Auditors in the financial meltdown: an examination

Aida Sy and Anthony M. Tinker

Abstract

Purpose – *This paper aims to investigate the financial crises and the role of auditors in those crises. The paper is concerned with the banking system, as the last financial crisis in 2008 was provoked by the mortgage business and the big banks and risks management.*

Design/methodology/approach – *The paper choses to use data from corporations, practices and professional websites. The authors use interviews that were available and related to the subject matter. Academic works are also used to discuss the literature review and various issues.*

Findings – *The paper explores the auditors' responsibilities and finds that there is a growing concern for auditing. This research is complex, as it discovers that corporate executives in the banking business should be more responsible; this is confirmed by the high risks in the financial area that still persists.*

Research limitations/implications – *This is a very complex topic; however, the authors designed it so that it can be read and used by non-accountants, that is to say, CEOs and governmental agencies that are in charge of the regulatory system. Further research studies are needed to ensure ongoing discussions about the financial crisis. The Word is not free from such bad economic events.*

Practical implications – *The contribution is important; this research can be used by organizations, governments and academics.*

Social implications – *The paper includes implications for the banking and auditing industries. It extends to the public interest.*

Originality/value – *This paper contributes to the literature for academic and can be used for teaching purposes. Students can understand the paper, as the authors did not use a regression model.*

Keywords *Financial crisis, Internal control, Banking industry, Risks management, SOX 2002*

Paper type *Research paper*

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Introduction

The paper investigates the role of auditors in the financial crisis. The last financial crisis in September 2008 occurred in the USA with the fall of the four Giants of Wall Street; Bear Stearns Failure - Toxic Assets; Lehman Brothers Bankruptcy; Merrill Lynch; American International Group, and had a global repercussion on the World Economy. (Yew *et al.*, 2007). The USA does business with the rest of the World and vice-versa. The nature of today's economy is international. 40 per cent of the investors in the US Financial Markets are foreigners; only 60 per cent are US investors. This research has an impact on an international level. (See IMF Report, 2009)[1] The nature of audit and auditing practices and theory is not limited to one or a group of countries but applies to economies. The Big accounting firms that conduct auditing have operations in all countries (developed, large economies and emerging countries as well as developing nations). The paper uses some statistics to support the argument (Figure 1).

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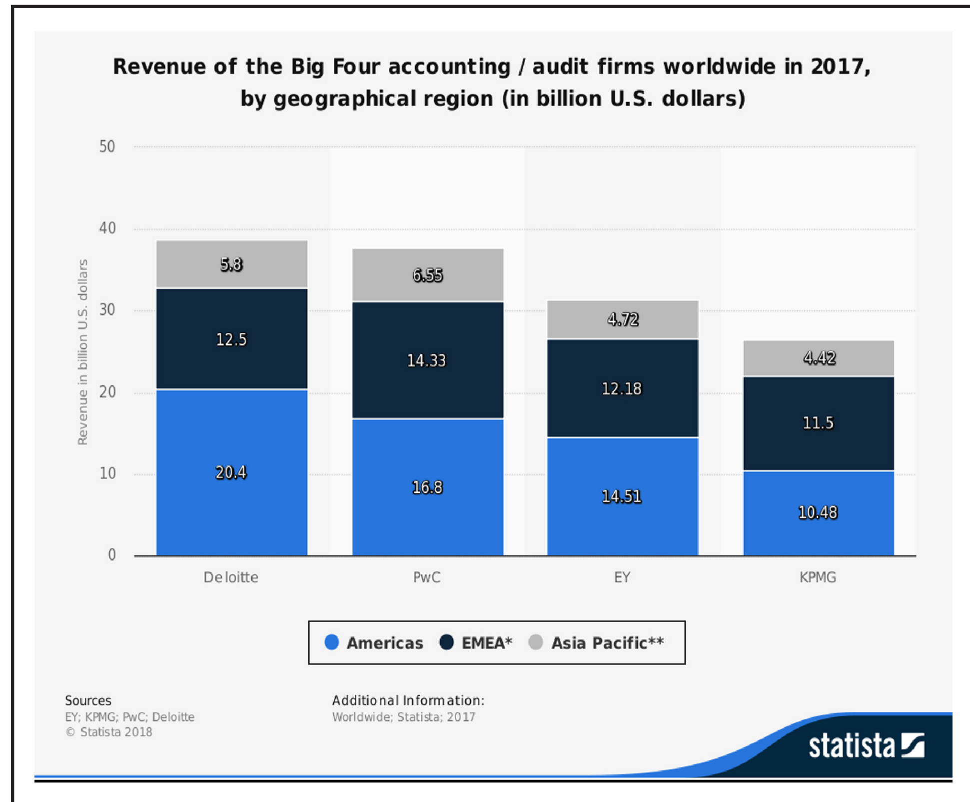
Figure 1 On big four accounting audit firms global operations



Part one: the culpability of auditors for the financial crisis

Section A: A complex subject matter to begin with

As the intricacy and size of business entities and markets increases, so too does the need for adequate auditing. However, the position of auditors in to-days era is unclear; there is no agreement as to the extent of the auditor's position. The numerous company scandals since the new millennium in addition to the recent financial crises have led to an increasingly difficult environment for both internal and external auditors. It goes without saying that the business world is facing a very complex issue. (Briloff, 1981; Gowan, 2009)

Section B: Meaning of the function of the auditors, responsibilities

Auditors play a vital position in understanding the financial position of a firm. The main obligation of the auditor is to examine data on a firm to discern the legitimacy of said evidence and determine whether or not financial data is fairly and accurately presented. In addition to reviewing financial statements and underlying firm processes, auditors must constantly be aware of the possibility of fraud. Should the misstatement of financial data be discovered, either because of fraud or error, it is the position of the auditor to disclose such data. (Briloff, 1972; Lindblom, 1984; Tinker, 1985; Okcabol and Tinker, 1993)

The auditor can also withdraw from an audit without offering any opinion under certain circumstances. Often, the audit process can become a complicated task that places many demands on the auditor. The auditor's job becomes even more challenging during times of financial collapse when there are significant time constraints and ethical pressures (AICPA, website, 2018).

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The issue of auditing has become even more vital in the wake of scandals and financial crises. Scandals like those of Enron and WorldCom shook the financial industry and their effects continue to impact standard-setting agencies and norms within the industry. Furthermore, the global economy is still recurring from a series of financial crises, particularly those in the USA and throughout Europe. (Briloff, 1981; Domanick, 1991; Carcello and Nagy, 2002; Romanus *et al.*, 2008; Cooper, 2008).

