

**GUIDELINES FOR
SPECIAL REVIEW OF THE BANKS'/ DFIs
INTERNAL CONTROL OVER FINANCIAL
REPORTING PROGRAMME UNDER THE
'GUIDELINES ON INTERNAL CONTROL'
ISSUED BY THE STATE BANK OF
PAKISTAN**



**The Institute of
Chartered Accountants
of Pakistan**

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GUIDELINES FOR SPECIAL REVIEW OF THE BANKS'/ DFIs INTERNAL CONTROL OVER FINANCIAL REPORTING
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1. Introduction

The State Bank of Pakistan (SBP) issued Guidelines on Internal Controls vide BSD Circular No. 7 of 2004 dated May 29, 2004 (here-in-after referred to as the SBP Internal Control Guidelines; guidelines). As per paragraph 7 of the guidelines, all banks/DFIs are required to include a 'Statement on Internal Controls' in their annual reports that should include the following:

- A statement of management's responsibilities for establishing and maintaining adequate internal control and procedures followed by the management's evaluation of the effectiveness of the bank's/DFI's internal control;
- Board of Directors' endorsement of the management's evaluation; and
- Statutory Auditors' attestation to, and report on, the Board's endorsement regarding efficacy of the bank's/DFI's internal control, which are relevant to the financial reporting only.

Various clarifications and related additional guidelines have been issued on the subject by SBP from time to time that require the banks/DFIs to adopt a well-recognized framework in relation to their Internal Control Programme (IC programme) while the statutory auditors would also follow the available best international practices to discharge their responsibility under the SBP Internal Control Guidelines relating to carrying out of an audit of the Internal Controls over Financial Reporting (ICFR) and forming an opinion thereon.

In order to ensure consistency in the process of compliance with the relevant guidelines, SBP has provided a structured roadmap identifying various activities/ stages involved and has also required banks/DFIs to submit well structured status reports and time bound plans for the completion of various stages in the roadmap. The IC programmes of the banks/DFIs have accordingly been developed considering the stages identified in the SBP's prescribed roadmap, targeting adoption of a suitable, generally accepted/ recognized internal control framework and compliance with the requirements set out under the SBP Internal Control Guidelines..

In consideration of the industry's status of preparedness in terms of compliance with the relevant framework/ guidelines/ standards, the requirement for external auditors' attestation and its publication in the annual report is being deferred since 2004. As per the recent BSD Circular No.9 of 2009 dated October 12, 2009, the auditors are required to submit their report on ICFR for the year 2009 to the management for submission to SBP. However, from the year 2010, they will be required to express an audit opinion on ICFR in the annual report, as required under the SBP Internal Control Guidelines.

The Institute of Chartered Accountants of Pakistan (ICAP) is currently working on prescribing a standard for the audit of ICFR. In this connection, required amendments shall be incorporated in Auditing Standard 5 (AS 5) issued by the Public Companies Accounting Oversight Board (which is used for audits of ICFR in the US under section 404 of the Sarbanes- Oxley Act) to make it aligned with the local requirements.

However, notwithstanding the above, the ICAP understands that at present, the banks/DFIs, in general, are, in the process of achieving various stages/ milestones of their IC programme in line with the SBP's specified schedule of activities and they expect to complete certain stages during 2009. As the work performed by the banks/DFIs in these completed stages forms/ will form the basis for eventual compliance with the SBP Internal Control Guidelines and the relevant internal control framework as adopted by the bank/DFI, it is critical that the external auditors perform a special review of the work undertaken by the banks/DFIs in the completed stages and report factual findings identified to the management for submission to SBP. This review will help the banks/DFIs in seeking some level of comfort over the granularity and quality of initiatives undertaken and in proactive identification of any aspects that may be material in relation to eventual audit opinion on ICFR so that those can be addressed on a timely basis. Similarly, the auditors' report on review of ICFR will provide an independent assessment to SBP of the work performed and representations made by the management in their own report on internal controls. The external auditors will also be able to seek some comfort on the stages completed that may provide useful evidence during the audit of ICFR.

