INTERNAL CONTROL AND AUDIT PRACTICES IN BANKING SECTOR OF JORDAN

The previous chapter presented an overview of Jordan’s developing economy, its constituent sectors and their development, economic indicators highlighting the progressive trends in the economic growth and financial structure of the country. A detailed review has also been made of Jordan’s banking sector, tracing its evolution, progress and development and the present status with special focus on banking sector. The crucial part which these banks have played in capital formation for financing the economic development through mobilization of savings and growing volume of deposits, the constantly increasing volume of loans and advances flowing to the investors through the medium of banking sector, has also been discussed.

The banking sector conduct their business through lending funds to deficit economic units of industry and trade and also make investment in business securities. But their investible funds are made up of public deposits which are, in fact, savings of the peoples. Banks hold these saving deposits as trust money. The banking institutions are under fiduciary duty to repay the deposit money on demand from the depositor. The characteristics of the deposit funds, therefore, cast upon banks the legal obligation to ensure safety of savers money transformed into deposits and use them in doing their business with utmost honesty and professional integrity so that savers not only get their principal amount of deposit back on demand but a reasonable return too. The banking business, therefore, involves creation of public trust that their saving deposits with banks are not unsafe but secure and their use by the banks is not scandalous but prudent and judicious. Such a trust can be created when a check is
exercised on the banks in handling of depositors money, on making financial transactions and entering them into various books of accounts as well as the appropriateness of making investment decisions. The control and check on the utilization of deposit money by banks needs to be applied both internally as well as externally. Governments, in order to secure public interest involved in utilization of banks funds, have enacted legislations for external examination, or audit, of banks accounts, through independent, qualified and professional persons not connected with the bank in any way. The banks, on their part introduce measures aimed at enforcing internal control and audit of the transactions and utilization of investible funds in order to nip in the bud any error, frauds or embezzlements of public money. Effective programs of internal control and audit ensure the authenticity and fairness of banks accounts and financial statements in the public eye. Practices of internal control and audit, in fact, satisfy not only the depositors but also the creditors, investors, borrowers, and all other customers of the banks.

The present chapter is, accordingly, devoted to a detailed study of internal control system and audit procedure and practices conducive to exercise a regular check on monetary transactions and financial operations of the banks in Jordan so as to ensure that the working is errorless, fraud free and trustworthy. It also studies the adequacy and effectiveness of internal audit programs and gauges the extent to which the measures enforced have checked the occurrence of frauds, embezzlements and other monetary mishandlings as well as the contribution of such measures in the smooth functioning of the banks in Jordan. The study is broken into two parts for a detailed discussion of the internal control and audit systems and for making a Jordan specific review of Audit procedures and practices as prevalent in the banking sector of Jordan.
Section-I, accordingly, presents a comprehensive discussion of internal control and audit. It explains the need for internal control, its objectives, and organizational structure that makes functioning of the system smooth and effective. Components of internal control system are also discussed. A detailed description is made of the Audit, its objectives, process and procedures and the credibility it lends to the banking operations is also highlighted.

Section-II makes a detailed study of the internal control system and audit practices obtaining in the banking sector of Jordan. It discusses the relevant banking legislative provisions mandating the observance and establishment of internal control system in the commercial bank of Jordan. A review is also made of the procedures and practices of Audit as prevalent in Jordanian commercial banking sector. The compatibility of audit conducted in banks of Jordan with international audit standards is also examined.

SECTION – I

INTERNAL CONTROL AND AUDIT

Internal control is an essential pre-requisite for the efficient, effective and smooth working for financial institution like bank in particular and every other business organization in general. The organization must establish and maintain adequate systems of internal control appropriate to the size and nature of business of the entity.

SAP 6 (Standard Audit Practices 6) defines the system of internal control as “the plan of organization and all the methods and procedures adopted by the
management of an entity to assist in achieving management’s objective of ensuring, as far as practicable, the orderly and efficient conduct of its business, including adherence to management policies, the safeguarding of assets, prevention and detection of fraud and error, the accuracy and completeness of account records, and the timely preparation of reliable financial information. The system of internal control extends beyond those matters which relate directly to the functions of accounting system.”

Internal controls can be classified into two broad categories, viz. accounting controls and administrative controls. “Accounting Control Comprise primarily the plan of organization and the methods and procedures that are concerned with the safeguarding of assets, prevention and detection of fraud and errors, accuracy and completeness of accounting records and timely preparation of reliable financial information. Administrative Controls include all other managerial controls concerned with the decision making process”.

The audit of financial information is primarily concerned with the accounting controls since these have a direct and significant bearing on the reliability of financial information. Administrative controls, on the other hand, have only an indirect relationship with financial records and the auditor may evaluate only those administrative controls which have a bearing on the reliability of financial records.

The financial controls, in turn, comprise of the ‘internal check’ and ‘internal audit’. Internal check is a system of instituting checks on the day-to-day transactions which operate continuously as part of the routine system whereby the work of one person is proved independently or is complementary to the work of another, the object being the prevention and early detection of errors or fraud. Accordingly, the
procedures are so designed that no single person is authorized to carry out all the stages involved in a transaction. The objective of such an allocation of duties is that no single individual should have an exclusive control over any one transaction or a group of transactions. Thus, a fraud cannot take place unless there is collusion between two or more persons. Apart from the complementary allocation of duties, an internal check system also involves prompt and independent verification of an individual’s work by prescribing cross-checks and cross reconciliations as a part of the operating procedure itself.

‘Internal Auditing’, which is the other important part of ‘financial control’ in the series of functions involved in internal control, is an independent appraisal function established within an organization to examine and evaluate its activities as a service to the organization. The objective of internal auditing is to assist members of the organization in the effective discharge of their responsibilities. To this end, internal auditing furnishes them with analyses, appraisals, recommendations, counsel and information concerning the activities reviewed. The internal audit ensures that the accounting and allied records have been properly maintained, the assets of the enterprise adequately safeguarded, and the policies and procedures laid down by the management are complied with. Internal audit also includes a review whether the resource utilization in the enterprise is efficient and effective. In fact, the internal audit is essentially a post-transaction review to evaluate the records, controls and operations in an organization.

Internal checks are in-built in the system itself and take place concurrently with the execution of transaction whereas internal audit is a distinct function which is carried out after the transaction have taken place.
Chapter – IV: Internal Audit Control and Practices in Banking sector of Jordan

Objectives of Internal Control

The objectives of an Internal Control System are determined by factors like specific circumstances of the enterprise which include nature of business, scale of operation, degree of professionalization of management, etc.

SAP6 identifies the following objectives of internal controls relating to the accounting system:

1. The transactions are executed with the management authorization.
2. All transactions are promptly recorded in an appropriate manner to permit the preparation of financial information and to maintain accountability of assets.
3. Assets are safeguarded from unauthorized access, use or disposition.
4. Assets are verified at reasonable intervals and appropriate action is taken with regard to the discrepancies.

STRUCTURE OF ACCOUNTING CONTROLS

Accounting controls are exercised through the establishment of a structure based on adequate policies and procedures. While the specific control policies and procedure depend on the nature of transactions, manner of information processing and other similar factors, most of these policies and procedures generally fall into the following five categories.

1. Segregation and Rotation of Duties

The work involved in a transaction is allocated to different persons in such a manner that both the work of one person is complementary to the work of another person, or the accuracy and correctness of work performed by one person is
independently checked by another person. The purpose is to minimize the occurrence of errors and fraud.

The functions which are typically segregated are:

(a) authorization of transaction
(b) execution of transaction
(c) physical custody of related assets
(d) maintenance of records and documents

Rotation of duties is also considered desirable. It seeks to ensure that error or fraud committed by a person does not remain undetected for long and that a person should not develop vested interest by holding a position for a very long time.

2. Authorization of Transactions

Delegation of authority has to be made to different persons at different levels to enable them to execute specific type of transactions. Authorization may be general covering all transactions that conform to prescribed conditions or it may be specific with reference to a single transaction.

It is necessary to establish procedures which provide assurance that authorizations are issued by persons acting within the scope of their authority and that the transactions conform to the terms of the authorization.

3. Maintenance of Adequate Records and Documents

Accounting controls should ensure that the transactions are recorded at correct amounts and that they are classified in appropriate accounts. Besides, recording of transactions should be such as would facilitate maintaining the accountability for
assets such as sufficient description of fixed assets to make identification possible, its location etc.

Assurance that transactions have been properly recorded can be obtained through a comparison of records with an independent source of information which provides an indication of the execution of the relevant transactions. Another procedure to obtain assurance about the accuracy and completeness of records is the use of reconciliations.

4. Accountability and Safeguarding of Assets

Assets accountability is achieved by maintenance of assets and their periodic comparison with the related assets. Frequency of comparisons would differ for different assets depending upon their nature and amount. Assets susceptible to loss through errors or frauds needs to be compared more frequently with the related records.

In order to safeguard assets, the access to assets should be restricted to authorized persons only. Effective controls must exist over the physical custody of assets like goods, cash, investment scripts and fixed assets. Special procedures regarding physical custody of assets have to be designed.

5. Internal Audit

Appraisal of functioning of the Internal Control System requires independent checks on performance of the system in order to ascertain whether the control procedures are being performed properly.⁴

The important method of independent checks is the system of Internal Audit.
Thus Internal Audit is the independent appraisal of activity within an organization for the review of accounting, financial and other business practices as a protective and constructive arm of management. It is a type of control which functions by measuring and evaluating the effectiveness of other types of controls.

