

**Deloitte.**

Auditing governance  
Having a voice where it counts



# Contents

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Foreword	1
Getting started	2
Challenging effectively	4
Areas of focus in governance	6
Conclusion	8

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# Foreword

The financial services sector is coming to terms with revised expectations from the regulatory and investor communities around corporate governance. The inquests into the financial crisis have illustrated, vividly, the disparity between governance intentions and their effectiveness in practice at some organisations.

The recent Chartered Institute of Internal Auditors guidance “Effective Internal Audit in the Financial Services Sector” recommended that Internal Audit functions should include governance within their remit.

The guidance echoes the Prudential Regulation Authority’s and the Financial Conduct Authority’s ambitions for Internal Audit functions to raise the bar in this area. There is an expectation that Internal Audit will challenge risk appetites, risk management processes and governance effectiveness on a more holistic basis.

Organisations should already be assessing whether their governance arrangements are fit for purpose. Good governance reflects an effective culture and provides visibility of management’s commitment to embedding it in the organisational structure. Now is the time for Internal Audit functions to challenge the gains that have been made and can play a pivotal role in ensuring that:

- The design of governance arrangements are fit for purpose.
- Governance standards have been widely communicated and understood.
- Incentive structures support, rather than conflict, with governance objectives.
- Desired governance outcomes are being secured.
- Commitments are made by management.

This paper is essential reading for Heads of Internal Audit, as well as other interested and impacted parties including Boards, Audit Committees and senior management within the business. It is informed by our Partners’ and practitioners’ experience of the approach adopted by leading organisations, as well as their understanding of regulatory and investor expectations.

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**“Internal Auditors must be front and centre of ensuring their firm acts with integrity and will be alert to potential risks. Sadly we have seen what happens in both the retail and wholesale markets when the right arrangements are not in place.”**

**Martin Wheatley, FCA Chief Executive**

# Getting started

## Defining objectives

For some Internal Audit functions governance will be a new area within their audit universe. For others now is the time to take stock and challenge their existing approach. As with all audits, having clearly defined objectives is the foundation for delivering the desired results. Key questions to consider include:



Will the main purpose be to assess minimum compliance with external governance standards and codes, or to assess against internal standards and expectations of good governance?



What approach to coverage will be taken? Will every audit incorporate an assessment of the related governance arrangements or will specific governance audits be conducted via thematic or stand-alone audits?



To what extent will audits go beyond assessing design effectiveness and consider operating effectiveness of governance arrangements?



Will governance audits provide a current point-in-time assessment or include a forward looking perspective i.e. whether the current governance approach is fit-for-purpose in the context of longer-term strategic plans?



Will the audit seek to assess the suitability and competence of individuals within the leadership team?

## Governance in action

Larger organisations are embedding an assessment of governance into existing audits such as risk audits. How Internal Audit functions choose to slice and embed governance audits into the existing audit plan will be driven by three main factors: 1) complexity of the organisational structure; 2) existing audit types; and 3) size and structure of the Internal Audit function.

## Governance in action

Internal Audit functions are not only establishing their own definitions but leading functions are developing a range of supporting tools, for example a library of good and bad practice to benchmark against their audit observations.

