

**Approved by  
Resolution of December 29, 1999  
by the Management Board  
of the Central Bank of Azerbaijan Republic  
(Protocol No.12)**

**Registry No.138**

**REGULATIONS ON ORGANIZATION OF  
INTERNAL CONTROL  
AND  
INTERNAL AUDIT  
IN BANKS**

(as amended on April 15, 2010)

These Regulations have been developed in accordance with the Laws of Azerbaijan Republic «On banks and banking activities in Azerbaijan Republic», and «On the Central Bank of Azerbaijan Republic», and identifies internal controls and internal audit mechanisms and arrangements for all commercial (joint stock commercial) banks operating in Azerbaijan Republic.

## **1. General provisions**

The Supervisory Board and Management Board of a bank shall be responsible for determining the strategic objectives of banking activities and policy, including establishment and implementation of an internal controls system, as well as proper and effective conduct of banking transactions and operations. The bank's Financial Inspection Commission shall be responsible for regularly auditing the bank's operations in order to evaluate whether the bank is in compliance with the existing laws, regulations, as well as its own internal policies and guidelines.

Internal audit shall be responsible for ensuring that the appropriate controls designed to provide security of the bank's assets are adequate or exist, and that periodic reports presented to the bank's shareholders, regulators and the general public are accurate, complete and fair.

Internal controls are an important tool for timely identification and prevention of potential mistakes, deficiencies and losses in the bank's operations, and minimizing the bank's risks. Establishment of internal controls is essential for ensuring reliability, effectiveness, safety and compliance of the bank's operations.

All banks shall follow the below described principles and guidelines in order to ensure that their internal controls are adequate in relation to their operations:

- a) An excellent organizational structure;
- b) Necessary policies and accounting procedures;
- c) Asset security measures;
- d) An effective internal audit program.

## **1. Organizational structure**

2.1. The Supervisory Board, Financial Inspection Committee and Management Board shall be responsible for developing the bank's relevant internal control policy, as well as ensuring compliance of the bank's management and personnel with this policy. This policy and internal controls shall cover the entire structure of a credit institution, including its branch offices and divisions.

2.2. A clear and precise division of responsibilities and powers should be provided in the organizational structure. Relevant policies approved by the Supervisory Board, such as lending, investment or trading transaction policies (foreign exchange, securities trading) shall clearly and precisely define the authorities of the bank's staff.

Regardless of the position held, each employee shall have a limit of the amount of lending, investment, trading (foreign exchange and securities trading) and other transactions and deals;

- a limit monitoring and reporting system should be established;
- policy compliance reports should be regularly presented to the management, Supervisory Board and Financial Inspection Committee.

2.3. Appropriate policies and internal procedures should be developed for each line of the bank's business, as well as adequate control systems should be put in place to monitor

compliance with such policies and procedures:

- each policy shall be subject to approval by the Supervisory Board;
  - each policy shall be subject to review at least once a year;
  - the bank's policies should be communicated to all relevant employees;
  - current training courses should be organized in order to ensure unconditional compliance with the policies and procedures;
  - status reports on each activity shall be presented to the Supervisory Board and Financial Inspection Committee, indicating the effectiveness of such activity/line of business.
- Credit institutions should develop the following policies, procedures and guidelines as a minimum:
- the bank's management structure and decision-making procedures;
  - documents determining the division of duties and powers among individual business units and employees of the bank;
  - procedures regulating the bank's internal audit;
  - procedures regulating the bank's lending policy and deposit taking;
  - liquidity, asset and liabilities management policy;
  - securities issuance and investment policy;
  - customer account opening and maintenance procedures;
  - computer system, their use and security procedures;
  - staffing policy;
  - other policies, procedures and guidelines.

Such policies, procedures and guidelines shall be consistent with the existing laws, the Central Bank's regulations, procedures and guidelines.

2.4. Duties should be distributed in a manner that would prevent the same person from being responsible for a transaction from inception to completion, i.e., the same person should not be responsible for executing and controlling a transaction.

For example:

- the employee responsible for loan documentation should not be authorized to grant the loan;
- persons authorized to operate correspondent accounts should not be authorized to process such operations in the balance sheet and personal accounts;
- documents should be reconciled against the balance sheet, turnover balance spreadsheet and personal accounts not by the person who executed the transfer but by a different employee;
- persons who send or receive telex communications should not be authorized to execute the operations specified in such communications, process them in balance sheet and personal accounts or reconcile the associated accounts.

