

# The Impact of Global Financial Crisis on Internal Auditing Practices in Banks of Dubai Emirate

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## Abstract

This research aims to identify the impact of the global financial crisis on Auditing Practices in banks of Dubai Emirate, where it was addressed to the procedures and practices that are carried out by the Central Bank of United Arab Emirates for the Purposes of Supervision and control over the work of the banks. The research was conducted on a sample of two bank, (Dubai National Bank, and Dubai Commercial Bank). And through reviewing the annual reports issued by the two banks for the years during which the crisis occurred, results indicated that the global financial crisis had an impact on both the audit by the Central Bank or the Internal Audits. Where the focus increased on risky factors, also the Internal Audit Department in all banks became followed administratively to the Audit Committee, which is headed by one of the independent members of the Board of Directors.

**Keywords:** Global financial crisis, Auditing, Central Bank of U.A.

## Introduction

Banking officially began in the United Arab Emirates after opening a branch by the British Bank of the Middle East in Dubai in 1946, which was named “Imperial Bank of Iran”. The expansion in areas that have seen oil discoveries, in addition to the commercial ties that were deep linking India to Countries in the region lured foreign banks to open three more branches.

In light of this development, it was necessary to establish national banks to participate in the economic recovery and keep abreast of business developments, and the oil boom that made the state the focus of everyone’s attention and an attractive area for global banks. Therefore, Dubai National Bank, was established in 1963 to be the first national bank and Dubai Commercial Bank in the year 1969, in addition to many branches of foreign and Arab Banks. But now the number of banks operating in the United Arab Emirates is 47 banks, including 22 national banks and 25 foreign banks, mostly stationed in Dubai. All of these banks are subject to the instructions and Supervision of the central bank of United Arab Emirates. Where there is a competent department in the bank to control and inspection of banks entrusted with the responsibility of verifying and integrity of the conditions of financial institution, including local banks and branches of foreign banks and the offices of representation.

Since the banking sector in general is the most sensitive to the impact of financial crisis from other sectors, this research aims to shed light at the methods of audit and control that were imposed by the global financial crisis on auditing practices on the banking sector in Dubai Emirate, by both the central bank and internal auditing in the banks.

## Problem Statement and questions

This research determined the problem according to the following statement: “The causes and repercussion of the global financial crisis affected the strategies of audit and control exercised by the Central bank of U.A.E on the banks, as well as the internal audit and control procedures in those banks.”

## This problem will be discussed according to the following questions

- 1- To what extent Dubai banks were affected by the global financial crisis and its consequences?
- 2- What are the changes that have taken place on the international Standards on Auditing by the global financial crisis?
- 3- To what extent were the compliance of internal auditing departments in banks in Dubai Emirate, to the international standards for auditing?

## The research significance

The significance of this research stems from the great role of the banking sector in strengthening the national economy, and regulating the relationship between investors and the seekers for funding, and keeping deposits of the citizens safely. These tasks and others required the need to impose strict control over their practices in order to ensure the safety of the economy, and the preserve the money of depositors, and to meet the need of those who are in need of funding, especially as the global financial crisis has occurred in U.S. banks in the absence of Federal Reserve roles.

## Research objectives

This research aims to achieve the following purposes:

- 1- To identify changes in the regulatory strategies of the central Bank of U.A.E due to the global financial crisis.
- 2- To identify the suitability of such changes to International standards on Auditing issued to address the global financial crisis.
- 3- To clarify the response of banks operating in Dubai Emirate to implement internal auditing methods that are consistent with these changes.

## Research Methodology

This research was conducted according to the qualitative research approach, where the researcher collected the relevant data from the annual reports of two banks operating in Dubai Emirate in addition to the instructions of U.A.E Central Bank.

