Financial Services Commission

Guidance Note

Internal Audit Function in Banks

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Introduction

During 2012, the Basel Committee first consulted on, and subsequently issued, revised supervisory guidance for assessing the effectiveness of the internal audit function in banks. This replaced the guidance issued in 2001 and formed part of the Basel Committee's on-going efforts to address bank supervisory issues and enhance supervision through guidance that encourages sound practices within banks. The guidance takes into account developments in supervisory practices and in banking organisations and incorporates lessons drawn from the recent financial crisis.

The guidance issued by the Basel Committee encompasses a total of 20 overarching principles. The principles set out supervisory expectations in relation to the internal audit function in banks and promote a strong internal audit function within banking organisations. The principles also provide guidance for the supervisory assessment of this function. The 20 principles issued by the Basel Committee were divided into 3 sections: principles 1 to 15 related to the expectations relevant to the internal audit; principle 16 related to the relationship of the supervisory authority with the internal audit function, and; principles 17 to 20 related to the supervisor's assessment of the internal audit function. Principles 1 to 15 form part of this Guidance Note.

The guidance applies to all banks, including those (a) within a banking group, (b) holding companies whose subsidiaries are predominantly banks, and (c) holding companies subject to prudential supervision whose subsidiaries are predominantly banks. All of these structures are referred to as banks or banking organisations in this Guidance Note. The Guidance Note takes into account the principle of proportionality i.e. that the application of the principles should be commensurate with the significance, complexity and international presence of the bank.

Supervisory expectations relevant to the internal audit function

Principle 1

An effective internal audit function provides independent assurance to the board of directors and senior management on the quality and effectiveness of a bank's internal control, risk management and governance systems and processes, thereby helping the board and senior management protect their organisation and its reputation.

1. The internal audit function

The internal audit function plays a crucial role in the on-going maintenance and assessment of a bank's internal control, risk management and governance systems and processes – areas in which supervisory authorities have a keen interest. Furthermore, both internal auditors and supervisors use risk based approaches to determine their respective work plans and actions. While internal auditors and supervisors each have a different mandate and are responsible for their own judgments and assessments, they may identify the same or similar/related risks.

The internal audit function should develop an independent and informed view of the risks faced by the bank based on their access to all bank records and data, their enquiries, and their professional competence. The internal audit function should be able to discuss their views, findings and conclusions directly with the audit committee and the board of directors, thereby helping the board to oversee senior management.

2. Key features of the internal audit function

The key features described below are essential for the effective operation of an internal audit function.

(a) Independence and objectivity[1]

Principle 2

The bank's internal audit function must be independent of the audited activities, which requires the internal audit function to have sufficient standing and assignments with objectivity.

On the basis of the audit plan established by the head of the internal audit function and approved by the board of directors, the internal audit function must be able to perform its assignments on its own initiative in all areas and functions of the bank. It must be free to report its findings and assessments internally through clear reporting lines. The head of internal audit should demonstrate appropriate leadership and have the necessary skills to fulfil his or her responsibility for maintaining the function's independence and objectivity.

The internal audit function should not be involved in designing, selecting, implementing or operating specific internal control measures. However, the independence of the internal audit function should not prevent senior management from requesting input from internal audit on matters related to risk and internal controls. Nevertheless, the development and implementation of internal controls should remain the responsibility of management.

Continuously performing similar tasks or routine jobs may negatively affect an individual internal auditor's capacity for critical judgement because of possible loss of objectivity. It is therefore a sound practice, whenever practicable and without jeopardising competence and expertise, to periodically rotate internal audit staff within the internal audit function. In addition, a bank may rotate staff from other functional areas of the bank to the internal audit function or from the internal audit function to other functional areas of the bank. Staff rotations within the internal audit function and staff rotations to and from the internal audit function should be governed by and conducted in accordance with a sound written policy. The policy should be designed to avoid conflicts of interest, including the observance of an appropriate "cooling-off" period following an individual's return to the internal audit staff before that individual audits activities in the functional area of the bank where his/her rotation had been served.

The independence and objectivity of the internal audit function may be undermined if the internal audit staff's remuneration is linked to the financial performance of the business lines for which they exercise internal audit responsibilities. The remuneration of the head of the internal audit function should be determined in accordance with the remuneration policies and practices of the bank. Remuneration to reward the performance of the head of internal audit or internal audit staff members should be structured to avoid creating conflicts of interest and compromising independence and objectivity.

