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Guidelines

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Guidelines on the Work of the Internal Audit Section
of Financial Undertakings

Issued in accordance with the second paragraph of Art. 8 of Act
No. 87/1998 on Official Supervision of Financial Activities

24 September 2008

Contents

1. Introduction

According to Article 16 of Act No. 161/2002, on Financial Undertakings, financial undertakings other than electronic money enterprises and securities brokers shall have an audit section to handle internal auditing.

The Board of Directors of a financial undertaking shall engage the director of the undertaking's audit section (hereafter the Internal Audit Director), who shall be responsible for internal auditing on the Board's behalf. Internal audit is part of a financial undertaking's organisational structure and one aspect of its internal surveillance system. According to this same statutory provision, the Financial Supervisory Authority may grant an exemption from the operation of an internal audit section, in consideration of the nature and scope of the operations, and establish special conditions for undertakings granted such exemptions. In its Guidelines no. 4/2003, the Financial Supervisory Authority set criteria to be used as references in deciding on the granting of exemptions from the operation of an internal audit section in financial undertakings and the conditions to be set for such exemptions.

In drafting the Guidelines, consideration was given to standards issued by the Institute of Internal Auditors (IIA) (http://www.theiia.org/) and guidelines of the Basel Committee on Banking Supervision of August 2001 (http://www.bis.org/publ/bcbs84.htm).

2.Definition and objectives

Internal auditing is an independent, objective assurance and consulting activity aimed at improving an undertaking's operations.

Internal audit assesses and improves the efficacy of risk management, supervision methods and corporate governance through systematic and disciplined working practices, thereby assisting the undertaking concerned in achieving its objectives.

3. Management of the internal audit section

The Internal Audit Director shall have a formal charter from the undertaking's Board of Directors, setting out the purpose, authority and responsibility of the section. The charter shall also account for the section's position in the organisational chart, its unrestricted access to documentation, employees and other aspects of significance in conducting evaluations.

The Internal Audit Director shall submit an annual plan to the Board of Directors, indicating how the section will perform those tasks entrusted to it. Such an internal audit plan must be risk-based.

4. Position in the organisational chart and independence

Internal audit is a unit comprised of independent and impartial experts within a financial undertaking, which in organisational terms is responsible directly to the undertaking's Board of Directors.

Although internal audit is part of the financial undertaking, efforts shall be made to ensure that its employees are in fact unbiased and work independently of those operating units which they audit. This can be ensured through the organisational position of internal audit and by the Internal Audit Director following objective working practices.

Strong emphasis must be placed on the independence of the audit section. The audit section shall not be responsible for internal quality control of activities, nor for the introduction of such. The section may, however, provide advice for senior management regarding decisions on new methods for quality control of activities.

The organisational position of internal audit can affect the impartiality of persons employed in its work. The Internal Audit Director must therefore report directly to the top executives and employees of the section should not perform other duties within the financial undertaking unless it insured that those duties do not prejudice their independence.

The efficacy of internal quality control and risk management is the responsibility of the Board of Directors and management of the financial undertaking concerned.

5. Authority

To achieve the objective of internal audit, the Internal Audit Director must have:

- unlimited access to all aspects of the financial undertaking's activities, such as assets, employees, reports, files and other data which the Internal Audit Director considers necessary to achieve the audit's objectives, including information from management and the minutes of Board and committee meetings;
- authority to demand that all employees and directors provide the information and explanations required within a reasonable length of time;
- unrestricted communication with those parties performing external audit of the undertaking in question.

Management must provide internal audit with information on all important events concerning a breach of security and/or violation of statutory provisions and rules without delay.

Management must also ensure that the audit section is kept informed of developments, innovations, products and changes in operations.

All operating units and subsidiaries of the financial undertaking concerned should, as far as practicable, be included in the scope of the audit section's work. The same applies to those tasks of the financial undertaking which have been outsourced. The Board of Directors must provide specific grounds for doing otherwise.

6. Qualifications and professionalism

The Internal Audit Director must show professionalism and expertise in carrying out his/her work. Furthermore, in must be ensured that employees of internal audit possess the necessary professional competence to conduct their audit in each instance.

In assessing what expertise employees, selected to work on internal audit, need to possess, regard shall be had for the objectives which internal audit is intended to achieve.

