BASICS OF INTERNAL BANKING AUDIT IN ROMANIA

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ABSTRACT: *Internal audit should be a permanent function. In carrying out its duties and responsibilities, the bank's management should take all necessary measures so that the bank can always count on an adequate functioning of internal audit appropriate to the size of the bank and the nature of its operations. These measures include providing the internal audit department with adequate resources and staff to achieve its objectives.*

KEY WORDS: *audit, banking, standards, objectives, principles*.

JEL CLASSIFICATIONS: *B21*, *M42.*

1. INTRODUCTION

The objectives, responsibilities and principles of the internal audit activity are expressed and summarized in some documents of international character (International Standards of Auditing Activity and Code of Ethics of the Internal Auditor, issued by the Institute of Internal Auditors or those relating to auditing, in general, issued by the International Auditing Practices Committee within the International Federation of Accountants) and of national character: GEO 75/1999-Financial Audit Activity-republished and updated in 2013 by Law no. 149/2013, B.N.R. Norms no. 17/2003 regarding the organization and internal control of the activity of banks, the management of significant risks, as well as the organization and performance of the internal audit activity within banks; "Minimum Norms of Audit Activity" of the Chamber of Financial Auditors of Romania. It is worth mentioning that the globalization of financial markets and capital flows has required the alignment of national audit standards with international ones, through the accession of national auditor organizations to international ones and to the documents issued by them (for example, the norms developed by the International Auditing Practices Committee were assimilated by the Chamber of Auditors of Romania).

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At the same time, in the banking field there are recommendations as guidelines at international level (the principles enunciated by the Basel Committee on Banking Supervision), reflected at national level through central bank regulations, and at the level of each banking institution – through the Internal Audit Charter.

The audit charter guarantees the status and authority of the bank's internal audit department". The audit charter must include, according to the principle stated by the Basel Committee on Banking Supervision, at least the following: - objectives and scope of activity; - the position of the department within the organization, its rights and obligations; - the responsibilities of the head of the internal audit department. The B.N.R. adds to these elements the terms and conditions under which internal auditors may provide consulting services or perform special tasks. The charter must be drawn up and periodically reviewed by the internal audit department, approved by the bank's management and the board of directors (with the opinion of the audit committee) and brought to the attention of all bank personnel.

The Internal Audit Charter developed by the Bank for International Settlements, which serves as a guideline for banks, stipulates as components of the charter the declaration of the mission, independence and objectivity of internal audit, the definition of the scope and responsibilities, the delimitation of the authority and standards of this activity. According to this document, the mission of internal audit is to ensure that the bank's operations are carried out in accordance with the highest standards. As for the position of the internal audit department within the bank, it is defined by the effective position within the organizational chart and the relationship diagram that ensures its independence (the department is directly responsible to the bank's management and reports to the audit committee appointed by the board of directors) and by the delimitation of its activities from the other bank operations, which gives it objectivity (internal audit is not involved in the daily control activities, which are carried out by each organizational structure.

According to the Charter, the scope of internal audit activity includes the review of risk management procedures, the internal control system, information systems and the management process. As regards authority, the Charter establishes the right of internal audit to have access to all areas of the bank, to all documents, to all necessary information, from documents, records or from persons, to communicate with any member of the bank's staff. In addition to this, the B.N.R. mentions the need for the statute to expressly provide for the internal auditor's right to initiative, as well as his right to have access to "information intended for management and minutes and other materials of a similar nature of all decision-making and advisory bodies, which are relevant in the performance of his duties." The responsibilities defined in this document refer both to the level of the internal audit department and to its head, related to the planning, development, reporting of the internal audit activity, as well as the relationship with the external audit. The Charter stipulates that the internal audit activity should be carried out in accordance with the standards of the best professional practice, as defined by the Institute of Internal Auditors or the Basel Committee on Banking Supervision. As can be seen, the statute of the internal audit activity represents the normative act that regulates the internal audit activity, the regulation of the organization and functioning of the respective department within the bank.

