



Internal Audit Systems under Corporate Governance Regulations A Comparison between Kuwait and New York Stock Exchanges

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Abstract

Objectives: The research aims to provide recommendations to the development of legislation relating to internal audit systems for listed companies on the stock exchange, so to positively reflect on Kuwait economic development in particular and the region in general. **Method:** The instrument was the comparative legal analysis between USA and Kuwait legislation. This research focused on the legislation in Kuwait and the USA pertaining to internal audit systems, since the US has long history and experience in the internal audit systems for listed companies on the stock market. **Results:** The research reached a number of results; the principle of "internal audit systems" helps the listed company achieve its goals, and that there is a lack of knowledge about these systems and their implementation by the listed companies, as well as the Capital Market Authority, which resulted in different opinions and disparity in commitment. **Conclusion:** The research concluded with a number of recommendations, inter alia the need to benefit from the experience of the NYSE in the field of "internal audit systems".

Keywords: Internal audit system, Corporate governance rules, Listed companies, Capital market authority.

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Introduction

The first code of corporate governance rules in Kuwait was issued in 2013⁽¹⁾. This code introduced new principles relating to corporate governance for listed companies⁽²⁾. One of these principles requires that each listed company should have an internal audit system. Despite the code being updated in 2015, Kuwaiti listed companies and the Capital Market Authority⁽³⁾ lack experience in internal auditing systems, which from time to time affects the implementation of, or compliance with, these rules.

In discussing the internal audit system in Kuwait, this paper compares the provisions of corporate governance in the United States (US)⁽⁴⁾ and

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- (1) The 2013 Kuwait Corporate Governance Code was replaced by the subsequent code, released in 2015. Several provisions were changed. For example, according to the 2013 Code, compliance with the code was mandatory. Failure to comply with the provisions of the code was a breach of Securities Law No 7 of 2010. Whereas according to the 2013 code companies were required to send a quarterly report to the Kuwaiti Capital Market Authority confirming compliance with all the provisions of the code. The 2015 code has replaced this provision with a requirement that the company file an annual report with the CMA.
 - (2) There are eleven main corporate governance principles in Kuwait, namely: 1) appointing qualified candidates to strengthen the composition of the board of directors; 2) setting out the clear roles and responsibilities of those who serve on the board; 3) recruit highly qualified candidates for appointment to the board of directors and to positions of senior management; 4) ensure that financial reporting is clear and done with integrity; 5) require companies to establish and enforce adequate systems of risk management by the application of proper internal controls; 6) promote the highest levels of ethical standards and conduct within companies; 7) ensure that any material information is disclosed timely and effectively; 8) ensure that boards of directors recognize the interests of stakeholders in all matters; 9) encourage the highest level of performance among executives; 10) impress upon management the importance of corporate social responsibility; and 11) ensure that the rights of shareholders are protected.
 - (3) The Capital Markets Authority was created by the 2010 Kuwaiti Capital Markets Act. The CMA is a regulatory body that is responsible for regulating securities activities in Kuwait. The objective, duties and powers of the CMA are set out in the second chapter of the Act (article 2 to article 30).
 - (4) There is no formal corporate governance code in the US. Corporate governance requirements are formed by various federal laws, such as the Sarbanes-Oxley Act 2002, the Dodd-Frank Wall Street Reform and the Consumer Protection Act, the federal securities law and regulations, rules and other guidance promulgated by the Security and Exchange Commission, and the listing standards of registered stock exchanges that require listed companies to maintain specified corporate governance rules.

those in Kuwait. This article will consider the topic based on a comparative legal analysis of the position in the USA relating to internal audit systems as the regulations are applied on the New York Stock Exchange (NYSE)⁽⁵⁾ to improve the 2015 Kuwaiti Corporate Governance Code (KCGC).

The introduction to this paper consists of the following four sections: the aims of the article, the methodology of the article, the scope of the article, and the organization of the article.

Until recently, the principle of internal auditing as it applied in Kuwait had not been clarified. Without proper regulation and legislation, there was widespread controversy about this subject. This article will clarify this principle and compare it with legislation that has a long history and has been the subject of scholastic research and practical application. A comparison with more advanced stock exchanges is advantageous and gives developing countries the opportunity to learn from their experience.

The primary goal of this research article is to provide a detailed explanation of the Kuwait Corporate Governance Code (KCGC) as it relates to an internal audit system. It focuses on whether the Code offers an appropriate framework and, if applicable, suggests amendments to the Code⁽⁶⁾.

In addition to the main aim, as set out above, this paper will enhance the knowledge of the Kuwaiti people on the topic of corporate gover-

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- (5) The NYSE was established in 1792 by twenty-four stockbrokers who gathered under a buttonwood tree outside the building at 68 Wall Street to sign the agreement known as the "Buttonwood Agreement". This agreement aimed to regulate prices and commissions of the stock market. This agreement remained in place until 1974, when the government intervened to break up the monopoly. Since then, the phrase "Wall Street" has been applied to the New York Stock Exchange and has come to represent all the US financial markets.
 - (6) Traditional enforcement of corporate governance principles has proven unsuitable in practice. A new enforcement method is needed that combines rules and codes, securities laws and other legal mechanisms need to be developed. In some countries enforcement is done by means of corporate law, whereas other countries apply securities laws and other delegated legislation such as listing rules for enforcing corporate governance principles.

nance⁽⁷⁾. By setting out in detail the various topics below, the article will be a useful addition to the topic and literature in this field. Furthermore, it should provide a new avenue of research for other Kuwaiti scholars to expand on, improve and develop the national economy.