7. Quality assurance

The Internal Audit Director shall be responsible for developing and maintaining effective quality assurance that covers all aspects of the internal audit activity. It is important that the Internal Audit Director regularly inform the Board of Directors on quality assurance of the section's activities.

8. Tasks of internal audit

The tasks of internal audit should include an analysis and assessment of whether quality control procedures/systems exist, are appropriate and are effective. The outcome of the above should be a risk assessment, showing the strengths and weaknesses of the financial undertaking's quality control procedures/systems.

Internal audit shall regularly carry out examinations of the following aspects of the undertaking's internal quality control:

1. whether the undertaking has set objectives for its main risk factors, such as credit risk, market risk and liquidity risk, and how these objectives are enforced;
2. whether clear and comprehensive written working procedures exist, describing the tasks, responsibilities and authorisations of individual employees and managers, and whether these are followed;
3. whether the undertaking's working procedures and structure include such internal quality control as can be practically implemented. Examine whether the working procedures provide for sufficient separation of employees handling financial assets and those working in accounting. Also employees responsible for keeping accounts and those who are responsible for reconciling the same accounts;
4. whether control mechanisms and working procedures exist in each instance to respond to any risk arising from the undertaking's small size and lack of necessary separation of tasks;
5. what arrangements exist for the safeguarding and handling of the undertaking's assets, recording of obligations and control of accounting;
6. examining by sampling the implementation of custody agreements, i.e. that investments accord with investment strategy agreements and that assets are in place;
7. examining by sampling the reliability and quality of reports relied upon by the undertaking's management and public authorities;
8. evaluating the undertaking's information systems, including with regard to control of their use and operating security;
9. conducting special reviews of the diversification of credit and defaults, the situation of the largest debtors and largest parties in default and collateral securing these same obligations;
10. conducting special reviews of the financial undertaking's system of assessing its capital relative to its estimate of risk;
11. appraisal of the economy and efficiency of the operations;
12. testing by sampling both individual transactions and the functioning of internal control procedures;
13. conducting a review of the systems established to ensure compliance with statutory and regulatory requirements and the implementation of policies and procedures;
14. a review of the undertaking's actions to combat money laundering and terrorist financing, including sampling;
15. an examination of follow-up on previous observations of the Internal Audit Director;
16. other examinations considered necessary to achieve the objectives of internal audit.

9. Reporting

Strong emphasis is placed on having formal actions or projects in the area of internal audit conclude with a report, giving an account of the premises of the action and its conclusions in an appropriate manner. Management must be informed at regular intervals of the progress of internal audit. The report must be clear and comprehensive and include information which can be supported with reliable and appropriate data.

10. Relations between internal and external auditors

The existence of an internal audit section can affect the scope and nature of auditing actions for audit by the external auditor of the annual financial statements of the financial undertaking concerned, but does not affect the latter's responsibility.

External auditors should have access to the reports of the Internal Audit Director and internal audit shall disclose information on aspects which could be of importance for auditing in connection with endorsement of annual financial statements.

11. Relations between internal audit and the Audit Committee

The Audit Committee shall supervise the arrangements and functioning of the financial undertaking's internal audit, cf. Point 1 of subparagraph b of Art. 2 of Act No. 80/2008.

The Audit Committee shall have access to the Internal Audit Director's reports and the latter must disclose aspects which could be of importance to the Committee.

12. Relations between the Financial Supervisory Authority and the Internal Audit Director

The Financial Supervisory Authority may decide to use the work of audit sections in assessing risk factors in a financial undertaking's activities.

The Financial Supervisory Authority may convene meetings with internal audit to discuss risk factors in the activities of the financial undertaking concerned and in its responses to them.

In the estimation of the Financial Supervisory Authority it is good practice for management of a financial undertaking to give notification when an Internal Audit Director ceases employment as such. The Financial Supervisory Authority decides whether a meeting shall be held with the person in question thereafter.

13. Standards

It is considered good internal auditing practice to comply with the standards and guidelines recognised in this field. Examples of such are the standards issued by the IIA (the Institute of Internal Auditors) (http://www.theiia.org/) and ISACA (the Information Systems Audit and Control Association) (http://www.isaca.org/), and the guidelines of the Basel Committee on Banking Supervision (http://www.bis.org/publ/bcbs84.htm).

Reykjavík, 24 September 2008

FINANCIAL SUPERVISORY AUTHORITY

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