

### Best Practices for a Highly Effective Internal Audit Function

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# AGENDA



#### SNAPSHOT AGENDA

- What is internal audit?
- Planning and risk assessment
- Resource management
- Reporting considerations
- Measuring effectiveness
- Adding value
- Relationship building
- I'm just one auditor!
- Best practices



# WHAT IS INTERNAL AUDIT?





#### **DEFINITION OF INTERNAL AUDITING**

"Internal auditing is an <u>independent</u>, <u>objective</u> <u>assurance</u> and <u>consulting</u> activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to <u>evaluate</u> and <u>improve</u> the effectiveness of risk management, control, and governance processes"

- The Institute of Internal Auditors, April 2013

#### INDEPENDENT AND OBJECTIVE

- Who are you reporting to?
- Are you and your staff sufficiently removed?
- Development of an internal audit charter
  - $\circ\,$  Describes objective and scope
  - Describes reporting, authority, and responsibility
  - Approved by the Supervisory/Audit Committee
  - $\,\circ\,$  Gives authority to the internal auditor

#### SYSTEMATIC AND DISCIPLINED

- Are there internally defined standards for conducting, reviewing, and reporting work?
- International Standards for the Practice of Internal Audit (Institute of Internal Auditors Standards)
  - Code of ethics
  - $\circ~$  Establishes a framework for internal audit work
  - $\circ~\mbox{Recognized}$  as the authoritative standards
- External review
  - Auditors will be examining in more detail
  - $\circ$  Periodic third party assessments

#### INTERAGENCY GUIDANCE

- Interagency Policy Statement on the Internal Audit Function and Outsourcing
  - Issued in 2003, following the implementation of Sarbanes-Oxley
  - $\circ$  Updated by the Federal Reserve in January 2013
  - Provides standards for establishment of:
    - Internal audit programs
    - Evaluation of third parties
    - Responsibility of the Audit Committee
    - Relationship between audit and risk Management

#### **REGULATORY FOCUS**

- Federal Reserve has issued an updated policy statement on the internal audit function and the Office of the Comptroller of the Currency has proposed guidance for large institutions
  - Encouragement to adopt professional standards issued by the Institute of Internal Auditors and develop stated policies, procedures, and controls
- Examiners increasingly including the internal audit function in procedures
- Trend is to allow examiners further ability to rely on internal auditors
- External auditors can rely upon internal auditors, however requires assessment of the internal audit function, policies, and procedures

### **PLANNING AND RISK ASSESSMENT**



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#### PLANNING - GENERAL

- When was the last time you revisited your audit programs?
- Fixed versus adaptive scheduling
- Seeking management input when developing audit timing and procedures
- Taking a cue from the external auditor
  - $\circ$  Understanding the entity
  - $\circ$  Risk assessment
  - $\circ$  Walkthroughs
  - $\circ$  Testing

#### PLANNING - RISK ASSESSMENT

- How is management monitoring risk? What controls and policies are in place?
- Are these monitoring activities and policies effective?
- What accepted risks is management taking?
- What are the most important control systems?
- Are certain areas being overlooked in audits?
  - $\circ$  Material estimates
  - $\circ$  Technology
  - $\circ$  Vendor management

#### HOW TO GET STARTED

- Gain an Understanding of the Area to be Audited

   Develop an "Audit Universe" to identify major
   controls that must be audited
  - Interview key personnel to gain an understanding of those products, services and functions the business unit is responsible for
  - Decide which controls are important in executing the audit
  - $\,\circ\,$  Is sampling an option?

#### DEVELOPING AN "AUDIT UNIVERSE"

- Multiple approaches, which may include:
  - Process Level This approach aligns the universe with key processes (examples: loan origination, loan servicing, new account opening, etc.).
  - Functional Level This approach is developed by business or responsibility unit (i.e. branch or department) Audit universe is a list of all auditable entities or functions.
  - Product Level This approach focuses on specific product (examples might be SBA Lending, certificate of deposit, etc.) Business units (branches, lending operations, accounting, etc.)
  - Business Level (Enterprise Risk) This approach focuses on key risks in the organization and prioritization of internal audits in those key risk areas.

#### SIMPLE EXAMPLE - AUDIT UNIVERSE

xam					
	ssessment				
s of :	November 2007				
		· · ·	Audit Universe		
No.	Process or Activity	Unit	Sub-Unit	Additional Information	Focus Issues
1	Allowance for losses	Accounting and Finance	Credit Risk	Prepared by	Calculation and methodology
2	Budgeting	Bank Administration			
3	Capital plan	Bank Administration			
4	Cash flows	Accounting and Finance			
5	Closing books monthly, quarterly, annually	Accounting and Finance			
6	Correspondent banks	Accounting and Finance			
7	Due from bank reconcilements	Accounting and Finance			
8	Fed fund lines-correspondent banks	Accounting and Finance		Yield Analysis	
9	Fed fund lines-correspondent banks	Wire Department		Investment and borrowing transactions	
10	Fed funds settlement	Accounting and Finance			
11	Federal Home Loan Bank relations	Accounting and Finance			
12	Financial statement	Accounting and Finance			
13	General ledger reconciliation	All Department			
14	Interest Rate Risk	Accounting and Finance		Outside consulting firm	
15	Journal entries	Accounting and Finance			
16	Liquidity	Accounting and Finance			

