

GUIDELINES ON MINIMUM AUDIT STANDARDS FOR INTERNAL AUDITORS OF LABUAN BANKS

1.0 Introduction

- 1.1 The internal audit function in Labuan banking industry is of paramount importance in the context of the change and growth in this industry. Increased competition, pressure to operate profitably or to improve performance, introduction of new financial products and the change in information technologies could result in management giving inadequate emphasis to sound operational and risk controls. It is therefore, incumbent upon the management to enhance and to upgrade the internal audit function so as to enable the internal auditors to play a more proactive and meaningful role in assisting the Labuan banks to achieve sound and stable growth.
- 1.2 The Guidelines on Minimum Audit Standards for Internal Auditors of Labuan Banks (Guidelines) is issued to meet the following objectives:
- (a) To enhance the quality and effectiveness of the internal audit function;
 - (b) To re-emphasise the role, duties and responsibilities of internal auditors to the board of directors (board), all levels of management and the external auditors; and
 - (c) To provide a uniform practice guide on internal auditing.
- 1.3 Labuan FSA envisages that the quality and effectiveness of the internal audit function in the Labuan banks would be further enhanced with the implementation of the Guidelines. An effective internal audit function would complement the work of the external auditors.

1.4 The Guidelines is not meant to be exhaustive nor intended to provide detailed audit steps required to perform the audit of every operational area of Labuan banks. For this, the internal auditors should also be guided by the authoritative pronouncements issued by the relevant professional accounting and auditing bodies. However, the minimum requirements contained in the Guidelines are to be complied with and appropriately implemented taking into account the circumstances and the operations of the Labuan bank concerned.

2.0 Applicability

- 2.1 The Guidelines is applicable to all Labuan banks under the following categories:
- (a) Labuan bank licensed under Part VI of the Labuan Financial Services and Securities Act 2010 (LFSSA);
 - (b) Labuan Islamic bank licensed under Part VI of the Labuan Islamic Financial Services and Securities Act 2010 (LIFSSA); and
 - (c) Labuan bank that has been given approval to undertake its business as a Labuan Islamic bank under Part VI of LIFSSA.
- 2.2 The Guidelines is applicable to **all** Labuan banks. The Guidelines should be read in conjunction with other prudential guidelines issued by Labuan FSA. The Guidelines is also applicable for the internal audit function of the Labuan banks which is to be undertaken by the bank's group internal auditors.

3.0 Legal Provision

- 3.1 The Guidelines is issued pursuant to Section 4A of the Labuan Financial Services Authority Act 1996 (LFSAA) in respect of Labuan banking business or Labuan Islamic banking business for the purpose of clarifying the minimum internal audit standards for Labuan banks.

3.2 Any person who fails to comply with the Guidelines commits an offence and may be punishable under Section 36B and 36G of the LFSAA.

4.0 Effective Date

4.1 The Guidelines shall come into effect on 6 June 2014 and would remain effective and applicable unless amended or revoked.

4.2 With the issuance of the above Guidelines, the following Guidelines and Circulars will be superseded, accordingly:

- (a) Guidelines on Minimum Audit Standards for Internal Auditors of Labuan Banks dated 8 April 1997;
- (b) Circular on Guidelines on Minimum Audit Standards for Internal Auditors (No.: 2001/1/OB) dated 1 August 2001; and
- (c) Circular on Supplementary Guidelines to Minimum Audit Standards for Internal Auditors (No.: BG/OB/02/4) dated 7 June 2002.

5.0 Arrangement of Sections

5.1 The Guidelines are organised into five parts as follows:

- (a) Part I covers the **Organisation of Internal Audit Function**. This part addresses the basic principles governing the independence and objectivity, the professional proficiency, relationship and communication and audit governance of the internal audit function.
- (b) Part II describes the main **Duties and Responsibilities** expected to be carried out by the internal auditors. This part does not cover other duties and responsibilities which the internal auditors may be called upon to perform.

- (c) Part III relates to the **Scope of Audit Work** which not only encompasses the appraisal and evaluation of the system of internal control but also assesses the management efficiency and effectiveness.
- (d) Part IV on **Reporting and Documentation** covers the audit report and the documentation and retention of audit working papers.
- (e) Part V covers the **Audit of Critical Areas of Operations** which the internal auditors should focus and give due consideration. More time and attention should be devoted to these critical areas. The critical areas identified below are not exhaustive and the internal auditors are encouraged to include other operational areas deemed critical. The critical areas are:
 - (i) Credit Operations;
 - (ii) Treasury Operations;
 - (iii) Derivatives;
 - (iv) Investment in Debt and Equity Securities;
 - (v) Information Systems;

5.2 Part I to IV of the Guidelines cover the basic principles and audit standards common to all the Labuan banks.

PART I: Organisation of Internal Audit Function

6.1 Overview

6.1.1 Internal auditors play an important functional role in helping to establish and maintain the best possible internal control environment at their Labuan banks. An effective internal audit function is crucial to ensure a sound financial system as a whole. Important consideration has to be

given to the organisation of the internal audit function in the Labuan bank to ensure its effectiveness, independence and objectivity. Fundamental among them is the establishment of an Audit Committee (AC). Besides independence and objectivity, professional proficiency and integrity are key characteristics expected of internal auditors.

6.1.2 Certain Labuan banks, which by virtue of their nature and size of operations, may find the establishment of an internal audit department too onerous. For reasons of synergy and economies of scale, these Labuan banks may use the services of the group internal auditors. The reporting lines of the internal audit function in such cases, must be clearly defined. However, prior approval from Labuan FSA is required before the group internal audit department can render its services to them. This Part explains the minimum requirements expected of the internal audit function of all Labuan banks with regard to the independence and objectivity, professional proficiency, relationship and communication and audit governance.

6.2 Audit Committee

6.2.1 An AC generally comprises non-executive directors. The role of the AC in the context of the Guidelines is basically to provide an avenue for the internal audit department to effectively voice their findings. The effectiveness, independence and how influential the AC is, would to a great extent, depend upon the professional competence of the members themselves.

6.3 Independence and Objectivity

The independence and objectivity of the internal auditors are important prerequisites in the proper conduct of audits so as to render impartial and

unbiased judgements. Internal auditors should not only be independent in fact but also be seen to be independent.

6.3.1 Organisational Status

- 6.3.1.1 The status of the internal audit department within the Labuan banks overall organisation structure should be sufficient and distinct to permit the internal auditors to accomplish their audit objectives. Internal auditors should have the support of the management in order to gain the cooperation of the auditees and to perform their work free from interference. The position of the Chief Internal Auditor (CIA) should be equivalent to the status of other key functional heads to enable him to deal effectively with his peers and superiors when discharging his duties and responsibilities. The appointment, remuneration, performance appraisal, transfer and dismissal of the CIA should be decided by the AC.

- 6.3.1.2 The CIA should be functionally responsible to the AC although administratively, he may report to the Chief Executive Officer (CEO). The CIA should have unrestricted access to the AC. Regular communication with the AC helps to assure independence and provides the means for the CIA to keep the AC informed on audit matters.

- 6.3.1.3 Internal auditors should not be responsible for any operational or system function. Internal auditors should have unrestricted access to the institution's records, assets, personnel and premises which are necessary for the proper conduct of the audit. Any such restriction should be promptly communicated in writing to the AC for the latter to resolve with the management.

6.3.2 Objectivity

6.3.2.1 Objectivity is an independent mental attitude which would enable the internal auditors to exercise judgement, express opinions and present recommendations with impartiality.

6.3.2.2 The internal auditors should at least observe the following:

- (a) Avoid any conflict of interest situation arising either from their professional or personal relationships in an organisation or activity which is subject to audit;
- (b) Have no authority or responsibility over any unit or activity that is being audited;
- (c) Should not be assigned to audit operational areas which they were previously involved as a non-audit staff until an independent audit has been conducted during the intervening period; and
- (d) Act in advisory capacity when recommending controls on new systems or reviewing procedure prior to their implementation.

6.4 Professional Proficiency

The effectiveness of the internal audit function depends substantially on the quality, training and experience of the audit staff. The internal audit staff should be suitably qualified and be provided with the necessary training and continuing professional education for the purpose of enhancing or enriching their audit and relevant technical skills.

