Financial Services
Commission

Banking Guidance Note No. 6
Internal Audit

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Context

1 This Guidance Note deals explicitly with the internal audit function in banks and communications between the internal audit function with the external auditors and the FSC. The guidance note applies to banks formed or incorporated under the laws of Gibraltar and third country bank branches that are licensed under the Banking Ordinance 1992. The note is issued as part of the FSC's efforts to address bank supervisory issues and enhance supervision through guidance that encourages sound practices. Adequate internal controls within banking organisations must be supplemented by an effective internal audit function that independently evaluates the control systems within the organisation.

Legal sources

2 Section 23 (3)(h) of the Banking Ordinance 1992 requires a bank i.e. at all times to maintain adequate accounting and other records of the business and adequate systems of control of the business and records. Internal audit as a function in the institution can provide senior management with an additional check to ensure that the bank continually meets the licensing criteria in respect of internal controls on a continual basis as specified under section 25(2) of the Banking Ordinance 1992.

Internal Audit

3 Internal audit is an integral part of the systems of internal control established and maintained by management and may provide independent assurance over the integrity and effectiveness of these systems.

The existence, scope and objectives of internal audit are dependent upon the judgement of management as to its own needs and duties, the size and structure of the institution and the risks inherent in its business, the degree of risk associated with each area of operation, the amount of control by senior management over day-to-day operations, the degree of centralisation and the extent of reliance on information technology. Important considerations in assessing the effectiveness of internal audit include the scope of its terms of reference, its independence from operational management, its reporting regime and the quality of its staff.

The following control functions could be undertaken by internal audit:-

(a) Review of the appropriateness, scope, efficiency and effectiveness of internal control systems, policies and procedures;

(b) Review of the implementation of management policies;

(c) Detailed testing of transactions and balances and the operation of individual internal controls to ensure that specific control objectives have been met;

(d) Special investigations for management or the Board;

(e) To ensure compliance with the external legal and regulatory requirements and codes of conduct;

(f) Review of accounting and other records and the internal control environment;

(g) The testing of the reliability and timeliness of regulatory reporting; and

(h) Follow up recommendations made in previous reports.

It is important to ensure that the internal audit function is appropriately structured and resourced to enable it to provide the independent appraisal of internal controls. There should be clearly defined terms of reference and its independence should be assured by an obligation to report regularly to an executive specified by the Board. Internal audit should not have authority or responsibility for the activities it audits.

4 Internal audit should have unrestricted access to all of an institution's activities, records, property and personnel to the extent necessary for the effective completion of its work. The internal audit function should be staffed with individuals who are appropriately qualified for the function either by holding professional qualifications or by having the requisite experience. Internal Audit is designed to add value and improve an organisation’s operations. It helps an organisation accomplish its objectives by brining a systematic, disciplined approach to evaluate and improve effectiveness of risk management, control, and governance process.

5 An effective internal audit function is a valuable source of information for bank management, as well as bank supervisors, about the quality of the internal control system. The need for objectivity and impartiality is especially important for the internal audit department within the banking industry. Advising senior management on the development of internal controls is often a cost-effective way of ensuring that management makes an informed decision when controls need to be introduced. Internal auditors should not be precluded from analysing and criticising the internal controls that have been put in place by, or at the direction of, senior management.

Who is Responsible?

6 The bank's board of directors has the ultimate responsibility for ensuring that senior management establishes and maintains an adequate and effective system of internal controls, a measurement system for assessing the various risks of the bank's activities, a system for relating risks to the bank's capital level, and appropriate methods for monitoring compliance with laws, regulations, and supervisory and internal policies. The bank's senior management is responsible for developing processes that identify, measure, and monitor and control risks incurred by the bank.

7 Internal audit is part of the ongoing monitoring of the bank's system of internal controls and of its internal capital assessment procedure, because internal audit provides an independent assessment of the adequacy of, and compliance with, the bank's established policies and procedures. As such, the internal audit function assists senior management and the board of directors in the efficient and effective discharge of their responsibilities as described above.

