

# INTERNAL AUDIT CHARTER

## 1. INTRODUCTION

The Internal Audit Charter (the "Charter") defines the purpose, authority, scope, accountability, responsibility, and position of the Internal Audit Division within the Bahrain Islamic Bank B.S.C. (the "Bank").

The Charter will be made available to all internal and external stakeholders.

The Internal Audit Charter will be reviewed annually or when there are material changes in the operation, the responsibilities, and the organizational structure of the Internal Audit Division or auditing practices and applicable regulations which necessitate amendments to the Charter. The Board of Directors' (the "Board") approval will be sought for any amendments to the Charter.

## 2. PURPOSE AND MISSION

The Bank's Internal Audit Division's purpose is to provide independent, objective assurance and consulting services designed to add value and improve the Bank's operations.

The mission of the Internal Audit Division is to enhance and protect organizational value by providing risk-based and objective assurance, advice, and insight.

The Internal Audit Division helps the Bank accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of governance, risk management, and control processes.

## 3. STANDARDS

The Internal Audit Division will govern itself by adherence to:

- The mandatory elements of The Institute of Internal Auditors' International Professional Practices Framework, including the Core Principles for the Professional Practice of Internal Auditing, the Code of Ethics, the International Standards for the Professional Practice of Internal Auditing, and the Definition of Internal Auditing.
- Auditing and governance standards issued by the Accounting and Auditing Organization for Islamic Financial Institutions.
- The applicable regulations.
- The Bank's Code of Conduct.

The Chief Internal Audit will report periodically to the Audit, Compliance, and Governance Committee ("ACGC") regarding the Internal Audit Division's conformance to the Code of Ethics, Standards, applicable regulations, and the Bank's Code of Conduct.

## 4. STANDING AND PERMANENCY OF INTERNAL AUDIT DIVISION

The Internal Audit Division reports directly and functionally to the ACGC and administratively to the Chief Executive Officer ("CEO").

The Board ensures that the Internal Audit Division is a permanent function and commensurate with the size, the nature and complexity of the Bank's operations.

## 5. INDEPENDENCE AND OBJECTIVITY

The Chief Internal Audit will ensure that the Internal Audit Division remains free from all conditions that threaten the ability of internal auditors to carry out their responsibilities in an unbiased manner, including matters of audit selection, scope, procedures, frequency, timing, and report content. If the Chief Internal Audit determines that independence or objectivity may be impaired in fact or appearance, the details of impairment will be disclosed to ACGC.

Internal auditors will maintain an unbiased mental attitude that allows them to perform engagements objectively and in such a manner that they believe in their work product, that no quality compromises are made, and that they do not subordinate their judgment on audit matters to others.

Internal auditors will have no direct operational responsibility or authority over any of the activities audited. Accordingly, internal auditors will not implement internal controls, develop procedures, install systems, prepare records, or engage in any other activity that may impair their judgment, including:

- a) Assessing specific operations for which they had responsibility within the previous year.
- b) Performing any operational duties for the Bank or its affiliates.
- c) Initiating or approving transactions external to the Internal Audit Division.
- d) Directing the activities of any Bank employee not employed by the Internal Audit Division, except to the extent that such employees have been appropriately assigned to auditing teams or to otherwise assist internal auditors.

Where the Chief Internal Audit has or is expected to have roles and/or responsibilities that fall outside of internal auditing, safeguards will be established to limit impairments to independence or objectivity.

Internal auditors will:

- a) Disclose any impairment of independence or objectivity, in fact or appearance, to ACGC.
- b) Exhibit professional objectivity in gathering, evaluating, and communicating information about the activity or process being examined.
- c) Make balanced assessments of all available and relevant facts and circumstances.
- d) Take necessary precautions to avoid being unduly influenced by their own interests or by others in forming judgments.

The Chief Internal Audit will confirm to the ACGC, at least annually, the organizational independence of the Internal Audit Division.

The Chief Internal Audit will disclose to the ACGC any interference and related implications in determining the scope of internal auditing, performing work, and/or communicating results.

The independence of the Internal Audit Division does not prevent the Bank's management from requesting input from Internal Audit on matters related to risk and internal controls. Nevertheless, the development and implementation of internal controls remains the responsibility of the Bank's management.