In fact, internal audit implies an audit of the accounts by the employees of the business. The work is done by a separate qualified group of staff whose function is practically the same as of the statutory auditor. In addition to that, the internal auditor has to see that there is no wastage and the business is carried on efficiently.

It is a kind of continuous audit but conducted by the staff of the concern. In the case of large concerns like banks and insurance companies, they have a separate Internal Audit Department.

**AUDITING**

Auditing is a systematic and independent examination of data, financial statements, accounts records, operations and performances both financial and otherwise, of an enterprise for the purpose of verifying their authenticity, veracity and fairness. In any auditing situation, the auditor perceives and recognizes the proposition before him for examination, collects evidence, evaluates the same and, on this basis, formulates his judgment. The judgment is communicated through the Audit Report which is the end result of auditing. The insiders and outsiders of the organizations are solely guided by the audit report whether the financial accounts and statements present a fair and true view of the performance and functioning of the organization. In fact, the report is of particular interest to different groups each of which has a financial stake in the success or failure of the business enterprise.$$^5$$
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IMPACT

The impact of Audit depends upon the nature of the report. The positive report reflects the soundness of the financial health of the organization. It convinces and creates a confidence about the smooth conduct of financial operations and business activities in the minds of all those connected with the organization. It helps gain their renewed trust in the functioning and performance of the enterprise. Besides, it raises the image and status of the organization in financial markets and enhances the prospects of attracting investors and enlarging their interest in the business of the organization ultimately resulting in increased volume of business. On the other hand, a negative report brings to light the deficiencies and irregularities committed by the organization calling for the need of their rectification and improvement. It shakes the trust of the stake holders in the functioning of the organization. Financial markets represent an unclean image of the enterprise detracting investor's interest with adverse impact on the growth and development of the organization.

Audit, thus, assumes the significance as a catalytic tool of change which may mar or make the organization as a successful business entity.

AUDIT OBJECTIVES

Multifarious purposes are served by audit. Each audit is, however, for a specific purpose. The objective of audit, hence, depends upon the type of audit to be conducted. Cost Audit, Tax Audit, Management Audit, social audit, etc. are some of the specific type of audits often conducted. But most common and important is the financial audit, which is an examination, with the help of evidence, of the accounts record and the financial statements constructed by an organization to demonstrate its business performance over a specific period of time. Positive audit reporting on the
accounts records and financial statements confirms and reassures that the financial exposition made by the enterprise represents a fair and true view of its financial position.\textsuperscript{6}

**CHART 4.1**

<table>
<thead>
<tr>
<th>Main objective</th>
<th>Secondary objective</th>
<th>Specific objective</th>
</tr>
</thead>
<tbody>
<tr>
<td>Expression of expert opinion</td>
<td>Detection and Prevention</td>
<td>Error</td>
</tr>
<tr>
<td>Error of Principal</td>
<td>Error of Duplication</td>
<td>Compensating Error</td>
</tr>
<tr>
<td>Embezzlement of cash</td>
<td>Misappropriate of good account</td>
<td>Fraudulent manipulation</td>
</tr>
<tr>
<td>Clerical Error</td>
<td>Error of omission</td>
<td>Error of commission</td>
</tr>
<tr>
<td>Partial omission</td>
<td>complete omission</td>
<td></td>
</tr>
</tbody>
</table>

Creating a trust in the organization through satisfying the need for an independent opinion as to the fairness of the financial statements provided by the
management is the chief objective of audit. The larger the enterprise and more remote and scattered are the parties whose interests coincide with it, the greater becomes the significance and value of audit of accounts records and financial statements. Rendering of an independent opinion on the truth and fairness of financial statements is legally compulsory in the case of a joint stock company, banking institution, an insurance organization and a cooperative association.

Detection and prevention of errors is the next important objective of audit. An error is an unintentional mistake in the account books by way of mathematical miscalculation, oversight or misinterpretation of fact, or misapplication of accounting principles. Arising from these reasons, there can be clerical errors, compensating errors, duplication errors and errors of principle. The audit which involves a thorough examination of the accounts books brings to light these errors. It also seeks their rectification and future prevention. The audit serves the important objective of eliminating the impact of such errors on the financial statements and makes them fair and trustworthy.  

Misappropriation of funds by employees or ‘fraud’, also finds a significant place in the objectives of audit. Fraud includes any deception, cunning or trickery with an intention to deceive or cheat. Generally frauds are committed by manipulation or falsification of accounts or through window-dressing in the Financial Statements. Frauds usually occur when internal control system is ineffective and weak or not at all present in the organization. Frauds, misappropriation embezzlements and malpractices are detected and highlighted by audit timely enabling preventive measures to be taken before any further loss or damage to the organization.
Audited accounts and financial statements are acceptable as true, authentic and credible by tax authorities, institutional investors, financial markets players’ stakeholders and corporate management. This further underscores the significance of the audit objectives.

**AUDIT PROCESS**

Audit process consists of various stages to go through till the completion of the task. In all audit situations, the following well defined stages are commonly followed.

1. Identification of the objective of audit.
2. Collection of evidence relevant to the audit objectives.
3. Formation of judgment on the basis of evaluation of evidence and communication of the same through audit report.

The process of audit is well illustrated in the chart diagram-4.2.

Different types of audit are conducted and each of these is aimed at certain specific objective. Depending upon the nature of audit, the objective differs as to detect frauds or errors to find out whether the resources are being used efficiently and economically. Audit of annual financial statements has the prescribed objective to ascertain whether the Balance sheet and the Profit and Loss Account give a true and fair view of the financial position and working results of the organization. Government audit sets the objective to determine whether the expenditure was authorized, regular, proper and within the budget. Based on the objective, the audit programme is formulated to achieve the objective. ⁹
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**CHART 4.2**

**OVERVIEW OF AUDITING PROCESS (Financial Statements)**

<table>
<thead>
<tr>
<th>Identification of objectives</th>
<th>Determine audit objective(s), e.g. whether the financial statements give a true and fair view of financial position and working results.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Collection of evidence</td>
<td>Obtain knowledge of the business of the enterprise</td>
</tr>
<tr>
<td></td>
<td>Obtain understanding of the accounting system and related internal controls and perform the compliance procedures.</td>
</tr>
<tr>
<td>Evaluation of evidence and reporting</td>
<td>Determine the nature, timing and extent of substantive procedures based on results of internal control evaluation.</td>
</tr>
<tr>
<td></td>
<td>Perform substantive procedures (i.e. tests of details of transactions and balances, and analytical procedures).</td>
</tr>
<tr>
<td></td>
<td>Evaluate the results of audit procedures – Determine whether the financial statements give a true and fair view.</td>
</tr>
<tr>
<td></td>
<td>Report whether the financial statements give a true and fair view.</td>
</tr>
</tbody>
</table>
Evidence collection starts post the objective is set and clear. Gathering of evidence include physical inspection of tangible assets, examination of relevant documents, deeds, certificates, licenses, etc., verification and confirmation of facts and figures from insiders and outsiders of the organization, taking statements of various officials about the status of cases and matters connected with the organization, etc. Personal observations of a process or procedure as well as physical stock-taking are also the best means of evidence. Credible evidence also requires computation of significant ratios and carrying out a trend analysis in respect of the financial and business operation of the organization.  

‘Compliance and Substantive’ procedures are applied to get the appropriate reliable evidence. ‘Compliance Procedure’ requires examination of a random sample of certain vouchers to find out whether the prescribed procedure has actually been followed. Under ‘substantive procedure’ documents relating to certain transaction are examined to find out whether goods have actually been supplied as per the terms of transaction, or whether proper acknowledgements have been received from the payee and whether the amounts have been properly entered in the books.

Evaluation is carried out on the basis of evidence. Utmost care is exercised in the evaluation process in which events should match and conform to the evidence. A disagreement means errors or fraud. On the basis of evaluation, the judgment is formulated. The final verdict as emerging from the audit is communicated through the ‘Audit Report’ The report is the ultimate credible outcome of audit and respected universally.
SECTION – II

INTERNAL CONTROL AND AUDIT PRACTICES IN THE BANKING SECTOR OF JORDAN

The previous section ginned up about the need of internal control and discussed the nature of internal control, the objectives it serves, audit procedures and the value it adds to the quality of management as well as the credibility it lends to the banking activities and the financial statements issued by banks which are reviewed by stakeholders and all those interested in the organization.

The present section-II is devoted to a detailed study of the internal control and audit practices in the banking sector of Jordan. A review is made of the procedures and practices of internal check and audit as prevalent in the Jordan banking sector. The compatibility of these internal control procedures and practices with international standards is also examined.

Banking sector in Jordan have designed and structured a full-fledged and result-oriented mechanism for internal control comprising the conduct of internal check and internal audit. The bank management has been made responsible for arranging and implementing an effective internal control dispensation in the banks.

This study reviews the internal control system in the banking sector of Jordan by splitting it into the following three parts:

Part-A: Regulatory framework for internal control
Part-B: Procedures of internal control
Part-C: Internal audit practices

A detailed review of each of these parts follows:
PART-A: REGULATORY FRAMEWORK FOR INTERNAL CONTROL SYSTEMS IN JORDAN

The statutory regulatory control on the banking sector of Jordan is exercised by the Central Bank of Jordan (CBJ). Pursuant to the stipulation of Article (45/a) of the Central Bank’s Law and Article (99/b) of the Banking Law of Jordan, the Central Bank has promulgated regulatory framework for the Internal Control System in the banking sector of Jordan. The regulation lays down instructions with regard to the observance, establishment, and conduct of internal control in the banks. Presented below are the minimum control measures required to ascertain and ensure that the banks management carries out the proper internal control over the bank’s activities.

