

Audit Committee: A Central Bank Perspective

Banco de México, September 2019



Outline

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Introduction

2

Integration and functions of the Audit Committee

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Strengthening the internal audit activity

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Three Lines of Defense model

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Final remarks

1. Introduction

1

OECD and G20 Corporate Governance Principles^{1/}:

To consolidate the foundation of an effective framework of corporate governance, the following elements are necessary:

- Responsibilities must be distributed among different areas/departments.
- Responsibilities of supervision, regulation and enforcement activities must be attributed to functionally independent areas/departments.
- Accountability in exercising duties must exist.
- Corporate governance powers, appropriate resources and capacity to perform must be made available.
- Internal auditors must report to an independent audit committee within the Council or other equivalent body.

2

International Standards on Auditing (The IIA):

Their goals are to:

- Promote adherence to the mandatory elements of the International Professional Practices Framework of Internal Audit.
- Provide a framework to exercise aggregate value in internal auditing functions.
- Lay the foundations to assess the internal audit engagements.
- Promote the improvement of the institution's processes and operations.

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Banco de México Audit Committee

Consistent with international practices, the Governing Board has an Audit Committee:

- Its functions are established in Banco de México's Internal Bylaw, are not limited to the oversight and monitoring of the audit process or to the follow-up of comments and recommendations.
- The committee has its own operational rules.

^{1/} OECD and G20 Corporate Governance Principles.

1. Introduction

- Evolution of the Audit Committee

Expanding the scope of functions

- Involvement in the institutional system of internal control.
- Quality of non-financial risk management framework.
- Guidelines for preparing financial and anticorruption reports.

Adopting corporate governance practices

Functioning and operating rules have been established, based on the principles that ensure impartiality, independence and effectiveness.

Reorganization

January 2019 marked the beginning of the analysis to adopt better auditing practices. As a result, the organization, functioning and the powers of the Auditing Committee were strengthened.

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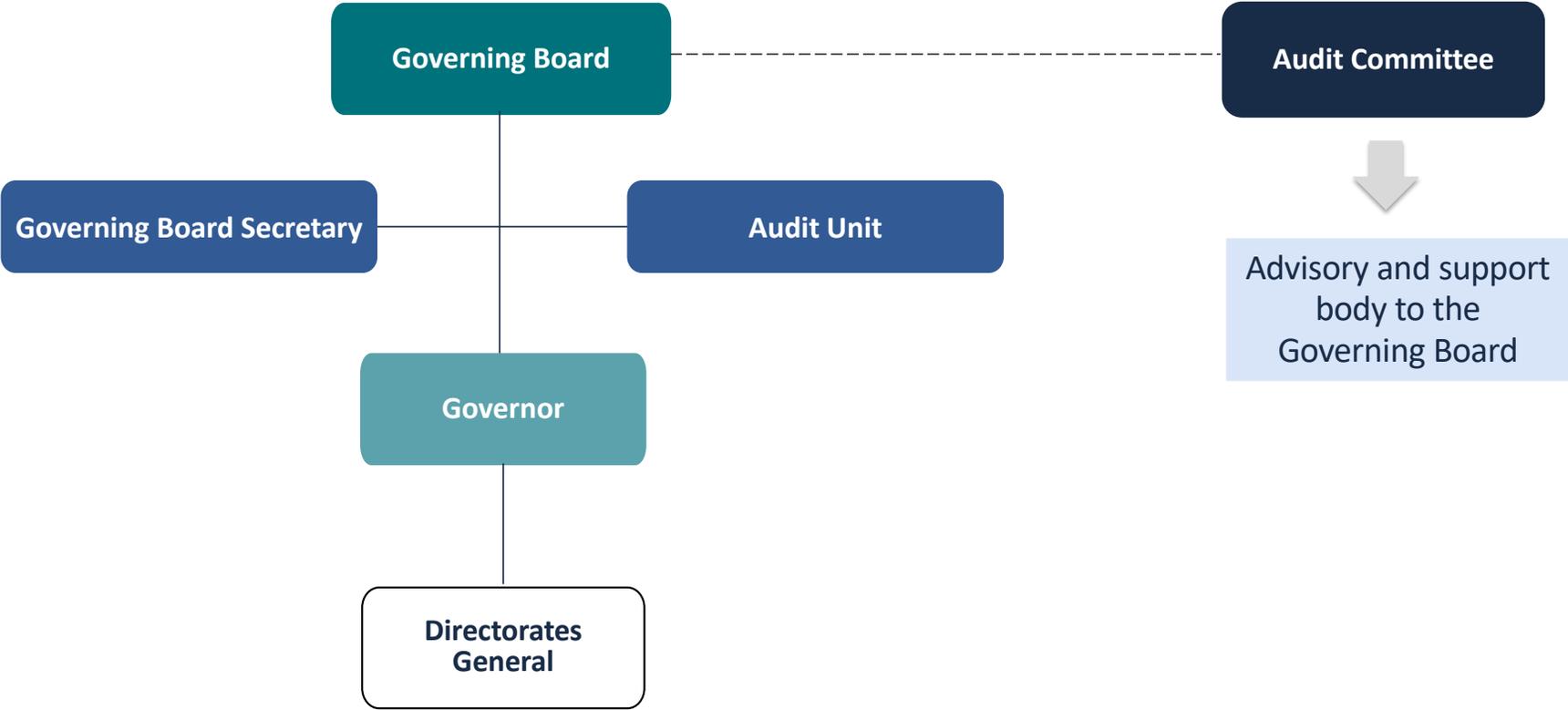
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Three Lines of Defense model