This article examines legislation in the US, which is a developed market to evaluate its potential for averting problems in the future and bringing a better understanding of this subject.

The United States has legislation to ensure that firms have an effective internal audit system. This legislation has evolved over the years to increase the effectiveness of corporate governance. As a result, the use of a comparative law approach in this article helps to determine which laws and regulations are the most effective⁽⁸⁾.

The article will focus on explaining the existing legal frameworks applicable to the KCGC⁽⁹⁾ and to analyze the more controversial role of an

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- (7) Corporate governance principles are based on ethical behavior, which means that, in listed companies' activities, it is important to know that simply because something is legal does not mean that it should be done. Something that is legal is not necessarily ethical. Saying that a company is law-abiding does not mean the same as saying that a company is ethical. Business ethics seeks to identify a balance between doing what is right for the community and doing what is best for a company's shareholders. In terms of business ethics, it is important to study the following important points: corporate governance, risk management and how the 'comply or explain' approach works. Companies have a social responsibility that comes with different ethical challenges. For example, in business a good reputation can be more important than legal compliance. Being ethical can sometimes be better than following the 'letter of the law'.
 - (8) A comparative law approach to research is merely one methodology that can be chosen. Since this article aims to assist readers from Kuwait learn from the experience of other jurisdictions, a comparative law approach was chosen for this article. This approach allows readers see how other countries apply laws and regulations to similar problems experienced in their jurisdiction. It is hoped that this approach will assist readers to find ways of solving legal problems in a progressive way.
 - (9) The Kuwait Corporate Governance Code combines corporate governance principles with the Companies Law 2016, the Securities Law 2010 and listing rules, disclosure rules and regulations promulgated under the KCGC. The KCGC is applied to all companies listed on the KSE and licensed shareholding companies, whether they are listed or unlisted, except the units subject to the supervision of the Central Bank. Under the Kuwaiti Corporate Governance Code 2013, corporate governance provisions =

internal audit system. This article does not cover an external audit system or the audit committee⁽¹⁰⁾.

Method

The topic of internal auditing is multi-faceted, relating to inter alia accounting, legal, administrative, management, and other aspects of corporate governance. However, this article solely focuses on the legal aspects as they relate to corporate governance.

To achieve its aims, this article is divided into three sub-sections. Section one discusses the definition of an internal audit system. The second section considers the current approach in Kuwait toward this subject, as well as a comparison between the approaches in Kuwait and the US, with a view to propose recommendations for amendments of the Kuwaiti Code 2015. Lastly, the research and recommendations are summarized in the conclusion.

Definition of Internal Audit System

Before discussing internal audit systems in detail, it would be advisable to consider the subject of corporate governance (CG). Corporate Governance started developing as early as the 1970s. Several corporate scandals highlighted the risk to investors resulting from the irresponsible, negligent, and even fraudulent actions of the executive management of companies, which ultimately contributed to a fall in the company's value and often to a complete collapse of the company (Paccès, 2012, p.3). This problem is not limited to just one country as can be seen by the examples below (Mallin, 2013, p.2–7). Unfortunately, this problem has not been

= became mandatory for all companies. However, some of the provisions of the 2015 KCGC are mandatory, while others are voluntary, especially those relating to 'comply or explain' principles.

(10) An audit committee is one of the various committees established by the board of directors in terms of the corporate governance principles. Boards of directors establish these committees to carry out some of their roles and responsibilities, which is recognized as good corporate governance practice. Audit committees are made up of several directors, which number differs from country to country.

eradicated as can be seen from the 2008 financial crisis and other similar scandals⁽¹¹⁾.

Corporate governance is a complex topic and includes such aspects as proper risk management, eliminating bribery and fraud and guarding against poor board practice. This has in turn given rise to many research opportunities such as the best practice in connection with board composition, effectiveness of the board of directors, the role of the various board committees, international best practices in relation to risk management, establishment of remuneration committees and effective remuneration policies, how to effectively manage the relationship between the board of director and the shareholders, how to eliminate bribery and corruption, proper IT governance, managing corporate mergers and acquisition of other entities, succession planning for boards of directors, sustainability of the business model and corporate entity, talking the issue of climate change, and proxy access amongst others.

As can be expected, setting rules of corporate governance that are applicable in every country is not possible. Corporate governance principles must evolve over time. Nordberg equates corporate governance to driving a car, which requires use of amongst others a steering wheel, brakes, and the accelerator to ensure that the car reaches its destination. (Nordberg, 2011, p.7).

The term ‘corporate governance’ is not easy to define as it relates to various matters, including such things as law, economics, management, accounting, and others, and each of these fields has its own nuances and developments. Thus, it can be said that corporate governance is multi-fac-

(11) The table below lists several well-known corporate scandals from around the world.

