ANNUAL REPORT

on the operation of Internal Audit Department

in 2011

KOMERCIJALNA BANKA AD Skopje

Internal Audit

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I. INTRODUCTION

The Internal Audit Department is an independent organizational part, which is separated from the other organization units of the Bank in terms of its function and organization, directly reporting to the Supervisory Board and Audit Committee. The main objective of the Internal Audit Department is to provide an objective and independent assessment of the internal controls, through measuring, monitoring and testing the adequacy of the internal controls, aimed towards efficient performance of the operative processes in accordance with the internal policies and procedures and the law regulations, as well as with the aims and objectives of the Bank's Business Policy.

Pursuant to article 97 of the Banking Law (Official Journal No. 67/2007), article 121 of the Statute of Komercijalna Banka AD Skopje and Section VIII of the Rules of Procedures of the Internal Audit, the Internal Audit of the Bank submits Annual Report on its operation in the year ending on 31.12. 2011.

Pursuant to the provisions of the above mentioned acts, the Report on the operation of the Internal Audit in the course of 2011 contains the following information:

- ✓ Description of the individual regular and additional audits carried out;
- ✓ Additional audits and other activities of the Internal Audit in the course of 2011;
- ✓ Realization of the aims prescribed by the Annual Plan for the operation of the Internal Audit in the course of 2011;
- ✓ Evaluation of the adequacy and efficiency of the systems of internal control of the Bank made on the basis of the findings from the audits carried out;
- ✓ Findings form the audits carried out, recommendations given for mitigation of the weaknesses identified, status and level of recommendation implementation;

Starting from the risk profile of the Bank, the structure of the assets and liabilities, types of credit and deposit products, main business activities with the Bank, in the course of 2011, the Internal Audit had directed its activities towards revision of the adequacy of the controls of the internal control system of the Bank for managing the essential material risks the operative processes are exposed to, thus individually auditing and testing the respective controls in the systems for undertaking, measuring, monitoring and managing the credit, currency, liquidity, market, legal risk and the risk from changes in the interest rates. Within the regular on-site audits carried out in accordance with the Annual Plan for operation in 2011, the Internal Audit carried out complete audit and control of the operation of 4 (four) branches of the Bank: the branches in Veles, Strumica, Kumanovo and Kocani.
Most of the individual audits of the business technological systems were accompanied by IT audit on the adequacy of the computer support and controls within the application solution on the operation within the integrated IT system of the Bank.

In the course of 2011, and according to the Annual Plan of the Internal Audit Department, prepared on the basis of previous internal identification of IT risks, regulatory requirements and current knowledge on the organization of the information technology of the Bank, the Internal Audit made IT audits in all significant segments in the operation of the ICT system of the Bank (operative systems, computers network, the system of the branches and city-branches, web servers, etc.).

I.1. Review of the individual audits carried out in the course of 2011

In the course of 2011, and pursuant to the Annual Plan for the operation, the Internal Audit realized 36 regular individual audits in the following spheres of the operation of the Bank:

No.	**Regular activities**
1	Audit on the processes of approving and administering loans and guarantees to citizens in the Head Office of the Bank in the period 01.01.-31.12.2010 as well as a part of more significant credit placements as at 31.12.2010;
2	Audit on the processes and way of management of the due claims from credit placements approved to citizens prior to initiation of procedures for enforced collection, as at 31.12.2010;
3	Audit on compliance with a part of the law tax regulation of the Bank as a property tax payer (property tax and estate turnover tax) and personal income tax in the period 01.01.2010-28.02.2011;
4	Audit on the systems for management of the Bank's data, as at 28.02.2010;
5	Audit on properness in part of reporting to NBRM – recording and submitting reports for concluded loans with non-residents on its behalf and on its/third party's account, in the period 01.01.2010-10.03.2011;
6	Audit on the implementation of the recommendations on improvement of the credit risk management system provided by the written warning No. 7466/10.11.2010 of Governor of NBRM;
7	Audit on a part of the activities within the internal control system for identification, monitoring and managing the reputation risk the Bank is exposed to in its operation, as at 30.04.2011;
8	Follow-up audit on the implementation of the Internal Audit recommendations upon the audit carried out as at 31.08.2010 on the implementation of the methodology for internal ranking of the clients and credit portfolio classification;
9	Audit on the current organization of the IT system of the Bank and support to a part of the reputation risk management processes, as at 31.05.2011;
10	Audit on a part of segments in currently implemented internal control systems of the processes of strategic risk management in the Bank, as at 31.03.2011;
11	Audit on the current organization of the IT system of the Bank for support to a part of the strategic risk management processes, as at 31.05.2011;
12	Audit on a part of the processes of the credit risk management – procedures of assessment of real estate, movable property and equipment accepted by the Bank as security under credit placements, as at 30.04.2011;
13	Audit on procedures for establishing lien over movable and immovable property as a security instrument for credit placements approved to citizens and legal entities, as at 31.03.2011;
14	Audit on the banking integrated system for business intelligence – Tezauri, as at 31.03.2011;
15	Audit on the operation of the Kocani Branch in the period 01.07.2010 30.06.2011;
16	Audit on the operation of the Kumanovo Branch in the period 01.07.2010 30.06.2011;
17	Audit on the organization the information-communication technology in the branches in Kocani and Kumanovo, as at 30.06.2011;

