencies regarding internal control found out by the internal auditors and all risks not controlled efficiently should be reported in time to the Audit Committee and suitable management departments and urgent dealing of such departments should be ensured. The concerned bank personnel should be notified about such findings.

It is obligatory that necessary corrections are realized within a predetermined reasonable period of time by the Internal Control Department, Top Risk Committee and the Top Executives as agreed upon with the Board of Internal Auditors.

In the event that the responsible department fails to implement or fulfill the requests and suggestions of the board of internal auditors, then the CAE should ensure that such hitch is notified to the board of directors immediately along with additional measures required.

The fundamental fields of control involve activity fields focusing on ordinary controls and examinations held at regular intervals and special examinations upon request or immediate and quick examinations without a period basis and other fundamental fields of control that are provided for inclusion in the audit system are as follows:

- Preparation of the reports and other information requested by the BRSA for the purpose of supervision,
- Ensuring allocation of provisions at an adequate level,
- Urgent and unexpected condition planning.

Board of internal auditors is responsible for:

- Auditing all units and processes of the bank, independently from daily activities, periodically and in a risk based manner,
- Assessment of the adequacy and effectiveness of the risk management and internal control systems,
- Auditing the information systems of the bank, including electronic information systems and electronic banking services, due to the principles determined by the regulatory authority,
- Review of accuracy and reliability of accounting and recording system and financial statements,
- Investigation of such issues as violation of limits, unauthorized trading activities and valuation transactions not settled or discrepancy in accounting records,
- Review and verify the conformity of the bank's activities to the laws, regulations and strategies of the board of directors,
- Testing the practices of internal control procedures established for the operational activities,
- Assessing the present instructions and written procedures for the activities of the bank and making improvement suggestions due to the deficiencies,

- Auditing the accuracy, reliability and compliance to the time limitations of the reports presented to the board, Audit Committee and legal reports,
- Launching special investigations on the fraudulent activities when needed,
- Presenting yearly audit plan and the activity reports to Audit Committee, Board and Regulator Authority.

Board of internal auditors takes necessary measures to execute following items in order to fulfill its duties and responsibilities. These measures can be stated as the following:

- Plan the audit activity and implement the audit programs due to the plan,
- In the aim of preparing the audit plan in a risk based manner, take opinions of senior management,
- Take approval of the Board and Audit Committee for the amendments of the yearly audit plan without any delay,
- Prepare yearly budget of board of internal auditors that consists of personnel hiring and other expenses for the audit activity and present the budget for approval to the Board and Audit Committee,
- Hold the auditor number in an adequate level to continue the audit function without any interruption and plan the necessary training programs for the existent auditors in a determined frequency,
- Provide adequate and uninterrupted administrative support for the audit activity,
- Organize the meetings and schedule of the Disciplinary Committee,
- Provide healthy communication channels for the bank's staff to inform the board of internal auditors about any matter they hesitate to put in practice or any suspicious activity,
- Audit reports to be written according to the determined standards and to be communicated to the Audit Committee and senior management without delay,
- Follow up the actions taken by the appropriate management level about the findings and suggestions in the audit reports,

- Held the board of internal auditors personnel performance in an uppermost level.

#### **6.10 Internal Control Function of the Board of Internal Auditors in Bank X**

Activities within the scope of the internal control function are pursued by the board of directors, top executives and personnel at all levels of the bank as well as the board of internal auditors, internal control department and risk management group. It is among the powers of the board of directors to take necessary measures for performance by such departments of their duties independently from the fundamental activities of the bank and in an objective manner.

Efficiency of internal control process is assessed periodically. Such assessment should be realized in the form of personal assessments on the efficiency of the control mechanisms applied, in relation with their fields of responsibility by the authorized personnel in charge of monitoring the internal control process. Examination of such assessments by the top executives, internal control department and the board of internal auditors should be ensured. It is suggested that assessments of various levels are provided to the executives and authorities of the subject.

The duty of monitoring the efficiency of the internal control process and whether policies and implementations are complied with procedures are finally conducted by the board of internal auditors.

At the time of determination by the board of directors of the working principles and procedures of the internal control department, the board of internal auditors should present its opinions on the scope of the principles and procedures in question.

Internal control process and internal control activities are designed, planned and coordinated together by the internal control department, board of internal auditors, bank risk committee and top executives taking into consideration the characteristics of the operations held by the bank.



## **6.11 Fundamental Characteristics of the Internal Audit Activity in Bank X**

Fundamental characteristics of internal audit activity in Bank X can be stated as the following:

### **Independency**

Board of internal auditors is subordinated to the Board and Audit Committee in the aim of carrying out the audit activity independently from the activities held by business units and senior management of Bank X.

Board of internal auditors has an independent and nonobligatory structure away from the intervention of senior management to determine the objective and the scope of the audit engagements, carry out the audit activity and communicate the audit results. The Board of Directors assures the guarantee of this structure.

### **Scope**

The scope of the internal audit activity covers the process of preparing the audit plan, bringing the plan into force, executing the plan via audit programs, communicating the audit results to board of internal auditors, appropriate level of management, Audit Committee and to the Board via Audit Committee and following up whether necessary actions are being taken by the involved units and management. All transactions, activities and units within the bank and within its partnerships under its control are in the scope of the internal audit activity.

### **Continuity**

Internal audit is an activity, performed according to an audit plan reviewed by the Audit Committee and approved by the Board, which might be revised under necessary conditions. Audit activity should not be interrupted for any reason.

## **Objectivity**

Internal auditors should be objective and unprejudiced and avoid any conflict of interest while performing their work. To establish such an environment salaries, appropriations and employee personnel rights of the internal auditors are determined by the Board.

## **Proficiency**

Internal auditors should possess the knowledge, skills and other competencies needed to perform their individual responsibilities while performing audit engagements.

While planning the audit activity, assignments are designated according to the knowledge, skills, competencies and previous performances of internal auditors. In case of a lack of adequate skilled, competent staff resource while planning the audit activity, board of internal auditors takes necessary precautions to remove this deficiency. These precautions might include special trainings for internal auditors, advice taken from experts outside the bank and other appropriate support.

## **Due Professional Care**

Internal auditors should apply the care and skill expected of a reasonably prudent and competent internal auditor. Due to this principle, internal auditors should perform sufficient examinations to most of the possibilities during audit engagements.

## **Code of Ethics**

Board of internal auditors' staff should adopt the fundamental characteristics of internal audit activity stated in the charter. Board of internal auditors' staff should also accept and respect the code of ethics published by the IIA.

## **6.12 Purpose of the Internal Audit Activity in Bank X**

Purpose of the internal audit activity in Bank X is to provide reasonable assurance to Audit Committee, the Board and the senior management that banking activities are in compliance with the local legislation, related regulations and bank's policies, strategies and internal control and risk management systems are efficient and adequate.

In accordance with this purpose, all branches, units, material information, accounts and records and the personnel of the bank and of its partnerships under its control are in the scope of the audit activity without any restriction.

### **6.12.1 Audit Plan and Risk Based Audit**

Audit plan in Bank X is prepared annually appropriate to the purpose and the scope of the audit activity. Audit plan should be arranged for an efficient, effective and economical audit activity and should be risk based to strengthen the performance of the audit activity. Audit plan covers all units and subjects to be reviewed and also resources needed to perform these engagements.

Ensuring the high-risk areas is prioritized in the audit plan of Bank X. The annual audit plan is based on the previous experience and the rating of the last audit of either the branches or head office departments.

Audit plan in Bank X is prepared in December every year and the plan leans on the risk assessment results. Audit plan is prepared by a team led by the deputy CAE, unit head of branch audits and special investigations and senior internal auditors and approved by the CAE before the Audit Committee and the Board. During the planning phase the requests and the opinions of the senior management should be considered.

Audit plan is communicated to Audit Committee by CAE. After necessary amendments according to the opinions of the committee, revised plan is presented to the Board for approval.

Approved audit plan can be revised by the board of internal auditors' management if necessary during the year. For any amendments approval of the Board is obligatory.

In Bank X, internal audit activity is trying to be exercised in a risk based manner. For this purpose:

- Risks the bank exposed to are concerned priority while preparing the audit plan.
- Audit activity should be carried out appropriate to the plan prepared according to the risk assessments.
- For the significant risk areas determined after the approval of audit plan, plan can be revised or significant engagements can be performed out of the plan. During planning phase resources for such cases should be considered.

#### **6.12.2 Carrying Out the Audit Plan**

Engagements mentioned in the audit plan of Bank X are assigned to appropriate board of internal auditors' staff. Another important matter to be considered while assigning the engagement is to consider whether the auditor has a conflict of interest due to the ~~area~~ or the unit to be audited. For this reason deputy CAE claims from the auditors in charge to make an assessment about team members and himself concerning this subject.

Auditor in charge considers, whether team members performed a consulting engagement before in the audit entity or acted an active role in establishing the internal control mechanism in the process of the audit entity or have any relatives or close relations with the personnel of the audit entity. The responsibility of these assessments are on the auditors in charge and finally on deputy CAE.

### **6.12.3 Engagement Types**

Engagement types performed by the board of internal auditors' staff of Bank X are defined below:

- **Compliance Audit:** Review the compliance of the activities of the bank to related legislation, regulations and Bank's internal procedures, instructions and policies.
- **Operational Audit:** Review the efficiency, effectiveness of the planning, and implementation and control processes of the activities within the audit entity.
- **Information Technologies Audit:** Review of the continuity and reliability of the electronic information systems and accuracy of the information produced through these systems and examine the defined authorizations.
- **Process Audits:** Reviewing the whole process of the audited activity, determining the managerial and control deficiencies regarding the process, examining the compliance with the ongoing quality procedures, analyzing the work flows and adequacy of resources used for the process.

One or more of engagement types mentioned above can be performed during the audit engagement. In addition, one activity can be examined as covering more than one process. The decisions are stated in the annual audit plan.

## **6.13 Performing Internal Audit Engagements in Bank X**

### **6.13.1 Initiating the Engagement**

In Bank X, engagement tasks are assigned to related board of internal auditors' staff by deputy CAE or unit head. Assignment communications cover the scope, engagement type, team organization and time anticipated for the engagement. Tasks should be assigned to the related in charge staff a week before the engagement date, but this time may differ due to the nature of the work. Staff assigned to the task contacts with the team leader and get information about engagement and necessary preparations.

Auditor in charge evaluates the team formation and decides whether there exist any negative circumstances that affect the efficiency of the engagement work such as conflict of interest or lack of adequate knowledge, training or skills among team members. Auditor in charge presents this information to unit head or deputy CAE and asks for appropriate solution or a change in the team formation.

Initiation of the engagement work may differ due to the engagement task or type. Engagements performed in branches start with the count of the cash in vault and other commercial papers recorded in the accounts. For this reason branch management is not informed about the engagement.

For other engagements performed in head office units or in partnerships, auditor in charge determines the legislation, regulations, bank's internal procedures and other sources related to the activity. Before the engagement date, auditor in charge makes all team members review the related documents, understand the activities and nature of the process-unit and overcome any kind of deficiencies on knowledge or other issues.

Auditor in charge schedules an opening meeting with the entity managers. Objective, scope, duration, techniques are used during engagement, reporting procedure and expectations from the entity management and personnel is discussed with the management in the meeting. Attendees from board of internal auditors' management to the meeting are determined according to the management level of the audit entity or process. Entity managers also express their expectations from the engagement, and auditor in charge reviews audit program and work plan considering these expectations when necessary.

### **6.13.2 Managing the Audit Engagement**

The auditor in charge manages the audit team. All of the responsibilities of the team and team members are on the auditor in charge. The team members perform their work according to the audit program and work plan is prepared by the auditor in charge.

Audit techniques, used during the engagements and examinations are recorded on the working papers. Working papers are prepared to demonstrate the examination techniques and engagement work performed according to the audit program. Working papers contain the name, surname and signature of the auditor, sampling techniques, sample size used for tests and features of the sample selected.

Related documents, traced lists and other staff used during engagement that would assist the next engagement team are communicated to the board of internal auditors with working papers whether in electronically or hardcopy forms. Electronic forms and documents are kept in predetermined folders in server and hardcopy documents are kept in separate files.

### **6.13.3 Ending the Audit Engagement**

Engagements end after all examinations and related work mentioned in the audit program are completed. Team members communicate reports for audit findings to the auditor in charge. Auditor in charge inserts his findings and prepares a draft final report.

Auditor in charge schedules a closing meeting and findings in the draft report are discussed with the related managers in this meeting and managers' opinions and answers about findings are obtained.

After the closing meeting, auditor in charge prepares the final report including the answers of the management accordingly the reporting standards. Reports may be prepared at the entity location or after the team left the location. Engagement ends when the final reports are communicated to the related parties.

### **6.13.4 Reporting Standards**

Results of the engagements are kept in record via the audit reports. Auditors express their final opinions in the reports. If auditors can not reach a final conclusion at the engagement, this situation is also expressed in the reports with reasons. Reports should be reasonably short and a clear language should be used.