Auditors in today's era need to be concerned with adhering to all applicable standards, upholding the high standards of their position, and identifying possible problems in the business entities they audit. The auditor's position is even further tested as there is a difference between simply observing regulations and forming opinions that are based off actual business sense. The tasks of auditors are consistent worldwide both for internal and external auditors despite varying regulatory authorities (Sweeny and McGarry, 2011; Sy, 2017).

(This paper will identify the to-days responsibilities of auditors through examine of to-days literature, discuss the effectiveness of this position and provide suggestions for the future of the profession).

Section C: the external auditors

The position of the external auditor, in dealing with large public corporations, is complicated due to the nature of the profession. External auditors, although likely employed by an accounting firm, are ultimately hired by the audited firm. This unique relationship between auditor and management of the audited firm often places auditors in a delicate position. While auditors are legally required to perform an audit per standards released by various regulatory authorities, management tends to place pressure on the auditor to present findings in a favorable light. Additionally, regulations do not always coincide with practices that make sense from a business or accounting standpoint. This overlapping of legal responsibilities, client pressures and ethical implications creates the need for auditors to balance their position and prioritize actions taken (Okcabol and Tinker, 1993; Briloff, 1972; Tinker, 1985; Carcello and Nagy, 2002; Romanus *et al.*, 2008).

Section D: Going concern

One particular area that is relevant to the auditor's position during a financial collapses the issue of going concern. Given the extent of the recent financial in the USA, more warnings should have been identified by auditors in terms of the going concern qualification. The going concern qualification is applied to business entities whose viability as an entity is questionable looking forward no more than one year. This classification is determined by a number of financial metrics, such as liquidity measures and net income. Standards regarding going concern are very broad, considering there are no specific audit procedures to help identify going concern issues. Instead, it is expected than any going concern issues will be identified through the conducting of standard audit procedures (Venuti, 2004; Messier and Emby, 2005; Marshall *et al.*, 2008).

The auditor's opinion regarding going concern will consider the likely effectiveness of any plans management has developed to address going concern issues. Should the auditor feel management's plan is inadequate in addressing these issues, an explanation must be given as to the deficiencies? This explanatory paragraph is generally considered the final word concerning serious going concern issues.

Research conducted by Lindquist and Drogt following the 2008 financial collapses concluded that audit reports for eight business entities heavily involved in the collapse failed to include explanatory paragraphs regarding going concern. The study faults this emittance on the lack of regulatory guidance regarding for auditor's surrounding going concern and pressures from clients against any such going concern disclosures. Another

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possible explanation for the lack of going concern explanation is that the events leading up to the financial meltdown occurred so rapidly that issues were not clearly identifiable when the previous year's audit was conducted.

These findings are consistent with the idea that the auditor's position is often blurred and that there is much leeway in terms of which actions an auditor should take (Venuti, 2004; Davis, 2007; Lindquist and Drogt, 2008; Ernst & Young, 2013).

Section E: a growing problem for auditing and why?

Auditing has become a crucial aspect of markets due in large part to corporate scandals and widespread financial crises.

> As business entities and markets upsurge so is the demand for competent auditing. The place of auditors is unclear, there is no contract of the auditor's location. There have been many business collapses since the new period. The recent financial crises have led to a growing problematic for both internal and external auditors. (Briloff, 1981; Ghosh, 2017; Hitzel, 2013; Sy and Tinker, 2015)

Now having said that, here is what the Regulators provide business with.

Section F: the Sarbanes–Oxley Act of 2002; internal control over financial reporting; the public company accounting oversight board (PCAOB)

The Sarbanes–Oxley Act of 2002 (SOX) is an act passed by the USA Congress to protect investors from the possibility of fraudulent accounting activities by corporations. SOX mandated strict reforms to improve financial disclosures from corporations and prevent accounting fraud. On July 30, 2002 President Bush signed into law the SOX Act, named after Senator Paul Sarbanes and Representative Michael Oxley, who were its main architects, with the following comments:

> [...] and now with a tough new law we will act against those who have shaken confidence in our markets, using the full authority of government to expose corruption, punish wrongdoers and defend the right and interests of American workers and investors [...]

SOX was enacted in response to accounting scandals (mentioned in previous sections) and bankruptcies in the early 2000s, such as Enron, and WorldCom, Xerox, Sunbeam and others, which shook investor confidence in financial statements and required an overhaul of regulatory standards (The SOX Act, 2002, website, 2018) (AICPA, Website, 2018).

Today, tens of thousands of companies face the task of ensuring that their accounting operations are in compliance with the SOX Act. Auditing departments typically have a comprehensive external audit by a SOX compliance specialist performed to identify areas of risk first. Next, specialized software is installed that provides the "electronic paper trails" necessary to ensure SOX compliance. There are numerous SOX-Compliant ERP (Enterprise Resource Planning) Software systems available on the market and the top rated and reviewed among which are E2 Shop System, Intacct, NetSuite and more (The SOX Act, 2002, website, 2018; AICPA, Website, 2018; The CPA Journal, 2013; Hoffelder, 2012).

The SOX Act is arranged into 11 titles. The most important sections within these are considered to be 302, 401, 404, 409, 802 and 906. It contains two certification requirements, one under Section 302 and another under Section 906. The certification requirement applies to reports on Forms 10-K, 10-KSB, 10-Q, 10-QSB, 20-F and 40-F.

Sec. 302. Corporate responsibility for financial reports requires that CEO (Chief Executive Officer) and CFO (Chief Financial Officer) are directly responsible for accuracy, documentation and submission of all financial reports as well as the internal control structure to the SEC. It also implies that CEO and CFO must review all financial reports.

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Financial report must not contain any misrepresentations and information in the report must be "fairly presented" (The SOX Act, 2002, website, 2018) (AICPA, Website, 2018).

Sec. 401. Disclosures in periodic reports state that financial statements published by issuers are required to be accurate and presented in a manner that does not contain incorrect statements or admit to state material information. These financial statements shall also include all material off-balance sheet liabilities (liabilities that do not appear on the balance sheet), obligations and transactions (The SOX Act, 2002, website, 2018) (AICPA, Website, 2018).

Sec. 404. Management assessment of internal control is the most complicated, most contested, and most expensive section to implement of all the Sarbanes Oxley Act sections for compliance. All annual financial reports must include Internal Control Report which states management's responsibility for an "adequate" internal control structure, and its assessment of the control structure effectiveness. Any shortcomings in these controls must also be reported. In addition, registered external auditors must attest to the accuracy of the company management assertion that internal accounting controls are in place, and they are operational and effective (The SOX Act. 2002, website, 2018), (AICPA, Website, 2018).