<u>Date</u>	<u>State</u>	<u>Firm</u>
2012	Japan	Olympus Corporation
2009	India	Satyam
2008	UK	Royal Bank of Scotland (RBS)
2003	Italy	Parmalat known as Europe’s Enron
2001	US	Enron

eted. Corporate governance focuses on the relationship between the board of directors and the shareholders and determines the best ways of governing and controlling a company. The essence of corporate governance can therefore be reduced to two main points: the first is about the control of the day-to-day operations of the company, and the second is about the strategic future direction of the business of the company.

It is vital that corporate governance is applied to reduce company scandals, protect the shareholders, improve performance of listed companies, and prevent negative management behavior. According to Andrew Chambers' Corporate Governance Handbook, the success of a company is directly related to the application of corporate governance principles. In other words, the greater the emphasis on application of corporate governance principles, the greater the likelihood of success in a company. (Chambers, 2012, p.351). The application of corporate governance principles in relation to the establishment of an internal audit system is seen as a vital step in leading a company to financial success. Doing so, companies ensure that the actions of the board of directors and executive management are subject to oversight.

The concept of internal auditing is not new and has a long history with a variety of different applications such as bookkeeping⁽¹²⁾. Internal audit systems developed in relation to achieving corporate objectives. During the 1920s, the function of the internal audit system was expanded to include rules and systems aimed at improving financial reporting and safeguarding assets. During the 1950s, attempts were made to define internal controls. These distinguished between administrative controls which included implementing managerial policy by means of training programs and quality controls. The second set of controls included accounting controls which related directly to safeguarding assets and producing reliable financial records. Examples of these controls include duty-sharing among bookkeepers and maintaining proper recordkeeping systems. However, during the 1990s, a comprehensive study of internal controls was carried out. This led to auditing standard-setters removing the distinctions between administrative and accounting controls and incorporating newer policy and compliance controls.

(12) Institute of Internal Auditors Association Research Foundation, *Internal Audit Capability Model*. 2.

Internal auditing initially started as an extension of external auditing. Internal auditing became more and more important as the control systems mentioned above evolved to include non-financial systems elements. This led to internal auditing functions expanding to encompass the design, administration and testing of these systems. It has evolved remarkably over the last 60 years⁽¹³⁾. However, in recent times the role of internal auditing has become more important than ever before. This is due to the increase in corporate scandals and financial mismanagement by boards of directors and unscrupulous management of companies⁽¹⁴⁾. Firstly, the scope of internal auditing has rapidly extended and listed companies have been forced to implement internal auditing systems, such as those in the Kuwait Stock Exchange⁽¹⁵⁾ and the NYSE. Secondly, the internal auditing function has expanded to cover management control and accounting, assisting external auditors, and other related functions.

As a result, internal audit systems can now be defined as follows: “An internal audit system is an independent and objective assurance and advisory activity that aims to increase value and enhance the organization’s functions”⁽¹⁶⁾. The scope of its role covers four important areas, which are firstly enhancement of organizational value, secondly protection of organizational value by providing risk-based and objective assurances by limiting the risk of fraud; (Westhausen, 2017, p.223), thirdly advice, and insight fourthly.

(13) Ibid.

(14) Corporate governance failure can manifest in various forms, which inevitably result in financial disaster for the company. Poor risk management, fraudulent transactions, financial manipulation, insider trading and conflict of interest are often evidence of poor corporate governance within a company. Boards of directors who are motivated by increasing shareholder returns and creating large dividends at the expense of retaining profit or reinvesting money into company performance, often create problems for these companies. In turn, the mismanagement of companies has resulted in false economic progress, but ultimately lead to larger corporate scandals. (Stout, 2012, p.83–85).

(15) In terms of Kuwaiti law, a Stock Exchange is defined as: “...the place where stocks and other securities are bought and sold. A Stock Exchange Market follows the procedures applicable to trading and carries out the usual functions of a stock market in accordance with the standards and regulations issued by the Authority” Article 31 of the Kuwaiti Capital Markets Act 2010.

(16) Institute of Internal Auditors Association Research Foundation, *Guidance Notes*.

The board and Internal Audit Systems

The system of internal controls is part of the responsibility of the board of directors. This is crucial in ensuring that the business is managed with integrity and ethical practices, as well as providing accountability for the conduct of the internal control responsibilities. Since senior executives are responsible for key business functions and operating units, they should play a key role in designing and implementing of internal controls that address related objectives.

The Audit Committee and the Internal Audit System

The audit committee is tasked with managing the internal control system and the internal audit system, particularly relating to financial reporting⁽¹⁷⁾. Their function is to produce reliable financial statements as well as to ensure that the company's activities are monitored by the broader system of internal controls. The audit committee must ensure that the internal audit function is managed independently and objectively to carry out its work effectively throughout the company. This will result in the internal audit providing the audit committee with a clear picture of the organization's governance, control, risk and monitoring activities.