There are 4 kinds of reports used in internal audit system of Bank X. These reports are as follows:

- **Audit Report:** It contains the techniques used during engagements, audit findings, opinions and recommendations with appendices and are communicated to Audit Committee, the Board, senior management and other appropriate managers. Audit report is prepared according to the determined standards. The auditor in charge writes the report in a free format if there exists no standard for that type engagement and reporting. Deputy CAE or the unit head reviews the report when it is in draft form. When approved and communicated, the auditor in charge prepares a new standard for that type of report.
- **Special Report:** It is used for immediate communication before the engagement ends for emergent issues to inform board of internal auditors or senior management such as problematic matters, unrecognized risk areas, etc. Special reports might also be used to communicate such matters after the engagement if the situation is not emergent. Entity management is not asked for answers to issues mentioned in special reports and these reports are not communicated to the entity management.
- **Personnel Evaluation Report:** It is prepared about performances of the personnel of the branch or head office department. There exist standards for this type of reports and reports are prepared according to these standards.
- **Executive Summary:** It is prepared to summarize the findings, opinions and recommendations mentioned in audit reports, which are relatively important at the risk point of view. Executive summaries are at most prepared three pages. Findings are represented in an order as outlines in executive summaries according to the risks they indicate. All executive summaries contain the recommendations of the auditors about the improvements of controls on risks and processes.



It is essential to produce all reports mentioned above after the engagements in Bank X. But some of the reports are not written with directions and approval of board of internal auditors' management after some kind of engagements. At least an audit report must be prepared for all kinds of engagements conducted in Bank X.

Audit reports in Bank X contain at least these following items:

- Objectives and scope of the engagement,
- Audit findings, relative importance of findings and details,
- Recommendations if any and expected benefits of recommendations,
- Other information for parties that the report would be communicated.

Team members review final draft report, and misspellings and other deficiencies are corrected. The report first communicated to the deputy CAE, unit head or the related senior internal auditor or internal auditor to be reviewed.

Reviewed reports are communicated to CAE and deputy CAE with the opinions of the last reviewer. The internal auditor who prepared the report is informed about the approved reports.

Reports approved for communication to related parties are printed as one copy and signed by the auditor and send to the entity manager for answers in not later than 2-5 days depending on the size of the entity or the activity audited. But if all answers and opinions of the management obtained in the closing meeting then there exist no need for this duration. Reports other than the audit report are not communicated to the entity managers and answers are not obtained for the issues in these reports. But if the engagement subject is a process or a product of which the related manager is one of the senior managers, then all reports are communicated to the management.

The auditor in charge has the right for the last comment for the answers and opinions of the entity management. These comments are represented in the report just below

the answers of the related managers and managers do not answer to the comments of the auditor.

Last page of the report and all other pages, which contain answers and opinions of the management, are signed by the representative entity managers. Reports are transmitted to board of internal auditors and are communicated to the Audit Committee and related parties by the board of internal auditors. Signed copies of the reports are kept in files in board of internal auditors of Bank X.

Audit entity manager prepares an action plan about the deficiencies and findings mentioned in the report within 15 days after the communication date of the report to Audit Committee and the Board. Action plan is sent to CAE.

Board of internal auditors follows the actions mentioned by the management by the auditor in charge or another appropriate board of internal auditors' staff. These communications of the management are kept in board of internal auditors of Bank X to use in audit plan or next engagement.

#### **6.13.5 Activity Report**

CAE of Bank X presents a report about board of internal auditors' activities to Audit Committee at least in 3 months periods. The following items are mentioned in this activity report:

- Completed and continuing engagement and compliance of the ongoing work with the annual audit plan,
- Trainings taken by the board of internal auditors staff during the period,
- Important accounting deficiencies, findings on engagements and hesitations about the reports communicated to the Regulatory Authority by the bank,
- Information about the engagements on information systems,
- Summaries of deficiencies on internal controls,
- Work done during the period about risk assessment,

- Opinions on weaknesses that communicated to the senior management during the period,
- Other related subjects that are asked by Audit Committee or board of internal auditors management want to communicate.

Besides activity reports prepared in 3 months periods, annual consolidated activity report is communicated to Audit Committee in month January of the following year. Report reviewed by and discussed with Audit Committee is presented to the Board. Annual activity report is communicated to the regulator authority within 10 days after the presentation to the board.

#### **6.14 Internal Audit Charter of Bank X**

Internal audit charter of Bank X describes the mission, independence and objectivity, scope and responsibilities, authority, accountability and standards of the internal audit function and has been issued according to Regulation About The Internal Systems of the Banks published in the Official Gazette on November, 1 2006.

##### **6.14.1 Mission**

The mission of internal audit in Bank X is to provide reasonable assurance to Audit Committee, the Board and the senior management that the banking activities are in compliance with the local legislation, related regulations and bank's policies, procedures, strategies, targets and principles. Through a systematic and disciplined approach, internal audit helps the bank accomplish its objectives by assessing and improving the adequacy and effectiveness of risk management and internal control systems.

##### **6.14.2 Independence and Objectivity**

To ensure independence, internal audit in Bank X is directly linked to the Board and Audit Committee. To maintain objectivity, internal audit is not involved in day-to-day control activities.

### **6.14.3 Scope and Responsibilities**

In Bank X, the scope of internal audit work includes the review of risk management procedures, internal control systems, information systems and governance processes. This work also involves periodic testing of transactions, best practice reviews, special investigations and appraisals of regulatory requirements.

To fulfill its responsibilities, it is expected from internal audit in Bank X to:

- Identify and assess potential risks to the bank's operations.
- Review the adequacy of controls established to ensure compliance with policies, plans, procedures and business objectives.
- Assess the reliability and security of financial and management information and the systems and operations that produce this information.
- Assess the means of safeguarding assets.
- Review established procedures and systems and propose improvements.
- Appraise the use of resources with regard to economy, efficiency and effectiveness.
- Contribute to the development of projects, selected according to the risk involved, by confirming that the bank's project methodology is followed and that, in particular, adequate controls are incorporated.
- Follow up recommendations to make sure that effective remedial action is taken.
- Carry out ad hoc appraisals, investigations or reviews requested by Audit Committee or senior management.

### **6.14.4 Authority**

Internal audit aims to perform engagements and promote effective controls at reasonable cost. To achieve this, internal audit in Bank X is authorized, in the course of its activities, to:

- Enter all areas of the bank and its partnerships under its control and have access to any documents and records considered necessary for the performance of its functions.
- Require all members of staff and management of the bank to supply such information and explanations as may be needed within a reasonable period of time.
- Require heads of departments to inform internal audit without delay of any significant incident concerning security or compliance with regulations and procedures.

#### **6.14.5 Accountability**

Internal audit in Bank X prepares an annual risk assessment report and an audit plan. In risk assessment work, contributions of Risk Management and Internal Control Units are preferred. The plan is based on this risk model that identifies business risks and on input from line managers. It provides information about the risk assessment, the current order of priority of audit projects and how they are to be carried out.

The plan is presented to the Audit Committee and the Board of Directors for approval. Risk assessments and the audit plan are communicated to the BRSA within 10 days after the approval. In case of need, adjustments could be made to the plan during the year. They would also be communicated to the Audit Committee and approved by the Board.

Internal audit in Bank X is responsible for planning, conducting, reporting and following up on audit engagements included in the audit plan and decides on the scope and timing of engagements. The details of these processes are defined in audit manuals prepared by related board of internal auditors staff. Audit fieldwork should be conducted in a professional and timely manner. Reporting of results includes an open process to agree on the facts and the validity of audit recommendations. A detailed audit report and a letter to management summarize the objectives and scope of the audit as well as the observations, findings and recommendations. All reports, audit programs and work papers signed by auditors are kept in files in the board of

internal auditors. In all cases, follow-up work is undertaken to ensure adequate response to audit recommendations.

#### **6.14.6 Standards**

Internal audit adheres to the regulations of BRSA and standards of best professional practice, such as those published by the IIA and the Information Systems Audit and Control Association, and the relevant reports and recommendations of the Basel Committee on Banking Supervision.

#### **6.15 Audit Committee of Bank X**

The Audit Committee in Bank X was established in year 2006. It consists of two non-executive members of the board of directors of the bank.

##### **6.15.1 Purpose**

The Audit Committee is appointed by the board of directors of Bank X in order to:

- Assess the integrity of the financial statements of the bank,
- Review and confirm the appropriateness of the external auditor's qualifications and independence,
- Assess and review the performance of the bank's system of internal controls, audit process and external auditors,
- Confirm the compliance by the bank with legal and regulatory requirements.

The Audit Committee has oversight responsibility for the bank's internal systems which consist of the board of internal auditors, the internal control unit, the risk management unit and the legal compliance unit.

### **6.15.2 Authority**

In Bank X, the Audit Committee is empowered to:

- Oversee the efficiency and adequacy of the operations of the internal systems, the accounting process and the reporting systems of the bank within the framework of the law and the relevant regulations.
- Monitor the integrity of the produced information.
- Assess independently support service organizations or agencies that are contracted by the board to provide goods or services to the bank and monitor the service received.
- Pre-approve the system of internal controls' activities.
- Coordinate and ensure the quality of the internal audit activities for the partnerships and branches that are subject to consolidation.
- Act as a communication point between the board of directors, CAE and external auditors.
- Seek any relevant information and documents from all the units of the bank through established communication channels.
- Retain outside counsel, accountants, experts and other advisors if it is appropriate to assist the committee in the performance of its functions.
- Conduct and authorize investigations into any matters within its scope and responsibilities.

### **6.15.3 Organization**

The Audit Committee in Bank X is composed of two non-executive and independent members of board of directors one of which has financial expertise. The members of the Audit Committee are elected by the board of directors and may be replaced by the Board.

In the event that the number of members of the committee falls below two then appointment of adequate number of members of the board of directors with the same qualifications is obligatory within fifteen days.

#### **6.15.4 Meetings**

Except for mandatory situations, the Audit Committee of Bank X meets regularly on the first Wednesday of each month.

Committee minutes are recorded in the Audit Committee minutes register. Every resolution is undersigned by members by no later than one month after the date of the resolution. Members sign the resolutions they don't concur with, stating their reasons or dissent.

The Audit Committee meets periodically with management, the internal auditors and the external auditor in separate executive sessions. Meeting agendas are prepared and submitted before the meetings in order to be reviewed by the committee members.

#### **6.15.5 Responsibilities**

The Audit Committee of Bank X is authorized to perform the following tasks in the areas stated below:

##### **Financial Reporting**

- To confirm that financial statements are free from any detected errors and improprieties as well as ensure compliance with the law.
- To review the financial statement certification of the members in charge of preparing and signing of the financial reports as well as to ensure those are drafted in the format specified by BRSA. The Audit Committee also confirms that financial statements and accounting books conform with the provisions of "Regulation on Procedures and Principles with regard to Accounting Practices of Banks and Retention of Documents" as appropriate.



- Review the controls that management has established to protect the integrity of financial reporting.

### **Audit Process (Activity)**

- To monitor whether the board of internal auditors fulfilled its responsibilities set out in internal policies and regulation.
- To supervise whether the internal audit system covers the current and planned activities of the bank and risks arising from such activities, to review relevant internal policies of the bank regarding internal audit due to be approved of the board of directors.
- To monitor whether internal auditors fulfill their duties independently and impartially.
- To review and approve the annual risk-driven audit plan submitted by the CAE on the basis of a risk assessment performed by the internal audit system.
- To submit to the board of directors the internal audit report to be prepared by the board of internal auditors at least on quarterly basis.
- To request special audits in line when this need arises.

### **System of Internal Controls**

- To monitor compliance with internal control procedures and policies as approved by the Board and to make suggestions to the board of directors on any necessary actions.
- To review regular reports from the internal system according to the requirements of the regulation and external auditors. The Audit Committee is responsible to inform the Board on the issues which might affect the effectiveness, efficiency, completeness and reliability of the operations of the bank or any violations of the regulations and the internal codes.
- To establish the communication channels and ensure direct access of all personnel of internal systems on the communication of relevant information to the system of internal control and the Audit Committee.

- To make recommendations to the board of directors for the selection of the resources in the Board of Internal Auditors, Internal Control Unit, Risk Management Unit and Legal Compliance Unit reporting to the Audit Committee and provide opinion at the time of their dismissal by the board of directors.
- To independently assess the opinions and recommendations of the senior management with regard to internal systems according to decisions taken by the Board and requirements of the regulator.
- To establish procedures in order to receive confidential, anonymous submissions by employees or complaints from third parties regarding accounting, auditing or internal control issues.
- To monitor the effectiveness and timely completion of issues and remediation actions as per the internal audit reports.
- To assess the professional skills and competencies of the resources working in the units of internal systems.
- To assess the appropriateness of the methods, tools and application principles established in order to determine, measure, monitor and control the risks of the bank.
- To inform regularly the board of directors on opinions and assessments performed by the system of internal controls of the bank. (Executive management, internal control and internal audit personnel and the external auditors)

#### **External Support Services Including External Auditors**

- To review the appropriateness of the scope of external audit prior to the audit.
- To hold meetings regularly with the external auditors within the timetable of the audit and determine an appropriate agenda.
- To hold meetings with external auditors in order to confirm financial reports accurately reflect the bank's financial position and the results of performed operations.