## 6. SCOPE OF INTERNAL AUDIT ACTIVITIES

The scope of internal audit activities encompasses, but is not limited to, objective examinations of evidence for the purpose of providing independent assessments to the Board, ACGC, management, and outside parties on the adequacy and effectiveness of governance, risk management, and control processes for the entire Bank, including the Bank's outsourced services, subsidiaries (including SPVs), and branches.

Internal audit assessments include evaluating whether:

- a) Risks relating to the achievement of the Bank's strategic objectives are appropriately identified and managed.
- b) The actions of the Bank's officers, directors, employees, and contractors are in compliance with the Bank's policies, procedures, and applicable laws, regulations, and governance standards.
- c) The results of operations or programs are consistent with established goals and objectives.
- d) Operations or programs are being carried out effectively and efficiently.
- e) Established processes and systems enable compliance with the policies, procedures, laws, and regulations that could significantly impact the Bank.
- f) Information and the means used to identify, measure, analyse, classify, and report such information are reliable and have integrity.
- g) Resources and assets are acquired economically, used efficiently, and protected adequately.

An annual internal audit plan based on a robust risk assessment (including direct or indirect input from Senior Management and the Board) is established prior to year-end, which ensures adequate coverage of matters of regulatory interest. The ACGC approval of the audit plan also requires that an appropriate budget will be available to support the Internal Audit Division's activities.

The Chief Internal Audit also coordinates activities, where possible, and considers relying upon the work of other internal and external assurance and consulting service providers as needed in strict compliance with the Standards for the Professional Practice of Internal Auditing and applicable regulations. The Internal Audit Division may perform advisory and consultancy services in accordance to "Consultancy/Advisory Service" section of this Charter.

Opportunities for improving the efficiency of governance, risk management, and control processes may be identified during engagements. These opportunities will be communicated to the appropriate level of management.

## 7. AUTHORITY

Internal Audit aims to promote effective controls at reasonable cost. To achieve this, Internal Audit is authorized, in the course of its activities, to:

- a) With accountability for confidentiality and safeguarding records and information, it is authorized, in full, to initiate direct communication with any member of staff, to examine any activity or entity of the bank, and to have full and unconditional access to any records, files, data and physical properties of the bank. This includes access to management information systems and records and the minutes of board and sub-board committee meetings and all consultative and decision-making committees.
- b) Require all the members of staff and Management to supply such information and explanations as may be needed within a reasonable period of time.
- c) The Internal Audit Division has free and unrestricted access to the Board, through direct access to the ACGC.

## 8. ACCOUNTABILITY

The Internal Audit Division lead by the Chief Internal Audit is accountable to the ACGC on all matters related to the performance of its mandate as described in this Charter and the safeguarding of confidential information in its possession.

Cases of Internal Audit misconduct are reviewed and handled by the ACGC in accordance to the Bank's policies.

## 9. RESPONSIBILITIES OF THE CHIEF INTERNAL AUDIT

The Chief Internal Audit has the responsibility to:

- a) Submit, at least annually, to the ACGC a risk-based internal audit plan for review and approval
- b) Communicate to senior management and the ACGC the impact of resource limitations on the internal audit plan.
- c) Review and recommend to the ACGC adjustments to the internal audit plan, as necessary, in response to changes in Bank's business, risks, operations, programs, systems, and controls.
- d) Communicate to senior management any significant interim changes to the internal audit plan.
- e) Ensure each engagement of the internal audit plan is executed, including the establishment of objectives and scope, the assignment of appropriate and adequately supervised resources, the documentation of work programs and testing results, and the communication of engagement results with applicable conclusions and recommendations to appropriate parties.