Sec. 409. Real time issuer disclosures mandate that issuer make public disclosure of information on material changes in their financial condition or operations on an urgent basis.

Sec. 802. Criminal penalties for altering documents imposes penalties of fines and/or up to 20 years imprisonment for altering, destroying, mutilating, concealing, falsifying records, documents or tangible objects with intent obstruct, impede or influence a legal investigation.

Sec. 906. Corporate responsibility for financial reports addresses criminal penalties for certifying a misleading or fraudulent financial report. Under SOX 906, penalties can be upwards of $5m in fines and 20 years in prison (The SOX Act, website, 2018) (AICPA, Website, 2018).

Financial reporting responsibilities. Although there are many provisions in the legislation and subsequent regulations, three issues are of primary importance for accounting. These involve the financial reporting responsibilities of the Public Companies Accounting Oversight Board, corporations (including their boards of directors and managers) and external auditors.

The Public Companies Accounting Oversight Board and the PCAOB (www.pcaob.com) is responsible to report to the SEC, which appoints members of the Board. The Board has five full-time members. The Board establishes auditing standards for external audits of publicly traded companies and oversees the accounting firms that provide these audits. Accounting firms that provide external audits of companies that report to the SEC must register with the PCAOB and report information about their audit clients, audit fees, and the services provided to clients. As part of its oversight responsibilities for accounting firms, the PCAOB issues standards for accounting firms that provide guidance concerning auditor ethics and independence; supervision, hiring and development of audit personnel; and client acceptance and continuation. Also, the PCAOB is responsible for inspecting auditing firms to ensure their compliance with SOX regulations and professional auditing standards. The PCAOB is responsible for investigating potential violations of SOX regulations, rules of the Board and professional accounting standards. The Board may impose sanctions on accounting firms, including suspension from auditing public companies and civil penalties. The Board may refer these matters to the SEC and the Department of Justice for further legal action if it believes such action is needed (Briloff, 1981; Tinker, 1980; The SOX Act, website, 2018; AICPA, Website, 2018; SEC, website 2018).

Responsibilities of corporations. The SOX Act affects corporations that are required to report financial information to the SEC. These corporations must provide a certification from CEO and CFO along with their financial reports. The officers certify that the financial reports comply with the requirements of the Securities Exchange Act of 1934 and contain information that fairly presents, in all material respects, the financial condition and results of

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operations of the issuer. A company's balance sheet reports its financial condition, and its income statement and statement of cash flows report its results of operations. Consequently, the officers are required to confirm that a corporation's financial statements reliably represent its economic activities. These provisions affect a company's annual (10-K) and quarterly (10-Q) reports that must be filed with the SEC. A penalty for falsely certifying financial statements is a fine of up to $5m and imprisonment for up to 20 years (The SOX Act. 2002, website, 2018) (AICPA, Website, 2018).

SOX also effectively mandates that corporations create audit committees as part of their boards of directors. Members of the audit committee must be independent of corporate management, meaning that managers of a corporation cannot serve on the audit committee. The audit committee is responsible for selection, compensation, and oversight of a corporation's external auditor. Thus, the audit committee, rather than the corporate management, is the primary contact for a corporation's external auditor. The audit committee must include a member who is a financial expert. A financial expert is defined as someone who has an understanding of generally accepted accounting principles, internal controls, financial statements and audit committees and who has experience preparing, auditing, analyzing or evaluating financial statements. The audit committee must approve of any services provided by the external auditor, particularly those that are not directly related to the financial audit. These services must be disclosed in reports to the SEC. Corporation's financial reports must disclose all material off-balance sheet transactions and activities that have a material effect on the corporation's current or future financial condition. Off-balance sheet items usually involve obligations that do not fit the definition of liabilities that must be reported on the balance sheet. Corporations also must disclose on a rapid and current basis material changes in their financial conditions and operations. A corporation also must disclose whether it has a code of ethics for its top managers. Among other things, a code of ethics should promote honest behavior, accurate and timely disclosure of financial information, and compliance with laws and regulations. A corporation is required to make its code of ethics available to the public (The SOX Act, 2002, website, 2018) (AICPA, Website, 2018) (PCAOB, 2003, website 2018).

Responsibilities of external auditors. A corporation's external auditor must provide timely information to the audit committee about important accounting practices and policies adopted by corporate management and any discussion between the auditor and management about alternative practices or policies. Any disagreements between the auditor and management about these matters also must be disclosed to the audit committee. SOX prohibits external auditors to provide certain services to a client corporation.

These services include the following: bookkeeping or other services relating to the accounting records or financial statements of the audit client; financial information systems design and implementation; appraisal or evaluation services, fairness opinions or contribution-in-kind reports; actuarial services; internal audit outsourcing services; management functions or human resources; broker or dealer, investment advisor, or investment banking services; legal services and expert services unrelated to the audit; and any other service that the accounting board (PCAOB) determines, by regulation, is impermissible (PCAOB, 2003, website 2018; Wadee, 2011; Vuko and Berket, 2012; SOX Act, 2002; Mohammad and Owhoso, 2010).

The auditor must attest to and report on management's assessment of a corporation's internal controls. The auditor is responsible for examining the client firm's internal control system and verifying that the system is adequate to provide reasonable assurance of reliable financial reporting information. The auditor expresses an opinion concerning management's assertions about its internal control system. This opinion is based on the results of the auditor's assessment and appears in a report that accompanies the company's audited financial statements. This report is in addition to the auditor's attestation of the financial statements themselves. The external auditor must be independent of management in fact and appearance. As part of this requirement, SOX mandates that the

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CEO, CFO and CAO (Chief Accounting Officer) cannot have been employed by the company's external auditor during the one-year period preceding the audit. It is not uncommon for employees of audit firms to take positions with client corporations. SOX limits the ability of corporations to hire employees from their external audit firms. (Wadee, 2011; Vuko and Berket, 2012; PCAOB, 2003, website, 2018)

Part two: internal audit and the financial crisis: a focus on the banking system

Section A: important issues with internal audit

The financial and economic crisis showed the importance of a strong risk management process and the need of important changes in order to improve the risk management process in each bank and for the banking system as a whole. In the same time internal audit had to face new challenges as a result to the new context and the need to strength its support for the management in tailoring a more adequate risk management and internal control system (Carcello and Nagy, 2002; IIA, 2004; IIA, 2009; AII, 2011; Sy and Tinker, 2015; Ghosh, 2017).

In the process of the risk management improvement, internal auditors have their important role. Studies realized in different organizations analyzing the management perception on internal audit function have highlighted the fact that CEOs and CFOs in banks expect internal auditors to fulfill an active management supporting role, by contributing to the continuous improvement of the risk management and internal control system as well as the operational processes.