- To review the assessments of the external auditors within the context of compliance with the bank's accounting policies as well as with the law and other relevant legislation.
- To assess the results of external audit on annual and quarterly financial statements to ensure effective and timely resolution of issues identified by the external auditors.
- To receive a written report at least once a year from the partner chief auditor of the external auditors on issues and conclude on any required measures that need to be taken on the basis of all services provided to the bank by the external auditors.
- To advise regularly the board of directors on findings made by external auditors and coordinate communication between the external auditors, the members of the board of directors and appropriate staff.

#### **Other Responsibilities**

- To review annually the Committee charter for adequacy and recommend any necessary changes to the Board.
- To report to the board of directors a description of the activities performed within a maximum of six month period and conclude on results of such operations.
- To include in the report any measures required to be taken by the bank; significant for in order for the bank to continue with its operations.
- To establish appropriate communication channels to ensure that a copy of the professional liability insurance policy issued against any losses that may arise out of services provided by support service firms, is communicated to the board of directors.
- To submit to BRSA and Republic of Turkey Central Bank, the external audit reports issued and presented to the Board of Directors by the Committee.

## **6.16 Results, Conclusions and Recommendations**

In Bank X, internal audit system is established with the aim of maintaining stability and trust in the financial sector, increasing transparency and ensuring a banking system in which there is efficiency, effectiveness and competition.

Internal audit system in Bank X consists of the board of internal auditors and internal control department and it is responsible from the establishment of such an environment within the bank by applying certain standards and procedures and conducting audits and examinations about the processes.

Findings, conclusions and recommendations about the internal audit applications regarding the case study that have been conducted in Bank X are discussed in the following paragraphs.

In Bank X, board chairman and the CEO are different persons. This situation helps to enhance the checks and balances function of the boards of directors, independency of the board is established and there exists a stronger control environment within the bank.

In Bank X, there is the board of internal auditors and internal control department which are directly linked to the Audit Committee of the board of directors. As a result of this situation, independence of the internal audit function is ensured in Bank X.

There is an Audit Committee in Bank X. It was established in year 2006 and consists of two non-executive members of the board of directors of the bank. Also, one of the members of the Audit Committee has financial expertise. The Audit Committee has oversight responsibility for the bank's internal systems which consist of the board of internal auditors, the internal control unit, the risk management unit and the legal compliance unit. Existence of the Audit Committee within the bank is an important indicator about the independence of the internal audit function within the bank.

Bank X has a corporate governance committee which was established to ensure compliance with, improve and advise the board of directors on the corporate governance principles. But, on the other hand, Bank X does not have risk management, remuneration, nominations and compliance committees.

Bank X established Shareholder Relations Department in order to protect the rights of its shareholders and ensure effective communication between the boards of directors and shareholders. Shareholder Relations Department is accountable to the corporate governance committee.

Stakeholders are informed of all issues concerning them during General Meetings and via the statements of material events that the bank furnishes to Capital Market Board (CMB) and Istanbul Stock Exchange (ISE), its corporate website and the media.

Bank X is registered with the SEC, so it is subject to Sarbanes Oxley Act. The Sarbanes Oxley Act aims to strengthen auditor independence and the company's Audit Committee. The bank must have an Audit Committee comprised only of independent members, and must also disclose whether it has at least one Audit Committee financial expert on its Audit Committee. Bank X has already established an Audit Committee with non-executive members of the board of directors and one of the members of the committee is already a financial expert.

In Bank X, analytical written policies and procedures are limited to the head office. They do not cover sufficiently the monitoring procedures of the partnerships, which results deviations from corporate governance best practices. On the other hand, partnerships may be able to operate based on their own policies and procedures, which in certain cases may be in conflict with those of Bank X. This is a practice that does not ensure sufficient control.

According to international best practices, the main objective of the boards of internal auditors must be defined in cooperation with management and Audit Committee in order to give a full picture of the organization needs, incorporate value added practices and priorities during the risk assessment stage. Finally, it must be approved

by the Board of Directors or the Audit Committee of the board of directors in order to be in accordance with the main organizational objectives. In Bank X, there are written scope and objectives within the charter of the board of internal auditors and the charter has approved by the Audit Committee of the board of directors of the bank.

In Bank X, there exists a risk management department and risk management function is directly linked to the Audit Committee of the board of directors. But in Bank X, there is lack of cooperation between the internal auditing and risk management functions despite the procedures in Bank X advice cooperation between those departments. Internal auditing can not take advantage of the work of risk management department and also the risk management department does not benefit from the work of the board of internal auditors. It is suggested that strong cooperation should be developed and standardized among these two related functions mainly for the part of identification, assessment and management of operational risk issues, an area that the board of internal auditors usually possesses an important experience.

It is thought that the management of Bank X believes that internal auditors possess sufficient skills and competencies in order to add value to the activities of the bank. As a result of this situation, members of the board of internal auditors in Bank X take part in important projects such as development of information systems or mergers and acquisitions.

In Bank X, the budget of the board of internal auditors, the internal audit plan, promotion and remuneration of the staff are generated by the Audit Committee of the board of directors. Board of internal auditors is strictly under the supervision of the Audit Committee. This contributes effectively to the independence and objectivity of the board of internal auditors in Bank X.

Reporting lines and the responsibilities of internal auditors and internal controllers in Bank X are thought to be specific and clear. There is no lack of written job descriptions of the board of internal auditors' and internal control unit staff. This situation is important for strengthening the control environment of the bank.

In Bank X, there are formal communication channels between the board of internal auditors and other business departments and partnerships of the bank. This practice enables timely identification of problems by the board of internal auditors that can occur within the bank or its partnerships.

Internal audit staff (both board of internal auditors' and internal control unit's) in Bank X does not sign forms concerning their compliance with the Standards for Professional Practice of Internal Auditing and the relative Code of Ethics. In addition, many of the staff is not members of the IIA so they are not obliged to comply with such standards. It is suggested that members of the board of internal auditors and internal control department must sign a form regarding compliance with the Professional Standards of Internal Auditing and the Code of Ethics.

Board of internal auditors of Bank X has not developed and implemented performance measures for the accomplishment of its tasks. Board of internal auditors in Bank X does not perform surveys which analyze the level of satisfaction of the auditees and does not correlate cost benefit relation. It is suggested that the bank must promote the development and implementation of performance measures and also analyze survey results regarding the level of satisfaction of the auditees by internal audit services in order to have value added internal audit services.

Proficiency, competency and seniority of staff of the board of internal auditors in Bank X can be considered as a weakness for the bank. In Bank X there are only 5 internal auditors out of 81 which have professional certifications such as CIA (Certified Internal Auditor) and CISA (Certified Information Systems Auditor). Also the average seniority of the staff of the board of internal auditors of Bank X is about 2.30 years. All internal auditors should seek certification as a mean to strengthen their position both within and outside the bank and average seniority of the staff should be raised by employing senior internal auditors.

It is thought that the board of internal auditors of Bank X is understaffed. It has 81 internal auditors. The bank has about 410 branches and many head office departments that should be audited by the internal auditors periodically. When the

number of internal auditors are considered, their average seniority and take into consideration that the board of internal auditors in Bank X is not be able to audit all of the branches and departments, it can be concluded that there is a lack of sufficient staff within the board of internal auditors of Bank X.

In Bank X, staff appraisals are not usually linked with employee's progress and take place yearly and not after the completion of each project. This practice does not ensure independence and objectivity. It is suggested that there must be a clear link between efforts and rewards and also incentive schemes for internal auditors, which will allow professional development.

While the annual audit plan is being conducted in Bank X, the board of internal auditors does not focus on various risks such as financial, operational, compliance, etc. Rather, the annual audit plan is based on only the previous experience and the rating of the last audit that have been conducted in the department or the branch. There is no advanced internal audit budget in Bank X, but there exists only a budget containing the total time period that is needed in order to complete an engagement. It is suggested the introduction of procedures that will ensure collection of all useful information regarding risks and use of this information for the development of the annual audit plan of the board of internal auditors. This plan must contain all areas that the corporate audit universe consists of and take into account the objectives setting and the overall strategy of the bank. Also, it is important to develop an internal audit strategic plan in order to cover all areas in a specific minimum timeframe.

The board of internal auditors in Bank X has a charter that contains its responsibilities, audit planning, scope of work, reporting issues and the main services offered to bank. The charter is approved by the Audit Committee of the board of directors of Bank X. Also, the board of internal auditors in Bank X has developed a written set of methodologies that will describe the type of audits, stages, audit tools, working papers and sampling methods in order to adequately evidence and document issues.



Audit reports in Bank X lack a ranking of the audit findings such as significant, major, minor, etc. and there is no link with the potential risks. As a result they contain much information that is not useful for the audit scope and purpose. It is suggested that for each issue there must be a recommendation by the board of internal auditors in order to overcome the problems arising, comply with the organization's policies and procedures and implement best practices. There should also be categorization of findings within the reports. Auditees must actively participate in this process, accept the recommendations and present an implementation plan and timeframe.

Another issue that the board of internal auditors of Bank X needs further improvement is the use of computer assisted audit techniques (CAATs) in order to record and assess potential risks, sampling methods, evidence of audit findings and the generation of reports, and finally electronic files and working papers. This results to ineffective review and use of sampling methods. In Bank X only ACL (Audit Command Language) is used for supplying branch and department data to internal auditors but its use is limited. It is suggested the use of computers in all the aspects of the internal audit work and more specifically in risk assessment, planning and evidence of audit work and finally on the generation of reports.

Consulting services are advisory services which are usually conducted by request of an engagement client. Internal audit activity and the engagement client determine the scope and the nature of the consulting engagement together. In Bank X, board of internal auditors does not engage in consulting activities. As a result of this situation the staff is unable to have a broad knowledge of operations of different departments of the bank and it can be seen as an obstacle to value adding internal auditing.

One of the most important aspects of the Sarbanes Oxley Act is the requirement to certify that quarterly and annual reports are fully compliant with applicable laws and present a fair picture of the financial situation of the company. So, the Audit Committee and the internal auditors of companies have responsibilities about truth of the financial statements. But, in Bank X, the board of internal auditors does not audit the financial statement preparation process within the bank. Board of internal

auditors does not conduct financial audits, instead it mainly focuses on operational and compliance audits.

Functional separations within the boards of internal auditors are important in order to have specialized staff for certain functions and increase efficiency of the internal audit system. Board of internal auditors of Bank X does not have a functional separation yet, but it plans to form departments within the board of internal auditors such as information technology audit, branch audit, head office audit departments, etc. On the other hand, functional separations within the internal control department of Bank X have been established. In internal control department there is branches control facilities management, central controls management and action follow up management sub divisions.

Members of the board of internal auditors should evaluate their control results in an objective manner, should recommend corrective actions and make the follow up of their corrective actions. With the help of the follow up activities they should direct and inform management in order to ensure that remedial action is taken. Board of internal auditors of Bank X has not established a systematic follow up process yet, but it plans to establish a follow up process to form an efficient following and monitoring system by the internal auditors.

In Bank X, board of internal auditors and internal control department conduct similar work. They make similar examinations in the same branches or in head office departments, in case of operational audits they conduct same types of engagements and their some examination topics are the same as those of the board of internal auditors'. The only difference between the work of these two departments is that, internal control department conducts examinations subject based and within frequent periods; on the other hand board of internal auditors conduct their work process based and within more extensive periods. This is a result of the lack of coordination between these departments.

Boards of internal auditors and internal control department should be in coordination with each other, since the board of internal auditors is the primary control and audit organ within the banks it should arrange work of internal control department,

monitor and audit it. This has crucial importance in order to ensure efficiency and effectiveness in using bank resources.

### **6.17 Information About Bank Y**

Bank Y is a real commercial bank which does business in Turkish national banking system. It is a mid-size Turkish bank, predominately serving medium scale companies. The bank's primary activities consist of corporate, commercial and individual banking; the latter is mainly geared toward deposit taking and asset management services.

Bank Y became a listed company in 1995 when it offered 20% of its shares to the public. Now one of Turkey's leading conglomerates hold 95% of the shares of the bank while remaining shares is publicly traded on the ISE.

Bank Y, through a network of 34 branches across the country, is well positioned to cater to Turkey's most important commercial and population regions, where 75% of the country's GNP is generated. It has about 750 employees.

In the field of corporate banking, Bank Y has undertaken the mission of leadership, along with contributing to the development of Small and Medium Size Enterprises (SMEs), which have a great share in Turkish economy, with all banking services known and with its short-term or medium-term finance capabilities.

It has adopted the customer oriented service and quality focused approach as the principles in its relationship with SMEs which have been designated as the bank's strategic target customers. In this context, besides banking services for SMEs, projects are being developed for increasing management quality, supporting them in finance and operational management areas and presenting business specific solutions.