(b) Professional competence and due professional care

[1] Both "independence" and "objectivity" have a specific meaning in an internal audit environment. The Glossary of The Institute of Internal Auditors refers to independence as the freedom from conditions that threaten the ability of the internal audit activity to carry out internal audit responsibilities in an unbiased manner. Objectivity is referred to in the Glossary as an unbiased mental attitude that allows internal auditors to perform engagements in such a manner that they believe in their work product and that no quality compromises are made. Objectivity requires that internal auditors do not subordinate their judgement on audit matters to others.

Principle 3

Professional competence, including the knowledge and experience of each internal auditor and of internal auditors collectively, is essential to the effectiveness of the bank's internal audit function.

Professional competence depends on the auditor's capacity to collect and understand information, to examine and evaluate audit evidence and to communicate with the stakeholders of the internal audit function. This should be combined with suitable methodologies and tools and sufficient knowledge of auditing techniques.

The head of internal audit should be responsible for acquiring human resources with sufficient qualifications and skills to effectively deliver on the mandate for professional competence and to audit to the required level. He/she should continually assess and monitor the skills necessary to do so. The skills required for senior internal auditors should include the abilities to judge outcomes and make an impact at the highest level of the organisation.

The head of internal audit should ensure that the internal audit staff acquires appropriate ongoing training in order to meet the growing technical complexity of banks' activities and the increasing diversity of tasks that need to be undertaken as a result of the introduction of new products and processes within banks and other developments in the financial sector.

Internal auditors collectively should be competent to examine all areas in which the bank operates. Alternatively, when outsourcing[2] arrangements are in place, it is the responsibility of the head of internal audit to maintain adequate oversight and to ensure adequate transfer of knowledge from external experts to the bank's internal audit staff. The head of internal audit should ensure that the use of those experts does not compromise the independence and objectivity of the internal audit function.[3]

Internal auditors must apply the care and skills expected of a reasonably prudent and competent professional. Due professional care does not imply infallibility; however, internal auditors having limited competence and experience in a particular area should be supervised by more experienced internal auditors.

(c) Professional ethics

Principle 4

Internal auditors must act with integrity.

Integrity establishes trust as it requires the internal auditor to be straightforward, honest and truthful. This provides the basis for reliance on the internal auditor's professional judgement.

Internal auditors should respect the confidentiality of information acquired in the course of their duties. They should not use that information for personal gain or malicious action and should be diligent in the protection of information acquired.

The head of the internal audit function and all internal auditors should avoid conflicts of interest. Internally recruited internal auditors should not engage in auditing activities for which they have had previous responsibility before a sufficiently long "cooling off"

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[2] Outsourcing is the engagement of experts from outside the banking organisation to perform internal audit activities to support the internal audit function.

[3] If internal experts from within the bank (so-called guest auditors) are used in lieu of or in addition to external experts, the head of internal audit has the same responsibilities for oversight, knowledge transfer, independence and objectivity.

period has elapsed. Moreover, compensation arrangements should not provide incentives for internal auditors to act contrary to the attributes and objectives of the internal audit function.

Internal auditors should apply the bank's code of ethics (when there is one) or should adhere to an established international code of ethics for internal auditors, such as that of The Institute of Internal Auditors.[4] A code of ethics should at a minimum address the principles of objectivity, competence, confidentiality and integrity.

3. The internal audit charter

Principle 5

Each bank should have an internal audit charter that articulates the purpose, standing and authority of the internal audit function within the bank in a manner that promotes an effective internal audit function as described in Principle 1.

The charter should be drawn up and reviewed periodically by the head of internal audit and approved by the board of directors. It should be available to all internal stakeholders of the organisation and, in certain circumstances, such as listed entities, to external stakeholders.

At a minimum, an internal audit charter should establish:

- The internal audit function's standing within the bank, its authority, its responsibilities and its relations with other control functions in a manner that promotes the effectiveness of the function as described in Principle 1 of this guidance;
- The purpose and scope of the internal audit function;
- The key features of the internal audit function described under Section A.2 above;
- The obligation of the internal auditors to communicate the results of their engagements and a description of how and to whom this should be done (reporting line);
- The criteria for when and how the internal audit function may outsource some of its engagements to external experts;
- The terms and conditions according to which the internal audit function can be called upon to provide consulting or advisory services or to carry out other special tasks;
- The responsibility and accountability of the head of internal audit;
- A requirement to comply with sound internal auditing standards;
- Procedures for the coordination of the internal audit function with the statutory or external auditor.