8 Senior management should ensure that the internal audit department is kept fully informed of new developments; initiatives, products and operational changes to ensure that all associated risks are identified at an early stage. The bank should be able to continuously rely on an adequate internal audit function appropriate to its size and to the nature of its operations. These measures include providing the appropriate resources and staffing to internal audit to achieve its objectives. The bank's internal audit function must be independent of the activities audited and must also be independent from the every day internal control process. This means that internal audit is given an appropriate standing within the bank and carries out its assignments with objectivity and impartiality.

Independence of the Internal Audit Function

9 The internal audit department must be able to exercise its assignment on its own initiative in all departments, establishments and functions of the bank. It must be free to report its findings and appraisals and to disclose them internally. The principle of independence entails that the internal audit department operates under the direct control of either the bank's chief executive officer or the board of directors. The head of the internal audit department should have the authority to communicate directly, and on his/ her own initiative, to the board, the chairman of the board of directors or the external auditors where appropriate.

10 Independence also requires that the internal auditors should not have a conflict of interest with the bank. The compensation scheme for internal auditors should be consistent with the objectives of the internal audit. The bank's senior management should provide the internal audit department with the right of initiative and authority to have direct access to and communicate with any member of staff, to examine any activity or entity of the bank, as well as to access any records, files or data of the bank, including management information and the minutes of all consultative and decision-making bodies, whenever relevant to the performance of its assignments.

11 The internal audit function should be objective and impartial, which means it should be in a position to perform its assignments free from bias and interference. Objectivity and impartiality entails that the internal audit department itself seeks to avoid any conflict of interest. To this end, staff assignments within the internal audit department should be rotated periodically whenever practicable. Internally recruited auditors should not audit activities or functions they performed within the last twelve months. Impartiality requires that the internal audit department is not involved in the operations of the bank or in selecting or implementing internal control measures. Otherwise it would have to assume responsibility for these activities, which would impair its judgmental independence. Subsequent internal audit reports can contain recommendations relating to deficiencies and weaknesses and suggestions for improving internal controls.

Quality of Staff

12 The professional competence of every internal auditor and of the internal audit function as a whole is essential for the proper functioning of the bank's internal audit function. The professional competence of each internal auditor as well as his/ her motivation and continuing training are prerequisites for the effectiveness of the internal audit department. Professional competence must be assessed taking into account the nature of the role and the auditor's capacity to collect information, to examine, to evaluate and to communicate. In this respect, account should also be taken of the growing technical complexity of banks' activities and the increasing diversity of tasks that need to be undertaken by the internal audit department as a result of developments in the financial sector.

Scope of activity

13 Every activity and every entity of the bank should fall within the scope of the internal audit. None of the bank's activities may be excluded from the internal audit department's scope of investigation. From a general point of view, the scope of internal audit should include the examination and evaluation of the appropriateness and effectiveness of the internal control system and of the

manner in which assigned responsibilities are fulfilled. In many respects, this represents a risk analysis of the bank's internal control system. In particular, the internal audit department should evaluate: the bank's compliance with policies and risk controls (both quantifiable and non-quantifiable); the reliability (including integrity, accuracy and comprehensiveness) and timeliness of financial and management information; the continuity and reliability of the electronic information systems; and the functioning of the staff departments.

14 The internal audit department should give adequate consideration to the legal and regulatory provisions covering the bank's operations, including the policies, principles, rules and guidelines issued by the FSC with regard to the manner in which banks are organised and managed. However, this does not imply that the internal audit department should assume the compliance function.

15 Internal audit should carry out regularly an independent review of the risk management system developed by the bank to relate risk to the bank's capital level and the method established for monitoring compliance with internal capital policies. Furthermore, the internal audit department should not limit itself in this respect to auditing the bank's various departments. Rather, it should also pay special attention to auditing a banking activity through all engaged entities within the bank. The internal audit department should ideally produce an audit plan based on their risk assessment of the bank’s activities and discuss this at board level in order to carry out their audit work.