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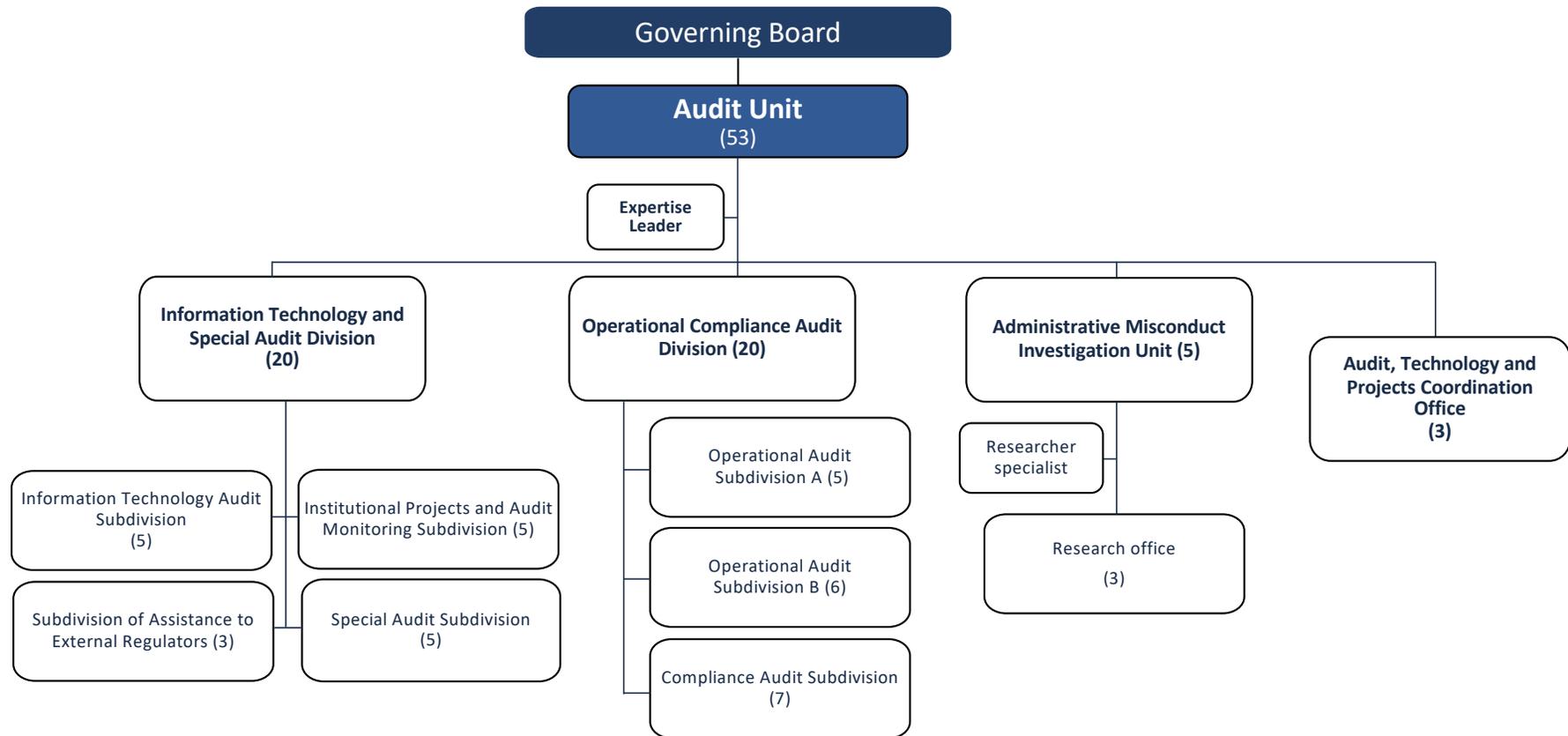
Final remarks

2. Integration and functions of the Audit Committee



2. Integration and functions of the Audit Committee

- Audit Unit structure



2. Integration and functions of the Audit Committee

- Integration



2. Integration and functions of the Audit Committee

- Main functions

1

Issue an opinion on the Annual Audit Program submitted by the Head of the Audit Unit to the Governing Board for approval.

2

Supervise and oversee the internal audit process and the follow-up of observations and recommendations. In addition, propose actions to the Audit Unit and the Risk Unit and inform the Governing Board about them.

3

Evaluate the institutional system of internal control and its efficiency to mitigate risks, the quality of the non-financial risk management framework and the financial reports guidelines.

4

Follow up on the information presented by the Comptroller and Risk Management Department regarding complaints involving alleged administrative or labor violations by public servants.

Previous

New

2. Integration and functions of the Audit Committee

- Main functions

5

Submit to the Governing Board an Annual Audit Activities report and an evaluation of the Audit Unit functions.

6

Provide an annual feedback to Banco de México's external auditor, with the purpose of continually improving its performance, in terms under service contract. Such feedback is also presented to the Governing Board.

7

Issue rules required for its operation. Give an opinion on the regulatory framework of the Audit Unit, before approval of the Governing Board.

8

Analyze the annual financial statements provided by the external auditor jointly with the areas responsible for preparing and revising them, and, based on such analysis, recommend its approval.

9

Others introduced by the Chair of the Committee, related to the abovementioned, prior authorization of the Governing Board.

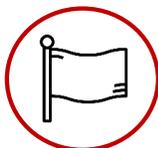
Previous

New

2. Integration and functions of the Audit Committee

- Corporate governance

Independence



Chair of the Audit Committee:

- Maximum term in office.
- Neither the Governor nor the person chairing the Public Servants Responsibilities Committee can occupy this position.

Independent members:

- Recruitment approved by the Governing Board.
- Term of office.
- Services for tiered period.

Impartiality



Independent members must:

- Provide services personally.
- Not be public servants of other entities.
- Meet the legal requirements for recruitment.

Effectiveness



- Minimum 4 annual ordinary sessions.
- Assess the Audit Unit (AU).
- Annual self-assessment committee (the results are presented to the Governing Board).
- Participation of the external auditor, the Directorate General of the Comptroller and Risk Management, the AU, and other Administrative Units to ensure continuous improvement.

2. Integration and functions of the Audit Committee

- Curricular profile of independent members



Be highly qualified in the fields of Economics, Finance, Accounting or Law, have extensive experience as a member of the Board of Directors or Audit Committees, or have previous experience at performing audit or comptroller functions in renowned financial institutions.



Be a person of acknowledged integrity and have excellent reputation and honor.



Have no relatives within the fourth degree of consanguinity or affinity with any public servant in Banco de México; have no record of being a public servant in Banco de México, or of having provided any service to the Bank, or be a partner, a shareholder, an associate or an employee of a legal entity, that is, a supplier or a service provider to Banco de México, for five years prior to hiring.



Have no previous record of being sentenced for intentional crimes or being disqualified from engaging in business or taking up employment, position or commission in the public service or in the Mexican financial system.

2. Integration and functions of the Audit Committee

- Curricular profile of independent participants

The Audit Committee, with the approval of the Governing Board, defined additional requirements to be fulfilled by candidates nominated for independent members:



Have 3 years of verifiable experience as a member of the Audit Committee and/or managing audit areas specialized in audit and/or financial institutions.



Have sufficient time to do work as part of the Audit Committee, which shall be confirmed with a written guarantee.

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Updating the regulatory framework

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Selection criteria to prepare the Annual Audit Program

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Quality Assurance and Improvement Program

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Information sharing with central banks

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Managing IT services in the AU

3.1 Updating the regulatory framework

- Internal Audit Charter



The purpose, authority and responsibility of the internal audit are formally defined in the Charter, which has the favorable opinion of the Audit Committee and has been approved by the Governing Board (the highest body in the institutional hierarchy).

