

**EASTERN CARIBBEAN CENTRAL BANK**



**GUIDELINES FOR INTERNAL AUDITING OF INSTITUTIONS  
LICENSED UNDER THE BANKING ACT**

**EASTERN CARIBBEAN CENTRAL BANK**  
May 2006

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## **Banking Prudential Guidelines No.4 of 2006**

The Eastern Caribbean Central Bank, in exercise of the powers conferred on it by section 36 of the Banking Act, 2004, No.4 of 2004 makes the following Prudential Guidelines –

### **INTRODUCTION**

#### **I. Overview**

These Guidelines aim to:

- a) Provide a framework for performance and promotion of a broad range of internal audit activities;
- b) Outline best practices for a financial institution's internal audit function;
- c) Establish the basis for measuring performance in the internal audit function;
- d) Indicate how the work of the internal audit function can improve the financial institution's processes and operations.

#### **II. Interpretation**

##### ***Audit committee***

The audit committee is a committee established by the board of a financial institution with oversight responsibilities for both the internal audit function and the external audit. Ideally, members of this committee should be independent of the management and should have a working knowledge of accounting processes and procedures.

##### ***Chief Executive Officer***

The highest-ranking executive officer within the financial institution, who is responsible for carrying out the board's policies and has responsibility for the over-all management of its day-to-day affairs under the supervision of the board of directors.

### ***Internal auditing***

Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve the financial institution's operations. It helps the organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes (*Institute of Internal Auditors (IIA) June 1999*).

### ***Internal auditor***

The internal auditor is an employee of a financial institution or independent third party who examines internal control procedures to ensure compliance with relevant laws and regulations and to ascertain that board directives and management policies are being properly executed.

### ***Vested interest***

The right of beneficial interest in real or personal property, which may be deferred for enjoyment in future years.

## **III. APPLICATION**

These guidelines apply to all financial institutions licensed under the Banking Act.

## **IV. COMMENCEMENT**

These guidelines shall come into effect on.....



## **GUIDELINES**

### **1.0 FRAMEWORK FOR INTERNAL AUDITING**

To promote effective and efficient internal auditing, a financial institution must ensure that the structure and staffing of the internal audit function is commensurate with the size, complexity and risk profile of the financial institution. It is imperative that measures be implemented to maintain an internal audit function of high quality.

#### **1.1 OBJECTIVES OF INTERNAL AUDITING**

The principal objective of the internal audit function is to assist management and the board of directors, through the audit committee, in the effective discharge of their responsibilities as follows:

- (a) To ensure that internal control, governance and risk management systems are reviewed, improved and optimised in response to the dynamic environment within which the financial institution operates.
- (b) To provide reasonable assurance to management, staff and the audit committee that significant risks in the financial institution are being appropriately managed, with an emphasis on the effectiveness of internal controls.
- (c) To contribute to the financial institution's governance processes by evaluating and improving the process through which the values and goals are established and communicated.
- (d) To monitor the accomplishment of goals and ensure that there is accountability.

#### **1.2 SCOPE**

The internal audit should entail the review of all areas of the financial institution including relevant systems, records, personnel and physical properties in order to satisfy the agreed upon objectives, to appraise and report on the adequacy of internal control systems (i.e.

managerial, financial, operational and budgetary controls) and their reliability. The scope should focus on, but not be limited to:

- (a) Examining and evaluating the adequacy and effectiveness of the internal control systems, including information technology controls, and considers the impact over annual and interim financial reporting. This should include:
  - (i) Reliability and integrity of financial and operational information systems;
  - (ii) Effectiveness and efficiency of operations;
  - (iii) Safeguarding of assets;
  - (iv) Compliance with laws, regulations and controls.
- (b) Reviewing the application and effectiveness of risk management procedures and risk assessment methodologies;
- (c) Reviewing the financial institution's system of assessing adequacy of its capital in relation to the estimate of risk to capital;
- (d) Appraising the efficiency and effectiveness of operations given the current operating environment;
- (e) Testing transactions and internal control procedures;
- (f) Analysing systems established to ensure compliance with legal and regulatory requirements, codes of conduct and the institution's policies and procedures;
- (g) Testing the reliability and timeliness of regulatory reporting; and
- (h) Conducting special investigations.

- 1.3 Senior management should ensure that the internal audit department is kept fully informed of new developments, initiatives, products and operational changes to ensure that all associated risks are identified at an early stage and adequate controls and documentation are in place to address any identified risks.
- 1.4 The actual areas to be reviewed by the internal audit unit should be determined by a risk assessment of the internal control systems. The results of this assessment will guide the internal audit planning process.

## **2.0 THE AUDIT COMMITTEE**

The board of directors should develop a charter detailing the audit committee's composition, authority, duties and the manner in which the committee should report to the board. The charter should be approved by the board of directors and reviewed and updated periodically.

