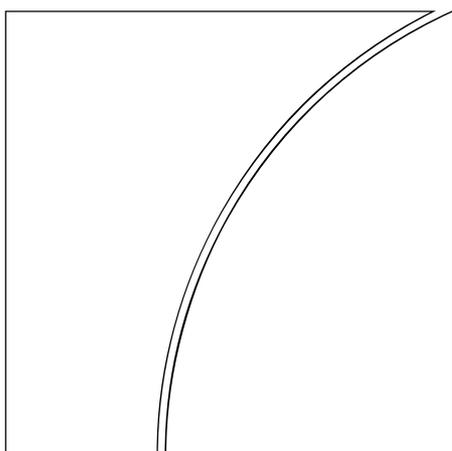


Basel Committee on Banking Supervision

Internal audit in banks and the supervisor's relationship with auditors: A survey

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Internal Audit in Banks and the Supervisor's Relationship with Auditors: A Survey

Introduction

1. Strong internal control, including an internal audit function and an independent external audit, are part of sound corporate governance. In banks, these are also important for the safety and soundness of operations and can contribute to an efficient and constructive working relationship between bank management and banking supervisors. Appropriate communication between banking supervisors and banks' internal and external auditors will improve the effectiveness of audits and supervision.

2. In August 2001 the Basel Committee on Banking Supervision issued its best practices paper "*Internal audit in banks and the supervisor's relationship with auditors*" (the Internal Audit Paper), which highlights the important work of internal auditors in banking organisations and the need for cooperation between banking supervisors and banks' internal and external auditors.

3. Importantly, the Internal Audit Paper calls for a permanent and independent internal audit function in all banks, and provide a number of guiding principles concerning internal audit. As its starting point, the paper emphasizes the responsibilities of the board of directors and senior management in the areas of internal controls, risk measurement and compliance with laws and regulations. The importance of internal auditors independence is also underlined. Accordingly, each bank should have an internal audit charter, which has been approved by senior management and confirmed by the board of directors, to enhance the standing and authority of the internal audit function. Because the operations of modern banks are increasingly complex, internal auditors must have adequate professional competence and apply risk-focused approaches in their work. The Internal Audit Paper further notes that the work of banks' internal auditors can support banking supervisors' work. Banking supervisors should therefore have periodic consultations with each bank's internal auditors to discuss the risk areas identified and the measures taken.

4. The survey results presented in this report indicate that the important principles for internal audit that the Basel Committee promotes are obtaining general acceptance within the banking industry.

5. The Basel Committee issued an updated and expanded version of its paper "*The relationship between banking supervisors and banks' external auditors*"¹ in January 2002. This document was jointly developed with the International Auditing Practices Committee (IAPC).² The Basel Committee and the IAPC share the view that a greater understanding among banking supervisors and external auditors of their respective tasks and responsibilities will enhance the effectiveness of each party's work.

6. The Basel Committee documents referred to in this paper are available on the website of the Bank for International Settlements at www.bis.org.

¹ This document is also known as International Auditing Practice Statement 1004.

² The IAPC has been renamed *International Auditing and Assurance Standard Board (IAASB)*.

The Survey

7. The Accounting Task Force of the Basel Committee conducted a survey during 2001 and 2002 to find out how key arrangements have been made for the internal audit function in a sample of banks in 13 countries. Structured around the principles set forth in the Internal Audit Paper³, the survey also looked into the relationship between banking supervisors, internal auditors and external auditors. This report, which has benefited from input from the Institute of Internal Auditors (IIA), presents a broad overview of the findings of the survey.

8. The survey covered the banking supervisors and 71 banks in the following countries represented in the Basel Committee: Belgium, France, Germany, Italy, Japan, Luxembourg, Netherlands, Spain, Sweden, Switzerland and the United States. Austria and Singapore, observers in the Committee's Accounting Task Force, also participated in the survey.