#### **CREATING A RISK ASSESSMENT**

- Utilize a basic risk assessment scenario avoid models that are exceedingly complex, unless your corporate structure warrants this.
- Guidance for risk assessment may include:
  - Federal Reserve's "Framework for Risk Focused Supervision of Large Complex Institutions"
  - Office of the Comptroller of Currency (OCC) Handbook "Large Bank Supervision"
  - COSO "Internal Control Integrated Framework"

#### KEY COMPONENTS OF RISK ASSESSMENT – A SHORT GLOSSARY

- Audit Universe Collection of all business units, functions or activities that should be subject to audit
- Inherent Risk Probability that loss or other undesirable event will occur absent of any controls to help mitigate or control risk
- **Controls** Activities or processes implemented by management which serve to reduce risk to an acceptable level
- **Mitigated Risk** Probability that loss or other undesirable event will occur taking control processes into consideration

#### EXAMPLE RISK ASSESSMENT

Relative Risk Sheet	-						
	A- Previous	B- Changes in Processes	C- Changes	D- Changes in Personnel and	E- Size and Complexity of the Dept. or	F- Experience And	
AUDIT SUBJECT	Audit	and Systems	in Products	Management	Function	Training	Total
I. LOAN DEPARTMENT							
Loan Quality and Operations							
Member Business Lending (Loan Quality Review)	3	2	2	2	2	2	2.17
Mortgage Department and Secondary Marketing	3	1	1	2	2	1	1.67
Consumer Lending (equity loans, auto, credit card, student lending)	3	1	1	2	2	1	1.67
Loan Servicing and Operations	3	1	1	1	2	1	1.50
Collections and OREO	3	1	1	1	2	1	1.50
Loan Compliance							
Equal Credit Opportunity Act (ECOA)	3	1	1	1	2	1	1.50
Fair Credit Reporting Act (FCRA)	3	1	1	1	2	1	1.50
Fair and Accurate Credit Transactions Act (FACTA) / Red Flags	3	1	1	1	2	1	1.50
Fair Lending / Fair Housing	3	1	1	1	1	1	1.33
Flood Insurance	3	1	1	1	2	1	1.50
Home Owners Protection Act	3	1	1	1	1	1	1.33
Home Mortgage Disclosure Act	3	2	1	1	2	1	1.67
Real Estate Appraisals (FIRREA)	3	1	1	1	2	1	1.50
Real Estate Settlement Procedures Act (RESPA)	3	1	1	1	2	1	1.50
S.A.F.E Act	3	2	1	1	1	1	1.50
Truth-in-Lending Act (TILA)	3	1	1	1	2	1	1.50

#### EXAMPLE RISK ASSESSMENT

Combined Risk Sheet													
AUDIT SUBJECT	Credit	Market	Liquidity	Transactional / Operational		Reputation Strategic	Risk Totals	Relative Risk Factor	Total Inherent Risk Score	Key Controls in place	Strength of Controls	Multiplier	Total Risk Score
I. LOAN DEPARTMENT													
Loan Quality and Operations													
Member Business Lending (Loan Quality Review)	3	3	3	2	2	2	15	2.17	33	<ul> <li>All Member Business Loans approved by VP-Loans and Loan Committee</li> <li>All Member Business Loans are secured by real estate or other assets</li> <li>Member business loans reviewed during financial statement review</li> </ul>	Moderate	0.75	24
Mortgage Department and Secondary Marketing	3	3	3	2	2	2	15	1.67	25	<ul> <li>10% independent QC review on all mortgage loans underwritten to investor standards.</li> <li>Mortgage loans maintained in portfolio are approved by VP-Loans and Loan Committee</li> </ul>	Strong	0.50	13
Consumer Lending (equity loans, auto, credit card, student lending)	3	2	2	2	2	2	13	1.67	22	Key loan requirements including loan-to-value and debt- to-income ratio included in loan policy. Included in loan policy.     Most loan officers have relatively low (\$15,000) loan limit for unsecured loans. Larger loans are approved by VP- Loans and Loan Committee.     CUDL 360 used for online consumer applications which is loaded with Credit Union requirements.		0.50	11

#### TIPS FOR SUCCESSFUL RISK ASSESSMENT

- Use your judgment to evaluate the final risk assessment product.
- Dovetail your internal audit risk assessment to your institution's Enterprise Risk Assessment (ERA), but don't rely on the ERA to drive your risk assessment.
- Be sure to include as complete a universe as possible.

