BAHRAIN ISLAMIC BANK B.S.C.

Internal Audit Charter

2020

Internal Audit Division
## Document Control

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1 Introduction
1.1 The Internal Audit Charter (the “Charter”) defines and describes the principles and basic operational concepts of the Internal Audit within Bahrain Islamic Bank B.S.C. (the “Bank”), a subsidiary of National Bank of Bahrain B.S.C. (the “Group”). In addition, the Charter also defines the set of principles and rules which Auditors must adhere to when performing their roles.

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

1.3 The Charter is in compliance with the current legal and regulatory framework.

1.4 The Charter will be reviewed annually or when there are material changes in the operation, the responsibilities, and the organizational structure of the IAD or auditing practices which necessitate amendments to the Charter. The AC’s recommendation for Board approval will be sought for any amendments to the Charter.

2 Definitions
2.1 Internal Audit
   2.1.1 Internal auditing is defined as “an independent, objective assurance and consulting activity designed to add value and improve an organization’s operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes.”

2.2 Role of Internal Audit
   2.2.1 The internal audit activity is established by the AC and its roles and responsibilities are defined by the AC as part of their oversight role.

2.3 Internal Audit Charter
   2.3.1 The Charter is a formal document that defines the authority, scope of work, and responsibility of IAD. The charter establishes the IAD’s position, power and responsibilities within the organization; authorizes access to records, personnel, and physical properties relevant to the performance of engagements.
3 Mission of Internal Audit

3.1 Perform all and any types of audit to all units, local and cross-border activities and third parties who provide substantial (critical) services to the Bank, in order to form a reasonable, objective and independent opinion about the adequacy and the effectiveness of the Internal Control System (the “ICS”) of the Bank. Such audits will be subject to applicable regulations and will be discussed with the AC on case by case basis. Local regulator will be kept informed about any specific limitations.

3.2 Provide objective assurance, as defined, through the AC to the Board of Directors of the Bank with regards to the results of the assessment of the adequacy and effectiveness of the Bank.

3.3 Perform any other activity that is specifically required by the legal and regulatory framework.

3.4 Assess the ICS based on criteria deriving from international standards and best practices.

4 Internal Audit Authority

4.1 The IAD, with strict accountability for confidentiality and safeguarding records and information, is authorized full, free, and unrestricted access to any and all of Bank records, physical properties, and personnel pertinent to carrying out any engagement.

4.2 All employees are requested to assist the internal audit activity in fulfilling its roles and responsibilities. Restriction to these accesses imposed by any employee or management of the Bank, which prevents the IAD from performing its duties, will be reported immediately to the Chief Executive Officer (the “CEO”) and/or directly to the AC, based on circumstances as determined by the Chief Internal Audit Officer (the “CIAO”).

4.3 The IAD will also have free and unrestricted access to the Board. The CIAO will have direct access to the AC and the Group IAD and will communicate directly to the Chairperson of the AC and the Group CIAO, any matter that is believed to be of sufficient magnitude and importance to require immediate attention of the AC and the Group IAD.
5 Operational Structure
5.1 The IAD operates as a single pool comprised of auditors. The CIAO is responsible for setting up the strategy and ensuring the smooth operation of the IAD, in accordance with the legal and regulatory framework and the international best practices.
5.2 The CIAO is supported by Auditors. Auditors are allocated to audit teams according to audit requirements and time constraints of specific audit engagements. Participation of experts (internal or external) may be sought whenever this is deemed necessary and only following approval by the AC with regard to the associated cost.
5.3 The IAD has an annual budget, which is executed under the supervision of the AC, always in accordance with the established procedures.