Internal audit function is very dynamic, and this characteristic is so evident and challenging in the credit institutions. Strategy, corporate governance and corporate risk are important responsibilities of the management and were considered, in many cases, "no go" areas for internal audit. The recent studies showed that weaknesses in these areas were the source of the present global financial crisis. It is important to mention that good practice dictates that independent assurance is needed in all these areas mentioned above and thereby they should be included in the internal audit plan (Carcello and Nagy, 2002; IIA, 2004; IIA, 2009; IIA, 2011; Sy and Tinker, 2015; Ghosh, 2017).

The financial crisis showed that the organizations, including credit institutions, have to reanalyze their risk management process, to identify the weak areas and take the needed measures for improving risk management process. Internal audit function must be implied in this process; its independent opinion and recommendations are, indeed, useful in strengthening the risk management process. Functions like internal audit, risk management and compliance must be improved based on the analysis and conclusions retained from the crisis lessons.

We argue that there is a need of changes in the banking sector and beyond as far as internal audit is concerned. This need is as vast as the financial crisis was gigantic.

Section B: skilled organizations, experts: analysis of their deductions and comebacks for the financial crisis

The financial and economic crisis's causes, evolutions and impacts were analyzed by important skilled organizations and experts. The inferences, corollaries and responses provided are very essential for the banks' professionals in their effort to improve corporate governance and better understand and mange risks. The authors consider useful to retain in the present paper the conclusions of some of these studies, based on which they built their analysis on banks. (Carcello and Nagy, 2002; Hoffelder, 2012; Sy and Tinker, 2015; Ghosh, 2017).

In June 2008, the Institute of International Finance (IIF) published its report on the Committee on Market Best Practice providing a set of principles of conduct and best practice recommendations for banks in the light of the financial crisis. In March 2009, at IIF request, Ernst & Young conducted a survey having as objective to assess the implementation stage for the IIF recommendations and to identify how the banks are responding to the Committee

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recommendations. The survey emphasizes very important conclusions that can be very useful, in our opinion, for the internal audit work. Ernst & Young report retains the following main deductions of the banks (Ernst & Young, 2009, p. 5; website, 2018).

Needing changes in governance and risk appetite, the role of the risk function, stress testing and risk transparency. Liquidity risk is also underlined by some banks.

The banks registering severe impact of the crisis started to work on radical changes. In the markets less affected by the crisis the banks learned from the problems else were and reviewed the controls.

The top issues amongst the UK, the US, Swiss, The Netherlands and German banks are in order: corporate governance and risk appetite, liquidity risk, culture and compensation, stress testing, valuation and transparency/quality of information.

The study shows that 92 per cent of the respondents indicated governance and risk appetite as the most important issues to work on. Another 77 per cent of respondents placed culture and compensation as a second priority in their reviewing process, this response being linked by the importance showed to the corporate governance and risk appetite.

During the year of 2009, KPMG issued its survey; KPMG's experts concluded that the significant weaknesses in banks' were (weaknesses in risk culture and governance; gaps in risk expertise at the non-executive Board level; lack of influence of the risk function; lack of responsibility and accountability of those on the front line; weakness in the way risk is measured and reported. (Hashagen *et al.*, 2009, p. 3; KPMG, 2009; website, 2018).

One can see that both studies from E&Y and KPMG have dealt with the same important issues. So the concern remains the same across the accounting profession. Therefore, these weaknesses found should be subject of analysis and improvements for the banks executives which also mean that the profession has the responsibility to determine internal audit assessment and implication in the improvement processes (E&Y, 2009; website, 2018 KPMG, 2009; website, 2018).

In 2009, OECD issued a report, "The Corporate Governance Lessons from the Financial Crisis", in which it stressed that important conclusions that must be subject of the debate and measure plans in many financial institutions (Grant, 2009, p. 1). Here are some of those conclusions:

- Financial crisis can be to an important extent attributed to failures and weaknesses in corporate governance arrangements which did not serve their purpose to safeguard against excessive risk taking in a number of financial services companies.
- Accounting standards and regulatory requirements have also proved insufficient in some areas.
- Remuneration systems have in a number of cases not been closely related to the strategy and risk appetite of the company and its longer term interests.
- The importance of qualified board oversight and robust risk management is not limited to financial institutions.

As a general conclusion (Grant, 2009, p. 1), "the current turmoil suggests a need for the OECD to re-examine the adequacy of its corporate governance principles in these key areas".

The authors believe that a solid internal audit function and an effective communication between internal audit, audit committee and board of directors could emphasize some of these weaknesses and make risk management more effective and coherent. Now, internal audit contribution must focus on the future developments of risk management process.

The financial crisis determined consistent feedback from the financial community. On December 2009, Basel Committee on Banking Supervision issued two new consultation

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papers with proposals for strengthening global capital and liquidity regulations with the goal of promoting a more resilient international banking sector[2]. These two papers together with the Basel II enhancement package issued in July 2009 will determine major changes in the banks' activity determining systems' changes and impacting the banks' profitability (see the following URL: https://en.wikipedia.org/wiki/Basel_Committee_on_Banking_Supervision).

All these new requirements will determine changes in the banks' risk management process, liquidity management inclusively. Internal audit will be asked to follow and assess all these new implementations to provide the assurance on the conformity and effectiveness of the implemented solutions.

Section C: further precisions of the banking industry and internal audit

The Basel Committee papers were assimilated in the banking regulations starting with 2006 and this update of the banking regulatory framework still continues. Many banks have adjusted their documents and supervision activity to the Basel Committee requirements. As a result of the Basel Committee documents and also the conclusions retained from the financial and economic crisis, those banks followed up by issuing new regulations increasing the requirements on risk management and compliance functions and increasing the internal auditors' responsibilities on assessing compliance and risk management functions and the internal control system as a whole.

The banks implemented, as a response to the Basel Committee papers, the specific requirements related to Pillar I and Pillar II. Years 2007-2009 were characterized by the effort to implement ICAAP in all banks. As a general remark, being an ongoing process, the implemented stress tests and scenarios were not very extended. It is important to mention that, till October 2009 the banks requirements on these issues were not very detailed being let at the banks' decision the depth and extension of the scenarios and stress tests (see the following URL: https://en.wikipedia.org/wiki/Basel_Committee_on_Banking_Supervision) (IIA, 2004) (Barfield *et al.*, 2009).

