CENTRAL BANK OF BAHRAIN

Proposed Directive on Internal Audit Function in Banks

4th April 2013

(Deadline for comments: 5th May 2013)

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I. Introduction

This consultation paper is based on the Basel Committee's final paper issued in June 2012 "The internal audit function in banks". The purpose of the consultation paper is to promote a strong internal audit function within banks. This document also encourages banks' internal auditors to comply with and to contribute to the development of national and international professional standards and it promotes due consideration of prudential issues in the development of internal audit standards and practices.

It takes into account developments in supervisory practices in banking organisations and incorporates lessons drawn from the recent financial crisis. It also details the responsibilities of a bank's Audit Committee.

The contents of this paper are intended to apply in their entirety to all locally incorporated banks, including those within a banking group, and to holding companies whose subsidiaries are predominantly banks. While Module LR requires that all banks including branches must have an internal auditor as a controlled function in the Kingdom, only Sections 2, 4 and 8 would be directly applicable to branches of overseas banks in Bahrain in terms of the internal audit function located here. Branches should ensure that equivalent arrangements are in place at the parent level for other sections in this paper and these arrangements provide for an effective internal audit function over activities conducted under the Bahrain license.

1.1 The internal audit function

1.1.1 **<u>Bank licensees</u> must establish and implement an effective internal audit function which provides an 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, to protect the bank and its reputation.**

1.1.2 **The internal audit function must develop an independent and informed view of the risks faced by the bank based on its access to all bank records and data, its enquiries, and its professional competence. The internal audit function must discuss its views, findings and conclusions directly with the audit committee and the board of directors at their routine quarterly meetings (as required in Appendix A to Module HC), thereby helping the board to oversee senior management.**

2.1 Key features of the internal audit function

2.1.1 The key features for the effective operation of an internal audit function are:

(a) Independence and objectivity;
(b) Professional competence and due professional care; and
(c) Professional ethics

Independence and objectivity

2.1.2 "Independence" is defined in the Glossary of The Institute of Internal Auditors as "the freedom from conditions that threaten the ability of the internal audit activity to carry out internal audit responsibilities in an unbiased manner".

2.1.3 "Objectivity" is referred to in the Glossary of The Institute of Internal Auditors 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".

2.1.4 The bank's internal audit function must be independent of the audited activities. This means that the internal audit is independent of all functions including Compliance, Risk Management and Financial Control functions. Also the internal audit function must have sufficient standing and authority within the bank to communicate directly to the board, the chairman of the board of directors, members of the audit committee, the internal audit functions and audit committee of subsidiaries and associates, and administratively to the CEO, thereby providing a framework for internal auditors to carry out their assignments with objectivity.

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

2.1.6 The internal audit function must not be involved in designing, selecting, implementing or operating specific internal control measures. The development and implementation of internal controls is the responsibility of management. Senior management may request input from internal audit on matters related to risk and internal controls but may not ask the internal audit function to develop such controls.

2.1.7 Continuously performing similar tasks or routine jobs may negatively affect an individual internal auditor's capacity for critical judgment 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 (normally designated as at least one full financial year) 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.

2.1.8 The internal audit staff's remuneration must not be linked to the financial performance of the business lines for which they exercise internal audit responsibilities as it may undermine the independence and objectivity of the internal audit function. The remuneration of the head of the internal audit function must be determined transparently 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 must be structured to avoid creating conflicts of interest and compromising independence and objectivity.

Professional competence and due professional care

2.1.9 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.

2.1.10 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.

2.1.11 The head of internal audit must have the responsibility 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 (i.e. no other function must have the authority to dictate the qualifications and skills level required). He/she must continually assess and monitor the skills necessary to do so. The skills required for senior internal auditor staff must include the abilities to judge outcomes and to influence senior management of the benefits of improving the internal control environment of the organisation.

2.1.12 The head of internal audit must ensure that internal audit staff acquire appropriate ongoing training, development, and mentoring in order to understand and improve the controls over the technical complexity of the bank's activities, the introduction of new products and processes and other developments in the financial sector.

2.1.13 The Internal Audit function collectively must be competent to examine all areas in which the bank operates. It is the responsibility of the head of internal audit to maintain adequate oversight and to ensure adequate transfer of knowledge from appointed experts to the bank's internal audit staff, when such experts are used. The head of internal audit must ensure that the use of those appointed experts does not compromise the independence and objectivity of the internal audit function.

2.1.14 If internal experts from within the bank (so-called guest auditors) are used in lieu of or in addition to appointed experts, the head of internal audit retains the responsibility for oversight, knowledge transfer, independence and objectivity of the Internal Audit function.