The charter should empower the internal audit function, whenever relevant to the performance of its assignments, to initiate direct communication with any member of staff, to examine any activity or entity of the bank, and to have full and unconditional access to any records, files, data and physical properties of the bank. This includes access to management information systems and records and the minutes of all consultative and decision-making bodies.

[4] The Institute of Internal Auditors (The IIA) and the International Ethics Standards Board for Accountants (IESBA) have each issued a code of ethics. Both codes emphasise the importance of the principle of integrity.

4. Scope of activity

Principle 6

Every activity (including outsourced activities) and every entity of the bank should fall within the overall scope of the internal audit function.

The scope of internal audit activities should include the examination and evaluation of the effectiveness of the internal control, risk management and governance systems and processes of the entire bank, including the organisation's outsourced activities and its subsidiaries and branches.

The internal audit function should independently evaluate the:

- Effectiveness and efficiency of internal control, risk management and governance systems in the context of both current and potential future risks;
- Reliability, effectiveness and integrity of management information systems and processes (including relevance, accuracy, completeness, availability, confidentiality and comprehensiveness of data);
- Monitoring of compliance with laws and regulations, including any requirements from supervisors (see the following sub-section for more details); and
- Safeguarding of assets.

The head of internal audit is responsible for establishing an annual internal audit plan that can be part of a multi-year plan. The plan should be based on a robust risk assessment (including input from senior management and the board) and should be updated at least annually (or more frequently to enable an ongoing real-time assessment of where significant risks lie). The board's approval of the audit plan implies that an appropriate budget will be available to support the internal audit function's activities. The budget should be sufficiently flexible to adapt to variations in the internal audit plan in response to changes in the bank's risk profile.

Principle 7

The scope of the internal audit function's activities should ensure adequate coverage of matters of regulatory interest within the audit plan.

Internal audit should have the appropriate capability regarding matters of regulatory interest and undertake regular reviews of such areas based on the results of its robust risk assessment. These include policies, processes and governance measures established in response to various regulatory principles, rules and guidance established by the relevant authorities. In particular, the internal audit function of a bank should have the capacity to review key risk management functions, regulatory capital adequacy and liquidity control functions, regulatory and internal reporting functions, the regulatory compliance function and the finance function.

(a) Risk management

A bank's risk management processes support and reflect its adherence to regulatory provisions and safe and sound banking practices. Therefore, internal audit should include in its scope the following aspects of risk management:

- the organisation and mandates of the risk management function including market, credit, liquidity, interest rate, operational, and legal risks;
- evaluation of risk appetite, escalation and reporting of issues and decisions taken by the risk management function;
- the adequacy of risk management systems and processes for identifying, measuring, assessing, controlling, responding to, and reporting on all the risks resulting from the bank's activities;

- the integrity of the risk management information systems, including the accuracy, reliability and completeness of the data used; and
- the approval and maintenance of risk models including verification of the consistency, timeliness, independence and reliability of data sources used in such models.

When the risk management function has not informed the board of directors about the existence of a significant divergence of views between senior management and the risk management function regarding the level of risk faced by the bank, the head of internal audit should inform the board about this divergence.

(b) Capital adequacy and liquidity

Banks are subject to the global regulatory framework for capital and liquidity as approved by the Basel Committee and implemented in national regulation. This framework contains measures to strengthen regulatory capital and global liquidity. The scope of internal audit should include all provisions of this regulatory framework and in particular the bank's system for identifying and measuring its regulatory capital and assessing the adequacy of its capital resources in relation to the bank's risk exposures and established minimum ratios.

Internal audit should review management's process for stress testing its capital levels, taking into account the frequency of such exercises, their purpose (e.g., internal monitoring vs. regulator imposed), the reasonableness of scenarios and the underlying assumptions employed, and the reliability of the processes used. Additionally, the bank's systems and processes for measuring and monitoring its liquidity positions in relation to its risk profile, external environment, and minimum regulatory requirements, should fall within the audit universe.

(c) Regulatory and internal reporting

In addition to the matters identified above, internal auditors should regularly evaluate the effectiveness of the process by which the risk and reporting functions interact to produce timely, accurate, reliable and relevant reports for both internal management and the supervisor.

This includes standardised reports which record the bank's calculation of its capital resources, requirements and ratios. It may also include public disclosures intended to facilitate transparency and market discipline such as the Pillar 3 disclosures and the reporting of regulatory matters in the bank's public reports.

