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Internal Auditing from a Regulatory Perspective in Turkish Capital Markets

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Abstract

In Turkey, the contribution of finance sector to the overall state of the economy is paramount. Thus regulation of this area is vital to have a fully functioning capital market. About this, regulators have imposed and introduced new rules concerning finance sector actors, and internal audit plays a significant part in the new regulations. The aim of this paper is to depict the role of internal audit in Turkish capital markets by comparing the internal audit structure of the main financial institutions. To be able to present the big picture; regulations concerning banks, intermediary institutions (also referred to as 'brokerage houses') and portfolio management companies are compared by using a conceptual and descriptive approach. According to the results of this endeavor, it is clear that banks have a more developed internal audit system when compared to brokerage houses and portfolio management companies in the sense that the latter is starting to resemble the former due to the rules imposed by the new regulation. Another finding is that internal audit regulations of Banking Regulation and Supervision Agency (BRSA) are more demanding about internal auditor competency as opposed to Capital Markets Board of Turkey (CMB) regulations concerning internal audit. As a result, the internal audit regulations concerning portfolio management companies are in need of improvement.

Keywords: Capital Markets, Financial Institutions, Regulation, Internal Audit

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1. Introduction

Turkish economy depends on several industries that act like pioneers and these are mainly construction, tourism and finance sector. The latter is especially important since it takes up significant place in creating employment and income. There is a 3.5 % increase in employment rate in finance sector when compared to previous years' data according to TBB

(2014) and has a production value of TRY1,276,270,147 (TUIK 2012).

Data mentioned above only show what is already known to finance sector actors: Capital markets act like the spinal cord of an economy. Globalization effect has caused capital markets all over the world to become integrated and as a result, majority of stock markets felt the effects of the recent global crisis. It is probable to say that financial institutions took the hardest blow in the crisis environment, thus the main changes in the regulation were made in the areas that concern financial institutions and capital markets. Internal audit took the lion's share during this phase; meaning that the majority of the changes made were in touch with the concepts of corporate governance, transparency and internal auditing.

The recent Istanbul International Finance Center (IFC) Project of the government echoes the significance of this sector as a part of a new brand to be introduced to world finance arena. Consequently, the magnitude of the role of finance sector for Turkish economy cannot be denied and because of that phenomenon internal audit in financial institutions should have a much active role than the one it is considered to have today.

2. Literature Review

Internal audit is one of the most important functions of an organization today, or the modern organization. Recent developments starting with the scandal of Enron involving Arthur Andersen have placed internal audit practices as well as financial auditing practices under the limelight. If we take a more global perspective there are numerous incidents in the field of finance that are borne from lack of proper, efficient internal audit mechanisms. The latest financial crisis provides living proof that internal audit and the regulations did not perform enough to prevent fallout, although Oţetea et al. (2013) argue that it was not possible to prevent that outcome with the efforts of internal audit. ACCA (2012) states a contradictory point in *Corporate Governance and the Credit Crunch*; lack of accountability in financial transactions and internal audit not being able to provide assurance for complex transactions and improper financial records simply make up the foundation for the recent global crisis.

Inevitably, the recent credit crunch and global crisis have brought attention of public towards internal audit in securities markets and investment firms acting in these markets (Zaharia, et al., 2014). Especially the capitalist system was under attack concerning its construction versus the lack of regulation (Hellwig, 2009). The aftermath of the crisis seems to affect finance sector the most, since both the unwanted attention of public and regulators are focused on the firms involved especially with the government aid aimed to "save" these institutions have made them greatly unpopular. "IFAC CEO Ian Ball reports, 'implementing governance, risk management, and internal control as integrated parts of [their] management systems" (Cain, 2013) has become the focal point in capital markets in the aftermath of the crisis.

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The importance of capital markets for Turkish economic system as well as the rest of the world cannot be denied in any way, thus internal audit in financial institutions should play a very active role. The recent global crisis could not have been prevented, but at least the effects could have been kept under control if internal audit departments of financial institutions had played a bigger role; meaning that internal auditors need to expand and improve their knowledge and skills, especially to gain insight of complex derivatives transactions, which by the way were the soft spot of the financial institutions that were caught in the midst of the crisis. The competency of the auditors employed in investment firms are in question, since internal audit is an area in which constant improvement of employee skills are considered as vital.