2.1.15 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 must be appropriately supervised by more experienced internal auditors.

Professional ethics

2.1.16 Internal auditors must act with integrity. Integrity includes, as a minimum, communicating with people in a manner that they understand and interpret as intended by the internal auditor, and demonstrating honesty and truthfulness at all times.

2.1.17 Internal auditors must respect the confidentiality of information acquired in the course of their duties. They must not use that information (particularly 'confidential information' as defined in Article 116 of the CBB Law) for personal gain or malicious action and must ensure that such information is not disclosed to others except where such disclosure is authorized by the bank and permitted by law.

2.1.18 The head of the internal audit function and all internal auditors must avoid conflicts of interest (See HC-2.3). Internally recruited internal auditors must not engage in auditing activities for which they have had previous responsibility before a sufficiently long "cooling off" period has elapsed, as noted in Para 2.1.7 above. Moreover, compensation arrangements must not provide incentives for internal auditors to act contrary to the attributes and objectives of the internal audit function.

2.1.19 Internal auditors are professionally bound to comply with the code of ethics of the professional audit institution(s) of which they are a member, and also the code of ethics of the bank (refer to Section HC-2.2). A bank's code of ethics must at a minimum address the principles of objectivity, competence, confidentiality and integrity for the internal audit function.

2.1.20 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.

3.1 Internal Audit Mandate

3.1.1 All banks must have an internal audit mandate 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 Section 1.1.

3.1.2 The mandate must be approved by the bank's audit committee, and endorsed by the board. The Audit Committee must review the Audit mandate no less than annually to ensure that it meets the needs of the bank. The Audit mandate must be available to all stakeholders, and the principle elements disclosed in the bank Annual Report.

3.1.3 At a minimum, an internal audit mandate must establish:

- **a) The internal audit function's standing within the bank and its relations with other control functions in a manner that promotes the effectiveness of the function as described in Section 1.1. of this paper;**
- **b) The purpose, authority, and responsibilities of the internal audit function;**
- **c) The scope of work for the Internal Audit function;**
- **d) The relationship between the Internal Audit function and the Audit Committee, including the requirements for Internal Audit to report the status of its work to the Committee;**
- **e) The key features of the internal audit function described under Section 2.1 above;**
- **f) The obligation of the internal auditors to communicate the results of their engagements and a description of how and to whom this must be done (reporting line);**
- **g) The criteria for when and how the internal audit function may outsource some of its engagements to appointed experts;**
- **h) 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;**
- **i) The responsibility and accountability of the head of internal audit;**
- **j) A requirement to comply with sound internal auditing standards. The professional standards which the Internal Audit function adheres to must be included in the mandate; and**
- **k) Procedures for the coordination of the internal audit function with the external auditor.**

3.1.4 The mandate must 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 committees.

4.1 Scope of activity

4.1.1 Internal audit must examine and evaluate the effectiveness of the internal control, risk management and governance systems and processes of the entire bank, including the bank's outsourced activities and its subsidiaries, branches, SPVs and other entities under the control of the bank (see Module PCD).

4.1.2 The internal audit function must independently evaluate the:

a) Effectiveness and efficiency of internal control, risk management and governance systems in the context of both current and potential or actual emerging risks;

b) Reliability, effectiveness and integrity of management information systems and processes (including relevance, accuracy, completeness, availability, confidentiality and comprehensiveness of data);

c) Monitoring of compliance with laws and regulations, including any requirements from the CBB; and

d) Safeguarding of assets.

4.1.3 The head of internal audit must establish an annual internal audit plan. This plan must be an integral part of a multi-year strategic plan. It must be based on a robust risk assessment (including input from senior management and the board) and be updated at least annually (or more frequently to enable an ongoing real-time assessment of where significant risks lie).

4.1.4 The board's approval of the audit plan also requires that an appropriate budget will be available to support the internal audit function's activities (See HC Appendix A (e)). The budget must be sufficiently flexible to adapt to variations in the internal audit plan in response to changes in the bank's risk profile.

4.1.5 The audit plan must ensure sufficient coverage of matters of regulatory and legal interest to provide the CBB with comfort that the Internal Audit function work can be relied upon to provide an accurate, timely, and relevant assessment of the controls which the bank has in place to ensure compliance with all legal and regulatory requirements.