6.4.1 Resources

6.4.1.1 The CIA, in consultation with the CEO, has to decide the right resources required for the internal audit department taking into consideration the size and complexity of operations of the Labuan banks. The level of the resources required should be justified and endorsed by the AC. The CIA should establish suitable criteria for the recruitment of the internal audit staff. The effectiveness of the internal audit function may be enhanced by the use of specialist staff or consultants, particularly when the auditable areas are highly technical in nature.

6.4.2 Qualification, Knowledge, Experience and Skills

6.4.2.1 The academic background and expertise required of the CIA varies depending on the size and complexity of the Labuan bank's operations and on the management's emphasis placed on the internal audit function. Essentially, to commensurate with his position in the organisational hierarchy, the CIA should possess relevant academic/professional qualification and sufficient audit experience. However, those without the relevant academic/professional qualification but regarded by management to be competent may also have in-depth knowledge of the business and organisational, technical, communication and other relevant skills.

6.4.2.2 Internal auditors should be proficient in applying approved auditing guidelines and accounting standards, legal and regulatory requirements, directives and guidelines issued by Labuan FSA and other authorities, and other rules and regulations issued by the relevant associations of the banking industry.

6.4.3 Supervision

6.4.3.1 Supervision is a continuing process from the planning to the conclusion of the audit assignment. The CIA is responsible for the audit performed by his subordinates. The CIA should ensure that the audit objectives stated in the approved audit programme have been achieved. The CIA should set a reasonable time frame for the completion of each audit assignment (i.e. from the commencement of the assignment to the issuance of the audit report) after considering its nature and complexity.

6.4.4 Code of Ethics

6.4.4.1 The internal auditors should at all times exercise due professional care when discharging their duties and responsibilities. They should carry out their work independently, objectively, professionally and with utmost good faith. The internal auditors should subject themselves to the highest ethical standards and avoid any conflict of interest situation. They are required to maintain strict confidentiality with regard to all information obtained in the course of their work and must never misuse any privileged information for personal gain.

6.4.5 Training

6.4.5.1 The AC has a responsibility to ensure that the internal audit staff receive the necessary training to perform the audit work. There should be a programme of continuing education and training to enable the internal auditors to keep abreast with the business trends and developments as well as to upgrade and enhance

their technical skills. The CIA should ensure that on-the-job training is provided to new recruits under the supervision of suitability competent and experienced internal auditors. Training should be a planned and continuous process for all levels of internal audit staff. The CIA, in consultation with the AC and the CEO, should determine the budget requirements for the training needs of the internal audit department.

6.5 Relationship and Communication

Internal auditors are expected to have constructive working relationship with the management and should be in constant communication with the external auditors and Labuan FSA on areas of common interest.

6.5.1 Management

6.5.1.1 There should be mutual respect and cooperation between the management and internal auditors. Consultation with management may lead to the identification of areas of audit concern which require the CIA's attention. Internal auditors should avail their expertise in an advisory capacity as a value-added resource to the management.

6.5.2 External Auditors

6.5.2.1 Internal auditors should develop a close working relationship with the external auditors. Regular meetings should be held with the external auditors on areas of common concern such as audit planning, audit priorities and scope to avoid overlapping of work. Internal auditors should also coordinate with the external auditors to ensure that the timing of the audits coincide so as to reap maximum benefits from auditing activities.

6.5.3 Labuan FSA and Other Regulatory Authorities

6.5.3.1 Internal auditors should immediately report to the AC and CEO any significant audit findings uncovered in the course of audit that would adversely affect the Labuan banks operating and financial condition. Labuan FSA and the home supervision authority should be promptly informed of such audit findings.

6.5.3.2 Internal auditors should maintain close cooperation with other regulatory authorities on areas of common interest.

6.6 Audit Governance

Internal audit department should have audit charter, audit plan, audit manual, audit programme and internal control questionnaires (ICQ) in place. Although these documents may be called by different names and differ in comprehensiveness, they are accepted as long as they serve the intended purpose.

6.6.1 Audit Charter

6.6.1.1 The audit charter is a formal written document that identifies the purpose, authority, scope, independence and responsibility of the internal audit function. The audit charter must be approved by the AC and endorsed by the board so that the internal audit function may be effectively discharged. The audit charter also serves to inform the CEO and all levels of management on the role, duties and responsibilities of internal auditors.

6.6.2 Audit Plan

- 6.6.2.1 The CIA should develop an audit plan as a means of directing and controlling the audit work. The audit strategic plan may range from one to five years depending on the size and complexity of operations. The plan should set out the audit objectives, auditable areas, scope of coverage, frequency of audit, resources required and duration of each audit assignment. The CIA should assess the risks of the auditable areas before determining the audit frequency and scope of coverage. The risk assessment methodology used for this purpose should be documented and regularly reviewed.
- 6.6.2.2 For subsidiaries, the audit cycle should at least twice a year. At least one of the audits should be a full audit while the other can be, at the discretion of the CIA, a “specialised or focus” audit.
- 6.6.2.3 For branches, the minimum audit cycle is once a year, and the internal auditors should coordinate with the external auditors to ensure that the timing of the audits do not coincide.
- 6.6.2.4 Surprise audit can be carried out provided Labuan FSA is informed, at least on the first day of audit, of the audit.

6.6.3 Manual

- 6.6.3.1 The audit manual provides the audit department personnel with a set of uniform audit standards for guidance and reference. It also serves as a valuable training aid for new recruits. The audit manual should contain written audit policies, objectives, standard procedures and programmes. The CIA should ensure

that the audit manual is comprehensive enough to cover at least the major operations of Labuan bank and is modified periodically to reflect corporate, regulatory and industry trends.

6.6.4 Audit Programme and Internal Control Questionnaires

6.6.4.1 Audit programme is a set of detailed step-by-step audit procedures for each auditable area and is usually supplemented by the ICQ. Both the audit programme and ICQ should be comprehensive and tailored to keep abreast with the current developments relevant to the industry. A well-designed audit programme and ICQ would provide a systematic audit approach. In addition, the internal auditors' judgement and analytical skills are essential in ensuring high quality audit.

PART II: Duties and Responsibilities

7.1 Overview

7.1.1 The core function of an internal audit department is to perform an independent appraisal of the Labuan banks activities as a service to the management. The internal audit function plays an important role in helping management to establish and maintain the best possible internal control environment within the Labuan banks. A sound internal control environment would ensure the Labuan bank's compliance with legal and regulatory requirements, safeguarding of assets, adequacy of records, prevention or early detection of frauds, material errors and irregularities and efficiency of operation. This Part describes the main duties and responsibilities of the internal auditors which are necessary in promoting a sound financial system.

7.2 Adequacy and Effectiveness of System of Internal Control

7.2.1 Internal auditors are responsible for assessing the soundness and adequacy of the Labuan bank's accounting and operating controls. Careful evaluation of the system of internal control should be made to assess the degree of reliance the management can place on these controls. The internal auditors should determine whether the established system of internal control is effective, operative and complied with. The review of the system of internal control should be on-going to ensure that internal controls continue to effectively support the successful execution of the Labuan bank's business strategies. The reliability and integrity of financial information and the means used to identify, measure, classify and report such information also need to be assessed to ensure a sound management information systems (MIS).

7.3 Compliance with Policies, Procedures, Rules, Guidelines, Directives, Laws and Regulations

7.3.1 In carrying out their audit, the internal auditors should evaluate whether the Labuan bank is in compliance with the applicable laws and regulations, guidelines and directives issued by Labuan FSA and other regulatory authorities (both Malaysia and other countries), and applicable rules set by the various associations. The internal auditors should also review compliance with the internal policies and procedures of the Labuan bank.

7.4 Detection of Frauds, Errors, Omissions and Other Irregularities

7.4.1 The responsibility for the prevention and early detection of frauds, errors, omissions and other irregularities rests with the management through the implementation and continued operation of an adequate system of internal control. Such a system reduces but does not eliminate the occurrence of frauds, errors, omissions and other irregularities. Hence, in assessing the soundness and adequacy of the system of internal control, the internal auditors should be alert particularly when the internal control environment is weak or conducive for the perpetration of fraud or increases the risk of fraud or error.