## Theoretical framework and Review of literature

### Causes of the global financial crisis:

Causes of the global financial crisis back to the beginnings of this millennium, according to (Cortey, 2008), the crisis began in the form of a bubble in the U.S. housing market. And this bubble began to grow, when the involvement of banks and mortgage brokers to the promotion and sale of mortgages in order to get the fees that are commensurate with the volume of mortgage that they gave. Banks earned large fees securitizing mortgages, selling them to capital markets in the form of mortgage backed securities and collateralized debt obligations, and servicing them after they were sold. The mortgages backed securities became a collateral for a new mortgage, which turned the crisis to become a credit crisis. Because of the darting in granting such loans, this darting to grant these loans, accompanied by an overestimation of the value of the collateral, and not to study and analyze the financial situation of the borrower, resulting in a large number of borrowers in danger of not being able to pay. This led to a sharp decrease in the banks liquidity, and all of that happened during the absence of the role of the Federal Reserve (Blundell et al, 2008). In order to avoid such situations, banks must be a subject for rigid control by the central banks, and the external auditor, or even the internal auditing department in the banks. In this regard, Al Sabaah (2009) pointed out that the reasons of the global financial crisis are:

- The weakness in controlling tools to some of financial transactions, especially those of investment banks and funds, mortgage corporations and insurance companies.
- The multiplicity of financial tools, and widen in loan's granting.
- The inefficiency of traditional tools of the monetary policy in affecting the basic monetary indicators such as, liquidity, credit, and the levels of interest rates.

The effects of the global financial crisis make adjustments to the decisions of the Basel I, in particular with regard to the control of banks. Basel II consists of three mutually supporting pillars, the second pillar:

*"Supervisory pillar allows supervisors to evaluate each bank's assessment of its own risks and to determine whether those assessments seem realistic. Eventually, each bank's management is responsible for assessing and reacting prudently to all of the risks that a bank faces, including those that might not be considered under the first pillar. The second pillar will therefore encourage a dialogue between banks and their supervisions on the nature of the risks that banks face and the measures they take to control them, including holding a side sufficient levels of capital. That dialogue creates great implicit incentives for management to undertake careful evaluations of the bank's capital needs."* (Kania, 2006, p.72)

For the United Arab Emirates, the main responsibility of the central Bank is formulation and implementation of banking, credit and monetary policies, to ensure the growth of the national economy of the UAE in a balanced manner.

The central Bank of UAE is also working to maintain a fixed exchange rate of the dirham against the U.S.dollar and to ensure the free convertibility of the national currency into foreign currencies, in addition to its role as "Bank of Banks" and the Government's bank and its financial adviser.

Supervisory methods of the Central Bank of United Arab Emirates during and after the Global Financial Crisis, the central Bank of UAE had Convinced during the occurrence of the global financial crisis to activate its role to protect the banking system in the state especially in order to preserve the national economy and the rights of shareholders and depositors, where the central Bank has formed a high professional team called the economic stability team (Al Jamous, 2014). Also the central bank of UAE imposed tougher restriction on lending operations, especially the real estate sector loans ([www.icn.com/an/article/2014/09/25](http://www.icn.com/an/article/2014/09/25)).

The central Bank's strategy to control the banking system in the state based on the following regulatory Programs to meet the global financial crisis consequences:

- 1- In its notice No. 4004/2009 which was issued to all banks in 30/8/2009 the Central Bank of the U.A.E issued the following instructions for the banks:

Based on the coordination between the Central Bank and the Ministry of Finance, and in view of the existing global financial crisis, which continue to adversely impact various economic sectors, hence require further prudence and caution, the Central bank decided as follow:

- 1- Banks should work towards increasing their capital adequacy to 11% latest by 30<sup>th</sup> September 2009, Tier-1 capital of which must not be less than 7%.
- 2- Banks must increase their capital adequacy once more to 12% latest by 30<sup>th</sup> June 2010, Tier-1 Capital of which must not be less than 8%.

These percentages shall be applied on a temporary basis and will be reexamined at the beginning of 2011, to determine whether or not to be continued (Central Bank web site).