Bank Y has the Board of Directors; Risk Management, Board of Internal Auditors and Internal Control Coordination Department which are directly linked to the Board of Directors and the following departments which are linked to the general manager:

- Marketing
- Fund Management
- International Financial Institutions
- Financial Control
- Operations
- Information Technologies
- Human Resources
- Credit Management
- Legal

In order to ensure the effective working of the bank activities the following committees meet in specific periods.

#### Corporate Governance Committee

In Bank Y the corporate governance committee was established in 2005. The committee is headed by an independent member of the board of directors and monitors compliance to corporate governance principles.

#### Asset and Liability Committee (ALCO)

The committee is assigned by the board of directors with the duties of determining the policies for asset and liability management, mobility of the funds and taking decisions to be executed by relevant units within the framework of the bank's balance-sheet management and monitoring implementation of the activities.

#### Discipline Committee

CAE and deputy general managers are the members of the discipline committee. The head of the committee is the CAE. In discipline committee actions and behaviours of employees which are contrary to policies, procedures, laws and regulations are discussed.

### Credit Committee

Members of the credit committee are head of board of directors, general manager, deputy general managers of credit management and marketing. The members of the committee meet once a week and discuss credit proposals.

### **6.18 Some Figures of Bank Y**

Since 2003, Bank Y's strategy has centered on developing commercial banking, with a particular focus on SMEs. SMEs account for between 70-80% of the active customer portfolio. These customers are able to receive far more than standard banking services; their diverse and often unique needs demand individual attention. Bank Y's guiding business approach is designed to help companies develop by applying flexible and tailor-made solutions, rather than only a set of static products and services.

Bank Y's total asset base increased by 36% in 2006 and reached US \$1.4 billion, while consolidated equity grew 29%. Consolidated net income was US \$26.7 million. Interest income from lending activities rose 77%, reflecting a 49% increase in the overall lending portfolio. The efficiency of the bank's branches was again on display in 2006, with Bank Y's ratio of total branch cash and non-cash lending to total number of branches placing it second among the Turkish bank.

On the liabilities side, customer deposits has increased further from US \$488 million in 2005 to US \$793 million at the end of 2006, corresponding to a 62% increase. Total external funds borrowed reached US \$324 million from US \$227 million in the previous year, increasing their share of total liabilities from 21% in 2005 to 23% in 2006. At the end of 2006 the total trade transaction volume through import and export activities that Bank Y has intermediated reached US \$1.5 billion, corresponding to 0.75% of the country's total trade.

## **6.19 Internal Audit and Internal Control System of Bank Y**

Bank Y's board of internal auditors and internal control coordination department oversee and coordinate all audit and control activities. While each department's duties and responsibilities are separate and unique as laid out in charters approved by the board of directors of the bank, it is expected that they coordinate with each other in order to form a balanced and comprehensive system of internal control within the bank.

Board of internal auditors and internal control coordination department ensure that all of the activities of Bank Y conform to governance and organizational structures approved and established by the bank's Board of Directors, Audit Committee, Senior Management and government laws and regulations. All of the employees of Bank Y are held responsible for upholding management's strategies and policies, adhering to applicable laws and regulations, and performing their work in a manner that is consistent with the bank's operating principles.

Internal audit system of Bank Y works connected to the Audit Committee and it is independent from all of the functional departments of the bank. Audit Committee of the bank consists of two non-executive members of the board of directors and is responsible from the activities of both internal audit and internal control coordination departments against the board of directors of the bank.

Board of internal auditors and internal control coordination department issue periodical reports and hold quarterly meetings with the Audit Committee in Bank Y to review the departments' and branches' activities and discuss the main issues about the operations of the bank.

Responsibilities of the board of internal auditors are; to cover audit and investigation activities to ensure bank compliance with internal procedures, government laws and regulations; accuracy and completeness of financial and management information; upholding the principles of efficiency and effectiveness.

The principal activities of the board of internal auditors in Bank Y include:

Audit Activities:

- Periodic audits of all branches, departments and partnerships,
- Periodic audits of the Internal Control Coordination and Risk Management Departments,
- Inspection and investigation.

Advisory Activities:

- Providing recommendations to maximize efficiency and effectiveness of all banking activities and minimizing and managing risks,
- Supplying input on new products and services and providing relevant procedural guidelines,
- Providing training to maximize performance and efficiency within the board of internal auditors,
- Maintaining relations with the BRSA.

Internal Control Coordination Department of Bank Y provides overall central control, with an emphasis on collateral, income, reconciliation of accounts and limit compliance. The principal duties of the Internal Control Coordination Department include:

- Maintaining central control,
- Control of collateral and income-based operations,
- Ensuring compliance with treasury transaction limits,
- Reconciling accounts of Bank Y with counterparty records,
- Monitoring credit and product pricing,
- Maintaining relations with the BRSA.

## **6.20 Internal Control System of Bank Y**

In Bank Y, internal control function signifies all of the control activities which are performed under the governance and organizational structure established by the bank's board of directors and senior management. Each individual within the organization must participate in order to ensure efficient and effective performing of the bank's activities according to the laws, regulations and procedures.

On the other hand, internal control system in Bank Y includes all of the financial, operational and other control systems which are carried out by the staff of internal control coordination department. It involves monitoring, independent evaluation and timely reporting to management levels systematically in order to ensure that all the bank activities are performed by management levels in accordance with current policies, methods, instructions and limits.

Operations within the scope of internal control function are carried out by the board of directors, senior management, bank staff, board of internal auditors, internal control coordination department and risk management group. It is the responsibility of the board of directors to ensure all measures to be taken required that these units carry out their tasks impartially and in an independent manner.

In Bank Y, internal control coordination department ensures coordination of the internal control activities within the bank. Internal control coordination department conducts monitoring, examination and controlling activities to establish a sound control environment with the participation of bank employees from all levels.

### **6.20.1 Internal Control Activities in Bank Y**

The internal control process in Bank Y includes the following activities:

- Board of directors and the bank's senior management reviews



Board of directors reviews the bank's process towards its goals and compliance with the budget and performance targets and makes the internal control process functional.

- Activity controls

These are the reviews and assessments of division managers on general performance reports together with periodic reports concerning the unexpected situations.

- Physical controls

They focus on verification of compliance with the restriction procedures concerning accessibility, use and secure assets such as cash and securities.

- Review of compliance with limits

This review focuses on the compliance with the general and specific risk limits and following-up non-compliance with risk limits.

- Approval and authorization system

Functional segregation of duties should be assigned, authorizations and responsibilities should be clearly defined and there should be approval or authorization for the transactions over certain limits.

- Verification and reconciliation system

Internal control system is functioned through verifying the transaction details and the output of risk management models used by the bank. Results of these verifications are reported to senior managers when problems are detected.

## **6.20.2 Working Principles of Internal Control Coordination Department in Bank Y**

In Bank Y, working principles of internal control coordination department are established by the board of directors of the bank. These principles are as the following:

### Determination of Internal Control Points

In Bank Y, internal control points are determined by internal control coordination department. It's expected that internal control coordination department coordinates with the board of internal auditors while determining those control points.

### Execution of Internal Control

In Bank Y, internal control function is executed by internal control coordination department staff. Internal control coordination department staff executes distant monitoring of branch and head office departments activities. They do not conduct on site examinations in branches and head office departments.

### Reporting Control Results

Internal control coordination department prepares a report at the end of each distant control activity. Findings are shared with related departments or branches and reports are sent to the Audit Committee and senior management in order to take corrective action.

## **6.20.3 Control Techniques Used in Bank Y**

Internal control coordination department of Bank Y use only distant control techniques, on site control techniques are not used.

In distant controls, internal control coordination department staff accesses to transactions of a department or branch. Samples are chosen according to the scope and attribute of the controlling activity. Activities of chosen branches and departments are monitored and are reported to the Audit Committee and senior management. Main scope of the monitoring activities is abnormal fluctuations in accounts, records and monitoring activities related to authorization and approval processes.

#### **6.20.4 Key Components of Internal Control Process in Bank Y**

In Bank Y, internal control is carried out as an ongoing process at all levels. In order to establish the internal control process in an efficient manner and to achieve objectives of the internal audit the following are taken into account:

- Main duties and responsibilities of the board of directors and senior management within the internal control process and components of internal control environment,
- Distribution of internal control activities, responsibilities and functional duties,
- Information system and the communication structure,
- Activities for monitoring the internal control process and the implementation procedures,
- Identification and assessment of risks.

#### **6.20.5 Major Control Areas in Bank Y**

Major control areas are the areas of activity on which regular controls and reviews performed periodically. Major control areas in Bank Y can be stated as the following:

- Preparation of reports and other documentation required by the BRSA,
- Ensuring that adequate provisions are set aside,
- Compliance with applicable laws and regulations,

- Ensuring that operations are planned and carried out in a prudent manner,
- Financial accounting and management information systems,
- Special control of main operational areas,
- Automation and data processing,
- Contingency planning,
- Prevention of money laundering.

#### **6.20.6 Responsibility of the Board of Directors in Internal Control**

Board of directors of Bank Y develops strategies and policies concerning the control activities of the bank and periodically reviews their implementation. They take some measures in order to establish and maintain efficient internal control and risk management systems in accordance with the institutional structure of the bank.

Board of directors of Bank Y aims to ensure that bank's organizational structure embodies the internal control and risk management systems. It also defines principles and procedures concerning the administrative structure, personnel and quality of the internal control system.

Board of directors periodically reviews assessments of internal control function made by senior management, internal auditors, internal control coordination department, risk management group and external auditors. It verifies whether external auditors' recommendations for improvement of internal control systems are being acted upon. It also periodically assesses the compliance with bank's strategies and policies with the current risk exposure limits.

#### **6.20.7 Responsibilities of Senior Management in Internal Control**

Senior management of bank Y is responsible to the board of directors for the following issues:

- Formulation, execution and periodic review of internal control strategies, policies and processes,

- Development of methods and instruments in order to identify, measure, monitor and control the risks the bank is exposed to,
- Defining authorities and responsibilities,
- Monitoring whether the duties and responsibilities are effectively carried out.

#### **6.20.8 Responsibilities of Other Personnel in Internal Control**

To be able to ensure efficient internal control, authority and responsibilities of all personnel which are inconsistent with professional ethics, bank's policies or are illegal, to the senior management, are set out in written form and notified to related personnel in Bank Y.

Any policy and implementation are avoided encouraging operations which can be thought as inconsistent with professional ethics of the bank, causing to inefficient use of the funds of the bank as a result of an improper allocation of duties and authority, not running a proper sanction mechanism for misconducts.

#### **6.21 Structure of the Board of Internal Auditors of Bank Y**

Board of internal auditors of Bank Y consists of one CAE, two internal audit managers, internal auditors, assistant internal auditors, other audit staff and sufficient administrative staff. The number of staff employed in the board of internal auditors of Bank X is 18.

Specific units might be established in the board of internal auditors organization to execute special engagements that need expertise. Experts within the bank or from other institutions might be hired to work for board of internal auditors.

#### **6.22 Internal Audit System of Bank Y**

In Bank Y, internal audit system is a systematic audit process which is carried out independently by internal auditors of the bank. Internal audit system covers all the activities and units of the bank and enables the assessment of these activities and

units. The audit process in Bank Y includes on-site examination of all material information, accounts and records and off-site examination depending on the bank's organization and nature of its activities.

The following tasks are performed by the auditors of the board of internal auditors of Bank Y:

- Review and assessment of sufficiency and efficiency of the bank's risk management system, review of risk assessment methodology and examination of the system.
- Review of sufficiency of operational controls, management and financial information systems including electronic banking services and testing of efficiency of transactions and financial information systems and an examination of compliance of employees with policies and procedures.
- Investigation of violation of limits, unauthorized trading activities and discrepancy in accounting records.
- Review of accuracy and reliability of accounting system and financial statements.
- Verification of the conformity of transactions with banking legislation.

### **6.23 Position of the Board of Internal Auditors in Bank Y**

In Bank Y, board of internal auditors is subordinated to the board of directors and conducts engagements in the name of the board. This ensures independence and objectivity of the internal audit function and blocks intervention of senior management.

In Bank Y, board of internal auditors carries out its function under the supervision of the Audit Committee and it is the sole authority to carry out the audit function in Bank Y. Audit Committee's activities are carried out under the board of directors and the board of directors has adopted the arrangements in order to ensure that audit function is in a respected status within the bank.

#### **6.24 Administrative Structure of the Board of Internal Auditors in Bank Y**

Administrative structure of internal audit activity in Bank Y is determined by the board of directors.

Board of directors and the Audit Committee have the authority about appointment of board of internal auditors' members, promotions, recruitment, education and annulment of the labor contracts of internal audit staff. These issues should be suggested by the CAE and approval of the board of directors is obtained.

Setting the fundamentals of payments of salary, subsidy and travel allowance and expenditure realization of members of the board of internal auditors are under the authority of the board of directors.