2. INTERNATIONAL INTERNAL AUDIT STANDARDS

Given the diversity of cultural and legal environments, of organizations in which internal audit operates, the Institute of Internal Auditors issued in June 1999 a set of "International Standards for the Professional Practice of Internal Auditing", to establish the essential responsibilities of this activity, regardless of the field or environment in which it is carried out (applicable, therefore, also to banks) and which constitute, practically, the equivalent of the principles stated by the Bank for International Settlements. These Standards define the basic principles and the framework for implementation ("Attribute Standards"), the quantification of internal audit performance ("Performance Standards") and the method of applying general standards to some concrete actions ("Implementation Standards"). The mention of these international standards is made for informational purposes only, the exposition regarding the activity of internal banking audit being focused on the principles stated by the Basel Committee on Banking Supervision and on the normative act of the National Bank of Romania.

3. INTERNAL AUDITOR CODE OF ETHICS

The International Auditing Practices Committee of the International Federation of Accountants has developed a Code of Professional Ethics in the field of auditing, a code to which the Romanian legislation in force on financial auditing also refers. As regards internal banking auditing, the National Bank of Romania regulation also refers to a code of ethical conduct for internal auditors, without specifying whether it is the one mentioned above or the Code of Ethics for Internal Auditors developed by the Institute of Internal Auditors. The latter, to which the Basel Committee on Banking Supervision also reports, establishes the principles that internal auditors must follow (in accordance with the principles of internal auditing), as well as the conduct that must be observed for the application of these principles.

Thus, the activity of the internal auditor must be based on the following coordinates:

- objectivity (the analysis carried out by the internal auditor must be balanced and not influenced by his own interests or the interests of other persons);
- confidentiality (the internal auditor must not disclose the information to which he has access in his activity except in the situations provided for by regulations);
- competence (the internal auditor must have the necessary training and experience for his activity).

Integrity means that the internal auditor must perform his duties honestly, diligently and responsibly; must not knowingly take part in illegal activities or engage in actions that may discredit him; must comply with the law and make only those disclosures permitted by law or the profession; must respect and contribute to the achievement of the ethical objectives of the organization to which he belongs. To maintain objectivity, the internal auditor must not participate in activities or have relationships or accept anything that could influence his professional judgment, and if he has knowledge of a fact that could distort the activity, he must disclose that fact.

Respecting the principle of confidentiality implies prudence in the use of information, protecting the information to which he has access in the performance of his duties and not using the information for personal gain or in any other manner that could harm the interests of the organization to which he belongs. Competence in the work of the internal auditor means that he/she does not engage in activities for which he/she does not have the necessary training and experience, that he/she complies with international auditing standards and that he/she continuously improves his/her professional training and the quality of services.

4. OBJECTIVES AND METHODS OF ACTION OF THE INTERNAL BANKING AUDIT

Emergency Ordinance no. 75/1999 (republished and updated in 2013 by LAW no. 149/2013), with subsequent amendments, identifies the following objectives of the internal audit: -verifying the compliance of the activities of the audited economic entity with its policies, programs and management, in accordance with the legal provisions;

- evaluating the degree of adequacy and application of the financial and non-financial controls ordered and carried out by the management of the unit in order to increase the efficiency of the economic entity's activity;
- evaluating the degree of adequacy of the financial and non-financial data/information intended for the management to know the reality of the economic entity;
- protecting the balance sheet and off-balance sheet assets and identifying-methods for preventing fraud and losses of any kind.

It is noted that here are defined, in fact, the paths of action for achieving the objective of the internal banking audit. In other words, those listed could be categorized as "intermediate" objectives: ensuring the consistency of the activity with the policies, programs, norms and legal provisions, increasing the effectiveness of the control activity, improving the quality of the decision-making process, increasing the efficiency of the activity. From the norm of the National Bank of Romania, from the articles of Section I – Objective of the internal audit, Chapter VIII, the following references to this subject can be extracted: "The objective of the internal audit is to improve the activity of credit institutions" and "… to contribute to the achievement of their (banks') objectives by presenting a systematic and disciplined approach….".

Therefore, it can be summarized that the objective of internal banking audit is to contribute to the achievement of bank objectives (improving the activity representing the primary and general objective of a bank), and the specific objectives, by activity area, are:

a) ensuring the consistency of the activity with policies, programs, norms and legal provisions;
b) increasing the effectiveness of the control activity;
c) improving the quality of the decision-making process;
d) increasing the efficiency of the bank's activity.