7.5 Management Audit

7.5.1 In order to provide value-added service to the management, the internal auditors should review that the available resources are deployed and utilised in the most efficient, effective and economic way. This is to determine whether management has established systems and procedures to ensure the accomplishment of the Labuan banks objectives and goals.

7.6 Information Systems Audit

7.6.1 The computerisation of Labuan bank's operations has changed the work procedures, processing of information and maintenance of records. Internal auditors should ascertain that adequate controls are in place to minimise the vulnerability of information and to provide the necessary protection against the possibility of frauds and errors. Computerised operations are usually an important aspect of the Labuan bank's internal control structure. It is therefore crucial for the internal auditors to carry out IS audit in order to ascertain that control features are adequate to cover all computerised activities and effective to support the bank's operations and reporting requirements.

7.7 Participative and Consultative Role

7.7.1 The internal auditors should play a participative and consultative role in assisting management to accomplish the Labuan bank's overall objectives and goals. As the activities of the Labuan bank have become increasingly diverse and complex and coupled with the competitive environment, internal auditors may be requested to participate on a consultative basis in the development of new products and systems to ensure that the necessary control features are incorporated. The internal auditors' consultative role should, however, be made known to the management in order not to be construed as compromising their independence.

7.7.2 To provide value-added service to the management, the internal auditors' expertise may be consulted in the planning, design, development, implementation and operation of major computer-based systems. The internal auditors should participate in this role in an advisory capacity.

PART III: Scope of Audit Work

8.1 Overview

8.1.1 Generally, audit scope should entail the examination and evaluation of all functions and activities of the Labuan bank including control features, operational systems and procedures as well as assessment of the quality of management performance in discharging their duties and responsibilities. This Part deals with the scope of audit which the internal auditors are required to perform when carrying out an audit assignment. The minimum audit coverage on the specific critical areas of operations is discussed in Part V of the Guidelines.

8.1.2 The scope of audit work covered under this Part should not be construed to be exhaustive but serves to provide the minimum scope to be covered under any audit assignment. The CIA should ensure that sufficient coverage and depth be given to each audit assignment based on the assigned risk factors. The CIA, after having considered the level of risk for each auditable area, should decide whether to expand or limit the audit scope. Such decision should be properly documented. The internal auditors should also decide on the appropriate level of audit sampling in order to achieve their audit objectives. The internal auditors should be guided by the International Auditing Guideline on Audit Sampling.

8.2 Evaluation and Appraisal of System of Internal Control

Management is responsible for establishing a strong system of internal control to ensure the soundness of a Labuan bank. An effective system of internal control helps to reduce the risk of frauds, errors, omissions and other irregularities from occurring. In a computerised environment or otherwise, the internal auditors should understand, document, evaluate and test the system of internal control. The audit scope should cover the effectiveness of the system of internal control, the reliability and integrity of MIS, the prevention or timely detection of frauds, errors, omissions and other irregularities, and the means for the safeguarding of assets. The areas of audit concern are discussed below:-

8.2.1 Effectiveness of System of Internal Control

8.2.1.1 The effectiveness of system of internal control depends, among others, on the overall control environment in which the Labuan bank operates. A strong control environment, however, does not by itself ensure the overall effectiveness of the system of internal control. The internal auditors have to be wary of other factors that may affect the control environment. For each

auditee, the extent of audit coverage and frequency would depend on the assigned risk factor of the auditee based on a risk assessment methodology applied during the audit planning. The scope of the audit should be broadened when the assigned risk level of the auditee is high. The internal auditors have to be satisfied that the overall system of internal control is effective, adequate and functioning as planned; key control procedures exist and are adhered to; proper segregation of incompatible functions is practised at all times; and the existing control systems are adequate in realising the Labuan banks objectives and goals.

8.2.2 Reliability and Integrity of Information

8.2.2.1 Internal auditors should review the relevance, reliability and integrity of financial and operating information generated and the means used to identify, measure, classify and report such information. In addition, internal auditors should determine that information is provided to the management on a timely basis for their decision making. For each audit concern, the internal auditors should perform the following:

- (a) Ascertain that financial and operating records and reports contain accurate, reliable, timely, complete and relevant information and are prepared in compliance with approved accounting standards;
- (b) Determine that control procedures over record keeping and reporting are adequate and effective;
- (c) Evaluate the process in which information is captured, recorded and protected;

- (d) Ascertain that the system for generating reports to Labuan FSA is adequate and effective; and
- (e) Verify accounting records and reconciliations.

8.2.3 Safeguarding of Assets

8.2.3.1 Internal auditors should review that adequate controls are in place to safeguard the Labuan bank's assets against losses from theft, fire and unauthorised use. Assets in this context cover all physical assets beneficially owned by the Labuan bank.

8.2.4 Detection of Frauds, Errors, Omissions and Other Irregularities

8.2.4.1 The existence of an effective system of internal control reduces but does not eliminate frauds, errors, omissions and other irregularities from occurring. There will always be some risk of internal controls failing to operate as intended. Any system of internal control may be ineffective against fraud involving collusion among employees or fraud committed by the management. Although internal auditors are not responsible for detecting frauds, errors, omissions and other irregularities, they should be vigilant and alert where auditee's operations substantially deal with cash transactions or involve high risk activities.

8.2.4.2 The internal auditors should be in a position to determine the auditable areas where the possibility of frauds, errors, omissions and other irregularities are most likely to occur. Accordingly, the audit scope should be widened to cover at least the following areas of concern:

- (a) System of internal control is effective such that errors and omissions (whether intentional or unintentional and irrespective of their materiality) are prevented or detected promptly;
- (b) Situations exist whereby errors, omissions or defalcations can be concealed particularly in situations where the persons holding those positions are able to manipulate the records and have access to assets;
- (c) Major deviations from established policies, practices and procedures are investigated;
- (d) Propriety of management's claims is ascertained and the claims incurred are in line with the Labuan bank's approved policies and procedures; and
- (e) Indicators exist whereby records can be manipulated especially when key officers or other employees' financial rewards are linked directly to the operating results.

8.2.4.3 During the course of the audit, if significant control weaknesses are uncovered or internal auditors have received information from sources within or outside the organisation about suspicious activities, the internal auditors' scope should be extended to confirm or dispel whether frauds, errors, omissions and other irregularities have occurred. An investigation is warranted if there is sufficient evidence or indication that fraud or material irregularities are likely to occur. Management and Labuan FSA should be informed of the investigation results. A police report should be made, if necessary, when criminal wrongdoing is suspected. The internal auditors should assist management to revise and strengthen the control features to prevent the recurrence of similar fraud or material irregularities in future.

8.3 Compliance with Policies, Procedures, Rules, Guidelines, Directives, Laws and Regulations

8.3.1 All Labuan banks should ensure strict compliance with all applicable laws and regulations, guidelines, directives, reporting requirements and internal policies and operating procedures. The audit scope should cover the Labuan bank's compliance with:

- (a) Labuan Companies Act 1990, LFSSA, LIFSSA and Labuan Business Activity Tax Act 1990;
- (b) Guidelines, directives and circular issued by Labuan FSA and pronouncements or rules issued by the relevant associations; and
- (c) Internally approved policies and operational procedures.

8.4 Adequacy and Effectiveness of Risk Management System

8.4.1 A risk management system is essential to the Labuan bank. In view of increasing competition, complexities of operations and financial innovations, management should develop a formalised system to ensure that risk exposures are identified and adequately measured, monitored and controlled. The risk management system should commensurate with the scope, size and complexity of the bank's activities and the level of risk a bank is prepared to assume.

8.4.2 Labuan banks, particularly those engaging in financial derivatives activities, should have comprehensive risk management system. The process of risk management for derivative activities should be integrated with the Labuan bank's overall risk management system to the fullest extent using a conceptual framework common to the Labuan bank's other activities. Such a common framework enables the institution to manage its consolidated risk exposure more effectively.

