

Financial Services Internal Audit insights

Effective Internal Audit **RAISING THE BAR**

May 2014



BACKGROUND AND CURRENT ENVIRONMENT

BACKGROUND

The regulatory direction been building over several years: Basel guidance for Banks; Federal Reserve; Office of the Comptroller; and UK CIIA guidance ('code') issued in July 2013

Financial Services organisations undertaking internal audit activities conducted "gap" analysis versus requirements

KPMG INTERPRETATION/ INSIGHTS

This raises the bar of expectations on Internal Audit functions

Comply or explain fully

“

... I think one of the relatively untold stories of the financial crisis concerns how little attention the [bank internal audit] functions have attracted.

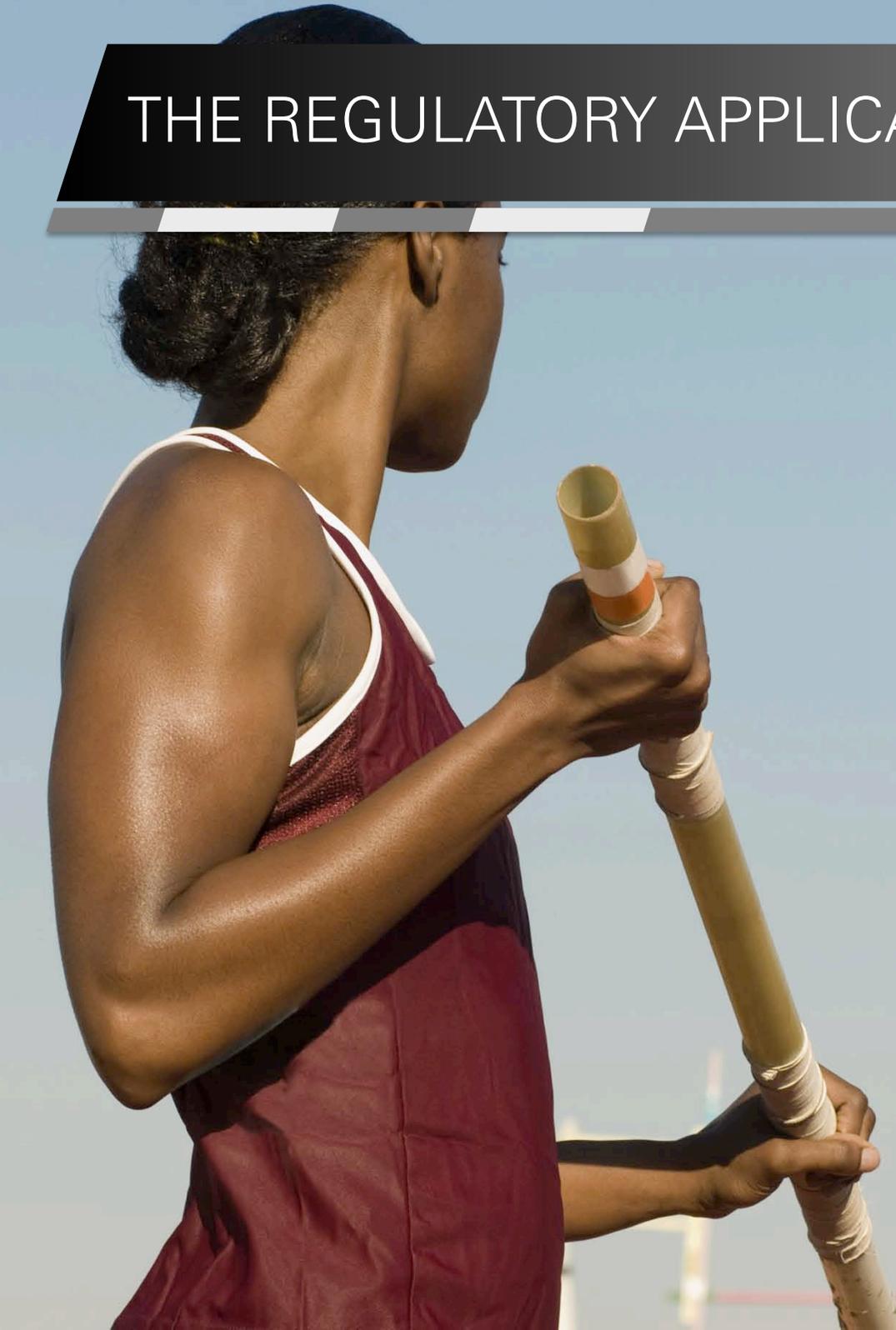
Boards and senior management [...] must be supported by robust and well functioning audit functions [...]. Unfortunately when I look across the landscape, I don't believe that we are in the right place today in terms of the role and influence of ... audit functions.