OBLIGATION ON BOARD OF DIRECTORS

In addition to what the relevant Banking Law of Jordan provided for, the bank’s Board of Directors must ensure the existence of adequate and effective internal controls, supervision regulations and must continuously follow it up through, as a minimum, pursuing and observing the following controls.11

1. Awareness of the major risks facing the bank and approve acceptable limits to such risks and to supervise the bank’s executive management to ensure taking the necessary procedures to define, measure, control and supervise such risks.

2. Approval of the organizational structure of the bank, form the committees and delegate powers and authorities.

3. Approval of the bank’s strategies, policies, annual budgets, and code of conduct and to review same periodically.
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4. Ensuring that the executive management works towards realizing the effectiveness of the internal control systems.

5. Apprising the Board or the committees emanating there from of the reports of the supervising authorities, external and internal auditors and to follow-up the violations and remarks mentioned therein and to make certain that the executives to prevent the recurrence of the violations and remarks, in addition to any other reports relating to compliance, risk management or any other relevant issues.

6. Exercising authority outside executive management’s scope.

7. Assessing the performance of the executive management, extent of its adherence with the Board’s policies, success in realizing the projected results and objectives as well as to remedy the deviations.

**Duties of the Executive Management**

In addition to what the relative legislation provided for, the bank’s executive management must, at a minimum adhere to the following:

1. To develop and update the policies and strategies and work towards implementing the same after gaining approval by the Board of Directors.

2. To prepare and develop the work procedures in a manner that ensures defining, measuring controlling and supervising the risks that the bank encounters and to implement such procedures.

3. To prepare the financial statements and the closing accounts.

4. To prepare an organizational structure in accordance with item (Four) and to ensure adherence to it after it is approved by the Board of Directors.
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5. To prepare an annual budget to be approved by the Board of Directors and to report performance periodically to the Board of Directors illustrating the actual performance deviation from the projection.

6. To set-up adequate internal control policies and to implement them after they are approved by the Board of Directors.

7. To execute the duties according to the authorized powers.

8. To accomplish the effectiveness of the internal control systems and to report, at least annually, to the Board of Directors about the implementation and effectiveness of the systems.

9. To set-up the procedures that guarantee the assessment of the capital adequacy and to report periodically to the Board of Directors in that regard.

10. To provide the external and internal control entities, such as the supervisory authorities, internal and external auditors and any other relevant entities, at the time specified by such entities, with the information and statements so required which are necessary to carry out its tasks in an optimal manner.

11. The annual report must include a statement about the executive management’s responsibility for providing internal control systems that guarantees the quality and transparency of the published information and data.

12. To articulate a bank’s Code of Conduct, get it approved by the Board of Directors and circulate it among all administrative levels at the bank.
13. To develop the skills and professional behavior of the bank’s employees up to par with the latest benchmarks and requirements.

**Internal Audit Administration**

The bank must abide by creating an independent internal audit administration that reports directly to the Audit Committee (constituted in accordance with the stipulations of Article (32) of the Banking Law) (or its equivalent in respect of the foreign banks branches) to whom periodical reports shall be made. The audit administrator’s tasks shall be as follows, at a minimum.\(^{12}\)

1. To set-up an Internal Audit Charter and approve it by the Board of Directors, provided it comprises the audit administrator’s tasks, responsibilities, powers and work methodologies.

2. To set-up internal audit procedures consistent with the best practices and international standards.

3. To prepare an annual audit plan approved by the Audit Committee where its is contrived from the bank’s strategies plan, provided it encompasses the majority of the bank’s activities and its organizational units including the risk management according to the level of risks in such activities.

4. To prepare an annual report about the extent of adequacy of the internal controls and supervision regulations to limit the risks that the bank is subjected to and to work towards providing the proper recommendations to rectify the weaknesses.

5. To augment the internal audit administration with qualified employees of adequate technical qualifications and related practical experience to audit
all activities and operations provided such comprises qualified staff to assess the information risks and its related technology.

6. To follow-up the violations and comments mentioned in the supervisory authorities and independent authors’ reports and to ascertain working towards its ramifications towards of appropriate controlling measures placed at the disposal of the executive administration to ensure its non-recurrence.

7. To ascertain the existence of the proper procedures to receive, remedy and maintain the customers’ complaints and the remarks relating to the accounting system, internal control and supervision, audit operations and to periodically report the same.

8. To maintain the audit reports and documents for periods consistent with the relevant stipulations of the legislation in force, in an organized and safe manner to be available for review by the supervisory authorities and the independent auditors.  

Risk Management

Assessment and risk management are deemed to be the responsibility of each of the bank’s units according to the unit’s positions and objectives, the bank must, as a minimum, abide by the following:

1. To set-up a risk management system compatible with the bank’s size and nature of operations, by which the system comprises of the following

(a) The existence of risk policy-policies approved by the Board of Directors that covers/cover the entire bank’s operations and sets/set a clear measure and limit
for every type of risk and to ascertain that all employees, at all administrative
levels, are apprised and fully aware thereof and to review the same
periodically, provided that such policy/ policies includes/include requisite
procedures to ensure the following:

(i) Periodical definition of the major and sudden changes of risks reflected in the
financial statements, developments in the markets, the legal environment etc.
in addition to assessing such changes and reporting same to the concerned
units.

(ii) To ascertain that the bank adopts “Risk Mitigation”, through avoiding
transferring reducing accepting and disclosing the risk in the financial
statements.

(a) The existence of a specialized and independent administrative staff charged
with analyzing and reviewing the risks consequent upon the bank’s operations
and to develop the necessary methodologies to manage and control such risks.

(b) The existence of a specialized and independent administrative staff charged
with analyzing and reviewing the risks consequent upon the bank’s operations
and to develop the necessary methodologies to manage and control such risks.

(c) To supervise adherence to the risk control procedures and policies as well as
the risks limits of all types. 14

(d) Procedures that ensure the delivery of good quality information to the decision
makers about any deviations having a material effect, the necessary measures
to remedy such deviation and to follow-up the implementation of such
measures.
(e) Regular assessment of risk procedures, policies, and limits in light of the degree of the manifested problems, the bank’s strategies, and market development.

2. Adoption of the means that assist in risk management including but not limited to:

(a) Self-assessment of risks and setting-up risk indicators.

(b) Preparation of a profit/loss historical database defining its source and categorizing the same according to the type of risks.

3. To ascertain, before introducing any new (product/operations/system) that it is compatible with the overall policy of strategic development; that all risks involved including the operational risks have been determined, that the new controlling measures and the procedures or the amendments that it has undergone have been done in conformity with the risk limits acceptable to the bank.\(^\text{15}\)

4. To form an independent committee for risk management emanating from the Board of Directors whose membership may include some of the higher executive management members and shall be charged, at the least, with the following:

(a) To review the risk management strategy being approved by the Board of Directors and to continuously assess its effectiveness to ascertain its conformity with the variables.
(b) To ascertain the availability of policies, framework, programs, and the tools necessary for risk management, to review it at least annually to ascertain its effectiveness and to amend it if necessary.

(c) To report periodically to the Board of Directors showing the compatibility extent of the existing risks with the adopted policies and the acceptable levels of risks specified therein in a manner that enables the Board to make the proper decisions.

(d) To supervise the development of the database necessary for risk management.

(e) To discuss the risk management reports.

(f) To ascertain the existence of business continuity plan and to examine it periodically.

5. The imperativeness of using modern information systems for risk management that guarantee the availability of quality information about the risks that the bank encounters.

**The Bank’s relationship with the External Auditor**

In addition to the Stipulations of the Banking Law and any other stipulations provided for under any relevant legislation, the bank must abide by the following, as a minimum.

1. To sign an “Engagement Letter”\(^{16}\) with the external auditor to audit the bank’s business where it should encompass carrying out all matters assumed by the auditor and which are in conformity with the requirements of the International Audit Standards, provided that the letter includes that the auditor shall carry out the following:
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(a) To provide the Board of Directors with a detailed report showing all weaknesses in the accounting systems, internal supervision and any other issues of a negative effect that the auditor became cognizant of during the audit process.

(b) To verify the accuracy and integrity of the data presented to the auditor during the audit process.

(c) To provide the Central Bank with copies of any reports that the external auditor presents to the bank within the audit mandate that the auditor was assigned for.

2. To obtain the prior approval of the Audit Committee before entering into an agreement with the external auditor to offer any non audit services in conformity with the Audit Profession Practice Law and the instructions issued in its pursuance provided such services are declared.

Financial and Accounting Systems Requirements

The bank must have the following:

1. Financial and Accounting Systems that help it to present the bank’s true financial position and the availability of the requisite information to make the decisions that enable it to prepare the periodical and annual financial statements in conformity with the International Financial Reporting Standards or the equivalent in respect of Islamic Banks.

2. Written and sound financial accounting and documentary systems that ensure recording the financial transaction upon its occurrence.
3. Written procedures to ascertain the keeping of books and records in an organized and safe manner for not less than the statutory period provide for under the legislation in force that can be easily audited and inspected.

4. Periodical audit procedures, particularly for the accounting records to ascertain that it has been properly recorded.

5. A mechanism that enables the confirmation of the quality of financial information and data that is presented to the supervisory authorities.