9. The information about banks that was gathered in the survey is based on the national supervisory authorities' own knowledge, supplemented with interviews of internal auditors and others in a sample of banks of various sizes in the participating countries. Even though the sample may not be representative of the state of internal audit in the banking industry in all participating countries, the survey provides useful results. The findings of the survey should however be read with some caution as this type of survey may provide somewhat biased answers.

Key findings of the survey

Internal audit

10. According to the Basel Committee's Internal Audit Paper, the scope of internal audit, from a general point of view, includes the following:

- the examination and evaluation of the adequacy and effectiveness of the internal control systems;
- the review of:
 - the application and effectiveness of risk management procedures and risk assessment methodologies;
 - the management and financial information systems, including the electronic information system and electronic banking services;
 - the accuracy and reliability of the accounting records and financial reports;
 - the means of safeguarding assets;
 - the bank's system of assessing its capital in relation to its estimate of risk; and
 - the systems established to ensure compliance with legal and regulatory requirements, codes of conduct and the implementation of policies and procedures;

³ Principle 10, concerning the review of the bank's internal capital assessment procedure was not included in the survey, as this assessment is not yet a formal part of the Basel Capital Accord.

- the appraisal of the economy and efficiency of the operations;
- the testing of both transactions and the functioning of specific internal control procedures;
- the testing of the reliability and timeliness of the regulatory reporting; and
- the carrying-out of special investigations.

11. The survey shows that, in practice, the scope of internal audit also is broad and includes such major areas as internal control systems, risk management procedures, financial information systems, testing of transactions and procedures, adherence to legal and regulatory requirements, testing of regulatory returns and special investigations.

12. Although most surveyed countries report that the audit of accounting records is within the scope of internal audit, the audit of the bank's financial statements is not included in the scope of internal audit of some banks in some countries. In these cases, auditing financial statements seems to be considered the sole responsibility of the bank's external auditors, the role of internal audit in this area being limited to supporting the external auditors.

13. The survey shows that there is an increasing tendency for the area of adherence to legal and regulatory requirements to be evaluated by a separate compliance function rather than by internal audit. Recent corporate failures as well as the Basel Committee's paper "*Customer due diligence*" (October 2001) illuminate the importance of banks having in place adequate arrangements for assessing that legal and regulatory compliance is ensured. The Committee will consider the need for guidance that encourages sound practices in this area.

14. Surveyed banks consider whistle blowing by internal auditors to compromise their function. They consider informing the supervisor to be a task of the board of directors and, at least in many countries, also of the external auditors.

15. The survey's findings concerning the scope of internal audit are broadly consistent with the IIA's definition of internal auditing: "Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organisation's operations. It helps an organisation accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes." (Source: <http://www.theiia.org>.)

Internal audit and consulting

16. An important issue relating to internal audit is the use of internal auditors as in-house consultants. The need for objectivity and impartiality does not necessarily exclude them from giving advice in their area of expertise. However, the Committee is convinced that advising or consulting should be ancillary to the basic function of internal audit, which is an independent appraisal function established within the bank to examine and evaluate its internal control systems. In cases where the audit committee authorizes the internal auditors to offer ancillary consulting services, caution should be exercised so that objectivity in evaluating activities on which the staff has consulted is not compromised. The IIA's Standards for the Professional Practice of Internal Auditing (the IIA's Standards) address issues relating to internal auditors performing consulting services.

17. The surveyed banks indicated that by far most of the internal auditors' time, between 75–95%, is spent on internal auditing. The time spent on training and on consulting ranges from 5–20% and from 0–20%, respectively. Concerning their consulting work, the surveyed auditors stressed that they are not taking any operational responsibility. Responding banks

indicated that consulting is restricted to making control-related recommendations to specific major projects or plans. Banks seem to be aware of the need to ensure that any consulting work performed by internal auditors does not compromise the responsibility and independence of internal audit.

