Internal Audit Challenges & Opportunities

Speaker: Laurie Shen, Director, Grant Thornton LLP

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Speaker Introduction

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Laurie Shen is a Director at Grant Thornton's Northeast Internal Audit Practice.

Laurie has more than 20 years of experience serving the financial services industry. Laurie's consulting experience spans business, internal audit, finance, operations, technology, and compliance projects for asset managers, wealth management, private bank, investment banks, broker-dealers, and service providers. She has led and performed projects in assessing and improving risk and controls, compliance, operational and technology processes and organizational structure.

Agenda

Introduction

Review of current regulatory environment

Key internal audit priorities

Description of standard IA process

The QAR process – why it is important

Audit committee responsibilities

Open discussion – Q&A

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Review of current regulatory environment

Current Regulatory Challenges:

- **Passage of Dodd Frank Financial reform law** – major impact on financial institutions

- **Regulatory focus on Internal Audit programs** – regulators reviewing audit methodologies, plans, reports and remediation

- Internal audit programs need to address key risks to the institution and should be integrated into the organization overall risk management process

- **Risk based focus on internal audit programs** - systemic risk provisions of Dodd Frank

- Management time and attention increasingly focused on regulatory, compliance and internal control issues

Review of current regulatory environment

- Dodd-Frank provisions relating to financial services and derivative markets
- Registration of Investment Advisors
- Systemic risk provisions of Dodd-Frank financial Stability Oversight Council
- Capitalization of financial institutions
- Regulatory focus on compliance & internal audit programs
- Additional focus on governance and Audit Committees

Key internal audit priorities

- Regulatory compliance

- Anti-Money Laundering

- Finance and financial reporting

- Information technology & network security

- Emerging issues – social media, etc

- Integration with risk management programs

- Industry specific areas

- Continuous monitoring & improvement

Standard internal audit process

- Internal audit programs must stand up to regulatory scrutiny – key focus of regulatory exams

- Internal audit program can be outsourced to reputable firm, co-sourced to obtain specific technical expertise, or fully in-sourced (depending on size and scale of organization)

- Programs must be supported by a structured framework and process

- Internal audit process must include active engagement by Audit Committee

- Framework should include documented methodology, audit manual and templates for risk assessment, audit programs, test matrices and reports

- Audit process and documentation can be supported by standard tools and software including automated work flows

- Audit process should begin with risk assessment, and proceed through planning, fieldwork, reporting and remediation stages

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Standard internal audit methodology

The standard framework should be consistent with industry (IIA) standards

- The methodology will generally consist of distinct phrases:
    - Risk Assessment
    - Audit planning – prioritization of audit universe, audit timing and frequency
    - Fieldwork and execution
    - Reporting and management response
    - Remediation and re-testing

