

RBI adopts the Global IIA Standards for banks; Mandates Risk-Based Internal Audit for select NBFCs and UCBs



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The Reserve Bank of India recently adopted the international standards of the Global Institute of Internal Auditors (IIA) for scheduled commercial banks and has also mandated Risk-Based Internal Audit (RBIA) for select Non-Banking Financial Companies (NBFCs) and Urban Cooperative Banks (UCBs). This is an important milestone for the internal audit profession in the country.

Overview

Internal audit is recognized as an integral part of sound corporate governance and is considered as the third line of defense. A robust internal audit function plays an important role in contributing to the effectiveness of the organization's risk management, internal control and governance framework.

Under section 138 of the Companies Act, 2013, appointment of an internal auditor is mandatory for certain class of companies. There are also specific requirements for listed companies under SEBI (Listing Obligations and Disclosure Requirements), Regulations, 2015.

The Reserve Bank of India had provided detailed guidelines in December 2002 on risk-based internal audits in banks in line with the decision to move towards risk-based supervision (RBS) of banks. Under the RBS approach, the supervisory process would leverage the work done by internal auditors of banks. The implementation of risk-based internal audit would ensure that greater emphasis is placed on the internal auditor's role in risk mitigation and also expects them to identify areas of potential risks and play an important role in protecting the bank from the risk of loss and reputational damage.

During January and February 2021, RBI issued two circulars on Risk-Based Internal Audit, the first as a supplemental guidance to the December 2002 circular for banks and the second which mandates risk-based internal audit for select NBFCs and UCBs. These circulars are aligned with the revised paper "Internal Audit Function in Banks" issued by Basel Committee on Banking Supervision (BCBS) in June 2012 and the Global IIA International Professional Practices Framework.

Risk-Based Internal Audit

- a) The supplemental guidance issued on January 7, 2021 applies to all Scheduled Commercial Banks, Local Area Banks, Small Finance Banks and Payments Bank.

The following are the highlights:

- i. Banks have to effectively put in place a system of risk based internal audit which relies on a well-defined policy which includes matters relating to functional independence, sufficient standing and authority within the bank, adequate resources with competence and maintaining effective channels of communication.
- ii. International Standards: Banks have to adopt the

International Internal Audit Standards of Basel Committee of Banking Supervision and The Institute of Internal Auditors.

- iii. **Stature and Independence:** The Head of Internal Audit (HIA) must be a senior executive who will have the ability to exercise independent judgment. The HIA will report to the Audit Committee of the Board or MD & CEO or a Whole Time Director (WTD). Where the performance appraisal of the HIA, owing to the reporting structure, is done by the MD/CEO or the WTD, it has to be reviewed by the ACB and accepted by the Board. In the case of foreign banks operating in India as branches, the HIA will report to the internal audit function in the controlling office/ head office. Remuneration of internal audit staff should not be linked to financial performance of business lines as that may compromise their independence.
 - iv. **Competence:** Requisite professional competence, knowledge and experience of each internal auditor is essential for the bank's internal audit function. Board needs to prescribe a minimum period of service for staff in the internal audit function. Staff members from related departments may also spend a minimum period, as defined by the Board, in the internal audit function during their service with the bank.
 - v. **Resourcing:** The internal audit function should be set up within the bank and therefore, the function shall not be outsourced. However, experts, including former employees, may be hired on contractual basis subject to review by the Audit Committee of the Board.
 - vi. **Documentation:** Adequate documentation must be maintained of the RBIA framework and its components to evidence its implementation which would be in relation to organisation structure, business model and risks of the bank.
- b) The circular issued on February 3, 2021 applies to
- All deposit taking NBFCs
 - Non-deposit taking NBFCs of asset size of Rs 5000 crores or more
 - All Urban Co-operative Banks of asset size of Rs 500 crores or more

The following are the highlights:

- i. Detailed guidelines on Risk-based Internal Audit have been provided which are intended to enhance the efficacy of internal audit systems and processes followed by NBFCs and UCBs.
- ii. The entities will have to move from a traditional approach

with focus on transaction testing to a framework that will include evaluation of risk management and control procedures which should help in identifying and anticipating potential risks and mitigation thereof.

- iii. RBIA policy has to be approved by the Board/ Audit Committee of NBFCs and the Board of UCBs which is primarily responsible for providing oversight to the internal audit function. Audit Plans have to be approved by the Audit Committee of the Board/ Board. The ACB/ Board will also review the performance and formulate a quality assurance and improvement program for the internal audit function.
- iv. Senior Management is responsible for ensuring adherence to the internal audit policy approved by the Board. It is also responsible for establishing a comprehensive and independent internal audit function which should promote accountability and transparency.
- v. Description of key attributes such as independence, reporting lines, tenure of the HIA, competence, outsourcing and other aspects are similar to the guidelines for banks.
- vi. Detailed guidelines for RBIA are contained in an Annexure that includes responsibilities of the internal audit function including matters relating to compliance with policies and procedures as approved by the ACB/Board, Risk Assessment methodology for the development of the audit plan, execution of audits, audit resources and communicating audit results through internal audit reports.
- vii. Key audit issues should be reported to ACB/Board and the function should track management action plans and report follow-up status to the ACB/ Board.
- viii. Implementation of these guidelines is expected to be done by March 31, 2022.

An internal committee of senior executives has to be established which will formulate a suitable action plan for implementation of the Risk-Based Internal Audit methodology. Progress has to be reported periodically to the Board and Senior Management.

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