Objectives and tasks of the internal audit function

18. The Basel Committee's Internal Audit Paper states that 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 internal policies. The board of directors should at least once a year review the internal control system and the capital assessment procedures. The bank's senior management is responsible for developing processes that identify, measure, monitor and control risks incurred by the bank. At least once a year senior management should report to the board of directors on the scope and performance of the internal control system and the capital assessment procedures.

19. The surveyed banks indicated that their boards of directors and senior management are aware of the importance of these best practices and that the boards and senior management undertake the responsibilities described in the Internal Audit Paper.

20. The boards of directors of the surveyed banks have taken a variety of structural measures to manage their responsibilities, including:

- drawing up an audit charter;
- creating an audit committee or an audit and risk management committee within the board;
- promoting regular contact between internal and external auditors;
- restructuring the internal audit department in accordance with supervisory instructions;
- issuing policy guidance for the internal audit function; and
- reviewing and approving annual audit plans of the internal auditors.

Principles of internal audit

Permanent function - continuity

21. The Basel Committee's Internal Audit Paper states that each bank should have a permanent internal audit function. In fulfilling its duties and responsibilities, senior management should take all necessary measures so that the bank can 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.

22. All surveyed banks confirm that they have created permanent internal audit functions.

23. In general, senior management takes various actions to verify that it has provided the appropriate resources and staffing to the internal audit department. This is done either on a continuing basis or on a yearly basis by comparing the work done by the internal auditors with the work planned. Another means of determining appropriateness of resources would be to conduct periodic benchmarking activities to compare a bank's internal audit function to other banks within its peer group.

24. Internal audit is not a sizeable activity in a bank as internal auditors represent on average about 1 % of the work force of a bank. The actual percentage of internal auditors on an individual bank's work force varies and depends on the size of the bank and on its activities.

Independence, objectivity and impartiality

25. The Basel Committee's Internal Audit Paper reminds readers of the importance of an internal audit department functioning in accordance with the principles of independence, objectivity and impartiality. Compliance with the IIA's Standards, is also helpful to support these principles. Effective in January 2002, the IIA's Standards require that audit departments have ongoing quality improvement processes including an independent quality review every five years.

26. All surveyed banks stated that their internal audit departments are independent of the activities audited and of everyday internal control processes. All internal audit departments believe they are able to exercise their assignments without management interference and are free to report their findings and appraisals and to disclose them internally without management interference. These rights of the internal audit departments are assured by the establishment of audit charters, by supervisory regulation or by both. An audit charter enhances the standing and authority of the internal audit department within the bank.

27. All audit charters are approved by the board of directors or at an equivalent level, given the particularities of the different corporate governance models in the various countries. In general, the audit charters are communicated to all staff within the bank or at least made available to them (e.g. through an Intranet). However, in a small number of surveyed banks the audit charter is only communicated to a more limited number of people, such as the audit staff and management.

28. Almost all of the surveyed banks authorize the head of internal audit to communicate directly and on his/her own initiative to the board of directors, typically through its chairman, the members of the audit committee and, where appropriate, to the external auditors. The Basel Committee underlines in its Internal Audit Paper that the head of the internal audit department should have the authority to communicate in this manner according to rules defined by each bank in its audit charter.

29. The measures taken to safeguard objectivity and impartiality vary across the surveyed banks. The most often cited measures include:

- rotation of staff assignments within the audit department;
- no involvement in the operations of the bank;
- recognition of the internal auditors' independence in the audit charter; and
- an internally recruited auditor is not involved in the audit of his/her previous activity for a certain period.

Other measures that are taken include:

- internal auditors are recruited from outside the bank;
- formal review of and appraisal procedures for audit work and working papers;
- no performance or profit-related remuneration of internal auditors;
- segregation of duties in the implementation of recommendations; and
- no auditor involvement in the design of control and other administrative procedures.

Professional competence

30. The Basel Committee's Internal Audit Paper states that the professional competence of internal auditors is essential for the proper functioning of internal audit. The survey indicates that internal auditors are highly trained, particularly in the larger banks and in specialized areas such as the audit of trading activities and information technology (IT). This does not preclude the internal audit department from referring specialized IT audits to an external auditor. When recruiting internal auditors, smaller banks tend to look more to an individual's professional knowledge and experience in banking than to formal education or professional designations.