The audit committee will ensure that the internal audit system includes various activities such as meetings between the audit committee and the chief audit executive (CAE). Furthermore, the review of internal audit policy and the results of the internal audit process by the audit committee are vital tasks of the committee. The involvement of the audit committee in decisions concerning the appointment of the chief audit executive and the review of the application of the internal audit system by executive management are also important priorities of the audit committee. (Khelil, 2016, p.438).

Whilst the oversight of the internal audit process by the audit committee is onerous, it would be preferable to have stricter internal audit controls to prevent financial mismanagement (or even fraud) rather than to expect

(17) The SEC has issued interpretive guidance for boards of directors in relation to the "assessment and evaluation of internal control over financial reporting (ICFR)".

the external auditor to be the sole functionary identifying areas of concern. The cost of external auditors can be a heavy burden on companies, and it would therefore be preferable to strengthen the internal audit systems and controls to ensure that no mismanagement takes place, and, that it is identified prior to the external audit, if it does.

External Audit and Internal Audit Systems

The purpose of appointing an external auditor by the business is to audit the financial reporting and to confirm its reliability. In some jurisdictions, the external auditor is also required to monitor the effectiveness of the internal control system regarding the financial reporting. The external auditor is expected to communicate any deficiencies in internal control systems to the management for them to act on. However, depending on the significance of the problems identified, the external auditor should refer the matter to the audit committee. External auditors focus mainly on financial controls. However, the increasing focus on corporate governance and internal controls from regulators (and companies alike) has affected the roles and functions of external auditors. As a result, the position of the internal auditor has been strengthened whereas the external auditor has decreased (Holm & Laursen, 2007, p.227).

The role of the auditor in Kuwait is set out in Law No. 1 of 2016 dealing with company law. Articles 227 to 233 set out the regulations pertaining to the audit profession and its role in Kuwait. In terms of the law, all Kuwaiti public companies must appoint an auditor. Article 227 mentions the appointment of the auditor in public companies stating that “the Public Shareholding Company shall have one or more auditors to be appointed by the ordinary general meeting following approval of Central Bank of Kuwait with regard to companies subject to its supervision”. One of the most important features of a good auditor is independence from the board and company managers. Article 228 emphasizes this when it states:

The auditor shall not be the chairman or a member of the board of directors of the company the accounts of which he is auditing, nor a person assuming any administrative tasks or supervising its accounts, nor a relative of the second degree of a person overseeing the company’s management or accounts. During his term the auditor shall not purchase or sell

shares in or assume any consultation services for the company the accounts of which he is auditing.

According to Kuwaiti company law, the auditor has the right to inspect the company's accounting records at any time. The auditors' rights furthermore include verifying the various company's assets and liabilities⁽¹⁸⁾. The report of the auditor must include specific things such as: 1) The company maintains accurate and proper accounting records. 2) The company has provided the auditor with proper access to these records to carry out his work. 3) The accounting records reflect the true situation of the company. 4) The company has complied with all legal requirements imposed by law. 5) The accounting records are maintained in line with the best practice standards. 6) The report needs to state whether there have been violations of any law or of company contracts during the financial year and whether these violations still exist. 7) Any additional relevant information pertaining to the financial management of the company that the auditor deems necessary⁽¹⁹⁾.

Effective corporate governance practices are based on the application of CG principles and rules that ensure that internal auditing carries out its stated functions in an appropriate way. The internal auditing function is part of corporate governance principles. The value of an effective internal audit function for all listed companies is as a matter of basic good governance⁽²⁰⁾. The challenges in implementing the internal audit function in a company relate to the costs involved in doing so, as well as ensuring the independence of those who are involved. An internal audit system is only effective if properly carried out.

Around the world, the internal audit function is recognized as a key component of corporate governance (Mubako & Mazza, 2017, p.831). By implementing an internal audit function (IAF) companies will improve their corporate governance and the overall performance of the company (Getie & Bligh, 2017, p.740) The lack of proper internal audit systems is linked to many corporate failures. For this reason, most corporate gover-

(18) Article 229 of the Law No. 1 of 2016 on the Promulgation of the Companies Law.

(19) Article 230 of the Law No. 1 of 2016 on the Promulgation of the Companies Law.

(20) Institute of Internal Auditors Association, Letter to SEC.

nance codes now require that listed companies disclose information about their internal control functions (Ismael & Roberts, 2018, p.289).

The Committee of Sponsoring Organizations (COSO)⁽²¹⁾ published a framework in which it defined an internal control as a “process, effected by an entity’s board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives relating to operations, reporting and compliance”⁽²²⁾. The COSO was established in 1985 in the US. Its main aims were to assist companies and organizations with financial controls and reporting systems as well as in assessing their control systems. This framework was given as an example of a “suitable control framework” by the Securities and Exchange Commission (SEC) and has been used by listed companies ever since. The framework was updated in 2013.

The COSO framework includes the following objectives: 1) Objectives pertaining to the company’s operations (including operational and financial) with a view to improving the effectiveness and efficiency; 2) Those relating to the internal and external reporting of the company, focusing particularly on such matters as reliability, transparency, and other items required by regulators; 3) Objectives relating to compliance with laws, rules, and regulations specific to each organization.