(d) Compliance[5]

The scope of the activities of the compliance function should be subject to periodic review by the internal audit function.

Compliance laws, rules and standards include primary legislation, rules and standards issued by legislators and supervisors, market conventions, codes of practice promoted by industry associations, and internal codes of conduct applicable to the staff members of the bank.

The audit of the compliance function should include an assessment of how effectively it fulfils its responsibilities

(e) Finance

A bank's finance function[6] is responsible for the integrity and accuracy of financial data and reporting. Key aspects of Finance's activities (e.g. calculations, profit and loss

[5] To be read in conjunction with the Basel Committee's *Compliance and the compliance function in banks*, April 2005

valuations and reserves) have an impact on the level of a bank's capital resources and therefore associated controls should be robust and consistently applied across similar risks and businesses. As such, it is important that these controls are subject to periodic internal audit review, using resources and expertise to provide an effective evaluation of bank practices.

Internal audit should devote sufficient resources to evaluate the valuation control environment, availability and reliability of information or evidence used in the valuation process and the reliability of estimated fair values. This is achieved through reviewing the independent price verification processes and testing valuations of significant transactions.

Internal audit should also include in its scope (the list is not intended to be exhaustive):

- The organisation and mandate of the finance function;
- The adequacy and integrity of underlying financial data and finance systems and processes for completely identifying, capturing, measuring and reporting key data such as profit or loss, valuations of financial instruments and impairment allowances;
- The approval and maintenance of pricing models including verification of the consistency, timeliness, independence and reliability of data sources used in such models;
- Controls in place to prevent and detect trading irregularities;
- Balance sheet controls including key reconciliations performed and actions taken (e.g. adjustments).

5. Corporate governance considerations

Annex 1 provides an illustrative overview of relevant principles and standards with respect to the internal audit function, corporate governance structure, and communication channels within a generic bank's governance model.

(a) Permanency of the internal audit function

Principle 8

Each bank should have a permanent internal audit function, which should be structured consistent with Principle 14 when the bank is within a banking group or holding company.

In fulfilling its duties and responsibilities, senior management and the board should take all the necessary measures to ensure that the bank has a permanent internal audit function commensurate with its size, the nature of its operations and the complexity of its organisation.

Internal audit activities should normally be conducted by the bank's own internal audit staff. When internal audit activities are partially or fully outsourced, the board of directors remains ultimately responsible for these activities and for maintaining an internal audit function within the bank. Outsourcing of internal audit activities is further addressed in principle 15 and related paragraphs.

(b) Responsibilities of the board of directors and senior management

[6] Finance includes valuation, modelling, product control and financial control.

Principle 9

The bank's board of directors has the ultimate responsibility for ensuring that senior management establishes and maintains an adequate, effective and efficient internal control system and, accordingly, the board should support the internal audit function in discharging its duties effectively.

At least once a year, the board of directors should review the effectiveness and efficiency of the internal control system based, in part, on information provided by the internal audit function. Moreover, as part of their oversight responsibilities, the board of directors should review the performance of the internal audit function. From time to time, the board of directors should consider commissioning an independent external quality assurance review of the internal audit function.

Senior management is responsible for developing an internal control framework that identifies, measures, monitors and controls all risks faced by the bank. It should maintain an organisational structure that clearly assigns responsibility, authority and reporting relationships and ensures that delegated responsibilities are effectively carried out. It is an established practice for senior management to report to the board of directors on the scope and performance of the internal control framework.

Senior management should inform the internal audit function of new developments, initiatives, projects, products and operational changes and ensure that all associated risks, known and anticipated, are identified and communicated at an early stage.

Senior management should be accountable for ensuring that timely and appropriate actions are taken on all internal audit findings and recommendations.

Senior management should ensure that the head of internal audit has the necessary resources, financial and otherwise, available to carry out his or her duties commensurate with the annual internal audit plan, scope and budget approved by the audit committee.

(c) Responsibilities of the audit committee in relation to the internal audit function

Principle 10

The audit committee, or its equivalent, should oversee the bank's internal audit function.

This principle applies when the board of directors has established an audit committee. In cases where no audit committee exists, the responsibilities described below should be assumed by the board itself. As explained in paragraph 50 of the Committee's *Principles for Enhancing Corporate Governance,* large banks and internationally active banks should have an audit committee or its equivalent. Other banks are encouraged to establish an audit committee.

