

# **The Development of Internal Auditing at the Central Bank of Malta: A Study**

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# Abstract

**TITLE:** The Development of Internal Auditing at the Central Bank of Malta: A Study

**PURPOSE:** The main objectives of the study are to assess how the operational structure of the IAF at the CBM has developed over the years, to assess how the different exercises carried out by the IAF have changed since the inception of the Bank, and to examine how the approach to such different exercises has also changed over the years.

**DESIGN:** This study adopted a qualitative mixed-method approach to ascertain the achievement of these objectives. Semi-structured interviews were carried out with six participants encompassing both current and ex-IAF employees in various hierarchical positions. These were then backed up by an analysis of the CBM Annual Reports and any available unpublished internal audit documentation.

**FINDINGS:** The findings indicate that the objectives of the IAF have remained mostly unchanged over the years except for being broadened to enhance organisational value. Furthermore, stakeholder perceptions of the Function improved from being negative and invasive to being generally respectful. Notably, audits had to decrease in number over the years as most audits had become weightier, laborious, and time-consuming. Staff turnover started to decrease when more emphasis was placed on staff development and training. Moreover, over time quality increased significantly, with more focus being placed on objectivity, integrity, qualifications, and other competencies. Audit exercises have varied and widened in scope, with the Function evolving from one only carrying out checks of detailed transactions to one providing well-planned assurance/consultancy services. Also, the introduction and later refinement of risk-based auditing transformed the audit approach from a closed one to one which is open, transparent, and more democratic.

**CONCLUSIONS:** This study concludes that the IAF has gone through notable advancements in various stages over the last twenty years, mainly in terms of its operational structure, internal audit exercises and internal audit approach. In particular, the historical milestones identified as spurring such stages may also be found relevant in the future development of the IAF.

**IMPLICATIONS:** This study raises awareness on the developmental stages the IAF at the CBM had to go through to become an appreciated and value-adding function. It is hoped that the recommendations provided allow the function to improve further and develop so that it can enhance its importance within the CBM. Furthermore, the vicissitudes of the IAF history, to date, may also serve to help the IAFs of other financial institutions.

**KEYWORDS:** Development, Internal Auditing, Central Bank of Malta, Malta

**LIBRARY REFERENCE:** 20MACC048

## Dedication

*To my family  
for their continuous support, guidance  
and encouragement*

# Acknowledgements

Firstly, I would like to express my heartfelt appreciation to everyone who motivated and supported me throughout the course of this study.

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# Table of Contents

Abstract .....	ii
Dedication .....	iii
Acknowledgements .....	iv
Table of Contents .....	v
List of Figures .....	x
List of Tables .....	x
List of Abbreviations .....	xi

## Chapter 1: Introduction

1.1 Introduction .....	2
1.2 Background to the Study .....	2
1.2.1 The emergence of internal auditing.....	2
1.2.2 Defining internal auditing.....	2
1.2.3 IA as a profession .....	3
1.2.4 Brief history of the Central Bank of Malta.....	5
1.3 Need for the Study .....	6
1.4 Research Objectives.....	7
1.5 Scope and Limitations .....	7
1.6 Overview of the Study.....	7

## Chapter 2: Literature Review

2.1 Introduction .....	11
2.2 The Operational Structure of the IAF.....	13
2.2.1 Support, significance and dependence .....	13
2.2.2 IAor qualities .....	13

2.2.3	Reporting lines of the IAF .....	15
2.2.4	The IAF as a management training ground.....	16
2.3	The Development of Internal Audit Exercises over the years.....	16
2.3.1	Early days of IA development .....	16
2.3.2	IA development between 1941 and 1980.....	17
2.3.3	IA development between 1980 and 2000.....	17
2.3.4	IA development from 2000 till present day.....	18
2.3.5	Adding value through the types of exercises .....	19
2.4	The Different Approaches to IA over time.....	20
2.5	Conclusion .....	22

### **Chapter 3: Research Methodology**

3.1	Introduction .....	24
3.2	Preliminary Secondary Research .....	26
3.3	Research Design .....	26
3.4	Research Tool .....	27
3.5	Research Participants.....	29
3.6	Data Collection .....	30
3.6.1	Secondary data collection .....	31
3.6.2	Primary data collection.....	31
3.7	Data Analysis.....	32
3.7.1	Qualitative data analysis .....	32
3.7.2	Quantitative data analysis .....	32
3.8	Research Limitations .....	32
3.9	Conclusion .....	33

## Chapter 4: Research Findings

4.1	Introduction .....	35
4.2	Operational Structure.....	37
4.2.1	Establishment of the IAF .....	37
4.2.2	Internal audit Charter and Manual.....	37
4.2.3	Objectives of the IAF.....	38
4.2.4	Dependence and importance of the IAF .....	38
4.2.5	Significance, support and reliance towards the IAF .....	39
4.2.6	Composition of the IAF.....	41
4.2.7	Qualities of internal audit and their enhancement.....	42
4.2.8	The changing reporting lines of the IAF .....	44
4.3	Types and Scope of Internal Audit Exercises .....	44
4.3.1	Types and mix of audit and consultancy exercises.....	45
4.3.2	Relative importance of different exercises over time .....	46
4.3.3	Adding value through the types of exercises .....	47
4.4	Audit Approach .....	48
4.4.1	Audit approach steps .....	49
4.4.2	Involvement of various IAors in the audit process.....	50
4.4.3	The mix of verbal and written communications .....	51
4.4.4	The restructuring of the IAF .....	52
4.4.5	The establishment of the AC.....	53
4.4.6	Introduction to a risk-based auditing approach .....	54
4.4.7	Adherence to the IIA Standards .....	55
4.4.8	Reporting follow-ups over the years.....	56
4.4.9	Extent of influence from feedback.....	57
4.4.10	Extent of influence from EU IAors and European Institutions .....	58
4.5	Conclusion .....	58



## Chapter 5: Discussion

5.1	Introduction .....	60
5.2	The Major Milestones in the Development of the IAF .....	62
5.3	Stage 1 Infancy (1970 – 1997): A slow start.....	64
5.3.1	Operational structure: Why so little development?.....	64
5.3.2	Internal audit exercises: Too limited in scope? .....	66
5.3.3	Internal audit approach: Too time-consuming?.....	67
5.4	Stage 2 Childhood (1998 – 2002): Growth begins.....	67
5.4.1	Operational structure: Improved links with stakeholders?.....	68
5.4.2	Internal audit exercises: Wider and varied? .....	68
5.4.3	Internal audit approach: Was it enough to introduce testing? .....	69
5.5	Stage 3 Adolescence (2003 – 2010): Growth continues .....	69
5.5.1	Operational structure: Change in perceptions?.....	69
5.5.2	Internal audit exercises: More efficient and proactive? .....	70
5.5.3	Internal audit approach: Risk-based, therefore more open? .....	71
5.6	Stage 4 Adulthood (2011 – 2013): Stepping towards maturity .....	71
5.6.1	Operational structure: Are training and specialisation beneficial? ..	71
5.6.2	Internal audit exercises: More expertise to tackle fraud?.....	72
5.6.3	Internal audit approach: Updating for progress?.....	72
5.7	Stage 5 Middle age (2014 – 2019): On attaining maturity .....	73
5.7.1	Operational structure: More support towards gaining expertise?....	73
5.7.2	Internal audit exercises: More value adding?.....	73
5.7.3	Internal audit approach: Too much on the plate?.....	74
5.8	Stage 6: Looking towards the future (2020-onwards).....	74
5.9	Conclusion .....	75

## **Chapter 6: Summary, Conclusions and Recommendations**

6.1 Introduction .....	77
6.2 Summary .....	77
6.3 Conclusions .....	78
6.4 Recommendations .....	79
6.5 Areas for Further Research .....	81
6.6 Concluding Remarks .....	81

## **References**

General .....	R-1
Regulatory .....	R-6

## **Appendices**

Appendix 3.1 Letter of Introduction and Invitation to Participate .....	A3.1-1
Appendix 3.2 Interview Schedules.....	A3.2-1
Appendix 3.3 Statistical Data Analysis using the Friedman Test.....	A3.3-1

## List of Figures

Figure 1.1	The IPPF: The Framework for IA Effectiveness .....	4
Figure 1.2	Dissertation Overview .....	9
Figure 2.1	Outline of Chapter 2 .....	12
Figure 3.1	Outline of Chapter 3 .....	25
Figure 4.1	Outline of Chapter 4 .....	36
Figure 5.1	Outline of Chapter 5 .....	61
Figure 5.2	The Major Milestones in the Development of the IAF .....	63
Figure A3.1	The Degree of Enhancement of Objectivity .....	A3.3-1
Figure A3.2	The Degree of Enhancement of Integrity .....	A3.3-2
Figure A3.3	The Degree of Enhancement of Knowledge and Skills .....	A3.3-3
Figure A3.4	The Degree of Enhancement of Other Competencies .....	A3.3-4

## List of Tables

Table 3.1	Structure of the Interview Schedule .....	28
Table 3.2	Likert Scale .....	28
Table 3.3	Mixture of Closed-ended and Open-ended questions .....	29
Table 3.4	Category of Research Participants .....	30
Table 4.1	Quality Enhancement Across Time .....	43

## List of Abbreviations

AC	Audit Committee
ARC	Audit Review Committee
CAE	Chief Audit Executive
CBM	Central Bank of Malta
CEO	Chief Executive Officer
COIA	Chief Officer Internal Audit
EA	External Auditing
EAor(s)	External Auditor(s)
ECB	European Central Bank
ESCB	European System of Central Banks
EU	European Union
IA	Internal Auditing
IAC	Internal Auditors Committee
IAF(s)	Internal Audit Function(s)
IAor(s)	Internal Auditor(s)
IIA	Institute of Internal Auditors
IIARF	Institute of Internal Auditors Research Foundation
IPPF	International Professional Practices Framework
MFSA	Malta Financial Services Authority
NCB(s)	National Central Bank(s)

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# Chapter 1

## Introduction

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## **1.1 Introduction**

This chapter sets out the foundations of the study. Section 1.2 introduces the background to the study, followed by Section 1.3 which briefly explains the need for the study. Section 1.4 defines the main research objectives and Section 1.5 sets out the scope and limitations of the study. Finally, Section 1.6 outlines the structure of this study.

## **1.2 Background to the Study**

### ***1.2.1 The emergence of internal auditing***

The roots of auditing as described by Hald (1944 cited in Flesher 1996, p. 1), one of the founders of the Institute of Internal Auditors (IIA), are as follows:

*“Necessity created internal auditing and is making it an integral part of modern business. No large business can escape it...”*

As organisations grew, they became more complex and the volume of transactions increased, resulting in the separation of owners and managers (Ramamoorti 2003). Thus, once one party became entrusted with the property of another, scrutiny upon the faithfulness of the former became apparent (Mautz, Sharaf 1961). Nonetheless, organisations felt the need to establish an unbiased internal assurance function, with the aim of reviewing, verifying and evaluating the efficiency of work being performed and the honesty of employees. As a result, the Internal Audit Function (IAF) emerged in organisations taking on the role of the “*eyes and ears of management*” (Sawyer 1995, p. 46).

### ***1.2.2 Defining internal auditing***

The first official definition of Internal Auditing (IA), was issued by the IIA in 1978. IA was defined as an “*independent appraisal function*” with the aim of examining and evaluating activities. The objective of IA was to aid management in discharging their responsibilities through the provision of advice and recommendations. Primarily, IA involved the verification of accounting information, later expanding and broadening in scope to appraise all business

operations and to evaluate the effectiveness of internal controls (Ramamoorti 2003).

Consequently, in 1999, the Guidance Task Force updated the definition of IA as the existing one was not adequately portraying the changes that were occurring in the profession (Krogstad et al. 1999). The current definition of IA by the IIA states that:

*“Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organisation's operations. It helps an organisation accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes”<sup>1</sup>.*

According to Chapman and Anderson (2002), this new definition portrays the IAF as a more proactive and customer-oriented function. By providing assurance and consultancy services to both the Audit Committee (AC) and management, the IAF would be taking on the role of a strategic adviser and business partner to help improve organisational governance, decision making and better use of scarce resources (Ramamoorti 2003).

### **1.2.3 IA as a profession**

Although the roots of IA go way back, the growth of the profession started to occur in the 19th and 20th century. By November 1941, IA got the proper recognition it most definitely deserved following the establishment of the IIA by a small group of Internal Auditors (IAors). However, it was not until the late 1970s that IA started being recognised as a fully-fledged profession (Ramamoorti 2003). Nowadays, the IIA is the leading authority, educator and leader when it comes to guidance, standards, research and certification pertaining to IA.

The IIA issued the International Professional Practices Framework (IPPF) which is the conceptual framework containing authoritative mandatory and

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<sup>1</sup> Vide Definition of IA in the IIA's IPPF

recommended guidance to be followed by internal audit professionals worldwide (IIA 2015).



**Figure 1.1: The IPPF: The Framework for IA Effectiveness**  
(Source: IIA 2015)

The mandatory components of the IPPF include the:

- Core Principles for the Professional Practice of IA
- Code of Ethics
- Definition of IA
- International Standards for the Professional Practice of IA

In 1978, the Standards were approved by the IIA. Such standards cover certain aspects of IA including independence, objectivity, scope of work as well as professional proficiency (Ramamoorti 2003), The Standards are split into two sections which are Attribute Standards and Performance Standards. Whilst the former explains the attributes that are expected to be followed by IAors when carrying out internal audit exercises, the latter outline the nature of IA and the quality criteria against which internal audit services can be measured (IIA 2015).



The purpose of the Code of Ethics<sup>2</sup> is to promote an ethical culture within the IA profession. The Code contains the principles and expectations that govern the behaviour of IAors in the conduct of internal audit exercises. The principles to be adhered to include: integrity, objectivity, confidentiality and competency.

The Recommended components of the IPPF are the:

- Implementation Guidance
- Supplemental Guidance

The implementation guidance includes certain practices to aid in effective application of the Code of Ethics and Standards. Such guidance includes the approach, methodology and consideration. On the other hand, the Supplemental Guidance includes detailed instructions to aid in the conduct of internal audit activities including the processes and procedures, tools and techniques, step-by-step approaches and programs (IIA 2015).

#### ***1.2.4 Brief history of the Central Bank of Malta***

The Central Bank of Malta (CBM) was set up on the 17<sup>th</sup> of April 1968 under the CBM Act with the first governor being Dr. Philip L. Hogg. Over the last fifty years, the function of the CBM developed and went through three main remarkable changes. Between 1968 and 1994, the CBM was the regulator and supervisor of banks. Other responsibilities at that time included the issuance of currency, the application of exchange rate policy, the controlling of the nation's reserves and the provision of banking services to banks, public sector organizations and the government.

The most significant change in the CBM's operations was between 1994 and 2002. During this short period of time, Malta witnessed a revolution in the financial services sector, with the introduction of an extensive amount of new laws and revisions of existing laws with the aim of bringing the financial services field up to date. Modifications were carried out on the CBM Act, thereby granting further

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<sup>2</sup> Vide IIA's Code of Ethics

independence with respect to the formulation and implementation of monetary policy.

The latest major change in the function of the CBM came between 2002 and 2007. In 2002, the Malta Financial Services Authority (MFSA) was established, becoming the sole regulator for financial services in Malta. The enactment of such an authority meant that the responsibility of regulation and supervision of banks, passed from the CBM to such authority, leaving the CBM mainly accountable for price stability of the financial system. In 2004, Malta became part of the European Union (EU) which led the CBM to join the European System of Central Banks (ESCB). In 2008, Malta joined the Euro area resulting in the CBM to becoming part of the Euro system and the decision-making body of the European Central Bank (ECB) [CBM n.d.].

### **1.3 Need for the Study**

Like any other organisation, the CBM, is governed by numerous distinct departments all fulfilling different, yet equally important functions. One such department is the IA Department. One of the most important assets to Central Banks is reputation which can be achieved by having a healthy and strong corporate culture. Nonetheless, the IAF is invaluable to the CBM as it aids in providing reasonable assurance to the ECB on the adequacy and effectiveness of the internal controls, risk management and governance of the Bank. Therefore, given that such a department is of utmost importance for the survival and prosperity of an organisation, it is important to understand how such a Function developed over the years given that;

*“Our past shapes our future whether we realise it or not.  
Remembering well is as important as doing well”.*

(Mullins n.d.)

Consequently, given that both the present and the future are impacted by occurrences of the past, it is vital that the major milestones and the development of IA to date are laid out. Till now the evolution of the operational structure, audit exercises and audit approach of the IAF at the CBM has not been wholly

documented. Nonetheless, such a study will help to compile and record the progression of the IAF through time for future guidance.

#### **1.4 Research Objectives**

The objectives of this study are as follows:

- a. To assess how the operational structure of the IAF at the CBM has developed over the years;
- b. To assess how the different exercises carried out by the IAF have changed since the inception of the Bank;
- c. To examine how the approach to such different exercises has also changed over the years.

#### **1.5 Scope and Limitations**

This study has a number of limitations. One limitation is that, given that the CBM has been in operation for over fifty years, a number of key individuals who were involved particularly in the early years were either untraceable or unavailable for interview.

A further limitation is that not all the documentation that may have been relevant for the completion of the CBM IAF's development story may have been provided.

Finally, this study limits developments and information relating to the CBM internal audit to the cut-off date of the 31<sup>st</sup> of March 2020.

#### **1.6 Overview of the Study**

**Chapter 1** introduces the research topic by providing some relevant background information as well as the need for the study, research objectives and the scope and limitations of the research.