If we have a look on the banking industry in 2007-2008, we can conclude that a main characteristic was the banks' business extension in order to achieve the objectives regarding the increase of the market share. This period registered important increase in loans demand and granting for corporate clients and individuals. This increasing loan demand corroborated with the objective to increase the market share determined a "sale-driven approach" in the banking business, the prudential credit approach being more or less visible (see the following URL: https://en.wikipedia.org/wiki/Basel_Committee_on_Banking_Supervision) (Barfield *et al.*, 2009).

As a result of the crisis' impact on the economy, year 2009 registered in the banking sector an important depreciation of the credit portfolio quality in all the banks. The lending process decreased dramatically and with all the efforts of certain banks to reactivate the lending process in order to push the economy out of its decline the credit remained at very low levels. As noticed, the loan demand from companies continued to decline, this decrease was more pronounced for long term loans; however, the credit institutions anticipate a demand revival for short-term loans in Q2/2010. Risk perception rose for almost all the economy sectors. Small and micro-enterprises are still considered the riskiest companies, according to banks' opinion. For the household sector, the same study retains that loan demand for mortgage loans has returned to negative levels, while for consumer loans continued to grow. Banks anticipate an increasing demand for both types of loans in Q2/2010.

Internal audit in banking industry registered important qualitative developments in the last years but, important developments are still required. In 2007, the auditors' professional association has assimilated the IIA standards. In this context and in corroboration with the important changes in the banking regulations the internal function faced with important professional challenges, alignment to the IIA standards and professional best practices on

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one hand and ensuring the alignment to the strengthened requirements of banks and boards as a result of important risk management development projects including ICAAP on the other hand. Not less important, but necessary to be also emphasized, was the important effort of the internal audit teams to assimilate the group standards, being known that numerous foreign banks are operating in most countries. This "crystallization" process and maturation of the internal audit functions in banks still continues. An important problem facing internal audit teams in banks is the expertise and needed skills not only related to the internal audit work but in the same time related to banking business and specific risks management issues. In such context, the important role of internal audit to fulfill an active management supporting role, by contributing to the continuous improvement of the risk management and internal control system as well as the operational processes, was hard to be entirely reached (See the following URL: https://en.wikipedia.org/wiki/Basel_Committee_on_Banking_Supervision) (Barfield *et al.*, 2009).

Due to the important changes in the banking regulations needing rapid implementation and the existence of a certain automatism in internal audit field, the conformity issues covered important space in internal audit work, risk approach being evident in the banks with a more developed risk culture and support from the internal audit group level. Some "sensitive areas" as strategies, corporate governance and corporate risk remained "no go areas" or less detailed subjects in audit missions in some cases (See the Big 4 websites: KPMG, 2009, website, 2018, E&Y, 2099; web, 2018; Deloite & Touche, 2018; PWC, 2009, website, 2018).

A survey realized by PricewaterhouseCoopers, between 2004 and 2008, on internal auditors' activity and the evolution of the internal audit profession emphasized very interesting conclusions that can be considered valid for other economies too. The analysis performed in 2007 conduct to some important conclusions, as follows (Mihaileanu, 2009):

- One third of the respondents declared that they have vacant positions in internal audit departments, being not found adequate human resources in six month or more extended recruitment period.
- 74 per cent of the respondents appreciated as a medium and major risk the lack of qualified personnel, according with the present requirement for internal audit.
- 68 per cent of the respondents considered that the incapacity to anticipate risk in the business determine medium and major risk.
- The PricewaterhouseCoopers analysis emphasized also two other important conclusions related to the companies' risks (Mihaileanu, 2009).
- Lack of a monitor process of the way the company's long term objectives are achieved.
- Granting incentives not aligned to the long term objectives of the companies.

These two conclusions were confirmed by the Ernst & Young and KPMG surveys in 2009 (presented above). Other conclusion retained from the PricewaterhouseCoopers study is that internal audit function had not sufficient and adequate resources (See: KPMG, website, 2018; E&Y, website, 2018); PWC, website, 2018).

For many economies that were corned in the financial markets meltdown, the PricewaterhouseCoopers survey emphasized some traps for the companies in the crisis period:

- to reduce the budget for internal audit: "cheaper" personnel can affect the quality of internal audit activity; and
- performing an internal audit activity strictly on the compliance with local regulatory requirements will negatively impact at the strategic level.

The study presents the trends in internal audit activity on a wider horizon (till 2012) the most important being the changes in the risk management. Almost 90 per cent of the

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respondents indicated the risk management and governance to be predominant in the internal audit activity. Another important conclusion of the study is that for the moment, the internal audit work is focused on compliance and controls' management. For the next years, the internal audit work must register important changes focusing on the conduct of risk management activities.

It is important to notice that these conclusions are aligned to the surveys' outcomes mentioned in the previous chapter presenting the banks' priorities.

Further discussions. For the banking industry, the regulatory framework was very dynamic in the past years and more requirements on risk management field have surfaced. This implies for the internal audit work continuous and detailed work on compliance side. This compliance must be accomplished on two levels: compliance with national requirements and compliance with best practice. The same approach internal auditors must apply in their professional work to attain and remain aligned to the best practices.

The surveys' conclusions (presented in this paper), on the banking industry and for the audit as well, must be used in the internal audit work offering information on the following issues:

- the weaknesses identified in the banks' activities;
- the banks' priorities;
- the future developments in the regulatory banking requirements; and
- the best practices in the internal audit work regarding risk management process.

For the internal audit work on risk management area, there is an extended professional framework. The most important thing, in the authors' opinion, is the way internal auditors get the deep understanding of these recommendations and standards and how well they succeed to apply in their day-to-day work. The internal auditors must succeed to plan and run their work in the most adequate tailored approach so that to reach the most critical activities and systems in the risk management process, and to cover interrelated areas as risk management, decision-making process (strategy inclusively) and internal control system.

The authors of this research have attempted to emphasize, among other things, the role of internal audit function in banking industry in the aftermath financial and regulatory environment and to underline the most important aspects to be subject of the auditors' work. We argue that operating in this challenging environment and having to face new requirements, internal audit function has to adjust its objectives and to approach these objectives in a new perspective.

Section D: leverage risks banking

There is a time-honored banking maxim: "never borrow short to lend long". For banks, 'borrowing short' involves using low-cost, immediately withdrawable deposits. "Lending long" means committing to long-term, not-so-easily liquidated, high-risk, high-return investments. There is no problem provided the value of a bank's investment portfolio remains unimpaired. Indeed, problems diminish as long as asset-values inflate in inflationary times (or in a speculative bubble). So it was with the housing market for several years. Then, the high returns from a growing investment portfolio exceeded the cost of financing from cheap depositor funds. Depositor's remains safe as long as inflationary conditions pertain.

