

Internal audit in financial services A new benchmark



“The UK financial sector is uniquely complex. For internal audit to fulfil its role in banks and other financial organisations, specific guidance is required on the tasks that it should carry out and how it should be positioned within institutions to allow it to work most effectively.”

Chartered Institute of Internal Auditors, 2013

Internal audit has long been viewed as a key element of financial services firms’ frameworks to manage risk – the third line of the three lines of defence. But now there is new guidance that raises the bar of good performance. The Committee on Internal Audit Guidance for Financial Services has issued its Recommendations for Effective Internal Audit in the Financial Services Sector,¹ following a year-long exercise of drafting and consultation.

The Chartered Institute of Internal Auditors has accepted in full the recommendations. The guidance seeks to reposition the focus of internal audit, from testing and reporting on the internal control environment, to supporting non-executive and executive management in the more effective management of key risks.

The guidance builds on existing professional standards from the global Institute of Internal Auditors but is explicit in taking to new levels the internal audit principles that have long existed – from the positioning of the audit function within the organisation (for example, reporting lines, remuneration) to areas of audit coverage such as governance, culture, or corporate events. Some of these areas will be difficult – and uncomfortable – for auditors to assess.

There has been much debate in the industry on the draft guidance, reflecting perhaps that internal audit is as much an art as a science. The guidance is delivered as a set of principles, which will require interpretation considering the context of organisation. The exact implementation is expected to differ to be proportionate to the organisation, but all organisations are expected to adopt the ‘spirit of the guidance’.

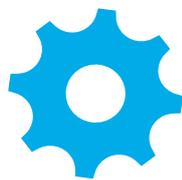
In the context of a financial services sector which has been subject to intense criticism over recent years, the guidance presents an opportunity and a welcome push for internal audit functions to proactively move onto the front foot and increase their relevance to their respective organisations and the financial services industry as a whole. It is expected that every financial services internal audit function will have to make some changes to meet guidelines, that clearly now represent the bar against which internal audit will be measured, both domestically and globally. In particular, the resources and skills within audit functions will be subject to increasing scrutiny and pressure as they seek to deliver the requirements of the new guidance.

Every internal audit function should perform an assessment of the impact the guidance has on the function and on the audit plan, and determine an appropriate response. This assessment should be discussed with executive management and agreed with the Audit Committee.

¹ <http://www.iaa.org.uk/policy/financial-services-initiative/>

Where might the most significant impact be?

The guidance is far reaching, setting a benchmark throughout the entire internal audit cycle. Some of the more significant challenges include:



Positioning within the organisation – Internal audit reporting lines should be clearly defined, and in many cases redefined, as completely functionally independent. The Chief Internal Auditor should report to the Chair of the Board Audit Committee, with all divisional Heads of Audit reporting directly to the Chief Internal Auditor, rather than to local committees. Primary reporting lines should be within internal audit, through which results are reported, objectives set and appraisals performed. Secondary reporting lines should be to the Chief Executive Officer only, to maintain independence from every part of the organisation and to promote the eminence of internal audit as a key element of the governance and risk management framework.



Employing significant professional judgment – Internal audit will need to extend its reach to highly judgemental areas. The organisations risk and control culture, and the risk appetite should be captured in the audit universe and subject to audit coverage. Management “tone from the top” should be considered, along with a ‘bottom up’ assessment of attitudes to control and risk management. Assessment of these specific areas is not widespread practice, certainly with the rigour and consistent approach envisaged by the guidelines, and may be difficult and uncomfortable for the internal audit function. In the absence of quantifiable measures of risk appetite or culture, the auditor would need to define parameters for assessment. With risk and culture being areas of focus in post-crisis commentary, these judgements are likely to be of significant interest to a wide community of stakeholders.



An outcomes-based approach – Auditing the processes and controls associated with a risk is a central part of most current internal audit methodologies. Shifting the focus to also have an opinion on outcomes leads to less familiar territory. Where processes and controls promote the reduction of the associated risk, but the outcome suggests the risk is not mitigated, the auditor should provide challenge of the judgement and actions of management. The fair treatment of customers is a good example of where this will be seen in practice, with valid complaints comprising a key measure of customer outcome. Auditors challenge of management judgements will be a core to future internal audit practices.