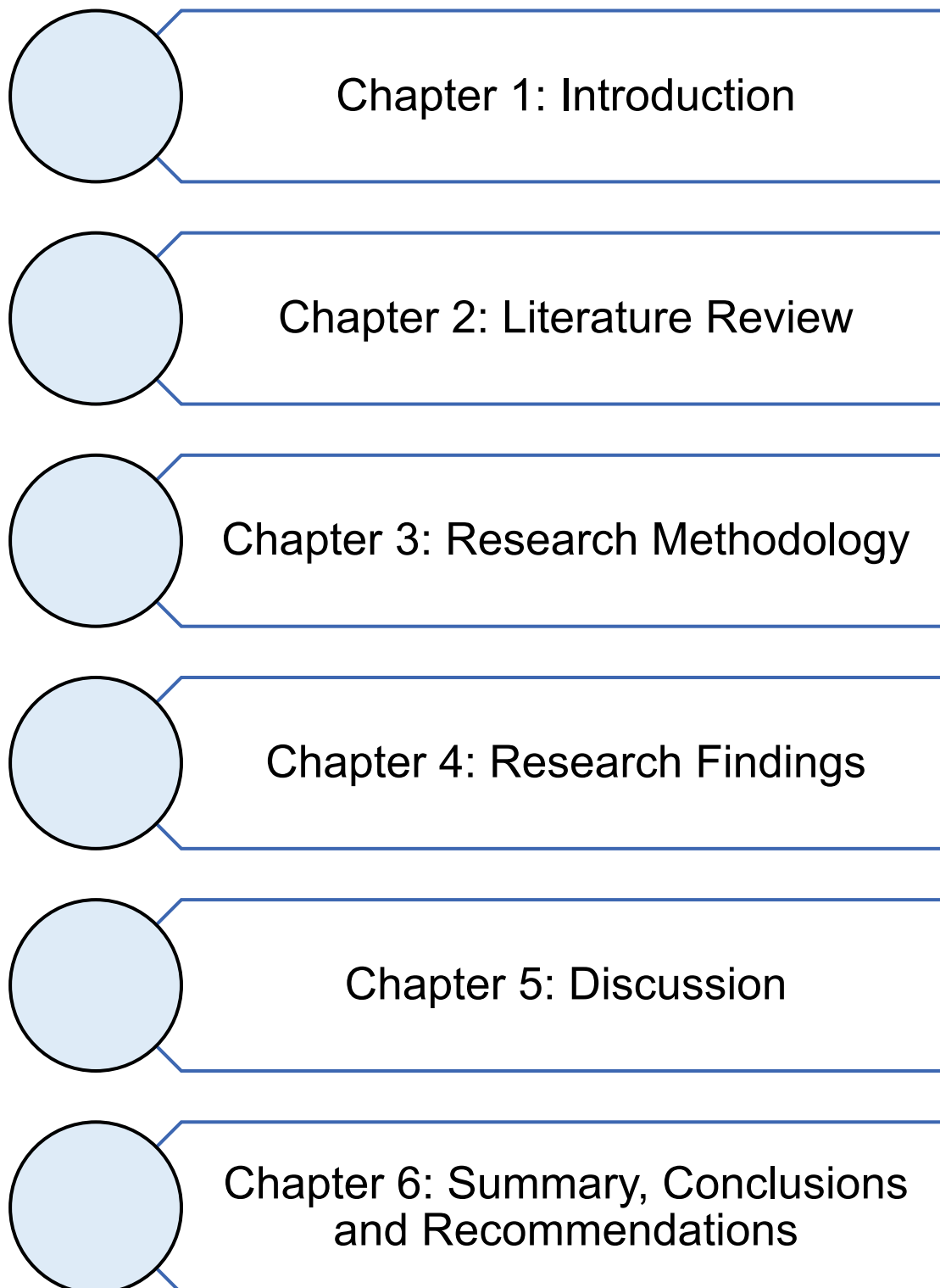
**Chapter 2** presents a review of existing foreign literature sources pertaining to IA.

**Chapter 3** outlines and justifies the research methodology chosen to achieve the research objectives.

**Chapter 4** presents the research findings that were obtained through the conduct of semi-structured interviews and the analysis of the CBM Annual Reports as well as the scrutiny of any available unpublished internal audit documentation.

**Chapter 5** deliberates on the research findings of the study in line with the literature review

**Chapter 6** concludes the study and presents a summary of the key findings as well as several recommendations and suggestions for further research. Figure 1.2 illustrates an overview of the study.



**Figure 1.2: Dissertation Overview**

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# Chapter 2

# Literature Review

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## **2.1 Introduction**

This chapter consists of an evaluation of existing literature on IA. As illustrated in Figure 2.1, Section 2.2 deals with the operational structure of the IAF whilst Section 2.3 explains the development of internal audit exercises over the years. Thereafter, Section 2.4 assesses the different approaches to IA over time. Finally, Section 2.5 concludes the chapter.

## **2.1 Introduction**

## **2.2 The Operational Structure of the IAF**

- **2.2.1 Support, significance and dependence**
- **2.2.2 IAor qualities**
- **2.2.3 Reporting lines of the IAF**
- **2.2.4 The IAF as a management training ground**

## **2.3 The Development of Internal Audit Exercises over the years**

- **2.3.1 Early days of IA development**
- **2.3.2 IA development between 1941 and 1980**
- **2.3.3 IA development between 1980 and 2000**
- **2.3.4 IA development from 2000 till present day**
- **2.3.5 Adding Value through the types of exercises**

## **2.4 The Different Approaches to IA over time**

## **2.5 Conclusion**

**Figure 2.1: Outline of Chapter 2**



## **2.2 The Operational Structure of the IAF**

### **2.2.1 Support, significance and dependence**

For the IAF to be able to have a positive impact on the organisation, potent and visible support is required from the executive management and the Board of Directors. According to Sawyer (1995), the first step in providing support is through the approval of an internal audit Charter. Moreover, whilst conducting audits, IAors should be provided with the necessary resources including access to all information, property and people. Additionally, IAors should also be given an appropriate platform to present their audit findings and recommendations by being allowed to attend operation meetings held throughout the year.

According to Nagy and Cenker (2002, p. 132), the IAF used to be perceived by several parties in the organisation as a “*necessary evil*” with its services often being unquestioned. However, Nagy and Cenker (2002), found that IA services were always perceived as being important from the perspective of top management. The perception of ‘them vs us’ from auditees towards IAors, changed upon realisation that IAors have a genuine interest in helping auditees to improve their operations. Nowadays, IAors do not solely instruct auditees to address any problems or weaknesses identified but rather explain and seek their opinion on possible solutions (Allen 1996).

Therefore, effective communication during the exercise of activities was essential for auditee-auditor relationships to form. This communication can be improved by timely provision of feedback and by pre- and post-engagement meetings (Gray, Gray 1996). Today, auditees have a greater level of respect towards IAors which was earned by being professional, knowledgeable and through the production of unbiased and factual reviews (Sawyer 1995).

### **2.2.2 IAor qualities**

Like any other profession, IAors are expected to possess certain fundamental qualities whilst conducting their work. The IIA (2017) Standard 1100 states that:

*“the internal audit activity must be independent, and internal auditors must be objective in performing their work”<sup>3</sup>.*

Although independence and objectivity are closely related, the IIA standards provide a clear distinction between the two terms. ‘Independence’ refers to organisational independence and is described as the freedom from certain organisational conditions. On the other hand, ‘objectivity’ refers to the unbiased mental state of IAors whilst performing certain engagements (Sarens, De Beelde 2006). IAors are expected to be honest and impartial in their work and to avoid situations that may lead to conflict of interest (Chapman 2001). Nonetheless, with respect to independence and objectivity, there is a general consensus that such attributes are of vital importance to ensure trustworthiness in the provision of IA services (Goodwin, Yeo 2001). Impairment in such attributes could result in a decrease in credibility as well as a deterioration in the professional image (Anderson 2003).

An organisation is only as strong as its people. The IIA (2017) Standard 1210 states that:

*“Internal auditors must possess the knowledge, skills, and other competencies needed to perform their individual responsibilities...”<sup>4</sup>*

According to the Competency Framework for IA published by the IIA, IAors should be in possession of communication, persuasion and collaboration as well as critical thinking skills when carrying out engagements. Additionally, IAors are to possess certain technical expertise in governance, risk, control and business acumen (IIA 2015). Sawyer (1995) stated that competence, integrity and loyalty are important qualities that must be exercised by IAors to gain respect by peers and supervisors. Moreover, the IAF should be composed of IAors with a mix of seniority, professional skills and competencies to be able to adequately audit the high-risk areas. Furthermore, proficiency is required through appropriate

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<sup>3</sup> Vide Attribute Standard 1100 of the 2017 IIA Standards

<sup>4</sup> Vide Attribute Standard 1210 of the 2017 IIA Standards

qualifications, certificates, training and continuous development programs (Chamoun, Van Greuning 2018).

### **2.2.3 Reporting lines of the IAF**

Upon emergence of the IA profession, the reporting lines were relatively simple. Although Sawyer (1995, p. 46) described IA as the “*eyes and ears of management*”, early research indicates that in most cases, IAors, used to report directly to the controller (today the Chief Financial Officer) given that IA was concerned with evaluating controls. However, given that by time IAFs started to serve a variety of customers all having different needs, a conflict was created regarding the ideal reporting lines (Institute of Internal Auditors Research Foundation [IIARF] 2003). Nonetheless, the IIA (2017) Standard 1110 states that:

*“The chief audit executive must report to a level within the organisation that allows the internal audit activity to fulfill its responsibilities...”<sup>5</sup>*

The above standard does not directly state for whom the IAF is accountable, however, appropriate reporting lines are critical for the IAF to maintain independence, objectivity and to effectively assess the internal controls (IIARF 2003). Nonetheless, for the ascertainment of transparency and thwarting of collusion and conflict of interest, the IIA recommends a dual reporting relationship to be maintained by the IAF. The Chief Audit Executive (CAE) should report administratively to the most senior executive management on matters regarding direction, support and administration and report functionally to the AC on strategic direction, reinforcement and accountability (IIA 2011).

The IIA does not prohibit reporting to other parties but the CAE must ensure that the reporting relationship is not interfering with the internal audit Charter (IIARF 2003). According to Johnson (2006), the IAF should not report to the CFO or other executive. Balkaran (2007) explained that having the IAF report to management, will end up degrading the level of independence and objectivity.

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<sup>5</sup> Vide Attribute Standard 1110 of the 2017 IIA Standards

Moreover, Al-Twajjry et al. (2003) stated that management pressures may cause IAors to inaccurately report on fraud, errors or wrongdoings. Hansen (1997) stated that having an IAF that is independent in terms of reporting, results in a better controlled environment as well as a reduction in reporting errors.

#### **2.2.4 The IAF as a management training ground**

In many organisations, the IAF serves as a training ground for personnel to further their career in other management positions within different departments in the organisation (Chadwick 1995). Given that IAors conduct a variety of tasks across different departments, they have the opportunity of learning how such departments function and can obtain a profound understanding of the whole organisational structure (Christopher et al. 2009). Thus, the IAF may be used “*to train versatile, well-rounded senior managers*” (Chadwick 1995, p. 63). However, the use of such a practice can have detrimental effects. Chadwick (1995) explains that most often, the individuals assigned to the IAF have no auditing experience or no interest in auditing. Knowing full well that their assignment in such a department is temporary, IAors will have little or no incentive to enhance the quality of the Function. Moreover, a question can be raised on the extent of objectivity of IAors whilst performing an audit, knowing their possible future employment within the department being audited (Christopher et al. 2009).

### **2.3 The Development of Internal Audit Exercises over the years**

#### **2.3.1 Early days of IA development**

Historians believe the roots of IA go back to around 4,000 B.C. In the Near East, they had established a system of formal record-keeping to ensure that the accounting of receipts and collection of taxes were properly recorded. Also, in Babylonia, Greece and the Roman Empire, a detailed system of checks and counterchecks was developed to audit their public finance systems (Ramamoorti 2003).

Prior to 1850, auditing was exclusively concerned with the checking and verification of each and every transaction. Thus, one can conclude that

identification of fraud was the main priority with respect to the conduct of an audit. Between 1850 and 1905, during the Industrial Revolution, largescale corporations started emerging, transitioning organisations from owner managed to separation of ownership and management. Given that owners started to become worried about their capital investment, auditing started to gain popularity.

According to Porter and Fiske (1934) and Cunningham (1948), between 1900 and 1941, the job of IAors mimicked that of a police officer. Most of the work consisted of checking the arithmetical accuracy of financial statements and detection of fraud and errors. Dicksee (1902) pointed out that IA was simply an extension of external auditing (EA) given the resemblance of their work. The only difference was that IA was to be carried out by the organisation and its employees. Apart from that, given that sampling was used to express an opinion on the financial statements rather than full verification, many corporations saw the need to set up an IAF simply to fill the void created by the External Auditors (EAors). Nonetheless, IAors were seen as a helping hand to EAors especially in the assistance of financial audits (Kent 1957).

### ***2.3.2 IA development between 1941 and 1980***

According to Cunningham (1948), IA started being recognised as a separate profession with the creation of the IIA in 1941. Kellogg (1951) and Vinten (1985), stated that during this time period, the main job of IAors consisted mostly of operational audits which entailed the evaluation of the operations of the organisation. Similarly, Spicer (1949) found out that the scope of the IA was much broader as IAors were involved in business practices, pricing, controls over purchasing, wage incentives and advertising.

### ***2.3.3 IA development between 1980 and 2000***

Significant developments in the field of IA occurred during such a time period. Between July 1983 and June 1989, the IIA issued seven Statements on IA Standards which provided a better understanding of the work that was expected from IAors. IAors were involved in the detection, investigation and reporting of

fraud, evaluation of plans to ensure efficiency, effectiveness and achievement of organisational goals, communication of results including recommendations, communication with the Board of Directors and co-ordination with independent EAors. Therefore, as explained by Ramamoorti (2003) and Lendle (2008), the areas that IA expanded to included fraud investigations, compliance, financial, management, and operational auditing, risk management and reporting and consultation.

#### ***2.3.4 IA development from 2000 till present day***

Organisation's activities have gone through multiple changes over the years, with the main influencer of change being globalisation. Such a phenomenon brought with it a change in communication and technology which exposed organisations to both opportunities and benefits, but also to a higher level of risk such as money laundering, fraud, corruption and complexity (Le Grand 2015, Kapoor, Brozzetti 2012).

One of the tasks of IAors is that of ensuring that management decisions and operations are in line with the organisation's goals, mission and strategies. Therefore, IAFs started to help in assessing strategic risks and provide guidance on the expansion or modification of businesses (Kapoor, Brozzetti 2012). Nonetheless, IAors were viewed as consultants which challenge management to improve and enhance business practices (Arena, Azzone 2009). Given that enterprise risk management is at the top of the agenda for certain organisations, IAors were expected to provide assurance that enterprise risk areas were being managed effectively by management (Kapoor, Brozzetti 2012).

Over the years, fraud perpetration increased so that IAors were more than ever asked to monitor the risks relating to fraud and the controls that are in place to mitigate them. Moreover, IAors were expected to help in identifying and investigating vulnerabilities and to provide advice on how to overcome any weaknesses (Kapoor, Brozzetti 2012). IAors also provided assurances that the internal control policies were truly in place and operating as planned (Sarens, De Beelde 2006, Sarens et al. 2009).

Given that organisations became more IT based, management became mostly concerned with the security, integrity and privacy of information. Throughout the years, changes in technology led organisations to invest in computerised operating systems to process their data. Thus, IAors were sought to audit the risks, controls, reliability and cost-effectiveness pertaining to IT areas. Apart from that, IAors were requested by management and the AC to participate in the development of their computerised systems and disaster recovery (Kapoor, Brozzetti 2012, Gupta, Ray 1992). IAors were also expected to support EAors, as the latter may at times have to rely on the work previously carried out by the IAors (Felix et. al. 2001). IAors were also expected to keep track of changes in laws and regulations to ensure the organisation is always compliant.

Therefore, whilst financial, compliance, and operational audits were still a crucial part of the IAor's work, the IAor became more heavily invested in governance, risk management, technology management and enterprise sustainability amongst others (Le Grand 2015). In fact, the IAor's responsibility expanded to various areas with the carrying out of strategic, ethics, quality, IT audits and due diligence (Kapoor, Brozzetti 2012).

### ***2.3.5 Adding value through the types of exercises***

According to the 1999 IIA definition of IA<sup>6</sup>, the IAF is expected to add value and improve the organisation's operations. Anderson (2003) stated that the first step in adding value is through the identification of customers. The customers of the IAF include but are not limited to, the Chief Executive Officer (CEO), AC, Board of Directors, auditees and EAors. However, such customers have contrasting needs and values. For example, IA can add value to auditees by pinpointing possible opportunities to improve the efficiency and effectiveness of their operations. On the other hand, the AC is mostly interested in the opinion provided by IAors regarding the adequacy of the internal controls, safeguarding of assets, compliance with laws and regulations and reliability of data (Anderson 2003).

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<sup>6</sup> Vide Definition of IA in the IIA's IPPF

One way how IAors can add value to the organisation, is through the provision of consulting services. Such services enable the IAF to address management needs as well as to help solve any problems that might arise. Moreover, the consulting arm enables IAors to be involved in the planning stage of operations, thereby reducing possible failures (Chapman 2001). Additionally, by extending the IAF's role to the provision of consultancy services, the status, capacity and image of the Function is raised, lifting it to a strategic level. Moreover, the IAF would be taking a more proactive role with respect to problem-solving enabling a closer working relationship with the Board and Management to aid in achieving their desired objectives. However, the role extension and involvement in both assurance and consultancy, may lower the independence and objectivity as well as damage the IAF's reputation within the organisation if the consultancy work fails or the objectives are not achieved (Anderson 2003).

#### **2.4 The Different Approaches to IA over time**

Traditionally, IA was a backwards-looking approach. One popular IA approach was the vouching approach. Such approach entails the independent and objective verification of all transactions carried out in the organisation, without the use of any information provided by management. Therefore, in such an auditing approach, no reliance is placed upon the system of internal controls of the entity nor on the information produced from that system. Eventually, as organisations started to expand in size, the vouching approach no longer remained sustainable given the large amount of resources that were required. As a result, new audit approaches including the procedures-driven approach and the risk-based approach developed, improving the overall efficiency and effectiveness of the audit (Fazal 2011).

The procedures-driven approach involves selecting the nature, timing and extent of audit procedures to be performed, independently from the level of risk that might be present. Therefore, in such an approach, the audits performed are simply carried out either because they are normally commonly conducted or because the audit was tested in a previous audit (Colbert, Alderman 1995).