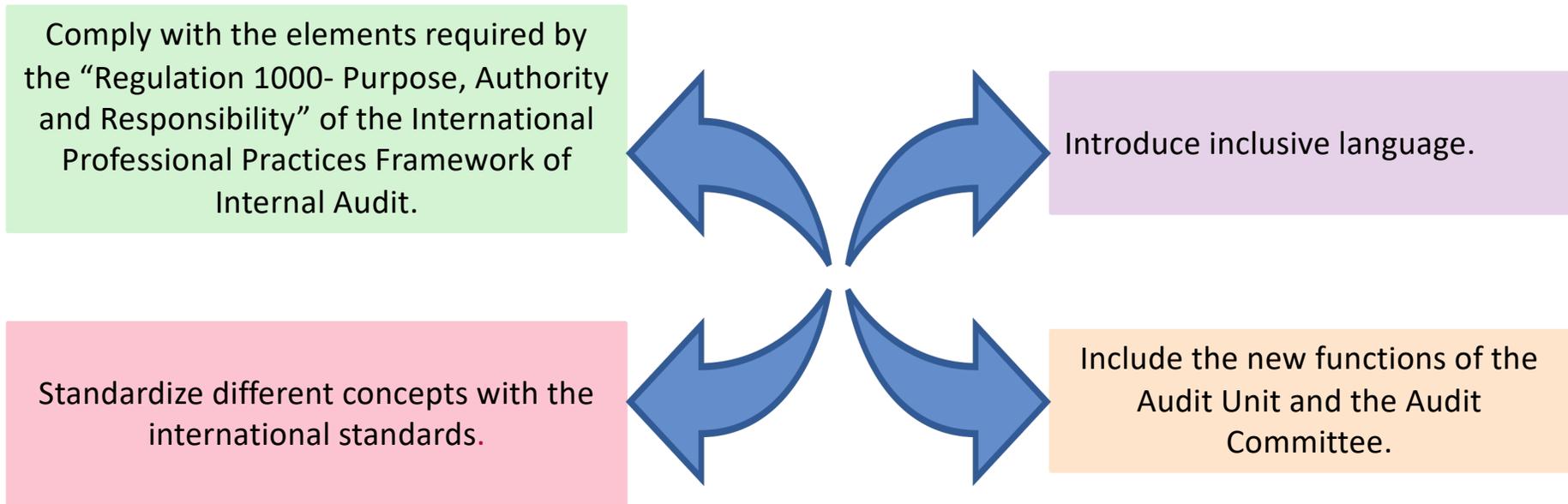


Its regulations comply with the International Standards of Professional Practice of Internal Auditing.



The Charter considers adjustments to the institutional rules, including the new functions of the Audit Committee.

3.1 Updating the regulatory framework



3.1 Updating the regulatory framework

Oriented to:

- Standardizing the audit process in line with best practices.
- Formalizing the criteria to prepare the Annual Audit Program based on risks.
- Transferring the investigation powers to the corresponding Unit to minimize the risk of a conflict of interest.
- Reorganizing the process associated to the delivery of financial information to external regulators and balance confirmation.

Updated regulatory instruments:

- Internal Audit Regulation.
- “Auditing Manual”.
- Procedures Manuals: “Internal Audit”, “Confirmation of balances”, and “Links to external regulators”.
- Internal instructions and guidelines.

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3.2 Selection criteria to prepare the Annual Audit Program

The International Professional Practices Framework of Internal Audit states that the Chief Audit Executive must establish a risk-based audit plan to establish the priorities of the internal audit activity.

7 Criteria

Determined with the purpose of obtaining an adequate selection of audits to integrate the program and to ensure the inclusion of relevant issues related to risks, strategic goals, and budget, among others.

Their implementation seeks to guarantee the principles of impartiality and objectivity when selecting and programming Banco de México's internal audits.

The Annual Audit Program can be adjusted, if necessary, in response to changes in the organization, and to risks, operations, programs, systems and controls, among others, subject to approval by the Audit Committee and authorization of the Governing Board.

3.2 Selection criteria to prepare the Annual Audit Program

Processes and systems with greater exposure to risks

New operations or operations that have not been audited

Previous audits' results

Budget exercise

Specific projects identified by the Audit Unit

Requests by Heads of Administrative Units

Requests by the Governing Board and the Audit Committee

Regardless of the criteria based on which the audit proposals were selected, the outcome of the risk assessment will necessarily be considered.

3.2 Selection criteria to prepare the Annual Audit Program

Processes and systems with greater exposure to risks

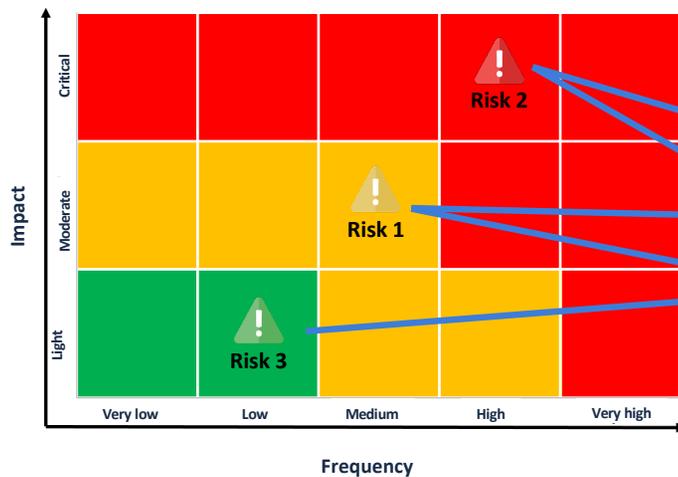


3.2 Selection criteria to prepare the Annual Audit Program

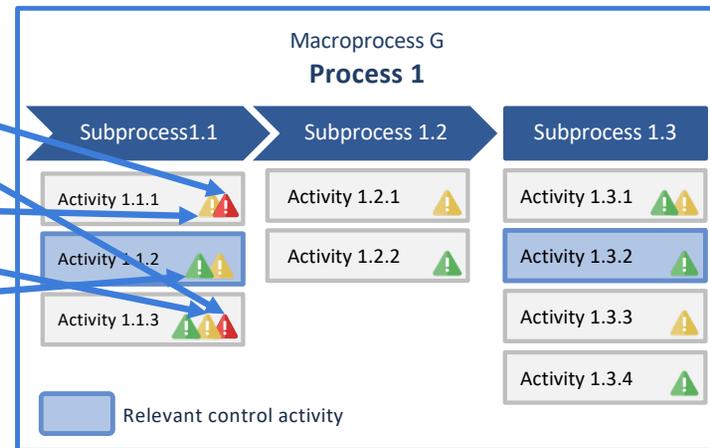


Risks identified in the process will be mapped in each activity where they can materialize.