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In view of the above, it is proposed that during the transition period, the external auditors should be required to perform a special review of the work performed by the banks/DFIs in the completed stages (to the extent it relates to ICFR) for assessment of compliance with the requirements set out under the SBP Internal Control Guidelines and the relevant internal control framework as adopted by the bank/DFI and submit the report of their factual findings to the management for submission to SBP.

ICAP will propose SBP to prescribe such transition period reporting requirements.

2. Scope of the Special Review

The purpose of these Guidelines for Special Review of the Bank's/DFI's Internal Control Programmes under SBP Internal Control Guidelines (here-in-after referred to as the Special Review Guidelines) is to provide necessary guidance for the special review of the completed stages of the bank's/DFI's IC programme (to the extent it relates to ICFR) and sets out list of procedures to be performed, as a minimum, in relation to various stages (as may be completed by a bank/DFI). Since the review by the auditors under the Special Review Guidelines is meant to eventually help them in their audit of ICFR, the procedures identified in this Framework have been developed considering the applicable auditing standards for the audit of ICFR besides the provisions of the SBP Internal Control Guidelines and the relevant internal control framework as adopted by the bank/DFI. Please note that the procedures set out in this document are only a minimum list and the auditors may perform any additional/ further procedures as may be required to assess compliance with the related framework/ standards. Any such additional/ modified procedures should be made part of the engagement letter to be signed between the bank/DFI and the auditing firm besides incorporating therein the procedures defined in these Guidelines.

The specified procedures should be performed on a reasonable sample of locations, transactions, balances and/ or events etc., as applicable. The auditors should seek guidance from the applicable auditing standards while reviewing the materiality used and financial reporting risk assessment performed by the management and in selecting the controls to be tested in terms of design and operating effectiveness etc. and the sample to be used for the purposes of their review..

This document also provides guidelines in relation to reporting of factual findings to the management for submission to SBP. In addition, management's responsibilities in relation to their IC programmes and auditors' responsibilities in relation to their review have also been listed as guidance to be considered while finalizing the relevant terms of engagement.

The Special Review Guidelines are applicable in relation to review of the bank's/DFI's IC programme for its domestic operations only and on a solo basis i.e. excluding of the subsidiaries within the group and the foreign branches. This is because ICAP understands that the banks/DFIs intend to approach SBP, through PBA, to allow interim exclusion of the mentioned entities from the scope of the IC programme.

For the sake of clarity, it is further emphasized that the Special Review Guidelines are applicable for review of the Bank's/DFI's Internal Control Programmes to the extent of ICFR.

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3. Special Review Procedures to be performed

As per the SBP's roadmap, the following are various stages of the bank's/DFI's IC programme:

Stage I:	Process and control documentation
Stage II:	Identification of gaps and recommendations
Stage III:	Development of detailed Remediation/ Implementation Plans
Stage IV:	Development of Management Testing Plan (for key controls to be identified under stage II)
Stage V:	Implementation of project initiatives, as planned
Stage VI:	Quality Assurance/ Validation on the initiatives completed
Stage VII:	Conduct of management testing of key controls and reporting of results
Stage VIII:	Audit of ICFR by external auditors

The procedures with respect to each applicable stage (from stages I to VII) are set out in paragraphs 3.1 to 3.7 below:

3.1 Stage I: Process and Control Documentation

The process and control documentation forms the basis for management's evaluation of ICFR in accordance with the SBP Internal Control Guidelines and the relevant internal control framework as adopted by the bank/DFI. The management's documentation of processes and controls related to significant accounts and disclosures must cover more than just the controls that management plans to test. The documentation should:

- enable management to understand the processes and controls underlying the significant accounts from beginning to end; and
- cover the initiation, authorization, recording, processing, and reporting of individual transactions.

Without such documentation, it would be difficult to identify:

- points in the process where a misstatement due to error or fraud could occur;
- the controls covering relevant information processing objectives and the financial statement assertions.