Contrastingly, the risk-based approach is a forward-looking approach aimed at addressing the potential risks preventing the organisation from achieving its desired objectives. The first step in the conduct of such an audit approach is planning. A preliminary survey or consultation with senior management and the Board is carried out to obtain an understanding of the organisations' strategies, objectives, business processes, risks and controls (Lemon, Tatum 2003). The IIA (2017) Standard 2010 states that:

*“the chief audit executive must establish a risk-based plan to determine the priorities of the internal audit activity, consistent with the organisation's goals”<sup>7</sup>.*

With organisations having a large number of procedures to be audited but a limited amount of IAors to perform the work, an exercise has to be carried out to assess which audits are of a priority to be performed in a given year and thus, which are to be included in the audit plan. There are various techniques that can be used to identify the riskiest procedures ranging from a judgmental selection of audits from the audit universe to extremely complex risk assessment models. Management and system changes, audit results and time since previous audit was conducted are typical criteria that are used when deciding which audits to perform. Moreover, given the move of the IA profession to a more assurance and consultancy based one, in the audit plan, a significant amount of budget time is allotted for unanticipated requests from customers (Nagy, Cenker 2002). The IIA (2017) Standard 2200<sup>8</sup>, requires IAors to develop a plan for each audit engagement. Audit staff are then to be assigned to particular engagements relative to their level of knowledge, experience and skills. Moreover, a detailed schedule indicating the timing of the engagement is designed (Prawitt 2003).

The second step of the risk-based approach is fieldwork. Once the audit is conducted, the auditee is consulted and an explanation of the findings and recommendations applicable are given. Nagy and Cenker (2002), found that customers are quite receptive towards recommendations given by IAors. This is

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<sup>7</sup> Vide Performance Standard 2010 of the 2017 IIA Standards

<sup>8</sup> Vide Performance Standard 2200 of the 2017 IIA Standards

mostly attributable to the fact that IAors generally work closely with the auditee when deriving the plan for implementing recommendations. The final step is reporting, whereby an audit report is prepared and presented to the auditees. Feedback following the audit engagement is at times obtained by the means of a survey sent to the auditees. Such a survey aids in assessing the IAor's effectiveness and professionalism. However, Nagy and Cenker (2002, p. 133) found that some IA directors consider such an exercise as "*worthless*" or which could "*potentially undermine the auditor's objectivity and independence*".

The adoption of a risk-based approach led to higher value-added audits to be performed (Lemon, Tatum 2003). Moreover, efficiency and effectiveness increased, given that the limited resources of the IAF were assigned to high-risk areas (Colbert, Alderman 1995). Therefore, through this proactive value-added approach, IAors are in a better position to guide management in improving internal controls as well as the quality of information so that better decisions can end up being taken (Bou-Raad 2000).

## **2.5 Conclusion**

This chapter provided a review of the existing literature pertaining to the study, including information on the operational structure, internal audit exercises and audit approaches. The next chapter describes the research methodology used in this study.

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# Chapter 3

## Research

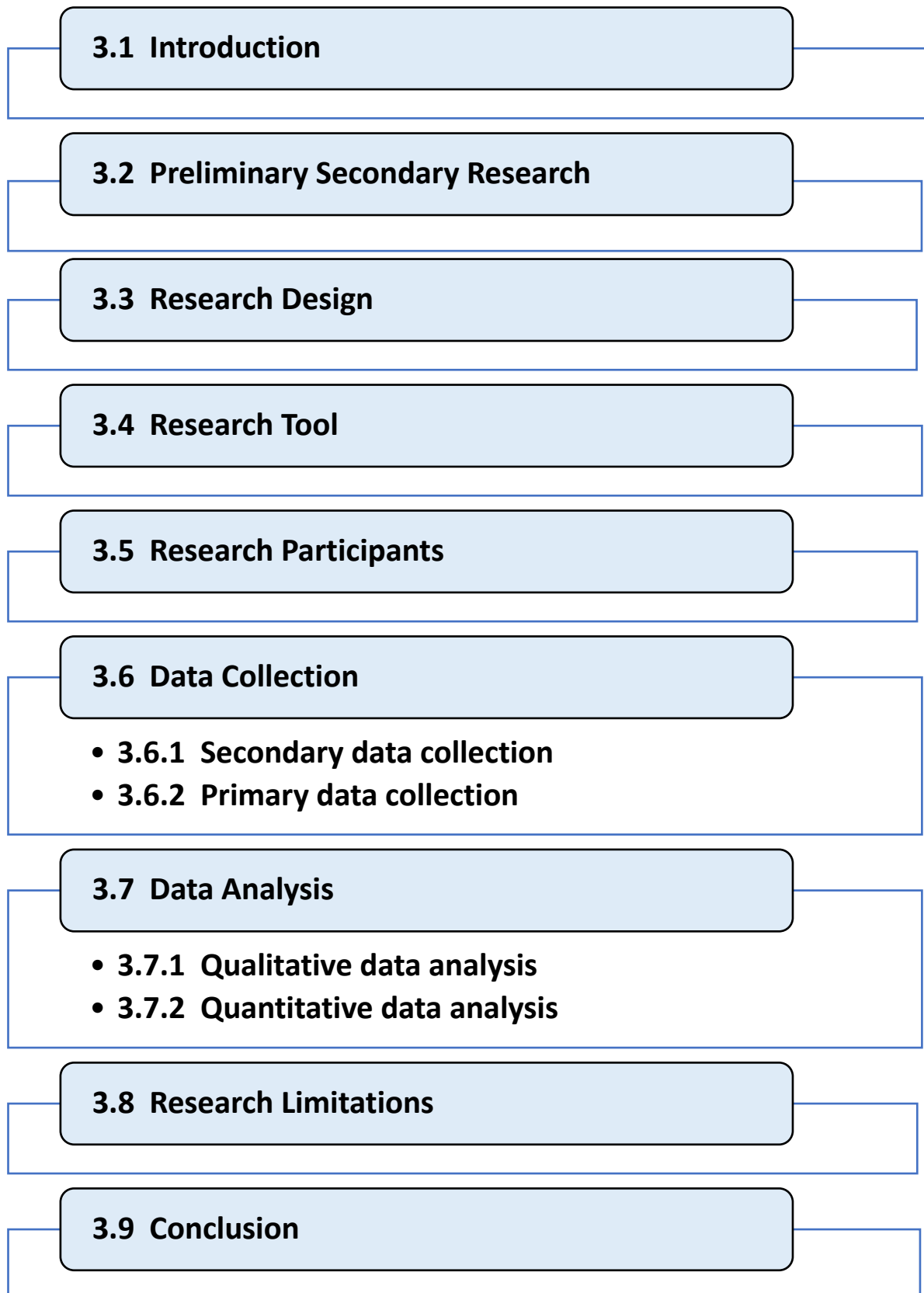
## Methodology

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### **3.1 Introduction**

This chapter highlights the research methodology adopted in the study. As illustrated in Figure 3.1, Section 3.2 describes the preliminary secondary research conducted. Subsequently, Section 3.3 provides an understanding of the research design adopted whilst, Section 3.4 describes the research tools used. Thereafter, Section 3.5 explains the motive behind the selected participants, and Sections 3.6 and 3.7 describe the data collection and analysis respectively. Finally, Section 3.8 outlines the various research limitations encountered, followed by Section 3.9 which concludes the chapter.



**Figure 3.1: Outline of Chapter 3**

### **3.2 Preliminary Secondary Research**

At the initial stages of the study, various existing literature sources and publications, such as books, journal articles, academic papers and dissertations, including both local and international were analysed, to gain more and better knowledge on the chosen research area.

Moreover, attention was also given to the relevant existing regulation, particularly the IIA International Standards for the Professional Practice of IA and the CBM's website.

### **3.3 Research Design**

The research design is considered to be the initial stage when planning the research process. Choosing the ideal research design is not the simplest of tasks, but it is the most fundamental in order to ascertain that accurate and reliable results are obtained. In establishing the research design, the primary focus should be the research question, because when this is well defined, the choice of research design becomes much easier (Toledo-Pereyra 2012). Moreover, the selection of the research design is also influenced by the researcher's personal experiences and audience of the study (Creswell 2014).

There are three main types of designs that can be used. These include qualitative, quantitative and mixed-methods (Creswell 2014). The former two are considered to be dichotomies (Newman, Benz 1998), whilst the latter is considered to be in the middle, as it contains elements that are attributable to both qualitative and quantitative approaches (Creswell 2014). Qualitative research involves using non-statistical techniques to obtain an in-depth understanding, whilst quantitative research uses statistical techniques to gather insights (Andrew et al. 2011).

Therefore, although both methods can aid in achieving different goals or objectives, they do not exist in isolation (Saunders et al. 2009). In reality, using a mixed methods approach can be more beneficial as the strengths of both the

qualitative and the quantitative approaches can be capitalised, and a better conclusion can be reached (Hesse-Biber 2015).

### **3.4 Research Tool**

The research tools considered as highly suitable in achieving the research objectives are semi-structured interviewing and an analysis of the internal audit department documentation including the Annual Reports. A semi-structured interview consists of a verbal interchange where one party, the interviewer, strives to obtain information from another party by asking questions (Longhurst 2003). The main distinguishing feature of semi-structured interviews is that, although the researcher will have a pre-prepared list of questions to be covered, the way the questions will be asked, will vary from one interview to the other. This means that some questions may be omitted, new questions may be introduced, or the order of the questions may change relative to the flow of the conversation (Saunders et al. 2009). Furthermore, given that an identical set of questions are posed to all participants, the data collected may be easily compared and further analysed (Mcintosh, Morse 2015).

For the purpose of this study, two varying interview schedules were prepared, one<sup>9</sup> containing technical and detailed questions aimed towards personnel occupying or formally occupying a position of authority (IA management) within the internal audit department of the CBM, and the other<sup>10</sup> consisting of non-technical questions targeted towards lower level personnel (IA staff) within the department. Table 3.1 depicts the three main sections constituting both interview schedules.

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<sup>9</sup> Vide Appendix 3.2 Interview Schedule A

<sup>10</sup> Vide Appendix 3.2 Interview Schedule B

Section Heading		Question Numbers	
		Interview Schedule A	Interview Schedule B
<b>Section 1:</b>	Operational Structure	1.1 – 1.7	1.1 – 1.4
<b>Section 2:</b>	Types and Scope of Internal Audit Exercises	2.1 – 2.3	2.1 – 2.2
<b>Section 3:</b>	Audit Approach	3.1 – 3.8	3.1 – 3.2

**Table 3.1: Structure of the Interview Schedule**

Both interview schedules, include a combination of closed-ended and open-ended questions, with the latter being predominant, to give the research participants, the opportunity to talk freely about the subject, such that a richer understanding can be obtained. The closed-ended questions were prepared in the form of a Likert Scale, where respondents were asked to rate them using a scale from 0 to 4, as illustrated in Table 3.2. Moreover, Table 3.3 differentiates between closed-ended and open-ended questions in each section of both interview schedules.

Response	Scale
Not at all	0
Lacking	1
Neutral	2
Substantially	3
Very highly	4

**Table 3.2: Likert Scale**



	Question Type	Question Number by Section		
		Section 1	Section 2	Section 3
<b>Interview Schedule A</b>	Closed-Ended	1.6	2.2	
	Open-Ended	1.1 – 1.5, 1.7	2.1, 2.3	3.1 – 3.8
<b>Interview Schedule B</b>	Closed-Ended	1.3	2.2	
	Open-Ended	1.1, 1.2, 1.4	2.1	3.1, 3.2

**Table 3.3: Mixture of Closed-ended and Open-ended questions**

### 3.5 Research Participants

The choice of a sampling technique, and ultimately the selection of research participants, directly influences the achievement of the research question (Saunders et al. 2016). Selecting adequately diverse research participants, guarantees that a reasonable understanding of the selected area of study is obtained (Fylan 2005). According to Morse (1991), a good research participant is considered one which is knowledgeable about the area, is able to reflect and provide detailed information and is willing to talk. For the purpose of this study, a purposive sampling technique was considered to be the most appropriate in meeting the research question. In a purposive sampling technique, participants, are chosen based on the researcher's judgement as to whether the participant has decent knowledge, experience and expertise in answering the questions (Miles et al. 2013).

After much deliberation on the research questions, it was decided that for the purpose of this study, the research participants were to be both current and past employees of the IA department at the CBM. Moreover, to be able to get a full understanding of the area of study, personnel occupying a different hierarchical position within the Department, including clerks, support officers, heads and chief

executives were chosen. Similarly, personnel working within the Department over the years, since the inception of the Bank till the present day, were traced and contacted. It goes to note that most of those contacted refused to be interviewed.

Initially, personnel within the IA department were contacted via email, using the corporate email address. Attached in the email was a letter of introduction<sup>11</sup>, signed by the Head of Department of Accountancy, including a brief introduction of the researcher and an explanation of the intention of the study. Eventually, such personnel helped in identifying eligible participants and provided contact information.

As shown in Table 3.4, a total of six interviews were carried out. Three interviews were conducted with clerks, one interview was carried out with a support officer, another interview with the Chief Officer Internal Audit (COIA) and a final interview with the Head of Internal Audit.

<b>Interviewee Category</b>	<b>Number of Research Participants</b>
Clerk	3
Support Officer	1
Head of Internal Audit	1
Chief Executive	1
<b>Total</b>	<b>6 participants</b>

**Table 3.4: Category of Research Participants**

### **3.6 Data Collection**

Data collection is the process of gathering information. There are various strategies that may be used to collect data. According to Saunders et al. (2016), the data collection technique chosen is affected by the research objectives. For

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<sup>11</sup> Vide Appendix 3.1

the purpose of collecting accurate and relevant information, a combination of secondary and primary data was collected.

### **3.6.1 Secondary data collection**

Secondary data includes the accounts of people or situations written by others (Creswell 2014). For the purpose of this study, various literature sources were collected and analysed in Chapter 2 of this dissertation. Consequently, such data served as the foundation for preparing the interview schedules. Prior to conducting the interviews, a pilot study was conducted to test the research instrument, whereby the interview schedules were presented to one interviewee for review. A pilot study can aid in providing an advance warning on the appropriateness of the research instrument or the complexity of the interview questions (Van Teijlingen, Hundley 2002). The interview schedule was then amended according to the recommendations provided.

### **3.6.2 Primary data collection**

Primary data was collected in two ways. In the first instance, semi-structured interviews were carried out between the 13<sup>th</sup> of November 2019 and the 18<sup>th</sup> of December 2019 at a place, date and time most convenient to the research participants. The interview schedule was not provided prior to the interview, but rather a printed version was made available to the interviewee during the interview. To ease the data analysis procedure, prior consent was obtained from the interviewees to be audio recorded. Moreover, an acceptable number of notes were taken during the interview itself, which facilitated identifying the main views of the interviewee.

The interview data was then triangulated both by an analysis of unpublished internal audit documentation and by an examination of the published Annual Reports of the CBM since its inception.

## 3.7 Data Analysis

### 3.7.1 *Qualitative data analysis*

Qualitative data was collected during the interviews from a variety of open-ended questions and the explanations given for the ratings assigned to the Likert Scale questions. The audio recordings of each interview were transcribed following each interview, enabling an increase in quality of subsequent interviews. Furthermore, a summary containing relevant information from Annual Reports and internal audit documentation was compiled, which together with the detailed transcripts and interview notes, were analysed and discussed enabling a better identification of similarities and differences.

### 3.7.2 *Quantitative data analysis*

The Likert Scale questions throughout the interview schedule resulted in quantitative data which was analysed using IBM SPSS Statistics.

The Friedman test<sup>12</sup> was used to compare the mean rating scores provided to each competency between the three phases (Inception, Over the years, Present day). These mean rating scores range from 0 to 4, where 0 corresponds to 'Not at all' and 4 corresponds to 'Very Highly'. So, the larger the mean rating score, the higher is the likelihood of this competency. The null hypothesis ( $H_0$ ) specifies that the mean rating scores vary marginally between the phases and is accepted if the  $p$ -value exceeds the 0.05 level of significance. The alternative hypothesis ( $H_1$ ) specifies that the mean rating scores vary significantly between the phases and is accepted if the  $p$ -value is less than the 0.05 criterion.

## 3.8 Research Limitations

In the conduct of this research study and particularly, in the semi-structured interviewing, a number of limitations were noted. In the first place, given that this study involved a fifty-two-year span, some participants exhibited insufficient

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<sup>12</sup> Vide Appendix 3.3

memory whilst answering and elaborating on certain questions. Consequently, some information also relevant to the study might thus have been missed.

A further limitation was the element of subjectivity and bias in some of the participant responses, particularly with respect to the Likert Scale question in the two interview schedules as well as in their explanations to justify their allocated ratings. Consequently, this might have led to some inconsistencies or inaccuracies in the collection of responses.

A final limitation was, that in view of time restrictions and for the sake of convenience, one participant preferred to contribute to the study by answering the interview questions via email. Although such a gesture was appreciated, this resulted in ambiguity of interpretation in some of the responses and the opportunity for clarifying such limitations was lost.

### **3.9 Conclusion**

This chapter laid out the research methodology that was implemented by the study. The following chapter presents the research findings obtained from the information collected and interviews conducted.

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# Chapter 4

# Research Findings

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## **4.1 Introduction**

This chapter contains the research findings obtained from (i) the semi-structured interviews, (ii) the Annual Reports and (iii) other internal audit documentation available. As illustrated in Figure 4.1 in the following page, Section 4.2 deals with the operational structure, whilst Section 4.3 and Section 4.4 are concerned with the types and scope of internal audit exercises and the audit approach respectively. Finally, Section 4.5, concludes the chapter.

## **4.1 Introduction**

## **4.2 Operational Structure**

- **4.2.1 Establishment of the IAF**
- **4.2.2 Internal audit Charter and Manual**
- **4.2.3 Objectives of the IAF**
- **4.2.4 Dependence and importance of the IAF**
- **4.2.5 Significance, support and reliance towards the IAF**
- **4.2.6 Composition of the IAF**
- **4.2.7 Qualities of internal audit and their enhancement**
- **4.2.8 The changing reporting lines of the IAF**

## **4.3 Types and Scope of Internal Audit Exercises**

- **4.3.1 Types and mix of audit and consultancy exercises**
- **4.3.2 Relative importance of different exercises over time**
- **4.3.3 Adding value through the types of exercises**

## **4.4 Audit Approach**

- **4.4.1 Audit approach steps**
- **4.4.2 Involvement of various IAors in the audit process**
- **4.4.3 The mix of verbal and written communications**
- **4.4.4 The restructuring of the IAF**
- **4.4.5 The establishment of the AC**
- **4.4.6 Introduction to a risk-based auditing approach**
- **4.4.7 Adherence to the IIA Standards**
- **4.4.8 Reporting follow-ups over the years**
- **4.4.9 Extent of influence from feedback**
- **4.4.10 Extent of influence from EU IAors and European Institutions**

## **4.5 Conclusion**

Figure 4.1: Outline of Chapter 4



## 4.2 Operational Structure

The eleven questions in this part (A1.1 – A1.7, B1.1 – B1.4) refer to the first Section of both interview schedules and relate to the operational structure of the IAF.

