

# Extent of Adoption of External Auditor on Internal Control in Bank Auditing

Omer Ali Kamil<sup>a</sup>, Esraa Abdulsattar Ahmed<sup>b</sup>, <sup>a</sup>College of Business Economics, Al-Nahrain University, Baghdad, Iraq, <sup>b</sup>Ministry of Higher Education and Scientific Research, Baghdad, Iraq, Email: [omeraldoori7@gmail.com](mailto:omeraldoori7@gmail.com), [sarrw84@yahoo.com](mailto:sarrw84@yahoo.com)

This research is an attempt by researchers to prove and identify the extent of adoption of external auditor on internal control in bank auditing. Based on the fact that external audit is a complementary step for the internal audit function and internal control as a system in economic units in general and banks in particular. Therefore, the complementary step must be based on the work of the previous step, in order to achieve the research objective by confirming and diagnosing size and how the external auditor adopted to the internal audit process of banks by attempting to prove the research hypothesis which is embodied in the over reliance of external auditors on the internal control of banks through their audits, scientific results may contribute positively to this area.

**Key words:** *Internal Control, External Auditor, Internal Auditor, Managerial Control, Audit Standards.*

## Introduction and Methodology

The expansion of the professional services of the auditor is not a luxury service to customers, rather a result of changes in the working environment and the emergence of effective demand for these services. The conflict of interest between management, shareholders and external threats to banks and variables in their internal environment created the need for information of an appropriate and reliable financial and non-financial nature (Faisal, et.al., 2016; Hussain, 2018; Afzal, et al. Faisal, & Salman, 2019; Shabbir, Kassim, Faisal, Abbas, & Sabti, 2018; Shabbir, Shariff, Bin Yusof, Salman, & Hafeez, 2018)

Therefore, an effective system of internal control in banks is an important requirement by modern management, in order to ensure the rights of shareholders, investors, depositors and other relevant parties. This system helps to achieve the desired goals and exploit available resources to an optimal degree, maintain funds and ensure good investment.

The internal control assessment process can be considered as an important pillar which the auditor adopts when preparing audit programs, determining tests to be performed and studies that will determine the scope for applying audit procedures and selecting the target sample. The study and evaluation of the internal control of the economic unit and the subject of audit are one of the auditor's priorities, due to the fact that coherence and strength of the internal control system are a measure to be relied upon by the auditor when determining the size of the sample necessary to obtain the evidence and assertions necessary to form a final assessment of audited financial data. (Hussain et al., 2018; Imran et al., 2018; Iqbal, et. al. 2017; Ramli et al., 2018; Shabbir, 2009; Shabbir, et. al., , 2016; Shabbir, Shariff, & Shahzad, 2017)

This research attempts to examine the extent of the auditor's adoption of internal control when he is assigned the task of auditing banks. The auditor seeks, through evaluation of internal control, to determine the degree of dependence and the possibility of relying on it. In this light, basic tests are being planned - the most important of which is the determination of the size and form of the audit sample - which aims to ensure the fairness of the financial data and provide an audit assessment.

Perhaps the research problem can be summarised by the difficulty of determining the effectiveness of internal control and accurate evaluation in economic units in general and banks in particular, thereby branching out from the main problem to the following sub-problems:

- 1- How to determine the effectiveness of accounting control in the adoption of the auditor on the internal control system in bank audits .
- 2- How to determine the effectiveness of the internal audit in the adoption of the auditor on the internal control system in bank audits .
- 3- How to determine the effectiveness of internal control (settings) in the adoption of the auditor on the internal control system in bank audits .

The research is based on the assumption that the auditor adopts, to a large extent, internal control of bank audits, and branches out from this main hypothesis to the following sub-assumptions:

- 1- Accounting control is effective when the auditor adopts internal control in the auditing of banks.

- 2- Internal audit is effective when the auditor adopts the internal auditing of banks.
- 3- Internal control (settings) is effective when the auditor adopts internal control in the auditing of banks.

The research aim is to prove and determine the extent of the auditor's adoption of internal control in auditing banks through the following:

- 1- Proving and determining the extent of the auditor adoption of accounting control in auditing banks.
- 2- Proving and determining the extent of the auditor adoption of internal control in auditing banks.
- 3- Proving and determining the extent of the auditor adoption of internal control (settings) in auditing banks.

### **Auditor Effectiveness and Internal Control**

#### ***- Auditing, Auditor and Internal Control - Background Theory***

The audit is mainly aimed at providing a degree of adequate protection against two types of risks: firstly material errors and fraud that may be present in the financial data and secondly the possibility of not detecting the defect points in internal control, which affect the quantity of samples subject to auditing and control of the auditor who can be defined as the person who performs the audit and submits a report expressing his or her opinion on the financial data of the economic unit. The person conducting the audit is called "auditor", "checker", "accounts auditor" or "accounts checker" (Abdullah, 2004: 151).