Risk identification at process level



Risk mapping on activities



3.2 Selection criteria to prepare the Annual Audit Program

2

Weighing operational risks

Subsequently, risks are weighed^{2/} based on the features listed in the following table, to determine their relative relevance in the process:

Operational risk features	Weight (Points)
1. Is considered an act of corruption.	10
2. Has already materialized.	15
3. Can affect operational continuity.	25
4. Location on the institutional risk map.	35
5. Has mitigation actions associated with it.	15

Impact	Critical	6	7	8	9	10
	Moderate	3	4	5	8	9
	Low	1	2	4	5	8
		Very low	Low	Medium	High	Very high
		Frequency				

^{2/}Weights correspond to the Audit Unit points of interest.

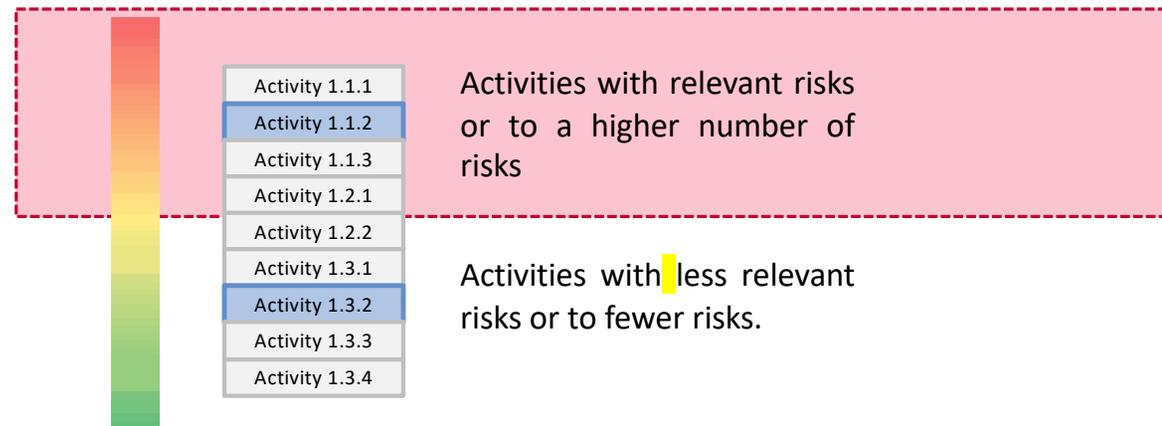
3.2 Selection criteria to prepare the Annual Audit Program

3

Prioritizing activities based on risks

Finally, the priority of activities will depend on both the number of risks that can materialize in each of them, and on their respective weight.

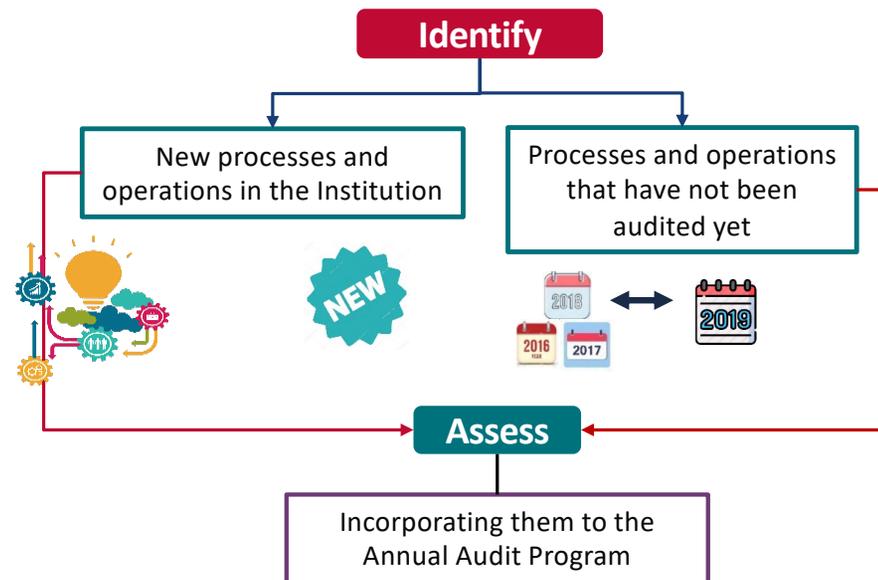
Prioritizing activities based on risks and their weights



3.2 Selection criteria to prepare the Annual Audit Program

New operations or operations that have not been audited

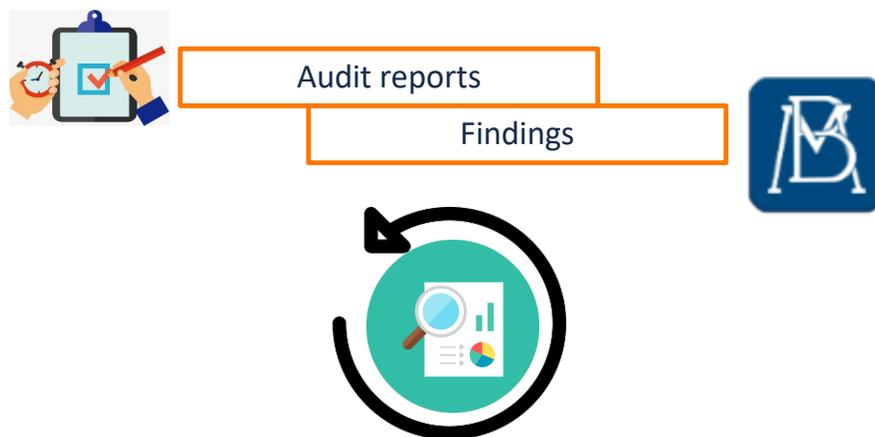
- As part of the audit universe updating, the Audit Unit identifies new processes and operations in the Institution, which are subject to be included in the Annual Audit Program.
- Furthermore, processes and operations that have not been audited in previous periods are identified.



3.2 Selection criteria to prepare the Annual Audit Program

Results of previous audits

- This criterion considers the experience and knowledge of the Audit Unit staff regarding the bank's processes that have been audited in previous periods.
- Similarly, relevant results of previous audits and actions taken by the administrative units to settle the issues observed will be taken into account.



3.2 Selection criteria to prepare the Annual Audit Program

Budget exercise

- Banco de México's authorized budget is one of the criteria considered when preparing the Annual Audit Program, since it reflects the monetary **public resources** required to address Banco de México's needs, which have been authorized by the Governing Board.
- The goals of budget-related audits are to verify that Banco de México has the control measures that ensure the rational and transparent use of the authorized budget, monitoring compliance with the relevant provisions set under the Laws and the internal regulations on this matter.
- The authorized budget is divided in two large parts:
 - a. **Fixed investment.**- Total expenditures of Banco de México to acquire fixed assets, supplies for banknotes production and purchase of metal currency.
 - b. **Current spending.**- Total expenditure to cover Banco de México's activities, which are not included in "Fixed investment".