In relation to the above, the auditor should, as a minimum, perform the following procedures:

- Review the management's documentation of the control environment i.e. processes and controls relating to overall governance, organizational structure, delegation of authority, management reporting systems, monitoring of controls etc. In this regard, the auditor should assess whether the top down risk based approach to ICFR is followed by the management with an emphasis on Entity Level Controls, as the starting point. For guidance, auditors should also refer to the applicable auditing standards.
- Review the management's process for identification of cycles/ sub cycles and processes/ sub-processes that are covered in the bank's/DFI's process flow documentation and assess their adequacy in terms of coverage of all significant areas of the bank's/DFI's operations. The examples of significant processes / cycles may include Cash Handling, Account Operations, Term Deposits, Remittances, , Credit (with sub processes such as credit sanction, disbursement, credit monitoring and administration, provisioning), Treasury and Foreign exchange dealings etc.

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- Evaluate that the process and control documentation developed by the management covers, end to end and in a detailed manner, activities and controls in all the relevant cycles, sub cycles, processes and sub processes in the form of comprehensive process flows specifying the following:
 - Processes and controls (distinguished from each other)
 - Authorities responsible for individual tasks – distribution of the controls amongst the relevant process/ control owners
 - Cross departmental flows
 - Manual/ automated controls
 - Initiation and authorisation controls
 - Physical controls
 - Reconciliation controls
 - Segregation of duties
 - Monitoring controls
 - Processing and accounting of information in subsidiary and general ledger (with all check points)
- Perform walkthroughs on various processes and controls to verify whether the documentation reflect the entire transaction/ event trail with all the important processes and controls properly identified and distributed amongst the relevant process/ control owners

3.2 Stage I (cont'd): Risk Control Matrices

The procedures to be performed in connection with the review of risk control matrices should encompass the following, as a minimum:

- Review the scoping study performed by the management for identification of significant accounts and disclosures in accordance with the provisions of the applicable auditing standards. The auditor will review whether the scoping is conducted on the bank's/DFI's balance sheet and profit and loss account supported by the relevant detailed notes to the financial statements and breakdowns of the information, as available in the supporting records. Such detailed analysis is necessary as the components of a potential significant account or disclosure might be subject to significantly differing risks and those should be evaluated on a more discrete level
- Review the management's process for identification of the relevant financial statement assertions for each of the significant accounts and disclosures in terms of compliance with the provisions of the applicable auditing standards.
- Assess whether the relevant quantitative and qualitative factors and materiality at the financial statement level, as mentioned in the applicable auditing standards, have been considered by the management while identifying the significant accounts and disclosures and their relevant financial statement assertions.
- Review the management's process for mapping of significant accounts and disclosures to the relevant cycle/ sub-cycles and processes.
- Evaluate the design of the risk control matrices with respect to the following aspects:
 - Risk control matrices are developed for all the relevant cycles/ sub-cycles and processes/ sub-processes
 - All significant financial reporting risks are clearly defined with an overall assessment as well as assessment of their impact and likelihood, with due identification of key risks
 - Risk control matrices incorporate all relevant financial statement assertions and mapping of risks to those assertions.

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- All significant financial reporting controls, as identified from the process documentation developed in Stage I, are duly incorporated with clear description and appropriately mapped to the relevant financial reporting risks and financial statements assertions relating to significant accounts and disclosures. Further, information processing objectives are identified against each control.
- Frequency of control performance and authorities responsible for control activities are duly identified in the matrices.
- Analyses of the control (i.e. whether the control is preventive or detective in nature, manual or automated) is provided in the matrices. In addition, categorisation of controls into recurring, non-recurring and exception based is available.
- All relevant key controls are appropriately identified in line with the provisions of the applicable auditing standards.

3.3 Stage II: Identification of Gaps and Recommendations

In order to assess the management's process for evaluation of design of internal control, the auditor should consider the following procedures, as a minimum:

- Review the adequacy of control design evaluation conducted by the management with respect to coverage of various important areas of the bank's/DFI's operations and significant types of control/ control dimensions mainly including the following:
 - Governance
 - Organisational structure
 - Policies, procedures, practices etc.
 - Manual/ automated controls
 - Data management and validation structures etc.
 - MIS reporting framework
 - Non-recurring processes and controls/ events etc.
 - Exception/ override and their reporting framework

For this purpose, the auditor should independently review the design of ICFR so as to assess whether all the major gaps pertaining to above-mentioned aspects have been identified in the management's evaluations and adequate initiatives/ recommendations are in place to address those gaps.