### 4.2.1 *Establishment of the IAF*

As noted in the 1969 Annual Report, up to the end of 1969, the IA that was being performed was being carried out by staff members who were only temporarily available from other departments. However, owing to the expansion in the Central Bank's activities and functions, it became necessary to establish a separate Internal Audit Office so that this would be able to conduct "*more systematic and frequent audits and carry out surveys*" (CBM 1969, p. 51) for improving the Bank's work. A new Department, called at the time "*Audit and Bank Inspection*", was subsequently set up in the beginning of 1970. This could be considered as a milestone of the IAF. In preparation for its setting up, in late 1969, specialised staff were recruited. Moreover, the International Monetary Fund agreed to provide technical assistance to help train locally recruited staff in auditing (CBM 1969, p. 51). From its initiation, the new Department started to carry out internal checking, supervision and examination of the accounting work of the Bank. By February 1970, the IAF was fully operational as an in-house function (CBM 1970, p. 30).

### 4.2.2 *Internal audit Charter and Manual*

The first question<sup>13</sup> asked IA management interviewees, whether, over the years, the IAF had had an internal audit Charter and internal audit Manual, and whether such documents had been periodically updated. Two of the respondents<sub>(2A)</sub> stated that, the first version of the Charter and Manual was introduced in 2005. Such documents can be considered another milestone of the IAF. Since 2005, the Manual has consistently included a description of the internal audit procedures and methodologies, as well as the practices and code of conduct expected to be adhered to by IAors (CBM 2005, p.73). Moreover, since its

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<sup>13</sup> Vide Q. A1.1 p. A3.2-2

introduction, the Manual has been following IIA Standards and complementing the policies currently included in the Audit Manual of the Internal Auditors Committee (IAC) of the ESCB<sub>(1A)</sub>. Three participants<sub>(2A, 1B)</sub> added that both Charter and Manual have been regularly updated to cater for any changes occurring both in the internal organisation, as well as externally, such as changes to the IIA Standards.

### **4.2.3 Objectives of the IAF**

In the next question<sup>14</sup>, IA management interviewees were asked to state whether, over the years, IAF objectives have been clearly specified as well as whether any changes have occurred. One respondent<sub>(1A)</sub> emphasised that IA objectives had been commonly considered as “*fancy words for telling the truth*” and were meant for IAors to consistently provide an “*independent*”, “*objective*” and “*unbiased*” picture of the CBM operations<sub>(2A)</sub>. S/he added that at least from 1998 to his/her knowledge, the core internal audit objectives had been clearly specified and also consistent. However, since then they had to be extended to be aligned with the widening scope of internal audit towards enhancing organisational value. One main driver of such an extension was the increased need for the Department to move on from being perceived as “*just another checking function*” towards proving itself by adding such expected value to the organisation<sub>(1A)</sub>. Other drivers of additions to the objectives included the increased significance being placed on the role of the internal audit profession as well as the development of the objectives of the Bank<sub>(2A)</sub>.

### **4.2.4 Dependence and importance of the IAF**

The IA management interviewees were asked<sup>15</sup> to comment as to whether, in their view, the dependence of the CBM on the IAF had changed over the years. One interviewee<sub>(1A)</sub>, stated that, similarly to the consistency in the core objectives, the basic need of the IAF to provide reasonable assurance had not changed. However, other needs have surfaced over the years, such as that of having to be

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<sup>14</sup> Vide Q. A1.2 p. A3.2-2

<sup>15</sup> Vide Q. A1.3 p. A3.2-2

more actively present as trusted advisor in corporate governance matters, including by participation at Board of Directors level - the highest level in the organisation. Another interviewee<sub>(1A)</sub> added that the COIA has arrived at the point of having access to board papers, participating in Board meetings and providing opinions to the Governors whenever needed. Furthermore, s/he referred to the fact that in recent years, the Governors have been requesting many 'ad hoc' and consultancy tasks from the IAF, this being indicative of the increased trust in both the COIA and the IAF.

Participants<sub>(2A)</sub> argued that whilst, in the past, the IAF was mostly appreciated by top management, the business areas have now also accepted the Function and in fact, at times request its guidance *a priori*. Therefore, the old perception of the IAF as a policing function, has been changing over time and is rendering the IAF more in demand.

A related question<sup>16</sup> asked to IA staff interviewees was about the level of importance of the IAF in terms of position within the organisation. Three participants<sub>(3B)</sub> were of the opinion that in the past, the IAF had not occupied a position of more-than-average importance in the CBM, as the Function was perceived merely as a supportive one, yet one with a "*negative connotation*" of being "*invasive in its work*". All participants<sub>(4B)</sub> stated that, in contrast, the IAF now holds a more important and prominent position. Little by little, such prominence by the Function has been gained in the eyes of the business areas. The perception is that the IAF is now much more helpful in the identification of weaknesses and in the provision of recommendations relating to improvements.

#### **4.2.5 Significance, support and reliance towards the IAF**

In the next question<sup>17</sup>, IA management interviewees were asked to comment on the significance, support and reliance towards the IAF placed by several parties (listed below) within the CBM. With regards to the significance of the IAF, interviewees<sub>(2A)</sub> expressed that this Function had always been necessary since

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<sup>16</sup> Vide Q. B1.1 p. A3.2-7

<sup>17</sup> Vide Q. A1.4 p. A3.2-2

inception. However, what changed over the years was the perceptions, as nowadays, the IAF is much more “*appreciated*” and “*respected*”<sup>(2A)</sup>. This is mostly due to the fact that the internal audit process is more democratic, in the sense that auditees have much more possibility of engaging in a discussion<sup>(1A)</sup>.

**(i) The Board of Directors and/or AC**

Both interviewees<sup>(2A)</sup>, stated that the IAF has the full support of the Board of Directors and the AC. In fact, in addition to the Board reliance on the COIA as stated earlier, the IAF drives the agenda of the AC. One interviewee<sup>(1A)</sup> further emphasized the significant amount of reliance the AC places on the IAF, by mentioning the fact that most probably, the AC might not even meet without the presence of the IAors.

**(ii) Management and User Departments**

Participants<sup>(2A)</sup>, stated that the level of co-operation between management and IAors has increased throughout the years as both parties have worked towards improving their relations. One participant<sup>(1A)</sup>, noted that, although management in no way expects IAors to run their Department, yet they are receptive of the advice and recommendations given by them.

**(iii) EAors**

One Interviewee<sup>(1A)</sup>, explained that the IAF mostly carries out operational audits, and that it is the EAors who conduct most financial auditing. Nonetheless, both interviewees<sup>(2A)</sup>, stated that EAors tend to place a significant amount of reliance on the IAF. At the start of their audit, EAors request to be given the audit work, findings and reports prepared by IAors since their last visit<sup>(2A)</sup>. Information is requested to help EAors to obtain a better understanding of the Organisation particularly in the initial years of their engagement as auditors<sup>(1A)</sup>.

#### **4.2.6 Composition of the IAF**

In the following question<sup>18</sup>, interviewees were asked to explain the changes that occurred over the years in the composition of the IAF with respect to volume of work and number of staff.

##### **(i) Volume of Work**

Several respondents<sub>(2A, 1B)</sub> pointed out that the number of audits conducted in a particular year has decreased tremendously since the introduction of risk-based auditing. Whereas prior to 2003, in which year risk-based auditing was introduced, around six hundred audits used to be carried out, on average; today, around twenty audits are completed in any one year. This is because each audit is much “weightier”, “laborious” and “time-consuming” and is consequently now taking around thirty-two man-days to complete. As a result, each and every auditor is carrying out around three-to-four audits every year<sub>(2A)</sub>. One respondent<sub>(1A)</sub>, added that the IAF has more control on the volume of work due to more detailed planning both for the audits originally included in the annual plan and also for the occasional ‘*ad hoc*’ or investigations that may arise.

##### **(ii) Number of Staff**

Two participants<sub>(2A)</sub>, stated that staff turnover had been consistently a major issue in the IAF, with several internally trained members of staff at different levels leaving the Bank in search for a higher paying job, this leading to professional skill attrition within the Function. In 2012, to minimise this problem and to improve quality, the COIA had initiated an internal training course covering governance, risk, compliance, and internal control procedures, followed by assessment<sub>(1A)</sub>. This proved that staff training could contribute to its retention. Such course can be considered as a milestone of the IAF.

Question b)<sup>19</sup> asked IA management interviewees about the extent to which the changes stated above helped to achieve the objectives of the Function and

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<sup>18</sup> Vide Q. A1.5 p. A3.2-3 and Q. B1.2 p. A3.2-7

<sup>19</sup> Vide Q. A1.5b p. A3.2-3

ultimately those of the organisation. The two respondents<sub>(2A)</sub> emphasised that former staff depletion clearly impacted adversely on the achievement of the internal audit objectives and ultimately also those of the organisation.

#### **4.2.7 Qualities of internal audit and their enhancement**

In the next question<sup>20</sup>, interviewees were asked to rate and comment on how far a number of qualities of Internal Audit Department members had been enhanced over the years. As shown in Table 4.1, the levels of objectivity, integrity, knowledge and skills and other competencies have all increased amongst IAors over time.

##### **(i) Objectivity**

Objectivity became significantly higher ( $p = 0.006$ ) since the inception of the IAF, with IAors becoming much more “*impartial*”, “*fair*” and “*unbiased*” whilst executing their tasks<sub>(2A)</sub>. Contributing to the deficiency in objectivity particularly up to 2007 was the fact that, up to that year, the IAF fell under the responsibility of the Director of Financial Stability<sub>(1B)</sub>. Moreover, one respondent<sub>(1B)</sub>, pointed out that IAors were not specifically trained on how to enhance objectivity.

##### **(ii) Integrity**

With respect to integrity, participants were asked to comment on both the level of honesty as well as assertiveness. Most participants stated that the level of integrity amongst IAors had been substantial since inception. Two participants<sub>(2B)</sub> explained that IAors had consistently been assertive in their work particularly in carrying out checks and counterchecks. For example, they had insisted over the years to check the amount of money in tills to the last cent.

##### **(iii) Knowledge and Skills**

Regarding knowledge and skills, significant improvements ( $p = 0.004$ ) were claimed to have been witnessed along the years. As explained by most participants<sub>(2A, 2B)</sub>, the Bank had a system of personnel rotation, whereby

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<sup>20</sup> Vide Q. A1.6 p. A3.2-3 and Q. B1.3 p. A3.2-7

approximately every five years, employees were transferred to other departments to help them gain new skills as well as to enhance their organisational knowledge. However, this meant that specialisation in one field was not possible. Moreover, as from 2014, IAors were highly encouraged and supported in obtaining the necessary professional qualifications such as relevant University Degrees or equivalent qualifications, including that of Certified Information Systems Auditor<sub>(2A, 1B)</sub>. In fact, today, the Function enjoys a high percentage of qualified financial and IT auditors<sub>(2A)</sub>.

#### (iv) Other Competencies

With respect to other competencies, participants remarked that over time, higher levels had been attained in IT, governance and market knowledge<sub>(2A, 1B)</sub>, as well as in soft skills, including increased abilities to analyse, understand and propose solutions<sub>(1A)</sub>.

		Mean	Std. Dev
<b>Objectivity</b> ( $p = 0.006$ )	Inception	2.17	0.753
	Over the years	2.50	0.837
	Present day	4.00	0
<b>Integrity</b> ( $p = 0.047$ )	Inception	2.17	0.753
	Over the years	3.33	0.516
	Present day	4.00	0
<b>Knowledge and Skills</b> ( $p = 0.004$ )	Inception	1.50	0.548
	Over the years	2.17	0.408
	Present day	4.00	0
<b>Other Competencies</b> ( $p = 0.005$ )	Inception	2.00	0.632
	Over the years	2.00	0.632
	Present day	3.86	0.378
Scale from 0 (Not at all) to 4 (Very Highly)			

**Table 4.1: Quality Enhancement Across Time**

### **4.2.8 The changing reporting lines of the IAF**

Interviewees were then asked<sup>21</sup> to state how the accountability of the IAF had changed over time. Interviewees<sub>(2A, 2B)</sub>, stated that in the initial years the IAF used to report directly to the Governor. However, over time, the reporting line changed a number of times. Such changes were also indicated in the Annual Reports (CBM 1998 – 2018). For example, between 1998 - 2000, the IAF used to report to the Deputy General Manager of the Banking Supervision and Audit Department, whilst during 2001 - 2003, the IAF used to report directly to the Deputy Governor. Moreover, during 2004 up to 2007, the IAF was accountable to the Director of the Financial Stability Division. Yet again, between 2008 - 2010, the Function started reporting again to the Deputy Governor. Eventually, in 2011, a major repositioning occurred as the IAF adopted a dual reporting line and started reporting functionally to the AC and administratively to the Governors. This can again be considered as another milestone of the IAF.

On a related note, IA management interviewees were asked<sup>22</sup> to state who are the current receivers of the internal audit reports. The primary receivers of the full audit report are the manager, head and chief officer of the auditee department. Moreover, the executive summary of every audit report is given to the AC periodically, at least every quarter. Whenever necessary, audit reports are also passed on to the Governors<sub>(2A)</sub>.

## **4.3 Types and Scope of Internal Audit Exercises**

The five questions in this part (A2.1 – A2.3, B2.1 – B2.2) refer to the second Section of both interview schedules and relate to the type and scope of internal audit exercises.

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<sup>21</sup> Vide Q. A1.7 p. A3.2-4 and Q. B1.4 p. A3.2-8

<sup>22</sup> Vide Q. A1.7b p. A3.2-4



### **4.3.1 Types and mix of audit and consultancy exercises**

Interviewees were then asked<sup>23</sup> to state the major types of audit and consultancy exercises which had been performed since the inception of the IAF and how the mix and scope of such exercises had changed. Respondents (2A, 4B), stated that the types of audit exercises performed by the IAF remained almost identical from inception till mid-2000s, with significant changes occurring after the introduction of risk-based auditing in 2003. In the past, the audits performed were primarily purely operational and used to cover mainly all the CBM services that were being provided. Interviewees stated that audit exercises consisted in performing checks<sub>(2A, 4B)</sub>, including those of transactions against vouchers (1A, 3B), of physical cash in cash tills<sub>(3B)</sub>, of vaults<sub>(3B)</sub> and payment sources<sub>(1B)</sub>, of payment authorisations<sub>(1B)</sub>, of signatories of inputters and authorisers of transactions<sub>(1B)</sub>, as well as other checks, such as bank reconciliations and checks<sub>(2B)</sub>, as well as other checks such as the stock taking of vaults, stationery and library<sub>(2B)</sub>.

Over the years the IAF branched out and started offering various types of assurance. Currently, the IAF conducts a mix of operational, financial, governance, compliance, cultural, fraud, IT, efficiency and ECB audits. As further explained by one interviewee<sub>(1A)</sub>, nowadays, operational auditing, mostly consists of auditing whether a particular process is being performed as expected, whether the risks associated with a process are being mitigated or whether adequate control mechanisms are in place. Such auditing includes payment systems, currency issues, banking and market operations and statistics (CBM 2007, p. 82).

Respondents<sub>(2A)</sub>, stated that, amongst the various National Central Banks (NCBs), there is an ongoing debate regarding the role of the IAF in the provision of consultancy services, and this in view of the possibility of conflicts of interest. At the Bank, such a possibility is now avoided by disallowing IAors that have previously provided any consultancy service to a department from conducting within a year an audit in that same department<sub>(1A)</sub>. Interviewees<sub>(2A)</sub> also explained how the IAF is currently moving towards being more proactive, this being more

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<sup>23</sup> Vide Q. A2.1 p. A3.2-4 and Q. B2.1 p. A3.2-8

evident in the provision over recent years of consultancy services to the business areas. In the conduct of such a role, as indicated by the 2013 Annual Report (CBM 2013, p. 98), the IAF mainly provides advice and recommendations on matters regarding project management, policy deployment, cost-effective implementation of control and oversight activities and consolidation as well on the enhancement of the Bank's risk assessment and information security framework.

Interviewees<sub>(2A)</sub> continued to emphasise that despite their consultancy work at the Bank, as yet, the main priority of the IAF, still remains that of providing assurance. Moreover, the yearly IAF plan caters minimally, if at all, for consultancy services given that most consultancy is requested at short notice and therefore, only rarely foreseeable. Yet, some leeway is allowed whilst formulating the audit plan to cater for any consultancy or 'ad hoc' requests or for investigations<sub>(1A)</sub>.

#### **4.3.2 Relative importance of different exercises over time**

Participants were then asked<sup>24</sup> to state how the performance of certain exercises has changed in importance over time. With regards to checks and counterchecks, participants<sub>(2A, 4B)</sub>, agreed that such a type of exercise was deemed highly important in the early years of the Bank, but has become much less of a priority over the years.

On the other hand, financial, operational, management, physical security and IT audits have grown to become more important over the years. However, such importance has abated again in recent years.

With respect to fraud and error detection, some interviewees<sub>(1A, 2B)</sub>, explained that, in the early years, no particular exercises were carried out in this direction and any detection that occurred was purely incidental. Yet, given the various ways created for fraud perpetration, since 2000 fraud audits started to be carried out, in which, whilst an analysis of the risks in terms of likelihood and possible

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<sup>24</sup> Vide Q. A2.2 p. A3.2-4 and Q. B2.2 p. A3.2-8

impact has been included, fraud susceptibility has also increasingly been tested<sup>(1A)</sup>. The IAF has now increasingly become an essential support to management oversight by participating in the custodianship of the Anti-Fraud Policy which was introduced in 2013 as part of an organisation-wide fraud awareness program. At the time, the IAors delivered presentations to all the Bank's management and staff on fraud, its prevention, identification and reporting<sup>(1A)</sup>. The introduction of Anti-Fraud Policy could therefore, be considered as a further milestone of the IAF.