The COSO framework states that internal controls are made up of five components, which are:

1. Controlled environment: This includes the standards, processes, and structures that are applied throughout the business. The board of directors and management are tasked with setting these standards and enforcing them (as well as applying them).
2. Risk assessment: This involves the process of identifying risks in and to the business, analyzing these risks and devising a plan on how to deal with these. The board needs to consider a many different factors that could affect the business and how to deal with these effectively.

(21) The Committee of Sponsoring Organizations (COSO) of the National Commission on Fraudulent Financial Reporting, also known as the Treadway Commission.

(22) Committee of Sponsoring Organizations, Home Page, <https://www.coso.org/Pages/default.aspx> (last visited October 7, 2019).

3. Control activities: These comprise actions carried out because of the policies decided on and procedures established by executive management with a view to lower the risks associated with the business objectives. They are performed throughout the business in all departments and in all stages of doing business.
4. Information and communication: These are vital for any business to be successful. Accurate information is particularly important in the internal control systems and responsibilities. Communication occurs within the company and between various departments. This allows the business to carry out its objectives, as well as provides personnel with the relevant information relating to internal control responsibilities and their importance.
5. Monitoring activities: It is the duty of the internal auditor to constantly monitor and evaluate the various components of the internal control systems to ensure that the abovementioned principles are present and functioning. In the event of any errors being detected or if any improvements can be made, the internal auditor should communicate with the senior management.

Since fraud is a serious problem in corporate culture and threatens the continued existence of many businesses, internal auditing is vital in the prevention and detection of fraud. As a result, the internal audit function must be well planned and well executed (Kabuye, 2017, p.928). The term internal audit function does not mean that every aspect of the business needs to be audited (Erasmus & Coetzee, 2018, p.90). Whilst the internal auditor should have access to every part of the business, and by rights should be able to audit each aspect of the company, this is not necessary nor an effective use of time and resources. The internal auditor generally concentrates on auditing specific aspects of the business. In the circumstances, measuring internal audit function effectiveness becomes challenging.

Before the enactment of the Sarbanes-Oxley Act 2002 (SOX), financial controls were implemented merely to strengthen and promote fair financial reporting. However, after the introduction of this legislation the focus was changed to include a prevention of fraud element. In Kuwait,

legislation was enacted for the purposes of strengthening the financial reporting of companies as well as internal controls. Prevention of fraud was not the main purpose of the legislation, but it has included more stringent controls with a view to preventing unauthorized activity.

It is evident that internal control systems are only effective if the board of directors is confident that the business is managed efficiently and able to mitigate risk to an acceptable limit, that the financial and other reporting complies with the applicable laws, rules and regulations, and that businesses comply with all these rules and regulations. An effective internal control structure will assist management to identify areas of progress in the business as well as areas that can be improved on. However, this does not ensure success for the business or even its survival. Information presented in this structure needs to be analyzed and acted upon by management. It is therefore vital that suitable personnel are employed in responsible positions. Internal control will never be an absolute assurance to management and the board that the organization is guaranteed to achieve its objectives. The mere establishment of effective internal controls is not enough to prevent, detect, or deter fraudulent financial reporting perpetrated by senior management.

According to the Institute of Internal Auditors (IIA)⁽²³⁾ based in North America⁽²⁴⁾, the core principles of having effective internal audit are that it should:

1. Prove integrity.
2. Prove competence and due professional care.
3. Be independent.
4. Be in line with the strategies, objectives, & risk tolerance of the organization.
5. Be appropriately positioned to carry out its work and adequately resourced.

(23) The Institute of Internal Auditors (IIA) sets the standards for the internal audit profession and provides certifications in internal auditing.

(24) The IIA was established in 1941. It is an international professional association and a recognized authority, acknowledged leader, chief advocate, and principal means of professional education. It has more than 185,000 members.

6. Prove quality and continual improvement.
7. Effectively communicate with others.
8. Provide risk-based assurance.
9. Be insightful, proactive, and future-focused.
10. Help organizational improvement⁽²⁵⁾.

The IIA Standards are an accepted best practice of the internal audit function in several stock exchanges, such as the NYSE⁽²⁶⁾.

In an interview for the CPA Journal, Mark Martinelli who at the time was the chief audit executive for Synchrony, answered the question about how the profession of internal auditing has changed in recent years with the response that, “There is a higher level of expectation that companies do the right thing. The right thing is not just what’s legal; it is what is fair. In many ways, we are not just auditing to the regulations, but to the expectations that society has.” Therefore, nowadays the internal audit function is more important to society (Martinelli, 2019, p.8).

The growth of the role of the IAF has in turn created a demand for skilled internal auditors. Since internal auditors with adequate knowledge, skills, and experience are in a better position to assist management in different activities such as establishing effective anti-fraud measures (Kabuye, 2017, P.939), there has been a unique shortage of internal audit personnel (Mubako & Mazza, 2017, P.831).

Countries around the world have different approaches to the requirements of internal auditing. For example, about the concept of ‘freedom to choose’ countries in the EU do not require compulsory internal audit functions in their corporate governance codes (Ismael & Roberts, 2018, P.290). In contrast, some countries, such as the UK, require companies to have internal audit systems, but do not enforce this requirement. This has led to

(25) The Institute of Internal Auditors, *Core Guidance*.