The oversight function of the audit committee includes ensuring that the internal audit function is able to discharge its responsibilities in an independent manner, congruent with principle 2. It also includes reviewing and approving the audit plan, its scope, and the budget of the internal audit function. It reviews key audit reports and ensures that senior management is taking necessary and timely corrective actions to address control weaknesses, compliance issues with policies, laws and regulations and other concerns identified and reported by the internal audit function.

Annex 2 of this document gives an overview of the responsibilities of an audit committee.

(d) Management of the internal audit department

Principle 11

The head of the internal audit department should be responsible for ensuring that the department complies with sound internal auditing standards and with a relevant code of ethics.

The head of the internal audit department should ensure compliance with sound internal auditing standards, such as The Institute of Internal Auditors' *International Standards for the Professional Practice of Internal Auditing*. In addition, auditors should adhere to a relevant code of ethics.

The audit committee should ensure that the head of the internal audit function is a person of integrity. This means that he or she will be able to perform his or her work with honesty, diligence and responsibility. It also implies that this person observes the law and has not been a party to any illegal activity. The head of internal audit should also ensure that the members of internal audit staff are persons of integrity.

(e) Reporting lines of the internal audit function

Principle 12

The internal audit function should be accountable to the board, or its audit committee, on all matters related to the performance of its mandate as described in the internal audit charter.

The Internal audit function should be accountable to the board of directors or its audit committee. It should also promptly inform senior management about its findings.

Senior management is responsible for implementing and maintaining an adequate and effective internal control system and processes. Therefore, the internal audit function should inform senior management of all significant findings so that timely corrective actions can be taken. Subsequently, the internal audit function should follow up with senior management on the outcome of these corrective measures. The head of the internal audit function should report to the board, or its audit committee, the status of findings that have not (yet) been rectified by senior management.

(f) The relationship between the internal audit, compliance and risk management functions

Principle 13

The internal audit function should independently assess the effectiveness and efficiency of the internal control, risk management and governance systems and processes created by the business units and support functions and provide assurance on these systems and processes.

The relationship between a bank's business units, the support functions and the internal audit function can be explained using the *three lines of defence* model. The business units are the first line of defence. They undertake risks within assigned limits of risk exposure and are responsible and accountable for identifying, assessing and controlling the risks of their business. The second line of defence includes the support functions, such as risk management, compliance, legal, human resources, finance, operations, and technology. Each of these functions, in close relationship with the business units, ensures that risks in the business units have been appropriately identified and managed. The business support functions work closely to help define strategy, implement bank policies and procedures, and collect information to create a bank-wide view of risks. The third line of defence is the internal audit function that independently assesses the effectiveness of the processes created in the first and second lines of defence and provides assurance on these processes.

Line of defence	Examples	Approach
First line	Front Office, any client-facing	Transaction-based, ongoing

	activity	
Second line	Risk Management, Compliance, Legal, Human Resources, Finance, Operations, and Technology	Risk-based, ongoing or periodic
Third line	Internal Audit	Risk-based, periodic

The responsibility for internal control does not transfer from one line of defence to the next line.

6. Internal audit within a group or holding company structure

Principle 14

To facilitate a consistent approach to internal audit across all the banks within a banking organisation, the board of directors of each bank within a banking group or holding company structure should ensure that either:

(i) the bank has its own internal audit function, which should be accountable to the bank's board and should report to the banking group or holding company's head of internal audit; or

(ii) the banking group or holding company's internal audit function performs internal audit activities of sufficient scope at the bank to enable the board to satisfy its fiduciary and legal responsibilities.

The board of directors of each bank in a group or holding company structure remains responsible for ensuring that the bank's senior management establishes and maintains an adequate, effective and efficient internal control system and processes. The board also should ensure that internal audit activities are conducted effectively at the bank according to the principles of this document. The internal auditors who perform the internal audit work at the bank should report to the bank's audit committee, or its equivalent, and to the group or holding company's head of internal audit.

The board of directors and senior management of the parent company have the overall responsibility for ensuring that an adequate and effective internal audit function is established across the banking organisation and for ensuring that internal audit policies and mechanisms are appropriate to the structure, business activities and risks of all of the components of the group or holding company.

The head of internal audit at the level of the parent company should define the group or holding company's internal audit strategy, determine the organisation of the internal audit function both at the parent and subsidiary bank levels (in consultation with these entities' respective boards of directors and in accordance with local laws) and formulate the internal audit principles, which include the audit methodology and quality assurance measures.