Here, the researcher can conclude that the capital adequacy became a subject for auditing process by the central bank and auditors whether internal auditor or external auditors in order to verify that the banks have committed to apply the notice of Central Bank No. 4004/2009.

- 2- The implementation of Basel II Accord will be phased, with banks, expected be compliant with at least the standardized approach for Credit Risk by 31 December 2007. For the implementation of Basel II, the central Bank of U.A.E has issued the notice number 3735/2006 to all banks in 27/8/2006. And as a part of the strategic initiative to implement Basel II in the U.A.E, the central Bank of U.A.E has conducted a high level survey to solicit feedback from banks operating in the U.A.E, then the Central Bank of U.A.E with cooperation of external consultants conducted a comprehensive diagnostic review and Gap Analysis, in order to verify the status of Basel II readiness (Notice number 3735/2006). For auditing process in this regard, auditors must make sure that banks have conducted the risk analysis including the market risk and the customer when granting facilities.
- 3- Field visits to the banks by the control and supervision department of the Central Bank to make sure the banks implement the instructions of the central bank.
- 4- The establishment of a special unit to combat money laundering.
- 5- Banks must apply the rules of corporate governance.
- 6- Make sure of the durability of the internal control system in banks.
- 7- Checking on the adequacy of liquidity in banks – Data and Reports Required by the banks, for the Purpose. ([www.alqabas.com.kw/node/611355](http://www.alqabas.com.kw/node/611355)).

Data and Reports required by the banks, for the Purpose of control and supervision by the central Bank:

1. The central bank must be informed by banks if they want to change the general Manager or any of executive managers.
2. Detailed reports regarding any lawsuits instituted between the bank and other organizations contains the legal pronouncement and the rulings rendered in that regard.
3. The debts that the bank has written off where it shall include the customer's name, amount of debt, collateral, the basic reasons for writing off such debts and any other information that the bank believes necessary to list. Provided that it includes the Board of Directors or the Audit Committee's (or its equivalent in respect of foreign branches) resolution in that respect.
4. The information relating to the members of the Board of Directors, executive management and the committees that include members of the Board of Directors as members therein according to the enclosed specimens, on an annual basis or upon the occurrence of any amendments.
5. A semi-annual report of the following shareholders:
  - a- Nationals, and foreigners ownership and their ratio to capital.
  - b- Members of the Board of Directors, their representatives and the executive management's ownership where it shows the name, number of shares, percentage of ownership and nationality.
  - c- The ten largest shareholders ownership in the bank, including the name. Number of shares, percentage of ownership and nationality.
  - d- Shareholders who are holding (10) thousand shares or more, where it shows the name. Number of shares, percentage of the ownership and nationality.
  - e- The Bank's participation where it shows the bank's name, number of shares, percentage of ownership and the bank's nationality.
  - f- Ownership that is less than (10) thousand shares displaying the number of shareholders, amount, and percentage of ownership as a total.
6. Name of liaison officer responsible for providing all the Central Bank's requirements for all areas and the name of an alternate officer on an annual basis or upon the occurrence of any amendments.
7. The annual budget and the assumptions upon which it was based and the goals desired to be achieved, and this should be carried out annually by the end of January at the latest.
8. Detailed report clarifying the circumstances of any embezzlement. Forgery, theft, fraud or major shortage in the assets with and illustration of the procedures that the bank is taking to recover its

rights and to guarantee the non-recurrence of such issues in the future.  
([www.alittihod.ae/details.pnp?id.](http://www.alittihod.ae/details.pnp?id.))

### **Impact of the Global Financial Crisis on Internal Audit**

Internal audit can be defined as an independent, objective and consulting process, designed to raise the value of the work of any organization, and helps to achieve the organizational goals by applying the systematic approach and controlled to assess the effectiveness of risk assessment, and evaluation of monitoring activities and to improve those activities and procedures (Abdel-Mohsen, 2009).