16 The internal audit department’s function is to indicate the relative importance of the deficiencies found or the recommendations made. It should also maintain a record of the assignments performed and of the reports issued. Senior management should ensure that the internal audit department's concerns are appropriately addressed. Therefore they should approve a procedure established by the internal audit department to ensure the consideration and, if appropriate, the timely implementation of the internal audit’s recommendations. The internal audit team should follow up its recommendations to see whether they are implemented.

Communication with the FSC

17 Sections 46A and 47 of the Banking Ordinance 1992 provide for communications between auditors and the Banking Supervisor. In this light the Banking Supervisor attaches great importance in the findings of an internal audit report, as this will aid the work of targeting which areas supervision need to be focused on. The FSC welcomes periodic consultations with the bank's internal auditors to discuss the risk areas identified and the measures taken. At the same time, the extent of the collaboration between the bank's internal audit department and the bank's external auditors may also be discussed. It is a good practice that whenever the head of the bank's internal audit department ceases to act in this capacity, the bank’s management should inform the Banking Supervisor in a timely manner. When the head of the internal audit department has been relieved of his/ her duties, the Banking Supervisor should be informed of the reasons.

18 Cooperation among the Banking Supervisor, the external auditor and the internal auditor aims to make the work of all concerned parties more efficient and effective. The cooperation may be based on periodic meetings of the supervisor, the external auditor and internal auditor. The cooperation aims at making the contribution of all concerned parties more efficient and effective, whereby each party concentrates on its own responsibilities. The Banking Supervisor may consider the presence of senior management appropriate at these meetings. During these meetings, each party provides information about areas of mutual interest and specific attention is given to the areas that will be

examined and the timing of the work. Also, all three parties discuss the implementation by the institution of the internal and external auditors' recommendations. Cooperation presupposes a relationship of trust between the bank, its external auditor and the supervisory authority. If there is no trust, co-operation cannot exist. Therefore, supervisory authorities expect to be informed by the bank's senior management about decisions, facts or developments which may have a significant influence on the bank's condition.

The relationship of the internal auditors and the external auditors

19 The FSC encourages consultation between internal and external auditors in order to make their cooperation as efficient and effective as possible. External auditors have an important impact on the quality of internal controls through their audit activities, including discussions with management and the board of directors and recommendations for improvement of internal controls. Generally the internal audit may be useful in determining the nature, timing and extent of external audit procedures. The external auditor should be advised of and have access to relevant internal auditing reports and be kept informed of any significant matter that comes to the internal auditor's attention which may affect the work of the external auditor. As an additional task the external auditors can carry out an independent review of the internal audit function.

Outsourcing of the internal audit

20 Regardless of whether internal audit activities are outsourced, the board of directors and senior management remain ultimately responsible for ensuring that the system of internal control and the internal audit, are adequate and operate effectively. Small banks may use an outsourcing vendor to perform virtually all of the internal audit work. Under such an arrangement, the institution should maintain a senior and experienced individual as head of internal audit and a small internal audit staff. The outsourcing vendor assists staff in determining risks to be reviewed, recommends and performs audit procedures as approved by the head of the internal audit department, and reports its findings jointly with the head of the internal audit department to the full board. The contract should explicitly provide that senior management must give its prior approval to the risk analysis performed by the outsourcing vendor and to the plan that has been established.

21 The contract should also state that senior management or its representative(s), the external auditor(s) or its representative(s), and the supervisory authority have at any time access to the outsourcing vendor's records relating to his assignments, including his/ her audit work plan and working papers.

22 The contract should provide that the outsourcing vendor commits him/ herself to devote the resources required to effectively perform his assignment under the audit plan. There should be a protocol for changing the terms of the contract, especially for expansion of audit work if significant issues are found. When an institution enters into an outsourcing arrangement, it increases its operating risks such as lost or reduced control over the internal audit function. The FSC expect banks to analyse the impact outsourcing of internal audit activities will have on their overall risk profile and the bank's internal control system. In case the arrangement suddenly terminates, the institution should have a contingency plan.