The group or holding company's internal audit function should determine the audit scope for the banking organisation. In doing so, it should comply with local legal and regulatory provisions and incorporate local knowledge and experience.

7. Outsourcing of internal audit activities

Principle 15

Regardless of whether internal audit activities are outsourced, the board of directors remains ultimately responsible for the internal audit function.

It is recommended that large banks and internationally active banks perform internal audit activities using their own staff. However, outsourcing of internal audit activities, but not the function, on a limited and targeted basis can bring benefits to banks such as access to specialised expertise and knowledge for an internal audit engagement where the expertise is not available within the internal audit function. Outsourcing could also alleviate temporary resourcing constraints which might otherwise jeopardise the execution of the audit plan. Banks should be able to explain the reasons for outsourcing specific internal audit activities.

The head of internal audit should ensure that outsourcing suppliers comply with the principles of the bank's internal audit charter. To preserve independence, it is important to ensure that the supplier has not been previously engaged in a consulting engagement in the same area within the bank unless a reasonably long "cooling-off" period has elapsed. Subsequently, those experts who participated in an internal audit engagement should not provide consulting services to a function of the bank they recently audited. Additionally, as a sound practice, banks should not outsource internal audit activities to their own external audit firm.[7]

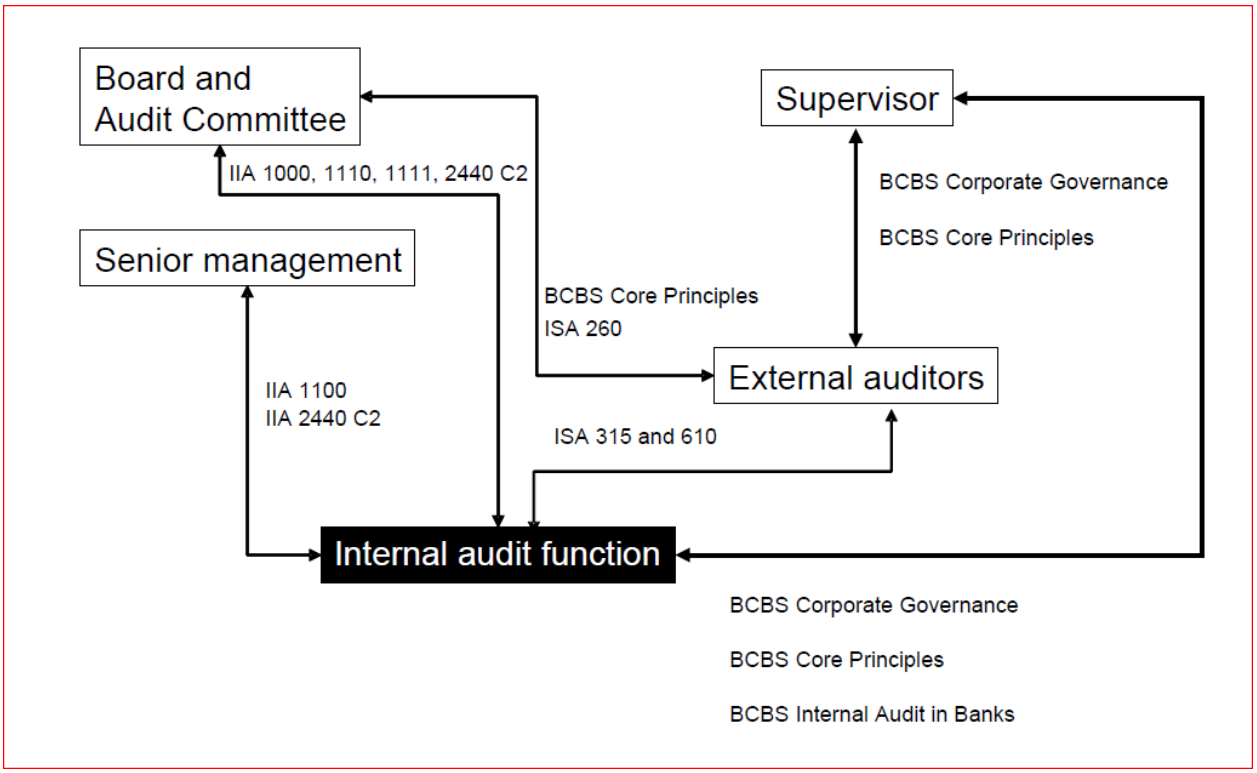
The head of internal audit should ensure that, whenever practical, the relevant knowledge input from an expert is assimilated into the organisation. This may be possible by having one or more members of the bank's internal audit staff participate in the external expert's work.