Furthermore, there are now exercises which since the beginning and up to recent years have not been carried out. For example, two interviewees<sup>(2A)</sup>, explained how the IAF upon joining the EU in 2004 was able to conduct the mandatory ECB audits. Such conduct yet again can be considered as another milestone of the IAF. Moreover, other examples include efficiency, governance and cultural audits, risk management and consultancy services (*the latter in areas such as adherence to General Data Protection Regulation, Health and Safety, Payments Directive, VAT*). In 2016, the Board annexed the IAF with the Legal Function and upgraded the organisational structure into a division under the responsibility of the COIA in order to improve those consultancy services with strong legal implications<sup>(1A)</sup>. Such annexation is yet again another milestone of the IAF.

### **4.3.3 Adding value through the types of exercises**

In the next question<sup>25</sup>, interviewees were asked to elaborate on how the changes in the types of exercises performed has helped the IAF in adding value to the organisation. Interviewees<sup>(2A)</sup> agreed that in his/her assurance exercises, the IAF goes far more than before in its effort to provide value. One interviewee<sup>(1A)</sup> explained that the first step in providing such value is that of spending more time to understand well the stakeholders, including the auditees, the AC, the Board, the ECB and the EAors. In this connection, IAors also attend wide-ranging courses in order to gain more insight into the work that is carried out by each business area<sup>(1A)</sup>. Moreover, the IAF considers being represented in every

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<sup>25</sup> Vide Q. A2.3 p. A3.2-5

committee of the Bank as helpful<sub>(2A)</sub>. As a result of all this, the IAF can become well-versed on how the organisation functions even well before the start of any audit. Furthermore, its selection of audit assignments is not based merely on the riskiness of the exercises, but also on their significance and relevance to the strategic direction of the Bank<sub>(2A)</sub>.

Interviewees<sub>(2A)</sub>, further explained that an additional way of adding value to the organisation over time has been that of widening the portfolio of deliverables. In this regard, the IAF no longer undertakes solely operational audits but also carries out fraud and efficiency audits. With respect to fraud audits, the IAF now applies improved methodology in order to be able to determine how risky and susceptible in terms of fraud are the processes under examination<sub>(2A)</sub>. In recent years with respect to efficiency audits, auditors have been presenting their opinion to all business areas on the extent to which their processes are being run efficiently and how they could be run more efficiently<sub>(2A)</sub>.

Participants<sub>(2A)</sub> also mentioned that value is particularly added through the execution of consultancy engagements. Through these, the IAF is not only able to provide advice including recommending improvements to the business areas but also to identify future risks<sub>(2A)</sub>. In fact, requests for the provision of consultancy work has been on the increase since 2014<sub>(1A)</sub>. The effective role of IAors has been further enhanced since 2011, with the introduction of specialisation through the matching of lead auditors with at least two business areas to ensure increased focus on specific, critical business areas<sub>(2A)</sub>. Moreover, in 2014, the concept of specialisation was refined even further<sub>(1A)</sub>. The provision of consultancy as well as the introduction and refinement of specialisation can both be considered as milestones of the IAF.

#### **4.4 Audit Approach**

The ten questions in this part (A3.1 – A3.8, B3.1 – B3.2) refer to the final Section of both interview schedules and relate to the audit approach.

#### **4.4.1 Audit approach steps**

Interviewees were asked<sup>26</sup> to describe and explain the different stages in the typical audit over the years. From a number of responses given<sup>(2A, 1B)</sup>, it is evident that there had been no significant changes in the way the typical audit has been executed since its inception up to the end of the 1990s. Most interviewees<sup>(1A, 3B)</sup>, explained that at the start of the earlier audit process, the audit manager/s would compile the list of audits to be conducted, with no particular ranking as to the relevance, importance and risk involved. This was then followed up by periodic meetings between the audit assistance and the respective managers. A number of respondents<sup>(3B)</sup> further remarked that in these meetings, tasks to individual auditors were assigned daily, weekly or monthly as warranted by the size of the audit. Audit assistants were given standing instructions according to the individual audit together with a specific number of days being allowed for each audit exercise<sup>(3B)</sup>. Before an audit was conducted, the manager of the IAF used to notify the management of the business area or department of the initiation of the exercise, so that the necessary resources and information would be provided to the staff upon assignment<sup>(2B)</sup>. The audit would then start physically at the business area location, the bulk of it consisting of vouching, ticking and stamping work (*in green colour*). Following that, a brief outline used to be written by the audit assistants<sup>(1A, 2B)</sup>. This was then passed on in a monthly report book to the manager for discussion with the Chief Auditor. In the case, of serious findings, matters would escalate to the respective deputy Governor/s so that a rectification plan would be drawn up<sup>(1A, 1B)</sup>.

Over time, and particularly since the introduction of risk-based auditing in 2003, the audit approach has differed significantly from earlier approaches. This has come to a point wherein since 2019, a five-year rolling strategy is continuously deployed with the aim of aiding the IAF to achieve its mission and objectives through a controlled process of slow yet constant and steady change along pre-defined lines<sup>(1A)</sup>. Such rolling strategy may be considered as another milestone of the IAF.

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<sup>26</sup> Vide Q. A3.1 p. A3.2-5 and Q. B3.1 p. A3.2-9 and Q. B3.2 p. A3.2-9

Furthermore, since the start of the 21<sup>st</sup> century, increased emphasis has been placed in the annual audit process in the planning stage, whereby, in the first instance, the audit universe, which is a list including all processes that may be subject to audit, is discussed with the business areas. Each process is also then verified as to whether it is correct and updated and has its inherent and residual risk values attributed to it<sub>(2A, 1B)</sub>. Given the audit complexity, the time constraints and the manpower restrictions, only a limited number of processes are then selected to be carried out in any particular year<sub>(2A, 1B)</sub>. Each selected process is risk-rated using a time-weighted average risk which involves the simple averaging of the inherent risk value and the most recent three residual risk values together with the addition of a time-weighted percentage varying with the length of time since the audit has last been conducted<sub>(2A)</sub>. A draft list of the riskiest audits is then compiled and further tweaked both to cater the strategic direction of the Bank<sub>(2A)</sub>, and to ensure that no oversaturation of any particular area materializes<sub>(1A)</sub>. A number of mandatory ECB audits are then also added to such list<sub>(2A, 1B)</sub>. This draft list forms part of the audit plan which is presented to the AC for examination and finally approved by the Board<sub>(1A)</sub>. In the implementation of any particular audit, agreement is first reached with the relevant business area on the timing and the necessary resources needed for its completion<sub>(2A)</sub>. Furthermore, the assignment of audits to the different IAors is based on their knowledge, skills and competence<sub>(1A)</sub>. In practice each auditor is assigned between three to four audits every year.

#### **4.4.2 Involvement of various IAors in the audit process**

In the next question<sup>27</sup>, IA management interviewees were asked about how the levels of auditors vary at the different stages of the typical audit process and whether this has changed over the years. Interviewees<sub>(2A)</sub>, first pointed out that the IAF has always consisted of different levels of auditors and that the Function now includes lead, operational and principal auditors, the Head and the COIA. They then explained how, in the past, the planning stage of the audit process was left completely to the managers. On the other hand, the execution stage of the

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<sup>27</sup> Vide Q. A3.2 p. A3.2-5

audit process was the responsibility of supervisors and their audit assistants or solely of audit assistants, with audit engagements being performed in groups of around two to three people<sub>(1A)</sub>. In contrast, currently the IAF normally only assigns one audit per auditor, and teamwork has been on the decline<sub>(1A)</sub>. Each auditor has a number of audits to conduct which are then reviewed by another auditor occupying the next hierarchical level<sub>(1A)</sub>. Moreover, the COIA has become increasingly responsible for audit planning, and, together with the Head of Internal Audit, is responsible for assigning each auditor to specific audits according to auditor competences, character traits and audit complexity<sub>(2A)</sub>. For example, the complexities often resulting in investigations typically entail the engagement of the COIA or Head of Internal Audit.

#### **4.4.3 The mix of verbal and written communications**

IA management interviewees were then asked<sup>28</sup> to elaborate on whether the mix between the verbal and written communication, both with the auditees and amongst the auditors themselves has changed over the years. Participants<sub>(2A)</sub>, stated that major changes have certainly occurred in auditor/auditee communications. Some interviewees<sub>(2A)</sub>, recalled that, until the end of the 1990s, auditors used to issue audit queries to those business areas, the processes of which were not according to expectations. Upon receipt of such audit query, the respective business area manager had to implement whatever was instructed, typically with “*no questions asked*”. Moreover, one interviewee<sub>(1A)</sub>, clarified, that in the past, the internal audit process was completely closed, with the business areas never being consulted prior to the issue of the final audit report.

Moreover, interviewees<sub>(2A)</sub>, placed more emphasis on the fact that, over the years, the communication process has become more open and transparent. The result is that in the current planning stage of each audit, IAors discuss in depth major issues with the business areas so as to get them on board and possibly included in the final drafting of the results. Furthermore, prior to any final report being issued, a closing meeting is held, during which the respective business

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<sup>28</sup> Vide Q. A3.3 p. A3.2-5

area is provided with the audit findings, enabling it to express its honest reaction thereon<sup>(2A)</sup>. Furthermore, if the business area disagrees with some of the recommendations provided, IAors are prepared to discuss the issues arising and possibly to adopt different recommendations, taking into account the auditee suggestions with the only proviso being that no risk differences arise as a result of such changes<sup>(2A)</sup>. This is highly indicative that auditor/auditee communications have improved over the years with a relaxation of rigidity towards “*equity*” and “*fairness*”<sup>(1A)</sup>.

With respect to communications amongst the auditors themselves, one interviewee<sup>(1A)</sup>, explained that in the past, the level of communication was somewhat weak. S/he further added that this was due to the fact that audit assistants were not notified early on of the end effects or repercussions resulting from their audit of the respective business area. Their knowledge was limited, if at all to “*something coming up from the previous audit*” and this only if they were instructed to audit that business area again. Contrastingly, respondents<sup>(2A)</sup>, emphasised that there are now regular communications amongst auditors at all stages. Of particular significance is the fact that IAors now regularly exchange relevant information acquired from previous meetings amongst each other.

#### **4.4.4 The restructuring of the IAF**

An internal report in the late 1990s entitled “*Restructuring the Internal Audit Department*” was drawn up by an Audit Review Committee (ARC) appointed by the Board of Directors with the aim of reviewing the IAF (ARC 1998). The Report identified four areas (*audit approach, audit scope, human resources and organisational standing*) in need of prompt changes (ARC 1998, p. 5). According to it, the existing scope of internal audit programmes was limited and several functions of the bank were not being audited or sufficiently audited, which is mainly due to shortage in skills and resources including that of sufficiently qualified professional personnel (ARC 1998, p. 7). The Report insisted on the strengthening of the auditing in various offices (*correspondent banking, exchange*



*control, security, financial control)* and on introducing new ones (*information technology, investments & reserves, risk management and human resources*).

The ARC (1998, p. 8) found that the IAF as yet had negative connotations in view of the highly routine, non-satisfying and uncreative tasks involved in most audit work at the time. In this connection, the Report emphasised the need for switching over to risk-based auditing and for such new challenges, commended the IAF to be manned by personnel of expertise in Investments and Financial Markets, Information Systems and Banking and Finance (ARC 1998, p. 9). Finally, the Report recommended that the IAF would be given a higher status within the organisation and to be backed up by management. Complementarily to this, there was the need for an audit charter and an AC to be introduced (ARC 1998, p. 4). This Report and the subsequent initiation of the restructuring process could be considered as milestones of the IAF.

#### **4.4.5 The establishment of the AC**

As indicated by Annual Report (2002, p. 80), the Bank established its AC in 2001. Such establishment can be regarded as another milestone of the IAF. The Committee was meant “*to strengthen the independence of the audit functions, improve the objectivity and credibility of financial reporting, and increase the quality of risk management, internal control, audit and accounting functions*” (CBM 2002, p. 80). Since its establishment, the AC has been meeting regularly with meetings varying annually from six to nine times. AC membership was also consistent, set at three directors with the regular presence of participants, including the Head of Internal Audit, and lately also the COIA and the Chief Risk Officer. It is noted in the Bank’s Annual Reports (CBM 2004 - 2018), that since its setting up, the AC has been discussing topics such as internal audit methodologies, plans and operations, exposures to risk, effectiveness of internal controls and risk management. Moreover, the AC has also consistently been conducting regular meetings with the Bank’s EAors, mainly to discuss the Bank’s financial statements as well as improvements in financial reporting.

#### **4.4.6 Introduction to a risk-based auditing approach**

IA management interviewees were then asked<sup>29</sup> to state when the risk-based approach was implemented. In 1990, Coopers and Lybrand reviewed the audit approach and programs that were adopted by the IAF. Until then, the vouching approach had been used, but further to this report the approach was shifted to an internal control, one with the use of updated systems and audit manuals. However, around the world, substantial advancements in auditing techniques and methodologies in the management of banks were occurring and the move was towards a more risk-driven approach (ARC 1998, p. 6)

In 2000, the then deputy manager internal audit was sent to undertake a course with the Bank of England dealing with risk-based auditing. Eventually, a report was presented to management entitled “*Introducing Risk-based Auditing at the Central Bank of Malta*” (Bugeja 2000). Such a report represented a complete re-thinking of how risk was to be identified, assessed and managed within the Bank. Moreover, the Report introduced new concepts such as risk appetite, inherent and residual risk assessments, the identification of operation-specific risks and the compilation of a risk matrix. Additionally, the Report recommended that the scarce internal audit resources would be directed towards the more risk-critical functions with the focus of audit’s work being to comment on the adequacy and effectiveness of the controls that were in place to protect the institution against loss. Following extensive discussions, by 2001, the Board accepted all the recommendations presented in the Report. Subsequently, presentations were delivered to the rest of the Bank explaining the changes that were expected to occur so that the risk-based audit approach could be implemented (Bugeja 2000). The Report and the resulting changes could be considered as a milestone of the IAF.

In the run-up to the introduction of a risk-based approach, the Bank set up a Risk Management Unit with the aim of identifying, mitigating and possibly eliminating risks. Moreover, methodologies were refined and a comprehensive, risk-

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<sup>29</sup> Vide Q. A3.4 p. A3.2-5

organised and ranked audit universe was built<sup>(1A)</sup>. Eventually, risk-based auditing was fully implemented by 2003<sup>(2A)</sup>. In 2006, the IAF developed the first version of the “*Audit Approach and Testing Methodology and Guidelines*” which consolidated the Manual further (CBM 2006, p. 72). Both the approach and the guidelines can be considered as milestones of the IAF.

The next part of the question asked<sup>30</sup> IA management interviewees whether there were any particular factor/s that induced the adoption of the risk-based approach. Two respondents<sup>(2A)</sup>, stated that the main factor was that of modernising the IAF and bringing it in line with the profession as being practised externally. One respondent<sup>(1A)</sup> added that opposition to this approach had been prevalent at the start of its implementation of the approach. Yet, such opposition had been overcome quickly by the realisation that the Bank was merely following the practices of other NCBs.

#### **4.4.7 Adherence to the IIA Standards**

##### Full compliance with IIA Standards and Code of Ethics

IA management interviewees were then asked<sup>31</sup> which standards are adhered to by the IAF when conducting internal audit exercises. One interviewee<sup>(1A)</sup> stated that by 2001, IAF audits started to be fully compliant with the IIA Standards and Code of Ethics. In adherence to such standards, the IAF started to face new requirements, particularly those relating to the conduct of an Internal Quality Assessment every two years and an External Quality Assessment every five years<sup>(2A)</sup>. The full adherence to the Standards and the quality assessments can be regarded as milestones of the IAF.

##### The first Internal Quality Assessment of the IAF

The first Internal Quality Assessment on the internal audit activity was carried out in 2006. Other assessments were carried out in 2010, 2012, 2015 and 2017. As stated by the CBM 2006 Annual Report, the main objective of such an

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<sup>30</sup> Vide Q. A3.4b) p. A3.2-5

<sup>31</sup> Vide Q. A3.5 p. A3.2-5

assessment was to determine the extent of internal audit compliance with the IIA Standards and Code of Ethics as well as confirmation of compliance with the audit Charter and Manual (CBM 2006, p. 72). Moreover, as also confirmed by two respondents<sup>(2A)</sup>, the execution of this assessment started to aid the IAF in identifying opportunities to enhance management and work processes, and also to help in adding value to the other functions and governance of the Bank (CBM 2006, p. 72).

#### *The first External Quality Assessment of the IAF*

On the other hand, the first External Quality Assessment on the internal audit activity was carried out in 2008. Subsequent assessments were carried out in 2013 and 2018. The objectives of the External Quality Assessment are twofold. First, it started to help in providing assurance on the level of conformity with the IIA Standards and the Code of Ethics. Secondly, it started to assess compliance with the ESCB-IAC audit Manual for the assurance and consultancy work that needed to be undertaken on behalf of the ESCB-IAC. Moreover, the more recent reviews now cover also the organisational structure of the IAF, the availability of resources, the work practices, technology, quality and performance management (CBM 2013, p. 98).

#### **4.4.8 Reporting follow-ups over the years**

Another question<sup>32</sup> asked IA management interviewees about the major changes in IA reporting follow-ups over the years. Respondents<sup>(2A)</sup>, stated that there had been considerable changes in follow-ups execution. In the early years of its establishment, the IAF used to conduct follow-ups four times a year, with the outcomes recorded in a database and reported to the AC. However, this resulted in the number of follow-ups in a year being too few and lacking the constant contact with the business areas as well as risking inaccurate reporting<sup>(2A)</sup>. However, in recent years continuous follow-ups were increasingly adopted, thus enabling a “*more rewarding relationship*” to be formed with the business areas<sup>(1A)</sup>. Furthermore, it became possible to adopt “*real time*” on the addressing of

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<sup>32</sup> Vide Q. A3.6 p. A3.2-5

findings<sub>(2A)</sub>, with the follow-up process now becoming “*fairer*” and “*more justifiable*”<sub>(1A)</sub>. One interviewee<sub>(1A)</sub>, added that despite the increased workload resulting from the more exacting follow-ups, these were still considered highly worthwhile.