Internal audit methodology
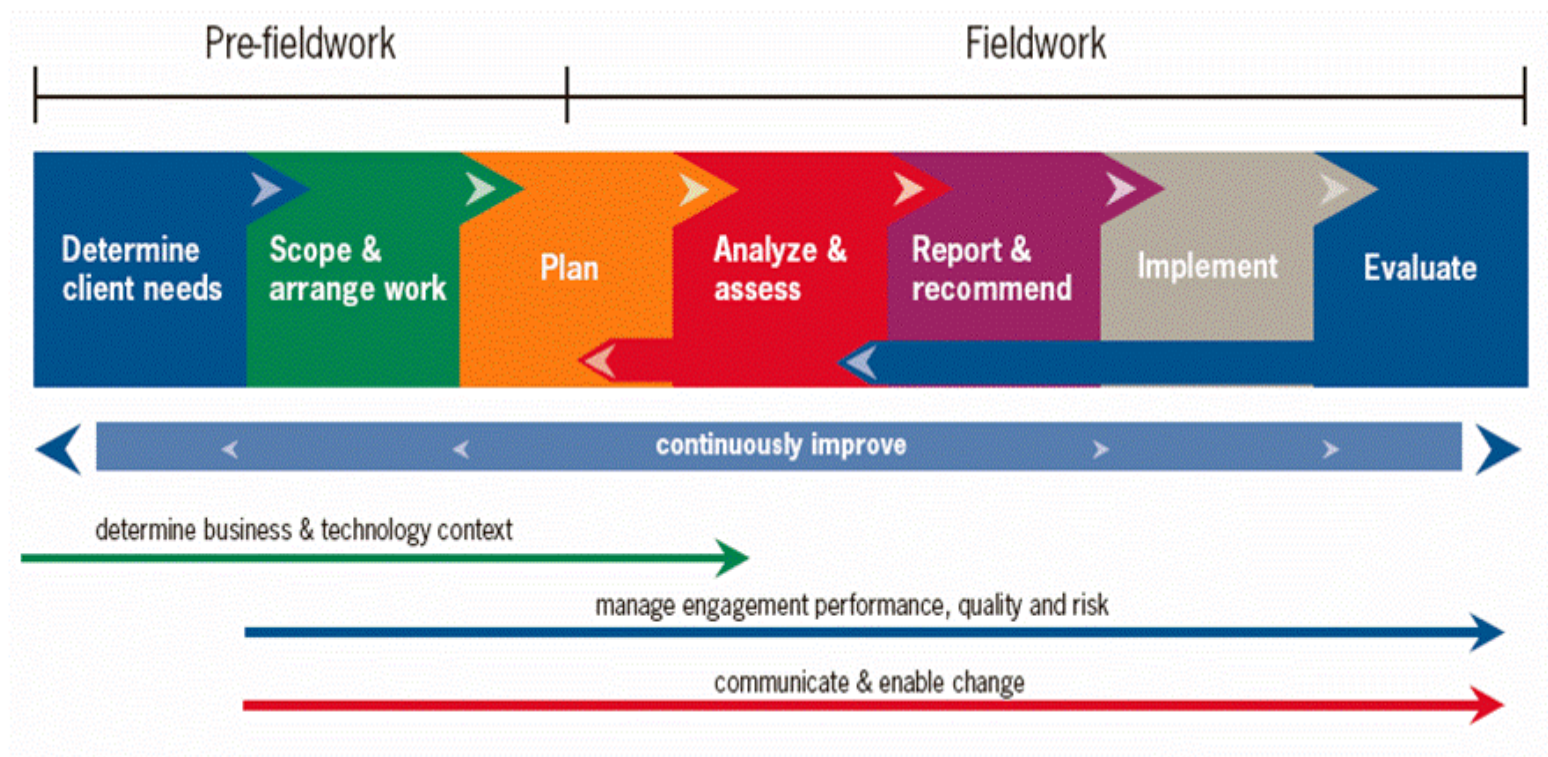
Internal audit methodology

Each phase of the internal audit engagement has key activities:

- **Business needs phase**: Determine engagement requirements with vendor (if outsourced)

- **Scoping and arrangements phase:** Determine terms of reference for audit

- **Planning phase:** Determine scheduling, coordinate appropriate skill sets, identify resources and third party resources, assess required tools and technology

- **Analyze & assess phase**: Document understanding of processes to be audited, identify key controls, develop and execute audit program

- **Report & recommend phase**: Frame findings and recommendations to add value to business process

- **Implement phase**: Business assumes responsibility for implementing recommendations

- **Evaluate phase**: Incorporate assessment of implementations into follow-up activity and planning.

Internal audit methodology

Sample risk assessment report

BBBB Bank

Transaction Cycle	Annual FDICIA Controls	Frequency of Review	Potential Impact	Likelihood of Impact	Executive Assessment	Total Risk Grade
Consumer & Commercial Lending	Yes	12	5	3	27	48.5
Treasury	Yes	12	4	3	4	40
Financial Reporting	Yes	12	3	2	14	39.5
Wires	No	12	5	2	19	36.5
Loan Servicing	Yes	24	3	2	5	36
Mortgage	Yes	12	2	2	2	35.5
Deposit Administation	Yes	24	2	2	10	35.5
Corporate Governance	Yes	24	2	2	4	33.5
Trust	No	24	1	2	N/A	30
Repossessed Assets	No	36	3	3	N/A	27.5
Accounts Payable and Fixed Assets	No	36	2	2	2	24.5
Payroll	Yes	36	1	2	N/A	24
Information Technology						
Network SecurityAdministration/Pen Test	No	24	3	3	13	30
Business Continuity	No	24	4	2	12	26
General Computer Controls	Yes	12	2	3	1	23
IT regulatory review	No	12	3	2	5	19
Processes Performed by Other Entities						
Employee Account Review						
ACH						
Credit Review						
BSA/AML						
Loan Compliance						
Other Compliance						
SAR and CTR Completion and Review						

