INTERNAL AUDIT IN BANKING ORGANISATIONS

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The Basel Committee on Banking Supervision in 2001 and 2002 published a study on internal audit in banking organisations and on the relation between institutions performing banking supervision and internal and external auditors. Effective internal audit, which independently evaluates control systems within the organisation, is the starting point for an appropriate internal control of banking institutions. External auditors provide their view on the internal audit. Institutions performing banking supervision by means of internal and external audit ensure that the bank's management applies effective procedures and practices and that it responds to shortcomings, where these have been identified by internal or external auditors. The cooperation of all these parties provides for optimal supervision over banking institutions.

The principles described are applicable in the full extent. However, differences exist between individual countries, where this is influenced by the position of external auditors, the management structure of banks, or the legislative conditions of banking. Application of the audit principles described in practice is therefore governed by the national legislative standards of each country.

Internal audit in banking organisations

The Board of Directors of the Institute of Internal Auditors in June 1999 described internal audit as: "Internal audit is an independent, material and consultancy activity, which adds value and improves the functioning of an organisation. It helps the organisation achieve its aims by means of a systematic, disciplined approach to evaluating and improving the effectiveness of risk management, control and the management process." Although the need for objectivity and impartiality is of particular importance for the internal audit department in a banking institution, this does not exclude the possibility that this department, too, may contribute to advisory and consultancy activity, if the independence of analyses and evaluations is ensured. Some banks have also introduced a system of evaluating their activities, which does not replace, but supplements the function of the bank's internal audit. This is a formal and documented process whereby management and employees analyse their activities and evaluate the effectiveness of the related internal control procedures.

Internal audit has several aims and principles which it is necessary to adhere to. It is the board of directors of the bank, however which bears final responsibility that the bank's management applies an appropriate and effective system of internal control, a system of evaluating banking activity risk and risks concerning bank capital, appropriate methods of monitoring compliance with laws, measures and internal procedures. Likewise, the bank's management is responsible for drawing up procedures which identify, measure, monitor and control the risks that the bank faces. The management must ensure an organisational structure that clearly defines powers and responsibility. It is responsible for risk management, proposing suitable internal control mechanisms and monitoring their adequacy and efficiency. Internal audit is a part of the repetitive monitoring of the internal control systems of the bank and its procedures for evaluating internal capital. As such, it assists management and the board of directors in the effective performance of their responsibility as outlined above.

The internal audit department

Every bank should have an internal audit department on which – with regard to the volume and nature of its activities – it can rely. In smaller banks internal audit is often provided externally. The internal audit department in a banking institution must be independent from the activities which it controls and must likewise be independent from the day-to-day internal control processes. In this way it is guaranteed that this department performs its activities objectively and impartially. Internal auditors may not have a conflict of interests with the bank. Every bank should have formalised principles of internal audit providing for its position and powers in the framework of the bank. There should here be codified the scope of work of internal auditors, the position of the whole department in the bank's organisational structure, relations with other control departments, etc.

Internal audit must be objective and impartial, meaning that it should perform its activity free of doubts and interference. Members of the internal audit team may not participate in the bank's operations or in the selection and implementation of internal control systems. The professional competence, as well as internal motivation and systematic professional development of each internal auditor are essential factors for the correct functioning of the whole internal audit department of the bank. It is also recommended to rotate individual auditors in the framework of the department, so that the routine performance of work activities is avoided. The internal audit department manager should be responsible that the department performs its activities in accordance with the due principles of internal audit. Especial care should be taken that the audit plan is drawn up formally and procedures for all members of the team are in writing. The professional competence of the department's employees must always be ensured, as must their regular training. The internal audit department is responsible to the bank's management and its board of directors, possibly also to the audit committee, if the bank has one. These bodies of the bank should primarily be informed as to the progress of the audit plan and the attainment of the internal audit department's objectives.

The audit plan

Each activity and each of the bank's subjects (i.e. its subsidiaries or branches) should fall within the scope of the internal audit. None of the bank's activities or any of its subjects may be excluded from an internal audit examination. The internal audit department should have access to the bank's records including and information and minutes from meetings of the advisory or decision-making bodies of the bank, where this is relevant would regard to the performance of the internal auditors' activity. As part of the process of assessing the bank's internal capital the internal audit department should regularly and independently control the risk management system, on the basis of which the relation of risk to the bank's capital is evaluated, and control the methods on the basis of which the compliance of internal procedures concerning capital is assessed. The assessment of risk in relation to the bank's capital is a part of risk management which is oriented on the bank's overall business strategy in various fields. It must be clearly identified in the bank the department or individuals responsible for controlling the bank's capital evaluation processes. This control may be performed by the bank's internal audit department or another department which is sufficiently independent from the bank's operations.

Internal audit includes a plan of the audit, an examination and evaluation of available information, communication of the results and fulfilment of recommendations. Several types of internal audit exist, for example:

a) financial audit, the aim of which is to evaluate the reliability of the accounting system and the information contained in the consequent financial results,

b) compliance audit, the aim of which is to evaluate the quality and suitability of systems proposed for the purpose of ensuring compliance with a legal requirements, measures and procedures,

c) operations audit, the aim of which is to evaluate the quality and suitability of other systems and procedures, analyse the organisational structure and assess the suitability of methods and resources,

d) management audit, the aim of which is to evaluate the quality of the management's approach to risk and control in the framework of the bank's overall aims.

Since the internal audit department examines and evaluates the overall activities of the bank, it should not focus simply on one type of audit, but should employ the most appropriate type depending on the objectives which the audit is to achieve.

