

NEXTLEVELSOLUTIONS RISK AND REGULATORY INSIGHTS

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INTRODUCTION

As a firm delivering solutions in the areas of Governance, Risk and Compliance (GRC) NextLevelSolutions is always cognizant of the need for regulated and non-regulated organizations to be fully updated on developing issues. Through our *Risk and Regulatory Insights*, we provide updates from a variety of sources together with insights, analyses and suggestions. *Risk and Regulatory Insights* seeks to bring focus to critical issues of which boards and senior management, risk and regulatory practitioners should be aware. In this very first issue, we look at the recent Central Bank of The Bahamas Guideline for assessing the effectiveness of the Internal Audit (IA) function in Supervised Financial Institutions (SFIs)

The Guideline was issued for consultation with the period ending in February this year. It effectively seeks to formalize widely applied IA best practices but more fundamentally, it will change the face of the relationship between those responsible for executing internal audit functions and those responsible for the corporate governance in SFIs. We provide for your perusal each section of the Guideline with brief commentary. You are encouraged to review in conjunction with the Guidelines: <https://www.centralbankbahamas.com/news/press-releases/internal-audit-guidelines-2021-industry-consultation>. To discuss any aspect of this document or the Guideline see contacts at the end of the document.

SECTIONS OF GUIDELINE	INSIGHTS
<p>1. Purpose - “These Guidelines set out the minimum standards that the Central Bank expects SFIs to adopt in respect of their internal audit function. SFIs are required to ensure that the internal controls in place are adequate to mitigate risks, governance processes are effective and efficient, and organisational goals and objectives are met”.</p>	<p>The Guideline is directed at the heart of effective risk management and corporate governance recognizing the critical impact of Internal Audit on the efficacy of these systems. Note that <i>this represents only a minimum standard</i> and should be treated as such in all material regard.</p>
<p>2. Applicability – “These Guidelines apply to all banks, banks and trust companies, credit unions and money transmission businesses incorporated in The Bahamas...These Guidelines do not apply to branches of foreign banks”</p>	<p>While this is related to regulated organizations, it is <i>instructive for any organization that require an internal audit function</i>. Used in conjunction with International Standards for the Professional Practice of Internal Auditing from www.theiia.org it provides effective guidance on what is expected in an effective IA regime.</p>
<p>3 Scope of Internal Audit – “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. The principal objective of internal auditing is to assist the Board of Directors (“the Board”), via the Audit Committee, in the effective discharge of their responsibilities”.</p>	<p>Often IA functions are not designed to facilitate independence or the actions and decisions of senior management and the board, and sometimes the indiscipline actions of IA professionals undermine it. It is critical to note the roles of IA and its contribution to governance through its support of the Board of Directors. <i>Lack of independence is fatal to objective assessment of internal systems.</i></p> <p><i>The Guideline provides extensive coverage scope and work of IA.</i></p>
<p>4 The Audit Committee – “An Audit Committee is a specialised committee of the Board and is a fundamental component of good corporate governance”.</p>	<p>Especially for smaller organizations, with limited boards, this is the single most important committee of the board. As one of the main</p>

conduit of independence and an important bridge between the board and operational management *the existence and effectiveness of the Audit Committee is fundamental to opining on the integrity of corporate governance.*

The Guideline provides details of the role and operation of the committee and interaction with IA.

- 5 **Responsibility of the Audit Committee** – “The Audit Committee *can expect to review significant accounting and reporting issues and professional and regulatory issues* to understand the potential impact on financial statements. Members of the Audit Committee should have an understanding of how management develops internal interim financial information in order to assess whether reports are complete and accurate”.

Boards should be comprised of *individuals who have very good working knowledge of financial, risk management and regulatory matters* and have the capacity to relate these to the operation of the organization. *The audit committee, at a minimum, should be a rich reservoir for this capacity and competence.*

Review the Guideline for the responsibility of the Audit Committee.