Financial & Operational Risk

	Materiality	Complexity	Significance of Recent Change	Market Risk	Technology Risk	Fraud Risk	Control Risk	Fin'l & Ops Risk Grade
Consumer & Commercial Lending	5	5	3	4	3	2	2	27.5
Treasury	4	4	2	4	2	3	2	24
Financial Reporting	5	2	2	2	3	5	2	24.5
Wires	5	3	2	1	3	2	2	21.5
Loan Servicing	4	3	2	2	4	3	2	23
Mortgage	3	3	3	3	2	2	2	20.5
Deposit Administation	2	3	3	4	3	2	3	22.5
Corporate Governance	2	2	3	2	1	3	3	18.5
Trust	2	2	2	2	2	3	2	17
Repossessed Assets	2	2	2	2	2	3	3	18.5
Accounts Payable and Fixed Assets	1	4	3	3	1	1	2	16.5
Payroll	3	2	2	1	3	2	1	16
Network SecurityAdministration/Pen Test		4	3	1	5	2	3	18
Business Continuity		3	3	1	3	1	2	13
General Computer Controls		2	4	1	3	2	2	14
IT regulatory review		2	3	1	2	1	2	11

Enterprise Risk

	Reputation Risk	Legal/ Regulatory Risk	Strategic Risk	Human Resource Risk	Competitive Pressure/ Impact	Enterprise Risk Grade
Consumer & Commercial Lending	4	4	5	4	4	21
Treasury	3	4	4	2	3	16
Financial Reporting	4	3	3	3	2	15
Wires	4	3	3	2	3	15
Loan Servicing	3	3	3	2	2	13
Mortgage	3	4	3	2	3	15
Deposit Administation	3	3	3	2	2	13
Corporate Governance	3	3	3	3	3	15
Trust	3	4	3	1	2	13
Repossessed Assets	2	2	2	2	1	9
Accounts Payable and Fixed Assets	2	2	2	1	1	8
Payroll	2	3	1	1	1	8
Network SecurityAdministration/Pen Test	4	2	2	3	1	12
Business Continuity	4	3	3	2	1	13
General Computer Controls	2	3	1	2	1	9
IT regulatory review	2	3	1	1	1	8

Internal audit methodology

Sample Risk Based Internal Audit Plan – derived from risk assessment

Audit Area	Inherent Risk	Residual Risk	Audit Freq	Year 1	Year 2	Year 3
Lending (CRE, Other Commercial Lending, Consumer, Mortgage)						
Allowance for Loan and Lease Losses	High	High	1	X	X	X
Credit Underwriting / Credit Review	High	High	1	X	X	X
Deferred Loan Fees	High	High	1	X	X	X
Impaired Loans / Troubled Debt Restructurings / Other Loan Modifications	High	High	1	X	X	X
Interest Income (AIR, Interest Rate Changes)	High	Med	2		X	
Participation Loans / Loan Servicing	High	Med	2		X	
Lending Limits / Loans to One Borrower / Loan Concentrations	High	High	1	X	X	X
Loan Commitments	High	Med	2		X	
New Loan Set up / Loan Maintenance / Loan Payments	High	High	1	X	X	X
Overdraft and Uncollected Funds	High	Med	2	X		X
Past Due Loans	High	High	1	X	X	X
Insider Lending	High	High	1	X	X	X

Quality Assurance Process

The QAR process – why it is important

- Compliance with IIA standards requires third party QAR

- Opportunity to improve process, auditor training, work paper management

- Generally executed by qualified firm with specific technical and industry experience

Quality Assurance Review: What needs to be addressed?

