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Bank Internal Audit – New Standards from the Bank for International Settlements?

The BIS has published new principles for internal auditors in banks. In this article we review each of these principles and consider the key areas which are likely to cause challenge for auditors.

The Basel Committee on Banking Supervision (BCBS) published paper 223 entitled The Internal Audit Function in Banks in June 2012. It sets out a series of principles with regard to internal audit which will be of interest to anyone involved in bank internal audit. It will be seen as international best practice by any regulator and generally sets out the approach that should be taken with regard to internal audit. There are some challenges for firms within some of these requirements, although many firms may already comply with the majority of the principles.

In terms of the international nature of regulation, the committee that developed these principles included three representatives from regulators in the USA, as well as representatives from Europe, Japan and Canada; so clearly there is international support. The document replaces the 2001 document Internal audit in banks and the supervisor's relationship with auditors. It takes into account developments in supervisory practices and in banking organisations and incorporates lessons drawn from the recent financial crisis.

Key Objectives

The paper states that a strong internal control system, including an independent and effective internal audit function, is part of sound corporate governance. It requires that banking supervisors must be satisfied as to the effectiveness of a bank's internal audit function, that policies and practices are followed and that management takes appropriate and timely corrective action in response to internal control weaknesses identified by internal auditors. The paper notes that an internal audit function provides vital assurance to a bank's board of directors and senior management (and bank supervisors) as to the quality of the bank's internal control system. In doing so, the function helps reduce the risk of loss and reputational damage to the bank. It is clear from recent lapses in bank controls that internal audit will be under even greater scrutiny and therefore the requirements of this paper will need to be clearly addressed by bank and their internal audit functions.

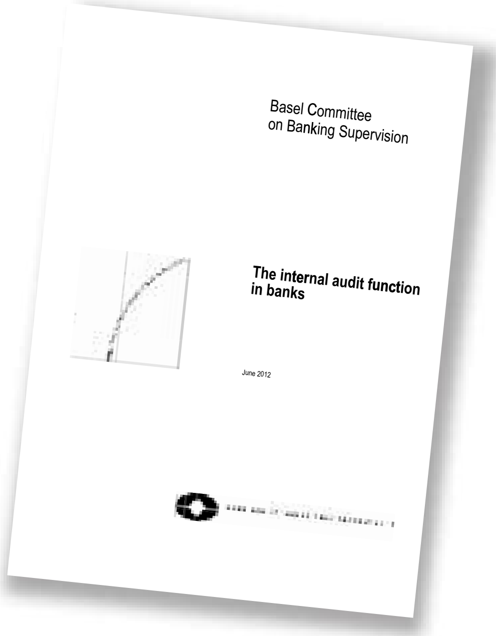
We will address each of the principles in turn.

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.

The requirement is that 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. Notice that this includes all bank records and data. I have become increasingly concerned that some internal audit functions limit their work to areas which fall below governance, for example. It is clear from this principle that the expectation is that all areas will be addressed.

The requirements also state that 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. This is generally what we see occurring in practice.



Notice that the requirements do not explicitly refer to the senior non-executive director role.

(a) Independence and objectivity

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 authority within the bank, thereby enabling internal auditors to carry out their assignments with objectivity.

This appears to be a requirement that firms would always comply with. However within the detail there are a couple of matters worthy of attention.

The paper states that:
"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

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should remain the responsibility of management."

This highlights the problems faced by internal audit when working on the development of systems and controls. It suggests that they should provide their input but neither approve nor be part of the management team for a major change project.

The paper then states:
"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 guidance on cooling off periods is welcomed, but the issue of continuously undertaking tasks leads to the issue of continuous auditing. The concern is that the effectiveness of the auditor is impacted by their being required to undertake repetitive tasks. It is clear that the audit planning process will need to ensure that there is clarity as to the intended goals of the testing conducted and that the approach adopted is such as to provide the required level of effective assurance demanded.

(b) Professional competence and due professional care

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.

The rules explicitly state that **"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."**

We would generally expect this to be best achieved through internal training using an external expert providing alignment with the actual requirements of the firm. However there should also be attendance at some external training events to ensure that the firm appreciates the standards being applied by their peers.