- Review the management's process for identification of gaps in ICFR and risk grading of deficiencies into various levels (which is critical in prioritizing the remediation of deficiencies identified).

3.4 Development of Detailed Remediation/ Implementation Plans

In order to review the effectiveness of remediation/ implementation plans, the auditor should consider performing the following procedures, as a minimum:

- Review whether the plans developed by the management clearly set out the following:
 - Projects/ initiatives and their timelines;
 - Assignment of project IDs to the specific initiatives and mapping to the relevant plans;
 - Departments/ Groups responsible;
 - Detailed guidelines for conduct of identified initiatives such as the following:
 - Required amendments/ updations in the existing policies and procedural frameworks;

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- Development of new policies/ procedural frameworks;
- Introduction of new or amendments in the existing organizational structure and/ or processes;
- System enhancements/ acquisitions etc.
- Mapping of initiatives to the gaps and recommendations identified in the previous phase

3.5 Development of Management Testing Plan (for Key Controls identified under Stage II)

To demonstrate effective ICFR, the management should determine whether the bank's/DFI's controls are operating effectively, an objective that requires testing of the controls. In order to evaluate the design effectiveness of management testing plans and the reporting framework, the auditor should undertake the following procedures, as a minimum, while seeking guidance from the applicable auditing standards in this regard:

- Review the testing plans with respect to the following key elements:
 - Key controls to be tested (including entity level controls)
 - Extent of testing
 - Timing of procedures
 - Description of the test
 - Test performing authorities
- Review whether testing responsibilities have been appropriately and clearly assigned to the relevant testing authorities considering the test performing function, frequency of control performance, independence from control operations, testing being integrated into operations etc.
- Assess whether adequate testing structure has been designed considering independence/ practicality perspectives. Also assess whether relevant roles and responsibilities and reporting lines are clearly defined.
- Review that an effective Entity Selection Framework is in place for implementation of testing plan.
- Review whether an adequate reporting framework has been developed by the management for reporting/documentation of the results of evaluation of operating effectiveness of key financial reporting controls.

3.6 Implementation of Project Initiatives as Planned/ Quality Assurance/ Validation on the initiatives completed

Once the remediation/ implementation plans are in place, remediation activity is undertaken by the management in accordance with those plans to address the deficiencies identified. In relation to the remediation stage, the auditor's procedures should include the following, as a minimum:

- Review that the implementation initiatives have been undertaken by the management in accordance with the relevant plans
- Assess whether the initiatives have been carried out by the departments/ divisions identified in the remediation plans. Where any changes have been proposed in the responsibilities initially assigned, the auditor should review whether the new authorities are competent and appropriate to carry out the implementation initiatives.

3.7 Conduct of Management Testing (of Key Controls) and Reporting of Results

Once the testing plans have been developed, the management commences the testing of key controls in order to evaluate their effectiveness. In case of banks/DFIs which do not have the ICFR audits performed for example either due to any material weakness remaining unresolved, testing period being insufficient, enough locations not covered or testing work not documented till the cut off date, the auditor should perform the following minimum procedures in relation to the review of this stage:

- Review that the testing of key controls has been performed by the management in accordance with the management testing plans. The auditors may also re-perform the tests on key controls to gain comfort on the effectiveness of management's testing.
- Review whether the extent of testing carried out by the management adequately supports the management's conclusion on the operating effectiveness of key controls and that it is in line with the extent identified in the testing plan.
- Review the appropriateness of the timing of tests of key controls e.g., whether a key control required to be tested at quarter end has been tested at the quarter end.
- Review that the control has been exercised for a reasonable period so that sufficient evidence is available with respect to the performance of the control and to support conclusions regarding the effectiveness of key control.
- Independently review the results obtained from management testing, considering the risk the control was intended to mitigate, nature of exceptions identified during testing, resolution of exceptions and the process for correcting recurring exceptions.
- Review whether the results of tests performed and the related conclusions have been reported to the relevant authorities in accordance with the testing/ reporting framework and appropriate actions taken by such authorities.