31. Professional competence is maintained through a variety of ways. The following are cited most often:

- on-the-job training;
- formal internal and external training (certified auditors are often subject to mandatory post-qualification continuing education);
- staff rotation within the audit department (although some think this may conflict with the need for specialization); and
- encouragement to become a Certified Internal Auditor.

Scope of activity and the organisation of the internal audit department

32. Particularly important for supervisors is that, consistent with the Internal Audit Paper, all surveyed banks report that every activity and every entity of the bank falls within the scope of the internal audit. In this regard, the survey inquired about the way internal audit departments are organised, particularly for larger international banks and for banks that are part of financial conglomerates.

33. According to the survey responses, the most common model for the organisation of internal audit is a centralized internal audit department. In larger banks, branches abroad may have a local internal audit unit. However, these local audit units are coordinated by the internal audit department of the head office. In smaller banks that are part of a group, internal audit may be outsourced to a group internal audit department.

34. At larger surveyed institutions, internal audit is often organised along business lines. The heads of these business line internal audit departments report to the head of the group internal audit department.

Functioning of internal audit

Working methods and types of audits

35. The activities of the internal audit department should include drawing up a risk-based audit plan, examining and assessing the available information, communicating the results, and following up recommendations. The surveyed banks indicate that they comply with this principle. The management of the internal audit department is responsible for preparing a risk-based audit plan, normally on an annual basis. These plans are approved by the bank's senior management or by the board (or its audit committee), depending on the corporate governance model.

36. Almost all banks report that various types of internal audits are performed by the internal audit department. The audit types mentioned are financial audit, compliance audit, operational audit and management audit.⁴ Management audits are performed less frequently than the other types of audits.

37. Banks report that their audit plans are risk-focused. This is achieved through a variety of methods, like scoring models and methods assessing qualitative and quantitative information. The IIA's Standards state that internal audit activities should assist the organisation by identifying and evaluating significant exposures to risk and contributing to the improvement of risk management and control systems. Best practices support a formal report on the assessment of risk to be delivered to the audit committee on at least an annual basis.

Procedures

38. All surveyed internal audit departments report that they prepare audit programs and document audit procedures in working papers. All state that they prepare written reports on a timely basis after each assignment. The audit reports are in general addressed and distributed to the auditees and senior management. Some surveyed banks mentioned that the actual distribution of audit reports depends on the severity of the audit results.

39. In all surveyed banks, the internal audit department follows up its recommendations to see whether they are implemented. The frequency depends in general on the importance of the recommendations.

40. All surveyed internal audit departments report that they regularly inform senior management about the status of implementation of the internal audit department's

⁴ These terms were not defined in the survey, but they typically mean the following:

- a financial audit aims to assess the reliability of the accounting system and information and of resulting financial reports;
- a compliance audit aims to assess the quality and appropriateness of the systems established to ensure compliance with laws, regulations, policies and procedures;
- an operational audit aims to assess the quality and appropriateness of other systems and procedures, to analyse the organisational structures with a critical mind, and to evaluate the adequacy of the methods and resources, in relation to the assignment; and
- a management audit aims to assess the quality of management's approach to risk and control in the framework of the bank's objectives.

recommendations. Depending on the severity of the audit findings, the internal audit department may inform the board of directors or the audit committee.

Management of the internal audit department

41. The surveyed banks confirm that the head of the internal audit department is responsible for ensuring that the department complies with sound internal audit principles. This is consistent with the principles in the Basel Committee's Internal Audit Paper.