6. Written procedures for the selection of the proper financial and accounting mechanical systems in addition to sufficient qualified staff to guarantee the effectiveness of the financial and accounting systems.

7. All the necessary technical means and backups to ensure the continuity of operations.

8. To insure all the bank’s assets against any risk such assets may be subjected to.

**The bank must provide the Central Bank with the following**

1. Any change that the bank wishes to carry out at the position of the General Manager or any of the bank’s executive management before making the decision.

2. Detailed reports regarding any lawsuits instituted between the bank and other entities that comprise the legal opinion and the rulings rendered in that regard.

3. The debts that the bank has written off where it shall comprise the customer’s name, amount of debt, collateral, the requisite reasons for writing off such debts and any other information that the bank deems necessary to list, provided that it includes
the Board of Directors or the Audit Committee’s (or its equivalent in respect of foreign branches) resolution in that respect.

4. The information relating to the members of the Board of Directors, executive management and the committees that include members of the Board of Directors as members therein according to the enclosed specimens, on an annual basis or upon the occurrence of any amendments.

5. A semi-annual report of the following shareholders:
   (a) Jordanians, Arabs and Foreigners ownership and its ratio to capital as a whole.
   (b) Member of the Board of Directors, their representatives and the executive management’s ownership where it shows the name, number of shares, percentage of ownership and nationality.
   (c) The ten largest shareholders ownership in the bank, displaying the name, number of shares, percentage of ownership and nationality.
   (d) Shareholders holding (10) thousand shares or more, where it shows the name, number of share, percentage of ownership and nationality.
   (e) Bank’s participation where it shows the bank’s name, number of shares, percentage of ownership and the bank’s nationality.
   (f) Ownership that is less than (10) thousand shares displaying the number of shareholders, amount, and percentage of ownership as a total.

6. Name of liaison officer responsible for providing all the Central Bank’s requirements for all areas and the name of an alternate officer on an annual basis or upon the occurrence of any amendments.
7. The annual budget and the assumptions upon which it was based and the goals desired to be achieved, and this should be carried out annually by the end of January at the latest.  

8. Detailed report clarifying the circumstances of any embezzlement, forgery, theft, fraud or major shortage in the assets with an illustration of the procedures that the bank is taking to recover its rights and to guarantee the non-recurrence of such issues in the future.

**PART-B**

**INTERNAL CONTROL PROCEDURES IN BANKS OF JORDAN**

Pursuant to the legislative provisions, the system of internal control exists in all the commercial banking institutions in Jordan. Internal control is, in fact, the statutory responsibility of the bank management. It consists of two parts – internal check and internal audit. Internal control has been designed by the Jordanian banking sector as a process to obtain reasonable assurance of:

- Control over operations
- Prevention of frauds
- Adequate self-checking mechanism and timely detection and resolution of errors
- Reliable financial data
- Compliance with applicable laws and regulations
- To down control culture and bank’s risk appetite assessed through sound and tested risk evaluation process.
The reasonable assurance sought on the above points through internal control requires pre-existence of certain components of control to accomplish the desired aims. The banks in Jordan have in existence all the components of management control. Present in these banks are the control environment, risk assessment processes, information and communication systems and monitoring activities. They are operating and functioning effectively and regularly in all the banks.

The component of paramount importance to obtain reasonable assurance of the objectives of internal control is however, the “Internal Audit” function. The Central Bank of Jordan (CBJ) also lays great stress on internal control of banking business operations through ‘internal audit’. It emphasis that:

“The internal audit is potentially of major importance since an effective internal audit system leads to improved accountability, ethical and professional practices, and effective risk management, improves quality of output, and supports decision making and performance tracking.”\(^{18}\)

Thus, internal audit as a part of internal control is given its due place in the banks of Jordan. It serves as a watch-dog on the business activities conducted by these banks and the existence of “internal audit” function lends credence to the financial records and decisions of the banks.

**INTERNAL AUDIT IN BANKS OF JORDAN**

‘Internal audit’ has been established as an independent and objective appraisal service within the organization of each commercial bank in Jordan. The management of banks which establishes the ‘internal audit’ function, overseas the mechanism, effectiveness and performance of the function in the banking institution of the country.\(^ {19}\)
With changing times, the concept of internal auditing in Jordan banks has undergone a sea-change. It is no more restricted to merely ensuring that the accounting and allied records have been properly maintained, the assets management system is in place in order to safeguard the assets and also to see whether policies and procedures are in place and are duly being complied with. Modern approach to internal audit in Jordan banks is wider in its scope. It is no more restricted to financial issues alone but also on issues such as the evaluation of risk management procedures, resource utilization and their deployment, cost-benefit analysis, prudence in making investments, matters of propriety and also the effectiveness of governance.

The present day Jordanian banks consider the internal audit as a function to assist management in accomplishing the mission set for the bank. The mission seek to ensure through internal audit that the banks business are conducted according to the highest professional and ethical standards by providing an independent, and objective assurance function and by advising on best practices. Through a systematic and disciplined approach, internal audit helps the bank accomplish its objectives by evaluating and improving the effectiveness of risk management control and governance processes. Based on this mission’ a set of responsibilities have been assigned to internal audit function in bank.

**SCOPE AND RESPONSIBILITIES OF INTERNAL AUDITING IN BANKS OF JORDAN**

The scope of internal audit work includes the review of risk management procedures, internal control system, information systems and governance processes. This work also involves periodic testing of transactions, best practice reviews, special
audits, appraisals of liquidity requirements, investigation and implementing measures to help prevent and detect fraud.\textsuperscript{20}

To fulfill its responsibilities, the internal audit in Jordanian banks, has to:

(i) Identify and assess potential risks to the bank’s business

(ii) Review the adequacy of control established to ensure compliance with policies, plans, procedures and business objectives.

(iii) Assess the reliability and security of financial and management information and the systems of operations (in-house or out-sourced) that produce this information.

(iv) Assess the means of safeguarding assets.

(v) Review established procedures and systems and propose improvements.

(vi) Appraise the use of resources with regard to economy, efficiency and effectiveness.

(vii) Contribute to the development of projects, selected according to the risk involved, by confirming that the bank’s methodology is followed and that, in particular, adequate controls are incorporated.

(viii) Follow up recommendations to make sure that effective remedial measures and actions are taken.

(ix) Carry out ad-hoc appraisals, audits or reviews requested by the Management/Audit Committee.

(x) Review specific operations at the request of the Audit Committee or management as part of the business.
(xi) Carry out examination and investigation of reported willful fraudulent acts, or other suggested activities internal or external

BASEL COMMITTEE GUIDELINES

Guidelines for conduct of internal audit as made by the Basel Committee which reviewed the various aspects of banking supervision have been duly taken into consideration by the banks in Jordan in designing, structuring and empowering their ‘Internal Audit’ function.

The Basel Committee set out twenty separate principles for the internal audit function to make it independent, impartial and effective. These principles broadly deal with such issues as continuity, professional competence, independence, and relationship of the internal audit with the external audit.

In the context of banking, the ‘Core Principles for Effective Banking Supervision’, developed under the auspices of Basel Committee on Banking Supervision, specifies the principle that banks should have in place internal controls that are adequate for the nature and scale of the business. These should include, inter alia, appropriate independent internal or external audit and compliance functions to test adherence to these controls as well as applicable laws and regulations.21

In assessing adherence to this principle, the Basel Committee’s “Essential Criteria” for the internal audit function is that it:

(a) Has unfettered access to all the bank’s business lines and support departments;

(b) has appropriate ‘independence’, including reporting lines to the Board of Directors and ‘status’ within the bank to ensure that senior management reacts to and acts upon its recommendations;
(c) Has sufficient resources and staff that are suitably trained and have relevant experience, to understand and evaluate the business it is auditing; and

(d) Employ a methodology that identifies the key risks run by the bank and allocate its resources accordingly;

These guidelines have been put into action in the audit function operating in Jordan Banking sector. As a result, the ‘internal audit’ finds an appropriate standing and carries out its assignments with objectivity and impartiality. The breadth of scope to internal audit by Jordan Banking sector also enables the internal audit function to add value to the institution, its Board and its senior management.²²

AUTHORITY

In keeping with the Basel Committee recommendations, the internal audit function in Jordan Banking sector has been strengthened by conferring on it the status of ‘independent authority’. Internal audit has been authorized in the course of its activities to:

(i) enter all areas of the bank and have unrestricted access to any documents and records, personnel, core issue analysis, investigation and determination of facts and statements of recommendations in its reports considered necessary for the performance of its functions;

(ii) Require all members of staff and management to supply such information and explanations as may be needed within a reasonable period of time.

(iii) To seek confirmation from customers and parties of any banking transaction considered necessary for an investigation.
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Also, senior management has to inform internal audit immediately on any occurrence of any significant incident concerning security and/or compliance with regulations and procedures, without delay.

ACCOUNTABILITY

Unambiguous accountability for internal audit functions exist in the banking sector of Jordan – The accountability, identities that the:

(i) Internal audit shall prepare an audit plan. The plan shall be based on a risk model that identifies business risks, and on input from line managers. It should provide information about the risk assessment, the current order of priority of audit projects and how they are to be carried out.

(ii) The plan shall be presented to the Audit Committee for approval. In case of need adjustments can be made to the plan during the year. Any such changes would have to be approved by the audit committee.

(iii) Internal audit owes the responsibility for planning, conducting, reporting and following up on audit projects included in the audit plan, and to decide on the scope and timing of audits. The details of these processes are defined in the Internal Audit Manual.