8.4.3 While the minimum audit coverage to be performed on derivative activities is covered in Part V of the Guidelines, the following are the audit concerns with respect to the overall risk management system:

- (a) Effective management supervision is practiced by the board and its delegated authorities;
- (b) Procedures that identify and quantify the level of risk on a timely basis are in place;
- (c) Limits or other controls are in place to manage the risk;
- (d) Reports to the management accurately present the nature and level of risk taken and any non-compliance with approved policies and limits;
- (e) Responsibilities for managing individual risks are clearly identified; and
- (f) Procedures relating to the calculation and allocation of capital to risks are in place.

8.4.4 Internal auditors should design auditing procedures that would assess the integrity of risks measurements, adequacy of control and reporting systems and compliance with approved policies and procedures.

8.5 Economical, Effective and Efficient Use of Resources

8.5.1 The principal objective of any Labuan bank is to increase its profitability through the economical, effective and efficient use of available resources. Management is responsible for setting measurement standards, benchmarks or productivity indices to gauge the returns from the utilisation of these resources. These measurement standards, benchmarks or indices have to be approved by the board.

8.5.2 The internal auditors should play a proactive role to determine the Labuan bank's optimum utilisation of available resources in the accomplishment of the organisation's overall objectives and goals. Such role will add value to their service to the management. Hence, the internal auditors should extend its traditional role of compliance audit to cover management auditing.

8.5.3 In regard to management audit, the internal auditors should review whether:

- (a) Established system for planning, appraising, authorising and controlling the use of resources are operational and effective;
- (b) Operating standards have been established for measuring the economy, efficiency and effectiveness of resources employed and have been met;
- (c) Deviations from operating standards are promptly identified, analysed and communicated to those responsible for taking remedial measures; and
- (d) Remedial or corrective actions have been taken.

8.5.4 In performing management audit, the internal auditors should highlight to the management whether there are underutilised resources, non-productive work, procedures which are not cost justified and over or understaffing. Internal auditors should ensure that management has developed action plans to address these deficiencies. Follow-up audit should be conducted to ascertain that the action plans have been implemented.

8.6 Accomplishment of Established Objectives and Goals

8.6.1 The board is responsible for the business plan and strategy to achieve the bank's overall objectives and goals. Based on the objectives and goals set by the board, the management is responsible for establishing operating or programme objectives and goals, developing and implementing control procedures, and accomplishing the desired operating or programmed results.

8.6.2 In evaluating the accomplishment of established objectives and goals, the internal auditors' scope should cover the entire operations or a subsection of it to determine whether:

- (a) Objectives and goals are clearly set and measureable;
- (b) Objectives and goals have been articulated and communicated to all staff and are being met;
- (c) Adequate controls are established for measuring and reporting the accomplishment of objectives and goals;
- (d) An effective control mechanism is implemented to monitor actual performance against budget. Any significant variances are analysed, investigated and promptly reported to the management and the board;
- (e) Management has considered the strengths, weaknesses, opportunities and threats of the respective operation or programme;
- (f) The achievement of established objectives and goals is in compliance with policies, plans, procedures, laws and regulations; and
- (g) The underlying assumptions used by management in developing business plan and strategy are appropriate and reasonable.

8.7 Audit Programme¹

8.7.1 In relation to the duties and responsibilities of internal audit in 7.3 and 7.4 in the guidelines, the internal auditors are to include in their audit programme, the following matters:

- (a) Anti-Money Laundering and Counter Financing of Terrorism measures as well as controls as required by the **Guidelines on Anti-Money Laundering and Counter Financing of Terrorism (AML/CFT) – Banking Sector**;
- (b) Proper management of the Labuan Banks' offices and branches including the co-located offices and marketing offices; in accordance with Labuan FSA's requirements; and
- (c) Accuracy of reports and statistics submitted to Labuan FSA.

8.7.2 Internal auditors are to comply with these requirements at all times in the performance of their audit. Internal auditors would need to have an exit discussion with Labuan FSA after their audit. Labuan FSA reserves the right to extend the scope of the audit of such other matters as may be necessary based on its supervision of the Labuan bank.

PART IV: Reporting and Documentation

9.1 Overview

9.1.1 Internal audit reports provide a formal means of communicating audit results and recommended actions to the management and the AC. Audit reports provide the avenue for the AC to highlight significant weaknesses and the management's proposed remedial measures to the board. The management's acceptance of the internal auditors' recommendations for reducing risks, strengthening internal controls and correcting errors would be the desired result of the audit reports.

¹ With effect from 1 August 2001

9.1.2 It is of primary importance that in the course of the audit, should the internal auditors uncover major findings or frauds that would significantly affect the Labuan bank's financial position or operations, they should immediately inform management to ensure prompt corrective actions are taken.

9.2 Audit Report

9.2.1 A signed report should be issued to Labuan FSA within three (3) months² after the completion of each audit assignment irrespective of the significance of the issues raised. The internal auditors should discuss the audit results and the recommendations thereof with the auditee before the final audit report is issued. The discussion should be carried out with those individuals who are knowledgeable of detailed operations and those who can authorise the implementation of corrective actions. The comments of the management of the auditee should preferably be incorporated in the final audit report. The CIA should review and approve the final audit report before it is presented to the AC. A copy of the final audit report should be forwarded to the AC or any independent group of management that has been given the responsibilities to review the audit report on a timely basis. An exit meeting with Labuan FSA to highlight preliminary significant findings shall be carried out immediately upon completion of the physical audit.²

9.2.2 Where the completion of an audit is likely to take longer period, interim audit report may be issued to communicate any significant issues which require management's immediate attention. The AC and the CEO should be kept informed of the issues as well as the audit progress. The issuance of interim audit report does not diminish or eliminate the need for the

² With effect from 7 June 2002

internal auditors to prepare a final report. The discretion as to whether an interim audit report is warranted rests with the CIA.

9.2.3 The CIA should ensure that an audit report should be of sufficient quality so as to command management's attention. In order to communicate the audit results effectively, the following standards should be adopted:

- (a) Audit report should be objective, clear, concise, constructive and timely; and
- (b) The structure of the audit report should preferably include the following:
 - (i) An executive summary;
 - (ii) Date of report and period covered by audit;
 - (iii) The scope and objectives of the audit;
 - (iv) The significance and magnitude of the problems or issues;
 - (v) The causes of the problems or issues;
 - (vi) Recommended solutions or preventive actions;
 - (vii) Auditee's comments on the issues and recommendations and remedial measures taken or proposed to be taken to address the audit issues;
 - (viii) Management's achievements noted during the audit; and
 - (ix) Overall conclusion.

9.3 Action and Follow-Up on Audit Recommendations

9.3.1 Management should treat all audit findings and recommendations seriously. The audit report must provide the details of the findings, management responses together with proposed remedial actions, to the extent approved by law.³ The internal auditors should monitor whether appropriate actions have been carried out on internal audit findings and

³ With effect from 7 June 2002

recommendations, unless management has understood and assumed the risk of not taking action.

9.3.2 Management's plan of corrective actions and implementation time table for completion should be developed and jointly agreed upon between the management and the auditee. The status of the corrective actions should be monitored and reported to the AC and the CEO so that follow-up action can be taken to inform the appropriate levels of management on outstanding audit issues.

9.4 Reporting of Significant Findings and Frauds

9.4.1 Internal auditors are required to make full disclosure of significant findings.³ The internal auditors should immediately report to the AC and the CEO any significant audit findings uncovered in the course of audit that would adversely affect the Labuan bank's operating and financial condition. Labuan FSA and home supervisory authority should also be promptly informed of such findings. Significant financial findings are those that would have an adverse impact on the financial performance and condition of the Labuan bank. Significant non-financial findings represent fundamental weaknesses that could lead to the collapse of the Labuan bank's system of internal control. The immediate audit report should incorporate preliminary summary findings, the impact or potential impact on the financial position and operations of the Labuan bank, and the proposed actions to be carried out by the internal auditors to investigate the matters.

9.4.2 A report should be submitted to the AC, the CEO and Labuan FSA and, if required under their guidelines, to the home supervisory authority once the investigation is completed. The investigation report should be as comprehensive as the normal audit report. It may also provide progress

report on the management's continuous actions to address the weaknesses and measures taken to prevent or minimise their recurrence.