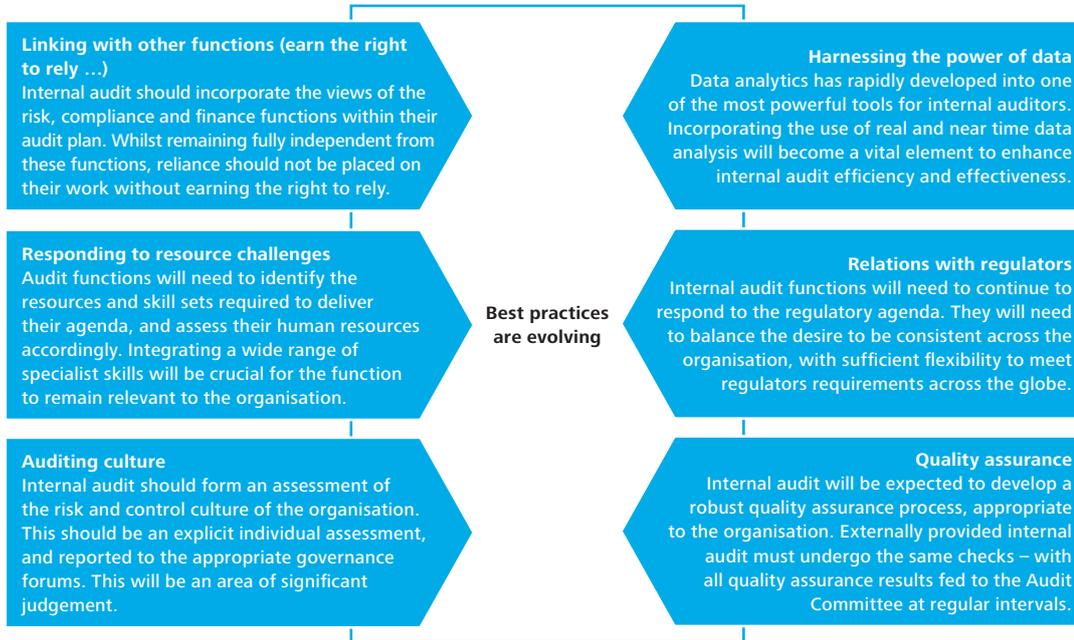


Resources – Auditing culture and risk appetite, and drawing conclusions based on outcomes, will draw heavily on auditors’ professional judgement. Professional judgement requires a high level of skill and experience and internal audit functions will need to review the adequacy of their resources, including technical specialists where necessary. Challenging senior management will require the auditor to be of a similar standing to the individuals they are challenging.

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Emerging best practices

The guidance reinforces some of the emerging best practices for internal audit. Below are some key areas of emerging internal audit best practice.



What every Head of Audit and Audit Committee member should consider

In the context of your organisation, what should internal audit be delivering? What changes to people, skills and methodologies are needed?

- How does internal audit establish “what good looks like”?
 - How often is there an assessment of the overall effectiveness of the governance, and risk and control framework of the organisation?
 - Does the internal audit function form and report an explicit assessment of the risk and control culture? Are processes, actions and “tone from the top” consistent with the values, ethics and risk appetite of the organisation?
 - Where controls and processes are found to be operating effectively, does the final outcome support this? To what degree has the associated risk been reduced – is it within appetite?
 - Does internal audit have access to live data in identifying and reacting to risks?
 - Does internal audit have the skills, capacity and methodology necessary to provide meaningful challenge throughout the organisation?
 - How is remuneration for the internal audit function structured?
- What management information is used to assess and manage the performance of the internal audit function?
 - How could evidence of a rigorous assessment of auditors’ independence and objectivity be demonstrated? Has this been performed through the defined reporting lines?
 - Are there any parties, other than the Chairman of the Audit Committee, influencing the objectives of the Chief Internal Auditor?



Contacts

Mark FitzPatrick

Vice Chairman, Internal Audit Lead
020 7303 5167
mfitzpatrick@deloitte.co.uk

Russell Davis

Partner, Banking and Capital Markets
020 7007 6755
rdavis@deloitte.co.uk

Paul Day

Partner, Banking and Capital Markets
020 7007 5064
pauday@deloitte.co.uk

Ralph Daals

Director, Insurance
020 7303 8129
rdaals@deloitte.co.uk

Terri Fielding

Director, Investment Management
020 7303 8403
tfielding@deloitte.co.uk

Mike Sobers

Partner, Audit Advisory
020 7007 0483
msobers@deloitte.co.uk

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Designed and produced by The Creative Studio at Deloitte, London. 28236A