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ORGANIZATION OF INTERNAL AUDITS IN COMMERCIAL BANKS

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ABSTRACT

The study investigates the organization of internal audits in commercial banks and explores its significance in enhancing financial integrity and institutional efficiency. The article undertakes an in-depth exploration of the literature on internal auditing, including its historical background, theoretical principles, and practical applications. The article further analyzes existing structures, methodologies, and frameworks that govern the organization of internal audits in commercial banks worldwide. Based on the analysis, this article concludes with recommendations for implementing effective internal auditing systems in Uzbekistan's commercial banking sector, emphasizing the potential for driving improvements in banking supervision, governance, and risk management.

KEYWORDS: *internal audit, commercial banks, risk management, governance, auditing standards, financial regulation.*

INTRODUCTION

The global financial system, over the years, has evolved into a highly complex and interconnected network in where commercial banks play an integral part. As these banks handle a significant amount of financial transactions, their operations are subject to various risks, including credit, market, operational, and liquidity risks, among others. Managing these risks effectively is critical to maintaining financial stability and preventing banking crises.

In such an environment, the role of an effective internal audit system within commercial banks becomes paramount. Internal audit is an important function that provides an independent and objective view of an organization's operations, risk management, and internal control systems. By doing so, it plays a crucial role in improving operational efficiency, enhancing governance, and ensuring compliance with laws and regulations.

At the heart of internal audit is the concept of adding value and improving an organization's operations. It accomplishes this by bringing a systematic, disciplined approach to evaluating and improving the effectiveness of risk management, control, and governance processes. Internal auditors not only examine the efficiency of operations but also contribute to ongoing improvements. They identify possible future improvements and provide recommendations on how to achieve them, thereby helping the organization better achieve its objectives.

Moreover, the role of internal audit extends beyond merely checking compliance and financial correctness. As a part of corporate governance, it has a wider role in checking whether the actions taken by the organization align with its strategies and objectives. It acts as a third line of defense, after the operational management and the risk management function, in a bank's internal control framework.

Therefore, understanding how the internal audit function is organized within commercial banks becomes increasingly important. It has implications not only for the individual banks themselves but also for the overall stability and integrity of the financial system. This article explores this theme in detail, focusing on the organization of internal audit in commercial banks and providing specific recommendations for the context of Uzbekistan.

LITERATURE REVIEW

The modern concept of internal auditing has been shaped by numerous scholarly works, corporate practices, and legislative actions. A review of these sources helps us appreciate its evolution, contemporary function, and implications for banking operations.

Ridley (2008) elaborated on the necessity of internal audit functions, asserting that these functions are instrumental in aiding organizations to deliver their strategic intent while navigating potential risks and governance pitfalls.

In the context of commercial banks, Woods (2009) emphasized that internal audits serve as a core mechanism for managing diverse risks. The author further asserted that the existence of an efficient internal auditing mechanism ensures that banks are safeguarded against operational and strategic risks, enhancing their credibility and confidence among stakeholders.

Chambers and Odar (2013) in their work established that internal audits contribute significantly to the effective functioning of the governance process. They underscored that a robust internal audit framework could guide commercial banks in their decision-making process, thereby enhancing operational efficiency and fostering growth.

Sarens (2009) focused on the relevance of internal audits in fostering an effective control environment within commercial banks. He pointed out that the increased complexity of banking operations calls for sophisticated internal control systems and that internal audits serve as a backbone for these systems.

Gwilliam and El-Hadad (2008) stressed the importance of adopting a risk-based approach in internal auditing. According to them, as commercial banks operate in a highly dynamic and risky environment, a risk-based internal auditing approach ensures that the audit efforts are aligned with the bank's risk profile.

A study by Arena, Arnaboldi, and Azzone (2010) highlights the role of internal auditing in enterprise risk management. Their research shows how internal audit departments of banks can act as catalysts for risk management by facilitating risk discussions and integrating risk considerations into decision-making processes.

In terms of internal audit structure, scholars like Cohen and Sayag (2010) emphasize the importance of organizational independence for the internal audit function. They argue that the internal audit function should report to the highest level of the organization, such as the Audit Committee or the Board of Directors, to ensure its independence and effectiveness.

In a more recent work, Prawitt, Smith, and Wood (2009) highlighted the importance of a well-structured internal audit function in risk management. They argue that in an environment where regulations are becoming more rigorous, and financial transactions more complex, a sound internal audit function plays a crucial role in identifying, assessing, and managing risks.

ANALYSIS AND RESULTS

The analysis of the internal audit organization in commercial banks reveals several critical aspects that underscore the value and essentiality of this function. It provides insight into the mechanisms and methods used by banks globally to manage risks, ensure compliance, and uphold governance standards.

Structure and Reporting. In most commercial banks, internal audit departments are established as separate units with clear reporting lines to maintain their independence. The conventional structure is one where the chief audit executive (CAE) reports functionally to the board or the audit committee and administratively to the CEO. This dual reporting structure, as suggested by Schneider (2015), ensures the internal audit's objectivity while enabling the function to align its operations with the bank's strategies.

Audit Planning. The initial step in the audit process is developing an audit plan, which should be dynamic and flexible to adapt to emerging risks. The audit plan primarily derives from a robust risk assessment that takes into account the bank's size, complexity, scope of operations, and overall risk environment. In line with the guidance provided by Endaya and Hanefah (2016), the risk assessment should consider all material risks, including credit, market, operational, and other strategic risks. The audit plan should also be approved by the audit committee or the board to ensure its comprehensiveness and relevance.