4.1.6 The head of internal audit must disclose to the CBB matters of regulatory significance in a timely manner.

4.1.7 Internal audit must have the appropriate capability regarding matters of regulatory interest and undertake regular reviews of such areas based on the results of an appropriate risk assessment. The assessment must include policies, processes and governance measures established in response to various regulatory principles, rules and guidance established by the CBB. In particular, the internal audit function of a bank must have the capacity to review key risk management functions, capital

adequacy and liquidity control functions, regulatory and internal reporting functions, the regulatory compliance function and the finance function as outlined below.

(a) Risk management

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

a) the organisation and mandates of the risk management function including market, credit, liquidity, interest/profit rate, operational, and legal risks;

b) an evaluation of the risk appetite approved by the Board of Directors; the processes and procedures for the escalation and reporting of issues to management and the Board; and the decisions taken by the risk management function;

c) 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;

d) the integrity of the risk management information systems, including the accuracy, reliability and completeness of the data used; and

e) the approval and maintenance of risk models including verification of the consistency, timeliness, independence and reliability of data sources used in such models.

4.1.9 The head of internal audit must inform the board about the existence of any significant or material divergence of views between senior management and the risk management function regarding the level of inherent and/or residual risk faced by the bank to ensure that the board of directors is fully aware of the situation in a timely manner.

(b) Capital adequacy and liquidity

4.1.10 The scope of internal audit must include an assessment of the controls over all of the provisions of the CBB regulatory framework. This encompasses the individual and holistic control frameworks as they relate to all functions, departments, products, people, and other resources utilized by the bank. It includes for example 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 as articulated in the CBB Rulebook and other relevant elements of the CBB regulatory framework.

4.1.11 Internal audit must clearly document the rationale underpinning the frequency of the review of the management process for stress testing capital levels, taking into account the frequency with which management undertake such exercises, their

purpose (e.g. internal monitoring vs. CBB imposed), the reasonableness of the scenarios used, the underlying assumptions employed, and the appropriateness and reliability of the processes used.

4.1.12 Internal audit must review 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.

4.1.13 The results of all tests must be clearly documented, reported to the Board, and where necessary suitable action plans to mitigate control weaknesses must be developed and implemented by senior management, with the approval of the Board.

(c) Regulatory and internal reporting

4.1.14 In addition to the matters identified above the internal audit function must at least annually evaluate the effectiveness of the controls over the process by which the relevant functions of the bank interact to produce timely, accurate, reliable and relevant reports for both internal management and the CBB. Such reports include the PIR and those intended to reflect the extent of compliance with the public disclosure requirements included in the CBB Rulebook, Module PD.

(d) Compliance

4.1.15 The internal audit function must at least annually review the scope of the activities of the compliance function. The audit of the compliance function must include an assessment of how effectively it fulfils its responsibilities to ensure compliance with applicable laws, regulations, rules and standards.

4.1.16 The laws, regulations, rules and standards include the Laws of the Kingdom of Bahrain, the CBB Law, plus all rules, regulations, resolutions and directives issued by the CBB, market conventions, codes of practice promoted by industry associations, and internal codes of conduct applicable to the staff members of the bank.

(e) Finance

4.1.17 A bank's finance function which includes valuation, modeling, product control and financial control, is responsible for the integrity and accuracy of financial data and financial reporting. The output from key aspects of a Finance function activities (e.g. calculations, profit and loss valuations and reserves) are an integral component of the calculations which determine a bank's capital resources. Therefore associated controls should be robust and consistently applied on an enterprise wide basis.

4.1.18 The internal audit function must review at least annually, using appropriate resources and relevant expertise the controls over the bank's finance function, in order to provide the Board with an effective, timely, and objective evaluation of the bank's practices within this function.

4.1.19 The internal audit function must 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.

4.1.20 The internal audit function must, as a minimum, also include the following aspects in its scope:

a) The organisation and mandate of the finance function;
b) 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;
c) The approval and maintenance of all valuation and pricing models including verification of the consistency, timeliness, independence and reliability of data sources used in such models;
d) independently testing the valuations accorded to significant transactions;
e) The controls in place to prevent and detect trading irregularities; and
f) Balance sheet controls including key reconciliations performed and actions taken (e.g. adjustments).

5.1 Corporate governance

a) Permanency of the internal audit function

5.1.1 The internal audit function must be permanent (see HC-3.2.3) and must be structured consistent with Section 6 of this paper when the bank is within a banking group or with a holding company structure. Senior management and the board must take all the necessary measures to ensure that the internal audit function is commensurate with the size, the nature and complexity of the bank's operations.