Deposits are the time-bomb on a bank's balance sheet. Their contractual status entitles them to repayment of principle, and payment of interest. Failure to comply with such payments authorizes depositors to sue for payment, and ultimately file for a winding-up/bankruptcy the delinquent bank.

Financial reporting supposedly provides the public with advanced warning of pending leverage risk. Accounting controls can be designed to block high-risk transactions and

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red-flag such transactions, if they occur. The paper explores how – and why – these safeguards were compromised, and the efficacy of the institutional restructuring aimed at resolving the current financial crisis. In previous sections, we showed the importance of SOX 2002; corporate governance was neglected by these executives which explained why the law insisted on assessment of management internal control over financial reporting.

Section E: accounting practices for disguising leverage

Leverage ratios and financial risk. Auditors firms are charged under the 1933-34 Securities Acts, and more recently, the SOX legislation of 2002, to certify the accounts of public quoted companies. This charge extends to assessing a firm's system of internal controls; including those of the banks that were selling sub-prime loans to poorly informed borrowers. Hence, SECURITIES AND EXCHANGE COMMISSION RELEASE NOS. 33-8238; 34-47986; IC-26068; File Nos. S7-40-02; S7-06-03] RIN 3235-AI66 and 3235-AI79 states:

"[. . .] the auditor is required to attest to management's assessment of internal control over financial reporting [. . .][3]".

Why did bank managers, auditors, and the regulators (SEC/PCAOB) fail to comply with this legal obligation? The root lies in the compromised circumstances of these institutions. Auditors are paid by the corporations they are required to audit[4]. Notwithstanding additional safeguards introduced by the 2002 SOX legislation, this basic contradiction remains in the form of pressure to 'please the client.'[5]

This willingness to accommodate the client was evident from the financial reporting practices of Enron, where the auditors (and regulators) allowed the firm to disguise its high-risk practices. The practice is known as 'off-balance-sheeting' the risk. The manner in which this was accomplished can be shown with a series of examples. Table I shows the Balance Sheet of a "normal" firm, with a tolerable risk profile.

Section F: risk management process in banks

How internal audit must adapt its approach in risk management process assessment. The authors of this research have already started dealing with the topic of risk in business and accounting. In this section we further investigate it. The effective management of risk is critical for the banks' survival. The risk management goal is to maximize the operational capability of the bank, ensuring an efficient use of resources, valuating the existing opportunities and maximizing the gain. To reach this goal, it is necessary to have a good and profound understanding of the existing risks, to implement an efficient internal control system to prevent or mitigate the risks. (Simmons, 2010)

Auditing risk management process is a very complex task for the internal auditors. In order to obtain consistent and reliable results from this mission, internal auditors must conduct their mission in a holistic approach over the risk management process. Punctual audits on different components of the risk management process are, in the authors' opinion, to be conducted:

Table I Normal Inc

ASSETS SB	*CLAIMS $B*
Investments 85	Equity 60
Cash 15	Deposits/Loans, etc. 40
Total 100	Total 100

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- at special requirements of the management;
- as a result of the new developments: there is a need of independent assessment of the effectiveness and compliance; and
- to periodically verify the capital adequacy computation as the regulation asks.

The universal (general) approach must be ensured even if for the planning purposes the audit mission on risk management process will be spitted on different components of the process. The auditors have the obligation to conduct a detailed documentation on risk management process implemented in the bank. On one hand the auditors should be committed to clear understand the regulatory requirements and best practice and on the other hand they must get a deep and clear understanding of the implemented process they are auditing. The internal auditors must obtain a strong and truthful understanding of the risk philosophy and risk models applied; of the risk appetite of the bank and to correlate such risks acceptance with the business strategy and the economic and financial environment the bank is operating in. The bank has the duty to ensure transparence on its risk appetite statement by presenting the total risk the bank is willing to take to achieve the strategic objectives and meet its obligations to stakeholders. This paper argues that a well-defined risk appetite is the starting point to adopting and implementing ERM in banks' business decisions, reporting and day-to-day business activities. So, internal auditors should have the commitment to start to work focused on these issues. The paper selects some, but not limited, of them. (Simmons, 2010):

- Current and forecasted risk profile (risk structure) and current and future risk management structure. In this respect internal auditors can evaluate the risk identification and assessment process (risk factors and reference parameters inclusively) and the early warning system implemented. It is very important to be implemented a consistent system of limits (alert limits inclusively) in accordance with the risk bearing capacity and risk philosophy adopted. Internal auditors should assess the effectiveness of this early warning system.
- The key risk indicators used in risk management and the reporting lines.
- The components of the risk management process, main participants, the characteristics of the risk information communication and the risk based decision process.
- The long-term capital management strategy; this strategy would include approaches regarding: defining long term capital targets, preferred capital structure, capital contingency plans and definition of roles and responsibilities of the units engaged in the capital management process and the approach towards transposing risk measures to capital requirements.

Risk management general approach implies correlations with corporate strategy, bank culture, corporate governance, management assessment of internal control over financial reporting and the management infrastructure, and it is based on internal and external risk identification, assessment and control. The universal approach of risk management implies the analysis of the correlation with the corporate governance and the bank culture. In the authors' opinion this correlation is not, a common approach and it is not, in general, subject of the internal auditors' work. The authors' documentation on internal audit functions activity reveal the fact that audits on corporate governance are performed just in few banks. Why? We believe that the reasons are: lack of imperative requirement in banks regulations, the "sensitive nature" of this audit, the lack of a documented statement on the bank corporate principles, lack of the auditors' experience and skills. (Simmons, 2010)

There must be a strong correlation between the business strategy of the bank and its risk strategy. This correlation must be, in the authors' opinion, one of the most important objectives in the audit mission. The business strategy reflects the objectives stated regarding the development of the business lines and the market shares, the level of assets,

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etc. In the current economic context, the business strategy must be based on consistent analysis of the macroeconomic and financial industry environment and being evident that alternative scenarios should be prepared. The objectives should reflect the key factors influencing the bank's activity and a careful assessment of the bank's potential in this context (COSO, 2009); (Chase-Jenkins *et al.*, 2008).

Risk management got an important role in the bank organization and ways of business conduct. There are strong relations between risk management, the business strategy (as already highlighted in previous sections), corporate governance and internal control system. In the authors' opinion, this correlation must be one major objective of the internal auditors' missions.

The risks' control and reporting is part of the internal control system and the linkage between internal control system and risk management process is very strong. The surveys' conclusions presented in the previous chapters showed important weaknesses in risk reporting. The internal auditor, having also the responsibility to offer annually its opinion on the adequacy of the internal control system and risk management, must in our opinion follow in his assessment this link and interface between internal control system and risk management (COSO, 2009) (Chase-Jenkins *et al.*, 2008).