2.5. The staffing policy should specify:

- position rotation should be provided and the rotation period should be sufficiently long to ensure effectiveness of such rotation;
- all employees, including executive officers should leave their workplaces at least for two weeks a year (vacation) to enable other employees to perform their duties during that period.

2.6. When a new banking service is introduced, a relevant control should be developed to measure and monitor the risk level of such transaction.

Internal control policies are important, but compliance with such policies is of paramount importance in order to ensure effectiveness of internal controls.

### **3. Accounting principles and procedures**

Each bank's accounting systems should be consistent with the international accounting standards and modern principles of banking as defined by the CBA. Accounting records of a bank should

fairly and correctly present the bank's financial position and performance. Presented below are some characteristics of a bank's accounting system:

- each bank should have internal procedures for daily accounting treatment of operations and data analysis;
- documents and records should be processed on a daily basis and should present the bank's everyday operations and activities, as well as the «as of» financial position;
- supporting documents, such as documents on deposit, lending, securities and foreign exchange transactions should correspond with the balance sheet, turnover and balance spreadsheet and personal accounts;
- original documents evidencing all accounting entries should be made available;
- reconciliations should be regularly conducted by employees who are not responsible for execution of operations and approval of documents;
- documentation and systems should be organized in a manner that would allow for tracing each transaction from inception to completion as it goes through the bank's books.

### **1. Physical protection of assets**

Each bank should develop and put in place effective procedures that would ensure protection of assets and that only authorized employees are allowed to operate such assets.

- 4.1. Employees dealing with cash should be provided with funds designated for them so as to allow for conducting examinations and determining responsibility. Procedures should be implemented that prompt reporting funds deficiencies. All reasons should be investigated once a deficiency is reported.
- 4.2. Joint custody should be used in certain cases. Under joint custody arrangements, two or more persons are equally accountable for physical protection of items or documents (for instance, several individuals keep the keys to the vault where confidential information, cash and valuables are stored). Such duties should be assigned to employees appointed for this purpose, and should be communicated to other employees.
- 4.3. Dual control shall be used for operations where actions of an employee must be checked or approved by another employee. (For example, cashing cheques).
- 4.4. All banks shall develop appropriate action plans to prevent most important assets and documents from suffering external and internal damages in emergency situations, for example, natural disasters, or other events.

### **1. Internal audit**

- 5.1. Internal audit is the most effective internal control available to the Supervisory Board, Financial Inspection Committee and Management Board. An internal audit program is considered excellent when the established internal controls and operating procedures ensure that any damages that may arise as a result of ineffectiveness, irregularities, or fraud or deliberate manipulations, are minimized. The auditor's role is to assist in securing the bank's assets by inspecting and analyzing the efficiency, effectiveness and reliability of operating systems, internal controls and documentation. Effective audit creates the necessary environment, and helps ensure the accuracy and reliability of bank transactions.

Purpose and duties of internal audit as defined hereunder do not prevent the bank's Financial Inspection Committee from fulfilling its statutory responsibilities. The Financial Inspection Committee may use internal and external audits in discharge of its duties and responsibilities.

5.2. Principal goals and duties of audit include:

- to ensure regular inspections in order to evaluate compliance of operations executed by individual employees and business unit of the bank;
- to investigate any instances of non-compliance by bank employees and to identify any irregularities or fraudulent patterns;
- to prepare recommendations to remove and follow-up on deficiencies identified;
- to document inspection and each audit finding;
- to report inspection findings, new risks, deficiencies and irregularities identified and related mitigation measures to the bank management in a timely manner;
- to oversee the personnel's training in laws, regulations, internal policy documents;
- to analyze the adequacy of accounting and reporting system;
- to evaluate the administrative controls and procedures, as well as effectiveness of operations;
- to ensure that appropriate internal controls are put in place when a new policy is developed and old policy is reviewed, or when new activities are planned and implemented.

5.3. Internal audit staff shall have the following rights:

- to access accounting, reporting, cash reporting and other documents for inspection purposes;
- to evaluate compliance of the personnel's actions and operations;
- to recommend suspension of individual operations;
- to engage employees from other business units to address a number of internal audit-related issues, when necessary.

5.4. In their interactions with the internal audit function, all bank employees shall:

- assist the internal audit function in performance of its duties;
- report any instances of non-compliance as well as damages to the bank to the internal audit function;
- consult with internal audit staff when compliance of individual operations is doubted;
- bank employees who may be considered «interested parties» may not be involved in certain transactions without giving a prior notice to the internal audit function.