(26) Around 400 of the largest securities firms in America are listed on the New York Stock Exchange. The NYSE rules therefore play an important role in monitoring and regulating the activities of its members, member firms and listed companies. Furthermore, it is an important feature in enforcing compliance with NYSE rules and federal securities laws.

the development of the ‘comply or explain’ principle that allows companies to comply or explain in their financial reports on why they choose not to have internal audit systems. Furthermore, some stock exchanges make it a compulsory requirement to have an IAF. These include the NYSE and the KSE. Hence, there is no clear standard relating to the auditing culture around the world, and there is a no clear guidance from regulators as to what they require (Sinha & Arena, 2018, P.13). This has created confusion for companies and has led to some companies avoiding compliance or not strictly applying good corporate governance principles.

Internal Audit Systems in the Kuwait Stock Exchange⁽²⁷⁾ and the New York Stock Exchange

Corporate governance principles in Kuwait can be classified as voluntary or compulsory. Rule V of Kuwait Code 2015 requires that the listed company implements sound internal audit systems. Rule V is compulsory

(27) The history of the Kuwait Stock Exchange started in 1983 when it was established as an independent body by Emiri Decree No. 20/1983. This was a momentous step as Kuwait became the first country in the GCC countries to establish a legal framework for the stock exchange. From 1983 the legislature enacted several laws aimed at regulating the stock exchange. In 1988, Decree Law No. 32 granted permission to GCC citizens to own shares in the Kuwaiti public companies listed on the KSE. Previously, GCC citizens were not permitted to buy shares in Kuwaiti companies. In 1990, a legal system for unit trusts was established by the enacting of Act No. 31. This act included provisions around organizing the trading of securities and the establishment of investment funds. In 2000, Law No. 20 allowed non-Kuwaiti citizens to buy shares in Kuwaiti companies. It was believed that this would result in attracting foreign investors. Also in the year 2000, the KSE market capitalization was US \$35 billion, and the value of trading was US \$22 billion, making the KSE the second largest in the Middle East. This prompted the government to make changes to the operation of the KSE. In 2005, Emiri Decree No. 158 amended some articles of the previous decree aimed at organizing the KSE. Before 2010, the Ministry of Commerce and Trade (MOCI), the Central Bank of Kuwait (CBK), the Market Committee (MC) and the KSE were responsible for regulating and supervising securities markets in Kuwait. Due to the absence of a comprehensive law setting out the creation and organization of the KSE, plus the lack of a single body with responsibility for regulating the exchange, resulted in some deficiencies that were exploited by unscrupulous dealers at the expense of small and large investors. The lack of a comprehensive and holistic legal system lead to misunderstandings and the inability to resolve serious systemic problems. In 2010, the Capital Markets Law (2010) was enacted to address these problems.

in nature and companies must comply with it. That means this rule is excluded from the scope of the ‘comply or explain’ regime. This latter principle means that companies must disclose the extent of their compliance or lack of compliance with rules in the code. If a company does not comply, it must specify the reasons for its non-compliance and give a detailed explanation for this in the governance report⁽²⁸⁾.

To ensure that the financial reports of a company are accurate and reflect the true state of affairs, companies in Kuwait are required to maintain internal audit systems. Article 1-2 of the CMA Executive Bylaws of Law 7 of 2010 makes it compulsory for companies to “Apply sound systems of risk management and Internal audit”. Should the company not comply with this rule it will be subject to penalties as set out in Law 7 of 2010.

There are four main issues that pertain to the requirements of the systems of control and internal audit⁽²⁹⁾. These will be discussed below.

1. The internal audit process must cover all activities of the company. The internal audit systems are set in place to ensure the accuracy of data and the financial health of the company. In addition, the process also ensures the effectiveness of the operations in various aspects, provided that the principle of double auditing (the four eyes principle) is implemented in company structures. This includes the following: “a. Sound identification of authorities and powers. b. Entire separation of roles and elimination of conflicts of interest. c. Inspection and dual audit. d. Dual signature”.
2. The internal audit department must have full independence. Whilst the roles and responsibility of the internal audit department are set out by the board, it should not be unduly influenced by the board of directors. There should be no interference with its work to ensure the integrity of the audit process and effectiveness of its control functions.
3. The internal audit department prepares a report that, amongst other things, includes a review of the company’s internal audit

(28) Article 1.1 of Kuwaiti Code 2015.

(29) Resolution No. (72) of 2015 Regarding Module Fifteen of the CMA Executive Bylaws of Law No. 7 of 2010 in respect of systems of control and internal audit.

system. The purpose of this report is to evaluate the systems employed by the company and how effective these are in protecting the company's assets, efficiency of operation, and ensuring that the administrative functions and financial reporting aspects of the business are accurate. Furthermore, it should compare the development of the risk factors and efficiency of the business's daily operations as well as its ability to encounter unforeseen market changes. Lastly, the report should review the performance of the board of directors related to the internal audit systems, as well as highlight any failures to apply the internal audit process. Should there be a need for recommendations on how to improve in these aspects, this can also be set out in the report.

4. After the internal audit process has run its course, an external auditor is appointed with a view to completing the annual audit process.