Directorate of the board of internal auditors in Bank Y consists of:

- CAE of board of internal auditors,
- Internal audit managers,
- Internal auditors, assistant internal auditors and service personnel of various titles.

Totally, board of internal auditors' staff of Bank Y consists of 18 employees.

#### **6.25 Scope and Responsibilities of Internal Audit Activity in Bank Y**

The objectives of the internal audit activity in Bank Y are represented by ensuring:

- Integrity of patrimony and of its management activity,
- Efficient control of the risks specific to the bank's activities,
- Reality and accuracy of information given to the bank's internal and external users,
- Complying with internal norms and regulations,

- Complying with the management's directives and performance objectives established,
- Permanent evaluation of the bank's policies and procedures, their application way and their efficiency and elaboration of recommendations in order to improve them,
- Optimization of resource utilization.

Internal audit activity verifies the operations, activities or functions carried out within the bank, as well as its organizational entities, targeting:

- Conformity of operations, activities, functions:
  - Legality – the internal audit activity verifies the measure of complying with the legal provisions in the domain, as well as the measure in which the internal norms comply with the legal background.
  - Regularity – the internal audit activity monitors the measure of complying with the provisions on the means and procedures of execution and control.
  - Complying with the value limits – the internal audit activity monitors the measure of not registering the exceeding of the maximum limit approved for the operation, activity or function audited.
- The economic character of operations or activities: the object audited meets the minimum cost requirement under the circumstances given. The minimum cost is determined on the basis of the opportunity cost of achieving the object audited.
- The efficacy of operations, activities or functions: the object audited ensures the fulfillment of the targets established. The fulfillment of the objective established must be achieved in a margin that the auditor considers reasonable.
- The opportunity of fulfilling the object audited: it is evaluated the measure in which the object audited was fulfilled in that circumstance conferring the



highest efficiency degree and the measure in which the fulfillment of the object audited is placed in a larger group of operations and activities.

- Covering the internal risk associated to the operation, activity or function audited: it is evaluated the degree and way in which the fulfillment of the object audited involved internal risks, the way of ensuring the control and monitoring the risks both upon the level of the objects audited, and of the bank's entire activity.
- Covering the system risk associated to the operation, activity or function audited: it is evaluated the measure in which the fulfillment of the object audited involved system risks, as well as the degree in which the management covered these risks in advance.
- The internal audit includes in its area all the activities carried out within the bank.

The board of internal auditors in Bank Y has the following attributions, but not limited to:

- Ensuring an independent evaluation of the internal policies, regulations, norms and procedures' adequacy to the legal and regulation background.
- Evaluation of all functions, activities, operations, norms and procedures, as well as of the subordinated units under the bank's control.
- Identification of the significant risks and preparation of the internal audit plan in conformity with those ones, the risk evaluation following to be carried out annually.
- Evaluation of the regularity of the systems of decision grounding, planning, programming, organizing, coordinating, monitoring and control related to the decision fulfillment.
- Evaluation and improvement of the internal control system, significant risk management process and of the methodologies for determining them as well as of the bank's management.
- Identification of the weaknesses of the management and control systems and the risks associated to them.

- Analysis of the adequacy degree of the equity according to the risks to which the bank is exposed.
- Analysis of the relevance and integrity of the data provided by the financial and management informational systems and by the IT system.
- Examination of the accounting system and its reliability.
- Evaluation of the economic character and efficiency with which the management and execution systems belonging to the entities audited use the resources.
- Protection of the balance sheet and off-balance sheet patrimony items, preparation of proposals in view to improve the prevention methods for frauds and losses.
- Carrying out the program for ensuring the audit quality.
- Periodical reporting, by the CAE of the findings and conclusions of the audit activities carried out.
- Provide consultancy to the departments within the bank's head office, to branches and agencies complying with the norms and practice principles in the field.
- Fulfill other tasks assigned by the bank's board of directors and the Audit Committee.

## **6.26 Other Functions and Responsibilities of Internal Audit in Bank Y**

### **6.26.1 Special Investigations and Examinations**

Board of internal auditors in Bank Y executes special investigations and examinations about the incidents in the bank in the name of the board of directors. Internal auditors and assistant internal auditors that will contribute to the investigations should have been accomplished the investigations.

The bank personnel are liable to communicate any case that has to be investigated immediately to the board of internal auditors. The top management of the bank and the board of internal auditors establish any kind of channels providing that this communication is done orderly.

Board of internal auditors' members of Bank Y can ask for oral or written defenses or suspend responsible personnel temporarily until the completion of the examination based on the authority delegated to them by the Banking Act. During the audit engagements, internal auditors may broaden the scope of examinations for the issues they determined and also they can initiate a special investigation personally under the knowledge of the CAE.

Although the investigation methods may differ for each case, the detailed techniques to be followed are explained to members of the board of internal auditors during training programs and the investigations are executed based on these principles. Board of internal auditors' member that executes an investigation should consider and analyze every possibility. Before finishing the investigation, it should be clear that every possibility has taken into consideration.

An examination or investigation report is written at the end of investigations. These reports should cover the flow of the case, assessment of every possibility and the final conclusion. Copies of intercepted documents, written defenses and all other related documents should be represented at the appendix of the report.

The appropriate penalties according to Disciplinary Committee Procedure should be recommended in the conclusion part of reports. Nevertheless, the Disciplinary Committee headed by CAE gives the final decision.

### **6.26.2 Consultancy Services**

Members of the board of internal auditors can perform consultancy engagements for the projects and other activities in the bank with the request of business units after the approval of CAE in cases that the board of directors and Audit Committee judge it necessary.

If board of internal auditors' staff is assigned as consultants, the benefits and contributions of this task to the internal systems and managerial processes of the bank should be assessed in the first instance.

During consultancy engagements, board of internal auditors' staff may not have an authority and responsibility related to execution. Board of internal auditors' staff does not have any decision making authority regarding execution. Auditors can not join at any audit activities of the unit or the activity that has been given consultancy service for 6 months following the engagement.

## **6.27 Principles Related to Internal Audit Operations in Bank Y**

### **Independency**

The board of internal auditors of Bank Y operates under the direct subordination of the board of directors, exerting a distinct and independent function from the activities of Bank Y. It must not be subject to the external interferences, starting with establishing the auditable objectives, the effective achievement of missions and the linked internal audit reports and until communicating its results.

### **Permanency of Internal Audit**

The internal audit function represents a permanent activity, covering the bank's functions and all of its units, carried out on the basis of a plan approved by the bank's board of directors.

### **Objectivity and Impartiality of Internal Audit**

The internal auditors of Bank Y must have an impartial attitude, must not have prejudices and avoid the conflicts of interests. The internal auditors try to fulfill their attributions objectively and independently, with professionalism and integrity, according to the norms and procedures specific to the internal audit activity. Selection of the members of the board of internal auditors and the appointment of the members must be carried out so that to avoid any conflict of interests.

The CAE of the bank has the right to initiative and the authority to include in the audit plan the missions considered necessary and opportune in conformity with the

risks identified, nature, complexity and context of carrying out the activities within the bank.

The internal auditors have the authority of communicating with any of the bank's managers, as well as with any employee of the bank, of having access to documents, files and information necessary to achieve the audit mission assigned.

### **Integrity and Professional Competence**

The selection and evaluation of the internal auditors will have in view their correctness, honesty, professionalism and incorruptibility, essential features in ensuring the independence of the opinions formulated in carrying out the audit missions.

The evaluation of the internal auditors' professional competence implies to identify and know their abilities of collecting information, analysis, synthesis and reporting.

The bank's management must ensure qualified personnel for the internal audit activity; allocate the necessary time and the budgets corresponding for carrying out the audit missions under efficiency conditions in correlation with the risks to which the bank is exposed.

### **6.28 Performing Internal Audit Engagements in Bank Y**

The internal audit engagements in Bank Y are carried out on the basis of the mandate of the bank's board of directors, by observing the internal norms and the audit techniques prepared. Regardless of their nature, internal audit engagements are assigned to those persons with the training and experience corresponding to the mission complexity level.

The CAE ensures that for each internal audit engagement, the appointed auditors have the knowledge, skills and competencies necessary for carrying out their duties correctly. For engagements requiring knowledge of strict specialty, consultancy

services may be contracted outside the bank. The quality and works of these services are supervised by the CAE.

According to the engagement objectives, the auditors monitor within the entity audited the conformity with the banking legislation, the norms and procedures prepared, the quality and efficiency of the activities carried out, the quality of the process of risk management and management, observance of the internal norms, observance of the bank's policy and of the objectives established.

The auditors have access to all the documents and information considered relevant for the objectives of the engagement carried out. The managers of the entities audited as well as the execution personnel must make available to the auditors the documents and information requested, as well as the conditions necessary to carry out the engagement.

The objectives and program of the internal audit engagement is presented to the managers of the entity audited, who ensure the conditions necessary to carry out the mission in good conditions. It will be established the employees of the entity audited who will collaborate with the members of the audit team making available the documents and information requested.

Auditors do not intervene in the functioning and management of the entity audited. They formulate remarks to be discussed with the management of the unit audited and inform the CAE, acting in conformity with his instructions. In special cases, the auditor informs the bank's management with regard to the findings of the audit team even during carrying out the engagement.

The findings within the internal audit engagement are sustained on the basis of documents, as well as by other proofs to be annexed to the engagement file. The findings related to the objectives investigated are registered in the work files prepared in conformity with the internal audit norms.

In case during the internal audit engagements there are found deviations from the procedural and methodological rules, from the legal provisions respectively, the

internal auditors must notify the manager of the entity audited. During the engagement, if necessary, the auditors address to the management of the unit audited a notice on the deficiencies found. All notices requesting an answer are to be submitted to the unit manager on the basis of receipt signature. The leaders of the entity audited answer to the notice in the period specified by auditors.

In case of identifying some important irregularities or possible damages, the members of the audit team are to immediately report to the CAE and he reports to the bank's management and to the internal control structure.

At the end of the engagement, the audit team's remarks, conclusions and proposals are discussed with the management of the unit audited. Then, auditors prepare a report comprising the observations, conclusions, proposals formulated further to the engagement carries out and the answers of the management of the structure audited in this respect. The report is submitted to the CAE who analyzes it and prepares a report comprising the main findings and proposals, which he presents to the bank's Audit Committee and board of directors.

#### **6.28.1 Audit Program in Bank Y**

In Bank Y the auditor in charge prepares the audit program. Audit program should be prepared to cover all components of the audit entity and the activity. During the preparation phase, auditor in charge asks for opinions of the board of internal auditors' management and related managers of the entity, when needed.

In Bank Y audit program should be prepared concerning the engagement types that would be performed. Audit program at least contains the following items:

- Whether the entity manager is informed about the engagement or not, if he is informed about the engagement then the date and contents of the opening meeting,
- Risk assessments,
- Examination and assessment of the internal control systems, policies and practices,

- Review of the compliance with the related legislation and regulations,
- Sampling methods and criteria for the sample size selection,
- Document testing, physical control or consequence control with the subsidiary accounts or book keeping records for the selected accounts and transactions, control for exceptional practices.

The auditor in charge prepares a work plan considering the team members' skills and proficiency after setting up the audit program. The auditor in charge determines the time for the engagement and work to be done in different phases of the engagement by the work plan. Work plan can be prepared as a separate document or included in the audit program.

Audit programs may differ according to the audit entity, activity or the product. Programs are prepared due to the determined subjects and scope of the engagement as in the audit plan. If details are not available for the engagement in the audit plan, the auditor in charge determines the scope and the engagement type and asks for the opinion of board of internal auditors' management and the previous engagement team leader. For such cases, final program, scope and the engagement type is approved by CAE with the view of the deputy CAE.

### **6.28.2 Types of Engagements**

Three types of engagements are performed by board of internal auditors in Bank Y:

- Compliance Audit: It consists of reviewing the compliance of the activities of the bank to policies, procedures and regulations.
- Operational Audit: It is about reviewing effectiveness and efficiency of activities under consideration.
- Process Audits: In case of process audits, process of a banking activity is reviewed, deficiencies, workflows and compliance issues are determined.



### **6.28.3 Engagement Reporting**

Audit reports in Bank Y contain objectives and scope of engagement, audit findings and recommendations of the internal auditor. Board of internal auditors in Bank Y mainly uses three types of reports regarding their audit activities. These reports can be classified as the following:

- **Audit Report:** It contains audit findings, opinions and recommendations. Audit reports are communicated to Audit Committee, the Board, senior management and other appropriate managers. The auditor in charge writes the report and internal audit manager reviews the report when it is in draft form.
- **Special Report:** It is used for immediate communication and to inform board of internal auditors or senior management about matters that require immediate action.
- **Executive Summary:** It is prepared to summarize the findings, opinions and recommendations mentioned in audit reports, which are relatively important at the risk point of view. Executive summaries are especially prepared for the board of directors and senior management.