[7] Any departure from this best practice should be limited to small banks and should remain within the bounds of the applicable ethical standards for the statutory or external auditor.

Annex 1

Internal audit function's communication channels

References to support these communication channels for the internal audit function are provided in the Basel Committee's Core Principles and other relevant guidance issued by the Basel Committee, International Standards on Auditing (ISAs) issued by the International Auditing and Assurance Standards Board, and the standards of The Institute of Internal Auditors (The IIA) as indicated. The diagram does not reflect all of the communication channels for parties other than the internal audit function.



• Basel Committee on Banking Supervision:

– Core Principles for Effective Banking Supervision

– Principles for Enhancing Corporate Governance

– The Internal Audit Function in Banks

• IIA: International Standards for the Professional Practice of Internal Auditing. Standards starting at 1xxx are Attribute Standards and Standards starting at 2xxx are Performance Standards. See International Professional Practices Framework (IPPF), The Institute of Internal Auditors, Altamonte Springs, Florida, USA, 2011.

– IIA 1000 - Purpose, Authority, and Responsibility

– IIA 1100 - Independence and Objectivity

– IIA 1110 - Organizational Independence

– IIA 1111 - Direct Interaction with the Board

– IIA 2440 - Disseminating Results

• ISA: International Standards on Auditing. Standards starting at 2xx deal with the overall objectives and responsibilities of the external auditor, standards starting at 3xx deal with risk assessment and response to assessed risk by the external auditor and standards starting at 6xx deal with the external auditor's use of the work of others. See Handbook of International Quality Control, Auditing, Review, Other Assurance, and related Services Pronouncements, 2010 Edition Part 1, International Federation of Accountants, New York, New York, USA.

– ISA 260 - Communication with Those Charged with Governance

– ISA 315 - Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment

– ISA 610 - Using the Work of Internal Auditors

Annex 2

Responsibilities of a bank's audit committee

The audit committee is a specialised committee within the board of directors. As such, it prepares the work of, and reports to the board of directors in specific areas for which it has designated responsibility. The board of directors assumes final responsibility.

The audit committee may invite the head of internal audit, the head of compliance, senior management, in particular the chief executive officer and other officials deemed relevant for the purpose of fulfilling its responsibilities to attend meetings of the committee. It is a sound practice that the head of internal audit and members of the audit committee have a private session, i.e. in the absence of management, to discuss issues of interest.

The main areas of responsibility of the audit committee are listed below by broad categories. The list provides a summary of sound practices for the audit committee of a bank. This list may vary according to local regulations and practices. For example, the responsibilities of an audit committee may be assumed directly by the board of directors in some banks or in some countries.

Financial reporting, including disclosures

(a) Monitoring the financial reporting process and its output;

(b) Overseeing the establishment of accounting policies and practices by the bank and reviewing the significant qualitative aspects of the bank's accounting practices, including accounting estimates and financial statement disclosures;

(c) Monitoring the integrity of the bank's financial statements and any formal announcements relating to the bank's financial performance;

(d) Reviewing significant financial reporting judgments contained in the financial statements; and

(e) Reviewing arrangements by which staff of the bank may confidentially raise concerns about possible improprieties in matters of financial reporting.

Internal control

(f) Ensuring that senior management establishes and maintains an adequate and effective internal control system and processes. The system and processes should be designed to provide assurance in areas including reporting (financial, operational, risk), monitoring compliance with laws, regulations and internal policies, efficiency and effectiveness of operations and safeguarding of assets.

Internal audit

(g) Monitoring and reviewing the effectiveness of the bank's internal audit function;

(h) Approving the internal audit plan, scope and budget;

(i) Reviewing and discussing internal audit reports;

(j) Ensuring that the internal audit function maintains open communication with senior management, external auditors, the supervisory authority, and the audit committee;

(k) Reviewing discoveries of fraud and violations of laws and regulations as raised by the head of the internal audit function;

(l) Approving the audit charter and the code of ethics of the internal audit function;

(m)Approving, or recommending to the board for its approval, the annual remuneration of the internal audit function as a whole, including performance awards;

(n) Assessing the performance of the head of the internal audit function; and,

(o) Approving, or recommending to the board for its approval, the appointment, re-appointment or removal of the head of the internal audit function and the key internal auditors.