Relationship of internal audit and banking supervision

Banking supervisory authorities should evaluate the work of a bank's internal audit department and, where satisfied with their work, may rely on the internal audits findings in identifying areas of potential risk. Bank audit bodies issue various measures concerning banking internal control systems. However, the scope of these measures varies from country to country, though in general covers the basic principles of a suitable control system in the fields of bank capital, credit risk management, and other risk (for example exchange rate, interest rate, liquidity management risk). Banking supervision makes use of various approaches to evaluating the quality of internal control. One of these is that it evaluates the work of the internal audit department, including testing management processes in identifying, measuring, monitoring and controlling risks. If the bank's supervisory authority is satisfied with the internal audit department's work, it may use the internal auditors' reports as the primary mechanism for identifying the bank's potential problems or fields of potential risks that the auditors have not yet controlled.

Banking supervisory authorities should hold regular discussions with a bank's internal auditors on fields of risk and measures that it will be necessary to implement in connection with these risks. Although internal auditors do not draw up all the procedures in a bank – other than internal control procedures – it is their duty, and in the bank's shareholders' and creditors' interest, to notify the board of directors and audit committee (where the bank

has one), if it believes that the bank's management is acting in conflict with legal regulations or the bank's internal regulations. Banking supervisory authorities should organise regular meetings of the managers of the internal audit departments of various banks. Individual department managers may at these meetings exchange knowledge and opinions on topics of common interest in their banking sector.

Mutual coordination of auditing functions and supervisory activities

External and internal auditor

Banking supervisory authorities support consultation between internal and external auditors with the aim of improving, as far as possible, the efficiency of their cooperation. External auditors influence the quality of internal control by means of their auditing activities, including discussions with management and the board of directors for the audit committee and recommendations for improving internal control. Internal audit is in general useful for determining the nature, time frame and scope of the audit's external procedures. Nevertheless, the external auditor is responsible for his/her opinion on the financial statements. the external auditor or should have access to all relevant reports from the internal audit department and should be informed on all significant matters that the internal auditor learns of and which could influence the internal auditor's for work. Vice versa, the external auditor, too, informs the internal auditor of all significant matters that may influence the internal audit. The internal audit department manager should ensure that the department's work does not overlap with that of the external auditor's. Internal and external auditors should regularly communicate, exchange information, auditors reports and knowledge on various audit techniques and methods.

External auditors should perform work for banking supervisory authorities only on a contractual basis. All tasks commissioned by banking supervisory authorities to external auditors should correspond to their regular activity and should fall within their competence. Both banking supervisory authorities as well as external auditors have an interest that an appropriate accounting system exists at the bank. The role of external auditors varies from country to country. A common factor is, however, the expectation that external auditors understand the internal control system of the bank to the extent in which it influences the precision of the bank's financial statements. Similarly, from external auditors it is expected that they will inform both the bank's management as well as the banking supervisory authorities of all significant shortcomings that they find in their work. Various fields exist for which the work of the banking supervisory authorities and external auditors is mutually beneficial. An advantage is that external auditors can gain an overview of a bank directly from banking supervisory authorities. In some countries the role of external auditors is even taken to include, for example, controlling methods used in banks, evaluating the adequacy of organisation and the internal control system, determining whether a bank complies with all legal requirements, evaluating and the activity of a bank's internal audit department, giving an opinion as to whether all accounting procedures have been adhered to. It is however recommended to apply legal procedures that do not impose the burden of liability on external auditors for information that they provide in good faith to banking supervisory authorities.

In some countries banks outsource internal audit, while in other countries it is, conversely, required that internal audit be performed by an internal department of the bank. Regardless of whether internal audit activities are outsourced or not, the board of directors and the bank's management remain responsible for the effective functioning of the internal control system and the internal audit itself. In certain countries it is required that internal auditors coming from an environment outside the bank are independent from the bank's external auditors. Elsewhere it is permitted that internal auditors are from the same firm as external auditors. The contract signed between the bank and the firm providing internal audit services to the bank contains provisions concerning the tasks and responsibilities of internal auditors. Banking supervisory authorities always require an evaluation of the operations risk in a bank outsourcing its internal audit services. In general the services of a consultancy firm providing internal audit are much more advantageous and acceptable in smaller banks.

Standing audit committee

A practical solution to all the difficulties that could arise from the fact that the bank's board of directors has the task of ensuring the existence and functioning of an appropriate control system is to set up a standing audit committee. Such a committee strengthens the internal control system as well as internal and external audit. Therefore, in general it is recommended that banks, in particular those with complex activities have a standing audit committee. Also the subsidiaries of a bank may then consider the suitability of such a committee in the framework of their boards of directors. In setting up such a committee the bank's board of directors should set out, in writing, the powers, responsibility and duties of

the audit committee, as well as the form of reporting, which the committee is to prepare for the board of directors. The board of directors should regularly update this written document. The audit committee should be composed of at least three members of the board of directors who are neither current nor former members of the bank's management. At least one of the members should be well-qualified in financial reporting, accounting or auditing and all members should be knowledgeable in fields necessary for fulfilling the duties of such a committee. Members of the committee may have access to certain information for the purpose of performing control. The audit committee regularly submits reports to the bank's board of directors.

Conclusion

Co-operation between banking supervisory authorities, external auditors and their internal auditors with the aim of improving the effectiveness of their work is very important, where each of the parties concentrates on its own field of responsibility. Such co-operation may, for example, be founded on regular meetings, where each of the parties presents information on areas of common interest, the recommendations of internal and external auditors are discussed and each of the parties gives its opinion on them. The cooperation of banking supervisory authorities, internal auditors and external auditors requires a relationship founded on trust.