To achieve these objectives, internal banking audit acts in the following ways:

1. assessing the efficiency and adequacy of the internal control system;

2. assessing the application and effectiveness of risk management procedures and methodologies for assessing significant risks;
3. analysing the relevance and integrity of data provided by management and financial information systems, including the IT system;
4. assessing the accuracy and credibility of accounting records and financial statements;
5. assessing the adequacy of the level of own funds of credit institutions according to the risks to which they are exposed;
6. assessing the manner in which the protection of balance sheet and off-balance sheet assets is ensured and identifying methods for preventing fraud and losses of any kind;
7. testing both operations and the functioning of specific control procedures;
8. assessing the efficiency of credit institutions' operations;
9. assessing the manner in which the provisions of the legal framework, the requirements of the codes of conduct are complied with, as well as assessing the manner in which the policies and procedures of the credit institution are implemented;
10. testing the integrity, credibility and, where appropriate, the timeliness of reports, including those intended for external users.

As can be seen, the area of competence assigned to the internal bank audit is all-encompassing: internal control system, risk management, information system, accounting, quality of asset management, operations. Thus, internal audit appears as a super-controller of internal control, it is more than any form of external control or supervision, but at the same time, part of the internal control system of a bank. By examining the global problems of the bank, assessing risks, control, quality, efficiency, technology and formulating clear and adequate opinions, the internal bank audit represents a very valuable tool at the service of the management of a bank, a true “gray eminence” of the bank. In some countries (including Romania), although accounting records fall within the scope of internal audit, auditing financial statements is not included in its competence.

Thus, it is considered that this falls under the responsibility of the bank's external auditors, the role of internal audit being limited, in this area, to supporting external auditors. Also, from the practice of some countries, it can be observed that there is an increasingly significant trend for the assessment of the way in which a bank's activity is framed in the legal and regulatory provisions to be done not by internal audit, but by a separate organizational structure, dedicated to this issue. As for the consultancy function assigned to internal audit, a study by the Basel Committee shows that this should be an auxiliary one to the main function and that it should be exercised with great care so as not to compromise the objectivity of the assessment of the activities in which the internal auditors have provided consultancy. Moreover, in practice, most of the time is allocated by the audit department to carry out the basic function (75-95%) and only 0-20% for consultancy.

Moreover, the consultancy activity is limited, most of the time, to recommendations related to the control of certain projects or plans, without assuming operational responsibilities.

5. PRINCIPLES OF INTERNAL BANK AUDIT

The Basel Committee on Banking Supervision outlines the framework for the development of the internal bank audit activity in the form of principles that cover both the general characteristics of the activity, the requirements for internal auditors, and the development of internal audit. In the following, the principles with general features have been extracted.

Independence of internal bank audit. "The internal audit department of a bank must be independent of the activities audited. The department must also be independent of the day-to-day internal control process. This requires that the internal audit department be given an appropriate status within the bank and that this department carry out its tasks with objectivity and impartiality". Thus, to ensure its independence from the rest of the bank's activities, the internal audit department must be directly subordinated to the bank's executive management or the board of directors or the audit committee (in addition to the board of directors). In addition to ensuring the independence of the department within the bank's organizational chart, this principle must also apply to its activity.

The internal audit department must be able to exercise its powers on its own initiative in all departments, offices and activities of the bank. The results of its activity, its assessments must be made known, internally, and, in some cases, even directly to the board of directors, the audit committee or the external auditor (for example, when it is considered that a decision of the bank's executive management was taken without complying with the legal provisions). The National Bank of Romania fully subscribes to these requirements regarding ensuring the independence of internal audit, both through organizational and functional - institutional means, and opts for subordinating the internal audit department to the bank's board of directors, not to the executive management.

Impartiality of the internal audit of banks. "The internal audit department should be objective and impartial, which means that it should be in a position to carry out its duties without bias and without interference." This principle complements the first statement, emphasizing the aspect of independence of judgment that internal auditors must be able to make. Therefore, internal auditors must not be involved in the bank's operations or in the design of procedures and the implementation of internal control measures, and those recruited from within the bank must not have been involved in the activities being audited in the recent past; at the same time, periodic rotation of the audited areas is taken into account. The National Bank of Romania is of the opinion that personnel involved in an audit engagement may audit an area in which they have worked only after a period of at least one year has passed.