- 6 **“Composition and Powers of the Audit Committee - The Audit Committee can more effectively fulfil its oversight responsibilities when a majority of the members are independent.** The size of the Committee should vary according to the size, complexity and risk profile of the SFI, but should ideally comprise a minimum of three directors, with independent directors forming the majority. The Board should review the composition of the Audit Committee annually.”

Best practice states that *all members of the audit committee should be independent non-executive directors (INED).* Often the size and composition of Boards have an adverse impact on this. Rather than undermine the essence of its effect organizations should *consider reassessing the composition of boards to ensure there are qualified and competent directors to constitute a truly independent and effective Audit Committee.*

The Guideline delineates important activities and powers of the Audit Committee.

- 7 **The Internal Audit Charter** – “SFIs *must have an Internal Audit Charter* that documents the purpose, scope, authority and responsibilities of the internal audit function”.

This critical element is often overlooked. Like the board, all committees should have a clear charter. *The effectiveness of corporate governance demands clear terms of engagement and consequently a clear basis for assessing performance.* Importantly, a charter also *undergirds the independence of the committee and manages reporting obligations and relationships* with IA and other independent functions, as may be applicable.

The Guideline outlines the minimum requirement for what should be contained in the Charter.

- 8 **The Audit Plan** – “The Head of Internal Audit should prepare the audit plan annually, which outlines the areas to be audited within the SFI. The plan should establish priorities, set objectives and ensure the efficient and effective use of audit resources. The *areas to be audited by the internal auditors should be determined by a risk assessment* of the internal control systems and the results of this assessment should guide the internal audit planning process.”

The Audit Plan is fundamental to the effective performance of the IA function. The requirement for it to be signed off by the Audit Committee easily conveys its import. Critically the Guidance points to the need for risk assessment as the basis of the suit plan. *Too often, a risk assessment is excluded from this process or done ineffectively.* Notably the Guideline points to the inclusion of AML/KYC in the audit plan. This is an area where *effective risk assessment makes a significant difference to the organization risk management and the efficacy of IA’s work* and holds important implication for both cost and reputation.

<p>9 Internal Audit Independence and Objectivity – <i>“Independence and objectivity are two vital components of an effective internal audit function. Internal auditors are independent when they render impartial and unbiased judgment in the conduct of their engagement. In the performance of his/her duties, the internal auditor should be free from managerial or other interference in determining the scope of an internal audit, performance of related audit tasks and direction of communication. In addition, an SFI’s internal audit activities should be independent of its daily operations and internal control processes”.</i></p>	<p>Careful attention should be paid to managing the independence and objectivity of the IA function. <i>Where this cannot be achieved internally then consideration should be given to outsourcing</i> (see outsourcing below).</p> <p><i>Review the Guideline to see what element helps to secure independence and objectivity.</i></p>
<p>10 Internal Audit within a Group of Holding Company Structure – “To facilitate a consistent approach to internal audit across all SFIs within a group or holding company structure, the Board of each SFI should ensure that either:</p> <ul style="list-style-type: none"> • The SFI has its own internal audit function, which should be accountable to the Board and report to the group or holding company’s Head of Internal Audit; or • The group or holding company’s internal audit unit performs internal audit activities of sufficient scope to enable the Board to satisfy its fiduciary and legal responsibilities”. 	<p><i>The delineation for what happens within a group structure should not be seen as a reduction in the standards being promulgated or a abrogation of responsibility by the regulator.</i> The expectation will always remain that the highest standards of practice is brought to bear through the IA function. The Guideline recognized the need for consistency amongst group of companies and the role and responsibilities of holding/parent companies in the equation.</p> <p><i>Review the Guideline for more details on group audit arrangements.</i></p>
<p>11 Duty of Care of Internal Auditors – <i>“Internal audits should be performed with proficiency and due professional care. The Head of Internal Audit should ensure that the educational background of the internal audit staff are appropriate”.</i> The Head of the Internal Audit unit should ensure that internal auditors acquire appropriate on-going training in order to examine all areas in which the SFI operates”.</p>	<p><i>Internal Auditors are held to a high standard and are expected to act with due skill and care</i> in the performance of their duties. Training and professional development is a critical part of this equation. Many smaller organizations do not have internal arrangements but the requirement for ensuring that competent professionals are engaged does not diminish.</p> <p><i>Review the Guideline for further details.</i></p>
<p>12 Outsourcing – <i>“Where an internal audit activity is performed by external experts, it is the responsibility of the Head of Internal Audit to maintain adequate oversight and to ensure adequate transfer of knowledge from the external experts to the SFI’s internal audit staff.</i> The Head of Internal Audit should ensure that use of those experts would not compromise the independence and objectivity of the internal audit function”.</p>	<p>Transfer of knowledge is critical to the functioning of an organization especially as it grows and scales up, and operation increases in complexity. Outsourcing does not automatically guarantee objectivity and independence and therefore attention should be placed on these important factors.</p> <p><i>Review the Guideline for aspects to be considered when IA function is outsourced.</i></p>
<p>13 Requirements for Supervised Financial Institutions – <i>“The Board of an SFI has ultimate responsibility for the application of an appropriate and effective system of internal control. The Board is also responsible for risk governance and culture, assuring suitable internal control mechanisms and for monitoring their adequacy and effectiveness”.</i></p>	<p>The <i>accountability for the effective risk management and governance of an organization lies collectively with the board</i> but there is also individual responsibility on the part of directors to ensure that they effectively discharge their responsibilities. <i>The board or individual directors can be sanctioned by being declared “not fit and proper” to serve.</i> It is critical therefore that boards also engage in appropriate orientation, training and operate diligently to ensure that they understand the business, the risk associated and that those risk are effectively managed.</p> <p><i>See Guideline for further details on obligations of the board.</i></p>