According to Alzeban and Gwilliam (2014), there are several factors that influence the effectiveness of internal audit and these are competence and size of internal audit departments, relationship between internal and external auditors, management support for internal audit and lastly, independence of internal audit. In order to have effective internal auditors perhaps competence and management support are more of a game changer in finance sector.

Since internal audit is a discipline that redefines itself on a continuous basis (Daniela and Attila, 2013), constantly improving employee skills is paramount. Protiviti Consulting periodically questions the capabilities of internal auditors and according to its latest survey, internal auditors in financial institutions are highly competent in data analysis tools for statistical analysis and data manipulation, CAATs, continuous auditing. However, ISO 27000, fraud risk assessment, ISO 14000, Basel II and ERM areas need improvement by these internal auditors (Marshall and Magliozzi, 2009). Derivatives transactions should be included in this list as well. The results of the survey indicate that internal auditors agree that there is room for improvement concerning skills and expertise. Eventually, internal auditors need to enhance their skills, especially to gain insight of complex derivatives transactions.

In relation to this, the Institute of Internal Auditors (IIA) has published a set of rules to be used in auditing finance sector (2013). Since internal audit plays a key role to prevent future crises from happening, these rules are developed to further improve the skills auditors need and to provide the auditors with the necessary tools in establishing a robust and fully knowledgeable internal audit function. These rules imply that, internal audit must be unrestricted in scope; in other words it should have access to every document and knowledge within the organization including values and strategic decisions. In addition to this, there should be a culture built with internal audit; current internal audit quality needs improvement which can only be achieved by having different skills as auditors and these items should be risk based or risks should incline the process of internal audit.

The general trend in the world concerning internal audit is that it develops with a top-down approach because - especially in Turkish financial institutions - internal audit developments are always imposed within a regulatory framework. The following section discusses the development of internal audit in Turkish financial institutions.

3. Internal Audit in Financial Institutions

Banks, brokerage houses and portfolio management companies make up the major actors in Turkish capital markets. In fact these three types of firms are defined as “Investment Institutions” according to the new Capital Market Law (CML), which became effective on 30th December 2012. Thus, in order to gain insight on internal audit in financial institutions in Turkey, these institutions are ideal to investigate, since

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regulations concerning these institutions are all newly updated (in 2014) and show influences from each other when compared.

There is confusion about the role of internal audit in Turkish financial institutions because of misguiding regulatory definitions. This is more prominent in brokerage houses and portfolio management companies. The official definition of internal audit is "the integrated process of both the internal control system and the inspection/surveillance system" (CMB, 2003), which undermines the role of internal audit to a department called "internal control". Internal control is recognized as a separate department in Turkey, instead of being a part of everyday work of all employees.

Article 21 of the Communiqué on Principles Regarding the Internal Auditing Systems of Brokerage Houses, in relatively small sized companies only one internal auditor is employed who is allowed perform both internal control and internal audit activities in the brokerage house. Because of this situation, most auditors in Brokerage Houses perform day to day controls alongside of "inspections" and the lack of audit committee simply causes a bad influence over the segregation of duties principle. It is not possible to audit the effectiveness and productivity of internal controls if the same person who performs the control also performs the audit over the same control process. This article greatly undermines the initial assumptions of internal audit (Munteanu and Zaharia, 2014).

3.1. Internal Audit in Banks

In Turkey, Banks are regulated by the Banking Regulation and Supervision Agency (BRSA). Accordingly, 'internal systems' of banks are designed in relation to BRSA regulations, even though Capital Markets Board (CMB) is designated to audit banks for operations concerning capital markets.

Internal audit activities of banks are supervised according to the "Regulation on the Internal Systems of Banks", effective since 11th July 2014. Article 2 states the basis of this regulation as "Articles 23(3), 24, 29, 30, 31, 32, 43, 45 and 93 of Banking Law dated 19th October 2005 and No. 5411". This regulation defines internal systems by including risk management to internal audit and internal control.

For Turkish Banks internal control system is defined as follows by Article 9.

The purpose of the internal control system is to ensure that the assets of the bank are protected, that its activities are conducted efficiently and effectively and in accordance with the Law and other applicable legislation, with the internal policies and rules of the bank, and with the established practices of banking, that the reliability and integrity of the accounting and financial reporting system is maintained, and that information is available in a timely manner.

Unlike the common practice in the U.S. and developed countries, internal controls are not a part of daily work flow; they are performed by a separate and independent department of internal control. Article 14 defines the context of internal control in banks as depicted below.