However, ensuring the impartiality of internal auditors does not mean that the internal audit department cannot be requested opinions by the bank's management regarding the principles of internal control, reorganization plans, the initiation of new important or high-risk activities, and the management of the IT and information system. Its involvement must, however, be limited to this advisory role, and not extend to implementation measures. The National Bank of Romania defines more clearly the framework in which internal auditors can provide advice on operations in which they previously had responsibilities or which they have audited, namely "on the condition that they do not perform an audit engagement in the following year."

In the practice of some banks, in order to ensure the impartiality of internal auditors, rules are imposed regarding their recruitment from outside the bank, the non-correlation of their remuneration with the bank's performance or profit, the separation of duties regarding the implementation of recommendations, and the non-involvement of auditors in the design of control or administrative procedures. In Romania, the National Bank restricts access to the responsibility of internal auditors to persons who are spouses, relatives or in-laws up to the fourth degree inclusive of the managers of a bank.

Continuity of internal bank audit. The formulation of the principle of continuity of internal audit is not limited to the enunciative - declarative part, but extends to the means by which the permanent nature of this activity can be ensured: resources and personnel. Thus, it is highlighted that, in addition to the quality and number of internal audit personnel, adequate financial resources are also necessary (for remuneration, professional training, travel to territorial units), logistical, IT and information resources.

Bank management verifies the allocation of personnel and resources for internal audit, either permanently or annually, comparing the department's activity with the planned one or making comparisons with banks of comparable size. On average, the personnel allocated to internal audit activity in a bank represents approximately 1% of the total personnel; this percentage varies depending on the size of the bank and the activities carried out by it. The National Bank of Romania emphasizes that ensuring an adequate internal audit activity, corresponding to the size and nature of a bank's operations falls to the institution's managers.

The exhaustiveness of the internal audit of banks. All activities and all entities of a bank must fall within the scope of the internal audit". None of the activities or entities of a bank (including branches, subsidiaries and outsourced activities) can be excluded from the concerns of the internal audit department. However, for a correct understanding of the scope of internal audit, some nuances and clarifications must be made to this statement of exhaustiveness. In general, internal audit must examine and evaluate the efficiency and effectiveness of internal control (understood as a system, not as a department) and the way in which control responsibilities are fulfilled. From this point of view, the internal audit activity represents a risk analysis of the internal control system. In particular, internal audit must evaluate: compliance with policies, principles, rules, regulations (without overlapping, however, with the corresponding function of internal control); integrity, accuracy and coverage of financial and management information; continuity and soundness of information systems; the functioning of the bank's departments.

Even if there is a separate control and monitoring department for a particular activity or entity, the internal audit must also cover this activity/entity, as well as the control of this activity/entity. The banking and non-banking subsidiaries of a bank must have their own internal control systems and their own internal audit, the latter being carried out either by the internal audit department of the parent company or by a department of them, subordinate to the one in the parent company. In the second case, the internal audit principles must be established centrally by the parent company for the entire group of companies, and the central internal audit department must be involved in the recruitment and evaluation of internal auditors in the subsidiaries. To the extent that outsourcing some activities does not mean eliminating the bank's responsibilities in that area, then the bank's internal audit cannot be exempted from its duties in relation to these activities.

In the National Bank of Romania Regulation no. 17/2003, the principle of exhaustiveness is not distinctly formulated, but the enumeration of the activities that the internal audit must mainly cover suggests this idea.

In addition to the principles mentioned above, the National Bank mentions the confidentiality that must be maintained by internal auditors, in the sense of prudence in the use of information, of information protection; this requirement must be met, in fact, by the entire bank staff, as stipulated in the Banking Law.

6. ORGANIZATION OF INTERNAL BANK AUDIT

The internal bank audit activity is carried out through two organizational forms: the internal audit department and the audit committee. The audit department was discussed during the presentation of the principles of the activity and the internal audit charter, both from the point of view of its place within the bank's organizational chart and from the point of view of its duties and responsibilities. In this regard, only one aspect deserves to be detailed, namely that relating to the head of the audit department.

Starting from principle 12 stated by the Basel Committee on Banking Supervision, the National Bank of Romania's norm creates a true job description for the head of the internal audit department.