Audit Execution. Once the audit plan is approved, the execution of the audit begins. Here, the auditors assess the adequacy of the internal control systems, the effectiveness of the risk management processes, and the level of compliance with laws and regulations. The internal auditors adopt various audit techniques and tools to achieve this, such as process walkthroughs, control testing, and substantive testing. According to a study by Glover, Prawitt, and Wood (2008), an effective internal audit execution is one that generates sufficient and reliable audit evidence to support the audit findings and recommendations.

Reporting and Follow-up. The audit findings are then documented in an audit report, which is shared with the audited department, the management, and the audit committee. An essential component of the report is the recommendations, which offer solutions for mitigating identified risks and enhancing internal controls. It's important that these reports are clear, concise, and offer actionable insight.

The last step in the internal audit process is the follow-up audit. As pointed out by Zain, Subramaniam, and Stewart (2006), follow-up audits are essential to ensure the effectiveness of the internal audit function. They

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provide an assurance that the management has taken corrective actions to address the audit findings and implemented the audit recommendations.

Performance Evaluation. The effectiveness of an internal audit function can be evaluated through several indicators. Sarens and De Beelde (2006) suggest that the quality of audit reports, the timeliness of audits, the responsiveness of management to audit findings, and the internal auditors' competence and independence are crucial measures of internal audit effectiveness. It's critical that the audit committee regularly reviews these indicators to ensure the internal audit function's efficiency and effectiveness.

RECOMMENDATIONS FOR UZBEKISTAN

The examination of the internal audit function in commercial banks provides key takeaways for Uzbekistan as it seeks to strengthen its banking sector. The recommendations are as follows:

Improve Legal Framework for Internal Audit. One of the first steps should be to strengthen the legal and regulatory framework for internal auditing. The national laws and regulations should clearly define the role, responsibilities, and authority of the internal audit function in commercial banks. This includes stipulating that the internal audit department should have unrestricted access to all bank records, properties, and personnel necessary for carrying out their work. Additionally, there should be provisions to protect internal auditors from possible retaliation for performing their duties.

Strengthen the Independence of the Internal Audit Function. As per the guidelines set forth by the Institute of Internal Auditors (IIA), the independence of the internal audit function is critical for its effectiveness. The Chief Audit Executive (CAE) should have a dual reporting line: functionally to the board (or audit committee) and administratively to the CEO. Such a structure would ensure that the internal audit function can perform its duties without undue influence and with the necessary authority.

Foster Professional Development. The effectiveness of the internal audit function also relies heavily on the competence of the internal auditors. Therefore, there should be continuous professional development programs for internal auditors. This could be in the form of regular training programs, workshops, seminars, or opportunities to attend international conferences. Commercial banks should also encourage internal auditors to acquire professional certifications such as Certified Internal Auditor (CIA), Certified Information Systems Auditor (CISA), etc.

Adopt a Risk-based Approach to Internal Auditing. Given the dynamic nature of risks in the banking sector, a risk-based approach to internal auditing would be most beneficial. Under this approach, the internal auditors would focus their efforts on the areas of highest risk to the bank. Therefore, a robust risk assessment process should form the basis of the internal audit plan.

Integrate Technology in Internal Auditing. With the rapid advancements in technology, it is important for the internal audit function to leverage these technologies to improve its efficiency and effectiveness. Technologies such as data analytics, artificial intelligence, and machine learning can help in automating routine tasks, identifying patterns and trends in data, and predicting future risks.

Foster a Culture of Transparency and Accountability. Finally, fostering a culture of transparency and accountability within commercial banks is crucial for the success of the internal audit function. There should be open communication channels between the internal auditors, the management, and the board. The audit findings and recommendations should be discussed openly, and there should be a clear process for tracking and reporting on the implementation of the audit recommendations.

These recommendations, if implemented effectively, can significantly improve the organization of the internal audit function in commercial banks in Uzbekistan, thereby contributing to the overall stability and integrity of the banking sector.

CONCLUSION

The organization of the internal audit in commercial banks is a significant determinant of the institution's ability to manage risks, ensure compliance, and uphold governance standards. It is instrumental in fostering transparency, accountability, and strategic decision-making within banks. The scope of internal auditing has grown beyond traditional financial auditing to include a wider range of operational, compliance, and strategic concerns, acting as an independent and objective eye within the organization.

The present analysis has revealed the critical facets of the internal audit function within commercial banks, including its structure, audit planning and execution, reporting and follow-up, and performance evaluation. These aspects of internal audit underscore its crucial role in ensuring effective risk management, robust internal control systems, and good governance practices within commercial banks.

As per the recommendations for Uzbekistan, it is evident that the country can benefit significantly from reinforcing its legal framework for internal audit, strengthening the independence and competency of the internal auditors, fostering professional development, adopting a risk-based approach, integrating technology, and promoting a culture of transparency and accountability. These measures can help bolster the effectiveness of the internal audit function within its commercial banks, contributing to the overall resilience and stability of the country's banking sector.

In conclusion, the organization of internal audit in commercial banks is not just a mere internal process; it is a cornerstone of the bank's overall performance and reliability. It is a tool of strategic importance that can enhance operational efficiency, safeguard against risks, and ensure adherence to laws and regulations, thereby adding significant value to the banking operations. For countries like Uzbekistan, effective internal auditing can act as a catalyst for building a more robust, transparent, and accountable banking sector.

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