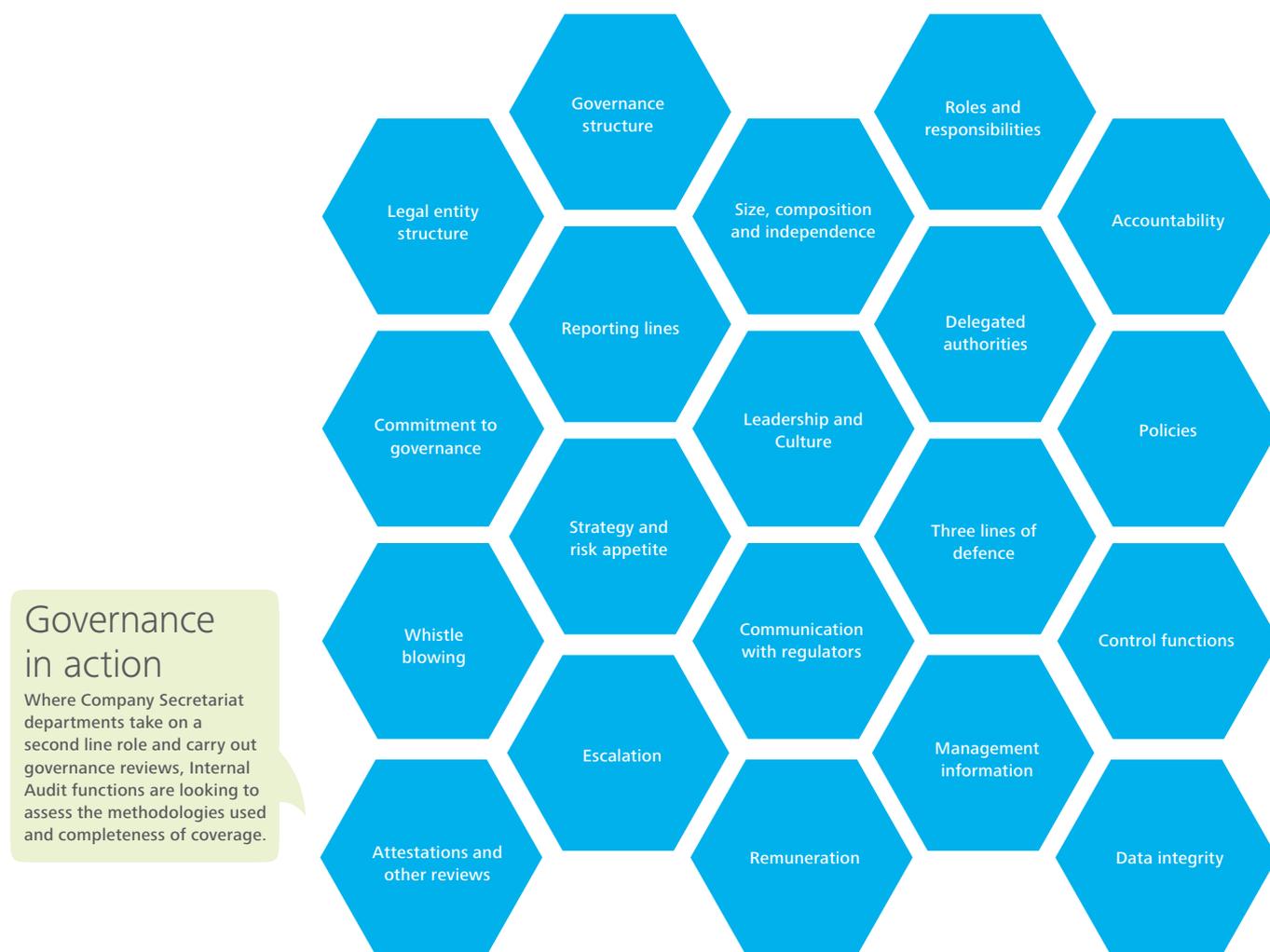
## Defining the scope

We have observed a number of organisations that do not have a clear articulation of what is meant by governance and hence the initial challenge Internal Audit functions face is defining governance. There are a number of definitions in the market, one of which is from the Organisation for Economic Co-operation and Development (OECD):

“Corporate governance involves a set of relationships between a company’s management, its Board, its shareholders and other stakeholders. [It] provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined.”

Underpinning this definition are a number of core components which should be subject to audit procedures. As a minimum, Internal Audit functions will want to ensure that the core components of the governance framework are clearly articulated. Figure 1 provides a list of areas that may inform the approach to auditing governance.

Figure 1. Examples of scoping areas for a governance audit



In addition, with respect to Board/Board committee effectiveness, many Internal Audit functions are grappling with inherent conflicts of interest and to ensure the function’s independence is not compromised if they seek to assess the governing body to which they report. To manage this conflict many financial institutions are leveraging external Board effectiveness experts, or, where effectiveness is primarily tackled in-house, ringfencing contentious areas and bringing in external expertise.

Historically Board level committee effectiveness has been the main subject of focus for governance reviews, however management level activity is increasingly seen as a critical part of governance. Deloitte’s 2012 global Leadership Premium survey<sup>1</sup> of companies across six geographies identified that analysts continue to focus on executive management in evaluating leadership effectiveness. Internal Audit functions will want to establish the extent to which executive management’s behaviour is aligned to and reinforces the governance principles agreed at Board level.