### **6.29 Major Elements of Internal Control and Internal Audit in Bank Y**

In Bank Y, internal audit and internal control systems aim to ensure the efficiency and effectiveness of activities, reliability and completeness of information and try to ensure that bank's activities are in compliance with procedures, policies, laws and regulations.

In order to achieve these objectives, the internal audit and internal control systems are established to ensure that:

- Activities of the bank are effectively planned and conducted in compliance with procedures, laws and regulations and with the strategies of the board of directors.
- The performance of transactions and fulfillment of obligations.
- Safeguarding the bank assets and controlling of its liabilities.
- Risks can be identified and necessary measures are taken in order to reduce risks.
- Records of the bank provide complete, accurate and timely information.
- The board of directors of the bank is monitoring the capital adequacy, liquidity, asset quality, profitability performance according to its budget, and its compliance with banking policies and regulations.
- Risk management system within the bank operates in an effective manner and supports the board of directors in identifying the probability of loss.
- Evaluation and examination of the effectiveness of the internal control mechanisms within the bank.

### **6.30 Audit Committee of Bank Y**

The Audit Committee in Bank Y was established in 2006. It consists of two non-executive members of the board of directors of the bank.

#### **6.30.1 Role**

The Audit Committee of Bank Y is appointed by the board of directors in order to assist the board of directors in fulfilling its oversight responsibility regarding:

- The effectiveness and adequacy of the accounting and reporting systems, which support the preparation and integrity of the bank's financial statements, compliance statement and oversight of related disclosure matters,
- Qualifications, independence and performance of, and the bank's relationship with the external audit,
- The effectiveness and adequacy of the bank's internal audit function,

- The effectiveness and adequacy of the bank's compliance function,
- The effectiveness and adequacy of the bank's internal control function,
- The effectiveness and adequacy of the bank's risk management function.

### **6.30.2 Responsibility and Authority**

The Audit Committee of Bank Y has the responsibility to receive reports from the units established within the scope of the internal control, internal audit and risk management systems, as well as from the external audit companies on a regular basis, in relation to the execution of their duties. The role and scope of the activities of the Audit Committee also cover the operations of the partnerships of Bank Y.

The Audit Committee in Bank Y has full, free and unrestricted access to the bank's senior management and employees, and to the bank's internal and external auditors. The Committee also has access to the bank's books and records.

The Committee has the authority to retain legal counsel, consultants, or other outside advisers, with respect to any issue or to assist it in fulfilling its responsibilities, without consulting or obtaining the approval of any officer of the bank.

### **6.30.3 Organization**

The Audit Committee of Bank Y is composed of two non-executive and independent members of board of directors one of which is required to have financial expertise. The members of the Audit Committee are elected by the board of directors and may be replaced by the Board.

In the event that the number of members of the Committee falls below two, then appointment of adequate number of members of the board of directors with the same qualifications is obligatory within fifteen days.

#### **6.30.4 Meetings and Reports**

The Audit Committee in Bank Y meets at least quarterly or more frequently if required. The committee receives regular reports from the board of internal auditors, internal control coordination department, risk management department and the external auditors and recommends appropriate actions as necessary based on their review.

The Committee has the authority on a discretionary basis to meet in separate private sessions with members of the management team, the internal auditors and the external auditor.

The Committee reports at least quarterly to the board of directors. These reports include matters that are within the Committee's responsibilities and with respect to such recommendations, as the Committee may deem appropriate. The presentation to the board of directors includes a summary of the Audit Committee meeting together and recommendations.

#### **6.30.5 Duties**

The Audit Committee in Bank Y performs the following functions and may carry out additional functions and adopt additional policies and procedures in furtherance of the role of the Committee and the local regulatory requirements.

#### **Financial Statements, Compliance Report and Disclosure Matters**

- The Audit Committee in Bank Y reviews and discusses with management and the external auditor the financial statements, accounting and disclosure policies of the bank.
- The Committee supports the board of directors in complying with reporting requirements under applicable regulatory requirements.
- The Committee reviews any points raised in written communications from the external auditor and agrees on any corrective action that may be required by the bank.

- The Committee discusses with the external auditor and management of the bank the effect of regulatory and accounting initiatives and off-balance sheet structures on the bank's financial statements.

### **Oversight of the Bank's Relationship with the External Auditor**

- The Committee oversees the work of the external auditor for the purposes of preparing or issuing an audit report or related work. The external auditor reports directly to the Audit Committee. The Committee annually reviews and recommends the appointment of the external auditor.
- The Committee reviews and approves in advance the annual plan and scope of work of the external auditor and reviews with the external auditor any audit related concerns and management's response.
- The Committee ensures the rotation of members of the audit engagement team as required by law and requires that the external auditor provides a plan for the orderly transition of audit engagement team members.
- The Committee performs such reviews of auditing services as may be required, from time to time by applicable company law, including external auditor's work, fees and the auditor's independence.

### **Oversight of the Bank's Internal Audit Function**

- The Audit Committee in Bank Y reviews and discusses with the board of internal auditors the annual audit plan of the board of internal auditors, including responsibilities, staffing, etc. and if appropriate it recommends changes about the plan.
- The Committee reviews the results of internal audits and discusses related significant internal control matters with the board of internal auditors and with the bank's management, including significant reports to management prepared by the board of internal auditors and management's responses.
- The Committee reviews arrangements and resources for internal audit to ensure that they are suitable.

### **Oversight of the Bank's Compliance Function**

- The Committee reviews the results of compliance reviews, significant compliance matters and management's responses.
- The Committee establishes policies and procedures for the receipt, retention and treatment of complaints received by the bank.
- The Committee discusses with external auditors and the board of directors any correspondence with governmental agencies and published reports, that may raise material issues about the financial statements or compliance policies of the bank.

### **Oversight of the Bank's Internal Control Function**

- The Committee oversees the establishment of and compliance with the procedures regarding the segregation of duties at appropriate levels of the bank.
- The Committee oversees the effectiveness and adequacy of the accounting and financial reporting systems.
- The Committee oversees the preparation and implementation of a Business Recovery Plan.
- The Committee oversees the results of the internal control activities and ensures that remedial actions are taken where appropriate.

### **Oversight of the Bank's Risk Management Function**

- The Committee oversees the establishment of risk limits at appropriate levels and compliance with risk limits.
- The Committee oversees that risks are monitored, measured and reported at appropriate levels.
- The Committee oversees the results of the risk management activities and ensures that corrective actions are taken where appropriate.

### **6.30.6 Reporting to the Board of Directors**

At least on a six monthly basis, the Audit Committee in Bank Y reports the results of the activities it has undertaken, and its opinions regarding the precautions that should be taken and practices needed in the bank and other issues it deems necessary to the board of directors.

### **6.31 Results, Conclusions and Recommendations**

Bank Y's board of internal auditors and internal control coordination department oversee and coordinate all audit and control activities. While each department's duties and responsibilities are separate and unique as laid out in charters approved by the board of directors of the bank, it is expected that they coordinate with each other in order to form a balanced and comprehensive system of internal control within the bank.

Findings and conclusions about the internal audit applications regarding the case study that have been conducted in Bank Y are discussed in the following paragraphs.

In Bank Y, there is separation between the chairman of the board and the CEO as it is the case in Bank X. They are the different persons. This condition enhances the checks and balances function of the board, board has an independent structure and it causes to a stronger control environment.

Board of internal auditors and internal control coordination department are linked to the Audit Committee and under the supervision of the committee. Also, the budget of the board of internal auditors, the internal audit plan, promotion and remuneration of the staff are generated by the Audit Committee. These ensure the independence of the internal audit function within the bank.

Audit Committee in Bank Y was established in 2006 and is composed of two non-executive members of the Board of Directors. Board of internal auditors, internal control coordination department and risk management department are linked to the Audit Committee and operate under the supervision of the committee in Bank Y.

Existence of Audit Committee ensures independence of the internal audit function within the bank.

In Bank Y the corporate governance committee was established in 2005. The committee is headed by an independent member of the board of directors and monitors compliance to corporate governance principles. On the other hand, the bank does not have risk management, remuneration, nominations and compliance committees.

Bank Y established Shareholder Relations Department to protect shareholder rights and ensure effective communication between the boards of directors and shareholders. Stakeholders are informed of all issues concerning them during General Meetings and via the statements of material events that the bank furnishes to CMB and ISE, its corporate website and the media.

The board of internal auditors in Bank Y has a charter and this charter contains its responsibilities, audit planning, scope of work, reporting issues and the main services offered to bank. The charter is approved by the Audit Committee. Also, the board of internal auditors in Bank Y has developed a written set of methodologies that will describe the type of audits, stages, audit tools, working papers and sampling methods in order to adequately evidence and document issues.

As it is in the case of Bank X, in Bank Y written policies and procedures do not sufficiently cover the monitoring procedures of the partnerships. Also, partnerships may be able to operate based on their own policies and procedures. This is a practice that does not ensure sufficient control.

There is a risk management department in Bank Y which operates directly linked to the Audit Committee. Similar to Bank X, in Bank Y there is also lack of coordination between the board of internal auditors and risk management department. They do not take advantage of each other's work and findings in their work.

Contrary to Bank X, it is thought that in Bank Y management does not believe that staff of the board of internal auditors has sufficient skills and competencies in order



to add value to the activities of the bank. Because, in Bank Y internal auditors do not take part in important projects other than branch and head office department audits.

As it is in Bank X, reporting lines of internal auditors and internal controllers are clear and there are written job descriptions of the staff of board of internal auditors and internal control coordination department in Bank Y. This situation strengthens the control environment.

Contrary to Bank X, formal communication channels do not exist between the board of internal auditors and other departments of the bank. There is no efficient communication between those departments. This situation delays timely identification of problems by the board of internal auditors.

As it is in Bank X, Internal audit staff of Bank Y (both board of internal auditors' and internal control unit's) does not sign forms concerning their compliance with the Standards for Professional Practice of Internal Auditing and the relative Code of Ethics. In addition, many of the staff are not members of the IIA so they are not obliged to comply with such standards.

As it is in Bank X, board of internal auditors in Bank Y does not develop performance measures for the accomplishment of its tasks. Also surveys which analyze the satisfaction levels of auditees are not conducted within the bank. It will be useful to implement engagement based performance measures and conduct surveys in order to have knowledge about the satisfaction levels of auditees about the work of internal auditors.

Proficiency, competency and seniority of staff of the board of internal auditors in Bank Y can be considered as a weakness for the bank. In Bank Y there are no internal auditors out of 18 which have professional certifications such as CIA and CISA. Also the average seniority of the staff of the board of internal auditors of Bank Y is about 1.70 years which is considered to be too low. All internal auditors should seek certification as a mean to strengthen their position both within and outside the bank and average seniority of the staff should be raised by employing senior internal auditors.

Also, it is thought that the board of internal auditors of Bank Y is understaffed as it is in Bank X. It has 18 internal auditors. The bank has about 34 branches and many head office departments that should be audited by the internal auditors periodically. When the number of internal auditors are considered, their average seniority and take into consideration that the board of internal auditors in Bank Y is not be able to audit all of the branches and departments it is concluded that there is a lack of sufficient staff within the board of internal auditors of Bank Y.

In Bank Y, while the annual audit plan of the board of internal auditors is being conducted, financial, operational or compliance risks of the branches or head office departments are not taken into consideration. Instead, board of internal auditors' management directs internal auditors to conduct engagements in as many branches and departments as possible without making branch or department based risk evaluations. Since, it is not possible for the board of internal auditors of Bank Y to audit all of the branches and departments of the bank; they take advantage of the last audit results and set the priority. It is recommended to determine the audit universe, collecting information regarding risks within the branches and head office departments, specifying the risk levels of branches and departments and give a priority level to each of them. This is important for using internal audit resources in an effective and efficient manner and conduct engagements within branches and departments which are relatively more risky compared to others.

Like Bank X, audit reports in Bank Y do not categorize audit findings according to their significancy and audit findings are not linked with potential risks. As a result audit reports contain much information that is not useful for the audit scope and purpose. It is suggested that for each issue there must be a recommendation by the board of internal auditors in order to overcome the problems arising, comply with the organization's policies and procedures and implement best practices. There should also be categorization of findings within the reports.

Bank X uses only the ACL as a computer assisted audit technique in a limited manner. But in Bank Y, no computer assisted audit techniques are used in assessment of risks, determination of sampling methods and evidence of audit findings. As in the

case of the applications of Bank Y, this results to ineffective review and use of sampling methods.

Like the application in Bank X, board of internal auditors of Bank Y does not take place in conducting of consulting activities. This causes the staff of board of internal auditors not to understand a broad range of the operations of the bank and is an obstacle to value adding internal auditing. Also, it restricts different perspectives and viewpoints of the internal auditors that can be useful for management.

There are no functional separations within the board of internal auditors and internal control coordination department. In case of board of internal auditors all the staff conducts any audit engagement that needs to be conducted. This audit engagement can be either in a branch or a business department. In case of internal control coordination department, internal controllers only conduct engagements within head office departments and they do not conduct audits within branches. Also, in near future Bank Y does not plan to establish functional separations within those departments.