18	Audit on the processes of development and maintenance of WEB application solution within the IT system of the Bank, as at 30.06.2011;
19	Audit and assessment of the system and effects from the liquidity risk management in the period 01.01.-30.06.2011;
20	Audit and assessment of the system and effects from the currency risk management in the period 01.01.-30.06.2011;
21	Audit and assessment of the system and effects from the market risk management in the period 01.01.-30.06.2011;
22	Audit of adherence to the supervision standards prescribed by the Banking Law as at 30.06.2011;
23	Audit of the way and extent of provided secrecy and protection of personal data while being processed in the Bank, as at 31.08.2011;
24	Audit of the Bank's methodology established for implementation of policies and procedures in outsourcing, as at 31.08.2011
25	Audit on the operation of Strumica Branch, as at 30.09.2011;
26	Audit on the operation of Veles Branch, as at 30.09.2011;
27	Audit on the organization of the IT system in Strumica and Veles branches as at 30.09.2011;
28	Audit and assessment of segments of the Bank's operative risk management system in the processes of identifying, measuring and assessment, as at 30.09.2011;
29	Audit on the current organization of the Bank's IT system for support of part of the operative risk management processes, as well as the activities of monitoring and managing the operative risk, as at 31.10.2011;
30	Audit on the Plan for continuity in the operation of the Bank and the Plan for extraordinary conditions, as at 31.10.2011;
31	Audit on the implementation of the Money Laundering Prevention Program as part of the Bank's system for managing the operative risk, as at 30.11.2011;
32	Audit on the characteristics of the automated data processing software within the activities for implementation of the Money Laundering Prevention Program, as at 30.11.2011;
33	Audit on the processes of accepting and administration of legal entities' deposits with and without purpose identified (except banks' deposits), as at 30.11.2011;
34	Audit on part of the Bank's credit portfolio, such as: processes of approving and administration of denar loans and denar loans with FX clause at the Bank's Head Office in the period 01.01.-31.10.2011;
35	Audit and assessment of the established system for management of the risk from incompliance of the Bank's operation with the law regulations, as at 31.10.2011;
36	Audit on the activities with credit mediators when approving consumer loans and realization of the contracts for credit mediation in the period 01.10.2010-30.11.2011.

The managing bodies of the Bank, Supervisory Board, Audit Committee and the Board of Directors are regularly and in due time reported on the findings and more significant weaknesses identified in the course of the audits carried out, through the 6 (six) individual reports made in the course of 2011, which is within the legal obligation for minimum reporting on quarterly basis. The action plans are usually prepared as constituent part of the regular reports. They are of internal and operative character and they provide details on the identified weaknesses, recommendations, as well as terms and officers responsible for the implementation of the recommendations given. Copies of the action plans are provided to the members of the Board of Directors, on regular basis, and these plans are used for regular control of the status of implementation of the recommendations in cooperation with the competent organizational units.

❖ Information on additional and extraordinary controls and audits in 2011

In the course of 2011, and at request of the managing bodies or other competent officers of the Bank, the Internal Audit made 4 (four) additional controls, as follows:

No.	Report on additional audits realized
1	Audit on the manner of the calculation made and the provisioning presented regarding the long-term benefits of the employees, as at 31.12.2010;
2	Activities undertaken under objection of Bank's client to the response received from the Independent Internal Inspection and Control Unit regarding the objection submitted related to the doubtful balance of USD 614,00 on FX account;
3	Control of the operation of the officer Svetlana Gogovska who, according to the decision made by the investigation judge, is determined detention
4	Control of the reasons for permanent increase of the negative balance on the denar account of Gostivar Branch as at break date 30.11.2011.

❖ Other activities of the Internal Audit Department in the course of 2011

Within the frames of its additional activities, the Internal Audit Department was frequently engaged in providing independent and objective consulting services regarding certain issues and at the request of the responsible officers of different OU in order to help the management to improve the internal control system controls aimed towards efficient management of the operative risks. It also took active part in consideration of the draft regulations of NBRM and other draft law regulations, as well as other draft amendments and supplements to the internal acts of the Bank.

❖ Human resources, participation in seminars, training courses and workshops in the first half of 2011

The regular and additional activities prescribed by the Annual Plan for the operation of the Internal Audit for 2011 were realized by 6 (six) officers due to the absence of two officers due to maternity leave in the course of 2011.
In the course of 2011, the authorized officers of the Internal Audit took part in seminars in the domain of auditing, accounting, tax regulations and IT systems protection, and the authorized auditor had fulfilled the legally prescribed 40 hours additional education at the Institute of authorized auditors. In the course of May 2011, two of the department officers participated at the 5th Annual Internal Audit for Financial Institutions, organized by Jacob Fleming Group- consulting company in cooperation with the European Commission and ISACA (Information Systems Audit and Control Association) in Barcelona.