### **2.1 FUNCTIONS/RESPONSIBILITIES**

The audit committee should inter alia be charged with:

- (a) Reinforcing the internal control system and the internal and external audit capabilities;
- (b) Communicating internal audit plans, resource requirements and limitations, including significant interim changes, to senior management and to the board of directors for review;
- (c) Establishing policies and procedures to guide the internal audit activity;
- (d) Reviewing the effectiveness of risk management policies;
- (e) Overseeing the reliability and accuracy of financial information provided to management and external auditors;

- (f) Communicating to relevant personnel, any material, accounting or auditing concerns identified as a result of the internal audit;
- (g) Confirming the audit programme, the internal audit plan, and resource requirements;
- (h) Reviewing activity reports, summary of the internal auditor's recommendations and corrective action taken by management;
- (i) Evaluating the financial institution's compliance with legal and regulatory provisions, its articles of association, charter and bylaws, and rules established by the board of directors;
- (j) Reporting periodically to the board on the performance of internal audit relative to the audit plan;
- (k) Reporting to the board and senior management significant risk exposures and control issues, corporate governance issues, and other matters requested by the board or audit committee;
- (l) Reviewing the functioning of the Internal Auditor/Unit to ensure that no limitations are placed on the scope of the work performed;
- (m) Overseeing the performance of the external auditor; and
- (n) Approving the appointment and dismissal of the head of internal audit.

## **2.2 COMPOSITION AND POWERS OF THE AUDIT COMMITTEE**

- 2.2.1 The audit committee should consist of principally non-executive directors. The size of the committee should vary according to the size, complexity and risk profile of the financial institution, but should comprise a minimum of three directors.
- 2.2.2 Each member shall have experience in Banking, Finance, Accounting or other related fields, and maintain competence at the time of his or her appointment, as determined by the board based on industry standards. At least one member should be designated as a financial expert.
- 2.2.3 There should be the requirement for continuous professional development for members of the audit committee to keep abreast with developments in the industry, in particular control and reporting requirements.
- 2.2.4 The committee may request access to any data or records and may order an investigation into irregularities disclosed in accounts, audits or other data.
- 2.2.5 To ensure efficiency and transparency of the audit committee, the chief executive officer, senior management and the external auditor should not be in regular attendance at audit committee meetings. Attendance of those persons should be only by invitation from the audit committee, as required.
- 2.2.6 The audit committee should meet at least once each quarter.

## **3.0 INTERNAL AUDIT INDEPENDENCE**

### **3.1 INDEPENDENCE**

The internal audit function should be independent in substance and appearance. When assessing the independence of internal auditing, the financial institution should consider, among other things, the following:

- (a) The financial institution's internal auditing activities should be independent of its daily operations and internal control processes.
- (b) In the performance of his duties, the internal auditor should be free from managerial or other interference in determining the scope of internal auditing, performing the audit tasks, and communicating results.
- (c) The internal auditor should not have a vested interest in any area of the financial institution.
- (d) The audit committee should recommend to the board the appointment and termination of the internal auditor.
- (e) The committee should ensure that the internal auditor's compensation scheme, appraisal and termination arrangements are consistent with the qualification, experience and performance of the internal auditor.
- (f) The internal audit function should be subject to an independent review by the audit committee, the external auditor or a qualified party.

### **3.2 OBJECTIVITY**

The internal auditor should be impartial and unbiased in performing the audit.

3.2.1 The internal auditor must disclose to the audit committee or the board of directors any situation that is likely to affect or might be perceived as affecting his impartiality.

3.2.2 The internal auditor should be removed or re-assigned in response to any perceived, actual, threatened or future bias.

### **3.3 ORGANISATIONAL STATUS OF THE INTERNAL AUDIT FUNCTION**

3.3.1 The organisational status of the internal audit unit should be sufficient to permit the accomplishment of its audit responsibilities.

3.3.2 The internal auditor should have the authority to communicate directly, and on his/her own initiative, to the board of directors, the chairman of the board of directors, the members of the audit committee or the external auditors, in accordance with policies and procedures established by the financial institution.

### **3.4 THE AUDIT CHARTER**

The internal audit charter should enhance the organisational status and authority of the internal audit unit within the financial institution.

3.4.1 The charter should at a minimum:

- (a) Specify the objectives and scope of the work of the internal audit unit;
- (b) Establish the internal audit function's position, powers and responsibilities within the organisation and define its relations with other control functions;
- (c) Underscore the accountability of the internal auditor; and
- (d) Outline the terms and conditions under which the internal audit function can be requested to provide consulting or advisory services or to carry out special tasks.

3.4.2 The internal auditor and audit committee should review the audit charter periodically. As part of its supervisory role the board of directors or audit committee is required to approve the charter.

3.4.3 The charter gives the internal audit unit the right to initiate activities relevant to the performance of its assignments. In particular, the charter should give the audit unit/department the right to:

- (a) Have direct access to and communicate with any member of staff;
- (b) Examine any activity or entity of the financial institution;
- (c) Access any records, files or data of the financial institution, including management information and the minutes of all consultative and decision-making bodies.

3.4.4 The charter should be circulated throughout the financial institution.

#### **4.0 PROFESSIONAL COMPETENCE**

Internal audits should be performed with proficiency and due professional care. The financial institution should ensure that the technical proficiency and educational background of internal audit staff are appropriate.