The auditor's work summarises the work completed by an external organisation that is not affiliated with the management or ownership of the economic unit and aims at neutral reporting on the fairness of the financial data (Nazmi and Al-Azab, 2012, p. 25).

The auditor's work is also a type of audit carried out by an external party independent of all parties related to the financial statements. The main objective of this audit is to give a neutral technical opinion in which the auditor indicates whether the financial data provides a true, fair or accurate picture of all financial aspects of the facility's financial position and the results of its operations and cash flows (Althunibat, 2006, p. 34).

As far as banks are concerned, internal controls are regulations, policies, procedures and processes implemented by the board of directors and senior management of the bank to protect its assets, reduce or control risks and achieve bank objectives. Effective internal control may prevent or detect potential errors, fraud or non-compliance with bank policies.

Banks must also maintain an effective internal or external audit program to help detect any deficiencies in the bank's internal control (Federal Reserve Bank of Minneapolis: 2012).

External or general auditors are not part of the banking institution and therefore not a part of its internal control, but have an important impact on the quality of internal control through their audit activities, including discussions with management and recommendations for the development of internal control. External auditors provide important reverse feedback regarding the effectiveness of internal control (STATE BANK OF PAKISTAN: 2004: 11).

The Basel Committee on Banking Supervision has confirmed that strong internal controls, including the function of internal auditing, are on the one hand are part of an independent external audit which on the one hand stands on its own right, while on the other hand, is only part of effective corporate governance (Socol: 2011: 1).

#### ***- Effectiveness of External Auditor***

Auditor effectiveness is determined by ensuring that all financial operations have been recorded in accordance with generally accepted accounting rules and principles. The published financial data is identical to the data presented in records, and the auditor report certifies the fair representation of these data for the results of the business for a specific period and the financial position at a specific date, based on audit standards, professional ethics and adequate and appropriate evidence. The audit report reflects the extent to which this data is free from errors and distortions and contains a neutral technical opinion regarding the financial data prepared by administration.

While the audit profession offers its services to all parties, either within or outside of bank, these parties adopt various decisions based on the auditor report because it represents a neutral and independent technical assessment, which requires the auditor in preparation of the report to analyse and adhere to various criteria that must be available in the audit itself. Interest in transparency and credibility of economic units performance in general and banks in particular and their accountability has recently increased their newly developing in their role, which greatly demands that financial activities be scrutinized by the auditor in order to achieve the required degree of community confidence in their financial reports and reduce the expectation gap. (Hassan et al., 2016 ,P. 17 ).

#### ***- Threats Facing the Auditor***

There is no doubt that there are many principles that govern the work of the auditor, perhaps the most important being the auditor's independence, which obligates him or her to provide a realistic picture of the financial position of the economic unit and ensure that results work

so that all concerned parties can rely on and benefit from the data. Therefore, threats to the auditor's independence may be reflected through pressures or factors that might weaken his or her objectivity to be independent. So, the auditor has to overcome these challenges which can limit his or her independence. These factors can be grouped according to the below :

1. Factors related to the internal environment:

Summarised as follows: (Al.Matarna, 2009, p. 89)

- i. Nature of the task.
- ii. Audit Technology.
- iii. Communication system.
- iv. Leadership style and supervision.
- v. Customer satisfaction.
- vi. Tension towards client.

2. Factors related to the external environment

Is there direct or indirect financial interest with the audited economic unit, meaning that the auditor obtains a direct or indirect financial benefit as a result of providing audit, accounting or consultancy services that exceed, are less than or equal the expected percentage. These factors include auditors' audit fees, consultancy services provided and their impact on auditor independence. Consultancy services are defined as "those services performed by an efficient person or a specialised party with substantial independence and adequate qualification in the same service, and the services are provided at the request of the concerned party and in accordance with the limits set by the party that has the right to enter into and apply or reject this service". (Al.Ja'afra, 2008, pp. 35-36).

On the other hand, we find that the control environment is reflected in the public attitude, awareness and procedures of the Board of directors and Executive Management regarding the importance of control activities. The control environment also provides the required discipline and structure for all bank operations and activities, making it a feature that the auditor can use and exploit in the face of these challenges (Office of the Controller of the Currency: 2013:p.2),

***- Internal Control Inspection and Evaluation of Effectiveness***

The auditor should examine the financial and administrative systems of banks as well as their internal financial control and ensure their suitability to the bank's work and the preservation of its funds. By adopting an internal control audit, the auditor can determine the scope of the audit work to be performed. Accordingly, if the internal control system of the bank is found to be robust, the auditor can modify it, thereby reducing the scope of audit.