(c) Professional ethics

Principle 4: Internal auditors must act with integrity.

This again leads to a discussion of cooling off.

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.

It further states the minimum requirements of the charter as follows:
"27. 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."**

It specifically goes on to state that the internal auditors should have access to management information systems and records and the minutes of all consultative and decision-making bodies. This clearly is intended to include the minutes of the Board.

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.

This means that in effect all of the outsourced activities, and their management, are included within the internal audit universe and should be risk assessed.

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It also emphasises that the internal audit plan will need to be flexible to deal with changes in the risk profile of the institution.

Principle 7: The scope of the internal audit function's activities should ensure adequate coverage of matters of regulatory interest within the audit plan.

The paper then goes on to specify some of the areas to be covered. It states that **"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."**

Of these it is perhaps the compliance function that provides the auditors with the greatest challenge. To audit this area, auditors will need to have some awareness of the local regulation and also the nature of the challenges that such a function faces. It is essentially auditing an expert, not something that many internal audit functions take on willingly. Of course there are always approaches that can be taken which minimise the need for explicit detailed knowledge, but increasingly regulators are seeking for internal audit to increase their emphasis in such areas.

It then considers risk management and requires a similar level of coverage, stating: **"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."**

These are again demanding requirements. By highlighting compliance and risk management the Bank for International Settlements are requesting that internal audit see these as high risk areas. If the skills to achieve this are not readily available within your team then again external assistance should be sought to supplement the existing team.

They also include work to be conducted on the finance function. It is clearly not acceptable to rely upon the work conducted by external auditors and the expectation is that internal audit will also be active in this area.

The paper states that: **"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)."**

(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.

It does go on to state that this will be commensurate with the size and complexity of the organisation.

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

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.

Two key issues are raised here. Firstly it states that 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. Secondly it specifies that senior management should be accountable for ensuring that timely and appropriate actions are taken on all internal audit findings and recommendations.

In some ways it is the second point that is perhaps most telling. If this is moved to the responsibility of senior management then it is senior management hat should do the follow up on audit findings, releasing scarce internal audit resource to identify new problems.

(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.

Annex 2 to the paper sets out their responsibilities.

(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.

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(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.

(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.

This is explained by the following table:

Line of defence	Examples	Approach
First line	Front Office, any client-facing activity	Transaction-based, ongoing
Second line	Risk Management, Compliance, Legal, Human Resources, Finance, Operations and Technology	Risk-based, ongoing or periodic
Third line	Internal Audit	Risk-based, periodic

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.

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.

So outsourcing of internal audit activities, but not the function, on a limited and targeted basis is allowed. The paper states that this 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.

The remaining principles relate to supervision as follows:

Benefits of enhanced communication between the supervisory authority and the internal audit function

Principle 16: Supervisors should have regular communication with the bank's internal auditors to (i) discuss the risk areas identified by both parties, (ii) understand the risk mitigation measures taken by the bank, and (iii) monitor the bank's response to weaknesses identified.

Assessment of the internal audit function

Principle 17: Bank supervisors should regularly assess whether the internal audit function has sufficient standing and authority within the bank and operates according to sound principles.

Actions to be undertaken by the supervisory authority

Principle 18: Supervisors should formally report all weaknesses they identify in the internal audit function to the board of directors and require remedial actions.

Principle 19: The supervisory authority should consider the impact of its assessment of the internal audit function on its evaluation of the bank's risk profile and on its own supervisory work.

Principle 20: The supervisory authority should be prepared to take informal or formal supervisory actions requiring the board and senior management to remedy any identified deficiencies related to the internal audit function within a specified timeframe and to provide the supervisor with periodic written progress reports.

What to do Now?

In conclusion you can see that the BCBS have increased the importance of internal audit within the supervisory framework. All internal audit functions should now undertake a gap analysis against these principles and see where they might be considered deficient. In such cases this should be reported to both the audit committee and the governing committee to enable remedial action to be taken.

This could involve amending the audit plan or improving the depth of knowledge of the audit team. It is also likely to include the identification of suitable resources to assist in complex audits.

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