1. 2012 global Leadership Premium survey [www.corpgov.deloitte.com/binary/com.epicentric.contentmanagement.servlet.ContentDeliveryServlet/IreEng/Documents/Home/dttl\\_The\\_Leadership\\_Premium\\_29Mar12.pdf](http://www.corpgov.deloitte.com/binary/com.epicentric.contentmanagement.servlet.ContentDeliveryServlet/IreEng/Documents/Home/dttl_The_Leadership_Premium_29Mar12.pdf)

# Challenging effectively

Given the sensitive and qualitative nature of governance audits, care needs to be taken in reporting audit observations. A key factor involves looking beyond inputs or processes and assessing **impact** and **outcomes**; i.e. evaluating the quality of change brought about by committees; whether a committee’s oversight has teeth; and how other stakeholders perceive governance impact?

Testing approaches need to get under the skin of effectiveness and should use a broad range of audit tools. Below we discuss six core audit approaches.

## Governance in action

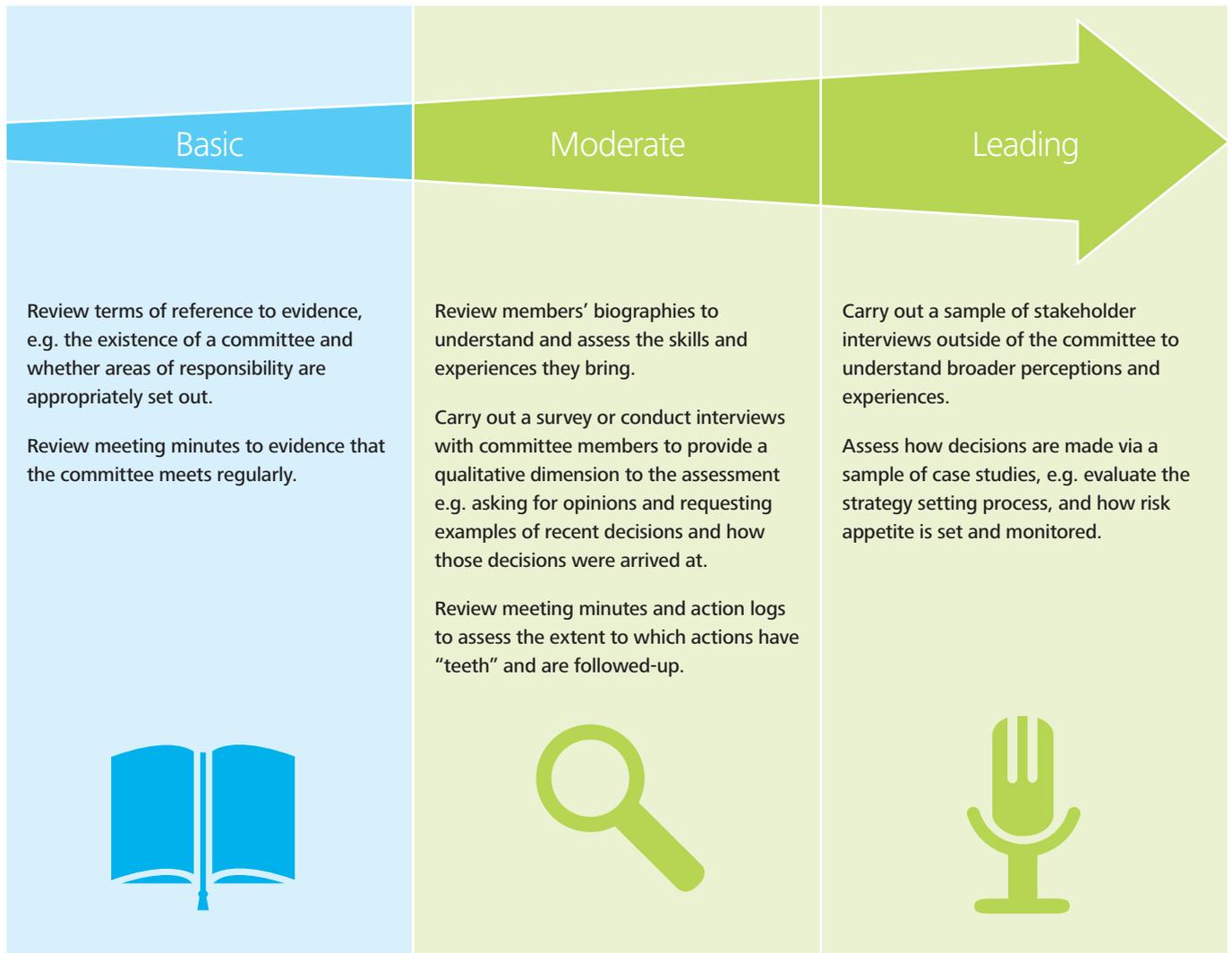
Internal audit functions may wish to consider “second-order” or historical trend benchmarking. Whilst benchmarking on areas such as board composition is readily available and provides a degree of insight, the overlay of historical trends can illustrate shifts in the composition balance providing a different perspective on organisation-specific points of interest.