42. According to the surveyed banks, the head of the internal audit department is also responsible for ensuring the use of sound internal audit standards by the internal audit staff, the existence of an up-to-date audit charter, the preparation of an appropriate audit plan, the existence of appropriate and up-to-date written policies and procedures for the internal audit staff, the appropriate professional competence and training of the audit staff and the adequacy of the internal audit department. The survey did not specifically inquire about the use of an external quality assurance review. Effective in January 2002, such a review is required at least once every five years by the IIA's Standards.

43. The surveyed banks note that their appropriate management levels receive a regular report for discussion from the head of the internal audit department. This report covers the progress compared to the audit plan and the results of recent audits.

The relationship of the supervisory authority with the internal audit department and with the external auditor

The relationship between the supervisory authority and the internal audit department

44. As recommended by the Internal Audit Paper, all supervisors participating in the survey evaluate the work of the internal audit departments of the banks they supervise. This is done through periodic meetings, on-site evaluations, or reporting to the supervisor. Supervisors report having consultations with the internal auditors to discuss the functioning of the internal audit department and the findings of the department, particularly in areas presenting a significant risk. Supervisors review internal audit reports to identify control problems and areas of potential risks. Supervisors in supervisory regimes where the external auditor has a specific role in supervision also use reports prepared by the external auditor to obtain information about the work of the internal audit department.

45. Supervisors in some countries organise sector-based discussions with internal auditors about a wide variety of issues of common interest such as developments in supervisory regulation and its impact on internal controls and internal audit.

The relationship between the internal auditors and the external auditors

46. Almost all supervisors underline the importance of regular consultation between external and internal auditors. In many countries, external auditors use the work of internal auditors, but they must first undertake various measures to determine the extent to which they can rely on the internal auditors' work. This co-ordination enables a more effective external audit and avoids duplication of audit work.

The relationship between the supervisory authority and the external auditor

47. The role of external auditors in banking supervision differs from country to country, and ranges from almost no involvement in supervision to very close collaboration with the supervisor.

48. There are many areas where the work of the banking supervisor and the external auditor can be useful for each other. The relationship between supervisory authorities and external auditors should be based on the criteria described in the paper "*The relationship between banking supervisors and banks' external auditors.*" In that paper, the Committee recommends that timely and appropriate measures be taken so that external auditors cannot be held liable for information disclosed in good faith to the supervisory authorities in accordance with applicable laws and regulations. These measures can take the form of legal initiatives or can be an agreement among the bank, its management, the external auditor and the supervisory authority. It is also important that there exists a legal gateway that enables supervisory authorities to disclose information that would be of interest to the external auditor because it may help the external auditor's understanding of the supervisor's concerns or it could affect his/her audit work or other reporting responsibilities.

Cooperation among the supervisory authority, the external auditors and the internal auditors

49. Cooperation among the supervisory authority and the external and internal auditors aims to make the work of all concerned parties more efficient and effective. The cooperation may be based on periodic meetings of the three parties.

50. Most countries report that, in general, supervisors meet with a bank's internal and external auditors on an ad hoc basis, e.g. to discuss the results of an audit or an on-site inspection.

51. In a few countries, the supervisory authority regularly holds periodic meetings with the banks' external and internal auditors.

Outsourcing of internal audit

52. The Basel Committee's Internal Audit Paper states that 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 internal audit are adequate and operate effectively.

53. According to the survey, in all countries internal audit is considered to be a core activity of the banks. Accordingly, outsourcing of the internal audit function is not common in most countries and, when it does occur, will be limited to a service provider that is part of the group to which the bank belongs.

54. In most countries, outsourcing internal audit may be considered a more acceptable practice for smaller banks. In this case, it is stressed that the bank does not outsource the audit responsibility but only the audit work.

55. As a matter of principle some countries do not allow outsourcing of internal audit to the bank's external auditor.

Recent trends for internal audit in banks

56. Improving the quality and the efficiency of the internal audit department seems to be one of the priorities for the chief internal auditors. The main trends that have been reported are greater specialisation by auditors in order to be closer to the activity being audited (e.g. mergers and acquisitions), strengthening of the audit and assessment of internal models, and more emphasis on risk-oriented audits.