INVESTMENT BUDGET	XX%
CURRENT SPENDING BUDGET	+ YY%
TOTAL AUTHORIZED BUDGET	100%

3.2 Selection criteria to prepare the Annual Audit Program

Budget exercise

- The account amounts to be audited are analyzed and the coverage is determined according to the total authorized budget.

Example: Budget audit “Transport equipment”

Budget allocation	Amount
079.01. Special equipment furniture and administration transport	300,000
344.49.05.02. Use of vehicles under the Security Directorate	150,000
344.37.03.02. Maintenance of automotive security equipment	80,000
345.37.03.01. Maintenance of general services automotive equipment	65,000
Total budget allocation	595,000
Total authorized budget	19,500,000
% accounting for total authorized budget	3%

3.2 Selection criteria to prepare the Annual Audit Program

Specific projects identified by the Audit Unit

- Projects and initiatives related to Banco de México's Institutional Goals and Guiding Principles that represent risk areas for the achievement of these goals are considered.
- There are specific projects in Banco de México that are not part of the Bank's macroprocesses, but which, according to their importance, need to be analyzed in order to determine if they are to be included in the Annual Audit Program.

One example of this type of projects is when the Audit Unit worked in parallel with the construction of Banco de México's Complementary Banknote Manufacturing Factory, which has been included in the Annual Audit Program since 2015.



3.2 Selection criteria to prepare the Annual Audit Program

Requests from
Heads of
Administrative Units

Every year, the Heads of the Directorates General or the Directors of the Administrative Units are requested to propose the relevant audits to be included in the Annual Audit Program by the Audit Unit. Such proposals must necessarily meet these four requirements:

1.- Operation: Identifying the operation, activity, system or project put forward to be audited.

2.- Administrative Unit: the Directorate, Division and Subdivision in charge of the operation, activity, system or project to be audited.

3.2 Selection criteria to prepare the Annual Audit Program

Requests from
Heads of
Administrative Units

Note: This criterion includes requests received by the Investigation Unit to execute audits that could result in suspected irregularities.

3.- Process: The macroprocesses, processes and subprocesses detailing the operation, activity or system to be audited must be specified, indicating if risks to such processes have also been identified by the Directorate of Risk Management.

4.-Motivation: Reasons why the request is presented: a risk situation or a materialized risk situation, changes in the operation or in systems, key personnel rotation, substantial changes to the law or regulation governing the operation.

3.2 Selection criteria to prepare the Annual Audit Program

Requests by members of the Governing Board and Audit Committee

- The proposals for audit refer to processes and projects that are of interest to the Governing Board or the Audit Committee, and that, **due to the identified risks, require special oversight.**

International Standards for the Professional Practice of Internal Auditing establish:

2010-A1.- *The internal audit activity's plan of engagements must be based on a documented risk assessment, undertaken at least annually. The input of senior management and the Board must be considered in this process.*

2010-A2.- *The Chief Audit Executive (CAE) must identify and consider the expectations of the senior management, the Board and other stakeholders for internal audit opinions and other conclusions.*

3.2 Selection criteria to prepare the Annual Audit Program

- Additional considerations for the Selection criteria

If a process is identified **as not having risk assessment**, the Risk unit will be notified Second Line of Defense.

Priority will be given to the integration of audit proposals that cover **the largest number of selection criteria**.

Audits will be chosen based on the results of the audits executed by the **external auditor**.

The number of audits in the Annual Audit Program will be established based on **the Audit Unit organization structure and staff available**.

The audit universe will be updated annually considering the changes in the bank's processes.

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3.3 Quality Assurance and Improvement Program

As part of its Quality Assurance and Improvement Program of Internal Audit activities, the Audit Unit.



Is currently analyzing and assessing:

The Audit Unit organizational structure and human capital, to ensure that they are qualitatively and quantitatively sufficient.

Job profile of the Audit Unit staff.

Audit staff turnover in order to encourage the development of their professional skills.

Such activities are included in the Internal Audit Charter, Section Three.- Professionalism, Independence and Objectivity: “Internal audit activities will be executed according to institutional policies and procedures, and will be conducted in a professional and ethical manner, in compliance with the International Professional Practices Framework of Internal Audit, regulated by the Institute of Internal Auditors.

Similarly, **the audit staff will strengthen and refine their knowledge, abilities and other skills needed to fulfill their responsibilities through continuing professional training.**

3.3 Quality Assurance and Improvement Program



Quality assessment of the internal audit functions influences the increased value of an institution.

Guarantee

Compliance with the International Audit Standards, the Internal Audit Charter, and internal and external regulations.



Background

On October 28, 2014, the Chief Audit Executive of Banco de México issued the "Guidelines for Quality Assurance and Improvement Program of Banco de México's Internal Audit activities".

A certification of the audit functions was obtained on January 1, 2015 from the *Institute of Internal Auditors*, through the Mexican Institute of Internal Auditors (IMAI).

Through the development and implementation of the referred Guidelines and the Quality Assessment Manual.

The certificate is valid for 5 years and expires on December 31, 2020. To renew it, the IMAI staff will assess if the Guidelines have been observed.

Legal background

"International Standard 1300 Quality Assurance and Improvement Program".

"The Chief audit executive must develop and maintain a quality assurance and improvement program **that covers all aspects** of the internal audit activity."

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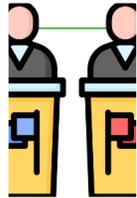
- Participation in the Central Bank Internal Auditors (CBIA) group^{3/}.

The CBIA reflects part of the structure of the Economic Consultative Committee of the Bank for International Settlements (BIS). The group includes the BIS, the European Central Bank and 17 other central banks.

CBIA MANDATE:



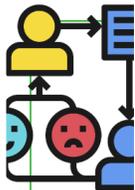
Share and promote best internal audit practices in central banks.



Contribute to discussions related to corporate governance, risk management, control and compliance in central banks.



Identify, research and inform on emerging risks, analyze key trends relevant to internal audit in central banks.



Provide information and feedback to relevant groups and committees in the BIS.



Contribute to the promotion and development of internal audit in the financial sector.

^{3/} The CBIA group (Central Bank Internal Auditors) is made up of the heads of the central banks' Audit Units.

Outline

3 Strengthening the internal audit activity

3.1 Updating the regulatory framework

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3.5 Managing IT services in the AU

3.5 Managing IT services in the AU

Banco de México's Audit Unit has its own area for managing IT services required for its operation, and which, among others, carries out IT activities, in compliance with the internal regulations governing the Institution:

- ❖ Develops IT applications for the automation of processes, prioritizing information security and confidentiality, using standardized tools.