9.5 Control and Filing of Audit Reports and Working Papers

9.5.1 The internal audit reports and working papers should be treated confidentially. The internal audit reports should only be disclosed to those persons authorised by the AC. As the internal audit working papers provide evidence of audit coverage and documentation of audit trails, they should be properly filed and stored. To ensure systematic filing and control of audit reports and working papers, the following minimum procedures should be observed:

- (a) The format for the working papers should be standardised;
- (b) There should be adequate referencing to identify the audit records, files and working papers created; and
- (c) There should be a system for filing and retrieving past reports and working papers.

9.6 Retention of Audit Reports and Working Papers

9.6.1 As a minimum requirement, the audit working papers on the routine audit should be retained until the next audit is carried out on the same auditable area. Reports and working papers on investigation matters should be retained until the matter is closed. All internal audit reports, however, should be retained for at least three years or until the next audit report on the same auditable area is completed.

10.1 Overview

- 10.1.1 Part I to Part IV of the guidelines address the minimum requirements expected of the internal audit function of the Labuan bank and would provide the foundation for a strong and effective internal audit function. Internal auditors are expected to review all auditable areas of the Labuan bank. However, internal auditors should pay more attention and direct their available resources to those operations or units which entail significant risks that may have an adverse impact on the operations and financial condition of the Labuan bank.
- 10.1.2 Part V of the guidelines covers the audit of certain areas of the Labuan bank's operations deemed critical and the minimum scope of audit work which the internal auditors must perform in the course of audit. The applicable critical operational areas identified are Credit Operations, Treasury Operations, Derivatives, Investment in Debt and Equity Securities, Information Systems. These critical areas of operations are not meant to be exhaustive and the internal auditors should also identify and review other operational areas deemed to be critical to the specific business undertaken by the Labuan bank.
- 10.1.3 In reviewing the critical areas of the operations, it is vital that the audit coverage is comprehensive. The internal auditors should extend their scope if serious unsatisfactory features are uncovered in the course of the audit.

10.2 Credit Operations

10.2.1 Introduction

10.2.1.1 Credit operations involve credit appraisal, approval, documentation, disbursement, supervision, recovery and rehabilitation. Credit operations cover the extension of both on and off balance sheet credit facilities. In most Labuan banks, loans and advances usually account for a significant proportion of the assets and contribute a substantial portion of total revenue. The risks associated with the credit operations are crucial and have to be addressed and managed. The Labuan bank's credit strategy, policies and risk management would affect the quality of loans and advances. This, in turn, may have a major impact on the profitability, liquidity and solvency of the Labuan banks.

10.2.2 Credit Strategy

10.2.2.1 A Labuan bank's credit strategy includes the organisation's defined objectives and goals for the extension of credit facilities so as to achieve profitable returns while managing risks within the credit portfolio. The credit strategy should establish a fundamental market posture, set goals for portfolio growth or contraction, impose limits on industry and geographical concentrations formulate policies on interest rates margin and fees, and identify and manage risks. Credit strategy is usually determined by management and approved by the board. Management should regularly review the credit strategy and policies to keep pace with the competition and changing market and economic conditions. The Labuan bank should address the risks inherent in credit operations when developing its credit strategy.

10.2.3 Risks Inherent in Credit Operations

- 10.2.3.1 The credit risk of a borrower is the most significant risk involved in credit operations. The potential inability of the borrowers to meet their repayment obligations will have an adverse impact on the Labuan bank's profitability, liquidity and solvency. The borrowers' repayment capacities may be affected by various factors, such as general economic condition, level of interest rates, unemployment and downturn in particular economic sectors and markets. As such, it is essential for the management to have a risk grading system on the borrowers. The internal auditors should assess whether the Labuan bank has adequately dealt with the potential credit risk profile of the borrowers in its credit policies and procedures.
- 10.2.3.2 Other risks associated with credit operations include collateral, concentration, country, foreign exchange, fraud, prepayment, interest rate, legal and regulatory, management and operations risks.

10.2.4 Policies and Procedures

- 10.2.4.1 Management is responsible for establishing sound and prudent credit policies and procedures. These credit policies and procedures may be in the form of credit manuals, credit standards or guidelines. The credit policies, which should be formalised and approved by the board, generally set the direction of lending, loan mix, approving limits, credit concentration, credit criteria for prospective borrowers, types of acceptable security, security documentation and prohibited lending. The credit procedures usually provide detailed

guidelines on the various credit processes and credit administration, including among others, monitoring and classification of delinquent credits, loan write-off and reporting. The board may delegate the authority to set the credit procedures to the management committee.

10.2.4.2 The CIA should decide on the scope of audit coverage based on risk assessment methodology. In any case, all large credit exposures granted to individual borrower or a single group of borrowers must be reviewed. The internal auditors should address the following areas of audit concern:

- (a) Credit policies and procedures are adequate;
- (b) Credit operations are in line with the approved credit strategy, policies and procedures;
- (c) Proper segregation of duties and responsibilities relating to loan processing, approval, custody of security and legal documents and loan administration is practised;
- (d) Creditworthiness and repayment capacities of the borrowers are carefully appraised and evaluated prior to the approval of the credit facilities;
- (e) Credit disbursements are only made after the security and legal documentation have been duly completed;
- (f) Effective system is in place for credit monitoring, supervision and recovery, accounting and financial reporting;
- (g) No over-concentration of credit to a particular economic sector at institutional level;
- (h) Management review of credit exposures to borrowers is carried out periodically and in a timely manner;

- (i) No credit facilities are granted for self-serving purposes i.e. credit facilities to nominees of the directors and officers of the Bank; and
- (j) Loan documents and correspondences are properly maintained.

10.2.5 Security and Legal Documentation

10.2.5.1 The Labuan bank may be exposed to credit loss if its interest in the credit exposures is not legally protected. It is pertinent that security and loan documents are duly executed, validated and lodged with the relevant authorities before the borrowers are allowed to utilise the credit facilities. Most Labuan banks have their own panel of solicitors and professional valuers to assist in the security and legal documentation and the appraisal of the value of landed securities. The procedures relating to safe custody of the security and legal documents must be properly addressed by the management to ensure there is adequate segregation of incompatible functions.

10.2.5.2 In carrying out the checking and physical verification of the security and loan documents, the internal auditors should pay particular attention to the following audit aspects:

- (a) Labuan bank's legal beneficiary rights to collateral have been duly registered with the authorities to ensure its enforceability in the event of borrowers' default;
- (b) Procedures relating to the safekeeping of and control over the access to security documents and proper maintenance of collateral records are adequate;

- (c) Security and loan documentation are undertaken by the Labuan Bank's panel of solicitors or other approved solicitors;
- (d) Appraisal of value of landed security are undertaken by the Labuan Bank's panel of valuers or other approved valuers; and
- (e) Procedures concerning the withdrawal, substitution and discharge of collateral are in place and adhered to.

10.2.6 Credit Disbursement

10.2.6.1 A pre-disbursement checklist is necessary to ensure that all security and legal documentation are in order and complete and conditions precedent are fulfilled before disbursement of credit. It is usually the responsibility of the loan administration officers to ensure that all pre-disbursement conditions are complied with by the borrowers before the release of credit facilities is approved by the appropriate authority.

10.2.6.2 The internal auditors' scope of coverage should include the following:

- (a) Pre-disbursement checklist is duly signed off by the loan and administration officer and approved by the relevant authority before the loan proceeds are released to the borrowers; and
- (b) Loan proceeds are released in accordance with the approved terms and conditions.

10.2.7 Credit Monitoring, Supervision and Recovery

10.2.7.1 Loan accounts should be reviewed prior to renewal, enhancement, reduction or restructure of existing credit exposures. This review normally includes analysing the borrower's periodic financial statements and financing requirements, reassessing collateral values, making site visits to the borrower's business premises and keeping abreast with trends and developments in the industry. An effective credit monitoring system could serve as an early warning system for detecting potential problematic loans. This should enable the management to take prompt action or measures to safeguard the Labuan bank's interest. There should be proper credit supervision to ensure that the Labuan bank's credit standards are met. An effective credit recovery system is essential to minimise loan losses should the loans turn non-performing.