(iv) Audit fieldwork shall be conducted in a professional and timely manner.

(v) Reporting of results will include an open process to agree on the facts and validity of audit recommendations. A detailed audit report shall be submitted to the management (Board of Directors) along with a letter containing a summary of audit and the recommendations.
(vi) In all cases, follow-up work will be undertaken to ensure adequate response to audit findings and recommendations.

(vii) Internal audit shall coordinate with external audit to ensure proper coverage and avoid duplication of effort.

ADHERENCE TO STANDARDS

Internal audit in banks adheres to the standards of best professional practices, such as those published by the Institute of Internal Auditors and the Information System Audit and Control Association. It strictly follows the relevant reports and recommendations of the Basel Committee on Banking Supervision too.

In addition, the banks also take into account for observance important applicable provisions of the International Standards on Auditing laid down by the International Auditing and Assurance Standards Board (IAASB). The Board establishes standards and provides guidance for auditors and professional accountants in specialized areas.

Observance and adoption of the International Standard have made the audit function more rigorous and lent transparency to audit process and accorded credibility to the financial results of the banking institution in Jordan.\textsuperscript{23}

COMPLIANCE FUNCTIONS

Compliance is a support function of banking sector in Jordan and is a part of Internal Control besides audit. The ‘compliance function’ within the bank is the independent oversight on behalf of management of those care processes and related policies and procedures that seek to ensure that the bank is in conformity with industry specific laws and regulations in letter and spirit, thereby maintaining the
bank’s reputation. The compliance function does not include regulations and policies covering capital adequacy, accounting standards, credit administration, etc. There are primarily covered by other support functions and business units, where applicable in consultation and cooperation with compliance.

The Board of Directors of Jordan’s Banking sector are fully committed to the bank’s corporate values and to the preservation of the integrity and reputation of their banks by complying with laws and regulations in each of the markets they operate in. Integrity is the corner stone of compliance function as it is the pivot of the banks corporate values.  

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The role and responsibilities of compliance function as a part of internal control within banks of Jordan are described below:

GUIDING PRINCIPLES

The compliance function is based on six guiding principles:

(1) Compliance is the individual and collective responsibility of each staff member in the bank within the given area of his/her responsibilities. All staff should be aware of relevant regulations and policies, he knowledgeable on how to comply and believe in the need to be complaint.

(2) Business unit management is responsible for compliance and acts as role model for all staff.

(3) The compliance function exercises independent oversight, enables and supports everyone to fulfill their roles, instills compliance discipline and ethical business conduct, prevents and detects violations of compliance policies.
The compliance approach is in principle risk-based, except where a rule-based approach is required on a case to case basis.

The compliance function acts in partnership with the business with complete access to business information and strategy.

The compliance function encompasses industry-specific laws and regulations as well as related business conduct.

**FUNCTIONS AND TASKS OF COMPLIANCE**

The compliance function performs the following tasks:

1. Identify risks and regulations relevant to the bank’s activities.
2. Design policies and procedures to minimize regulatory and reputation risk.
3. Advise, train and provide reports to management with regard to regulations and compliance with these regulations.
4. Promote effective compliance and ensure or oversee follow-up in case of non-compliance.
5. Manage regulatory inquiries and incidents.

**ORGANIZATION OF COMPLIANCE FUNCTION**

Compliance activities are predominantly performed in business-aligned groups to reflect the diverse nature of Jordan’s banking sector and the need for a direct interface with business management.

Activities that require consistency or highly specialized skills across business are conducted in dedicated organizational units in accordance with compliance. For cross cutting activities compliance, the management steps in as a centre of resolution.
Formal mechanisms are put in place to ensure ‘one face to the regulator’ which is the Head of Compliance Function.25

REPORTING AND COMMUNICATION LINES

Compliance head reports to the Management and he has a direct reporting line for doing so. Thus compliance representation is at the senior most level in the overall hierarchy.

The heads of the embedded compliance functions maintain intense and close relation with senior management within their jurisdiction and have overall responsibility for the quality of professional practices in their department. They have a solid reporting line into the head of compliance function.

An activity that requires overall consistency is client acceptance and anti-money laundering. Therefore, this activity is conducted by Compliance with close alignment with the embedded compliance functions within banking business units.

INDEPENDENCE AND AUTHORITY

Compliance is an independent function from the business and other line functions. Even the compliance reporting enjoys an independent status as the Compliance Head has direct representation and reporting line to the Board of directors through the Chief Executive of the bank.

In respect of authority, the compliance function has free access to information and personnel and has the right to advise internal audit to conduct investigations of possible breaches of the compliance policy and if required to appoint outside experts to perform this task.26
Compliance is the principal interface with the regulators on compliance issues. All contacts with the regulator on compliance issues are managed through or in consultation with compliance.

**OBSERVANCE OF STANDARDS**

Preservation of the integrity and reputation of bank is the commitment of the management of banks in Jordan. This is achieved by complying with applicable laws and regulations by banking institution of the country. Employees must adhere to all laws and regulations applicable to the bank and also to the ethical standards set by the bank. Who do not adhere to standards, face disciplinary action. All employees are expected to observe high standards of conduct and he aware of the laws and regulations of other countries when conducting cross-border transactions.

**ACCOUNTABILITY**

Compliance function follows a risk-based approach in addressing issues escalated to it or resulting from the monitoring conducted by it.

Compliance staff is also responsible to provide guidance and support to the bank business or issues related to laws and regulations. They are obligated to carry out and perform according to the overall compliance plan approved by the Bank Management.

**PART-C: AUDIT PRACTICES IN BANKS OF JORDAN**

The audit practices in the banking sector of Jordan are governed and regulated by the “Instructions of Internal Control System issued by the Central Bank of Jordan (CBJ) pursuant to the stipulations of Article 45/a of the Central Bank’s Law and
Chapter – IV: Internal Audit Control and Practices in Banking sector of Jordan

Article 99/b of the Banking Law. These instructions lay down the minimum control measures and the practices to be introduced to achieve the assurance that the Bank’s management carried out the proper control over the Bank’s activities. The Bank’s Board of Directors have been assigned the statutory responsibility to ensure existence of adequate and effective procedures and practices of internal control, supervision and regulation continuously.

Broadly analyzing, internal control over the following important activities of banking business are rigorously enforced in the banks of Jordan.

I. Treasury Operation Audit Practices

Treasury operation relate to financial market activities of the banks which make up the investment portfolio. Treasury operations have become more significant and complex today because of the role played by technology and the rapid changes in the financial sector. Hence, there is need to conduct, with specialized skills, the audit of treasury operations, more so in an environment of integrated treasury operations where the foreign and domestic treasury are fully integrated in the banks of Jordan.

The CBJ has introduced prudential norms for income recognition, valuation and provisioning norms for investments. As per its guidelines, the banks should undertake a half-yearly review of their investment portfolio which should, apart from other operational aspects of investment portfolio, clearly indicate and certify adherence to laid down internal investment policy and procedures and CBJ’s guidelines and put up the same with their respective Boards within a month. Further, a copy of review report put up to the Bank’s Board is forwarded to the CBJ on the fifteenth day of the expiry of each half of the financial year.
In view of the possibility of abuse, treasury transactions are specially subjected to a concurrent audit by the Internal Audit Function of the Banks in Jordan.

The treasury operations have been divided by the banks broadly in the three categories:

1. **Fixed Income:** It includes management of investment in the domestic market in the local currency and/or investment in the foreign securities in foreign currency.

2. **Foreign Exchange:** It involves management of foreign exchange assets, liabilities and reserves.

3. **Derivatives:** These are undertaken to hedge against various risks arising from various facets of assets and liabilities such as interest rate risks, foreign exchange rate risks, credit risks, etc.

In addition to the above the banks in Jordan also execute certain transactions on behalf of their constituents. These are also handled by the treasury operations.

The internal auditor in Jordan bank obtains a complete overview of the treasury operations and focuses upon the following while conducting a risk assessment of the treasury processes:

A. The bank’s overall management structure
B. The banks treasury structure
C. The deal execution process
D. The deal settlement process
E. The deal monitoring process
F. The flow of information and data to and from the treasury.
G. The accounting and valuation systems and procedures
H. The computer system that helps in all the above processes and the reliance that an auditor can place on the effective and efficient working of the same.

A. **Bank’s Overall Management Structure**

The Board of Directors has the overall responsibility of guiding the treasury operations. They specify their thinking through Investment Policy which lays down guiding principles of the treasury activity. An Investment Committee of senior management with one or more directors is formed to ensure that the Investment policy is properly implemented.

The internal auditor understands the intentions of the management by pursuing and reviewing the Investment Policy.

B. **Banks Treasury Structure**

In Jordan, banks follow the international best practices which have divided the ‘Treasury into three sections: the ‘front office, the mid-office and the back office. Front office is responsible for the deal execution; the back office settles the deal executed by the front office, and the mid office ensures adherence to the various tolerance limits of risk specified by the bank management.28

The internal auditor reviews the treasury structure and satisfies that inherent controls exist in the treasury structure such that there is no overlap of roles and responsibilities as also the intentions of best practices of segregation of duties are in place and working effectively.

C. **Deal Execution Process**

The front-office engages the dealers for each of the three components of treasury-fixed income, forex and derivatives. The internal audit overseas these dealers
and ensure that the mechanism and processes followed by them while executing a deal adhere to the overall framework of Investment Policy.