#### **4.4.9 Extent of influence from feedback**

IA management interviewees were then asked<sup>33</sup> about the extent to which the internal audit approach had been influenced over the years by the feedback of the user departments. The interviewees<sub>(2A)</sub>, explained that, over the years since the introduction of risk-based auditing in 2003, more emphasis has been placed by the IAF on feedback from auditees. In recent years, audit satisfaction questionnaires have been sent to the management of all business areas for them to complete<sub>(2A)</sub>. Regular feedback has also been obtained from the questionnaires sent to all departments when the periodic Internal Quality Self-Assessment is carried out and also from the reports based on the discussions carried out by the external reviewers of the External Quality Assessment<sub>(2A)</sub>. The resulting feedback has consistently been documented, analysed and transformed into KPI's, and action has generally been taken where the IAF or the AC have found reasonable grounds for change<sub>(1A)</sub>. However, one interviewee<sub>(1A)</sub> stated that over the years, the feedback and suggestions given by the user departments, have not actually resulted in major changes in the internal audit process. Another interviewee<sub>(1A)</sub> also emphasised that progress has been achieved in the recent past with regards to addressing what used to be repeated criticisms on the part of the business areas about their lack of involvement in the internal audit process. Consequently, the business areas are now far more involved in the audit process as from its planning stage<sub>(2A)</sub>. In fact, as stated by the respondents<sub>(2A)</sub>, as from that early stage, the business areas are sent planning documents which confirm the process to be audited, thus enabling their Chief Officers and Head of Departments to understand the audit exercise well.

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<sup>33</sup> Vide Q. A3.7 p. A3.2-6

#### **4.4.10 *Extent of influence from EU IAors and European Institutions***

In the next question<sup>34</sup>, IA management interviewees were asked about the extent to which the typical internal audit approach has been influenced over the years by interactions and exchanges with IAors in other European country counterparts and institutions. Interview participants<sub>(2A)</sub>, replied that the extent of influence has been quite significant. This has emanated from two main sources: the ECB and the IAC members. Whilst the ECB is specifically precluded from proposing how the IAF of the CBM is to be run, influence has been exerted to a large extent by physical meetings and teleconferences at the EU level and amongst NCB's exchanging ideas and discussing common issues that arise from time to time<sub>(2A)</sub>.

### **4.5 Conclusion**

This chapter presented the main findings that emerged from the semi-structured interviews conducted, scrutiny of Annual Reports and other internal audit documentation. The next chapter presents a discussion on the findings.

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<sup>34</sup> Vide Q. A3.8 p. A3.2-6

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# Chapter 5

# Discussion

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## **5.1 Introduction**

This chapter deliberates on the research findings of the study in line with the literature presented in Chapter 2. As illustrated in Figure 5.1, Section 5.2 depicts the major milestones in the development of the IAF. Subsequently, Section 5.3 till Section 5.7 discuss in detail the five development stages of the IAF and assess the changes that occurred with respect to the operational structure, internal audit exercises and internal audit approach in each and every stage. Then, Section 5.8 looks towards the future and finally, Section 5.9 concludes the chapter.



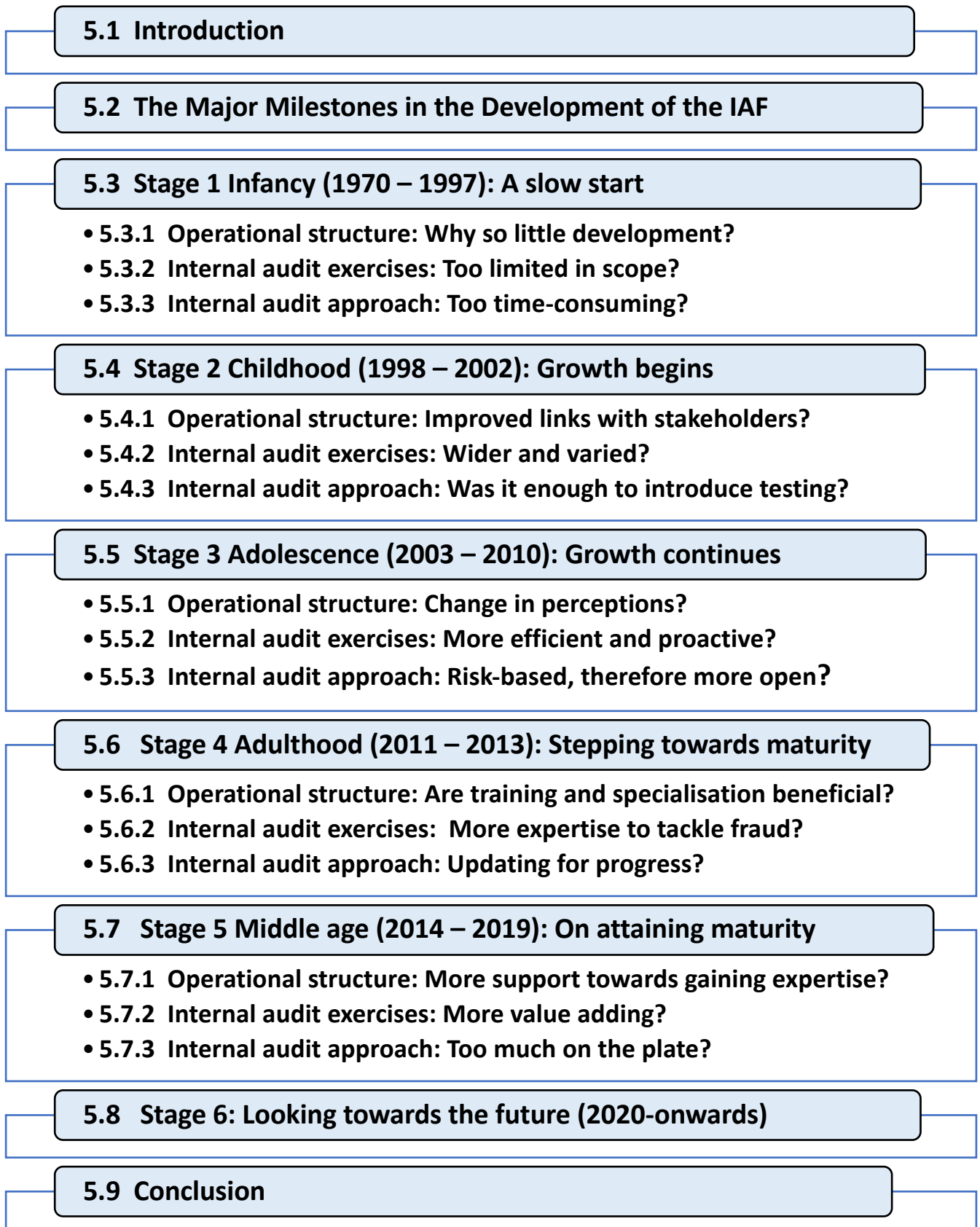


Figure 5.1: Outline of Chapter 5

## **5.2 The Major Milestones in the Development of the IAF**

Figure 5.2 below lays out, in chronological order, the major milestones in the development of the IAF. Such milestones will now be analysed for their historical significance in the lifespan of the IAF. As may be seen, the growth and maturity of the IAF may be closely analogous to the stages of human life development including infancy, childhood, adolescence, adulthood, middle age and senior years. This is despite the fact that in the case of the IAF, the latter senior-year stage has not yet been reached.

Year	Major Milestones
<b>Stage 1: Infancy (1970 – 1997)</b>	
1970	Establishment of the IAF (Section 4.2.1)
<b>Stage 2: Childhood (1998 – 2002)</b>	
1998	Restructuring of the IAF (Section 4.4.4)
2000	Internal audit report recommending risk-based auditing (Section 4.4.6)
2001	Establishment of the AC (Section 4.4.5) Full compliance with IIA Standards and Code of Ethics (Section 4.4.7)
<b>Stage 3: Adolescence (2003 – 2010)</b>	
2003	Implementation of risk-based auditing (Section 4.4.6)
2004	Initiation of audits on behalf of the IAC of the ESCB (Section 4.3.2)
2005	Introduction of the first AC Charter (Section 4.2.2) The first version of the internal audit Manual (Section 4.2.2)
2006	Developing of audit approach and testing methodology (Section 4.4.6) Conduct of first Internal Quality Assessment of the IAF (Section 4.4.7)
2008	Conduct of first External Quality Assessment of the IAF (Section 4.4.7)
<b>Stage 4: Adulthood (2011 – 2013)</b>	
2011	Repositioning of reporting lines (Section 4.2.8) Introduction of internal audit specialisation (Section 4.3.3)
2012	Design and delivery of the first internal training course (Section 4.2.6)
2013	The first Anti-Fraud Policy (Section 4.3.2)
<b>Stage 5: Middle age (2014 – 2019)</b>	
2014	Refinement of internal audit training and specialisation (Section 4.3.3) More focus on consultancy engagements (Section 4.3.3)
2016	Legal Function annexed with the IAF (Section 4.3.2)
2019	Introduction of a five-year rolling strategy (Section 4.4.1)

**Figure 5.2: The Major Milestones in the Development of the IAF**

### **5.3 Stage 1 Infancy (1970 – 1997): A slow start**

As can be seen in Figure 5.2, this was the initial stage of infancy and involved the first and only milestone in 1970, which was the setting up of the IAF. One may here comment that, as a vital organ in the organisation, the IAF was amongst the earliest function established by the CBM. Although infancy is the period of most rapid growth after birth, at least from today's perspective, the IAF seems to have remained too much in the infancy stage with slow development apparently having occurred over thirty years. Despite the fact that little progression may have the benefits of lower levels of disorientation and recklessness, yet being too conservative or resistant to change can lead to missed opportunities or even stagnation.

#### ***5.3.1 Operational structure: Why so little development?***

The root cause behind the apparently little progress achieved at this stage is as yet not exactly known. This may be partly due to too few surviving and available staff to supply the details. Yet, the indications from the interviewees are that a slow and laggard development indeed occurred in the period for a number of major operational factors including lack of expertise, high turnover and insufficient significance being allotted by the Bank to the IAF.

#### ***A lack of expertise***

The findings<sup>35</sup> indicate that, in the initial years, the Function was characterised by personnel with insufficient expertise in IA. Most probably, such personnel had no formal qualifications beyond the banking diploma recognised at the time in all banking sectors - a qualification which hardly, if at all, covered IA. In addition, it is understandable that a newly starting, unique organisation in a small state would find it difficult to engage sufficiently expert staff. Furthermore, the system of personnel rotation amongst the different departments which was prevalent at the time, permitted little room for specialisation<sup>36</sup>. During most of this period, this tended to result in staff - particularly at the lower levels - being typically assigned

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<sup>35</sup> Vide Section 4.2.1

<sup>36</sup> Vide Section 4.2.7 (iii)

at the IAF on a two-to-four-year basis and then transferred to other Bank departments. However, as stated by Chadwick (1995)<sup>37</sup>, while the temporary assignment of staff to IA may be found beneficial as a training ground for future managerial positions, such assignments of personnel with no previous experience or even any particular interest in auditing can be – and probably was counterproductive in the enhancement and development of the IAF.

### High staff turnover

Throughout this initial period, staff turnover and requests for internal transfers were also found to be recurring issues within the IAF. One major factor for such staff moves was that auditing work at the time consisted mostly of routine, non-satisfying and uncreative tasks<sup>38</sup>. Understandably, such a working environment was demotivating for staff who, unless transferred within a short time to other departments, tended to consider terminating their employment with the Bank. Added to this, no sponsorships for formal educational qualifications beyond that of the banking diploma are known to have been offered by the Bank at the time. In this regard, the only known incentive was the grant of a few days of study leave for those professional qualifications acceptable to the Bank, these excluding any IA qualifications, which were practically unknown at the time with IA not being perceived as a separate discipline. Clearly, it was yet too early for the Bank management to realise that more action was definitely needed if it was to preserve the quality of staff needed for such a specialised function.

### Insufficient significance within the organisation

At the time, the IAF was clearly perceived as insignificant in the eyes of the Bank management and the Board of Directors. As has already been seen earlier, the IAF was too commonly seen as “*just another checking function*”<sup>39</sup> with the “*negative connotation*” of “*being invasive in its work*”<sup>40</sup>. One major factor contributing to such perceptions was the lack of knowledge in IA by the top

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<sup>37</sup> Vide Section 2.2.4

<sup>38</sup> Vide Section 4.4.4

<sup>39</sup> Vide Section 4.2.3

<sup>40</sup> Vide Section 4.2.2

echelons of the Bank, this resulting in this Function hardly if at all, being utilised as an organisational tool beyond that of error detection. In consequence, the role of the IAF in internal control was as yet perceived to be rudimentary while the Function played no role within wider areas such as consultancy services. In addition, the IAF at the time would report directly to the Governor as there was yet no AC intermediation. Ostensibly this seemed to give the IAF sufficient status and, in this connection, even the literature<sup>41</sup> suggests that independence and objectivity could be enhanced when reporting to such a level. Yet the reality was that no Governor would, or even could, find enough time to explore deeply the IA potential with the result that even the required follow-up would be limited to overseeing error correction.

### ***5.3.2 Internal audit exercises: Too limited in scope?***

At least from today's point of view, in this initial period, the scope of the IAF was limited to the provision of basic assurances, and such provision was not even applicable to all Bank Departments. An example of this was the complete exclusion throughout the period of any auditing in the Exchange Control Division. Therefore, beyond the lack of any provision of consultancy services already referred to earlier, the IAF was as yet limited in its potential provision of much more meaningful and added value. Given such limitations, the IAF was, mostly focused on the continuous checking of the Bank's operations, with somewhat more focus on the Bank's Finance Section. Too often, this boiled down to exercises involving the carrying out of numerous checks and counterchecks with the aim of ensuring error detection. Therefore, the IAF was in practice an extension of EA, as such a limited role is described in the literature<sup>42</sup>: it was effectively acting as a mere checker and precursor to the annual visit of the EAors. At the time, the IA terms of reference were therefore thwarted towards evaluating and improving the column of internal control effectiveness and this only limitedly to some of the aspects of such control. The other two columns unreservedly assessed by the IAF today, that is risk management and

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<sup>41</sup> Vide Section 2.2.3

<sup>42</sup> Vide Section 2.3.1

governance effectiveness, were as yet completely unknown. One clearly contributory factor to such highly limited IAF scope was the lack in those early days of the external pressures which have since come into being with respect to adherence to the international benchmarks and standards, particularly the European ones.

### **5.3.3 Internal audit approach: Too time-consuming?**

In line with the literature<sup>43</sup>, the findings<sup>44</sup> indicate that throughout this early period, the IAF made consistent use of the vouching approach, thus entailing the complete and continuous verification of transactions carried out in the processes being subjected to audit. Such an approach invariably involved the thorough examination of each and every transaction for IAors to verify and then certify by their green stamps that it was correct. Evidently, this involved the auditors in the inspection of too many documents and resulted in an allocation of human resources which auditors later determined to be too wasteful of time resources and not so value-adding. This was notwithstanding the fact that, at the time, IAFs in other European countries were already changing their approach to a more systematic and disciplined one in line with accepted standards such as those of the IIA, thus rendering the work much less laborious and yet much more effective. However, the Bank's IAF at the time was not bound by any such or similar standards and therefore, retained its approach locked into such time-consuming procedures.

## **5.4 Stage 2 Childhood (1998 – 2002): Growth begins**

As can be seen in Figure 5.2, this childhood phase included four milestones involving major growth. Growth was spurred by the first milestone in 1998 which involved, a restructuring exercise undergone with the intention of analysing the then current IAF situation and of formulating a plan for structural changes, including those relating to the IAF human resources. The second milestone in 2000 involved an internal report on introducing risk-based auditing although such

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<sup>43</sup> Vide Section 2.4

<sup>44</sup> Vide Section 4.4.6

introduction was actually introduced in Stage 3. This was aimed at catching up with the changes occurring at the time within the IA profession. The third milestone in 2001 involved the setting up of the AC to monitor both IA and EA. The fourth milestone, also in 2001, was the initiation by the IAF to adhere fully to the IIA Standards and Code of Ethics this bringing in improved discipline in the audit work and was therefore, another step towards growth.

#### ***5.4.1 Operational structure: Improved links with stakeholders?***

Despite this being a shorter period than the previous one, the four major changes which occurred left an indelible mark on the development of the IAF. In the first instance, the ongoing problem of a lack of IA knowledge and expertise amongst internal audit staff clearly began to be addressed. In particular, the need was realised for the top personnel of the IAF to possess accounting qualifications and to have some such senior promotions from those suitably qualified but elsewhere within the Bank. This, therefore, ensured an improvement in the understanding of the Bank's business areas amongst the top internal audit personnel. Indeed, the result of such changes was that the IAF could provide improved services, this which is in line with both the literature<sup>45</sup> and findings<sup>46</sup>, that a sound understanding of stakeholders is the first step in adding value.

Additionally, the setting up of the AC later in this period continued to raise the status of the IAF as this enabled it to acquire access to all the key areas of the organisation. Moreover, through the direct participation of the COIA in AC meetings, the Function became more involved in the overall strategy of what the IAF was meant to do.

#### ***5.4.2 Internal audit exercises: Wider and varied?***

The initiation by the IAF at this stage to adhere fully to the IIA Standards and Code of Ethics resulted in the scope of the audit exercises being carried out becoming much wider and in line with what is expected by such Standards. The

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<sup>45</sup> Vide Section 2.3.5

<sup>46</sup> Vide Section 4.3.3



IA scope was extended to the whole Bank which meant that the exercises became not only more varied but also interesting to staff.

#### **5.4.3 Internal audit approach: Was it enough to introduce testing?**

At this stage, the internal audit approach changed from the vouching approach of Stage 1 to an internal control one based on compliance and substantive testing, thus alleviating the department from the heavy consumption of time involved in the approach of the previous stage. However, saving on time was clearly not enough: the business area managers were as yet, not involved at all in the audit approach but were typically expected to implement whatever was recommended with “*no questions asked*”<sup>47</sup> and without consultation prior to the finalisation of the audit report.