According to it, the coordinator of the internal audit department is responsible for:

1) developing and maintaining a quality assurance program and improving the internal audit activity;
2) monitoring and evaluating the efficiency of the internal audit quality assurance program;
3) ensuring the professional competence of internal auditors, their professional training, ensuring adequate resources for the performance of the activity;
4) establishing policies and procedures related to the internal audit activity;
5) coordinating the activities carried out by the internal auditors within the bank with those of the internal audit service providers outside the bank;
6) developing the internal audit plan;
7) informing the board of directors and the audit committee about the activity carried out.

The National Bank of Romania's Regulation no. 17/2003 (Art. 120 (1)) establishes the obligation to have an audit committee within each bank, taking over the recommendation of the Basel Committee on Banking Supervision. The motivation for this recommendation lies in the need for a permanent advisory body to support the board of directors of a bank in fulfilling the difficult task of maintaining and strengthening the internal control system. The National Bank of Romania also applies the recommendations of the Basel Committee regarding the composition, powers and functioning of the audit committee. It is thus specified that the committee's activity must be carried out on the basis of a regulation approved by the board of directors.

Regarding the composition of the committee, the recommendations of the Basel Committee aimed at preventing the emergence of conflict-of-interest situations are adopted (members should be members of the board of directors, but should not have been or should not be its managers), as well as those regarding professional competence (appropriate experience, and at least one member should have experience in the field of audit or accounting). The powers of the committee are either general (encouraging communication between the board of directors, bank managers, internal audit, external auditor and banking supervisory body), or specific:

- approving the internal audit charter, the audit plan and the necessary resources for this activity;
- ensuring the relationship with the external auditor, in the sense of receiving the audit plan from the external auditor, its conclusions and recommendations;
- analyzing the findings and recommendations of the internal audit and their implementation plan.

According to some opinions, the most important of these competences should be the one related to the selection of the best candidate for the position of coordinator of the internal audit department; the audit committee must ensure that the designated person corresponds to the moral and professional profile appropriate to the position. The main areas of concern of the audit committee refer to the functioning of the internal control system and the internal audit department, the risk areas to be covered by the internal and external audit, the correctness and credibility of the financial information provided to the bank's management and other institutions, the bank's compliance with the provisions of the legal and regulatory framework. The establishment of the periodicity of the audit committee meetings is left by the National Bank of Romania to the discretion of the banks, to be established within the committee's regulations. According to some opinions, the audit committee should meet at least four times a year, and one of these meetings must be dedicated to the annual financial statements.

7. OUTSOURCING OF BANK INTERNAL AUDIT ACTIVITY

Outsourcing can bring the advantages of high expertise, especially on special audit projects, but it can also generate risks for the bank (such as the risk of losses or the risk of having reduced control over the outsourced activity). These risks must be carefully monitored and managed, especially since the internal audit activity is very important, and the bank's board of directors remains responsible for the efficient functioning of the control system even in the case of outsourcing part of it. In some countries, the idea of outsourcing (total) internal audit is not accepted, considering that the bank's internal audit department must have the necessary level of professional competence to cover all the key activities of the bank.

However, the idea of co-opting an external expert to make certain assessments for the audit department (partial outsourcing) is accepted.

The National Bank of Romania is in favor of the idea of outsourcing a banking activity, but within limits clearly defined by a bank policy, provided that there are procedures for managing the risks associated with the outsourced activities and with a clear stipulation of the responsibilities of each party involved in the service provision contract. Thus, in the opinion of the central bank, the risk management procedures attached to the outsourced activities must refer at least to the following aspects: the criteria for evaluating the service provider, the level of competence for approving the outsourcing, the permanent monitoring of the implementation of the outsourcing contract and the existence of alternative plans in case it is necessary to change the service provider.

Regarding the particular case of internal audit, the National Bank establishes that the decision to outsource it in whole or in part must belong to the bank's board of directors, with the opinion of the audit committee and based on the substantiations and proposals formulated by the coordinator of the internal audit activity (who must remain within the bank). As for the firm providing internal audit services, in some countries (and in Romania) the condition is imposed that it be different from the external auditor, but the unanimously shared opinion is that it must meet conditions of professional competence and financial performance. Regarding financial performance, the National Bank of Romania's norm retains the solvency indicator, but emphasizes the quality indicators of the respective firm: reputation, quality of service, competent personnel, specialization in auditing the respective category of financial institution, etc.

