

Chapter 15

Internal Audit Structure and Fraud Risk Assessment From a Regulatory Perspective: An Insight Into the Turkish Financial Services Sector

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ABSTRACT

This chapter aims to depict the role of internal audit in Turkish capital markets by comparing the internal audit structure and its role in detecting fraud in financial institutions and developing a framework for assessing fraud risk in intermediary institutions. The newly constructed regulations concerning banks, intermediary institutions, and portfolio management companies are compared to a global benchmark by using a conceptual and descriptive approach. According to the results of this comparison, it is clear that Turkish legislation needs to be improved in critical areas. “Integrity” should be incorporated as a founding concept of the internal audit function. Certification of internal auditors needs to be encouraged, and internal audit standards need to be adapted. As a result, a fraud risk assessment template influenced by the new regulatory framework is developed for intermediary institutions.

INTRODUCTION

As generally acknowledged, the finance sector is the powerhouse of the economy on a global scale, and capital markets act like the spinal cord of the global economy. The reason behind the importance of financial sector is partly due to globalization effect, which has also caused financial markets all over the world to become integrated, and as a result, the majority of stock markets felt the effects of the 2008 crisis. It is possible to say that financial institutions took the hardest blow in the conjuncture after 2008. Thus, the main changes in the regulation were made in the areas that concern financial institutions and capital markets to address the public pressure in the aftermath of the crisis. The internal audit took the

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lion's share during this phase; meaning that the majority of the changes made were in touch with the concepts of fraud, corporate governance, transparency, and internal auditing.

With the influence of the events described above, fraud started to become more and more signified especially in financial markets. Fraud in capital markets results not only in financial loss for shareholders but has a more significant cost to the overall economy. Since it is not possible to single out a specific country from the world economy, an essential corporate loss can easily be signified in global financial markets.

Fraud risk is notably increased in economic downturns due to mounting financial pressure toward individuals. Most frequently committed fraud type is asset misappropriation, followed by corruption, although these fraud types are not very costly when compared to fraudulent reporting. The increasing fraud trend is living proof of deficiency in focusing on fraud risk. Mostly top management levels lack understanding of fraud risk and generally over trusting in employees cause a lapse in objective assessment concerning this issue. There have been many fraud cases affecting corporations and overall economy on a global scale. However, companies do not feel urged to take precautions if not pressured by government-imposed regulations. That is why increased regulation is a vital top-down approach to increasing awareness of fraud risk both for management and internal audit.

In Turkey, the contribution of the finance sector to the overall state of the economy is paramount. Thus regulation of this area is vital to have a fully functioning capital market. With the effects of recent developments in the global economy and public pressure; regulators have imposed and introduced new rules concerning finance sector actors, and internal audit plays a significant part in the new regulations. In addition to developments explained above a new venture of the government, called Istanbul International Finance Center Project, echoes the significance of this sector as a part of a new brand to be introduced to world finance arena. Consequently, the magnitude of the role of the financial sector for Turkish economy cannot be denied and because of that phenomenon, internal audit in financial institutions should have a much active role than the one it is considered to have today.

The primary objective of this chapter is to compare existing financial sector regulations and recent updates in these regulations to show the increasing importance of internal audit and fraud prevention and to develop a fraud risk assessment template for intermediary institutions as complementary to current legislation.

BACKGROUND

Internal audit acts like insurance against the pitfalls in corporations. Thus trustworthy internal audit departments are perceived as the go-to department for fraud related precautions and workflow. The structure and foundations of an internal audit department are crucial to success in the prevention of fraud. Thus, in this section, the internal audit structures in Turkish finance sector will be presented.

Internal Audit Structure and Foundations

Organizational governance demands management of all risks that the organization faces, securing efforts put in for reaching its ultimate goal of maximizing shareholder value. The importance of assurance services in this endeavor is signified in the Institute of Internal Auditors' (IIA) definition of governance: "The monitoring of organizational risks and the assurance that controls adequately mitigate those risks

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