4. Auditors' Reporting under the Special Review Guidelines

The auditors' report under the Special Review Guidelines will include the following aspects, as a minimum:

- Objectives and scope of the engagement
- Identification of the specific completed stages of the bank's/DFI's IC programme that the auditor will cover during his review under the Special Review Guidelines
- A statement that the engagement was conducted and the procedures were performed in accordance with the Special Review Guidelines, as issued by the ICAP
- Management's and auditors' responsibilities and other important terms of engagement
- Description of the special review procedures performed
- Limitations with respect to the engagement involving performance of special review procedures
- Detailed description of the factual findings resulting from the auditors' work identifying the gap/ issue identified and the recommendation to address the same
- Statement that the procedures performed do not constitute either an audit or a review under the applicable standards and, as such, no assurance is expressed

5. Guidelines in relation to the Terms of Special Review Engagement

In general, the following aspects will be covered in the engagement letter between the auditor and the bank/DFI:

- Nature of the engagement including the fact that the procedures performed will not constitute an audit or a review under the applicable standards and that accordingly no assurance will be expressed
- Stated purpose for the engagement
- Identification of the stages of the bank's/DFI's IC programme to which the special review procedures will be applied
- Description of the specific procedures to be applied
- Anticipated form of the report of factual findings
- Limitations on distribution of the report of factual findings

The following specific guidelines should be considered as a minimum while finalizing the terms of review engagement under the Special Review Guidelines:

- Under the Special Review Guidelines, the auditor will be responsible to perform review of the stages completed under the bank's/DFI's IC Programme for assessment of compliance with the SBP Internal Control Guidelines and the relevant internal control framework as adopted by the bank/DFI (so far these relate to ICFR). In this connection, they will follow the provisions of the Special Review Guidelines prescribed by the ICAP for use in this regard and perform the procedures identified as minimum list in the Guidelines.
- The management of the bank/DFI will be responsible for establishing and maintaining adequate ICFR (as defined under the applicable auditing standards) and assessing and reporting on the effectiveness of the ICFR, in accordance with the directives issued by SBP. They will also be responsible for preparation of the status report on their IC programme and submission to SBP. Under the Special Review Engagement, the auditor will not provide any assurance on the management's representations made in their report. They will only report the factual findings of their assessment of compliance with the relevant framework/ guidelines/ standards, as identified during performance of the special review procedures.
- The management will be responsible for the design and implementation of programmes and controls to prevent and detect fraud and for identifying and ensuring that adequate controls exist to ensure that the bank/DFI complies with the laws and regulations applicable to its activities. Furthermore, management of the bank/DFI is responsible for:
 - Notifying the auditor of all deficiencies in the design or operation of ICFR identified as part of management's assessment; and
 - Supporting its evaluation of ICFR with sufficient evidential matter, including documentation.
- The auditor will perform the special review procedures on a reasonable sample of locations, transactions, balances and/ or events etc. (as applicable) and report the factual findings resulting from the review to the management for submission to SBP. Any such report may not be provided to a third party without prior written consent of the auditor. Such consent will be granted on the basis that such reports are not prepared for the use or benefit of anyone other than the bank/DFI and SBP.
- The auditor will make specific inquiries of the management and others about the representations embodied in the management's Report on ICFR submitted to SBP and their assessment of the effectiveness of such internal control. The results of the auditors' tests,

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walkthroughs of bank's/DFI's controls, the responses sought to the inquiries etc. under the Special Review

Engagement will comprise the evidential matter upon which the auditor intends to rely while identifying matters that should be reported.

- The management will be responsible for making available to the auditors, upon request, all of the records and related information, and personnel to whom the auditor may direct inquiries.

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