14 RELATIONSHIP WITH THE CENTRAL BANK

No Commentary Required

- Resident internal auditors must notify the Central Bank of all planned internal audit reviews and provide the Central Bank with the audit plan and audit scope on an annual basis.
- Group internal audit must notify the Central Bank, in writing, prior to visiting The Bahamas to conduct an audit of operations. The Auditor should provide a brief overview of the Audit Department, its accountabilities, staffing, organisation, and the scope of the proposed audit
- Group and resident internal auditors must arrange a meeting with the Central Bank at the conclusion of the audit to discuss the methodology and preliminary findings.
- All audit reports, working papers and supporting documentation must be available to the Central Bank upon request and during the conduct of onsite examinations.
- SFIs are required to submit to the Central Bank, the results of the independent assessment of the internal audit function within 14 business days of receipt.

15 REQUIRED DISCLOSURES BY THE INTERNAL AUDITORS

No Commentary Required

- “An internal auditor should notify the Central Bank of any scope limitations requested or imposed by the SFI, or any obstacles to, or difficulties in obtaining information necessary to perform an audit. The notification should be immediate, particularly if the circumstances indicate that the submission of the audit or other report would be delayed.
- To communicate to the Central Bank any relevant material internal audit findings, particularly in the areas of AML/KYC controls, in a timely fashion.
- The Central Bank expects that internal auditors will immediately report any material deficiencies in the SFI’s financial or regulatory reporting or compliance. No person may obstruct any auditor in reporting on a timely and accurate basis to the Central Bank.
- Annually, within 120 days of the end of each calendar year, the Head of Internal Audit will be required to provide a certification to the Central Bank relative to the required disclosures.”

16 SPECIAL REQUIREMENTS OF THE CENTRAL BANK

No Commentary Required

“Notwithstanding the Central Bank’s assessment of an SFI’s internal audit function, the Central Bank may query the work of the internal auditors through the continuous supervision process, including on-site supervision and may require an SFI’s internal auditor to: Submit any additional information in relation to the audit that the Central Bank considers necessary; Perform special procedures, audits or examinations of SFIs; and Submit special reports on any matter(s).

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