Audit Approach	Description
<b>Document review</b>	Document review is a fundamental starting point. It should help the auditor to understand the design principles of their organisation’s governance framework. Assessing the completeness of: structure charts; terms of reference; management information; meeting agendas and minutes; schedules of delegated authority; and governance manuals will enable the auditor to identify gaps that must be addressed.
<b>Interviews</b>	Interviewing stakeholders can provide tangible insights into existing strengths, development areas and barriers to achieving the desired outcomes of governance standards.
<b>Observation</b>	Observing governance in action, particularly around the extent of challenge and debate at key forums, is extremely valuable in evaluating the dynamics and relationships between stakeholders and the extent to which governance processes have real “teeth” and lead to action in the business.
<b>Case studies</b>	Deep dives on: selected issues; transactions; corporate events; or significant decisions, where the auditor gains an understanding of the circumstances, escalation, approvals and decisions, and can benchmark these to desired governance outcomes provides demonstrable evidence of governance effectiveness.
<b>Survey</b>	Surveys allow Internal Audit to get individual perspectives on key issues. Auditors should ensure that survey respondents are strategically targeted; our experience suggests junior personnel are more readily prepared to reveal their true perceptions in a survey process as compared to direct questioning from a ‘superior’.
<b>Benchmarking</b>	Benchmarking externally, for example using available data in annual reports or external analysis such as the Deloitte <b>At the Helm survey</b> <sup>2</sup> , is valuable to gain insight on the design of governance arrangements outside of the organisation and understand best practice.

Clearly auditors must tailor their approach using the suite of options available to assess both design and operating effectiveness whilst recognising the maturity of governance arrangements within the organisation. So, whilst a review of a Terms of Reference may evidence that a particular committee’s role is designed appropriately, observing a meeting or carrying out a case study of a recent decision allows the auditor to assess operating effectiveness. See Figure 2 for a spectrum of audit practices to assess whether a committee is operating effectively.

2. 2013 At the Helm survey [www.deloitte.com/assets/Dcom-UnitedKingdom/Local%20Assets/Documents/Services/Tax/uk-tax-2013-at-the-helm-report-deloitte.pdf](http://www.deloitte.com/assets/Dcom-UnitedKingdom/Local%20Assets/Documents/Services/Tax/uk-tax-2013-at-the-helm-report-deloitte.pdf)

Figure 2. Spectrum of audit practices to assess whether a committee is effective



■ Design    ■ Operating effectiveness

# Areas of focus in governance

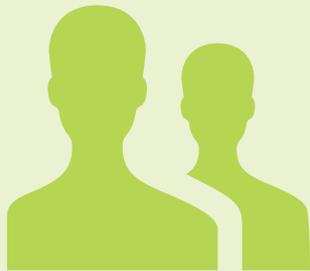
Governance red flags were present, albeit unaddressed, in many of the financial institutions that failed during the crisis including:

- A dysfunctional Board.
- A domineering CEO.
- Insufficient active Board involvement.
- Insufficient personal accountability at Board-level.
- Key posts being held by people with insufficient technical competence.
- Inadequate 'four eyes' oversight of risk.
- Inadequate understanding of the aggregation of risk.