- The *International Standards for the Professional Practice of Internal Auditing* describes a full "program" that should be designed to provide assurance of compliance with:

  – The standards as a whole

  – The Institute of Internal Auditors (IIA) Code of Ethics

  – The activities described in the definition of Internal Auditing
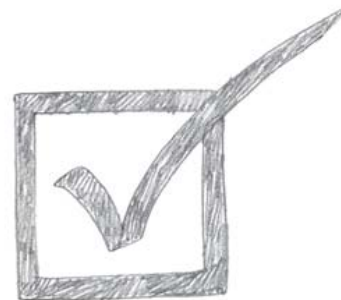
QAR goals

- A Quality Assurance and Improvement Program should provide the Board and Audit Committee with reasonable assurance that Internal Audit's:

  - Performance is in accordance with its charter, which should be consistent with the Standards and Code of Ethics

  - Performance is effective & efficient

  - Process is adding value & improving performance to the groups under review

  - Audit approach incorporates the use of key industry benchmarks

QAR is not a one-time event

1300 - Quality Assurance and Improvement Program

"The chief audit executive should develop and maintain a quality assurance and improvement program that covers **all aspects** of the internal audit activity and **continuously monitors** its effectiveness. The program should be designed to help the internal auditing activity **add value** and **improve the organization's operations** and to provide assurance that the internal audit activity is in conformity with the *Standards* and the *Code of Ethics.*"

Benefits of QAR

- Addresses audit committee's increased sense of responsibility and focus and management's need for accountability

- Allows for greater reliance on internal audit for regulatory compliance and risk management (including fraud prevention)

- Creates opportunity for improving internal audit quality and ability to add value

External assessment scope: assessment and recommendations

- Compliance with IIA standards – the baseline

- Expectations of Officers, Board of Directors and Audit Committee

- Integration into governance processes

- Tools & techniques employed

- Staff knowledge, experience and disciplines

- Adding value & improving operations

Five focal points of quality assurance review

- **Infrastructure**
  - "Tone at the Top"
  - Internal audit mission and focus
- **Communications**
  - Frequency of access to senior management and audit committee
  - Management involvement
- **Personnel**
  - Matching skill sets
  - Appropriate training
  - Performance review procedures
- **Processes**
  - Risk assessment
  - Use of tools and technology
  - Appropriate supervision
- **Monitoring**
  - Audit plan execution against plans and budgets
  - Compliance with IIA standards
  - Quality assurance process

Five focal points of quality assurance review

Infrastructure

- Internal audit organizational stature and structure within the overall organization
- "Tone at the Top" and management attitudes towards controls and audit
- Internal audit mission and focus of department goals and objectives
- Adequacy of financial budgets in relation to the audit plan, constituent expectations, business risks, and ability to carry out internal audit mission

Communications

- Frequency of access to senior management and Audit Committee
- Management involvement in audit scoping and planning activities
- Format and frequency of audit reports
- Frequency and nature of communication/coordination with management, internal audit, and other key stakeholders and third-parties regarding issues and status
- Management responses to audit findings and recommendations

Personnel

- Efforts to properly staff and execute the current year plan
- Channels used to recruit new staff
- Procedures for matching skill sets with specific audit projects
- Procedures to determine when to engage specialists or contractors to supplement or complement existing skill sets and resources
- Procedures to develop appropriate training to maintain professional proficiency
- Performance review procedures to improve individual performance
- Career paths and opportunities for advancement

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Five focal points of quality assurance review

Processes

- Risk assessment methodology used to identify risks and timing of audits
- Adequacy of audit risk scale rating system
- Correlation between risk assessment, audit universe and audit plan
- Use of electronic workpapers and other audit tools
- Adequacy of audit scope, budget and reporting procedures
- Consideration of core competencies involved in audits (IT, Operations, Fraud, Finance, Compliance)
- Procedures to provide appropriate supervision of audit staff
- Sampling methodology used to perform and evaluate audit tests
- Methods used to track audit progress and open issues