- f) Follow up on engagement findings and corrective actions, and report periodically to the CEO and the ACGC any corrective actions not effectively implemented.
- g) Ensure the principles of integrity, objectivity, confidentiality, and competency are applied and upheld.
- h) Ensure the Internal Audit Division collectively possesses or obtains the knowledge, skills, and other competencies needed to meet the requirements of this Charter.
- i) Ensure the Internal Audit Division staff and managers receive adequate continuous training and education supporting their professional development.
- j) Ensure trends and emerging issues that could impact the Bank are considered and communicated to senior management and the ACGC as appropriate.
- k) Ensure emerging trends and successful practices in internal auditing are considered.
- l) Establish and ensure adherence to policies and procedures designed to guide the Internal Audit Division.
- m) Ensure adherence to the Bank's relevant policies and procedures, unless such policies and procedures conflict with this Charter. Any such conflicts will be resolved or otherwise communicated to senior management and the ACGC.
- n) Whenever practicable and without jeopardizing competence and expertise, periodically rotate internal audit staff within the Internal Audit Division.
- o) Ensure conformance of the Internal Audit Division with the Standards, with the following qualifications:
  - i. If the Internal Audit Division is prohibited by law or regulation from conformance with certain parts of the Standards, the Chief Internal Audit will ensure appropriate disclosures and will ensure conformance with all other parts of the Standards.
  - ii. If the Standards are used in conjunction with requirements issued by other authoritative bodies, the Chief Internal Audit will ensure that the Internal Audit Division conforms to the Standards, even if the Internal Audit Division also conforms to the more restrictive requirements of other authoritative bodies.

## 10. OPERATIONAL STRUCTURE

The Internal Audit Division operates as a single pool comprised of auditors. Chief Internal Audit is responsible for setting up the strategy and ensuring the smooth operation of the Internal Audit Division, in accordance with the legal and regulatory framework and the international best practices.

The Chief Internal Audit is supported by auditors. Auditors are allocated to audit teams according to audit requirements and time constraints of specific audit engagements. The results of the engagement are communicated to the audit manager in charge prior to issuance of the draft findings.

The draft findings are then issued to the relevant unit head, from whom responses to address the findings are sought. Management's response, provided by management of the audited area should include a timetable for anticipated completion of action to be taken and an explanation for any corrective action that will not be implemented; ; the Chief Internal Audit must promptly inform the CEO and other related heads of functions about its findings. The Internal Audit Division will be responsible for appropriate follow-up on engagement findings and recommendations. All significant findings will remain in an open issues file until cleared.

The Internal Audit Division has an annual budget, which is executed under the supervision of the ACGC, always in accordance with the established procedures.

## 11. REPORTING AND COMMUNICATION

A written report will be prepared and issued by the Chief Internal Audit or designee following the conclusion of each internal audit engagement and will be distributed as appropriate. Internal audit results will also be communicated to the CEO and the ACGC.

The Chief Internal Audit will monthly report to the CEO the status of pending internal audit recommendations.

The Chief Internal Audit will keep the Chief Compliance and Governance Officer informed of pending internal audit recommendations that are three months post issuance if high priority and nine months post issuance if medium or low priority.

The Chief Internal Audit will report periodically to the ACGC regarding:

- a) The Internal Audit Division's purpose, authority, and responsibility.
- b) The Internal Audit Division's plan and performance relative to its plan.
- c) The Internal Audit Division's conformance with The IIA's Code of Ethics and Standards, and action plans to address any significant conformance issues.
- d) Significant risk exposures and control issues, including fraud risks, governance issues, and other matters requiring the attention of, or requested by, the ACGC and/or the Board.
- e) Results of audit engagements or other activities.
- f) Status of pending internal audit recommendations on a quarterly basis.
- g) Unjustified revisions to internal audit recommendations implementation dates.
- h) Resource adequacy.
- i) Any response to risk by management that may be unacceptable to the Bank.

## 12. INTERNAL AUDIT OUTSOURCING

In the case that appropriate expertise and skills cannot be ensured for the performance of an audit, audit work can be partially or fully assigned to third parties. The arrangement should receive in principle approval from the ACGC prior to undertaking the selection and risk assessment process. As per CBB directives, outsourcing arrangements cannot be made with the external auditor; CBB regulations must be adhered to strictly in the case of engaging in any outsourced/co-sourced audit activity.

Criteria for outsourcing include the reputation of the outsourced firm and the professional accreditations of the outsourced team, including an assessment of their track record and experience. The criteria are further elaborated in the Internal Audit Manual.

In any case, the outsourced or co-sourced team should follow the Audit Division's manual and charter, CBB, and other relevant regulations.

This outsourcing/co-sourcing arrangement is considered material in nature as per CBB requirements. Prior to requesting approval, the selection of the arrangements should follow the Bank's internal tendering criteria. The outsourcing procedure should also follow the requirements delineated in the "Operational Risk Management" module of the CBB Rulebook, and the arrangement should ultimately be approved by the ACGC.

## 13. CONSULTANCY/ADVISORY SERVICES

Internal audit is described as an "assurance and consulting activity". Consulting services are advisory in nature, and are generally performed based on a specific request. The nature and scope of the consulting engagement need to be agreed upon.