10.2.7.2 In evaluating the Labuan bank's credit monitoring, supervision and recovery system, the internal auditors should determine whether:

- (a) Collateral is valued periodically to ensure that the credit exposures are within the margin of advance;
- (b) Potential delinquent loans are identified in a timely manner and prompt follow-up measures are adopted;
- (c) Management is informed of the status of delinquent loans;
- (d) Adequate review of all the loan accounts is conducted before the borrowers' existing credit facilities are renewed, enhanced, reduced or restructured;

- (e) Borrowers are appropriately graded in relation to risks; and
- (f) Restructured/rehabilitated loan accounts are properly approved and closely monitored.

10.2.8 Accounting and Financial Reporting

10.2.8.1 It is the responsibility of the management to establish a proper accounting and financial reporting system. The accounting records should not only capture all the credit facilities granted but also the proper classification of credit facilities by loan types and economic sectors. An effective financial reporting system provides the management with information needed for credit management, decision making and target setting.

10.2.8.2 The internal auditors should address the following areas:

- (a) Loans are properly accounted for, correctly stated, classified and disclosed;
- (b) Reports on credit information to the management and the board are relevant, accurate, adequate and timely. These include analysis of the loan profile, loan growth, income contribution and concentration of credits in relation to economic sectors and borrowers;
- (c) Balances of the subsidiary loan records agree with the amount stated in the general ledger. Reconciliations should be current and immediate action should be taken to resolve any differences. The reconciliations should be reviewed and approved by the appropriate supervisory personnel;
- (d) Pertinent loan information is promptly recorded and independently verified to ensure accuracy;

- (e) Adequate system is in place to ensure that the credit exposures reported in the management accounts and Labuan FSA statistical returns are correctly stated; and
- (f) Accounting policies on income recognition, provision for loan losses and suspension of interest on non-performing loans are consistently applied.

10.2.9 Legal and Regulatory Requirements

10.2.9.1 The management is responsible for ensuring that credit facilities granted to borrowers do not breach any law and guidelines issued by Labuan FSA. In addition, the credit operations should be in adherence to the rules issued by the banking associations.

10.2.9.2 The internal auditors should review the Labuan bank's compliance with legal and regulatory requirements, in particular, the following:

- (a) Credits are not extended in excess of the single customer limit imposed by Labuan FSA;
- (b) Extension of credits to connected parties are in accordance with Labuan FSA guidelines; and
- (c) No approval of credit facilities in excess of the credit officers' delegated limits; and
- (d) Non-performing loans are properly classified according to the guidelines issued by Labuan FSA and appropriate amount of interest income are suspended and provisions are made for bad and doubtful debts.

10.2.9.3 The internal auditors should also ascertain whether there is an adequate system in place to ensure the following:

- (a) Classification and suspension of interest on non-performing loans and provision for bad and doubtful debts comply with the minimum requirements of Labuan FSA guidelines;
- (b) Credit facilities are classified correctly for the computation of risk weighted capital adequacy ratio; and
- (c) Statistical information submitted to Labuan FSA in relation to credit is correctly reported.

10.3 Treasury Operations

10.3.1 Risk Inherent in Treasury Operations

10.3.1.1 There are a lot of inherent risks in Treasury operations. The major risks associated with treasury operations are exchange rate, interest rate, credit, liquidity, country and operational risks. Management should establish an effective system of internal control to identify, monitor and manage these risks. An effective system of internal control should encompass a well defined organisational structure, clear formulation of policies and operating procedures, reporting requirements and accounting guidelines. Internal auditors should evaluate that the system of internal control designed is capable of identifying, monitoring and managing the major risks associated with treasury operations.

10.3.2 Policies and Procedures

10.3.2.1 Labuan banks should established clear and comprehensive policies and operating procedures for treasury operations. These policies should be approved by the board. The policies and operating procedures should be periodically reviewed and updated to reflect changes in market practices, economic conditions and regulations. Broad policies normally include the trading objectives and strategies, management control and supervision of FX and MM trading activities, duties and responsibilities of dealers, approving authorities and discretionary limits, approved list of brokers, operational and counterparties limits and trading hours outside normal business and off-premises dealings. The operating procedures should cover settlement, extension and cancellation of contracts, giving of preferential rates, approval and duration of excesses and detailed descriptions of accounting, revaluation and reconciliation processes.

10.3.2.2 The internal auditors should address the following areas of audit concern:

- (a) Adequacy of and compliance with established policies and procedures;
- (b) Treasury operations are in line with the objectives and strategies of the asset and liability management and the approved policies and procedures;
- (c) Proper segregation of duties and responsibilities relating to dealing, processing, settlement, accounting, revaluation and reconciliation functions are practised;

- (d) Adequacy of and compliance with internally approved trading limits;
- (e) Amendments made to contracts are properly authenticated;
- (f) Inward and outward confirmations are verified and matched. Any discrepancies are checked immediately with the counterparties and recorded in the log book and any unusual or irregular transactions are investigated;
- (g) Dealing positions of foreign branches and other related offices are adequately monitored;
- (h) Independent revaluation of foreign currency accounts is performed on a periodic basis;
- (i) Settlements of FX and MM transactions are in accordance with the instructions stipulated in the contracts; and
- (j) Proper controls exist over the transfer of funds.

10.3.2.3 Internal auditors should be alert of transactions which are exceptional or highly speculative in nature. The scope of coverage should be extended when such transactions are suspected.

10.3.3 Accounting and Financial Reporting

10.3.3.1 In reviewing the accounting system of the treasury operations, the internal auditors should determine whether:

- (a) Recording, revaluation and income recognition of FX and MM transactions are carried out promptly and in accordance with Approved Accounting Standards;
- (b) Accounting records are adequate for the preparation of position reports and for revaluation of FX positions; and

(c) Reconciliation is performed frequently and all unreconciled items are timely resolved.

10.3.3.2 Internal auditors should also assess the reliability of the system used to generate the management reports and Labuan FSA statistical returns such as the return on the maturity structures of assets and liabilities (Form LM (MS)). The frequency and types of reporting should be addressed in the policies.

10.4 Derivatives

10.4.1 Introduction

10.4.1.1 To carry out their audit effectively, the internal auditors must be conversant and knowledgeable about derivative products and transactions and must be guided by comprehensive audit manuals and programmes. The internal auditors must also be familiar with all the relevant regulations and guidelines governing derivative activities in order to evaluate the Labuan bank's compliance.

10.4.2 Risk Inherent in Derivatives

10.4.2.1 Risk inherent in derivatives include market, credit, operational, liquidity and legal risks. The internal auditors should assess whether risk exposures assumed by the Labuan bank either have become too excessive vis-a-vis its capital position or have not been timely identified to the extent that they represent an unsafe and unsound banking practice.

- 10.4.2.2 The internal auditors should review whether the Labuan bank has complied with the requirements on common integration of risks, risks measurement, limits and reporting, and management evaluation and supervision. The internal auditors should also conduct periodic review on the risk management models used by the Labuan bank.
- 10.4.2.3 The internal auditors should ascertain whether the management and officers involved in derivative operations are fully aware of the risks associated with all on and off balance sheet transactions and whether such transactions are carried out for hedging or speculative purposes. The internal auditors should also determine whether management exercised caution when the Labuan bank is involved in over-the-counter derivative transactions. The nature and types of derivative products, why and how they are transacted would dictate the level and amount of risk that the Labuan bank is prepared to assume.

10.4.3 Policies and Procedures

- 10.4.3.1 The Labuan bank should have written policies and procedures on derivative operations that will include parameters on risk activities, types of derivative products traded, approving authorities and discretionary limits, review of various operational and counterparty limits and list of traders. Policies and procedures should also cover organisational structure and job responsibilities, reporting requirements, monitoring and stop loss mechanism, permissible activities, approved list of brokers and counterparties, dealing guidelines (including off-market transactions and off-premise dealings), pricing assumption, model and mechanism, dispute resolution methodology,

detailed description of transaction processes, settlement, accounting, revaluation and reconciliation procedures.

