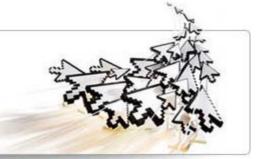




# Financial Institution Compliance Update



# March 12, 2013

This communication is designed to provide you with quick snapshots and timely perspective on recent regulatory developments.

# Federal Reserve Supplements Prior Guidance Regarding the Internal Audit Function

# **Background**

Late in January 2013, the Board of Governors of the Federal Reserve System issued additional guidance for internal audit functions in financial institutions. Officially, the guidance applies to supervised institutions with greater than \$10 billion in total consolidated assets. The recommendations included in the document, however (intended to supplement and formatted in a similar manner to the 2003 Interagency Policy Statement on the Internal Audit Function and its Outsourcing), could 'unofficially' apply to internal audit functions in financial institutions of all sizes. In other words, this guidance reinforces critical principles similar to those found in the Institute of Internal Auditors (IIA) International Standards for the Professional Practice of Internal Auditing.

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The IIA has long promoted the position that Chief Audit Executives (CAEs) should implement programs and processes aimed at continually improving the internal audit function. As issued by the Federal Reserve in January 2013, a recently-released supplemental policy statement builds upon previous Federal Reserve Board guidance and suggests that CAEs focus their efforts in this regard on the areas listed below. The degree to which an institution implements the internal audit practices outlined in the policy statement will be considered both in the regulatory assessment of the internal audit function and the firm's overall safety, soundness and compliance with consumer laws and regulations.

Key items you need to consider regarding the new guidance:

1. Further develop and implement enhanced internal audit practices that were identified as a

- result of the recent financial crisis.
- 2. Incorporate professional internal audit standards (such as those recommended by the IIA) into the firm's overall internal audit architecture.
- 3. Appropriately establish, execute and monitor internal audit outsourcing arrangements.
- 4. Ensure the independence of Public Accountants by separately engaging firms that furnish an opinion on consolidated or separate financial statements and those that provide internal audit services.
- 5. Ensure audit practices are of sufficient quality to potentially allow regulatory examiners to rely on the work of internal audit and thereby further streamline certain examination practices and events.

#### Requirements

The guidance addresses common internal audit practices, attributes and documentation standards for both successful internal functions and outsourced/co-sourced arrangements. To a lesser extent, the guidance also addresses the independent public accountant (i.e., external auditor) as well as considerations related to the regulatory examination process. Ensuring the Federal Reserve's most recent guidance is considered and implemented by an organization's internal audit function will improve the firm's internal audit function, its overall safety and soundness, and will demonstrate an organizational commitment to proactive risk management practices. Select components of the guidance are briefly discussed below.

#### **Internal Audit Practices**

In carrying out its assigned responsibilities, an institution's internal audit function should ensure it performs adequate organizational risk analyses to address both individual risks and overall risk management practices. The impact of thematic control issues should be assessed and reported. Management should be challenged to implement comprehensive policies and procedures and effective internal controls. Internal audit should verify appropriate oversight activities occur (e.g., ensuring the Board and management set and actively monitor risk limits) and evaluate governance at all levels of operations, with changes to organizational infrastructure (including critical systems and/or key internal controls) continually monitored and assessed.

#### **Internal Audit Attributes**

An effective internal audit should be independent (i.e., free from undue management influence and disassociated with day-to-day performance of internal control activities). Direct functional reporting to the audit committee is essential and administrative reporting to the CEO strongly recommended. Significant effort should be undertaken to ensure that the internal audit staff is appropriately qualified, that sufficient resources are devoted to annual training (from a variety of sources), and that knowledge gaps are identified and remediated. Auditors should be objective (i.e., free from interference, conflicts of interest, and other bias such as those caused by, for example, inappropriate compensation packages). Among other positives attributes, objectivity is often bolstered by a strong functional Code of Ethics.

#### **Internal Audit Charter**

Each firm should have an internal audit charter that describes the purpose, authority and responsibility of the internal audit function and that includes the critical components outlined within the guidance. The charter should be approved by the audit committee and periodically reassessed for ongoing adequacy.

# **Corporate Governance**

It's important to remember that the Board and management - not internal audit - are responsible for ensuring that the institution has an effective system of internal controls. This responsibility

cannot be delegated. The audit committee should establish (and provide oversight to) an appropriate internal audit function as well as any outsourced audit activities. Oversight data process can and should include: audit results; management progress in remediating noted control weaknesses; significant changes to audit plans practices, and/or staffing; the results of internal and external quality assurance reviews; and any other information deemed crucial by the committee. To help identify this other critical information, the audit committee and/or chairperson should have regular and ongoing interaction with the organization's internal audit leader.