- ❖ Manages the file server that stores data related to audit files to ensure its availability and confidentiality.

- ❖ Administers and gives timely maintenance to the developed systems, focusing on technological updates and on internal audit processes.

- ❖ **Manages collaborative sites, where information is shared with the units subject to audit review and with strategic areas in order to control and mitigate risks.**

- Support System for External Regulators

- Audit Control System

- Balance Confirmation System

- Audit Unit Transparency System



3.5 Managing IT services in the AU

- Benefits of managing IT services within the Audit Unit:



❖ Remains functionally independent from other administrative units of the Bank.



❖ Confidentiality and security in managing information obtained from the administrative units during the audit execution and which is managed in the AU systems.

❖ Control of priorities regarding IT requirements.



❖ Technical support and troubleshooting in less time.

Outline

4

Three Lines of Defense model

4.1

Interaction among the three lines of defense

4.2

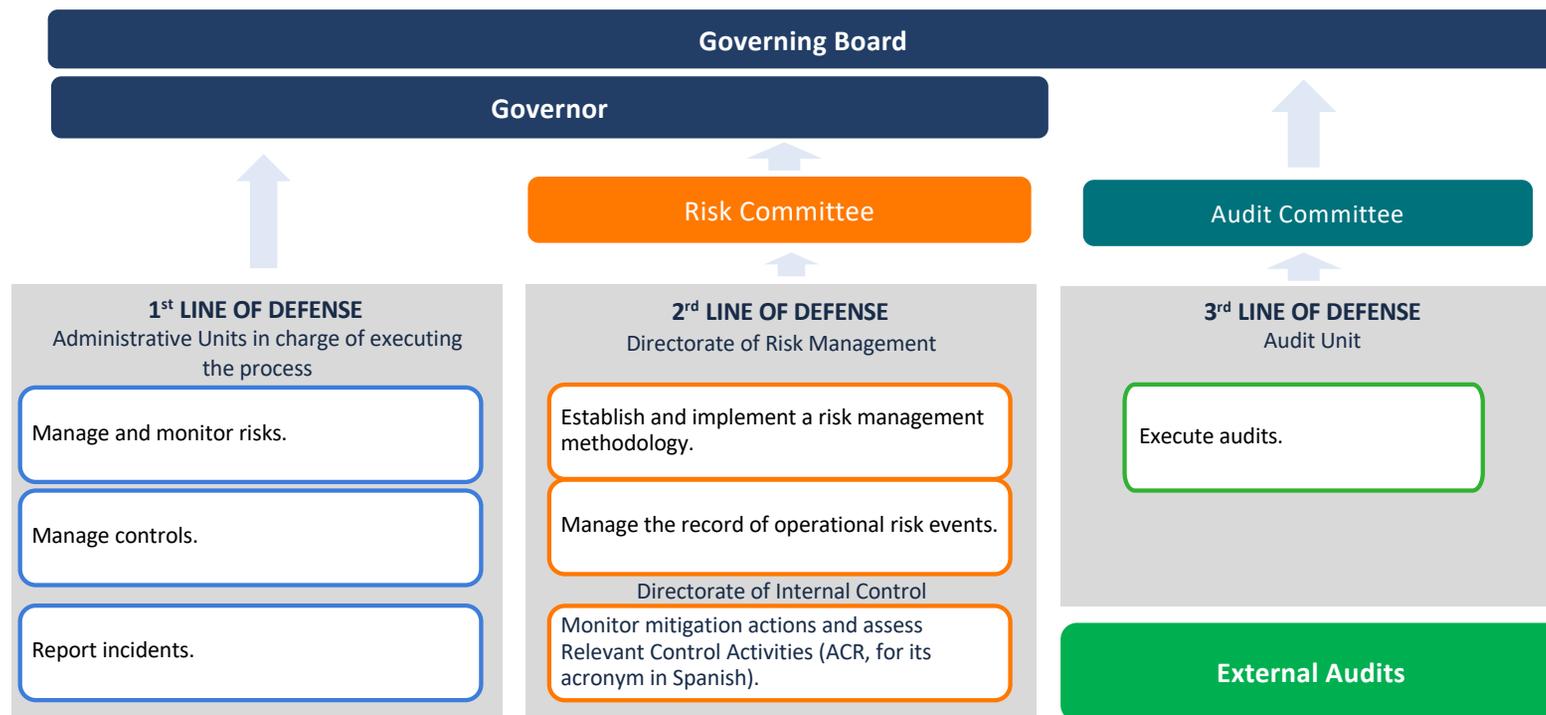
Following up on observations

4.3

Risk committee

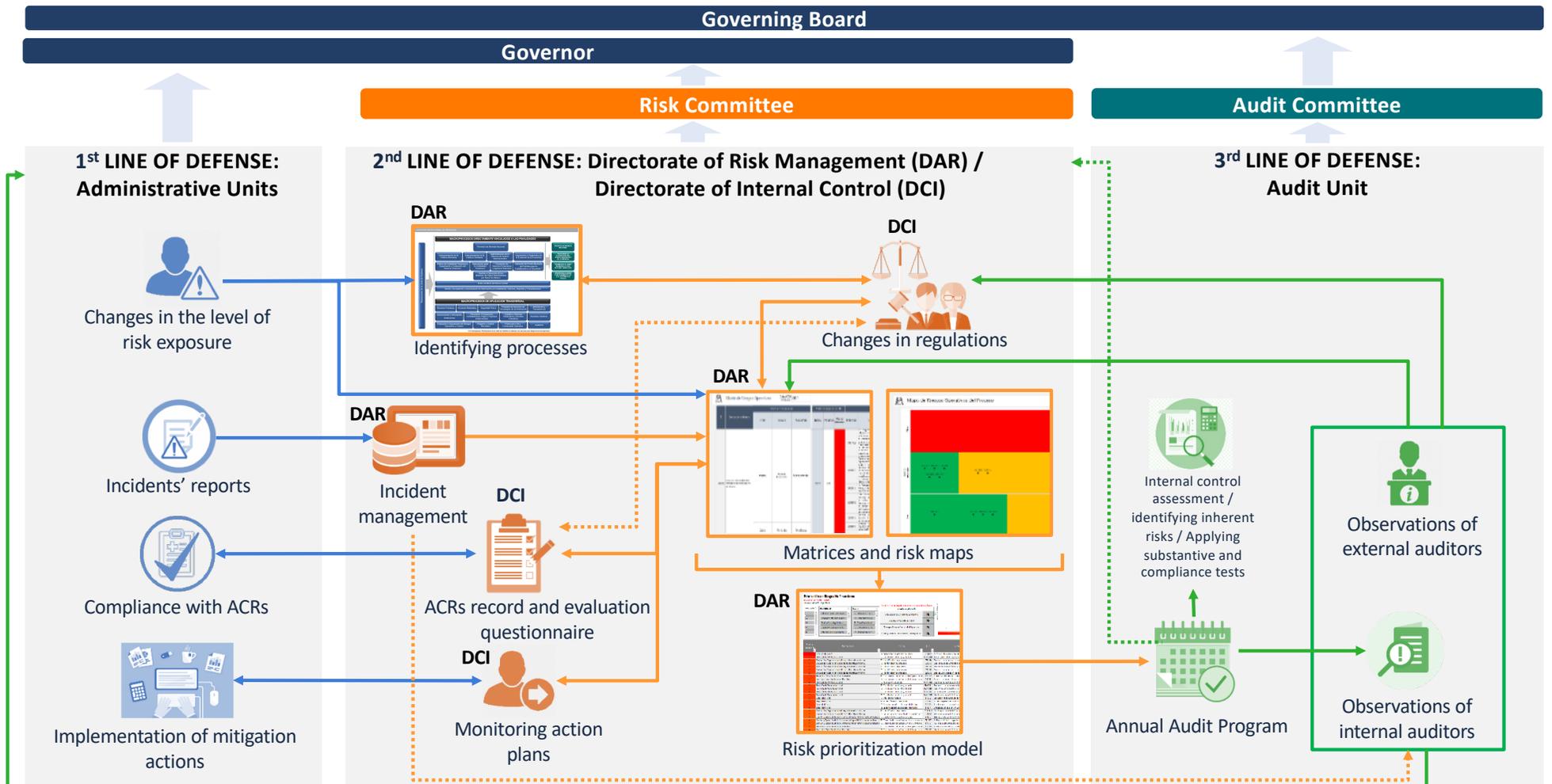
4.1 Interaction among the three lines of defense

- As part of the improvements to the risk management methodology, the Three Lines of Defense model has been established^{4/}. Its main goal is to define the roles and responsibilities of the different areas involved.

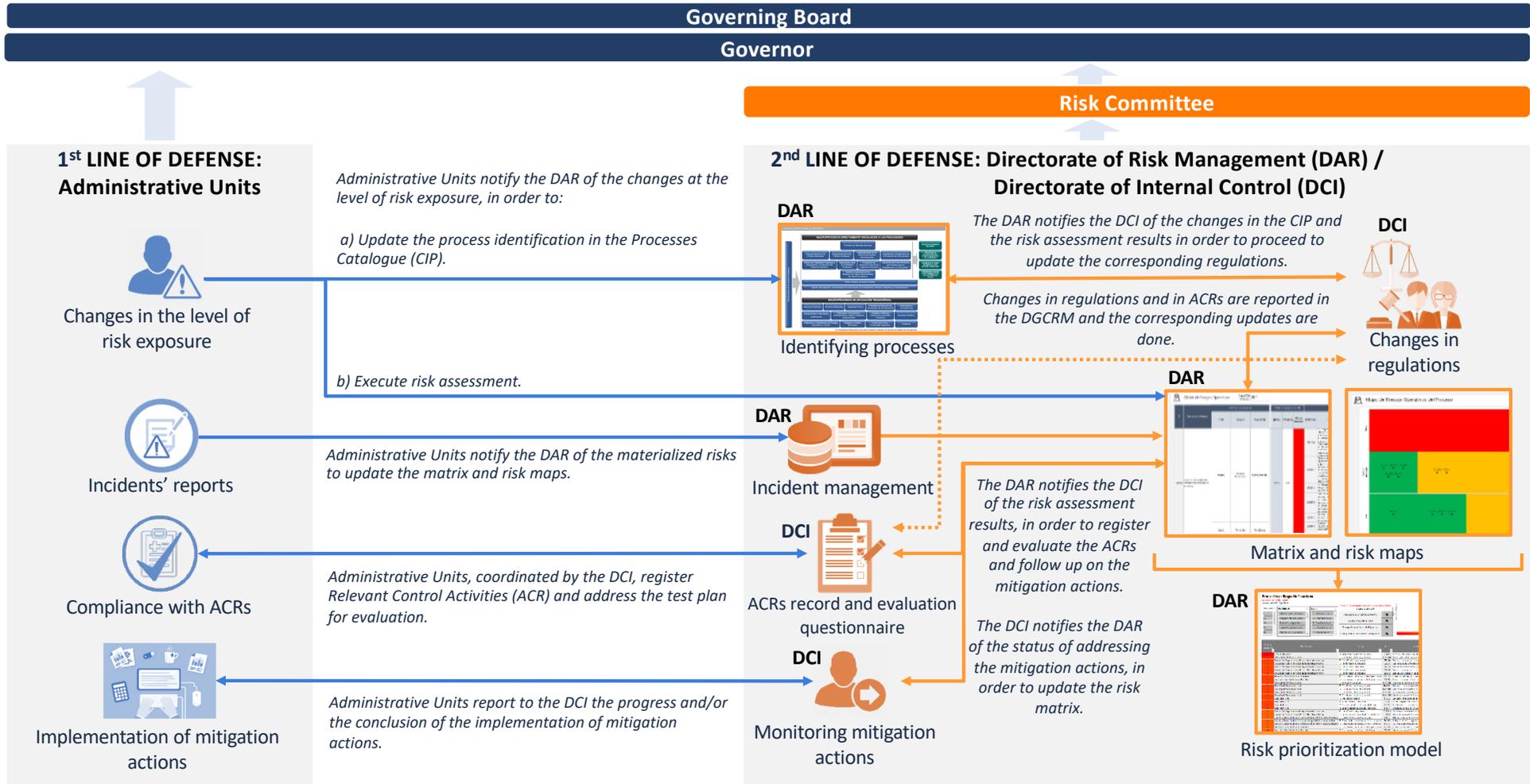


^{4/} COSO (2015). *Leveraging across the three lines of defense* in <http://aechile.cl/wp-content/uploads/2015/07/COSO-2015-3LOD-PDF-1.pdf>