“

Why Prudential Regulation Matters

Speech by **Andrew Bailey**
11 Oct 2011, APCIMS conference

THE REGULATORY APPLICATION.....



PRA presented at a recent Heads of Internal Audit forum, sponsored by KPMG:

“The PRA’s approach to internal audit

The PRA has a general statutory objective:

- To promote the safety and soundness of the firms it regulates, focusing on the adverse effects that they can have on the stability of the UK financial system
- Effective internal audit supports the PRA in achieving this objective

Regulators’ findings indicate that internal audit has generally failed to have the desired impact across the industry:

- scope and mandate resulting in internal audit not reviewing high risk areas
- resourcing, skills and audit approach resulting in IA not identifying key issues
- culture and standing in the organisation resulting in issues identified not being taken seriously and not remediated”

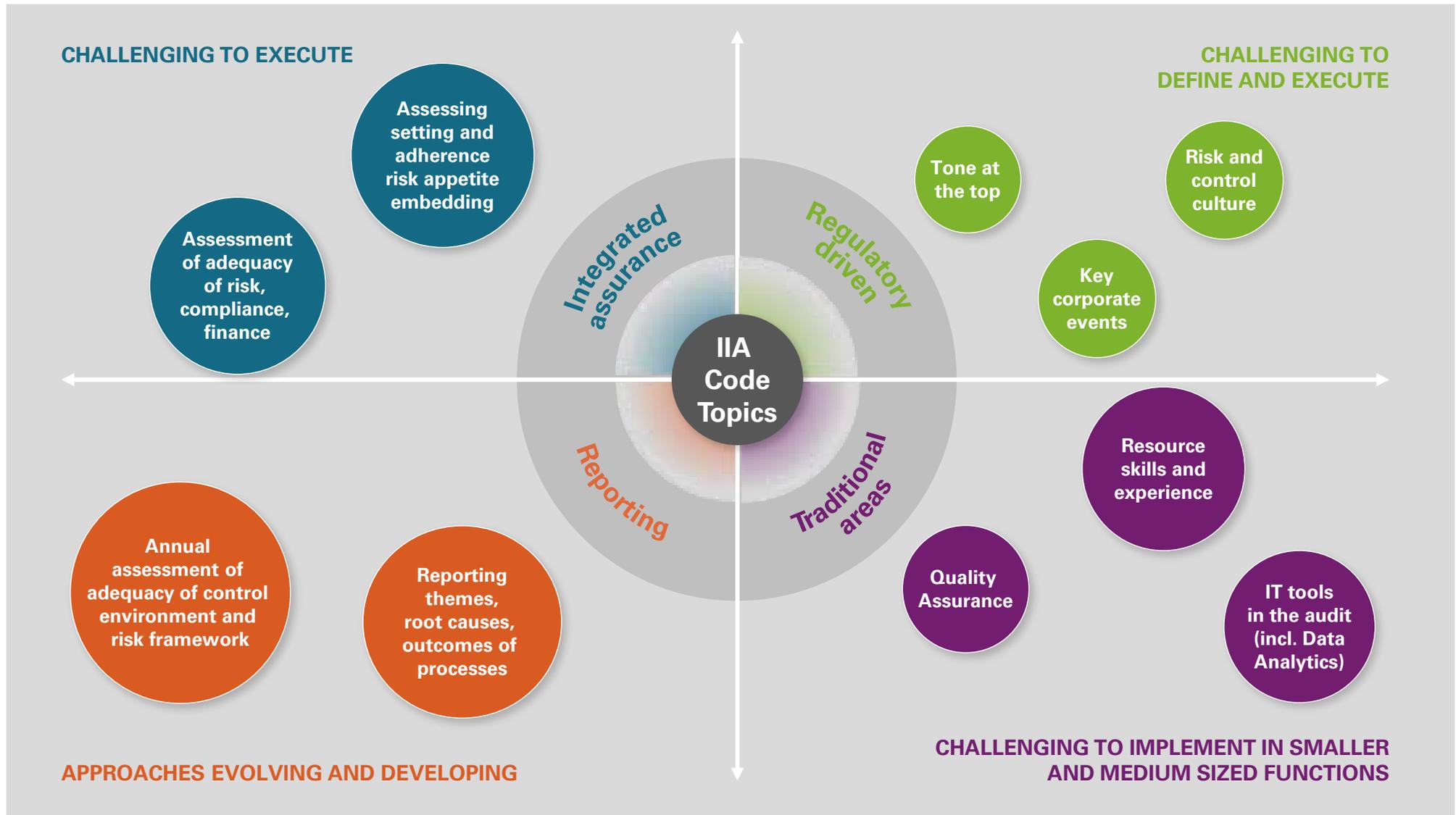
Anecdotally – of 20 IA functions reviewed to date...8 under further review focus