5.1.2 Internal audit activities must be conducted by the bank's own internal audit staff. If some internal audit activities are partially outsourced (such arrangement is subject to a maximum of a one year limit, subject to regulatory assessment), the board of directors remains ultimately responsible and accountable for these activities.

b) Responsibilities of the board of directors and senior management

5.1.3 The bank's board of directors must ensure that senior management establishes and maintains an adequate, effective and efficient internal control system (see HC-1.2.3(c)) and accordingly, the board must support the internal audit function in discharging its duties effectively (see Module HC - Appendix A: Duties and Responsibilities of the Audit Committee).

5.1.4 The board of directors must review at least annually, the effectiveness and efficiency of the internal control system based, in part, on information provided by the internal audit function (see HC-1.2.10). Moreover, as part of their oversight responsibilities, the board of directors must review the performance of the internal audit function. From time to time, and in any case at no more than five-yearly intervals, the board of directors must commission an independent external quality assurance review of the internal audit function.

5.1.5 Senior management, under the supervision of the Board, must develop an internal control framework that identifies, measures, monitors and controls all risks faced by the bank. It must maintain an organisational structure that clearly assigns responsibility, authority and reporting relationships and ensures that delegated responsibilities are effectively carried out. Senior management must report to the board of directors on the scope and continued effectiveness of the internal control framework (see Appendix A of HC Module (f)).

5.1.6 Senior management must 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.

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

5.1.8 The Board must 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 (see Appendix A of HC Module (e)).

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

5.1.9 The audit committee must oversee the bank's internal audit function (see also HC-3.2.3).

5.1.10 The audit committee must ensure that the internal audit function is able to discharge its responsibilities in an independent manner, consistent with Section 2 of this document. It also must review and approve the audit plan, its scope, and the budget of the internal audit function. It must also review audit reports and ensure that senior management is taking necessary and timely corrective actions to address control weaknesses, any aspects of non-compliance with policies, laws and regulations, and other concerns identified and reported by the internal audit function (see Appendix A of HC Module).

d) Management of the internal audit department

5.1.11 The head of the internal audit department must ensure that the department complies with internationally recognized internal auditing standards established by a professional body responsible for the internal audit profession, and with the relevant code of ethics as established by that body.

5.1.12 The audit committee must ensure that the head of the internal audit function holds relevant, appropriate, and current recognition as a member of a professional body which is internationally recognized as having oversight of, and responsibility for, the internal audit profession. The head of internal audit must be a person of unblemished integrity. This means that he or she will be able to perform his or her work with honesty, diligence and responsibility. It also requires that this person observes the law and has not at any time been a party to any illegal or unethical activity. The head of internal audit must also ensure that the members of internal audit staff are persons of the utmost integrity.

e) Reporting lines of the internal audit function

5.1.13 The internal audit function must be accountable to the audit committee, on all matters related to the performance of its mandate as described in the internal audit mandate. It must also promptly inform senior management about its findings.

5.1.14 The internal audit function must inform senior management of all significant findings so that timely corrective actions can be taken. Subsequently, the internal audit function must follow up with senior management on the outcome of these corrective measures. The head of the internal audit function must report to the audit committee, the status of findings that have not been rectified by senior management.

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

5.1.15 The internal audit function must 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 to the Board.

5.1.16 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 the management of 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 controls over the processes created in the first and second lines of defence and provides assurance on these controls. The responsibility for internal control does not transfer from one line of defence to the next line.

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

6.1 Internal audit within a group or holding company structure

6.1.1 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.

6.1.2 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 must ensure that internal audit activities are conducted effectively at the bank according to the principles and spirit of this Module/chapter. The internal auditors who perform the internal audit work at the bank must report to the bank's audit committee, or its equivalent, and to the group or holding company's head of internal audit.

6.1.3 The board of directors and senior management of the parent bank in a banking group must ensure that an adequate and effective internal audit function is established across the banking organisation and must ensure that internal audit policies and practices are appropriate to the structure, business activities and risks of all of the components of the group or holding company.

6.1.4 The head of internal audit at the level of the parent bank must 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.

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

6.1.6 If a bank has a significant branch abroad, the internal audit function must consider establishing a local office to ensure the timeliness, efficiency and continuity of its work. Such a local office must be part of the bank's internal audit department and must be organised in such a way as to comply with the principles set out in this Module/Chapter.

6.1.7 In the case of more complex group structures, including SPVs or other entities under the control of the bank, the bank must set up a Group Internal Audit function with

explicit responsibility for the internal audit of the group in relation to the implementation of group policies and procedures at subsidiary level. The Group Internal Audit function must be organised in such a way as to comply with the principles set out in this document and to have equivalent lines of communication to the concerned individual internal audit functions and to all concerned bodies within the Group.