The study conducted by the Basel Committee reveals that outsourcing of internal audit is not a common practice in most countries, and when external services are used, they are usually provided by a firm within the group to which the bank belongs. Most often, small banks outsource their internal audit, but only the activity itself, not the responsibility.

8. THE RELATIONSHIP BETWEEN THE INTERNAL AUDIT DEPARTMENT AND THE SUPERVISORY AUTHORITY

The relationship between n the supervisory authority and the internal audit department of a bank should be a two-way street: on the one hand, of control exercised by the authority over the internal audit activity, and on the other hand, of collaboration. "The banking supervisory authority should evaluate the activity of the bank's internal audit department and, if the result is satisfactory, may rely on it to identify areas of potential risk".

This represents an indirect approach to assessing the efficiency and quality of the internal control system, of which internal audit is also a part. The assessment of the activity carried out by internal audit can be made on the basis of the principles and rules contained in the banking regulations relating to both the organization and functioning of internal audit, as well as to the internal control and risk management systems, on the basis of the internal audit statute and the code of conduct of internal auditors.

If the “over-control” in a bank is of satisfactory quality, the supervisory authority may take over its reports to identify problems in the internal control system within the bank or to identify potential risk areas that have not recently come under the scrutiny of internal audit. Regarding the collaboration between the supervisory authority and the bank’s audit department, the Basel Committee on Banking Supervision believes that regular consultations should take place between the two parties to discuss areas of risk and the measures taken to cover the risks. At the same time, these discussions should be broadened to the entire banking system, for topics of common interest, related to policies and regulations. The Committee’s comments on the collaborative relationship go so far as to suggest that the supervisory authority should be a “shield” for the head of a bank’s internal audit department, protecting him from the measures that the bank’s management, “bothered” by his complaints, might take.

9. CONCLUSION

The professional competence of each internal auditor and of the internal audit department as a whole is essential for the proper performance of the internal audit role.

The internal audit department must cover all the bank’s activities, and these are becoming increasingly complex; moreover, this department may be asked for opinions on new areas that could be introduced into the bank’s nomenclature. Therefore, an internal auditor must have high knowledge, extensive experience, be continuously trained and constantly update his knowledge in the banking field and in that of audit techniques. At the same time, he must have the ability to collect information, examine it, evaluate the situation and communicate conclusions. To these requirements regarding professional training, the National Bank of Romania adds moral requirements: internal auditors must be fair, honest and incorruptible.

With such a “robot portrait”, recruiting specialists for a bank’s internal audit department appears as a challenge for the human resources department. If the requirements related to ensuring objectivity and impartiality are also taken into account, human resources management in the field of internal audit may even seem like an “impossible mission”. Assessing the adequacy of the level of training of candidates for internal auditor positions is a matter of policy for each bank in the field; some banks (especially small ones) place more emphasis, in recruiting audit staff, on professional knowledge and experience than on the existence of professional titles. Professional competence must be maintained through on-the-job training, internal and external training, staff rotation within the audit department, etc.

All activities and all entities of a bank must fall within the scope of internal audit. None of the activities or entities of a bank (including branches, subsidiaries and outsourced activities) can be excluded from the concerns of the internal audit department. However, for a correct understanding of the scope of internal audit, some nuances and clarifications should be made to this statement of completeness. In general, internal audit must examine and evaluate the efficiency and effectiveness of internal control (understood as a system, not as a department) and the way in which control responsibilities are fulfilled. From this point of view, the internal audit activity represents a risk analysis of the internal control system. In particular, internal audit must evaluate: compliance with policies, principles, rules, regulations (without overlapping, however, with the corresponding function of internal control); integrity, accuracy and coverage of financial and management information; continuity and soundness of information systems; functioning of the bank's departments.

Even if a separate control and monitoring department exists for a particular activity or entity, the internal audit must also cover this activity/entity, as well as the control of this activity/entity. The banking and non-banking subsidiaries of a bank must have their own internal control systems and their own internal audit, the latter being carried out either by the internal audit department of the parent company or by a department of the latter, subordinate to that of the parent company. In the second case, the internal audit principles must be established centrally by the parent company for the entire group of companies, and the central internal audit department must be involved in the recruitment and evaluation of internal auditors in the subsidiaries. To the extent that outsourcing of some activities does not mean eliminating the bank's responsibilities in that area, then the bank's internal audit cannot be exempted from its duties in relation to these activities.

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