The statutory or external auditor

Appointment, reappointment, dismissal and remuneration

(p) Approving a set of appropriate objective criteria for approving the statutory auditor or external audit firm of the bank;

(q) Approving, or recommending to the board or shareholders for their approval, the appointment, re-appointment and removal of the statutory auditor or external audit firm;

(r) Approving the remuneration and terms of engagement of the statutory auditor or external audit firm.

Compliance with relevant ethical requirements, in particular independence and objectivity

(s) Reviewing and monitoring the independence of the statutory auditor or external audit firm, and in particular the provision of additional services to the bank, including the related safeguards that have been applied to eliminate identified threats to independence or reduce them to an acceptable level;

(t) Reviewing and monitoring the statutory auditor's objectivity and the effectiveness of the audit process;

(u) Developing and implementing a policy on the engagement of the statutory auditor or external audit firm for the supply of non-audit services, taking into account relevant ethical guidelines on the provision of non-audit services by the external audit firm; and,

(v) Approving the total fees charged for the audit of the financial statements and for non-audit services provided by the external audit firm and external audit network firms to the entity and its components controlled by the entity.

The statutory audit or external audit

(w) Overseeing the statutory audit of the annual and consolidated accounts;

(x) Discussing with the statutory auditor or external audit firm key matters arising from the statutory audit or external audit, and in particular any identified material weaknesses in internal control in relation to the financial reporting process; and,

(y) Discussing the written representations the statutory auditor or external audit firm is requesting from senior management and, where appropriate, those charged with governance;

Remedial actions

(z) Ensuring that senior management is taking necessary corrective actions to address the findings and recommendations of internal auditors and external auditors in a timely manner;

(aa) Addressing control weaknesses, non-compliance with policies, laws and regulations and other problems identified by internal auditors and external auditors, and

(bb) Ensuring that deficiencies identified by supervisory authorities related to the internal audit function are remedied within an appropriate time frame and that progress of necessary corrective actions are reported to the board of directors.

Regulatory objectives and principles of good regulation – checklist

Which regulatory objectives are the proposals aimed to facilitate:?	
(a) To promote market confidence;	Yes – the guidance focuses on banks having strong internal control systems and establishing independent and effective internal audit functions which will serve to promote market confidence.
(b) The reduction of systemic risk;	Yes - systemic risk should be reduced by all banks within the industry applying strong internal audit systems and controls.
(c) To promote public awareness;	No – not applicable to public awareness objective
(d) The protection of the reputation of Gibraltar;	Yes - a strong internal audit function serves to verify a bank's internal control system and thus should reduce reputational risk arising.
(e) The protection of consumers;	Yes – an enhanced internal audit function of a bank should provide assurances to its board and senior management as to the quality and reliability of its internal control system, thus mitigating errors and losses and protecting consumers.
(f) The reduction of financial crime, including the funding of terrorism;	Yes – by promoting a stronger internal audit function, a bank's systems and controls will be enhanced thus mitigating risk and serving to reduce the possibility of the bank being used to perpetrate financial crime.
Do the proposals accord with the following principles of good regulation?	
1. The need to use our resources in the most efficient, effective and economic way;	Not applicable
2. The principle that the duty to manage a business falls upon the senior management of that business. The Directors of a licence holder, both executive and non-executive have ultimate responsibility for ensuring that the business is properly run and operates in accordance with regulatory requirements;	Yes – primarily sets out the expectations for the internal audit function and clearly aligns this with the corporate governance of a bank and the responsibility of the board and senior management for this.
3. The principle that a burden or restriction which is imposed upon authorised firms should be	Yes – the expectation is that a strong internal audit function serves to verify a bank's internal control system and

commensurate with the benefits expected to result from such action, so ensuring that the Authority is striking the right balance between achieving the statutory objectives and ensuring that the impact on those being regulated is not such as to be counterproductive;	thus reduces, inter alia, reputational risk and loss arising.
4. The desirability of facilitating innovation in connection with regulated activities;	Not applicable
5. The international character of financial services and markets and the desirability of maintaining the competitive position of Gibraltar; and	Not applicable
6. The need to consider the adverse effects of regulation on competition and consumer choice.	Not applicable
7. Does this match UK supervisory practices	Yes – it is expected that the UK adopts guidance issued by the Basel Committee as the FSA is very actively involved in the work of the Basel Committee.