10.4.3.2 The internal auditors should review the Labuan bank's compliance with the following significant areas:

- (a) Board must approve all significant policies relating to the management of derivative risks. These policies should be consistent with the organisation's approved broader business strategies, capital strength, management expertise and overall willingness to take risks;
- (b) Management, in carrying out the approved policies, should ensure that there are adequate operational guidelines and procedures in place for conducting derivative operations on both long-range and day-to-day basis. This responsibility includes ensuring that there are:
 - (i) Clear delineation of lines of responsibility for managing risk;
 - (ii) Effective system for measuring risk;
 - (iii) Comprehensive risk-reporting process;
 - (iv) Appropriate limits on risk taking;
 - (v) Adequate dealing, processing and settlement procedures and effective system of internal control;
 - (vi) Effective monitoring and enforcement at all levels of management;
 - (vii) Sufficient resources and competence to carry out daily operations and risk management functions effectively;
 - (viii) Adequate revaluation procedures for derivative transactions; and
 - (ix) Adequate pricing models or mechanisms for derivatives.

- (c) A committee has been set up to approve, oversee and control the derivative activities;
- (d) Independent research unit is set up to monitor and ensure that the derivative activities are conducted within the established policies and guidelines and to conduct research and recommend improved risk measurement methods and control procedures.
- (e) Development of risk policy and the process of measuring, monitoring and controlling risk should be performed independently of individuals conducting the derivative activities (marketing, dealing and processing). The individuals or units responsible for these functions must also be able to report risk exposures and compliance with control procedures independently to both the management and the board;
- (f) New derivative activities should be avoided until the management has acknowledged and fully understood the activity and is in a position to oversee or manage the new activity; and
- (g) Derivatives are offered to customers for hedging purposes only and assessment on the suitability of the derivative products offered is adequate.

10.4.4 Accounting and Financial Reporting

- 10.4.4.1 An accurate, informative and timely accounting, management and financial reporting system is essential for the prudent operation of derivative activities. The quality of MIS is an important factor in the overall effectiveness of the risk management process. All reports pertaining to the derivative operations must be submitted to the management and the board.

10.4.4.2 The internal auditors should determine whether the accounting and report preparation are being carried out by persons or units independent of the dealing or marketing function. The audit scope should at least cover the following:

- (a) Written accounting policies relating to trading and hedging with derivative instruments conform to Approved Accounting Standards;
- (b) Accounting records accurately state the cost and market value of derivative transactions;
- (c) Methods used to value the derivative positions are appropriate and that the assumptions underlying those methods are reasonable;
- (d) Revaluation procedures address the full range of trading instruments;
- (e) Market rates used for revaluation are independently obtained;
- (f) All off-market price transactions and off-premise dealings are properly accounted for and reported; and
- (g) Level of profit and risk positions are assessed based on earnings and risk reward profile of specific products.

10.4.5 Legal and Regulatory Requirements

10.4.5.1 The internal auditors should review whether the relevant laws, regulations and guidelines have been complied with.

10.5 Investment in Debt and Equity Securities

10.5.1 Introduction

10.5.1.1 Labuan bank's investment in debt and equity securities normally involves participation in two main financial markets namely, the capital market and the money and foreign exchange market. A typical investment portfolio usually consists of public debt securities, equity securities (quoted and unquoted), equity-link securities, Islamic and private debt securities. Equity securities and private debt securities may also be acquired in the primary market or as a result of underwriting commitment. Investment and trading securities may account for a sizeable proportion of the Labuan bank's assets and hence, securities of inferior quality may have an adverse impact on the Labuan bank's financial condition.

10.5.2 Investment Strategy

10.5.2.1 An investment strategy should be established and approved by the board and regularly reviewed to take into account the changing market and economic conditions. The strategy should include the investment objectives and goals, the size of the investment portfolio, the types and composition of securities, quality and maturity structure and target yields for the overall portfolio. The investment strategy should also distinguish securities that are held for investment and trading purposes. A guiding principle in investment strategy is to achieve profitable returns while at the same time, managing risks within the investment portfolio. The investment strategy adopted should commensurate with the risk that the Labuan bank is prepared to assume.

10.5.2.2 Management should formulate policies and procedures for the purpose of analysing various investment alternatives. This is to meet the organisation's objectives after taking into consideration the level of management expertise, the sophistication of the Labuan bank's control procedures and monitoring systems, its asset and liability structure and its capacity to maintain liquidity.

10.5.3 Risks Inherent in Investment

10.5.3.1 The risks inherent in investment include credit, price, liquidity, operational and country risks. The level of the risks inherent in investment depends on whether the investment is held for long term or short term and the complexity of the investment products. Internal auditors should review the mechanism used by the management to identify and manage these risks.

10.5.4 Policies and Procedures

10.5.4.1 Management should establish comprehensive policies and procedures for investment operations. These policies should be approved by the board and subject to periodic review. Investment policies should encompass objectives and goals, exposure limits for each major type of investment, basis for assessing risks of alternatives investments, approving authority and discretionary limits for the purchase or disposal of investments, evaluation and selection of securities dealers and custodians, revaluation of investments and recognition of income and losses. The policies should also cover the basis of classification of investment either for investment or dealing purposes. Established procedures should include organisational

structure of investment unit or department, duties and responsibilities of investment officers, monitoring mechanism and reporting requirements.

10.5.4.2 The internal auditors should focus on the following significant areas:

- (a) Adequacy of and compliance with policies and procedures;
- (b) Investment operations are in line with investment strategy;
- (c) Segregation of duties for trading, processing, custody, payment and receipt and maintenance of subsidiary records and accounting functions is practised;
- (d) No over-concentration of investment in a particular counter, sector or types;
- (e) Trading and exposure limits imposed by the board are not breached;
- (f) Revaluation exercise is carried out on the investment portfolio at least on a monthly basis;
- (g) Adequate provision for permanent diminution in value has been made for securities of inferior quality; and
- (h) Securities borrowed or lent out are properly accounted for.

10.5.5 Accounting and Financial Reporting

10.5.5.1 The accounting and financial reporting of investment in debt and security should conform to Approved Accounting Standards. The classification of debt or equity securities, as either for investment or dealing purposes, must accord with the approved policies. Such classification should be determined at the outset of the acquisition, and any subsequent reclassification should be approved and properly documented.

10.5.5.2 The internal auditors should evaluate the relevancy, accuracy, frequency and timeliness of reports submitted to the management and the board. Such reports should cover all types of investment, gains or losses from disposal, provision for diminution in value and transfer of securities between investment and dealing securities.

10.5.6 Legal and Regulatory Requirements

10.5.6.1 The Labuan bank's investment should comply with the regulatory requirements issued by Labuan FSA and various regulatory bodies from time to time. Internal auditors should verify that the investment is within limits.

10.6 Information Systems

10.6.1 Introduction

10.6.1.1 For the purpose of the Guidelines, IS refers to an environment where a computer of any type or size is used to process information that is of significance to the audit. The overall objective and scope of an audit do not change in an IS environment. However, the use of a computer changes the processing and storage of information and the traditional visible audit trails may no longer exist. Accordingly, the audit procedures in the evaluation of the computerised system and related internal controls would be different from those used in the review of a manual system. Due to the loss of visible audit trail, the review of an IS processing function would require specialised knowledge and skills. The Labuan bank should have an effective IS audit function to evaluate the internal controls of the computerised system.

10.6.1.2 This section describes the minimum coverage in performing an IS audit. Specifically, the IS auditors should review the effectiveness of IS in supporting the business activities of the Labuan bank and the adequacy of controls over the IS management, systems development and programming, computer operations and security, teleprocessing and data integrity. This section also includes the minimum IS audit coverage for the electronic funds transfer (EFT) system.

10.6.2 Management

10.6.2.1 The primary responsibility for the overall system of internal control rests with the management. With the emergence of more complex systems and the need to protect Labuan bank's resources and customer information, the Labuan bank should establish an IS security policy. This policy should provide guidelines on the administration of security to ensure the confidentiality, integrity and availability of the computerised system.

10.6.2.2 In reviewing the IS management function, the IS auditors should pay particular attention to the following:

- (a) IS strategic plan is in place;
- (b) IS strategic plan is consistent with the Labuan bank's business objectives and goals;
- (c) Participation from the internal audit department is included if an IS steering committee is established;
- (d) Standards and procedures on the various IS activities such as systems development and programming, computer operations and security, teleprocessing and

computerised applications are adequate and in compliance with the IS security policy;

- (e) The organisational structure of the IS department provides proper reporting line. Segregation of incompatible functions within the IS processing activities is practised (i.e. systems development and programming, computer operations and security implementation). Nevertheless, in cases where such segregation may not be possible (normally found in small IS installation), the IS auditors should determine the adequacy of compensating controls;
- (f) Management reports on the IS activities are adequate and effective in monitoring IS performance and in assisting management to make business decisions;
- (g) IS staff and users are adequately trained; and
- (h) IS activities have complied with relevant guidelines issued by Labuan FSA from time to time.