The internal control activities shall include as a minimum the following controls:

a) Control of actions to execute activities;

b) Control of the communication channels and information systems and the financial reporting system; and

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c) Compliance controls.

Again for banks, it is deemed as mandatory to establish an internal audit system that directly adheres to Board of Directors to ensure independence. This is the strictest regulation on internal audit due to imposing of an audit committee. Any other regulation, especially in the new Turkish Commercial Code No. 6102, which brings sophisticated rules concerning internal audit, does not require a mandatory audit committee.

Other articles of the regulation define the responsibilities of top management, audit committee, scope of internal controls, specifically for actions to activities, communication channels and information systems, financial reporting system and compliance controls, as well as the duties and authorities of internal control and internal audit personnel. This regulation is highly detailed and contains articles on audit methodology notwithstanding risk management and listing measurement methods including scenario analysis and stress testing.

3.2. Internal Audit in Brokerage Houses

Brokerage houses established in Turkey have to designate internal auditors and inspectors regarding the companies' scope. The framework of compliance activities for brokerage houses established in Turkey is drawn by CMB Communiqué Serial V, No. 68, called Communiqué on Principles Regarding the Internal Auditing Systems of Brokerage Houses and all employees of brokerage houses are expected to abide this regulation.

In order to ensure the objectivity of internal audit, CMB has included a special clause in Communiqué Serial V No 68 which states that internal auditor should refrain from performing duties that would cause conflict of interest or a specific disclosure to be featured in audit reports in such cases. Moreover, internal auditors are directly responsible and report to board of directors, which in turn evaluates the auditors performance and determine employee benefits. Thus, the independence of internal auditor is guaranteed.

Article 18- Inspectors shall not participate in any activity or be involved in any relationship that would impair the impartial conduct of their business and they shall refuse tasks and responsibilities that could impair the impartiality conduct of their business. During the inspection activities, if a condition that impairs objectivity arises, the inspector shall be obliged to inform the head of the inspection department about this case. Furthermore, in the course of any other activities in cases where a condition that impairs the objectivity of the inspector arises the inspector shall be required to disclose such conditions along with the results of the related task.

According to the CMB, "Brokerage houses shall establish, maintain and improve their internal audit systems in accordance with the organizational structure of the brokerage house in order to be able to cope in a sufficient, efficient and sound manner with the changing conditions of operations." The Internal audit system of a brokerage house consists of internal control system and inspection system.

The main purpose of an internal auditor employed in a brokerage house is to ensure compliance with related regulations. Under this context, there is a great difference between banks and brokerage houses that fall under the definition of intermediary institutions. This is due to different regulatory bodies that these institutions adhere to, in other words, banks are responsible to BRSA, while brokerage houses are responsible to CMB. However, CMB does have the authority to regulate and audit banks in their capital market activities, but regulationwise, banks' internal audit systems are regulated by BRSA.

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Communiqué Serial V, No. 68 on "Principles Regarding the Internal Auditing Systems of Brokerage Houses" is related to the core concept of this study. Purpose of this Communiqué states that establishing "internal auditing systems…would help [intermediary institutions] monitor and control all the risks that they are exposed to". Internal Audit system is defined as "the integrated process of both the internal control system and the inspection/surveillance system." All brokerage houses are required to form and maintain an internal audit system that is appropriate to its operations, size and trading volume. In addition to this, a member of Board of Directors should be appointed as responsible for internal audit matters, although the Communiqué does not mention a mandatory audit committee. The new Turkish Commercial Code also imposes a mandatory internal audit system for all joint-stock corporations, but audit committee is not deemed as compulsory. Article 12 clearly states that there are some additional requirements for employees to be appointed as internal auditors such as having an undergraduate degree, 3 years of job experience, and advanced CMB license.

3.3. Internal Audit in Portfolio Management Companies

It is mandatory for portfolio management companies to establish internal audit departments, similar to those of brokerage houses. Unlike banks and brokerage houses this is not regulated by a special communiqué; internal audit is regulated with the Communiqué on Portfolio Management Companies (CMB, 2014). Article 13 of aforementioned communiqué sets forth the rules to be imposed on internal audit.It is possible to say that internal audit in portfolio management companies is one level of institutionalization below of those in brokerage houses.

According to Communiqué on Portfolio Management Companies the following rules concerning internal audit must be obeyed.

• Internal audit department directly reports to board of directors, thus it is deemed to be independent. Audit committee is not mandatory in the new legislation, as it wasn't in the previous one.