In the new context and as a result of banks requirements, the internal auditors' periodical assessment on ICAAP is compulsory. ICAAP is an important component of risk management process, and it is very tide linked with corporate governance, business strategy, internal control system and shareholders' interests and expectations.

Section G: that audits are in high demand

Internal capital adequacy assessment process. Audit mission is very complex. This complexity, its novelty and importance of the mission's outcomes make the internal auditor task extremely difficult. Finalizing its mission, the auditor must give its assurance on the fact that the implemented ICAAP ensures:

- an appropriate identification and measurement of risks;
- an appropriate level of internal capital in relation to the bank's risk profile; and
- the application and further development of suitable risk management systems.

ICAAP consists of two basic areas: risk management and capital management. To limit ICAAP audit just to the assessment of the implemented procedures and capital adequacy calculus will not respond to the management expectations. The authors' opinion is that there must be a clear delimitation between the audits related to capital adequacy: periodical review of ICAAP and periodically audits of the outcomes of the capital adequacy computation:

In the audit of ICAAP, the scope is to offer an independent opinion on the conformity, completeness and effectiveness of ICAAP. Corporate governance issues are also followed in this audit. The auditor must give its assurance that the bank can meet its capital requirements at all times in a forward looking manner – including throughout a reasonably severe economic recession. The risk management and capital management processes and all the ICAAP components will be subjects of audit. The audits on the ICAAP must be performed annually;

In the second case, periodically audits of the outcomes of the capital adequacy computation, the auditors must give an assurance on the accuracy of the outcomes. This implies random checks on the accuracy and completeness of the data used in the computations of capital needs and also verifications, at random, on stress test calculations.

The periodically review of ICAAP is the responsibility of the management. The internal audit role is to present its assessments on ICAAP, identify the areas that must be improved and present recommendations for the needed improvements (Matten, 2008) (Liljestrom, 2008).

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In ICAAP audits it is important to have a clear understanding of the regulatory requirements. In this respect, the auditor must drive its audit following the principles established by the Committee of European Banking Supervisors (CEBS). All these principles are imbedded in the banking regulations, not as a list of principles but as requirements more or less explicit. In the authors' opinion the regulations must be understood and applied following the holistic approach of CEBS documents. (Matten, 2008); (Liljestrom, 2008)

There are also some important aspects, derived from the above mentioned principles, which must be investigated in ICAAP audit missions.

The senior management is responsible with defining the strategies and procedures for adherence to the capital requirements (defining the limits system) and for risk-based capital allocation. Internal auditor is asked to analyze these documents in order to give his assurance on compliance and adequacy aspects.

Adequacy of the risk profile of the bank. In defining the bank risk profile, it is necessary to select adequate risk indicators for the specification of the bank's risk structure and the indicators for most significant risks. The auditors must verify if the selected indicators are adequate, meaning in accordance with the bank's complexity, volume of activity and business characteristics. The actual risk profile must be analyzed in a forward looking approach, meaning the target risk structure. The analysis of the actual risk profile can emphasize risk concentration or imbalances between different risk types. The auditor has to highlight those aspects and follow the management reaction. The decided measures must conduct to the target risk structure. (Hashagen *et al.*, 2009)

If the proportionality principle is applied adequately. According with the CEBS's documents, there is no generally accepted definition of proportionality, and it is the bank's responsibility to assess the adequacy of its ICAAP methods, systems and processes. Based on indicators, the bank itself should identify the areas in which it should use more complex risk measurement and management methods, as well as the areas in which simpler methods can be used. The internal auditor must provide the assurance that the proportionality principle was applied in an accurate manner and as a result, the selected ICAAP methods, systems and processes are adequate (Demmerl, 2007); (Matten, 2008) (Liljestrom, 2008).

The ICAAP should not be treated as an isolated process but incorporated into the banks' strategic and operations management as a component of corporate management. The auditors must verify if ICAAP is really imbedded in the management process.

- If ICAAP ensure the assessment of all significant risks and the adequacy of the specific assessment procedures for all material risks.
- How is ensured the aggregation of risk at the bank level and group level.
- The reliance of the information provided by ICAAP and the way this information is used in risk based decisions.
- Each bank establishes the stress tests to be performed according with its complexity and nature of risks it is exposed to. The auditors must assess the adequacy of the stress tests performed and the reliability of the tests' results. The nature of the stress tests is determined by the complexity of the bank activity and the existing exposures to different risks and factors. It is also very important for the auditors to obtain the assurance that the stress tests and scenarios are adequate and their results are used in decision making process. The authors' investigation and analysis emphasize that the priorities for the banks must be.
- Developing the planning capital process based on a more consistent and detailed stress testing. This implies a detailed work to identify factors and variables to be used in the stress tests and a continuous analysis on the evolution of the economic and

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financial trends. Stress tests must use the key factors influencing the bank's activity and that can influence the bank's potential.

- Better define the risk appetite. This implies in the authors' opinion not just profound changes in the risk approach but also changes in the organization culture. This implies to move away from the "sales driven" culture and make everybody be aware of risks and focus on an explicit risk appetite and controlling that appetite. In the authors opinion internal auditor must verify if the risk appetite approved in the bank is based on the bank's bearing capacity.
- The type of risks considered in ICAAP should be extended.
- The scenarios should be better articulated and holistic.
- There should be focus on key econometric drivers.
- Development of IT dedicated tools for stress tests. These IT tools are compulsory in order to achieve the banks requirements on the extension of stress tests in order to improve ICAAP.
- Being aware of the necessity to adopt more advanced methods in the future. For the moment, many banks adopted mainly standard approach for credit and market risk and basic indicator approach for operational risk.
- Improved linkage between stress test outcomes and capital plan. All these aspects must be subject of internal auditors' assessment. Their opinion and recommendations are necessary to ensure the conformity to the NBR and best practice requirements and to improve the risk management process. (Matten, 2008); (Liljestrom, 2008)

Conclusion

The financial and economic crisis showed the importance of a strong risk management process and the need of important changes in order to improve the risk management process in each bank and for the banking system as a whole. At the same time, the financial crisis emphasized the importance of strong internal audit and compliance functions in each bank.

The race for profits and market share in the banking industry when the risks being assumed were, sometimes, poorly understood lead to errors in judgment and as a result to a sensitive credit portfolio in some banks. The lesson we all learned is that prudent risk taking in change for attractive returns is appropriate for the banking business. The price we are paying today for these sales-driven approaches and the bonuses paid based on the credit volumes seems to be very high.