### **5.5 Stage 3 Adolescence (2003 – 2010): Growth continues**

As can be seen in Figure 5.2, this adolescent stage involved major changes within the IAF within a relatively short period, such changes being earmarked by seven milestones, the highest number in any stage to date. The first milestone in 2003 was the introduction of the risk-based auditing approach that had been recommended twice in the previous stage. The second milestone in 2004 involved the Function starting to conduct ECB audits on behalf of the IAC. The third and fourth milestones in 2005 involved the introduction of the first AC Charter and also the first internal audit Manual. The fifth and sixth milestones in 2006 involved the development of the audit approach and testing methodology as well as the conduct of the first Internal Quality Assessment of the IAF. The final milestone in this stage was the conduct of the first External Quality Assessment of the IAF in 2008.

#### **5.5.1 Operational structure: Change in perceptions?**

The findings indicate<sup>48</sup> that up until the beginning of this stage, IAors were still mostly negatively perceived in the organisation. However, during this period,

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<sup>47</sup> Vide Section 4.4.3

<sup>48</sup> Vide Section 4.2.5

auditee perceptions changed radically as they became much more appreciative and respectful towards the IAF and the IAors themselves. Such changes were probably derived from the fact that the internal audit process was becoming more open with auditees, with auditors expressing more readiness to take into account auditee feedback (refer to Section 5.5.3)<sup>49</sup>, this probably following the internal quality assessments that started to take place. A possible additional factor was the improved communication and transparency amongst both auditors and auditees<sup>50</sup>.

### ***5.5.2 Internal audit exercises: More efficient and proactive?***

At this stage, increased formal documentation<sup>51</sup>, including the internal audit Charter and Manual, were introduced to ensure full compliance with the IIA Standards. This led to more consistency, stability and widening of IAF exercises and also improved coordination amongst IA members of staff. Additionally, the regular reviews of such IA documentation continued to contribute to the improvement of such exercises in view of the consequent regular updating of major audit tools. In this regard, the initiation of audits on behalf of the IAC of the ESCB further raised the awareness of IAF staff about the detailed procedures being carried out in other NCBs.

Furthermore, at this stage, risk-based auditing was introduced, and this led to the widening of the IAF role beyond the traditional one of evaluating internal control processes: the IAF now started to include the evaluation of the effectiveness of risk management processes as part of its work. The categorisation and prioritisation of risks which were thus introduced most probably enabled better and more efficient decisions in the allocation of the scarce IAF resources, thus clearly saving both time and money. Furthermore, the IAF could now start to be more proactive in identifying its major problematic areas.

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<sup>49</sup> Vide Section 4.3.1

<sup>50</sup> Vide Section 4.4.3

<sup>51</sup> Vide Section 4.2.2

### **5.5.3 Internal audit approach: Risk-based, therefore more open?**

At this stage, the risk-based auditing approach was finally implemented. The five years elapsing since its first recommendation in 1998 is highly indicative of the internal resistance by staff to such implementation – resistance which was to be expected since this involved a major overhaul<sup>52</sup>. Perhaps a major factor in the success of the IAF in introducing this approach was that by then, the Bank as a whole was much more interested in how other NCBs were approaching their IA work given that Malta was soon to become a new member and ultimately part of the Eurozone. Another possible factor was that, with the first trials of this approach, the user departments realised that it this was more open and democratic from their perspective. Contrary to previous audit approaches, this one involved them in the process, both at the planning stage and the audit report stages.

## **5.6 Stage 4 Adulthood (2011 – 2013): Stepping towards maturity**

As can be seen in Figure 5.2, this relatively short adulthood stage was composed of four milestones. The first and second milestones in 2011 were the repositioning of reporting lines and the introduction of internal audit specialisation respectively. The third milestone in 2012 was the design and delivery of the first internal training course, whilst the final milestone in 2013 was enactment of the first Anti-Fraud Policy.

### **5.6.1 Operational structure: Are training and specialisation beneficial?**

During this stage, the IAF adopted<sup>53</sup> a dual reporting line as per best practices, that is, functionally reporting to the AC and administratively reporting to the Governors. As indicated by the IIA<sup>54</sup>, appropriate reporting lines such as that adopted are extremely critical in ensuring transparency and in thwarting collusions and conflicts of interest.

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<sup>52</sup> Vide Section 4.4.6

<sup>53</sup> Vide Section 4.2.8

<sup>54</sup> Vide Section 2.2.3 and Attribute Standard 1110 of the 2017 IIA Standards

Additionally, the on-going issue of high staff turnover started to be seriously addressed by the provision of internal training courses<sup>55</sup>. In fact, the first internal audit course immediately proved fruitful with the reduction of staff requests for termination of employment. Perhaps a main factor behind such success is that such and similar courses typically help IAors to better understand the value of their role within the organisation, thereby enhancing their morale by instilling in them a higher sense of accomplishment and fulfillment as well as increased job satisfaction. Added on to this, the introduction of internal audit specialisation<sup>56</sup> probably led to increased focus on specific critical areas thus guaranteeing better service delivery.

### ***5.6.2 Internal audit exercises: More expertise to tackle fraud?***

At this stage, with the introduction of the first Anti-Fraud Policy<sup>57</sup>, the IAF started to provide assurance over fraud controls. Separate audit exercises were thus launched to include the analysis of significant fraud risk areas and the determination of the susceptibility of such areas to fraud. Consequently, with their participation in the custodianship of the Anti-Fraud Policy, IAors started to face even more pressures for specific expertise including both qualifications and experience.

### ***5.6.3 Internal audit approach: Updating for progress?***

During this period, the risk-based approach continued to be refined, particularly by the introduction of continuous updates in line with developments occurring internationally but especially in other European NCBs<sup>58</sup>. Another source of progress was the collective experience being gained progressively by the IA team. In this connection, findings obtained from post-audit questionnaires started to be more consistently analysed with prompt actions being taken to improve the overall approach<sup>59</sup>.

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<sup>55</sup> Vide Section 4.2.6 (ii)

<sup>56</sup> Vide Section 4.3.3

<sup>57</sup> Vide Section 4.3.2

<sup>58</sup> Vide Section 4.4.10

<sup>59</sup> Vide Section 4.4.9

## **5.7 Stage 5 Middle age (2014 – 2019): On attaining maturity**

As can be seen in Figure 5.2, this stage also included four milestones which took the IAF to its maturity. The first and second milestones in 2014 involved the refinement of internal audit training and specialisation and much more focus on consultancy engagements. The third milestone in 2016 was the annexation of the Legal Function with the IAF. The final milestone to date was the introduction in 2019 of a five-year rolling strategy.

### ***5.7.1 Operational structure: More support towards gaining expertise?***

Throughout this stage, both IA training and specialisation were further enhanced<sup>60</sup>. Periodic professional training was stepped up in specific audit areas, and staff started to be more exposed to local and overseas training and educational opportunities. Additionally, staff began to be more actively incentivised to gain professional, in particular IA qualifications, by the awarding of financial grants and concessions of unpaid leave. This encouraged them to seek better opportunities for further education which included several possibilities for even undertaking higher studies.

### ***5.7.2 Internal audit exercises: More value adding?***

During this stage, the IAF further widened its scope<sup>61</sup> to include the provision of several more varied consultancy services. This effectively led to the setting up of a role for the IAF involving the evaluation and improvement of the effectiveness of the Bank's governance process. Such a role was additional to the other two roles referred to earlier (refer to Sections 5.3.2 and 5.5.2) which had been set up in the earlier stages. Amongst other developments, this meant that the IAF became much more value-adding and that the COIA himself became a trusted advisor of the Board of Directors. IAF image was thus further enhanced and various improvements ensued in the working relationships between IAors and auditees. Moreover, the potential of the IAF to deliver added value was further

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<sup>60</sup> Vide Section 4.2.7

<sup>61</sup> Vide Section 4.2.4

enhanced by the annexation of the Legal Function with the IAF. While controversy still rages both in the literature<sup>62</sup> and in central banking<sup>63</sup> about the perils of including consultancy services, and this particularly in view of possible threats to IA independence, the CBM IAF accepted to be proactive and became one of the first NCBs to widen such consultancy services.

### **5.7.3 Internal audit approach: Too much on the plate?**

As indicated in the findings<sup>64</sup>, when formulating the annual audit plan, the COIA has to allocate some leeway for the various consultancy requests now forthcoming at this stage. Nonetheless, the human resources required to meet such requests remain difficult to foresee. As a result, the IAF may easily face the danger of engaging in too much additional work which was originally unplanned at the expense of the work set out in the annual audit plan. One way to resolve this dilemma may be that of completely separating the assurances and consultancy services in different sections and having different members of staff in each with the introduction of a strict Chinese wall between each section so as to ensure that there are no conflicts of interest and to ensure also that each section reaches its objectives.

## **5.8 Stage 6: Looking towards the future (2020-onwards)**

Amid the dynamic business environment, the IAF will be expected to continue to evolve and mature so as to remain relevant and vital within the CBM. More than ever, stakeholders will probably be demanding efficiency in assurances, consultancies and control and risk evaluations. In particular, the IAF will probably continue to shift from the manual testing of most risks and controls to a focus on the assessment of key and strategic risks. Further regulatory framework changes will also be expected with the additions of technology innovations and increased cyber risks. As a result, internal audit professionals will possibly become amongst the professionals most in demand at the CBM. Correspondingly, the IAF could

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<sup>62</sup> Vide Section 2.3.5

<sup>63</sup> Vide Section 4.3.1

<sup>64</sup> Vide Section 4.3.2

therefore find it even tougher to attract and formulate the appropriate internal audit teams with the required variety of specialisations and possessing additional forensic skills, as well as more critical thinking and judgement skills.

Furthermore, increased collaboration between the audit teams and stakeholders may be expected, thus enabling the IAF to complete most of its exercises within a relatively shorter time frame. This may be so, particularly with respect to its audit assurance exercises wherein further time savings may be gained at the various stages including audit planning, fieldwork and review.

With respect to future internal audit approaches, the IAF may be expected to continue to shift from the traditional to more agile ones. Such new approaches will probably be based on even more flexible and iterative planning whereby new challenges may include the undertaking of a continually updated backlog of risk-prioritised audits. Moreover, communication channels will also be expected to continue to improve if not radically change, thus enabling more frequent and possibly less formal reporting than there is today.

## **5.9 Conclusion**

This chapter discussed the research findings. The following chapter presents a summary of the findings and concludes the dissertation.

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# Chapter 6

## Summary,

## Conclusions and

## Recommendations

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## **6.1 Introduction**

This chapter concludes the dissertation. Section 6.2 provides a summary of the study, whilst Section 6.3 outlines the main conclusions emanating from this study. Section 6.4 puts forward a number of recommendations and Section 6.5 identifies possible areas for further research. Finally, Section 6.6 provides the concluding remarks.

## **6.2 Summary**

The main objectives of the study were to assess how the operational structure of the IAF at the CBM has developed over the years, to assess how the different exercises carried out by the IAF have changed since the inception of the Bank, and to examine how the approach to such different exercises has also changed over the years.

This study adopted a qualitative mixed-method approach to ascertain the achievement of these objectives. Semi-structured interviews were carried out with six participants, consisting of current and ex-IAF employees in various hierarchical positions. These were then backed up by an analysis of the 1968 - 2018 CBM Annual Reports and any available unpublished internal audit documentation.

The findings indicate that the objectives of the IAF have remained mostly unchanged over the years except for being widened to embrace the enhancement of organisational value. Furthermore, stakeholder perceptions of the Function improved from being negative and invasive to being generally respectful. Notably, the number of audits had to decrease over the years and this was because most audits became much weightier, laborious and time-consuming and also in view of the high staff turnover which resulted over many years. Nonetheless, there was a turnaround with respect to staff turnover in the later development stages when much more emphasis started to be placed on staff development and training. Moreover, over time internal audit quality increased significantly with more emphasis being placed on objectivity, integrity,

qualifications and other competencies. With respect to audit exercises, the Function evolved from one carrying out only checks and reviews of detailed transactions to one providing well-planned assurance and consultancy services which became also much more varied and widened in scope. Regarding the audit approach, the introduction and later refinement of risk-based auditing transformed this from being a closed one to being an approach which is open, transparent and more democratic and which involves much improved level of communication.

### **6.3 Conclusions**

The study concludes that the IAF has gone through notable advancements in various stages over the last twenty years with respect to its operational structure, internal audit exercises and internal audit approach. In particular, the historical milestones identified as spurring such stages may also be found relevant in the future development of the IAF.

With respect to the operational structure, during the first thirty years, the IAF underwent slow and laggard development as a result of a lack of expertise, high staff turnover and being considered insignificant within the Bank. Over time, the need was realised for the top personnel of the IAF to possess accounting qualifications and a sound understanding of the Bank's business areas. Additionally, the setting up of the AC continued to raise the status of the IAF mostly by permitting it access to all key areas of the organisation. Furthermore, as already stated earlier, auditees increasingly changed their originally negative perceptions and became much more appreciative towards the IAF and the IAors themselves. The on-going issue of high staff turnover was also addressed through the provision of internal training courses and more internal audit specialisation.

As for internal audit exercises, during the initial period, the IAF was practically an extension of EA with its scope mainly limited to the provision of basic assurances involving the carrying out of numerous checks and counterchecks to detect errors. Eventually, following the full adherence to the IIA Standards and Code of

Ethics as well as the increase in formal documentation, the scope of the internal audit exercises was widened. Moreover, with the introduction of risk-based auditing, the role of the IAF extended beyond the traditional one of internal control evaluation to one including the evaluation of the effectiveness of risk management processes. Additionally, with the introduction of the first Anti-Fraud Policy, the IAF started to provide assurance over fraud controls. Finally, with the provision of consultancy services, the IAF became more value-adding and proactive and the role of the Function started to extend further to the evaluation and improvement of the effectiveness of the Bank's governance processes.

Regarding the internal audit approach, the study concludes that initially the IAF made consistent use of the time-consuming vouching approach which entailed the thorough examination of all transactions. Subsequently, the approach changed to an internal control one based on compliance and substantive testing. Nonetheless, it was the introduction of the risk-based audit approach prior to Malta joining the Eurozone that rendered the audit approach more rigorous and efficient.

#### **6.4 Recommendations**

This study recommends:

- (i) more emphasis in IAor/stakeholder communications** (Section 5.4.1)

Given that the IAF has numerous stakeholders, it is recommended that more regular face-to-face meetings are to be carried out with them for the IAF to obtain and improve its understanding of their contrasting needs and interests as well as to identify and assess their priorities to keep on providing value.

- (ii) regular reviews of IA documentation** (Section 5.5.2)

It is recommended that the IAF reviews regularly and updates its IA documentation to ensure that the changes that are occurring in the regulations, audit processes and methodologies are adequately reflected. Moreover, such

updated documentation needs to be distributed to all IAors to guarantee that the most recent versions are available for use.

**(iii) increased interactions with ECB and NCBs** (Section 5.5.2 and 5.6.3)

It is recommended that internal audit representatives continue and possibly increase their participation in the regular conferences that are held relating to IA. Such conferences serve as an excellent opportunity for NCBs to interact with each other and to actively share their perceptions on certain areas to further enhance their knowledge and understanding of best industry practices.

**(iv) more significance to be placed on auditee feedback** (Sections 5.5.3 and 5.6.3)

It is recommended that feedback is not only collected by the means of questionnaires and face-to-face meetings after each audit but also that such invaluable information collected is thoroughly aggregated and analysed. Each audit's strengths and weaknesses may then be promptly identified, thus enabling any required changes to take place and also convey that auditee feedback is being taken more seriously.

**(v) the IAF to conduct on-going training** (Sections 5.6.1 and 5.7.1)

The business world is constantly changing and may quickly place IAors at risk of becoming unable to continue to provide relevant insights to their organisation. It is therefore recommended that the IAF provides continuous training to all staff focused on changes such as those in technology, communications, skills and ethics.

**(vi) the IAF to separate the assurance and consultancy roles** (Section 5.7.3)

It is recommended that the IAF separates its assurance and consultancy roles by ensuring that no personnel are involved in both roles at the same time or even within any reasonable period, for instance two years. This would help to minimise any possible conflicts of interest.

## 6.5 Areas for Further Research

This study identified the following potential areas of research:

**(a) Stakeholder perceptions of CBM Internal Auditors: An analysis**  
(Section 5.5.1)

As already stated earlier, stakeholder perceptions of IAors have changed materially over the years. However, a specific and deeper study on this development may help to further enhance the image of the auditors amongst the various stakeholders.

**(b) Achieving a balance in consultancy services by central bank auditors: A Maltese study** (Section 5.7.3)

The ongoing debate amongst central banks about the possible conflicts of interest relating to the role of the IA in consultancy engagements was referred to earlier in this study. A specific study on the sensitive issues arising may provide insights on the possibility of achieving the right balance with respect to such IA services within the context of the CBM.

**(c) Alternative approaches to risk evaluation by central bank internal auditors: A Eurozone study** (Section 4.4.1)

As stated earlier, there are various techniques that can be used to evaluate the risk processes of an organisation. A possible study in this regard amongst Eurozone central banks may compare such techniques and attempt to establish a best practices model.

## 6.6 Concluding Remarks

The development of the IAF from infancy to maturity is an important reminder of the series of challenges which the Function had to undergo to become an appreciated value-adding function within the CBM. It also heralds that new challenges will be looming in the future which must be met as the Function moves on to its senior years. Despite being at its maturity stage, for the IAF to remain effective it should *“not let a stage become an imprisonment, but rather an inspiration to keep growing and developing”* (Koon n.d.).

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# Appendices

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**Appendix 3.1 Letter of Introduction and Invitation to Participate**

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**LETTER OF INTRODUCTION AND INVITATION TO PARTICIPATE IN RESEARCH**

20<sup>th</sup> December 2018

Dear Sir / Madam,

This is to introduce Louanna Fiteni, a Master in Accountancy student at the Faculty of Economics, Management and Accountancy at the University of Malta.

The student is undertaking research within the Department of Accountancy regarding the Internal Auditing at the Central Bank of Malta. This research aims to explore the developments undertaken across the years at the Central Bank with respect to the Internal Audit.

In this regard, the said student would like to invite you to contribute on this research project by participating in an interview covering aspects of this topic, to provide relevant information and to provide access to employees at your convenience.