Legislators have different approaches to the application and enforcement of corporate governance principles. In some countries the legislation aims to force application of these principles by enacting legislation and rules, while others prefer to encourage application of these principles via a 'comply or explain' regime, as described above. By enacting legislation to force compliance with corporate governance principles has the potential to cause two problems. Firstly, it can limit or reduce the growth of the economy. Smaller businesses are reluctant to list on the stock exchange for various reasons, including the difficulties associated with having Internal Audit Systems. As a result, this harms the growth of business and the economy. Secondly, the cost of complying with all the necessary corporate governance principles can become a costly burden on the company. This may result in the company having to add more staff, incur extra costs, and retain legal counsel to ensure the correct application of corporate governance rules.

Voluntary compliance is advantageous for businesses. The principle of comply or explain allows smaller companies to implement corporate governance principles when they are in a suitable position to do so. Until such time, they are offered the opportunity to explain their non-compliance. The nature of business requires an easily developed and flexible means of en-

forcement because the application of rules and principles is not uniformed. As the saying goes: “one size does not fit all”.

For listed companies in Kuwait, there is no singular or “one-size-fits-all” approach to corporate governance. The KCGC do not distinguish between companies of different sizes. Therefore, what is feasible for a large company may not be appropriate for a smaller one which may find compliance to be too expensive. Compulsory rules are often onerous and expensive for small and medium-sized companies. Small companies are the engines of economic growth. Complying with compulsory corporate governance rules is a big challenge for small businesses due to the high costs involved. This should be addressed because smaller companies should be encouraged to list their shares as this will assist in providing needed capital for growth. Listing on the stock market is a flexible source of capital. The process of listing on the stock exchange could lead to a situation where the small business is likely to avoid such problems as issues with cash flow and bad debts.

The main reason for requiring a sound internal audit system in Kuwaiti corporate governance is that it will lead to effective risk management by the board of directors. Furthermore, it will help the board members to come to grips with the nature and extent of risks inherent in the company’s activities⁽³⁰⁾. For the most part, internal auditing is an independent and objective activity designed to improve the value of an organization’s operations. It allows business to focus on achieving their purposes by bringing a systematic, disciplined approach to evaluating and enhancing the effectiveness of risk management, control, and governance procedures. It also reduces financial statement errors, asset fraud, and deception within the organizations.

In Kuwait, the scope of the internal audit process includes 1) auditing to ensure the soundness of the financial statements⁽³¹⁾; 2) efficiency of the company’s activities, and 3) evaluation of the extent and commitment to supervisory measures⁽³²⁾.

(30) Article 6.1 of Kuwaiti Code 2015.

(31) The soundness of financial statements cannot be achieved without auditing financial statements and it is an important part of the financial information; du Plessis et al. (2018) 175.

(32) Article 6.2. of Kuwaiti Code 2015.

The topic of corporate governance has universal application in that each country around the world has its own corporate governance regime. However, the US is one of the most advanced corporate governance systems, due to the amount of legislation and the associated debate around the effectiveness and implementation of the legal approach. In the US, there is a multitude of laws and regulations that make up the corporate governance system, which in turn means that CG law is extremely complex. Listed companies are governed by several regulations and rules including 1) federal law⁽³³⁾, 2) state laws⁽³⁴⁾, 3) rules passed by the SEC, and 4) rules passed by the stock exchange itself, such as NYSE section 303A Corporate Governance Rules and stock exchange listed rules.

A good example of a federal law that has application to internal auditing systems is the Sarbanes-Oxley Act 2002 (SOX). This act requires public companies to include in their annual financial report details about their internal controls with regards to financial reporting. Hence, companies are required to use a suitable, recognized controlled framework to evaluate the effectiveness of their internal control over financial reporting (Kaiser, 2005, P.129). The focus of the SOX Act is to increase the integrity of financial statements and reports. The SOX set out several such controls, the most important of which require (1) CEO/CFO certification of the design and integrity of internal controls relating to financial reporting and (2) external auditors required to test these systems and express their opinion on the control design and effectiveness, including management's certifications. The SOX Act rules mention several points related to internal auditing, which could be applied to enhancing the function of internal auditing in Kuwait:

- An internal control report should be added to the annual report of a listed company.
- A ban on relationships between independent auditors and their clients that could potentially affect the objectivity of audits.

(33) For example, the following laws apply: Securities Act 1933, Securities Exchange Act 1934, Sarbanes-Oxley Act 2002 (SOX) and Dodd-Frank Wall Street Reform and Consumer Protection Act 2010.

(34) In the US, each state has its own corporate governance code, e.g., Delaware General Corporate Law (DGCL).

- Granting the audit committee sole authority to appoint and remove independent auditors as well as to approve any non-audit work by the auditors.
- The lead auditor or coordinating partner and the reviewing partner should no longer be involved in the audit after five years.
- Auditors are required to retain “all audit or review work papers” for a period of five years.