This means that the existence of strong internal control reflects the integrity of the business and the position of the bank (Jarbo, 2002, p. 155).

The auditor evaluates the mechanism of the internal audit section of the bank under investigation for the following reasons: (Mahmoud et al., 1994, p.99 )

The internal audit is part of the internal control system, which the auditor is obliged to evaluate.

The internal audit program prepared by the Internal Audit Department accurately assists the auditor in reducing the size of the sample being tested.

The internal auditor cooperates with the external auditor at certain stages of the examination process, which reduces time and effort.

Auditors must ask all banks, regardless of their size, to have an effective internal control system that is compatible with the nature, complexity, and risks of its activities both on-and off-balance-sheet that responds to changes in the bank's environment and circumstances.

In those cases where external auditors determine that the bank's internal control system is inadequate or ineffective for the bank's risk portfolio , they should take appropriate action towards rectifying it.

### ***- The Role of Auditor in Banks***

International auditing standards have been concerned with the role of bank auditors . The main objective of a bank audit is determined by the below :(International Standards on Auditing: 2018)

"Enable the auditor to express his or her opinion as to whether the financial data published by the bank give a real and fair image of the bank's financial position, and the results of its operations for the period in which this data is prepared".

Paragraph (24) of International Statement No. ( 1004 ) indicates that in order to configure an opinion on the financial data, the auditor seeks to obtain reasonable confirmation whether the information contained in the basic accounting records and other sources of information is reliable and sufficient to prepare the financial data , as that the auditor seeks to achieve this purpose through:

- Studying and evaluating the accounting system and the internal control system which they intend to adopt .
- Testomg the operation of controls to help determine the nature, extent and timing of other audit procedures.
- Conducting tests, inquiries and other procedures to verify the correctness of the accounting equations and account balances.

This statement is important in determining the role and responsibility of the auditor toward the examination of the internal control system of the audited bank, although it does not expressly refer to the auditor's obligation to be legally binding, which indicates the impact of internal control of economic units in general and banks in particular in conducting external audits both formally and objectively.

### The Research Hypothesis Test

To achieve the objectives of the research and test its hypotheses, a questionnaire was designed after referring to previous studies and forming a final sample approved for the purposes of research and analysis of (25) auditors, who were randomly selected.

- **Testing the First (1) Hypothesis:** (There is effectiveness of accounting control when the auditor depends on the internal control in bank auditing .

This hypothesis has been tested by adopting the resolution paragraphs (1) to (7), which are summarised in the responses of the research sample and analysed in Table (1) to show the extent to which the first hypothesis of the research is achieved :

**Table 1 :** Analysis of the effectiveness of accounting control in bank auditing

The results	Standard deviation	average	Strongly agree	Agreeable	Neutra l	Dis-	Totally disagreeable	The Gauge	Hypothesis (1) paragraphs
						agreeable			
Strongly agree	0.5	4.6	15	10	0	0	0	repetition	1
			60	40	0	0	0	rate	
Strongly agree	0.458	4.72	18	7	0	0	0	repetition	2
			72	28	0	0	0	Rate	
Strongly agree	0.614	4.72	20	3	2	0	0	repetition	3
			80	12	8	0	0	rate	
Strongly agree	0.737	4.28	11	10	4	0	0	repetition	4
			44	40	16	0	0	rate	
Strongly	0.637	4.36	11	12	2	0	0	repetition	5

agree			44	48	8	0	0	rate	
Agree	0.85	4.16	10	10	4	1	0	repetition	6
			40	40	16	4	0	rate	
Strongly agree	0.65	4.44	13	10	2	0	0	repetition	7
			52	40	8	0	0	rate	
Strongly agree	0.263	4.47	98	62	14	1	0	repetition	Axis result
			56	35.43	8	0.57	0	rate	

From the above data we discover that factors related to the effectiveness of accounting control in the bank audit process have a strong impact ratio from the point of view of the research sample, 91.43% of the sample population agrees and confirms the research hypothesis.

**- Testing the second (2) Hypothesis:** ( Internal bank auditing is effective when the auditor adopts the practice of internal control ).