Many of the weaknesses and issues revealed by the analysis and reports on the crises' sources relay on areas that internal audit has its own responsibilities on providing assurance: risk management and internal control system. How deep and tailored was the internal audit work in these areas and how much senior management took into consideration the internal audit alarm signals, if any, is very difficult to say. For sure, the internal audit function effectiveness must be analyzed in each bank, and the communication between internal audit, audit committee and top management must be improved.

Ensuring a strong internal audit function implies experience, skilled and trained people, with solid internal audit knowledge and deep understanding of the business, management mechanisms, risk issues and potential processes' vulnerabilities. In this respect, we will emphasize some of the authors' conclusions retained from their research in the banks, suggesting main areas of concern in internal audit work in the future:

- The authors believe that banks must allocate more time and resources in ERM implementation programs. Risk appetite must be a more developed and structured aspect in the banks' ERM programs. Defining risk appetite and risk tolerance must be

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in the authors' opinion a priority. Internal auditors must be implied in this process providing the assurance on the adequacy of the risk profile and risk strategy.

- The risk management process must take into consideration the fact that risks' action is interrelated and their consequences must be evaluated in this confluence. Risk travels through the bank in an interdependent and connected way. In this respect, risks must be recognized and managed holistically across the entire bank. It is very important for decision making on risk taking to aggregate individual risk from different part of the business into one common metric. The importance to have a common metric in place is emphasized by the confluence of risks events in the current financial crisis.
- In the same holistic manner, internal auditors must approach the risk management process. The auditors' responsibility is not limited to the reliability of the risk information on different types of risk in specific business lines and activities/units. The internal auditor task is also to assess the common metric of risks, if any, and the way management is using this information in the risk taking decision.
- The internal audit standards and the IIA paper on ERM audit represent an important and extended framework for internal audit work. In this respect, internal auditors' task is to apply this framework in a tailored manner responding to the specificity and complexity of the bank and to the management requirements. It depends on the internal auditors' skills, experience and implication in the bank life how accurate internal auditors will apply this framework. In the same time, continuous training and increasing expertise in complex domains as risk management, corporate governance, internal control system and strategies remain important goals for each internal auditor.

Even if compliance continue to remain an important part of the internal audit work, the authors consider that more objectives and internal audit activities must be planned and performed on risk management process and systems' effectiveness and adequacy. Internal audit work must focus more on strategies, policies and risk decision-taking.

Implementing IIA recommendations on ERM implies a deep understanding of the bank as a whole, a detailed knowledge of the existing business processes and their specific and significant risk monitor activities, risk reporting and risk based decision-making process. If the internal auditors' understanding will not reach this holistic approach and processes' correlation, their assessments and recommendations will continue to cover punctual processes and systems and their contribution to the risk management process improvement will continue to be limited. The executive management and supervision board members need support not just in improving different processes and systems but to make them work together in the same risk oriented approach.

An effective management of risk is critical for the bank's survival and internal auditors must be more implied in its improvement. In the same time, internal auditors must extend their mission on areas that, till, now here consider "too sensitive" as for example corporate governance, business and risk strategies. To better fulfill their role, internal auditors must benefit of a higher support from audit committee members. These committees have supervision responsibilities on the internal audit function but also can drive internal audit work on the most important areas ensuring the needed resource. The audit committee's members are in the same time board members and from this perspective they can focus the internal audit work on the activities and systems the board members are interested in.

Limitations and therefore needs of future research

In this paper, we attempt to deal with the financial crisis which started in the US context. We argue that because of the nature of business, that is to say, global economy, the impacts and damages of the US situation have been huge on other economies. So, we did more

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research as showed in the paper. However, business history shows that there will be future financial crises unless financial markets and banks are regulated at a global scale. That may or may be the case. Therefore, future research studies and continuation of this kind of research is needed.

Notes

1. Global Effects of the Recession. On January 28, 2009, the International Monetary Fund (IMF) updated its World Economic Outlook (available online at: www.imf.org/external/pubs/ft/weo/2009/update/01/index.htm), projecting that global economic growth, as measured by GDP, would be only 0.5 per cent in 2009. This represented a substantial reduction from an earlier IMF estimate and forecast the lowest growth rate since World War II. The graph below shows economic growth over the 2000-2009 period for advanced economies (the United States and major European countries), emerging and developing economies (China, India, Africa, and the Middle East), and the world (which is a weighted average of the advanced and the emerging economies).
2. The Basel Committee on Banking Supervision (BCBS) is a committee of banking supervisory authorities that was established by the central bank governors of the Group of Ten countries in 1975. It provides a forum for regular cooperation on banking supervisory matters. Its objective is to enhance understanding of key supervisory issues and improve the quality of banking supervision worldwide. The Committee frames guidelines and standards in different areas - some of the better known among them are the international standards on capital adequacy, the Core Principles for Effective Banking Supervision and the Concordat on cross-border banking supervision. The Committee's Secretariat is located at the Bank for International Settlements (BIS) in Basel, Switzerland. The Basel committee along with its sister organizations, the International Organization of Securities Commissions and International Association of Insurance Supervisors together make up the Joint Forum of international financial regulators.

   The present Chairman of the Committee is Stefan Ingles, Governor of the central bank of Sweden (Averages Risks Banking). William Coen is the current Secretary General of the Basel Committee.

   Member countries are: Committee members come from Argentina, Australia, Belgium, Brazil, Canada, China, France, Germany, Hong Kong SAR, India, Indonesia, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, Russia, Saudi Arabia, Singapore, South Africa, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States. The Committee's Secretariat is located at the Bank for International Settlements (BIS) in Basel, Switzerland. However, the BIS and the Basel Committee remain two distinct entities. (See the following URL: https://en.wikipedia.org/wiki/Basel_Committee_on_Banking_Supervision
3. Final Rule: Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, *SECURITIES AND EXCHANGE COMMISSION*, 17 CFR PARTS 210, 228, 229, 240, 249, 270 and 274, [RELEASE NOS. 33-8238; 34-47986; IC-26068; File Nos. S7-40-02; S7-06-03] RIN 3235-AI66 and 3235-AI79 MANAGEMENT'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND CERTIFICATION OF DISCLOSURE IN EXCHANGE ACT.
4. The system is akin to schoolchildren paying their teachers. If schoolchildren paid their teachers, all children would get A's. When auditors are paid by their client, the client is likely to receive a clean audit report.
5. For an accounting firm, the retention of a client is worth more than one year's audit fee. It is a series of fees –the present value of an annuity – plus any additional fees that may be extracted from the client by selling additional financial services. There are enormous pressures on audit partners to keep and please the client. Partners frequently received commissions for new business, and loss of income, and/or their jobs, if they lose a client.

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