KPMG'S PERSPECTIVE OF INTERNAL AUDIT

- The UK CIIA recommendations 'raise the bar' for IA functions in Financial Services and set a new Standard
- Analogous to the up-skilling of 'Risk' over the last 5 years
- Different organisations will face different challenges in meeting the requirements – potentially impacts medium and smaller FS organisations more than larger organisations
- All organisations have gaps – some commonality but less than expected
- Behavioural expectations on the Board and Executive lacking impact in practice

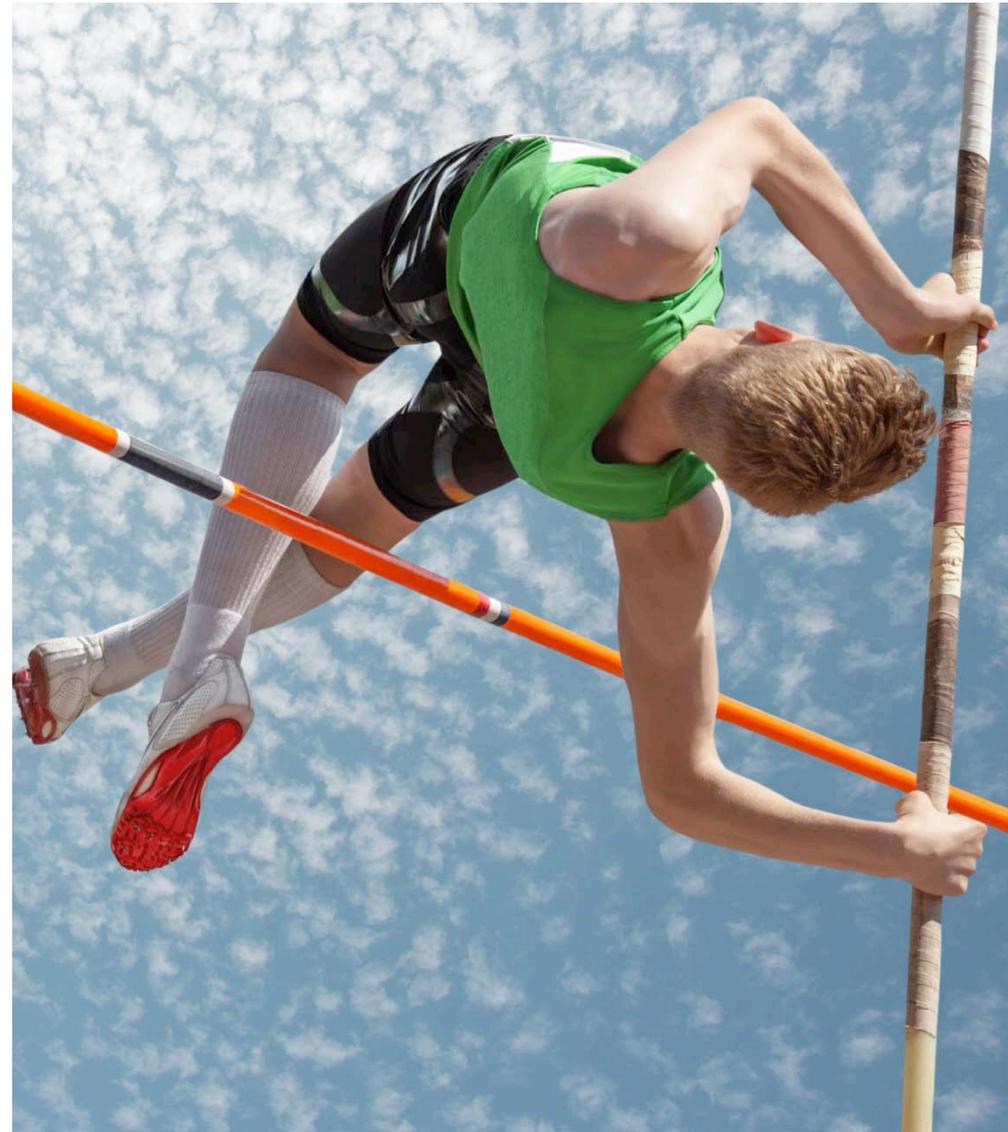


AREAS OF CHALLENGE IN IMPLEMENTING CHANGES



Areas where typical Internal Audit functions can improve – to meet the CIIA Guidance and/or increase effectiveness

- ⊙ **Section A, paragraph 2 of the Guidance:** The Board, its Committees and Executive Management should set the right 'tone at the top'
 - Significance of the position of this paragraph deliberate
 - Few self assessments consider this honestly: engagement and sponsorship overstated
 - Linked with the calibre of the IA leadership, function and team
- ⊙ **The Chief Internal Auditor should be at a senior enough level within the organisation to give him/her appropriate standing**
 - Typically in place for IA leader – trend of 'non IA' leaders coming in to IA to adopt a fresh approach
 - Highlights gap to remainder of the IA teams
- ⊙ **Expectations on the Audit Committee of 'hire/fire', remuneration and objective setting for the Chief Internal Auditor**
 - Work in progress at many organisations – some movement but a way to go
 - Many functions are re-working bonus mechanisms to remove links to short term performance of the business



INSIGHTS, BEST PRACTICES AND AREAS FOR DEVELOPMENT