10.6.3 Systems Development and Programming

10.6.3.1 Failure to use proven system development and implementation methodology could result in significant financial losses. Therefore, to ensure the reliability and integrity of computerised system installed, it is imperative that management provides adequate controls over the entire process of acquiring/developing computerised systems. Systems development and programming standards established by management should provide general guidelines on the design, programming, testing, conversion and implementation, documentation, maintenance of application and operating systems, software and hardware selection and acquisition and post-implementation review.

10.6.3.2 The IS auditors' role in the systems development and programming function should not only be limited to the auditing of systems already implemented. The IS auditors should also participate, in a consultative/advisory capacity, in the development of new computerised systems to ensure that appropriate audit and control procedures are designed and built into the systems. While participating in the systems development process, the IS auditors should maintain objectivity and independence from any operational responsibility of the system being developed. In the review of the systems development and programming function, the IS auditors' main areas of concern include the following:

- (a) Standards and procedures on the systems development and programming function are available and comprehensive;
- (b) The development of application systems has complied with the standards on the systems development and programming function;
- (c) An effective project management system is employed to monitor and control application development projects;
- (d) Application programmers do not have "write" access to production data and are not involved in the maintenance of operating systems software. Similarly, system programmers should not have access to production data and are not involved in the maintenance of application programmes;
- (e) Production system is properly segregated from the development or testing system;
- (f) Documentation maintained on the application systems is comprehensive and current. The documentation should at least include user manuals, computer operator

instructions, flowchart and description of the application systems and programmes;

- (g) Controls over the maintenance of application programmes and operating systems are adequate and effective to ensure the integrity of the data and programmes in the system. Procedures should ensure that all requests for changes are authorised and attended to timely. Only authorised programmes are catalogued to the production system and the relevant documentation updated to reflect the changes. Controls over urgent requests for application programme or operating system changes should also be in place since such requests would normally bypass the need for prior written authorisation;
- (h) Test plans and test results are adequately maintained for review;
- (i) Controls over the usage of powerful utilities with data altering capabilities are adequate and effective; and
- (j) Procedures to review purchase agreement and service contracts for hardware and software are available and adequate to protect the Bank's interest before they are executed.

10.6.4 Computer Operations

10.6.4.1 The computer operations section is responsible for the efficient and timely processing of data and the maintenance of the computer system. Generally, computer operation procedures should cover operations and maintenance of the computer equipment and its peripheral, problem handling and housekeeping of the computer room. With regard to the system reliability and availability, management has the responsibility to formulate a comprehensive disaster recovery plan, including identification of an alternative processing site and alternative processing capability.

10.6.4.2 The IS auditors should pay particular attention to the following areas:

- (a) Computer operations procedures are adequate and complied with;
- (b) Physical controls over the computer equipment are adequate and effective. Such controls may include access restriction to the console, teleprocessing equipment and back-up media library, maintenance of the computer room and installation of adequate protection against fire, flood and other disasters;
- (c) Controls are adequate to ensure correct tapes, disks or other storage media are used and data files are correctly written or read; and
- (d) Adequate detective and preventive controls are in place.

10.6.5 Computer Security

10.6.5.1 Management is responsible to institute adequate controls to ensure that unauthorised changes cannot be made to production programmes, operating system and data. Procedures should also be formulated by management on the implementation of the security administration function.

10.6.5.2 In assessing the adequacy of computer security, the IS auditors' main areas of concern should include the following:

- (a) The security administration function is clearly and properly assigned to a competent staff;
- (b) Procedures on security administration, such as on password issuance and maintenance and follow-up on access violations, are adequate and effective;

- (c) Assignment of access capabilities to users is properly done and in accordance with the access rule. Access to sensitive resources such as procedure libraries, powerful data and program altering utilities, system parameters, log and password files should be restricted. If a database management system is used, the assignment of access to the database should also be reviewed to ensure proper assignment of capabilities;
- (d) Logging, reporting and reviewing of activities, especially abnormal activities are adequate and effective; and
- (e) Security policy is communicated to users.

10.6.6 Teleprocessing

10.6.6.1 The diversification of information delivery channel poses an increased risk to data security through unauthorised access to a system. Management should ensure that adequate controls have been instituted over the Labuan bank's teleprocessing networks to ascertain that data transmitted are complete, accurate and authorised, routed to the correct destination and transmission errors are detected and corrected.

10.6.6.2 In reviewing the teleprocessing system, the IS auditors should look into the following areas:

- (a) Procedures on the teleprocessing activities are adequate and complied with. The procedures should at least include measures to restrict access to files, transactions, and terminals, logging, reporting and reviewing of deviations from normal transactions and backup procedures;
- (b) The security system implemented (for example, encryption, call-back and error detection techniques) to protect transmitted data over the telecommunication

media is adequate. In addition, the documentation on the design and development of the teleprocessing system should be adequately controlled by the Labuan bank;

- (c) All transmissions are received from authorised terminals and users;
- (d) Procedures on error detection and recovery are adequate and effective;
- (e) Network activities are logged, reported and reviewed by the network supervisor; and
- (f) Procedures are adequate to ensure system reliability.

10.6.7 Data Integrity

10.6.7.1 Most Labuan banks have installed computerised application systems, whether developed in-house or purchased from external software vendors, to process their operational activities. The accuracy and integrity of data are dependent upon the establishment of proper control procedures (programmed and manual) for transaction processing in both the user and IS departments of the Labuan banks.

10.6.7.2 Specific application review should be conducted by the IS auditor to test the integrity and reliability of data in a specific application system. In such review, the IS auditor should strive to use Computer-Assisted Audit Techniques (CAATs) since this approach could improve the checking of data integrity by auditing “through” the system rather than relying only on validation controls of input and output. The areas of concern in conducting such review are as follows:

- (a) Controls over the input of data are adequate and effective to ensure accuracy and completeness of data and to prevent initiation of transactions by unauthorised personnel;
- (b) Programmed controls (e.g. edit checks, reasonable checks) are adequate to ensure processing of information is correctly done. Such controls should include procedures on handling rejected and resubmission of data; and
- (c) Controls over output distribution are adequate. A comprehensive set of exception and discrepancy reports should be provided to authorised personnel for verification and error correction purposes.

10.6.8 Electronic Funds Transfer (EFT) System

10.6.8.1 Management is responsible for establishing policies and procedures for the EFT system which provides guidelines on the approving authority and discretionary powers, organisation of records and files, internal supervision in identifying irregularities and the relevant follow-up or punitive actions to be taken.

10.6.8.2 In reviewing the wholesale EFT system, the IS auditors should pay particular attention to the following:

- (a) Internal policies and procedures on funds transfer activities are adequate and complied with;
- (b) Controls over origination of input documents, processing and output distribution are adequate;
- (c) Teleprocessing controls are adequate to ensure the confidentiality, integrity and availability of data transmitted over the system;

- (d) Segregation of incompatible functions is enforced. For example, security administration, data entry and transmit functions should be segregated. Where data entry and transmit functions are not segregated for certain discretionary limits, adequate compensating controls should be in place;
- (e) Sensitive items, such as master password and log-in tables are kept under dual custody;
- (f) Reconciliation of the number of messages and value of the funds transmitted is performed on timely basis to minimise the exposure of erroneous transfer of funds or to detect unauthorised transfer of funds;
- (g) Reports printed to monitor activities in the system are adequate; and
- (h) Physical security over the terminals, records, equipment, source documents and system-generated reports is adequate.

Labuan Financial Services Authority
6 June 2014 (Updated)
7 June 2002 (3rd Issuance via Circular No: BG/OB/02/4)
1 August 2001 (2nd Issuance via Circular No: 2001/1/OB)
8 April 1997 (1st Issuance)