D. **Deal Settlement Process**

Once a deal is executed, the back office confirms the transaction to both the counterparts. On the settlement day the transaction is settled by exchange of funds or securities. The Internal auditor checks the manner in which the back office executes its role; the control systems that they have implemented and the manner in which issues or disputes are resolved with counterparties.

E. **Deal Monitoring Process**

The mid office is responsible for proper valuation of entire portfolio and ensuring adherence to the various tolerance limits specified by the management. These limits include stop loss limits, currency limits, broker limits, company/group industry exposure limits, VaR (value of risk), etc.

As the risk monitoring wing of the bank, this function of mid-office is closely understood and watched by Internal audit in Jordan banks. The internal auditor is very vigilant to ensure that the control functions within the risk tolerance levels in the mid office.

F. **Accounting and Validation Systems and Procedures**

The accounting functions of the treasury are handled by the back office while the valuation function is handled by the mid office. The internal auditor gains a complete understanding of these functions. Apart from applying the Auditing and Assurance Standards (AASs) the auditor uses the techniques and procedures mentioned in the Guidance Note or Audit of banks.
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The accounting procedures and adherence to the applicable accounting standards should be in sync with the regulatory requirements. The classification and categorization of investments should harmonize with the applicable requirements including income recognition and classification and providing norms. The internal auditor evaluates whether all these are diligently followed in compiling the financial statements of the bank.

H. Computer Systems

In today’s environment, it is difficult for a treasury to function without a system support. For the complex calculations required for understanding a derivative transaction to simple interest accruals, from VaR computation to identification of non-performing investments, from portfolio valuation to deal capturing and settlements – all these processes are computer based system.29

The internal auditor of the bank satisfies that controls are adequately deployed such that the computer systems are performing as desired and the output generated are free from material error. The auditor also focuses on the various interfaces from and to the application systems. Interfaces have linkages into another application system. Their unsatisfactory performance renders the integrity of the data available suspect for audit. The auditor takes the help of duly qualified systems auditor in this process.

II. RISK MANAGEMENT AUDIT PRACTICES

With the progressive deregulation and liberalization of the Jordan’s financial sector, banks are increasingly exposed to various kinds of risks – both financial and non-financial. Efficiency of the bank depends on how effectively it is managing the
risks and ensuring a competitive risk adjusted return on capital. Internal control systems are crucial to the conduct of banking business as well as to lead the bank more profitably.

The CJB has been advising the banks to adopt the emerging best practices in banking and finance and the need for enforcing effective risk management and internal control systems complying with prudential guidelines provided by the CBJ and as enunciated by the Basel Committee. The CBJ stresses on the banks to have a robust risk management system in view of the Basel-II Accord on Capital Adequacy. Under the Accord, a Three-Pillar approach is to be adopted for assessment of Adequacy. First Pillar which deals with the minimum capital heavily relies on the risk assessment in the areas of credit, market and operational risks in banks. Under the second pillar, the supervisor is required to review the risk management processes in the banks in order to satisfy that the capital maintained by the banks is in relation to the risks being taken by them. The Third Pillar aims at bringing market discipline on banks by introducing more and more disclosure and transparency.³⁰

This has led to the need for adoption of Risk Board Supervisory (RBS). Accordingly, the banks in Jordan are required to adopt risk management internal systems and practice in assessing, managing and controlling risks.

Taking into account these guidelines of Basel-II Accord and taking in view that the primary responsibility of protecting depositors’ interest and the interest of other stakeholders through corporate governance is that of banks own management, there is a paradigm shift in the focus of internal audit making it risk based. Each commercial bank in Jordan has set up proper risk management internal controls which are regularly monitored at the highest level.
Chapter – IV: Internal Audit Control and Practices in Banking sector of Jordan

The focus of the risk based internal control is on risk identification, prioritization of audit areas, and allocation of audit resources in accordance with the risk assessment. The Risk-Based Internal Audit (RBIA) while focusing on effective risk management and controls, would not only offer suggestions for mitigating current risks but also anticipate areas of potential risks and play an important role in protecting the bank from various risks. 31

The Jordan Central Bank (CBJ) issued Guidance Note to banking sector which deals with the broad contours of the risk based approach towards audit. The plan of Action requires the banks to take various steps to introduce RBIA which includes:

1. Development of a well-defined policy for risk based internal audit;
2. Adoption of a risk assessment methodology for formulating risk-based audit plan;
3. Development of risk profile and drawing up of risk matrix taking inherent business risks and effectiveness of control system for monitoring the risk.
4. Preparation of Annual Audit Plan, covering all risks and their prioritization based on the level and direction of each risk.
5. Setting up of communication channels between the audit staff and management, such as Risk-Based Internal Audit Report;
6. Identification of appropriate personnel to undertake risk based audit and imparting them with relevant training; and
7. Addressing transitional and change management issues.

During this study, the observation of banking sector in Jordan reveals that the banks have adopted the guided approach towards Risk Based Internal Audit.
However, they are at different levels of implementation of RBIA including some banks that have set up a proper strategy to assess the level of risk in various business segments.

**RISK BASED INTERNAL AUDIT SET-UP**

The set up of risk based internal audit practices in Jordan banks comprises several stages:

1. **Policy formulation:** As a first step banks have brought out a clear cut policy on adoption of risk based approach towards internal audit. Such a policy, approved by the banks Board of Directors contain the methodology for risk assessment, functions which should be subjected to risk based assessment and a check list of risk mitigation.

2. **Conduct of RBIA:** Once the policy is in place, the banks draw up a road map for implementation of RBIA. The road map outlines the arrangements for developing the risk profile and the sources thereof, classification, functions into low, medium and high risk and the periodicity of audit and the quantum of transaction testing. The risk profiles prepared are subject to periodical updation incorporating the findings of audit.

3. **Audit Reports: Preparation and Follow-up:** Risk-based internal audit findings are recorded in a specific format to enable the responsible persons to follow up the findings in order to correct any deviations. The RBIA serves its purpose through a Monitor able Action Plan (MAP) which the banks implement timely.

4. **Organizational Aspects:** For implementation of the roadmap for RBIA, the banks have devised a proper organizational set-up which consists of a Task Force of senior officers. The task force identifies the transitional and change management
issues. Steps are taken to address any issues in manpower management, re-skill the staff and bring about an all round awareness on risk management.

The availability of skilled auditors/inspectors is assessed on an ongoing basis so that audit resources can be re-allocated and, where necessary; training can be imparted to the officers and other staff. In fact, all concerned are made well aware of the risk management system in the bank. This is provided not only for drawing up risk profile and risk matrix, but also for prompt detection and correction of any deviations.

**APPROACHES TO ASSESS RISK IN RISK-BASED INTERNAL AUDIT**

Risk-based approach towards internal audit of banks business/branches needs methodology to the adopted by the banks for the purpose. Though Central Bank of Jordan (CBJ) issued broad guidelines on Risk-based Internal Audit (RBIA) but banks have adopted different yard sticks to assess the risk for RBIA. The following are some approaches to assess the risk for RBIA followed by bank in Jordan.\(^3^3\)

**A.** The internal audit function is designed to suit Risk Focused Internal Audit (RFIA). For the purpose of RFIA, the entire branches of a bank are divided into three categories: I, II & III. Top branches of the bank, contributing over 70 percent of interest income and 50 percent of other income (including forex income are categorized as Category-I (High Risk) branches. These branches account for over 90 percent of corporate advances and around 70 percent of overall advances. In view of this, the bank felt that probability of default and Loss-Given Default in these branches will be high and operational risk is likely to be high on account of large number of Forex and other transactions.

Category II branches are high interest earning branches which account for 25 percent of interest income and 40 percent other income. They are treated as Medium
Risk branches. The remaining small branches are category III branches with Low Risk.

Based on the above categories, the periodicity of RFIA is determined. Category-I branches have high frequency of inspection/audit in the financial year followed by category-II branches which are less frequently inspected and audited. Category-III branches are inspected/audited bi-yearly.

Once the branches are subjected to audit, findings of the same are reported in Audit Report Format. These are detailed and cover all areas of branches functioning.

B. For the use of Risk Based Internal Audit Methodology various business activities of the bank are grouped as follows called as “Audit Universe”, e.g.

(i) Project Finance Group
(ii) Retail Banking Group
(iii) Treasury
(iv) Retail Assets Products Group
(v) Subsidiary Companies
(vi) Information System, etc.

The Risk Based Internal Audit Methodology has been divided into following two parts:

Part-I: Explanation of Risk-Based Internal Audit Methodology.

Part-II: Application of RBIA Methodology:
Part-I: Explanation of RBIA Methodology

1. For the purpose of Risk and Control Assessment, a set of standard processes, which are generally common to any type of business, has been identified.

2. Risks are identified as Operational, Financial, Legal Regulatory, Reputational, etc.

3. For every process, exposure of above risks is measured on a scale, e.g. 1-6. Score of 1 signifies low risk and score of 6 signifies higher risk. A risk score is given for every process and every risk.

4. Quantification of Controls: To carry out this assessment, business specific rating models have been developed. These models are divided into various sub-processes for a given business area. For measuring controls in these sub-processes, parameters such as number of errors, financial impact etc. has been laid down.

5. Residual Risk Score: For every risk score, a control of 6 is an ideal score, which indicates that the risks are fully covered by the existing controls. However, in practice there would be a gap between the risks and controls. This gap is an indicator of the control environment in the Audit Unit.