Monitoring

- Audit plan execution against plans and budgets
- Compliance with IIA standards (independence, professional proficiency, scope of work, performance of audit work, management of internal audit)
- Adequacy of the operating policies and procedures
- Quality assurance process, including continuous improvement plans
- Performance measures and benchmarks used by management to assess the effectiveness and efficiency of the department
- Use of "customer" satisfaction surveys to determine customer expectations and evaluate the quality of the audit process

QAR approach objectives

QAR assessment will help focus Internal Audit's attention on its effectiveness as *an oversight group* and *an agent of change* in the organization

- **Compare internal audit against leading practices**
  - Does the group have a well-established "audit universe" (balance of operational, financial, compliance, technology)?
  - Does the group get direct input from a variety of stakeholders?
  - Does the group solicit and receive feedback from those it has audited?

- **Review field work and assess work standards to benchmarks**
  - Audits of internal audit's compliance with policies, laws, regulations and contracts
  - Internal Audit planning activities
  - Fieldwork and audit plan execution
  - Reporting

- **Compare internal audit and management expectations of internal audit**
  - Importance of internal audit to the organization
  - Customer/"Auditee" needs and wants
  - "Consultative" approach that delivers value-added recommendations

- **Review internal audit staffing, credentials, and training**
  - Interviews of Internal Audit management and staff
  - Review of the skills/competencies of internal audit personnel
 - Review adherence to certification requirements

Typical high level QAR approach

Understand Environment

Data Gathering

Analysis

Report

- Plan scope, timing and approach with your team and ours
- Develop understanding of business organization and culture
- Identify the prospective interviewees across the organization
- Identify and obtain the list of documents and projects to be evaluated, including audit charter, audit reports, etc.
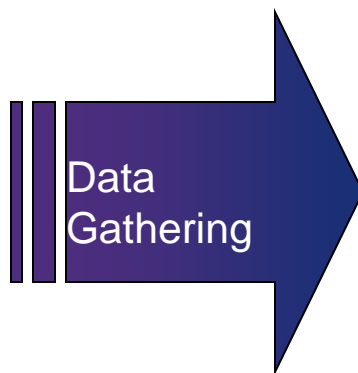
- Distribute/collect questionnaires
- Conduct interviews
- Performed detailed documentation analysis and document results
- Discuss results with interviewees and obtain preliminary feedback
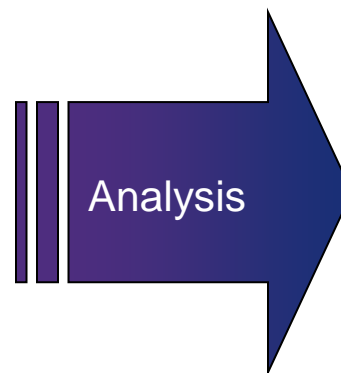
- Analyze results of interviews
- Document initial assessment of the recommendations for improvements
- Complete the benchmark assessment
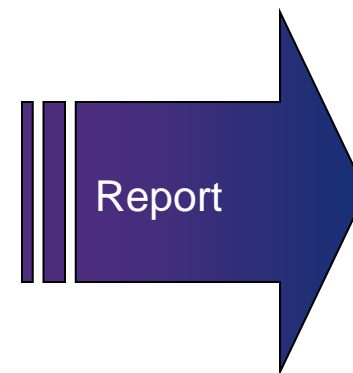
- Prepare draft report
- Finalize report and refine documentation of observations, issues and recommendations
- Discuss report with stakeholders as required
- Present report to management and key stakeholders

Audit committee oversight responsibilities and IIA standards

Audit committee internal audit oversight responsibilities
Reviewing and approving the internal audit activity's charter
Ensuring communication and reporting lines between the head of internal auditing and the audit committee
Reviewing internal audit staffing and ensuring that the function has the necessary resources
Reviewing and assessing the annual internal audit plan
Overseeing the coordination of the internal auditor with the external auditor
Reviewing periodic reports on the results of the internal auditors' work
Reviewing management's responsiveness to internal auditing findings and recommendations
Monitoring and assessing internal audit effectiveness

Open discussion/Questions

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