This research is important and valuable in enhancing understanding of the subject area and helping practicing professionals and practitioners like yourself, as well as informing policy and support initiatives. The student would be happy to share with you general findings ensuing from this research.

The student is to ensure that any information provided will be treated in confidence, also in line with general Faculty research requirements and ethical obligations. A consent form will be separately provided. You are, of course, entirely free to discontinue your participation at any time or to decline to answer particular questions.

While I thank you beforehand for your consideration as well as your possible kind support and involvement in this important research, should you have any queries on this research please feel free to contact me via email at: [accountancy.fema@um.edu.mt](mailto:accountancy.fema@um.edu.mt).

Yours sincerely,

A handwritten signature in blue ink, appearing to read "Peter J Baldacchino".

Mr. Peter J Baldacchino  
Head, Department of Accountancy  
Faculty of Economics, Management and Accountancy

**Appendix 3.2 Interview Schedules**

This appendix presents interview schedules A and B that were used during the interviews conducted. The number of responses for the closed-ended questions are included in *italics* in the schedule.



## Interview Schedule A

### Section 1: Operational Structure

- 1.1) a) Over the years, has the organisation had an Internal Audit Charter and Manual?
- b) If so, to your knowledge, how long have the Internal Audit Charter and Manual been utilized in the Function?
- c) Have both Charter and Manual been periodically updated?
- 1.2) a) In your opinion, have the objectives of the Function been clearly specified over the years?
- b) In your experience, have such objectives changed considerably over the years?
- c) If such objective changes have occurred in the past, how far were these due to:
- I) The need for any periodic re-alignment with the objectives of the Central Bank
  - II) Changes in the internal audit profession itself?
- d) Additionally, if any objective changes have occurred in the past, can you point out the major hallmark points of such changes over the years?
- 1.3) In your view, have the dependence of the Central Bank on the Internal Audit Function changed, and, if so, how and why?
- 1.4) a) How have the significance and support towards the Internal Audit Function in the organisation changed over the years?
- b) In particular, what is the perceived significance, reliance and/or support placed on the Function by the following parties:
- I) The Board of Directors and/or Audit Committee
  - II) Management and User Departments
  - III) External auditors

- 1.5) a) How has volume of work and number of staff in the Internal Audit Function changed during your years of engagement at the bank?
- b) To what extent, if in any way, did the changes stated in 1.4a), help to achieve the objectives of the Function and ultimately those of the organisation?
- 1.6) In your view, how far have the following qualities been enhanced by members of the Internal Audit Department over the years? *Please rate from 0 to 4 (0 not enhanced at all and 4 enhanced very highly), stating reasons where possible.*

		<b>Not at all</b>	<b>Lacking</b>	<b>Neutral</b>	<b>Substantially</b>	<b>Very highly</b>
		<b>0</b>	<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>
Objectivity	Inception			1	1	
	Over the years				2	
	Present day					2
Integrity (Assertiveness + Honesty)	Inception				1	1
	Over the years				1	1
	Present day					2
Knowledge and Skills	Inception		2			
	Over the years			1	1	
	Present day					2

Other Competencies	Inception		1	1		
	Over the years		1	1		
	Present day				1	1

- 1.7) a) To whom has/is the Internal Audit Function (been) accountable and, to your knowledge, how has such accountability changed since the inception of the Bank?
- b) With respect to internal audit reporting, who are the current receivers of reports, and how have such receivers changed, if in any way, throughout the years?

### Section 2: Types and Scope of Internal Audit Exercises

- 2.1) What were the major types of audit and consultancy exercises that were provided by the Internal Audit Function, and how has the mix and scope of such exercises changed since the inception of the Internal Audit Function?
- 2.2) In what period do you feel the following were/are important in terms of exercises performed?

	Inception	Over the Years	Present day
Fraud Detection		1	1
Checks and counterchecks	2		
Financial audits		2	
Operational audits		2	
Regulatory compliance audits			2
Management audits		2	
IT audits		2	

Cultural audits			2
Physical security audits	1	1	
ECB audits			2
Risk management			2
Consultation/Advisory exercises			2

- 2.3) How have the changes over the years in the types of exercises being performed helped the Internal Audit Function in adding value to the organisation?

### Section 3: Audit Approach

- 3.1) What stages are/have been involved in carrying out the typical audit?  
*Please specify any changes that occurred in such stages over the years.*
- 3.2) How do the levels of auditors vary at the different stages of the typical audit process and has this changed over the years?
- 3.3) In your view, has the mix between verbal and written communications both to auditees, and amongst auditors themselves changed over the years, if so, how, and why?
- 3.4) a) In particular, to your knowledge, how long has the risk-based approach been implemented as a significant part of the audit process?  
b) Were there any particular factor/s that induced the adoption of such risk-based approach?
- 3.5) In the conduct of internal audit exercises, what Standards are adhered to, and how far are they related to the IIA Standards?
- 3.6) What were the major changes in internal audit reporting follow-ups over the years?

- 3.7) To what extent in your view has the internal audit approach been influenced over the years by feedback from the user departments?
- 3.8) In your view, to what extent, has the typical internal audit approach been influenced over the years by interactions and exchanges with internal auditors in other European country counterparts and institutions?

## Interview Schedule B

### Section 1: Operational Structure

- 1.1) In your view, how important is/has been the Internal Audit Function in terms of position within the organisation?
- 1.2) How has volume of work and number of staff in the Internal Audit Function changed during your years of engagement at the bank?
- 1.3) In your view, how far have the following qualities been enhanced by members of the Internal Audit Department over the years? *Please rate from 0 to 4 (0 not enhanced at all and 4 enhanced very highly), stating reasons where possible.*

		Not at all	Lacking	Neutral	Substantially	Very highly
		0	1	2	3	4
Objectivity	Inception		1	2	1	
	Over the years		1	1	2	
	Present day					4
Integrity (Assertiveness + Honesty)	Inception			1	2	1
	Over the years				3	1
	Present day					4

Knowledge and skills  (Banking and in-house knowledge and Professional/s emi-professional auditing skills)	Inception		1	3		
	Over the years			4		
	Present day					4
Other Competencies	Inception			3	1	
	Over the years			3	1	
	Present day					4

1.4) To whom is/has been the Internal Audit Function accountable in terms of reporting?

### Section 2: Type and Scope of Internal Audit Exercises

2.1) What were the major types of audit services that were provided by the Internal Audit Function?

2.2) In what period do you feel the following were/are important in terms of exercises performed?

	Inception	Over the Years	Present day
Fraud Detection		2	2
Checks and counterchecks	4		
Financial audits	1	3	
Operational audits		4	
Regulatory compliance audits		2	2
Management audits		4	
IT audits		4	
Cultural audits			4

Physical security audits	1	3	
ECB audits		1	3
Risk management		1	3
Consultation/Advisory exercises			4

### Section 3: Audit Approach

- 3.1) What stages are/have been involved in carrying out the typical audit?  
*Please specify any changes that occurred in such stages over the years.*
- 3.2) What approach was taken when carrying out an audit? *Example: performing all audits, performing only those audits your superiors instructed, departments covered and not covered, any scope limitations, continuous/periodic auditing, risk-based etc.*



### Appendix 3.3 Statistical Data Analysis using the Friedman Test

The bar graphs presented in this appendix support the statistical table presented in Chapter 4. Such bar graphs depict better the results of the Friedman Test carried out on the Likert Scale question and give a visual representation of the significant or insignificant differences between the three phases (inception, over the years, present day) of each competency.

The error bar graphs display the 95% confidence interval of the actual mean rating score. When two confidence intervals overlap, the indication is that their mean rating scores are comparable and do not differ significantly. On the other hand, if the confidence intervals are disjoint or slightly overlapping, then their mean rating scores differ significantly.

#### Section 1: Operational Structure – Objectivity

Figure A3.1 depicts the degree of enhancement of objectivity throughout the three phases. The  $p$ -value ( $p=0.006$ ) is less than the 0.05 level of significance and the bars are overlapping, which demonstrate that the mean rating scores between the phases vary significantly, particularly between the last two phases.

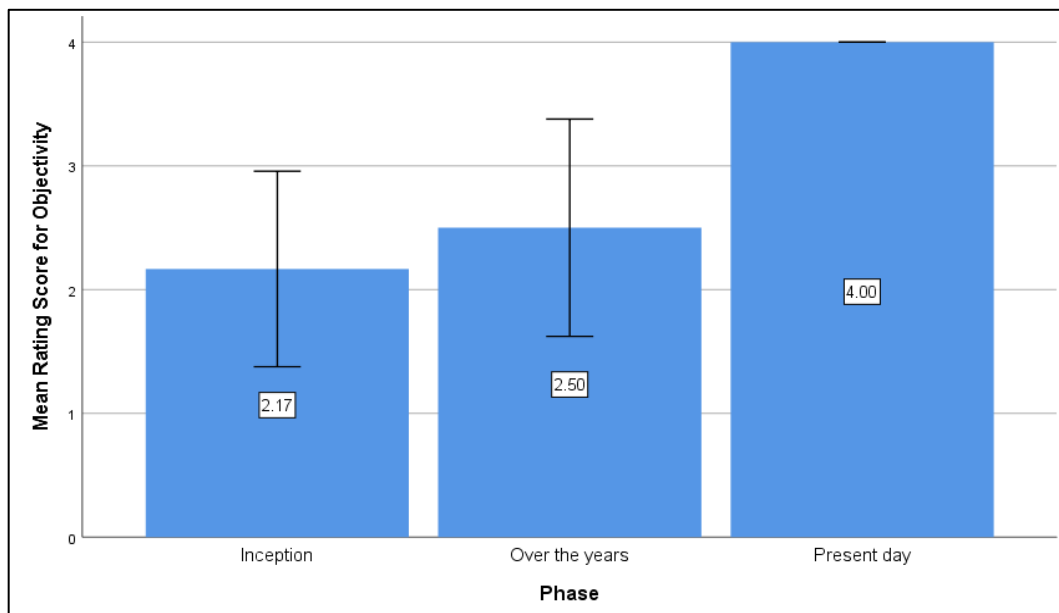
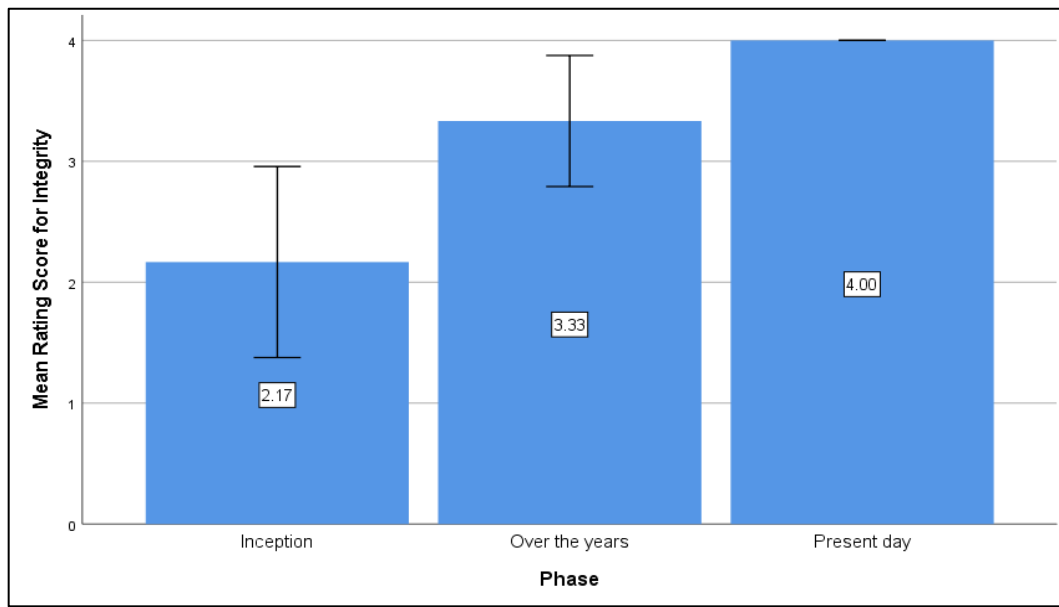


Figure A3.1: The Degree of Enhancement of Objectivity

**Section 1: Operational Structure – Integrity**

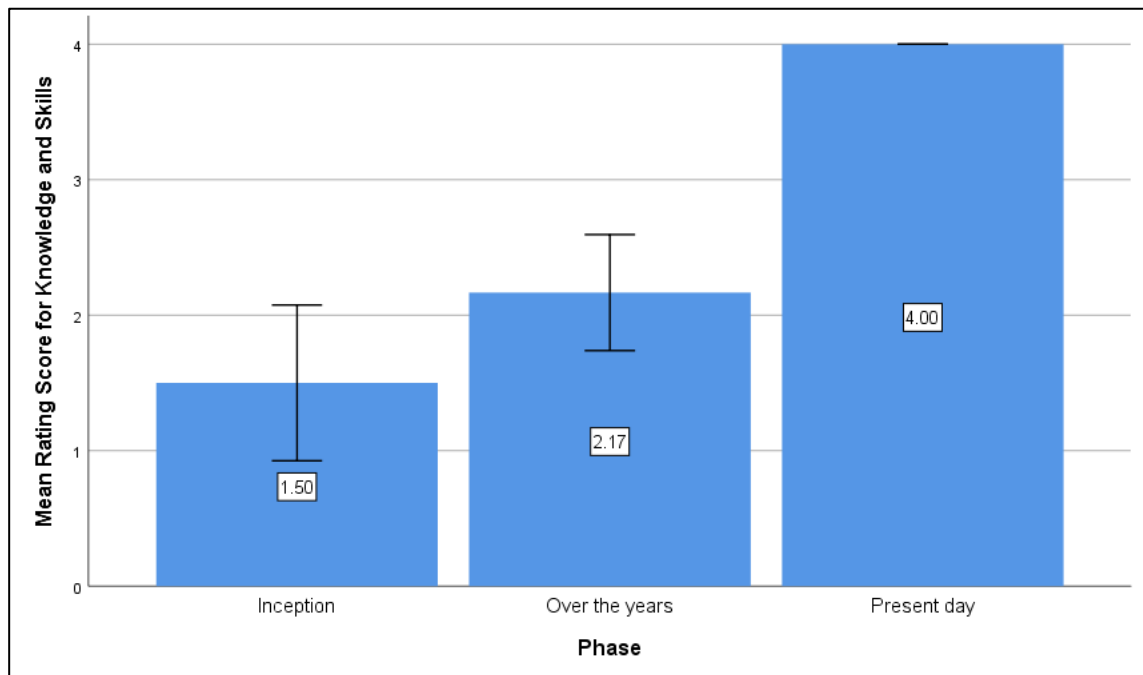
Figure A3.2 shows the degree of enhancement of integrity throughout the three phases. The  $p$ -value ( $p=0.047$ ) is less than the 0.05 level of significance and the bars are overlapping, indicating that the mean rating scores between the phases differ significantly.



**Figure A3.2: The Degree of Enhancement of Integrity**

**Section 1: Operational Structure – Knowledge and Skills**

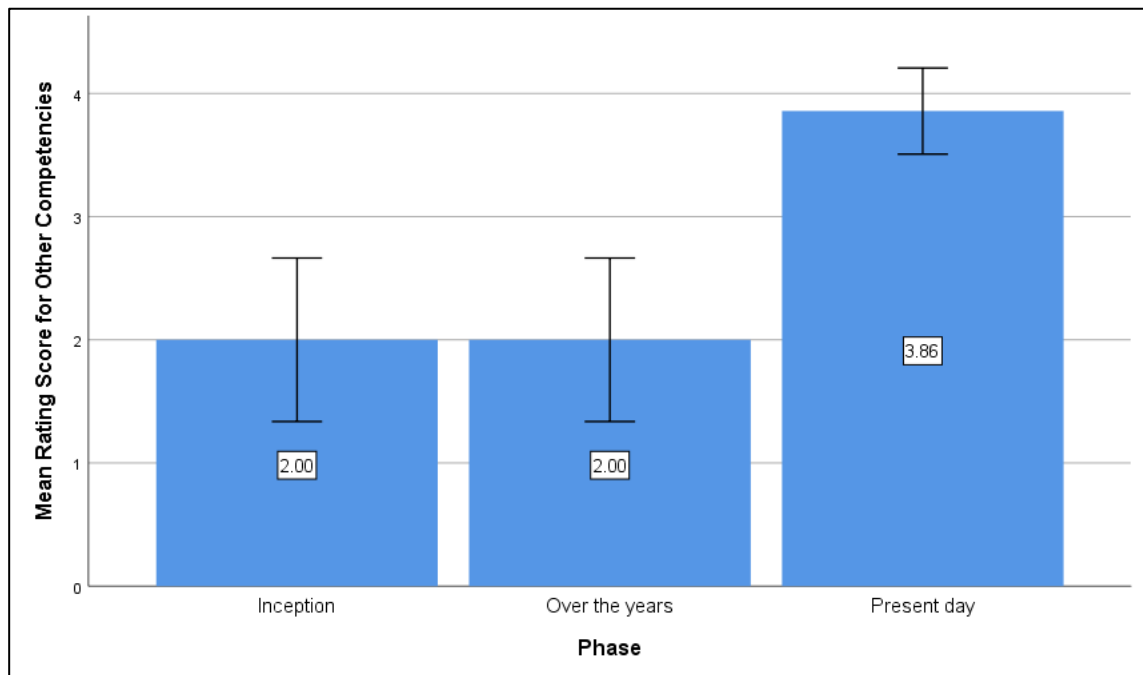
Figure A3.3 portrays the degree of enhancement of knowledge and skills throughout the three phases. The  $p$ -value ( $p=0.004$ ) is less than the 0.05 level of significance and the bars are overlapping, which indicate that the mean rating scores between the phases differ significantly.



**Figure A3.3: The Degree of Enhancement of Knowledge and Skills**

**Section 1: Operational Structure – Other Competencies**

Figure A3.4 depict the degree of enhancement of other competencies throughout the three phases. Given that the  $p$ -value( $p=0.005$ ) is less than the 0.05 level of significance and the bars are overlapping, the mean rating scores between the last two phases vary significantly.



**Figure A3.4: The Degree of Enhancement of Other Competencies**