The Institute of Internal Auditors (IIA) believes that the global financial crisis, affected the topics that require most focus of the internal auditors. The IIA foundation (IIAF) has conducted a survey in early march 2009.

The analysis of the survey showed the following results:

- 1- The global financial crisis has impacted not only the organizations, but also the internal audit activities in those organizations.
- 2- The focus of internal audit activities increased on the risk arising from changes in economic conditions.
- 3- The results indicate that the majority of respondents do not agree that good risk management can prevent the occurrence of the crisis, but they believe that internal audit is the most capable in this area.
- 4- The concentrations of internal audit affected by the changes in stakeholder's needs and expectations (the institute of internal Auditors, 2009).

Therefore, the activity of internal audit has become more focused on assessing the potential risks of banking operations, which consists of the following risks:

- Financial risks.
- Operational risks.
- Compliance risks.
- Credit risks.
- Liquidity risks.
- Effectiveness of risk management
- Expose the bank to deal with parties suffer from financial distress.
- Cost/expense reduction or containment.
- Model/Valuation validation.
- Reputational risks.

For U.A.E banks, the corporate governance rules has focused on the tasks and goals of the Internal Audit (Bahaar and khatib, 2007).

### **The internal control environment, that consists of**

- (1) Internal Control systems, which consists of the following:
  - The frame of internal control system must be assessed by the internal and external auditors once a year at least.
  - The annual report of banks must include, a report about the efficiency degree of internal control system, on Financial reporting such as disclosure of weaknesses in internal control systems, the responsibility of executive management for development of control systems, on financial reporting.
  - The banks has to develop procedures to allow staff from reporting, secretly and timely, the existence of concerns about the possibility of anomalies and that is to allow verification of these concerns, and the Audit committee must be responsible to follow-up the implementation of these actions.
- (2) Internal auditing:

In order to activate the role of internal audit department, the bank's management must pay more attention to the following tasks:

- The bank should recruit and employ a sufficient number of qualified staff to work in the audit department, and the bank must provide them by the sufficient training and rewards.
- The internal audit department has the right to obtain any information, and contact any staff member.
- Full powers must be given to the department of internal audit to enable it to perform its duties as required.
- The bank should document the responsibilities, powers and functions of the department of internal audit within the Internal Audit Charter adopted by the Board of Directors, and circulated within the bank.
- Internal audit reports will be sent to the chairman of the Audit Committee.

- Internal audit staff, must not, perform any operational responsibilities.
- The internal audit department implements its duties without any external intervention.
- Primary responsibility for the management of internal audit – which should be based on risk – includes at least the following:
  - Operations of financial reporting in the bank, to make sure that key information about financial matters, administrative and operations are available where precision, reliability and timeliness.
  - Compliance with the bank's internal policies, standards and international procedures, laws and regulations relevant (Abdelnabi, 2014).

### **Data Collection**

As mentioned earlier, this study is based on the verification of the commitment of the Dubai Emirate banks, to the requirements of internal audit, established by the Basel and adopted by the Central Bank of U.A.E. through a case study of two banks.

For the National Bank of Dubai, has created a committee called Board Audit Committee, chaired by an independent member of the Board of Directors. And the internal audit reports to the chairman of the committee. Internal auditors also became very much concentrating on making sure of risk that result from banking operations. Particularly in the area of finance, as the valuation of the guarantees provided by the borrower became a subject for risk analysis. (National Bank of Dubai, Annual report of 2008).

And through reviewing the annual report of Dubai Commercial Bank the researcher found that it perform the same procedures.

### **Recommendations**

This study presents the following recommendations:

- 1- Banks should get out of the traditional framework of the audit process designed to detect errors.
- 2- Banks should adjust their instructions to comply with the new requirements.
- 3- The executive management should not interfere in the work of the auditor to maintain independence.
- 4- New releases by Basel Committee and other relevant bodies must be followed by the bank.