#### **Internal Audit Processes**

To better understand an organization, internal audit should ensure that it has a well-developed risk assessment methodology that drives its risk assessment process. Internal audit is encouraged to utilize formal continuous monitoring practices as part of the risk-assessment processes. In that regard, computer-assisted auditing techniques are useful tools that warrant further consideration. And although often not the case, internal audit can also ideally rely on management's own risk and control self-assessment (RCSA) to augment its own assessment. An effective methodology serves as a solid foundation for additional audit activities, such as identification of the audit universe (i.e., the number of auditable entities within the organization).

Based upon the risk assessment, internal audit should develop and periodically revise its comprehensive audit plan and ensure that audit coverage for all identified, auditable entities within the audit universe is appropriate for the size and complexity of the institution's activities. This can be accomplished either via a multi-year plan (i.e., a three- or four-year plan; revised at least annually) or an annual, risk-based approach that focuses solely on the most significant risks.

# **Performance Monitoring**

Detailed guidance related to the performance of an internal audit should be consistently documented via a variety of means, included audit manuals, work programs, and other internal audit policies and procedures. This documentation should address:

- Audit Scope: Information gathered during audit planning should be used to determine the scope and specific audit steps to be performed.
- Work Papers: Work papers should contain essential information developed during all phases of the internal audit process (i.e., planning, fieldwork, reporting, and follow up).
- Audit Report: Reports should be issued in a timely manner and addressed to the
  appropriate individuals. Further, the reports should include essential components, e.g., an
  executive summary, audit's conclusions and key issues. Most audit reports also include
  management's action plans to remediate audit findings.
- Issues Tracking: Timely remediation of open issues is essential to an organization's risk reduction efforts. As such, internal audit should have effective processes in place to track and monitor open audit issues and to follow-up on such issues.

# **Quality Assurance and Improvement Program**

A comprehensive quality assurance program should include ongoing quality assessments. Regardless of whether the program is executed by an internal or external party, it should be performed by someone independent of the audit work being reviewed. Similar to reportable findings that result from other routine internal audit processes, action plan should be developed and progress toward remediation should be monitored and reported. Further, the guidance supports the IIA's recommendation that an external quality assessment of internal audit be performed by a qualified independent party at least once every five years.

#### **Outsourcing Arrangements**

An institution that chooses to outsource audit work should ensure that the audit committee

maintains ownership of the internal audit function. In other words, careful oversight of associated internal audit responsibilities is still warranted and the quality of work performed by the vendor should be consistent with the institution's standards of work expected of an in-house internal audit department. The audit committee should approve all significant aspects of outsourcing arrangements and should receive information on audit deficiencies in a manner consistent with that provided by the in-house audit department. In addition to contractual agreements, the audit committee process should address initial vendor competence, any factors that may impact vendors' ability to deliver high-quality audit services, and what will be done in the event of temporary or permanent service disruptions.

### **Benefits**

If the examiner determines that internal audit's overall processes are effective, work performed by internal audit may be relied upon (depending on the nature and risk of the functions subject to examination). An internal audit function is generally considered effective if its structure and practices are consistent with the 2003 Policy Statement and the guidance discussed herein. As such, the specific factors considered in determining whether the function's overall effectiveness include: audit committee adequacy and independence; the independence, competence, and overall quality of internal audit; the quality and scope of internal audit's methodology, audit plan, and risk assessment; and the adequacy of audit programs and work paper standards. Certain circumstances, enhancements or improvements may be noted by the examiner; however, they generally should not be a critical part of the overall operation of the internal audit function. In other words, an internal audit function that does not follow the enhanced practices and supplemental guidance outlined herein will generally be considered ineffective and examiners will not rely on internal audit's work - potentially elongating the examination process.

Ensuring practices addressed by both the prior and the newly released guidance have been implemented is important for many reasons, including improved day-to-day risk management practices (both within internal audit and across the entire organization) and corresponding improvement in the financial institution's overall stability. In conducting safety and soundness reviews and assessing compliance with laws and regulations, examiners will most certainly make a determination as to whether the internal audit function and its processes are effective or ineffective and whether examiners can potentially rely upon internal audit's work as part of the review process. Further alignment of internal audit practices, regulatory expectations, and the established Standards promulgated by the IIA may reduce the entity's risk profile and may also expedite the regulatory examination process.