The Internal Audit Division can provide consultancy services provided that the required resources and calibres are available and such services are monitored to determine the right balance between the two. In this regard, the Internal Audit Division will monitor the services provided and report to the ACGC to manage the amount of consulting that Internal Audit does. Requests for consulting services, especially the major one related to projects or proposals, need to be communicated timely in order to be considered while preparing the audit plan.

In this regard, any consultancy services provided do not provide an assurance to the consulting function, nor does it preclude it from an audit as per the audit plan or through an unplanned audit.

Further details are presented in the Internal Audit Manual.

## 14. COORDINATING WITH EXTERNAL THIRD PARTIES

The Internal Audit Division collaborates with supervisory bodies and external auditors of the Bank in order to ensure that audit needs are adequately covered and duplication of effort is minimized; all relevant internal audit reports should be provided to the external auditor, and the external auditor should be kept abreast of any significant matter that comes to the internal auditor's attention that affects the external audit, while the converse is also expected. The Internal Audit Division also ensures adequate independence and objectivity with its dealings with the external auditor. Internal audit may also be useful in determining the nature, timing and extent of external audit procedures. Principles governing the Internal Audit Division's relationship with the external auditor is further elaborated in the Internal Audit Manual.

## 15. COMMUNICATION WITH THE REGULATOR

The Bank's Chief Internal Audit must have formal regular communication with the Central Bank of Bahrain ("CBB") to:

- a) Discuss the risk areas identified.
- b) Understand the risk mitigation measure taken by the Bank.
- c) Monitor the Bank's response to weaknesses identified.

At least two weeks prior to the prudential meeting date, all internal audit reports issued since the last prudential meeting must be submitted to the CBB supervisory point of contact.

## 16. RELATIONSHIP WITH OTHER CONTROL FUNCTIONS

The relationship between the Bank's business units, the support functions and the Internal Audit Division can be explained using the three lines of defence model. The business units are the first line of defence. They undertake the management of risks within assigned limits of risk exposure and are responsible and accountable for identifying, assessing and controlling the risks of their business.

The second line of defence includes the support functions, such as risk management, compliance, legal, human resources, finance, operations, and technology. Each of these functions, in close relationship with the business units, ensures that risks in the business units have been appropriately identified and managed. The business support functions work closely to help define strategy, implement bank policies and procedures, and collect information to create a bank-wide view of risks.

The third line of defence is the Internal Audit Division that independently assesses the effectiveness of the controls over the processes created in the first and second lines of defence and provides assurance on these processes.

The responsibility for internal control does not transfer from one line of defence to the next line.

## 17. SENIOR MANAGEMENT'S RESPONSIBILITY TOWARDS INTERNAL AUDIT

Senior management must inform the Internal Audit Division of new developments, initiatives, projects, products and operational changes.

Senior management must inform Internal Audit without delay of any significant incident concerning security and/or compliance with regulations and procedures.

Senior management must ensure that all internal audit findings and recommendations are resolved within three months for high priority, six months for medium priority, and twelve months for low priority from the issue date of the subject internal audit report.

Senior management must ensure that the Chief Internal Audit has the necessary resources, financial and otherwise, available to carry out his or her duties commensurate with the annual internal audit plan, scope and budget approved by the ACGC.

## 18. ACCESS TO INTERNAL AUDIT FILES

Access to Internal Audit files is made available to the ACGC, the CBB, the CEO, and relevant staff of Internal Audit Division without restrictions. Access requests to Internal Audit files by any other individuals must obtain written approval by the Chairperson of the ACGC.

## 19. QUALITY ASSURANCE AND IMPROVEMENT PROGRAM

The Internal Audit Division will maintain a quality assurance and improvement program that covers all aspects of the Internal Audit Division. The program will include an evaluation of the Internal Audit Division's conformance with the Standards and applicable regulations and an evaluation of whether internal auditors apply The IIA's Code of Ethics. The program will also assess the efficiency and effectiveness of the Internal Audit Division and identify opportunities for improvement.

The Chief Internal Audit will communicate to the ACGC on the Internal Audit Division's quality assurance and improvement program, including results of internal assessments (both ongoing and periodic) and external assessments conducted at least once every five years by a qualified, independent assessor or assessment team from outside the Bank.