Since the release of the Bank for International Settlements’ (BIS) paper on the internal audit function in banks in June 2012, there have been two additional papers that have been released by the Federal Reserve Bank (FRB) and the Institute of Internal Auditors UK (IIA) on the internal audit function in banking organisations.

In the United States, the Federal Reserve Bank (FRB) released a Supplement Policy Statement on the Internal Audit Function and its Outsourcing in January 2013 which comprises of a number of enhanced internal audit practices in the areas of risk analysis, thematic control issues, challenging management and policy, infrastructure, risk tolerance and governance and strategic objectives.

The IIA (UK) released – ‘Recommendations from the Committee on Internal Audit Guidance for Financial Services’ in July 2013 which includes a number of recommendations to enhance the overall effectiveness of Internal Audit and its impact within firms operating in the financial services sector. These recommendations are grouped under the following categories: the role and mandate of internal audit, scope and priorities of internal audit, reporting results, interaction with Risk Management, Compliance and Finance, independence and authority of Internal Audit, resources, quality assessment and relationships with regulators.

The papers released by the FRB and IIA (UK) elaborate on a number of areas discussed in the BIS paper as well as bring to attention a number of new issues. The following provides details on the significant differences between the BIS paper and FRB and IIA (UK) papers.

1. There is greater elaboration on the reporting of internal audit findings to the Board Committees (e.g. Audit, Risk). Reporting to the Board Committees should outline a number of key issues including significant control weaknesses and root cause analysis, thematic issues identified across the organisation, risk management of the organisation and accompanying remediation plans and an annual assessment of the overall assessment of the governance, risk and control framework.

2. The FRB paper provides further guidance on the role of internal audit in assessing the effectiveness of a bank’s internal control, risk management and governance systems and processes, namely:

   - **Challenging Management and Policy:** Internal audit should challenge management to adopt appropriate policies and procedures and effective controls. Internal audit should report deficiencies in policies, procedures, and internal controls to senior management and the audit committee with recommended remediation (e.g. restricting business activity in affected lines of business until effective policies, procedures, and controls are designed and implemented). Internal audit should monitor management’s corrective action and conduct a follow-up review to confirm that the recommendations of both internal audit and the audit committee have been addressed; and

   - **Governance and Strategic Objectives:** Internal audit should evaluate governance at all management levels within the institution, including at the senior management level, and within all significant business lines. Internal audit should also evaluate the adequacy and effectiveness of controls to respond to risks within the organization's governance, operations, and information systems in achieving the organization's strategic objectives. Any concerns should be communicated by internal audit to the board of directors and senior management."

3. The FRB paper emphasises the need to establish a code of ethics for all institutions. The code of ethics should include principles of objectivity, competence, confidentiality, and integrity and be consistent with professional internal audit guidance (e.g. IIA code of ethics).
4. The FRB paper also provides the following additional guidelines on how internal audit can maintain objectivity and emphasises the following:

- Internally recruited internal auditors should not audit activities for which they were previously responsible in their first year in the internal audit function;
- Compensation schemes should not provide incentives for internal auditors to act contrary to the attributes and objectives of the internal audit function; and
- The internal auditor should not be responsible for the design, installation, procedures development, or operations of the institution's internal control systems.

5. In addition to ensuring adequate coverage of matters of regulatory interest in the scope of the internal audit function’s activities as emphasised in the BIS paper, the FRB and IIA (UK) paper expands the scope of internal audit activities to also include the following:

- Identification of thematic controls issues and its impact on the institution’s risk profile;
- Assessment of the involvement of the board of directors and senior management in setting and monitoring compliance with risk tolerance limits;
- Internal Audit should focus on higher risk areas when setting its priorities and deciding where to carry out more detailed work. The scope does not necessarily have to cover all of the potential scope areas every year; and
- Internal Audit should also consider the following within its scope:
  - The information presented to the Board and Executive Management for strategic and operational decision making;
  - The risk and control culture of the organisation;
  - Risks of poor customer treatment, giving rise to conduct or reputational risk;
  - Key corporate events; and
  - Outcomes of processes.

6. The FRB and IIA (UK) papers provide details on the role of the Chief Audit Executive/ Head of internal audit. The main roles and responsibilities of the Chief Audit Executive/ Head of internal audit outlined include the following:

- Communicating and reporting to the audit committee on audit-related matters;
- Developing and maintaining a quality assurance and improvement program that covers all aspects of internal audit activity;
- Continuously monitoring the effectiveness of the audit function;
- Providing the Audit Committee with a regular assessment of the skills required to conduct the work needed, and whether the Internal Audit budget is sufficient to allow the function to recruit and retain staff with the expertise and experience necessary to provide effective challenge throughout the organisation and to the Executive; and
- The Chief Audit Executive/ Head of internal audit should be accountable to the Chairman of the Audit Committee. The Chairman is accountable for setting the objectives of the Chief Internal Auditor, appraising his/her performance and recommending his/ her remuneration. The remuneration of the Chief Internal Auditor and Internal Audit staff should be structured in a manner such that it avoids conflicts of interest, does not impair their independence and objectivity and should not be directly or exclusively linked to the short term performance of the organisation.

7. One of the key differences between the BIS paper and the FRB and IIA (UK) papers is emphasis on the outsourcing of internal audit functions. Outsourcing is one of the key focus areas in the FRB and IIA (UK) papers which provides the following additional issues relating to the outsourcing of the IA functions:

- Institutions should establish policies and procedures to govern the selection and oversight of internal audit vendors, including whether to continue with an existing outsourced arrangement;
- Institution’s contingency plans should take into consideration the extent to which the institution relies upon outsourcing arrangements. When an institution relies significantly on the resources of an internal audit service provider, the institution should have contingency procedures for managing temporary or permanent disruptions in the service in order to ensure that the internal audit function can meet its intended objectives; and
• The quality of audit work performed by the vendor should be consistent with the institution's standards of work expected to be performed by an in-house internal audit department. The results of this quality assurance work should be presented to the Audit Committee at least annually for review.

8. Additional guidance on internal audit methodologies and resources is provided to ensure that the internal audit function performs effectively. This requires an internal audit function to ensure that the following are in place:

• A well-developed risk-assessment methodology that drives its risk-assessment process. The methodology should include an analysis of cross-institutional risk and thematic control issues and address its processes and procedures for evaluating the effectiveness of risk management, control, and governance processes; and

• Maintain an up-to-date set of policies and procedures, and performance and effectiveness measures for the Internal Audit function which should be continuously improved in light of industry developments.

9. The FRB and IIA (UK) papers highlight the need for a documented and comprehensive quality assurance process to ensure that the internal audit function performs at a high quality and in line with professional standards. The quality assurance process should include the following mechanisms:

• Performing an independent and objective external assessment of the internal audit function by an independent assessor. The individuals performing the assessments should have the standing and experience to meaningfully challenge Internal Audit performance and to ensure that Internal Audit judgements and opinions are adequately evidenced; and

• Evaluating the performance of the Internal Audit function against appropriate criteria on a regular basis by the Board or Audit Committee.

While these international pronouncements, and the recent release locally of APRA's latest prudential standards, CPS 220: Risk Management, all contain differing requirements with respect to the internal audit function, there is a clear and consistent trend toward a heightening of expectations by regulators globally with regard to the role of internal audit within financial institutions. This will in turn have a significant impact on the regulators expectations with regard to the quality and resourcing of the internal audit function. Heads of Internal Audit and Chairs of Audit Committees should, if they have not already done so, ensure that a formal assessment of the quality and capability of their Internal Audit functions is performed with specific focus on these latest international standards.

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