6 Independence and Impartiality
6.1 The internal audit in the Bank is a permanent function. The AC of the Board in coordination with the Bank’s executive management will ensure that appropriate measures are taken, including providing appropriate resources and staffing to ensure that internal audit achieves its objectives and that the Bank can continuously rely on an adequate internal audit function.
6.2 The CIAO will report functionally to the AC of the Board and administratively (i.e. day to day operations) to the CEO.
6.3 The IAD will have no direct operational responsibility or authority over any of the activities that are subject to audit. Accordingly, it will not develop nor install systems or procedures, prepare records, or engage in any other activity that would normally be audited and be independent from every day internal control process in order to be able to carry out its assignments with objectivity and impartiality.
6.4 The internal audit should be objective and impartial when it performs its assignment and should be free from bias and interference.
6.5 Internal audit should avoid any conflict of interest.
6.6 Whenever practical, staff assignments within internal audit should be rotated periodically.
6.7 Internally recruited auditors should not audit activities or functions they performed in the last two years.
6.8 The internal audit should not be involved in the operations of the Bank or in selecting or implementing internal control measures to avoid impairment of its judgmental independence.
6.9 The internal audit should not perform any operational duties for the Bank, the Group or its affiliates.
6.10 The internal audit should not initiate or approve transactions external to the IAD.
6.11 The internal audit should not direct the activities of any Bank employee not employed by the IAD, except to the extent that such employees have been appropriately assigned to auditing teams or to otherwise assist internal auditors.
6.12 In cases where audit opinion is requested, say, for an important new risky activity or system, the auditors will only give comments and should not be made responsible for the development and introduction of any measure as such tasks will remain the responsibility of management. The internal audit can audit such activities and subsequent internal audit reports can contain recommendations relating to deficiencies and weaknesses and suggestions for improvement.
6.13 Internal auditors will exhibit the highest level of professional objectivity in gathering, evaluating, and communicating information about the activity or process being examined. Internal auditors will make a balanced assessment of all the relevant circumstances and not be unduly influenced by their own interests or by others in forming judgments.

6.14 Where the CIAO 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:

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

6.15 The CIAO will disclose to the AC and Group CIAO any interference and related implications in determining the scope of internal auditing, performing work, and/or communicating results.

6.16 The independence of the IAD 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.

7 Audit Methodology

7.1 The audit methodology applied by the IAD is in compliance with the Standards for the Professional Practice of Internal Auditing of the Institute of Internal Auditors and the Auditing and governance standards issued by the Accounting and Auditing Organization for Islamic Financial Institutions.
8 Scope of Internal Audit

8.1 The scope of coverage for the internal audit will consider the whole Bank’s universe/activities. Audit planning is performed based on risk assessment for multi years audit plan. The audit centres which comprise the audit universe of the Bank are assessed and prioritized for audit according to their risk profile.

8.2 The scope of internal audit will include the examination and evaluation of the appropriateness and effectiveness of risk management, internal control and governance processes and the manner in which assigned responsibilities are fulfilled by the various branches and departments in the Bank.

8.3 The scope and objective of the internal audit will also cover, but not limited to, the following:

8.3.1 Review of the application and effectiveness of risk management procedures and risk assessment methodologies.

8.3.2 Review of the management and financial information systems, including the electronic information system and electronic banking services.

8.3.3 Review of the accuracy and reliability of the accounting records and financial reports.

8.3.4 Review of the Bank’s system of assessing its capital in relation to its estimate of risk.

8.3.5 Testing of both transactions and functioning of specific internal control procedures.

8.3.6 Adherence to legal and regulatory requirements, code of conduct, the implementation of policies and procedures.

8.3.7 Testing of the integrity, reliability and timeliness of the regulatory reporting.

8.3.8 Carrying out of special investigations at the request of the Board or management, as appropriate.

8.3.9 Compliance with policies, procedures and risk controls.

8.4 Reliability and timeliness of financial and management information including electronic information systems.

8.5 Assess the independence of external auditors.

8.6 Internal audit assurance engagements objectives include evaluating whether:

8.6.1 Risks relating to the achievement of the Bank’s strategic objectives are appropriately identified and managed.

8.6.2 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.

8.6.3 The results of operations or programs are consistent with established goals and objectives.

8.6.4 Operations or programs are being carried out effectively and efficiently.

8.6.5 Established processes and systems enable compliance with the policies, procedures, laws, and regulations that could significantly impact the Bank.

8.6.6 Information and the means used to identify, measure, analyze, classify, and report such information are reliable and have integrity.

8.6.7 Resources and assets are acquired economically, used efficiently, and protected adequately.

8.7 The CIAO 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.
8.8 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.