Areas where typical Internal Audit functions can improve – to meet the code and/or increase effectiveness

- ⊙ **IA functions should have Quality Assurance reviews** that include Internal Audit's (i) understanding and identification of risk and control issues (Quality of Opinion); and (ii) adherence to audit methodology and procedures. (Quality of Compliance). This may require the use of resource from external parties.
 - Many IA functions do not meet the expectations of 'independent and objective' for QA of their own work
 - Functions are creating 'Professional Practice' teams to support QA (and other IA developments)
 - Increasing frequency of external effectiveness reviews
 - Trend towards more holistic approaches to quality review and away from a checklist approach to reviews of audits
- ⊙ **IA should conduct audit activities which enable it to obtain a variety of views and form opinions on the control environment** (for example, within and across business units, functions, processes, and jurisdictions).
 - Trend towards more variety of audit types to broaden and maximise assurance – close and continuous; health check; design review, deep dive, horizontal (single themes reviewed across multiple business units) versus vertical (end to end process) reviews
 - Quality of reports on individual audits and to Audit committees is highly variable – the best reports are concise and impactful, and provide views on control environment – highlighting themes, root causes, and focused on outcomes
- ⊙ **Integrate IT audit with operational audit**, i.e., reviewing systems processes, and infrastructure in a single audit.
 - Increasing trend towards integrated audits – many functions have potential to do more, often limited by IT audit

INSIGHTS, BEST PRACTICES AND AREAS FOR DEVELOPMENT

An Internal Audit function should:

- ⊙ **Be forward looking in its risk assessment** process, through extensive use of continuous and anticipatory auditing processes, with strong awareness of the external environment, and be flexible to adapt its planned activities, sometimes rapidly in the face of new and emerging risks.
 - The UK CIIA Guidance is driving explicit risk assessment for specific areas including: (i) capital and liquidity; (ii) conduct/poor customer treatment; (iii) key corporate events; (iv) risk appetite(#); (v) Culture; and (vi) governance
- ⊙ **Focus on integrated assurance – embedding, effectiveness and reliance**
 - Many IA functions are driving greater coordination with other assurance functions (Risk, Compliance, and external audit) - most could do more – e.g. Integrated issues reporting, assurance mapping;
 - Undertake an assessment of the effectiveness and adequacy of the control functions: Compliance, Risk Management and Finance (driven by the Code) – report results; BEFORE any reliance is placed on Risk or Compliance
- ⊙ **Regularly revisit the audit plan on the basis of re-evaluations of key business risks** during the year or for unexpected changes in business conditions. Often this is aligned to Audit Committee meetings.
 - Many functions have become more dynamic in their audit planning – 6+6 common practice
 - Challenging to implement in pragmatic way, whilst monitoring emerging risks + participating in governance forums
 - Continuous monitoring programmes are improving – requiring significant efforts to formalise and embed

- *Internal Audit coverage of Risk Appetite has been further defined in the Financial Stability Board paper on Risk Appetite Assessment (November 2013). Section 4.6 sets out the areas of coverage for Internal Audit.*

INSIGHTS, BEST PRACTICES AND AREAS FOR DEVELOPMENT

An Internal Audit function should:

- ⊙ **Harness technology throughout its audit and administrative processes** (including knowledge management) to help maximize efficiencies and improve audit effectiveness.
 - Often a focus on “process” and not outcomes; a hindrance not an enabler
 - Data analytics an area of increasing focus – work in progress for most large IA functions
- ⊙ **Use an Internal Audit application covering enterprise risk assessment**, business risk profile, audit planning, issue tracking with supporting documentation and periodic follow-up of management action plans, project scheduling, time reporting, personnel administration, automated paper functionality and reporting.
 - Relatively few IA functions have really mastered the use of technology to support their own processes – those which have done so are more likely to be agile and focused on effective execution and better able to measure their own performance
- ⊙ **Have defined and maintained** a variety of **measures of its own performance** which are regularly reviewed and acted upon. Both ‘Hard’ (i.e. SLA regarding timescales to undertake activity) and ‘Soft’ measures (i.e. quality of interaction with the auditee).
 - The Audit Committee annually assesses the effectiveness of IA, using a mixture of quantitative and qualitative metrics, including using the output from the IQA function