This hypothesis has been tested by adopting the resolution paragraphs (1) to (7), which can be summarised in the responses to the research sample which have been analysed in Table (2) to show the extent to which the second research hypothesis is achieved :

**Table 2 :** Analysis of the effectiveness of internal audit in bank audits

The results	Standard deviation	Average	Strongly agree	Agreeable	Neutral	Dis-	Totally disagreeable	The Gauge	Hypothesis (2) paragraphs
						agreeable			
Strongly agree	0.764	4.4	13	10	1	1	0	repetition	1
			52	40	4	4	0	rate	
agree	0.666	4.12	7	14	4	0	0	repetition	2
			28	56	16	0	0	Rate	
agree	1.02	4.04	11	6	6	2	0	repetition	3
			44	24	24	8	0	rate	
agree	1.118	3.6	6	8	7	3	1	repetition	4
			24	32	28	12	4	rate	
Strongly agree	0.678	4.28	10	12	3	0	0	repetition	5
			40	48	12	0	0	rate	
agree	0.586	4.48	13	11	1	0	0	repetition	6
			52	44	4	0	0	rate	
agree	1.193	3.44	3	13	4	2	3	repetition	7
			12	52	16	8	12	rate	



agree	0.487	4.05	63	74	26	8	4	repetition	Axis result
			36	42.28	14.86	4.57	2.29	rate	

From the above table we find that the factors related to internal auditing effectiveness in the banking audit process have an important ratio effect ratio from the point of view of the research sample, 78.28 %of the sample population agrees with the research hypothesis, which confirms the second research hypothesis.

**- Testing the Third (3) Hypothesis:** (Internal control is effective (settings) when the auditor adopts the internal control process in bank auditing).

This hypothesis has been tested adopting resolution paragraphs (1) to (7), which can be summarised in the responses of the research samples and analysed in Table (3) to show the extent to which the third research hypothesis is achieved :

**Table 3:** Analysis of the effectiveness of internal control (settings) in bank auditing

The results	Standard deviation	average	Strongly agree	agreeable	neutral	Dis-	Totally disagreeable	The Gauge	Hypothesis (3) paragraphs
						agreeable			
Strongly agree	0.69	4.68	19	5	0	1	0	repetition	1
			76	20	0	4	0	rate	
Strongly agree	0.757	4.36	13	8	4	0	0	repetition	2
			52	32	16	0	0	Rate	
Strongly agree	0.757	4.36	12	11	1	1	0	repetition	3
			48	44	4	4	0	rate	
agree	0.862	4.08	7	15	2	0	1	repetition	4
			28	60	8	0	4	rate	
Strongly agree	0.764	4.2	10	10	5	0	0	repetition	5
			40	40	20	0	0	rate	
Strongly agree	0.866	4.4	13	11	0	0	1	repetition	6
			52	44	0	0	4	rate	
agree	1.166	3.88	8	11	3	1	2	Repetition	7
			40	44	12	4	8	rate	
Strongly agree	0.518	4.28	82	71	15	3	4	repetition	Axis result
			46.86	40.57	8.57	1.71	2.29	rate	

From the above table we find that factors related to internal control effectiveness in the banking audit process have an important ratio effect from the point of view of the

research sample, 87.43 % of the sample population agrees with the research hypothesis, which proves the third research hypothesis .

## Conclusions

Based on the above, the main findings of the research can be summarised as follows:

- 1- External auditors are not part of the banking corporation or their internal audit, otherwise they have an important impact on the quality of internal control because they provide significant feedback on their effectiveness, which – if effective = is considered to be a part of successful corporate governance, most importantly banks.
- 2- Recently the role and importance of external bank audits have increased due to growing interest in the transparency and credibility of their performance and accountability for financial results coinciding with their growing role in the economy, and to reduce the forecast gap in line with the development of international auditing standards.
- 3- The external auditor faces challenges and threats that affect the degree of his or her professional independence, which is the most important feature, some relating to the internal environment and others to the external environment. The auditor can take advantage of the internal control feature in facing these challenges and reducing their impact on external audits.
- 4- The repetition ratio for the first hypothesis test of the research was 56% strongly agree with an average of 4.47 strongly agreeing and a standard deviation of 0.263 strongly agreeing, which confirms to a large extent, the external auditor's adoption of accounting control.
- 5- The repetition ratio for the second hypothesis test of the research was 42.28 % agreeing with an average of 4.05 agreeing and a standard deviation of 0.487 agreeing, which confirms to a large extent, the external auditor's adoption, of internal audit within the internal control system in bank audits through the adoption of paragraphs and procedures in the details of audit work.
- 6- The repetition ratio for the third hypothesis test of the research was 46.86 % strongly agreeing with an average of 4.28 strongly agreeing and a standard deviation of 0.518 strongly agreeing, which confirms the external auditor's adoption, to a large extent, of internal control within the internal control system in bank audits through the adoption of paragraphs and procedures in the audit .



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