4.1 The officer in charge of the internal audit unit should possess at least a college/university degree and/or have some formal training in the practice of auditing. The officer in charge of the internal audit unit should be encouraged, where necessary, to work towards the attaining of a professional designation in auditing or accounting.

4.2 Internal audit staff should maintain technical competence through continuing education and training. Staff should also have sufficient up-to-date knowledge of auditing techniques and developments in the financial services sector.

#### **5.0 RESPONSIBILITIES OF THE INTERNAL AUDITOR**

The internal auditor should comply with professional standards established by internationally recognised professional bodies such as the IIA.

5.1 It is the responsibility of the head of the internal audit function to:

- (a) Establish plans to carry out the duties of the internal audit unit;
- (b) Develop written policies and procedures to guide the audit staff;
- (c) Establish a programme for selecting and developing the human resources of the internal audit function;
- (d) Collaborate with the institution's external auditors to ensure that they complement each other;
- (e) Establish and maintain a quality assurance and improvement programme in collaboration with the audit committee to continuously evaluate the effectiveness of the internal audit function and its conformity with recognised standards on auditing;
- (f) Maintain all working papers. These should adequately document all the work performed by the internal audit function, and support the conclusions reached;
- (g) Review the work of the audit support staff to ensure that they possess a level of technical competence appropriate to their assigned duties; and
- (h) Review the work of the internal audit support staff to ensure that their technical competency is adequate.

## **6.0 AUDIT PROGRAMME**

- 6.1 The internal auditor must prepare an audit plan which outlines every area to be audited in the financial institution. The plan should establish priorities, set objectives and ensure the efficient and effective use of audit resources. The audit programme should be based on the terms of reference of the internal audit unit as well as the audit risk assessment of the financial institution.
- 6.2 The audit plan should be documented and approved by the board of directors upon the recommendation of the audit committee and be amended as necessary to take account of changing circumstances. All amendments have to be approved by the audit committee or board of directors.
- 6.3 In developing the audit plan the following steps should be included:
- (a) Identify all auditable activities within the agreed scope of the internal audit;
  - (b) Conduct a risk assessment of these activities in conjunction with management, identifying categories such as high, medium, low risk;
  - (c) Prepare an audit needs assessment based on the risk assessment performed;
  - (d) Develop an overall audit plan from the audit needs assessment to cover risks identified;
  - (e) Identify and advise the audit committee of any mismatch between internal audit needs and actual resources;
  - (f) Complete all significant activities and systems in the period for which the plan is formulated. Ideally this should be annually;

- (g) Discuss the overall and individual audit plans with appropriate senior managers and the audit committee and amend as necessary; and
- (h) Present the audit plans to the audit committee for approval.

## 6.4 PROCEDURES

- 6.4.1 Every activity should be covered in the audit programme. It should describe the objectives and outline the audit work necessary to achieve these objectives. The procedures should be flexible and risk-based.
- 6.4.2 The audit report of each system/activity audited is to be issued as quickly as possible to the head of the area audited, the chief executive officer, the audit committee and senior management. The audit report presents the purpose and scope of the audit and includes the internal audit findings and recommendations, as well as management's responses.
- 6.4.3 The internal auditor should follow up to ascertain that appropriate action is taken on reported audit findings. The status of implementation of recommendations should be reported to senior management, the audit committee and/or the board of directors at regular intervals. Senior management should ensure that internal audit's concerns are appropriately addressed in a timely manner.
- 6.4.4 The internal auditor should also provide an annual report to senior management and the audit committee based on a self-administered quality review of the internal audit function.

## 7.0 OUTSOURCING

- 7.1 If the financial institution decides to outsource the internal audit function, the board of directors and senior management of an institution are responsible for ensuring that both the system of internal control and the internal audit function operate effectively. They

should maintain ownership of the internal audit function and provide active oversight of the outsourced activities.

7.2 Before a decision is made to outsource the internal audit function, the financial institution should consider the following:

- (a) The competence of the vendor;
- (b) Management of the vendor's business;
- (c) The system for maintaining communication between the internal audit function and the audit committee and senior management;
- (d) Contingency Plans to deal with any unanticipated events.

7.3 The institution should have a written contract (an engagement letter), which should cover at a minimum:

- (a) Expectations and responsibilities under the contract for both parties;
- (b) Scope and frequency of engagements;
- (c) Fees;
- (d) Work to be performed;
- (e) Reporting requirements (type, frequency, to whom);
- (f) Establish the process for changing the terms of the service contract, especially for expansion of audit work if significant issues are found, and stipulations for default and termination of the contract;

- (g) Ownership of internal audit reports and working papers and location of and access to them;
- (h) Terms for dispute resolution;
- (i) Liability for the cost of damages arising from errors, omissions, and negligence; and
- (j) State that the outsourcing vendor will not perform management functions, make management decisions, or act or appear to act in a capacity equivalent to that of a member of management or an employee.

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