7.1 Outsourcing of internal audit activities

7.1.1 The head of internal audit must ensure that any outsourcing providers comply with the principles of the bank's internal audit mandate. The head of internal audit must ensure that the outsourcing provider 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 must not provide consulting services to the bank they have audited within the previous 12 months (see OM-3).

8.1 Communication between the CBB and the internal audit function

8.1.1 The bank's internal auditors must have formal communication with the CBB on at least a quarterly basis to (i) discuss the risk areas identified, (ii) understand the risk mitigation measures taken by the bank, and (iii) monitor the bank's response to weaknesses identified.

8.1.2 The internal audit function is a key building block of the internal control environment because it provides an independent assessment of the appropriateness and adequacy of, and compliance with, the bank's established policies and procedures. Therefore, the CBB has an interest in engaging in a constructive and formalised dialogue with the internal audit function. Such dialogue can be a valuable source of information on the quality of the internal control environment.

8.1.3 The bank's internal auditors must meet on at least a quarterly basis with the CBB to discuss their risk analysis, findings, recommendations and the progress against the audit plan. The CBB will decide on a case per case approach whether other members of senior management must or must not be present at these meetings. These meetings are intended to facilitate the understanding of how and to what extent the recommendations made by the CBB or its representatives (including those made during on-site reviews) and internal auditors have been implemented. These meetings are required to enable the CBB to ensure the effectiveness of the actions taken by the bank to carry out these recommendations. The frequency of these meetings will be commensurate with the bank's size, the nature and risks of its operations and the complexity of its organisation. The CBB may also request copies of internal audit reports from time to time.

8.1.4 Internal audit should be able to provide the CBB with insight on a bank's business model including the inherent and residual risks in the bank's business activities, processes and functions, and the adequacy of the control and oversight of these risks. Examples include:

(i) Application and effectiveness of risk management procedures and risk assessment methodologies, as applied to credit risk, market risk, liquidity risk, operational risk (including information technology and business continuity management), and other risks relevant to CBB capital adequacy requirements;
(ii) Contingency planning;
(iii) Outsourcing arrangements; and
(iv) Fraud risk.

8.1.5 To the extent that accounting data drives certain regulatory measures or is included in regulatory reporting and market conduct issues as identified through the audit of the compliance function, internal audit must provide the CBB with the result of their work relating to:

i) Measurement (including fair values) and impairment of financial instruments;
ii) Significant transactions in financial instruments with a regulatory impact;
iii) Other judgemental accounting areas, including estimates;
iv) Transaction reporting;

v) **Adherence to rules for dealing with client assets;**
vi) **Anti-money laundering processes and controls; and**
vii) **Management of conflicts of interest.**

Appendix 1: Responsibilities of a bank's audit committee

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 audit

(f) monitoring and reviewing the effectiveness of the bank's internal audit function;
(g) approving the internal audit plan, scope and budget;
(h) reviewing and discussing internal audit reports;
(i) ensuring that the internal audit function maintains open communication with senior management, external auditors, the supervisory authority, and the audit committee;
(j) reviewing discoveries of fraud and violations of laws and regulations as raised by the head of the internal audit function;
(k) approving the audit mandate and the code of ethics of the internal audit function;
(l) approving, or recommending to the board for its approval, the annual remuneration of the internal audit function as a whole, including performance awards;
(m) assessing the performance of the head of the internal audit function; and,
(n) 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 external auditor

(o) approving a set of appropriate objective criteria for approving the external audit firm of the bank;
(p) approving, or recommending to the board or shareholders for their approval, the appointment, re-appointment and removal of the external auditor;
(q) approving the remuneration and terms of engagement of the external auditor.
(r) overseeing the external audit of the annual and consolidated accounts;
(s) discussing with the external audit firm key matters arising from the external audit, and in particular any identified material weaknesses in internal control in relation to the financial reporting and other processes; and,
(t) discussing the written representations the external audit firm is requesting from senior management and, where appropriate, those charged with governance;

Compliance with relevant ethical requirements, in particular independence and objectivity

(u) reviewing and monitoring the independence of the 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;
(v) reviewing and monitoring the external auditor's objectivity and the effectiveness of the audit process;
(w) developing and implementing a policy on the engagement of the 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,
(x) 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 bank and its components controlled by the bank.

Remedial actions
(y) ensuring that senior management is taking appropriate and relevant corrective actions to address the findings and recommendations of internal auditors and external auditors in a timely manner;
(z) remedying control weaknesses, non-compliance with policies, laws and regulations and other control issues identified by internal auditors and external auditors, and
(aa) 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 in a timely manner.