6. Financial Exposure: In order to ensure that the scale of operations is also considered while selecting the Audit Unit the size of the business of Audit Unit is another important factor for picking up the audit units. This factor has been termed as Exposure Score.

7. Risk Map: Based on Residual Risk Score and Exposure Score, a risk map has been prepared for deciding the audit frequency of the business units.
PART-II: APPLICATION OF RBIA METHODOLOGY

1. Selection for RBIA: The banks have adopted a simple way of assessing risk of bank business units/branches for the purpose of audit. Certain marks are allotted for the location of the branches in Metro and Urban areas, categorization of the branches (Extra Large / very large), Growth of Deposit, Growth of Advances, Growth of Profit, Monitoring of NPAs, Current Rating, etc. The total 100 marks can be allocated. Branches getting marks upto 40 are treated as Very High Risk Branches; those with marks from 41 to 60 are treated as High Risk Branches, those with marks 61-80 are medium risk branches, and those with above 80 marks are Low Risk branches. The RBIA frequency is determined based don these ratings. Higher the risk, higher the frequency, lower the risk lower is the frequency of audit of the branch concerned.

In this method, the pre-audit risk assessment does not specifically take into account business risk and control risk. All the business segments of the branch are subject to RBIA once it is selected for audit.

2. The banks draw, alternatively risk profiles of business units / branches on the basis of risks involved. In doing so, capital and group risks are omitted and all other control risks are retained. A Risk Matrix is drawn which is a combination of business risk and control risk. All the risks are categorized into Low, Medium and High with a provision for recording the direction of risk into increasing, stable, or decreasing. For example, there can be four items under credit risk: credit composition and growth, credit quality, other credit risk in non fund based limits, and adequacy of provisions. Chart 4.3 showing assessment of total credit exposure of branch in different lines of activity is given below:
### CHART 4.3

#### Assessment of Total Credit Exposure of Bank

<table>
<thead>
<tr>
<th>Major Segments and Indicators of Credit Exposure</th>
<th>Whole sale Banking</th>
<th>Retail Banking</th>
<th>Retail Assets Products</th>
<th>Project Finance</th>
<th>International Business</th>
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<tr>
<td><strong>1. Composition</strong></td>
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<td>Advances-growth Trend</td>
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<td>• Exposure to Sensitive Sectors</td>
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<td>• Non Fund based limits</td>
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<td>• Credit concentration</td>
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<td><strong>2. Credit Quality</strong></td>
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<td>a) Classification of Assets</td>
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<td>• Standard Assets to total Assets</td>
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<td>• Reduction/increase in Standard Assets</td>
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<td>• Sub-standard Assets to Total Assets</td>
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<td>• Doubtful Assets to Total Assets</td>
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<td>• Loss Assets to Total Assets</td>
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<td>• Watch/Special Watch Accounts</td>
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<td>• Quick Mortality Loans/Advances</td>
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<td>• Devolved Liabilities</td>
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<td>• Recoveries</td>
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<td>b) NPA Analysis</td>
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<td>• Trend of Gross NPAs</td>
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<td>• Chronic NPAs (more than 3 years old)</td>
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<td>• Net addition to NPAs</td>
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<td>• Upgradation of NPAs</td>
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<td>• Recoveries under compromise settlements</td>
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<td>• Achievement under NPA targets</td>
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<td>• Amount of write offs</td>
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<td><strong>3. Credit Risk-Non-Fund based limits:</strong></td>
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<td>• Exposure from LCs, Guarantees, Bills of Exchange discounted/rediscounted/co-accepted etc.</td>
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<td>• Credit Risk on account of Forex contracts</td>
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<td><strong>4. Adequate Provisions</strong></td>
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<td>• Total Provisions trend</td>
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<td>• Understatement of provision</td>
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<td>• Provision as percentage to NPAs</td>
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<td>• Quality of securities/collaterals</td>
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<td>Any other relevant Information</td>
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**Source:** Acquired from the records of banking sector, Jordan.
In the chart, detailed questions on each item of credit risk are given. Against each item of credit risk, both positive and negative factors are recorded and overall risk of each item is to be arrived at as Low, Medium and High as shown in Chart-I. Similarly four control risks are first classified into major items and each item is further divided into sub-items against which positive and negative factors are recorded to arrive at level of risk. Based on the risk assessment of business and control area, overall risk is assessed.

III. INVESTMENT AND SECURITIZATION TRANSACTIONS AUDIT PRACTICES

Funds Management Department of the bank is one of the most sensitive and dynamic areas of the bank’s operations. At any point of time it accounts for about 40 percent of total financial resources and more than 55-60 percent of a bank’s income. Rules and regulations are generally laid down governing the functioning of the activity by virtue of an investment policy document duly approved by the Board, which is required to be in conformity with regulatory guidelines issued by the Central Bank of Jordan (CBJ).

The investments are categorized into Statutory Liquidity Ratio (SLR) investments and non-SLR investments. The SLR investments are required to be maintained on daily basis in approved liquid assets and required to be reported to CBJ on a fortnightly basis. Failure invites CBJ’s regulatory action in the form of increased supervisory interventions and ultimate cancellation of bank license.\textsuperscript{34}
Securitization is a process by which the future cash inflows of an entity (originator) are converted and sold as debt instruments called pay through or pass through certificates with a fixed rate of return to the holders of the debt instrument in the form of beneficial interest. The originator of a typical securitization transfers a portfolio of homogenous financial assets to a Special Purpose vehicle (SPV) normally a Trust, which is basically funded by investors. In return for the transfer, the originator gets cash up-front on the basis of mutually agreed valuation of the receivables. The transfer value of the receivables is done in such a manner as to give the lender a reasonable rate of return. In pass-through and pay-through securitizations, receivables are transferred to the SPV at the inception of the securitization and no further transfers are made. All cash collections are paid to the holders of beneficial interests in the SPV (basically the lenders).

The objectives of investment are to satisfy statutory requirements and to deploy surplus liquidity and floats for generating optimum returns. The objectives of securitization transactions are several which inter alia include higher credit rating and cheaper borrowings.

**Internal Control System**

The internal control function ensures that the guidelines issued by the CBJ in regard to the internal control are strictly followed. There is a clear functional separation, as required by CBJ guideline, of (i) trading (ii) settlement, monitoring and control, and (iii) accounting. Similarly, there is a functional separation of trading and back office functions relating to bank’s own investments Accounts, Portfolio Management Schemes (PMS) Clients’ Accounts and other constituents (including brokers) accounts.35
For every account entered into, the trading desk prepares a deal slip which contains data relating to nature of the deal, name of the counter-party, whether it is direct deal or through a broker, then name of the broker, details of security, amount, price, contract date, and time. The deal slips are properly numbered and controlled separately to ensure that each slip has been properly accounted for. For PMS transactions separate serial numbers are maintained. Once the deal is concluded, the dealer immediately passes on the deal slip to the back office for recording and processing. For each deal there is a system of issue of confirmation to the counterparty. The timely receipt of requisite written confirmation from the counterparty, which must include all essential details of the contract, is closely monitored by the back office.

On the basis of vouchers passed by the back office after verification of actual contract notes received and the confirmation of the deal by counterparty, the Accounts Section independently writes the books of account. It is ensured that counterparty bank or the security purchased/sold is not substituted.

With regard to Subsidiary General Ledger (SGL) related transactions, the record of transfers have to be maintained, the balances in bank’s books are matched with the statements received from the Public Debt Offices (PDOs) and reconciled on a quarterly basis.

Ready forward deals in Government Securities including treasury bills are not allowed. No ready-forward and double ready forward deals are put through in any security including government securities on behalf of Portfolio Management Scheme (PMS) client’s account or on behalf of other constituents including brokers.
A record of bank receipts (BRs) issued/received, which are serially numbered, is maintained. Also in place is the system for verification of the authenticity of BRs and SGL transfer forms received from other banks and confirmation of authorized signatories. It is ensured that no BRs are issued on the basis of a BR of another bank held by the bank and no exchange is allowed on the basis of exchange of BRs held by the bank. No BR remains outstanding for more than fifteen days.36

Banks have also in place a reporting system to report to top management, on a weekly basis, details of transactions in securities, details of bouncing of SGL forms issued by other banks, BRs outstanding for more than fifteen days, capital market exposures, a review of investment transactions undertaken during the period and overall risk management and internal controls.

INTERNAL AUDIT

The internal audit function is an essential part of internal control of investments and securitization transactions. Internal audit of these transactions is done on an on-going basis. Compliance with the laid down management policies and procedures is monitored on regular basis. Internal audit report in regard to the deficiencies is made directly to the management of the bank.

Responsibilities

The internal audit function has the important responsibility of ensuring that the SPV (Special Purpose Vehicle) created for securitization transactions remains independent. For ensuring this, the internal audit function satisfies the following:
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1. Independence

(i) The originating bank transferring the assets to the SPV should not hold any interest, direct or indirect in the trustee company.

(ii) The originator should, under no circumstances, support losses of SPV.

(iii) The Trust should be non-discretionary.

(iv) SPV should adhere to transparency with regard to disclosures regarding constitution, ownership, capital structure, size of issue, terms of offer including interest payments/yield on instruments, details of underlying asset pool and its performance history, including details of the individual obligors, information about originator, transaction structure, service arrangement, credit enhancement details, risk factors, etc.

(v) Adequate disclaimers are made.

2. True Sale Compliance

For ensuring true sale of the pool by the originator to the PSV, internal audit function satisfies that:

(i) Transaction price is based on market trend;

(ii) Originator should not have any interest/commitment whatsoever for repurchase of assets.