9 Professionalism
9.1 The IAD will govern itself by adherence to;
   9.1.1 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.
   9.1.2 Auditing and Governance Standards issued by the Accounting and Auditing Organization for Islamic Financial Institutions.
   9.1.3 The applicable regulations.
9.2 The internal audit activity will also adhere to the Bank’s relevant policies and procedures and the internal audit activity’s procedures manual.
9.3 All staff members of the internal audit should have sufficient and up-to-date knowledge of auditing techniques.
9.4 Professional competence of internal audit staffs should be maintained through systematic training. Professional competence should be assessed taking into account the nature of the role and the auditor’s capacity to collect, examine and evaluate information, and to communicate the findings properly given the growing technical complexity of the Bank’s activities.
9.5 Whenever practicable, rotation of staff within the internal audit should be carried out periodically to reduce the negative impact of routine tasks that could affect the auditor’s capacity for critical judgment.
9.6 All internal audit staffs should sign and acknowledge an independence and objectivity confirmation declaration to the AC and the Group CIAO establishing the principles and rule of conduct covering the way the internal audit should be carried out.
10 Accountability of Chief Internal Audit Officer

10.1 Annually assess whether the authority and responsibility of internal audit as defined in the Charter, continue to be adequate to enable and enforce the internal audit activity to accomplish its objectives. The result of the periodic assessment should be communicated to Senior Management, the Group CIAO and the AC.

10.2 Ensure that the Charter is reviewed periodically and that the Charter is recommended by the AC for Board approval.

10.3 Ensure conformance of the Internal Audit Division with the Standards, with the following qualifications:

10.3.1 If the IAD is prohibited by law or regulation from conformance with certain parts of the Standards, the CIAO will ensure appropriate disclosures and will ensure conformance with all other parts of the Standards.

10.3.2 If the Standards are used in conjunction with requirements issued by other authoritative bodies, the CIAO will ensure that the IAD conforms to the Standards, even if the IAD also conforms to the more restrictive requirements of other authoritative bodies.

10.4 Establish and review on a regular basis the Charter, Audit Plan and the written Policies and Procedures for the internal audit staff.

10.5 Ensure continuous enhancement of professional competence and training of the audit staff and that the necessary resources are available.

10.6 Report to Senior Management, the Group CIAO and the AC on the audit findings, the performance of the ICS and the achievement of internal audit objectives.

10.7 Support the AC in assessing the independence, accountability and effectiveness of the external auditors and in monitoring the rotation arrangements of audit partners according to regulatory requirement. Apart from the above, Internal Audit will provide adequate support to the AC in respect of additional requests that may be raised.

10.8 Cases of Internal Audit misconduct are reviewed and handled by the AC in accordance to the Bank’s policies.

11 The Internal Audit Plan

11.1 The CIAO will submit to the Group CIAO and the AC an internal audit plan for review and approval. The internal audit plan will consist of a work schedule as well as resource requirements to properly and efficiently execute and implement the plan.

11.2 The CIAO will communicate the impact of resource limitations and significant interim changes to senior management, the Group CIAO and the AC. The internal audit plan will be developed based on a prioritization of the audit universe using a risk-based methodology, including input of senior management and the Board.

11.3 The CIAO will review and adjust the plan, as necessary, in response to changes in the organization’s business, risks, operations, programs, systems, and controls.

11.4 Any significant deviation from the approved internal audit plan will be communicated to senior management, the Group CIAO and the AC through periodic activity reports.
12 Reporting and Monitoring

12.1 A written report will be prepared and issued by the CIAO or designee following the conclusion of each internal audit engagement and will be distributed as appropriate.

12.2 The internal audit report should include management’s response and corrective action taken or to be taken in regard to the specific findings and recommendations.

12.3 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.

12.4 IAD will be responsible for appropriate follow-up on engagement findings and recommendations.

12.5 The CIAO will monthly report to the CEO the status of pending internal audit recommendations.

12.6 The CIAO will keep the Chief Compliance and Governance Officer (the “CCGO”) 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.