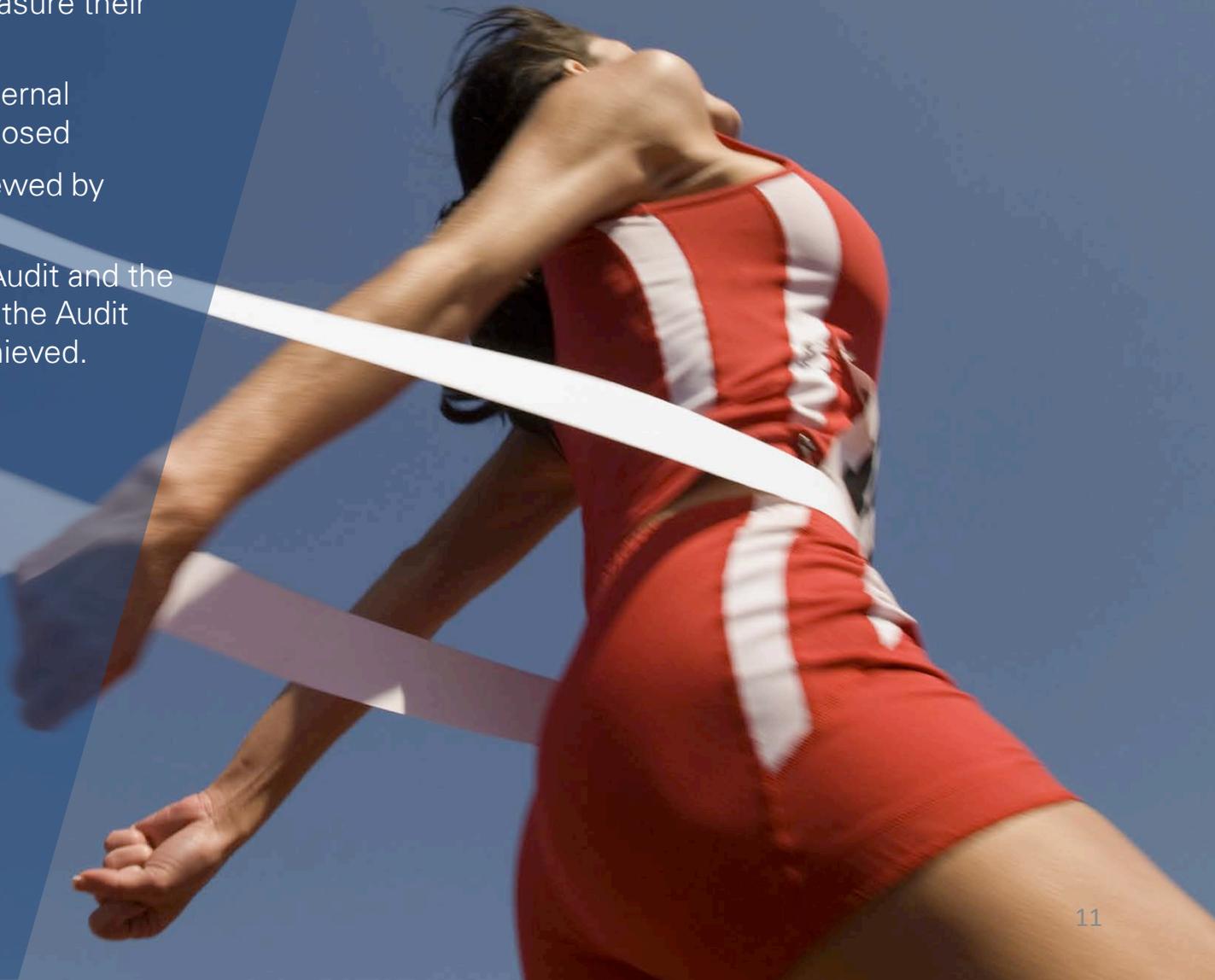
INSIGHTS, BEST PRACTICES AND AREAS FOR DEVELOPMENT

An Internal Audit function should:

- ⊙ **Align the short to medium-term staffing strategy to the strategic (2-3 year) Internal Audit plan.** It should also be forward-thinking in its medium to longer-term staffing strategy (for example, by considering growth areas in the business, new and emerging risk areas, and both internal and external factors affecting ability to attract talent from within and outside the organisation, by providing a value adding career development opportunity).
 - Only a few IA functions are able to demonstrate a clear medium term staffing strategy aligned to the risks of the business and the internal audit plan – significant work to do and an area of regulatory focus
- ⊙ **Contain individuals who are sufficiently senior and experienced,** with sufficient business understanding, to apply opinions, judgement and challenge to the business on a broad array of topics. In addition, these individuals should have the standing, credibility and impact to present views and influence the organisation.
 - Effectiveness reviews highlight this as an area of significant challenge – fundamental to IA's reputation and department effectiveness – senior experienced team members are thinly spread across functions
- ⊙ **Define competencies and learning maps by level/specialised position,** and effectively manage performance of individuals against these maps.
 - Expected that a 'map' of skills, experience and knowledge to risks and auditable entities
 - In past 1-2 years most large IA functions have improved or established a regular skills assessment
 - Skills gaps are common – esp. regulatory knowledge, business understanding and IT specialisms (e.g. Cyber)

CLOSING COMMENTS

- The UK CIIA Guidance is being implemented as a benchmark against which firms can measure their Internal Audit function.
- Gap analysis being conducted under Internal Effectiveness Review and gaps being closed
- Often viewed as 'optimistic' when reviewed by external parties
- Plans should be developed by Internal Audit and the implementation of actions overseen by the Audit Committee to ensure compliance is achieved.
- Regular reporting to Audit Committees



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