(iii) Sale should have been made with transfer of all risks and rewards with the assets.
(iv) The condition relating to no formal recourse, no PVT/CALL options in respect of investment instruments, no warranties by the originator or the bank, etc. must be adhered to and complied with.

(v) Where necessary, particularly in case of non-core services, opinion from solicitors in respect of True Sale is obtained.

(vi) The assets should be put beyond the originators as well as their creditors reach in the event of bankruptcy of the originator.

3. Classification

All outflows and investment instruments or shares in securitized assets require to be classified into Investments or Advances. Generally, these are instruments which are independently realizable at will and classified as investments under non-SLR category.

The above instruments are carried in the books of the bank at their value and on sale, the loss and gain is dealt with as under:

(a) If the sale is at a price below the net book value (NBV) the shortfall is debited to P&L A/c of that year.

(b) If the sale is for a value higher than NBV, the excess provision is not reversed but utilized to meet the loss on account of sale of other financial assets.

Sub-Classification

The entire investment portfolio of the banks (including SLR and non-SLR securities) is classified into three categories, viz. ‘Held to Maturity’, ‘Held for trading’ and ‘Available for Sale’.
‘Held to Maturity’ include securities acquired by the banks with the intention to hold them up to maturity. Under this category, banks are allowed to keep up to 25 percent of their total investments.

‘Held for Trading’ includes securities acquired by banks with the intention to trade by taking advantage of the short term price/interest rate movements.

‘Available for Sale’ are securities which do not fall under the above two categories.

Banks, however, can shift investments to/from ‘Held to Maturity Category’ with the approval of Board once a year.

VALUATION

The internal audit function ensures that there is proper valuation of Investments and Securitization instruments adhering to the internationally accepted practices and the guidelines issued by the CBJ. Value determination norms followed are as under:

**Held to Maturity:** (i) Investments classified under this category need not be marked to market but should be carried to acquisition cost. (ii) Any diminution in value, other than temporary, in the value of investments under Held to Maturity category should be determined and provided for each investment individually.

**Available for Sale:** The individual scripts under this category should be marked to market at quarterly or more frequent intervals. Securities under this category shall be valued script-wise and depreciation/appreciation aggregated. Depreciation should be provided for while appreciation ignored. The book value of the individual securities would not undergo any change after marking to market.
Held for Trading: Individual scripts in this category shall be marked to market at monthly or more frequent intervals and provided for as in ‘Available for Sale’ category. Also, the book value in this category would not undergo any change after marking to market.

Treasury Bills: are to be valued at Carrying Cost.

Investment Fluctuation Reserve: Banks have been advised by CBJ to build up Investment Fluctuations Reserve (IFR) of a minimum 5 percent of the investment portfolio in order to provide for the diminution in values of the investment and securities. In the event, provisions created on account of depreciation in the AFS and HFT categories are found in excess of the required amount in any year, the excess should be credited to P&L A/c.

Review and Reporting:

The Banking sector in Jordan follow the following practices in regard to review and reporting of investment transactions:

(i) Banks, as required by CBJ, undertake a half yearly review of their investment portfolio which should, apart from other operational aspects of investment portfolio, clearly indicate amendments, if any, made to the investment policy and certify adherence to laid down internal investment policy and procedures as well as CBJ guidelines. This review report is put up by banks before their respective Boards within a month after half-yearly review.

(ii) A copy of the Review Report as put up before the Board has to be forwarded to the CBJ.
(iii) Investment and Securitization transactions are separately subjected to internal audit and the results of the audit are placed before the CMD of the bank once every month.

(iv) The major irregularities observed by internal audit and the position of compliance thereto are incorporated in the half yearly review of the Investment Portfolio.

(v) All securitization transactions must be reviewed to ensure the following: Controls over receivables on due dates; ratio of non-performing assets (NPAs) in the portfolio in relation to agreed percentage at the time of take over; maintenance and disclosure of cash collaterals, compliance with terms of agreement.

IV. TRANSACTION AUDIT PRACTICES

Audit traditionally implies ‘Transaction Audit’. In every organization this basic type of audit is a usual imperative. The utility of Transaction Audit will remain beyond any doubt for all times to come, be it a trading or non-trading organizations or a commercial bank.

Transaction audit implies verifications of accounts based on accounting transaction flows. Effective internal control system is needed to ensure the authenticity and veracity of the every day financial transaction flows taking place in any organization. The Internal audit function is established in the organization as a watchdog to ensure error free and fraud-free conduct of this transactions.\(^\text{37}\)

As banks deal in money, and money alone, which has been and which will continue to be the main attraction, the traditional transaction audit system in banking
sector shall remain of permanent necessity. The banking sector of Jordan is no exception, and transaction audit procedures and practices are well established as a part of internal control system. They are, under regulatory provisions, devised by the Management of the bank keeping in view the requirements and objectives of the audit. Internal transaction audit practices in Jordan commercial bank are reviewed ahead.

INTERNAL CONTROL PRACTICES

Under Internal Control, Banking sector in Jordan establish an internal audit department/ cell for transactions audit in the bank. It is an in-house function. An Internal Auditor is appointed to head this function which is also staffed by other audit hands.

The internal control system for commercial bank transactions in Jordan broadly comprises the traditional two parts. The system establishes a procedure of internal check as well as a mechanism of internal audit of transactions.

The Internal audit function exercises a check on banking transactions concerning its usual business of deposits, payments, loans and advances as well as other allied financial services rendered by the banks to its clients. The objective is to ensure that the dealing staff follows in the course of conducting the transactions the laid down procedures, rules as also that the transactions are genuine and correctly put through by making right entries in the books of accounts. Such a watch through internal audit eliminates the chances of error, fraud, embezzlement etc. taking place during the course of banking business.

Broadly, the internal audit function in banking sector of Jordan comprises of the tradition two parts: Internal Check and Internal Audit.
INTERNAL CHECK

Internal check is a method of organizing the accounts system in such a way that the duties of different working hands are arranged such that the work of one person is automatically checked by another. Thus, the possibility of fraud or error or irregularity is minimized unless there is collusion between the staff members. Again, if the error or fraud has been committed, it will be detected very soon by another worker while the transaction is being automatically checked independently at two or more than two places. Responsibility for error or fraud is also accurately determined through internal check.38

The main features of internal check in the banking sector of Jordan as found under this study are summarized as below:

(i) The bank cashier does not have access to the customer’s ledgers and similarly the ledger keeper does not have access to the cash book.

(ii) The work of one official is checked by another official at the end of the day.

(iii) The duties of staff members are shifted from one counter to another counter from time to time.

(iv) The internal auditor(s) pay a surprise visits to the branches and send their reports to the head office.

(v) The balances in the Current Accounts, Deposit Accounts and Loans Accounts are checked at intervals by responsible supervising staff.

(vi) Securities lodged with the bank against loans, cash credit, overdrafts, etc. are verified by responsible official by actually examining the securities.
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(vii) Securities with the bank kept by customers for safe custody are verified by responsible official from time to time.

(viii) The coming and outgoing bills are under the custody of a responsible officer.

(ix) Cleaning house transactions are scrutinized on daily basis.

(x) Pass book balances are checked with the ledger at short intervals.

INTERNAL AUDIT

The internal audit of banking transaction is the responsibility of internal audit function in the banking sector of Jordan. Internal auditor with its team of workers conducts this function. 39

The internal audit function is a protective and constructive arm of management as it makes an independent appraisal of activity within the bank and its branches. The function makes a review on periodical basis of the accounting, financial and other operations of the bank and its branches. On the basis of this independent appraisal and review, the internal audit function makes timely reports to the management of commercial bank in Jordan whether the policies and plans prescribed by them have been implemented; whether the internal check and controls established were adequate; whether the actual results obtained were varying from the targets, etc. to enable the bank management to achieve the objectives in the planned manner. In fact, internal audit is a sort of continuous audit but is conducted by the own staff of the bank.

The Statutory Auditors (external audit) place considerable reliance on banks transactional operations as the internal control system is effective and smooth in the
Jordanian Banking sector: The internal audit function, in fact, works in close cooperation with the external statutory auditor as follows:\textsuperscript{40}

(i) The internal auditor fixes the audit programs in consultation with the external auditor to derive the maximum amount of advantage;

(ii) The programs so adopted are changeable from time to time according to the circumstances and the experience gained;

(iii) Internal auditors report to the management serves as a guide to the statutory auditor in doing external audit as it reveals if the standard procedures were followed; if action by management was timely taken.

CONCLUSION

The foregoing review and discussion signifies the imperative of establishing an effective and sound internal control system for the banking sector business activities. Without exception, the Jordan Banking sector have under regulatory provisions of their Banking Legislation and instructions from the Central Bank of Jordan, set up internal control system in the banks. It comprises the internal audit function and internal checks. Besides, ensuring error free and fraud free banking operations, the internal control system in banking sector of Jordan also keeps a monitoring eye and performs audit function for Treasury operations, Risk Management, Investments and Securitization as well as carries out the traditional transaction audit of accounting flows. Regular review and reporting emanating from the internal control provide important information communication and reinforces the management information system.
Keeping pace with the advancements in information technology, the banks have switched over and introduced computerized system of accounting and auditing. This has improved quality, efficiency, integrity and soundness of accounting and internal control systems as also has made handy the management information and communication. The next chapter is, accordingly devoted to a study and review of Information Technology Auditing in Banking sector of Jordan.

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