As it is in Bank X, Bank Y has not established a systematic follow up process either. Also they do not have a project to form a follow up process in near future. Follow up process should be established in order to ensure that remedial actions are taken and to build an effective monitoring system and control environment.

Like Bank X, board of internal auditors and internal control coordination department conduct similar work in Bank Y. But, different than the activities of Bank X, in Bank Y internal control coordination department only makes distant controls in head office departments and branches. It does not make on site examinations. So, in Bank Y activities of board of internal auditors and internal control coordination department in terms of distant controls coincide with each other. There should be coordination between those departments in order to ensure efficiency and effectiveness and for efficient use of bank resources.

## Chapter 7

### Case Studies: Overall Results, Conclusions and Recommendations

#### 7.1 Introduction

The IIA (1999) defines internal auditing as:

An independent, objective assurance and consulting activity designed 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.

Boards of directors of banks are responsible that management applies an effective internal control system. This system should be appropriate to evaluate banking risks and compliance with laws, regulations and internal bank procedures. The management of bank is responsible to establish an organizational structure that clearly identifies powers and responsibilities. Also, it should develop policies and procedures in order to identify, monitor and control risks within the bank. Internal auditing is a part of monitoring of the internal control system of the bank. It gives feedback to both the board of directors and management about effectiveness of performance of their responsibilities (Dumitrescu, 2004).

Corporate scandals and collapses that have been experienced in recent years pointed out the crucial role of the boards of directors in promoting effective corporate governance. Also, boards of directors are responsible to ensure an effective internal control system within their organizations. An effective internal audit function plays a crucial role in assisting the boards of directors to fulfill their corporate governance responsibilities (KPMG, 2003).

Internal audit activity serves checks and balances function for sound corporate governance. An internal audit function which operates in an objective manner identifies risk and control problems and has the authority to pursue its concerns and supports boards of directors in discharging their responsibilities. Boards of directors and senior management want to obtain information and advice from objective and trusted sources. So, internal audit activity should be properly organized, resourced and empowered in order to be able to provide reliable, impartial and competent information to both the board of directors and senior management (Laker, 2004).

Recent corporate collapses and scandals increased the value of corporate governance and highlighted that internal audit plays a supportive role to the board of directors in ensuring adequate oversight of internal controls and internal audit became an important part of corporate governance framework. Key roles that internal audit plays in fulfilling its corporate governance responsibilities can be briefly summarized as the following (KPMG, 2003):

- Reviewing the control culture of the organization,
- Evaluating the risk and internal control frameworks in an objective manner,
- Analyzing business processes and associated controls systematically,
- Reviewing the existence and value of company assets,
- Giving information about irregularities,
- Reviewing the compliance framework and compliance issues,
- Reviewing the operational and financial performance of the organization,
- Giving recommendations regarding the effectiveness and efficiency of operations,
- Making assessments of accomplishment of goals and objectives.

Since internal audit plays an important role in the establishment of a sound corporate governance system, an evaluation of internal audit applications in Turkish national banking system has been conducted. Case studies in two commercial banks have been accomplished and some conclusions and recommendations have been derived about the status and applications of internal audit activities within the banking system.

## **7.2 Results, Conclusions and Recommendations**

Results, conclusions and recommendations regarding the internal audit applications of commercial banks that have been obtained from the case studies are as the following.

### **7.2.1 Issues Regarding Role of Internal Audit in Corporate Governance**

In both banks, board chairman and the CEO are different persons. This helps to enhance the checks and balances function of the board. Independency of the board is established and there exists a stronger control environment.

Both banks have the boards of internal auditors and internal control departments (in Bank Y, its called internal control coordination department) which are directly linked to the Audit Committee of the board of directors. As a result of this situation, independence of the internal audit function is ensured in both of the banks.

Both banks have Audit Committees which were established in 2006 and each of the committees consists of two non-executive members of the board of directors. One of the committee members in each of the committees are financial experts. Existence of the Audit Committees within the banks is an indicator about the independence of the internal audit function.

Both banks have set up corporate governance committees members of which are non-executive members of the boards of directors. The role of corporate governance committees in these banks is to ensure compliance with corporate governance principles. But, on the other hand, banks have not established remuneration, nominations and compliance committees yet.

One of the most important aspects of the Sarbanes Oxley Act is the requirement to certify that quarterly and annual reports are fully compliant with applicable laws and present a fair picture of the financial situation of the company. So, the Audit Committees and the internal auditors of companies have responsibilities about the

truth of financial statements. But, in both of the banks, the boards of internal auditors do not audit the financial statement preparation process within the bank. Boards of internal auditors do not conduct financial audits; instead they mainly focus on operational and compliance audits.

Corporate governance is a new term for the banks which began to be used in recent years. So, boards of internal auditors of the banks are not sufficiently aware of their roles in sound corporate governance practices. Internal audit should have clearly established audit objectives in order to ensure that corporate governance mechanisms are monitored periodically. To be able to enhance the role of internal audit in corporate governance, emphasis should be placed on the capability of internal audit in providing assurance to management on integrity of flows of information, risk identification, risk assessment and provision of timely advice to management and to the board of directors. Internal auditors should assess whether the bank is in compliance with governance codes. If the bank is not in compliance, internal auditors should evaluate the impact and cause of the noncompliance.

There should be ongoing communication between the Audit Committee, the CAE, the CEO and the CFO. This communication is important to discuss concerns and misunderstandings and to be able to achieve good corporate governance. This process also ensures the Audit Committee to be more involved in matters such as disclosure issues in financial reporting and conflicts of interest.

Both banks have adopted the code of ethics as stipulated under the Banking Act. But, it is thought that boards of internal auditors do not take active roles in supporting banks' code of ethics in both of the banks. Governance practices of organizations reflect the ethical environment. It is thought that in order to reach an enhanced ethical culture, internal auditors should evaluate the clarity of ethical standards and their communication ways and frequencies and commitment of the bank to these standards.

In both banks, analytical written policies and procedures are limited to the head office. They do not cover sufficiently the monitoring procedures of the partnerships, which results deviations from corporate governance best practices. On the other

hand, partnerships may be able to operate based on their own policies and procedures, which in certain cases may be in conflict with those of the bank. This is a practice that does not ensure sufficient control.

Within an organization, governance responsibilities are assigned to different parties and each party is responsible from fulfilling its responsibilities about governance. In order to achieve good corporate governance, it is important to assign these responsibilities to related parties. Internal auditors should review the assignment of these responsibilities to appropriate parties and effectiveness of performance management and disciplinary action processes.

Both banks established Shareholder Relations Departments in order to protect the rights of their shareholders and to ensure effective communication between the boards of directors and shareholders. In both of the banks, the Shareholder Relations Departments are accountable to corporate governance committees. In case of stakeholders, they inform the stakeholders of all issues concerning them during General Meetings and via the statements of material events they furnish to CMB and ISE, their corporate website and the media.

Both banks have corporate websites. Their websites contain information on their current shareholders, corporate management structure, articles of incorporation, annual reports, periodical financial statements and reports, the material events regarding the banks, agendas of general meetings, shareholders attended general meetings and minutes of general meetings.

Both banks have corporate disclosure policies. Within the framework of their disclosure policies, they disclose publicly all material events regarding the banks through CMB and ISE and also send corporate news releases to media outlets. These banks' Investor Relations Departments hold an informative meeting following each disclosure of quarterly profit and balance sheet and prepare corporate reports and publish them on the corporate website. Such information is also shared with media representatives in the form of press releases or by holding press meetings. General-purpose disclosures, other than those legally required to be made and related to banks' products, services and strategies are made by Communications Department in



coordination with the operations of the other related departments. All media inquiries communicated to banks are classified by the Communications Department depending on their contents and responded to by the related departments or the Communications Department in accordance with the banks' goals and strategies.

In case of social responsibility, both banks believe that the environment should be protected in order to hand over the future to next generations in a healthy and protected manner. In these banks, Environmental Management System is part of the organizational procedures. They try to conduct their investment and funding operations in line with World Bank's Environmental, Health and Safety Guidelines and the local environmental laws and regulations.

Internal audit function should be able to inform the board of directors about the risks and do its job as expected from it. Findings of the internal audit function should not be perceived as obstacles. Boards of directors should support boards of internal auditors to make them stronger and more reliable and develop a culture which sees bad news of the audit function as good and valuable news. This will both strengthen the control environment and the corporate governance system within the bank.

Especially, within the banking sector fraud is a significant risk. Main reason of the corporate collapses leading to the emergence of corporate governance that occurred during the last decade was personnel fraud. In banks that operate in Turkish national banking system boards of internal auditors take action and conduct examinations when fraud occurs. But they do not take active roles in order to prevent occurrence of fraud. Fraud prevention and detection subunits within the boards of internal auditors should be established within the banks. In order to detect and prevent fraud, fraud trainings should be provided to internal auditors, fraud risk assessments should be conducted, models should be utilized for identifying potential frauds and computer assisted audit techniques should be adopted.

As a result of increasing importance of corporate governance, it is thought that it became crucial for boards of internal auditors to adopt governance-based internal auditing methodologies. By this way, internal audit function can add value to the banks by focusing on the effectiveness of corporate governance process as a whole.

Governance based internal auditing should include auditing the board to guarantee board's governance responsibility and its achievement and auditing governance, control and risk management processes.

In Turkish national banking system, all of the banks have boards of internal auditors and Audit Committees. Corporate governance committees have started to be established in recent years, but not all of the banks have corporate governance committees. Also, most of the banks have not established remuneration, nominations and compliance committees yet.

It is thought that for most of the banks in Turkey corporate governance is a new term and boards of internal auditors are not completely aware of their roles in sound corporate governance. Nearly all of the banks have adopted code of ethics but it is thought that the boards of internal auditors do not take active roles in the evaluation of ethical standards.

Banks in Turkey have shareholder relations departments, corporate websites and corporate disclosure policies which ensure effective communication between boards of directors, shareholders and stakeholders.

### **7.2.2 Scope and Objectives of the Internal Audit Function**

According to international best practices, the main objective of the boards of internal auditors must be defined in cooperation with management and Audit Committee in order to give a full picture of the organizational needs, incorporate value added practices and priorities during the risk assessment stage. Finally, it must be approved by the Board of Directors or the Audit Committee of the board of directors in order to be in accordance with the main organizational objectives. In both of the banks, there are written scope and objectives within the charter of the board of internal auditors and the charter is approved by the Audit Committee of the board of directors of each bank.

Both of the banks have a risk management department and risk management function is directly linked to the Audit Committee of the board of directors. But in Bank X,

there is lack of cooperation between the internal auditing and risk management functions despite the procedures in Bank X advice cooperation between those departments. Internal auditing can not take advantage of the work of risk management department and also the risk management department does not benefit from the work of the board of internal auditors. It is suggested that strong cooperation should be developed and standardized among these two functions mainly for the part of identification, assessment and management of operational risk issues.

One of the components of internal control is risk assessment. It contains the identification, analysis and management of an organization's risks. In both Bank X and Bank Y, internal audit functions are not involved in the enterprise risk assessment process. This situation prevents internal audit function from understanding main risks and focusing their efforts on the risk areas that have significant impact on the business. Also, the risk assessment of the bank should be refreshed periodically by the internal audit activity. It is important for the internal audit activity refreshing its risk assessment in order to understand the changing risk profile, making sure that the internal audit activity has the tools in place to address these risks and updating the annual audit plan.

In order to add value to the operations of the banks; boards of internal auditors should analyze the past and make projections related to the future to meet transparency and accountability needs of the bank. Besides existing problems they should also show potential opportunities, should make process based evaluations, conduct consulting engagements and evaluate risk management, control and governance processes. In order to add value and fulfill these objectives traditional audit approaches which are individual and error based should be left and process based auditing approaches should be implemented. Also, boards of internal auditors should inform the boards of directors about their roles, responsibilities and the ways how they can add value to the operations of the bank.

In Turkish national banking system, there are written scope and objectives within the charters of the boards of internal auditors and charters of the boards of internal auditors are approved by Audit Committees. Banks have risk management departments but it is thought that in most of the banks in Turkey there is lack of

cooperation between boards of internal auditors and risk management departments and they do not benefit from each other's work.

In most of the banks that operate in Turkey internal audit functions of banks are not involved in the enterprise risk assessment process. This situation prevents internal audit functions from understanding main risks and focusing their efforts on the risk areas that have significant impact on the business.

### **7.2.3 Management of the Internal Audit Function**

In both of the banks, the budget of the board of internal auditors, the internal audit plan, promotion and remuneration of the staff are generated by the Audit Committee of the board of directors. Boards of internal auditors are strictly under the supervision of the Audit Committees. This can contribute effectively to the independence of the board of internal auditors in both of the banks.

Reporting lines and the responsibilities of internal auditors and internal controllers in both of the banks are thought to be specific and clear. There is no lack of written job descriptions of the board of internal auditors' and internal control department staff. This situation is important for strengthening the control environment of the bank.