12.7 The CIAO will report periodically to the AC regarding:

12.7.1 The IAD’s purpose, authority, and responsibility.

12.7.2 The IAD’s plan and performance relative to its plan.

12.7.3 The IAD’s conformance with The IIA’s Code of Ethics and Standards, and action plans to address any significant conformance issues.

12.7.4 Significant risk exposures and control issues, including fraud risks, governance issues, and other matters requiring the attention of, or requested by, the AC and/or the Board.

12.7.5 Results of audit engagements or other activities.

12.7.6 Status of pending internal audit recommendations on a quarterly basis.

12.7.7 Unjustified revisions to internal audit recommendations implementation dates.

12.7.8 Resource adequacy.

12.7.9 Any response to risk by management that may be unacceptable to the Bank.

12.8 The CIAO will report periodically to the Group CIAO regarding:

12.8.1 Status of pending internal audit recommendations on a monthly basis.

12.8.2 The IAD’s plan and performance relative to its plan.

12.8.3 Results of audit engagements or other activities.

12.8.4 Scope limitations.

12.8.5 Significant risk exposures and control issues, including fraud risks, governance issues, and other matters requiring the attention of, or requested by, the AC and/or the Board.

12.8.6 The IAD’s conformance with the Standards and action plans to address any significant conformance issues.

12.8.7 Resource adequacy.

12.8.8 Any outsource/co-source arrangements.
13 Quality Assurance and Improvement Program
13.1 The IAD will maintain a quality assurance and improvement program that covers all aspects of the IAD.
13.2 The program will include an evaluation of the IAD’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 IAD and identify opportunities for improvement.
13.3 The CIAO will communicate to the Group CIAO and the AC on the IAD’s quality assurance and improvement program, including results of internal assessments (both ongoing and periodic) and external assessments conducted at least once every three years by a qualified, independent assessor or assessment team from outside the Bank.

14 External Communication
14.1 Any kind of communication of the IAD, other than regulatory requirements, with third parties, external to the Bank, takes place only after appropriate authorization by the Chairperson of the AC or the CEO.

15 Access
15.1 Only AC, the Group CIAO, and the Central Bank of Bahrain (the “CBB”) have unrestricted access to the audit files. Access to those files by any other individual is only permitted upon written approval by the Chairperson of the AC.

16 Internal Audit Outsourcing
16.1 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 AC 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.
16.2 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 Procedures Manual.
16.3 In any case, the outsourced or co-sourced team should follow the IAD’s manual and charter, CBB, and other relevant regulations.
16.4 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 get approved by the AC.
17 Communication with the Regulator

17.1 The Bank’s CIAO must have formal regular communication with the CBB to:
   17.1.1 Discuss the risk areas identified.
   17.1.2 Understand the risk mitigation measure taken by the Bank.
   17.1.3 Monitor the Bank’s response to weaknesses identified.

17.2 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.

18 Coordinating with External Third Parties

18.1 The IAD 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.

18.2 The IAD also ensures adequate independence and objectivity with its dealings with the external auditor.

18.3 Internal audit may also be useful in determining the nature, timing and extent of external audit procedures. Principles governing the IAD’s relationship with the external auditor is further elaborated in the Internal Audit Procedures Manual.

19 Relationship with Other Control Functions

19.1 The relationship between the Bank’s business units, the support functions and the IAD can be explained using the three lines of defense model. The business units are the first line of defense. 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.

19.2 The second line of defense 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.

19.3 The third line of defense is the IAD that independently assesses the effectiveness of the controls over the processes created in the first and second lines of defense and provides assurance on these processes.

19.4 The responsibility for internal control does not transfer from one line of defense to the next line.
20 Senior Management’s Responsibility towards Internal Audit

20.1 Senior management must inform the IAD of new developments, initiatives, projects, products and operational changes.

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

20.3 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.

20.4 Senior management must ensure that the CIAO 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 AC.

21 Approvals

21.1 The Terms of Reference for the AC will be approved by the Board. The AC will recommend the approval the Charter to the Board and approve the Three-Year Audit Plan. The detailed procedures and processes for the IAD will be approved by the AC and communicated to the relevant stakeholders.