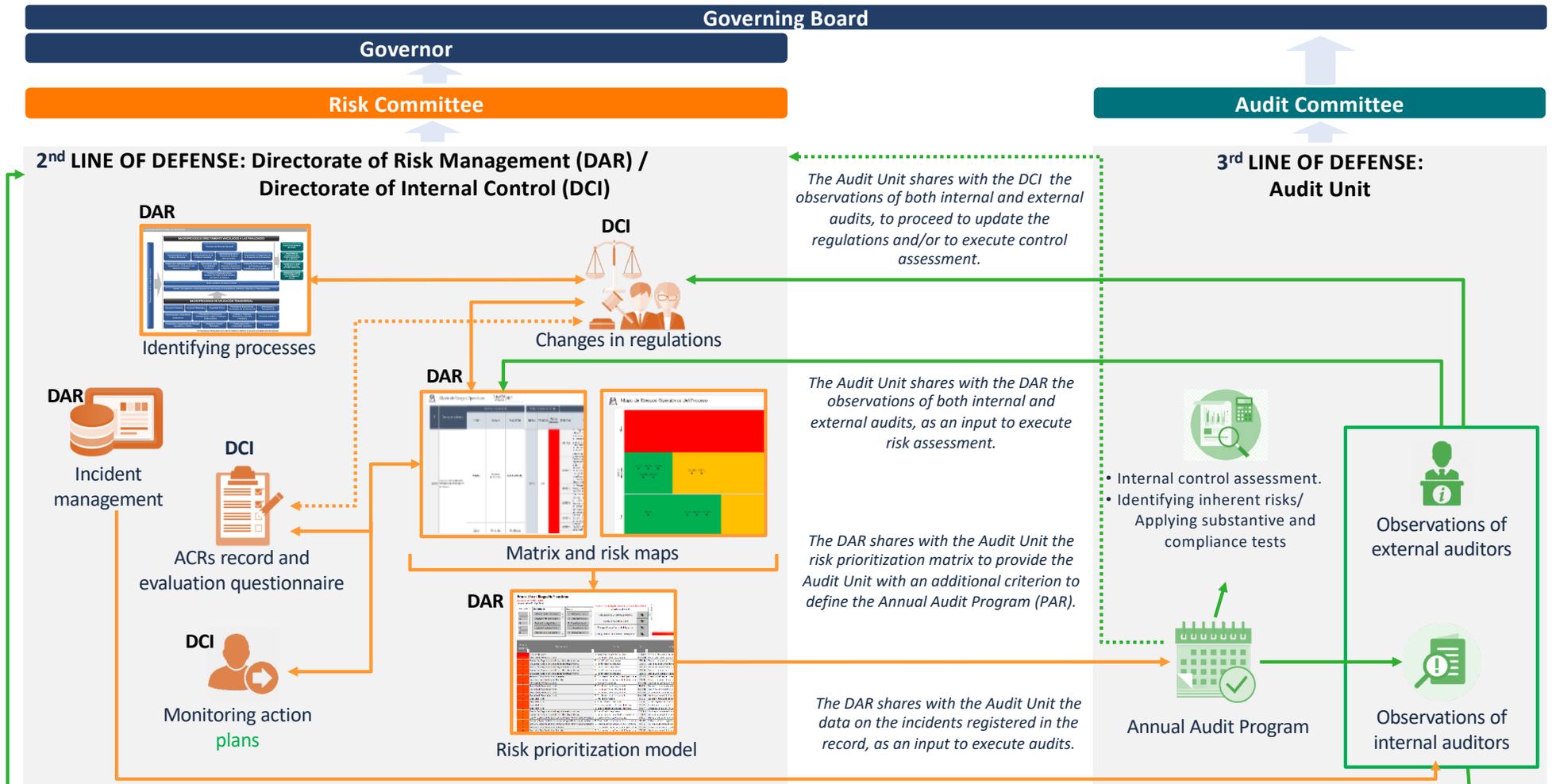
4.1 Interaction among the three lines of defense



4.1 Interaction among the three lines of defense



4.1 Interaction among the three lines of defense



Outline

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Three Lines of Defense model

4.1

Interaction among the three lines of defense

4.2

Following up on observations

4.3

Risk committee

4.2 Following up on observations

The process to follow up on the observations resulting from internal audits is done in a coordinated manner, between the 2nd and the 3rd line of defense, based on:



Activities are carried out systematically, **contributing to strengthen control** through a more timely attention by the 1st line of defense of the vulnerabilities identified by the 3rd line of defense.

Contenido

4 Three Lines of Defense Model

4.1 Interaction among the three lines of defense

4.2 Following up on observations

4.3 Risk committee

4.3 Risk Committee

- Background of the Risk Committee

Operational Continuity Committee of Banco de México (CCOBM)

It's a body of consultation and advice resolution, responsible for the actions to be taken in contingencies and during operational disruptions, which can lead to the announcement of warnings.

Internal Control Committee of Banco de México (CSCCIBM)

A collegiate body that informs the Governor on the activities related to the internal control system and receives guidelines regarding these issues.

Identified needs:

- Have an institutional forum that provides an overall outlook of risks, and of Banco de México's internal control system and operational continuity.
- Strengthen accountability to the Governing Board.
- Build an efficient communication channel between the first and second line of defense with the Governor and the Governing Board.

In April 2019, the following were ordered:

- **The creation of the Risk Committee.**
- The termination of Banco de México's Operational Continuity Committee and of Banco de México's Oversight Committee of the Internal Control System.

4.3 Risk Committee

- Risk Committee



Composed by:

- Governor(Chairperson).
- Officers at the level of Director General or Director who are directly assigned to the Governor.



Has a secretary and an assistant secretary (the Director of Internal Control and the Manager of the Internal Regulatory Control Division).



Participation of the Heads of the Governing Board Secretary, the Audit Unit, the Directorate of Risk Management, the Security Directorate and the Cybersecurity Directorate.



Holds sessions at least 3 times per year.

4.3 Risk Committee

- Functions of the Risk Committee

1

Serves as a consultative and advisory body to the Governor regarding non-financial risks, internal control system and operational continuity.

2

Suggests institutional guidelines for non-financial risk management and treatment.

3

Suggests actions to strengthen the management of non-financial risks, the internal control system and operational continuity.

4

Issues opinions on the criteria, methodologies, reports and others that the Directorate of Risk Management and the Directorate of Internal Control submit to its consideration.

5

Presents to the Governor the reports that will be presented to the Governing Board regarding non-financial risks, the internal control system and operational continuity, as well as the works and studies required to make decisions in this area.

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Final remarks

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- The Audit Committee's functions must evolve as follows:
 - **By expanding the scope of its functions.** In the institutional system of internal control; in the quality of non-financial risk management; and in the policies for preparing financial and anti-corruption reports.
 - **By adopting best corporate governance practices.** Establishing rules for its functioning, based on the principles seeking to ensure impartiality, independence and efficiency.
- Considering the above, it is advisable to:
 - **Create multidisciplinary working groups** with the participation of the areas of control, risk, auditing and legal.
 - **Strengthen the organization of Audit Committees** by updating their regulatory framework and their operating rules, and incorporating the best international practices in internal auditing.



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