Boards of internal auditors of both of the banks have not developed and implemented performance measures for the accomplishment of their tasks. Boards of internal auditors of the banks do not perform surveys which analyze the level of satisfaction of the auditees and do not correlate cost benefit relation. It is suggested that the banks must promote the development and implementation of performance measures and also analyze survey results regarding the level of satisfaction of the auditees by internal audit services in order to have value added internal audit services.

In order to ensure continuous improvement of activities and measure effectiveness of internal audit performance, boards of internal auditors should develop appropriate performance indicators to be able to measure cost effectiveness and the quality of their services.

Internal audit staff (both board of internal auditors' and internal control unit's) in both of the banks do not sign forms concerning their compliance with the Standards for Professional Practice of Internal Auditing and the relative Code of Ethics. In addition, many of the staff is not members of the IIA so they are not obliged to comply with such standards. It is suggested that members of the board of internal auditors' and internal control departments must sign forms regarding compliance with the Professional Standards of Internal Auditing and the Code of Ethics.

Functional separations within the boards of internal auditors are important in order to have specialized staff for certain functions and increase efficiency of the internal audit system. Boards of internal auditors of both of the banks do not have functional separations. But Bank X plans to form departments within the board of internal auditors such as information technology audit, branch audit, head office audit departments, etc.

In case of internal auditing approaches, both Bank X and Bank Y do not fall into any of the approaches (traditional audit approach, integrated audit team approach and fully integrated audit approach) discussed in Chapter four. In both of these banks, there is no specialization and there are no autonomous groups within the boards of internal auditors. There is a pool of internal auditors in each of the bank and they perform all of the engagements regardless of they have sufficient knowledge and skills.

Another classification regarding internal audit approach is risk-based, review-based and compliance-based approaches. In both Bank X and Bank Y compliance-based approach is highly preferred. Their main focus in audit engagements is compliance with policies and procedures of the bank. But, policies and procedures of the banks are prepared and approved by functional divisions and management. So, by adopting a compliance-based approach, internal auditors are auditing functional departments by taking into account policies and procedures which were prepared and approved by functional department managers and management. Instead, a review-based approach should be adopted and preparation process and validity of policies and procedures should be examined. Also in conducting audit engagements besides review-based approach risk-based approach should also be adopted. Materiality concept should be

taken into account in audit planning, audit priority should be given and limited resources of audit activity should be directed to high risk areas.

As it is discussed in Chapter four, there are mainly four dimensions of internal auditing which are centralized, decentralized, hybrid and decentralized with guidance. In both Bank X and Bank Y the structure of internal auditing is centralized which means there is only one board of internal auditors in each of these banks and they handle all of the auditees.

In the banks in Turkey boards of internal auditors are strictly under the supervision of the Audit Committees. This can contribute effectively to the independence of the boards of internal auditors in the banking system. It is thought that in most of the banks boards of internal auditors have not developed and implemented performance measures for the accomplishment of their tasks. In most of the banks boards of internal auditors of the banks do not perform surveys which analyze the level of satisfaction of the auditees and do not correlate cost benefit relation.

Internal auditing approaches of most of the banks do not fall into any of the approaches such as traditional audit approach, integrated audit team approach and fully integrated audit approach. In most of the banks, there is a pool of internal auditors and these internal auditors perform the engagements. Also, it is thought that in most of the banks traditional compliance-based approach is preferred; but especially in some of the foreign banks review-based approach is used.

#### **7.2.4 Staffing of the Internal Audit Function**

Staff appraisals in both of the banks are not usually linked with employee's progress and take place yearly and not after the completion of each project. This practice does not ensure independence and objectivity. It is suggested that there must be a clear link between efforts and rewards and also incentive schemes for internal auditors, which will allow professional development.

Proficiency, competency and seniority of staff of the boards of internal auditors in both of the banks can be considered as a weakness for the banks. In Bank X there are

only 5 internal auditors out of 81 which have professional certifications such as CIA and CISA. In Bank Y none of the members of the board of internal auditors have professional certifications. To maintain the confidence of stakeholders it is important for internal auditors to possess professional certifications.

Average seniority of the staff of the board of internal auditors of Bank X is about 2.30 years. On the other hand, in Bank Y, the average seniority of the staff of the board of internal auditors is 1.70 years. It is believed that average seniority of the staff should be raised by employing senior internal auditors. Also, it is thought that the boards of internal auditors of both of the banks are understaffed. When the number of internal auditors and their average seniority are considered, and take into consideration that the boards of internal auditors of the banks are not be able to audit all of the branches and departments, it is concluded that there is lack of sufficient staff within the boards of internal auditors of the banks.

In some of the countries, banks or other organizations do not hire internal auditors who do not have experience in functional departments of the organization. In Turkish national banking system, most of the banks hire internal auditors who do not have experience in other departments. It is thought that hiring internal auditors from other departments of the bank adds value to the operations of internal audit activity and ensures different perspectives. Also, internal auditors who are hired from functional departments have more detailed knowledge about processes and share their knowledge with other internal auditors.

It is thought that in Turkey, the important weaknesses of the internal audit staffs of banks are proficiency, competency and seniority levels of the staff. In case of proficiency and competency, most of the internal auditors do not have professional certifications and most of the ones that have professional certifications work in foreign banks. Especially, public banks do not encourage their internal audit staff to have professional certifications. Also, because most of the public banks in Turkey prefer traditional audit techniques they see professional certifications as unnecessary.

In case of average seniority, most of the banks in Turkey have internal audit staff average seniority of which is at most three or four years. When compared to other banks in other countries these levels seem to be too low.

### **7.2.5 Internal Auditing Methodologies**

While the annual audit plan is being conducted in both of the banks, the boards of internal auditors do not focus on various risks such as financial, operational, compliance, etc. Rather, the annual audit plans are based on only the previous experience and the rating of the last audit that have been conducted in the department or the branch. There is no advanced internal audit budget in the banks, but there exists only a budget containing the total time period that is needed in order to complete an engagement. The introduction of procedures that will ensure collection of all useful information regarding risks and use of this information for the development of the annual audit plan of the board of internal auditors are suggested. This plan must contain all areas that the corporate audit universe consists of and take into account the objectives setting and the overall strategy of the bank. Also, it is important to develop an internal audit strategic plan in order to cover all areas in a specific minimum timeframe.

Another issue that the board of internal auditors' of both of the banks need further improvement is the use of CAATs in order to record and assess potential risks, sampling methods, evidence of audit findings and the generation of reports, and finally electronic files and working papers. This results to ineffective review and use of sampling methods. In Bank X only ACL is used for supplying branch and department data to internal auditors but its use is limited. On the other hand, in Bank Y CAATs are not used. It is suggested the use of computers in all the aspects of the internal audit work and more specifically in risk assessment, planning and evidence of audit work and finally on the generation of reports.

Boards of internal auditors in the banks have developed a written set of methodologies that will describe the type of audits, stages, audit tools, working papers and sampling methods in order to adequately evidence and document issues.



Consulting services are advisory services which are usually conducted by request of an engagement client. Internal audit activity and the engagement client determine the scope and the nature of the consulting engagement together. In both of the banks, boards of internal auditors do not engage in consulting activities. As a result of this situation the staff is unable to have a broad knowledge of operations of different departments of the bank and it can be seen as an obstacle to value adding internal auditing. There should be clear guidance for internal auditors to establish a balance between compliance and consulting roles.

Members of the boards of internal auditors should evaluate their control results in an objective manner, should recommend corrective actions and make the follow up of their corrective actions. With the help of the follow up activities they should direct and inform management in order to ensure that remedial action is taken. Boards of internal auditors in both of the banks have not established systematic follow up processes yet. But Bank X plans to establish a follow up system in near future to form an efficient following and monitoring system by the internal auditors.

In both of the banks, boards of internal auditors and internal control departments conduct similar work. They make similar examinations in the same branches or departments. In case of operational audits they conduct same types of engagements and their some examination topics are the same as those of the boards of internal auditors'. In Bank X, the only difference between the works of these two departments is that, internal control department conducts examinations subject based and within frequent periods; board of internal auditors conducts its work process based and within more extensive periods. This is a result of the lack of coordination between these departments.

In case of Bank Y, internal control coordination department does not conduct on site engagements in branches or head office departments, only conducts monitoring activities. But it conducts similar engagements in head office departments and branches. Board of internal auditors and internal control department should be in coordination with each other, since the board of internal auditors is the primary control and audit organ within banks it should arrange work of internal control

department, monitor and audit it. This has crucial importance in order to ensure efficiency and effectiveness in the use of bank resources.

In most of the banks in Turkey CAATs are not used, instead internal audit functions prefer traditional methods. On the other hand, in some of the banks ACL system is used.

In Turkey, most of the boards of internal auditors (especially the ones in public banks) do not engage in consulting activities. In most of the banks duties of the boards of internal auditors and internal control departments are not defined properly and there is lack of coordination between these departments. Also, it is thought that in most of the banks systematic follow up processes of the boards of internal auditors have not been developed properly yet.

#### **7.2.6 Reporting and Communication of Internal Audit Work**

Audit reports in both of the banks lack a ranking of the audit findings such as significant, major, minor, etc. and there is no link with the potential risks. As a result they contain much information that is not useful for the audit scope and purpose. It is suggested that for each issue there must be a recommendation by the board of internal auditors in order to overcome the problems arising, comply with the organization's policies and procedures and implement best practices. There should also be categorization of findings within the reports. Auditees must actively participate in this process, accept the recommendations and present an implementation plan and timeframe.

In both of the banks there are no formal and standardized channels of communication of the internal auditing departments with the other business units or partnerships of the bank. It is a practice that enables the timely identification of the problems. Adoption of written policies and procedures for the standardization of the communication lines between the board of internal auditors and the other business units and partnerships are suggested. There should also be periodic communication between the CEO, the Audit Committee and the CAE, so that concerns and

misunderstandings are discussed. This communication is essential in arriving at some congruence in direction in order to achieve sound corporate governance.

It is thought that in most of the banks in Turkey audit reports lack a ranking of the audit findings such as significant, major, minor, etc. and there is no link with the potential risks. Also, it is thought that in most of the banks formal and standardized channels of communication of the internal auditing departments with the other business units or partnerships of the bank are limited.

### **7.2.7 Relationships with External Auditors**

It is thought that there is not sufficient coordination between internal auditors and external auditors. Financial report matters are left to external auditors alone and internal auditors deal with compliance and operational audits. Financial report matters should not be left for the external audit alone. To be able to use the resources efficiently, it is important to coordinate the work of internal and external auditors.

Internal auditors should participate in the work of external auditors because they know the organization in more detail than the external auditors. Since the majority of the objectives and the goals of external auditors coincide with those of the internal auditors close coordination between those parties should be established by the CAE. Internal and external auditors should share information about their risk analysis, share their audit plans and risk models.

### **7.3 Contributions to the Literature**

As a result of the financial crises and corporate collapses that have experienced recently in the world, importance of corporate governance and internal auditing raised significantly in the prevention of the crises and minimizing their destabilizing effects. In the literature review part of this thesis some articles and research papers were observed. But a detailed study such as a doctoral dissertation about the role of internal auditing in corporate governance and internal audit applications of commercial banks could not be observed. So, this study will be a detailed and an important source which studies corporate governance and internal auditing issues

both in theoretical and practical sides from an analytical approach. It will be an important resource for the banks and for the people who deal with these issues.

#### **7.4 Implications for Future Research**

This study gives information about corporate governance, role of internal auditing in corporate governance and internal audit applications of commercial banks that operate in Turkish national banking system. Since this study has a wide scope, it is thought that corporate governance and internal auditing in banking sector can be studied separately.

Role of internal auditing in corporate governance can be studied for companies that operate in real sector. Also, studies about relationship between corporate governance and internal auditing can be conducted both in the banking sector and in the real sector. Corporate governance practices of companies that have internal audit departments with those that do not can be studied.

Another unexplored area is the effectiveness of internal audit activities. What does it contribute? Are there some solid measures that make contributions of internal audit more visible? Do the companies that have internal audit departments outperform than the others that do not?

#### **7.5 Limitations of the Study**

The topic of this study has a wide scope and in fact corporate governance and internal auditing includes separate studies. Since these two topics are complementary of each others, it is aimed to give information by not going into too much detail about these topics.

One of the most important limitations of this study was difficulty to obtain some important information in practical side. Also in theoretical side, it was difficult to pick related information about the thesis within a huge literature about corporate governance and internal auditing. Also some old documentation and information about the banks could not be obtained to make some comparisons and evaluations.

Also because of time limitations and limitations in banks' managers willing to cooperate and sharing of bank data, case studies were conducted in two commercial banks.

As a senior auditor who is working in the banking sector; performing, monitoring and evaluating some of the main issues mentioned in this thesis was much more advantageous compared to other researchers. It is thought that it would be much more difficult to obtain much of the information and conduct interviews by other researchers.

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## **Curriculum Vitae**

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