• Auditors are required to present an audit report to board of directors after each fiscal period and there should be a board resolution about the reports.

• All auditors should have unrestricted access to all kinds of reports, documents and information.

The above stated items are mandatory for brokerage houses as well.

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4. Comparison of Internal Audit in Turkish Financial Institutions

In the previous sections, the foundations of internal audit in Turkish legislation were investigated. According to the results, there are similarities; however fundamental differences coexist with the similarities. First and foremost, the definition of internal audit differs in the regulations of banks and brokerage houses. The definition provided in BRSA regulation is broader in the sense that it includes risk management in the composition of "internal systems". The term "inspection" used in CMB regulation is rather old-fashioned and belongs to a previous era before the development of risk based approach in internal auditing. For portfolio management companies CMB regulation does not provide a general definition of internal audit.

Another important difference is that it is mandatory for banks to hold periodical meetings for audit committee, whereas for brokerage houses and portfolio management companies it is only advised.

CMB regulation makes it necessary to obtain Level 3 license (advanced level license in the previous regulation) for internal auditors, whereas in banks, there isn't a mandatory license for internal auditors.

Technological risks have become very important in today's world as financial services sector depends on technology more and more. Inevitably, significance of Information Technology (IT) audit has increased directly proportional to advances in technology and soaring risks (Stoel, et al., 2012). In Turkey, there are some rules imposed with CMB regulation on brokerage houses but these are limited in essence even though there is a resemblance of BRSA regulation which imposes COBIT standards.

Finally, preparing a risk based audit plan is mandatory for banks and brokerage houses, however for portfolio management companies there isn't a mandatory audit plan required, which puts internal audit in banks and brokerage houses in a more professional perspective.

The table given below summarizes the similar and different parts of internal audit in Turkish financial institutions.

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Table 1. Comparison of Financial Institutions

Banks	**Brokerage Houses**	**Portfolio Management Companies**
Internal audit is a subset under "Internal systems" definition.	Internal audit systems are a compiling approach to internal control and inspection.	No general definition exists.
Audit committee is mandatory.	Audit committee is not mandatory.	Audit committee is not mandatory.
No license requirement.	Internal auditors are required to have Level 3 CMB license.	Internal auditors are required to have Level 3 CMB license.
Risk based internal audit is imposed.	Risk based internal audit is imposed.	Internal audit is not risk based.
Risk management is a part of internal audit.	Risk management is not considered as a part of internal audit.	Risk management is not considered as a part of internal audit.
Internal control is a part of internal audit system.	Internal control is a part of internal audit system.	Internal control is not a part of internal audit system.
There is a specific regulation on IT audit.	There are specific clauses for IT controls.	No mentioning of IT audit & controls.
There is a 7 years of job experience requirement for internal control manager and internal audit manager.	3 years of experience in accounting, business, etc. is required.	3 years of experience in accounting, business, etc. is required.
Preparing an audit plan is mandatory.	Preparing an internal control program is mandatory.	Audit plan is not mentioned in the regulation.
Internal audit directly reports to board of directors.	Internal audit directly reports to board of directors.	Internal audit directly reports to board of directors.

5. Conclusion

Financial institutions make up the foundations of modern day economy and the basis of this is built on trust on both sides of the equation, which are institutions and consumers. Any disruption on the financial institution's side will damage the reputation of these institutions. Thus, having internal audit as an independent function is like insurance in financial markets. On the other hand, internal audit needs support from top management and regulators, since internal audit only develops with a top – down approach in Turkish financial institutions. If internal audit lacks the necessary tools and conditions, it is not fair to expect desirable results, thus regulators need to work with diligence in case of internal audit. Especially for brokerage houses, the regulation that enables one person to be employed for both internal control and internal audit departments should be revised with the influence of segregation of duties principle.

Another point is that internal audit system in portfolio management companies should be strengthened by imposing a mandatory risk based audit plan and specific IT audit or controls, since IT is a risky area

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where increased security measures are necessary. As a result, it is an obvious fact that banks in Turkey have a superior internal audit system when compared to brokerage houses and portfolio management companies. However, the new regulation has imposed some new rules which try to bring all financial institutions to a basic common ground. Unfortunately, this cannot be wholly achieved unless the definition of internal audit is not changed in regulation concerning brokerage houses. Even though the new rules promise a better future for internal audit in financial institutions, some perfection is deemed necessary.

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