I.2. Realization of the aims and objectives set by the auditing plan of the Internal Audit

As a primary objective in realization of the Annual Plan for 2011, the Internal Audit Department was focused on efficient and effective realization of the

planned audits within the available time and resources making efforts to keep and improve the quality of the auditing and results therefrom.

In the course of 2011, the Internal Audit mainly adhered to the planned regular audits and within the term plan for their realization in accordance with the Annual Plan for operation for 2011 approved by the Supervisory Board of the Bank at its 37th meeting held on 31.01.2011. The Internal Audit realized 36 individual audits, thus covering the planned segments and business processes assessed as the most critical and prescribed by the Annual Plan.

According to the Annual Plan for 2011, out of the planned 12 thematic IT audits, the Internal Audit realized 11 regular IT audits and 1 extraordinary IT audit.

The planned IT audit of the system for storing and analysis of audit traces in the Bank was postponed for the 4th quarter in 2012 due to the activities announced by the IT Division for purchasing and installation of new software module for analysis and monitoring of the audit traces for monitoring of the databases.

The Internal Audit has permanent cooperation with the independent Unit for inspection and control, which reports directly to the Board of Directors of the Bank, and is mainly focused on the operative processes of the Bank that are directly exposed to the operative risk, such as: counters' operations, deposit operations, domestic payment operations, vault operations, exchange operations and bank cards and ATMs and other operative segments. The cooperation is directed towards coordination of the control activities, for the purpose of avoiding their overlapping and unnecessary engagement of resources by both organizational units. The Internal Audit is regularly provided the reports and minutes prepared by the Unit for inspection and control, on the regular and extraordinary inspections and controls carried out, for the purpose of having insight in all other secondary segments of the business processes of the Bank. At the same time, the Unit for inspection and control is regularly suggested and recommended for carrying out inspection and control in those segments of the operation of the Bank which had not been controlled for a longer period of time.

I.3. Assessment of adequacy and efficiency of the internal control systems

The internal control is a continuous process conducted on all levels in the Bank by the managing bodies, management team and all employees designed to provide reasonable security for achievement of the following aims and objectives: protection of value of the assets, i.e. maximization of value of the Bank, workout of accurate financial reports, increase of the efficiency of the overall operation, advancement of the managing efficiency, as well as compliance with the internal policies of the Bank and the laws and regulations referred to banks.

The internal control system is subject to constant changes and adjustments depending on changes of the law regulations and acts of the Bank, changes of the technology of certain processes and systems and therefore it is a

significant component in managing and establishing a safe and stable base for operation of the Bank.

When evaluating the adequacy and efficiency of the internal control system in the audited processes and activities in the course of 2011, the Internal Audit considered the most significant components and aims of the internal control systems, as follows:

- Whether the audited processes or activities are regulated by internal policies and procedures and whether they are in accordance with the law regulations and business policy of the Bank;

- Whether there is implemented adequate division of authorities and responsibilities of employees in the organizational units of the Bank bearers of the audited working processes for the purpose of minimization of conflict duties and responsibilities and elimination of risk from deliberate and non-deliberate mistakes and misuses and on the way providing efficient control of management of risks the audited process is being exposed to;

- Whether the audited processes are supported by an adequate information system, the level at which the internal and external policies and procedures are integrated, in order to achieve automation of the processes of accepting and processing the orders on all levels and electronic data processing.

- Whether the system controls incorporated in the application solutions for operation are sufficient, safe and secure in order to prevent deliberate and non-deliberate errors and misuse and efficient enough to minimize the operative risks.

- Whether the internal control system of the Bank allows recognition and assessment of the significant risks the Bank is exposed to: credit, liquidity, currency, operative, reputation and other risks to which the business processes and the Bank's operation are exposed

Opinion: Based on the individual audits performed in the course of 2011, the auditors' evidences based on control of a representative sample of the audited material selected by random choice out of all audited processes, the Internal Audit hereby confirms the acquired reasonable assurance that the internal control systems in the Bank are adequately implemented in terms of minimization of all types of risks characteristic for banking, and in direction of efficient and appropriate implementation the law regulations and the Bank's Business Policy.

The findings from the IT audits carried out have confirmed the expected assessment of the Internal Audit for an established sound system of internal controls at all levels of the operation of the Bank's IT system, which provides full support of the business processes for the realization of the strategic aims of the Bank as a whole.

The weaknesses and errors identified in the course of the on-site controls did not have any material significance and were of operative and low-risk character. The recommendations given for improvement of the controls in the

internal control system for the purpose of minimization of the operative risks were almost in full accepted by the responsible officers of the controlled OU. The status of implementation of the respective recommendations is presented in the tables attached.

Skopje, January 2012

Internal Audit Department
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Manager