5.5. All commercial (joint stock) banks shall establish an internal audit function. The number of the internal audit function's staff members shall be determined by the Supervisory Board upon recommendations from the Financial Inspection Committee and Management Board, in consideration of the size of the bank's assets, scope of the bank's branch office network, scope and nature of internal controls as defined in the bank's policy.

Head and members of the internal audit function, or internal auditors, shall be appointed by the Management Board upon recommendations from the Supervisory Board and Financial Inspection Committee.

If branch offices of foreign banks operating in Azerbaijan Republic are regularly audited by their parent banks, such branch offices may not have a full-time internal auditor, however shall establish a system of internal controls meeting the requirements hereof.

Each bank shall have an appropriate internal audit program.

5.6. The audit function of banks shall meet the following minimum standards.

1) Auditor must be independent:

- shall report directly to the bank's Supervisory Board and Financial Inspection Committee;
- shall have the necessary authorities to perform his duties (shall have free access to documents and business units);
- shall have high ethic and professional qualities;
- shall not be related to the area under audit;
- no limitations shall be imposed on the audit program's implementation schedule or scope.

2) Auditor must be competent:

- shall have a higher economic education, relevant professional expertise, as well as shall be willing to continually upgrade his skills;
- shall be knowledgeable of banking operations and International Auditing Standards;
- shall be familiar with internationally accepted accounting standards.

3) Audit program:

- shall be approved by the bank's Financial Inspection Committee and Supervisory Board and shall be regularly reviewed;
- shall be in a written form and specify the purposes of audit;
- shall have a sufficiently broad scope to accomplish the purposes and objectives of audit;
- shall contain detailed work programs for each area to be audited;
- each program shall provide a clear and precise description of required audit activities, as well as the procedures for inspecting specific operations in individual departments of the bank, depending on the scope of the work. Procedures specified in the program may be modified depending on the scope and complexity of bank operations, among other things;
- if necessary, the program shall provide for approval of balance sheet accounts, in particular loan, deposit and correspondent accounts;
- audit timelines shall be predicated on the risks inherent in each area. When analyzing the bank's risks, the auditor shall pay particular attention to the nature of specific operations, associated assets and liabilities, existence of relevant policies and internal control requirements, effectiveness of internal controls and similar factors;
- all works performed shall be documented. Working documents on internal audit shall specify the grounds for analyses and opinions presented describing the audit work program, scope of inspection and operations performed.

The internal audit program shall mainly address the following:

- a) compliance with the policies and procedures approved by the Supervisory Board and management, including approval of appropriate authorizations for transactions;
- b) compliance with the existing laws and regulations;
- c) level of detail of bank documents, including accurate and timely recording of all operations in appropriate accounts;
- d) security and appropriate reporting of bank assets;
- e) a comprehensive analysis of revenues and expenses to ensure that they are properly accounted for, legitimate and comply with the bank's policies. This includes sample inspection of interest on deposits and loans, fines of delinquent payments, service fees and other computer-based calculations and documents, in order to ensure that calculations and documents are accurate;
- f) appropriate documentation and collateral monitoring, including accounting of off-balance sheet items such as letters of credit and security;
- g) analysis of documents on losses from loan charge-offs;
- gh) availability of accurate and properly approved documents on each transaction from inception to completion;
- i) security and liability of computer hardware and software, as well as development of contingency/emergency action plans (data security, storage and restoration).

4) Auditor's opinion:

- shall be prepared immediately upon completion of audit;

- shall report the purposes, scope and findings of audit and detailed recommendations for each problem area identified;
- recommendations shall provide a brief description of audit findings, corrective measures required, shall name the persons responsible for such measures and appropriate implementation timeframes;
- the opinion shall be presented directly to the Supervisory Board and Financial Inspection Committee, copies of the opinions shall be presented to the Management Board and unit managers (only relevant sections of the opinion);
- effectiveness of internal audit is predicated on follow-up to ensure that recommendations are actually acted upon. The Supervisory Board shall formulate a follow-up policy. The management team and internal auditor shall thereafter develop such follow-up policy.

5) Audit timeframe:

The timeframe of each audit is typically predicated on the risks inherent in individual areas to be audited. Audits shall be conducted at least once a year.

The Central Bank of Azerbaijan Republic shall be responsible for inspecting the internal control systems, including internal audit functions of credit institutions, and their compliance with the requirements hereof. In addition, the Central Bank may also require credit institutions to submit periodic reports on the status of internal control systems and audit findings.

These Regulations shall take effect as of the signing date.

**E.S. Rustamov,**  
**Governor,**  
**Management Board of the Central Bank**

January 10<sup>th</sup>, 2000