Figure 3. Focus areas in governance

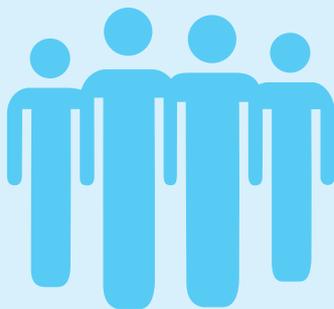
People and Culture	Tone from the top continues to be scrutinised. Are those people conveying messages around governance of the right standing in the organisation? Is it the voice of the Board and is the volume at the right level? Are governance messages given the same prominence as commercial messages?
	The <i>Changing Banking for Good</i> report by the Parliamentary Commission on Banking Standards identified the need for more individual accountability. With this in mind, regulators increasingly expect robust attestations and delegated authority frameworks that reflect individual accountability to be part of best practice governance.
	Organisational data is being utilised more holistically to understand culture and behaviours. Management information around: employee attrition; training delinquency; exit interview responses; escalation and whistle blowing data provide valuable indicators of the tone at the middle and bottom.
Board and Committees	There is regulatory and investor appetite to improve Boardroom diversity and address inertia in the appointment process. CRD IV will require a policy on Board diversity and this is raising expectations of the Nominations Committee.
	There is increased focus on the skills and experience that Board committee members contribute and on the role of the Chair in encouraging healthy and robust debate.
	Recent and relevant risk experience within Board committee membership is becoming a criterion for leading organisations. This follows on from the Combined Code's introduction of the concept of 'recent and relevant financial experience' in 2003.
	Board member stretch and non-executive time commitment has been a focus for a number of years. More recently an expectation has formed that Banking Board Chairs will be appointed on a full-time basis, as highlighted by the Parliamentary Commission on Banking Standards, and that the other directorships of non-executives will be capped in order to secure adequate time commitment, as formalised in CRD IV.
Management information	The quality of Board decision-making is dependent on the quality of management information. There is increasing challenge around how Boards ensure the robustness and completeness of the information presented to them.
	Whilst most companies have documented escalation policies and procedures in place, operating effectiveness of escalation is in need of review. For example, are there indicators of 'shooting the messenger' and delayed or failed escalation being tolerated?

To be effective, Internal Auditors must understand industry practices and recognise what 'good governance' looks like. This provides the basis for confident and credible challenge of the organisation. The areas in Figure 3 should be priorities with respect to ensuring audit coverage is up-to-date and reflects market and regulatory expectations.



Internal Audit functions should assess the commitment and engagement of senior leaders to governance matters and ensure that champions of good governance are embedded across the organisation, not just in support functions.

Internal Audit functions will need to assess the robustness of attestations as the use of these are likely to increase in the future.



Internal Audit functions will need to assess management information and data integrity, requiring a robust understanding of what good looks like. Examples are provided below:

- management information is of an appropriate volume, with balance between the level of detail and ease of use;
- key risk and performance indicators are highlighted to draw attention to risks and monitor management's progress against the strategy;
- there are regular reports from control and assurance functions such as internal audit, compliance and risk;
- management information includes a forward- looking and external perspective, not just a historical and internal perspective;
- management information encourages strategic debate through insightful analysis and commentary, not just data. For example, comparative figures are included, as appropriate, to allow the identification and analysis of trends; and
- A regular programme of review of the relevance and sufficiency of management information is in place, with specific personnel tasked with the responsibility.



# Conclusion

The absence of good governance has led to, in some cases, catastrophic outcomes for organisations and their Boards. Internal Audit is now explicitly expected to provide the Board with a view on governance practices, requiring a more holistic approach to that applied in giving assurance around an organisation's processes and controls.

The main challenge we foresee for Internal Audit functions is to overcome the sensitivity of auditing areas such as Board/Board committee effectiveness. It will be critical to obtain the necessary support from the Audit Committee and Board to ensure senior management are open to challenge and that access is provided to Internal Auditors. Such support will be much easier to gain where Internal Auditors help to address common management frustrations around poor management information and slow decision making. With this in mind, over time we expect greater recognition and appreciation of the value generated by governance audits.

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Designed and produced by The Creative Studio at Deloitte, London. 31750A