Of the 13 stock exchanges in the US, the New York Stock Exchange (NYSE) is the most significant for the current topic under discussion. This article, therefore, focuses on the NYSE rules as an example of US legislation in terms of internal audit function. The NYSE rules make it mandatory that listed companies have an internal audit function⁽³⁵⁾. In Kuwait, similar rules apply. The NYSE internal audit rule applicable for all listed companies from the day they list, but there is an exception for foreign private issuers. Any company transferred from another stock exchange needs to comply with the internal audit provision of section 303A within one year of transferring to the NYSE. At present, some other US stock exchanges, such as the NASDAQ and AMEX, do not have internal audit requirements. Every NYSE-listed company must annually confirm that it has complied with all NYSE listing standards, including the internal audit requirement. Any company that fails to comply with the rules will face disciplinary action. In comparison to the NYSE, the KSE is still needs time to improve the internal audit principle.

(35) Section 3 Corporate Responsibility; 303A.00 Corporate Governance Standards; 303A.07 Audit Committee Additional Requirement “(c) Each listed company must have an internal audit function. Commentary: Listed companies must maintain an internal audit function to provide management and the audit committee with ongoing assessments of the listed company’s risk management processes and system of internal control. A listed company may choose to outsource this function to a third-party service provider other than its independent auditor”.

Conclusion

Corporate governance has several principles. This article has addressed principles related to internal audit functions. It has compared the internal auditor system of the NYSE and that which is currently in use in the KSE. What follows is a summary of the recommendations put forward that will hopefully improve the KSE corporate governance rules.

- Both the KSE and NYSE require companies to have internal audit functions. Not every country has this requirement. As such, the KSE is already ahead in terms of application of improved corporate governance policies.
- However, the costs involved in having an internal audit function limit its suitability to the KSE. It is recommended that the KSE allows this corporate governance policy to fall under the ‘comply or explain’ principle, as this will allow companies more freedom. The cost implication of an internal audit function has resulted in the UK adopting the concept of internal audit functions but limiting their enforcement to the “comply or explain” regime. This has allowed companies to have IAF where possible, but where it is deemed too expensive, they are able to provide the reasons for not using such a process in their financial reporting. No one-size-fits-all approach to corporate governance is suitable, and that the KSE should consider being more flexible in its approach.
- Listed companies should have internal auditing but for smaller companies, this requirement could be relaxed. Whilst the formalities of an internal audit committee may make the process costly and difficult for smaller companies to implement, the principles behind having internal audit controls and systems should be applied.
- It is vital that the IAF should not be relegated to a mere reporting function and that the board of directors should ensure that the internal auditors’ recommendations are applied. Greater cooperation between the internal auditors and the board of directors will result in more effective controls and assist in achieving the plans and goals of the organization.

- The internal audit function must be provided with adequate resources and supporting infrastructure, such as auditing tools and applicable knowledge. It is especially important that internal auditors be provided with ongoing education in the best practices from other institutions around the world.
- Audits are not always able to detect every error or misstatement nor are they able to distinguish between errors and deception. This is true for all audit functions.
- It is extremely important that internal auditors are independent and can exercise their role without undue influence. Internal audit personnel should be able to exercise their functions objectively by being free from conflicts of interest or undue interest (especially from the board of directors).

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نظم التدقيق الداخلي وفقاً لقواعد الحوكمة: دراسة مقارنة بين بورصة الكويت وبورصة نيويورك

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ملخص

الأهداف: تستهدف الدراسة الوصول إلى نتائج وتوصيات، تساهم في تطوير التشريعات الكويتية الخاصة بنظم التدقيق الداخلي للشركات المدرجة في البورصة؛ مما ينعكس على التطور والتنمية الاقتصادية لدولة الكويت بشكل خاص والمنطقة بشكل عام. **المنهج:** المنهج القانوني المقارن التحليلي (Comparative Legal Analysis) هو أداة الدراسة، وهو في مجمله أسلوب يساعد الباحثين في الاطلاع على قوانين الدول الأخرى، والمقارنة بينها وتحليلها بهدف الاستفادة من خبراتها وتجاربها. تتناول هذه الدراسة موضوع نظام التدقيق الداخلي للشركات المدرجة في الكويت مع مقارنتها بالتشريع الأمريكي؛ لما له من تاريخ وخبرات في مجال التدقيق الداخلي للشركات المدرجة. **النتائج:** توصلت الدراسة إلى عدد من النتائج، منها: (1) أن مبدأ "نظم التدقيق الداخلي" هو نظام تدقيق داخلي يساعد الشركة المدرجة على تحقيق أهدافها. (2) من الواقع العملي نجد أن هناك نقصاً في المعرفة حول هذا النظام وحول الطريقة المثلى لتطبيقه من قبل الشركات المدرجة والبورصة وهيئة أسواق المال الكويتية؛ مما نتج عنه اختلاف في وجهات النظر وتفاوت في الالتزام بهذا المبدأ. **الخاتمة:** اختتمت الدراسة بعدد من التوصيات، من أهمها: ضرورة الاستفادة من خبرات بورصة نيويورك وتجاربها في مجال "نظم التدقيق الداخلي" للشركات المدرجة في البورصة.

الكلمات المفتاحية: نظام التدقيق الداخلي، قواعد حوكمة الشركات، الشركات المدرجة، هيئة أسواق المال.

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