### **RESOURCE MANAGEMENT**



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#### **RESOURCE MANAGEMENT**

- How are you allocating resources?
  - Are you using a budget?
  - $\,\circ\,$  Are you tracking time spent?
  - Are you leveraging for efficiency!
  - Are you leveraging technology (ACL, Red Flag Reports)
  - Are you focused on high risk areas?
  - $\,\circ\,$  Are you too focused on the past?
- Do you have the resources to complete your job?
  - $\circ~$  Staff includes availability and ability
  - Technology
  - o Training

#### RESOURCE MANAGEMENT AND PLANNING

- Should you outsource?
  - o Advantages:
    - Scheduled audits and deliverable dates
    - Outside perspective
    - Improved time management
    - Added ability to focus on emerging risks/strategies
  - Disadvantages:
    - Vendor management
    - Initial time investment
    - Cost
- You can't outsource responsibility!

# **REPORTING CONSIDERATIONS**



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#### DELIVERABLES ARE CRITICAL

- Your Deliverable is Key!
  - $\circ$  Many only see your report
  - Don't be too wordy
  - Make it Sing!
  - Service Oriented Read
- Know your audience hot buttons and expectations (talk with them!)
  - $\circ$  Management
  - $\circ$  Board
  - Supervisory Committee
  - o Regulators

#### REPORTING

- Talk with high-performing peers for ideas (Blogs, ACUIA Regional meetings)
- Don't play "I gotcha". Help provide consultative solutions, past and forward looking.
- Keep an ongoing audit trail (exceptions, resolution)





- Its all about measuring performance....KPIs!
- Key performance indicators (KPI) provide reportable performance to goal and provide analyzable data to measure efficiency and effectiveness
- There are numerous KPIs, some basic are # of audits and time spent (budget), but its much more!

- Budget to Actual
  - $\circ\,$  Audits completed to plan
  - $\,\circ\,$  Number of high risk and low risk audits per year
  - Number of hours per audit
- Coverage of high risk entities/activities
- Timeline from audit fieldwork to reporting (but be careful, don't sacrifice quality)
- External trainings attended and certifications obtained (outside of just internal audit!)

- Benchmarking to peers.
- Level of networking
- Organizational Reaction to IA:
  - Trend # of findings
  - Implementation of recommendations
  - $\,\circ\,$  Repeat findings and reasons
  - $\,\circ\,$  Desire to rotate through IA
  - Internal audit turnover... do they stay in the CU?
  - C-Suite/Board meeting involvement?



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#### ADDING VALUE

- Internal audit is not incongruent with value!
- What are the financial impacts of your findings?
  - Financial savings
  - $\circ$  Staff time savings
  - **o** Opportunities for process improvements
- What are the non-financial impacts?
  - $\circ$  Regulatory exposure
  - $\circ$  Reputational risk
  - $\circ$  Staff morale

#### ADDING VALUE

- Vision shift from production to strategy
- Recommendations that are business focused
- Request involvement and briefings on new infrastructure projects (e.g. core conversion)
- Internal rotations for auditors within the department and outside the department
- Rotations into the audit department for management trainees

#### ADDING VALUE

- Consulting is allowed by IIA Standards
  - $\circ~$  Allowable activities to be defined in the internal audit charter
  - Must consider ability to perform procedures as well as the benefit to the overall organization
  - Must refrain from assuming any management responsibility
  - Knowledge gains from consulting engagement should be considered in evaluations of entity controls
  - Must be alert to and report significant control deficiencies identified
- Internal audit department as a business unit
  - Annual reporting of savings
  - Annual reporting of budget to actual
  - Annual reporting of special projects

# **RELATIONSHIP BUILDING**



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#### **RELATIONSHIP BUILDING**

- Get to Know (Individual and Regular Meetings):
  - Key Process Owners
  - $\circ~$  Board and SC Members
  - Executive Management
  - $\circ$  Vendors
- Walk in Their Shoes (know what they do)
- Ask for input about key Strategies, Risks, Etc.
- Have a Service Oriented Mindset
  - Keep in constant contact
  - Understand projects, risks being faced, etc
  - $\circ~$  Look for and offer feedback on best practices
  - Increases Value Perception

#### **RELATIONSHIP BUILDING**

- Internal audit awareness activities
  - $\circ$  Education sessions
  - Fraud awareness
  - $\circ$  Explanations for key controls
- Reduces Resistance During Audit
- Increases Responses to Findings and Requests
- Encourages Others To Embrace What you Do
- Be Viewed as Part of the TEAM



### I'M JUST ONE AUDITOR!

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#### HOW DO YOU GET IT ALL DONE?

- ~6400 credit unions share 20% of all assets
- Outsourcing/Co-sourcing/Shared services
- Rotational support from credit union staff working in other departments.
- KPIs and demonstration of value to increase resources
- Leverage external auditors as change makers
- INTERNS!



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#### **BEST PRACTICES**

We are not just auditing the past anymore, we must be forward thinking/adding value!

- Build Relationships Internally and Externally
- Be Consultative
- Leverage
- Understand key CU initiatives and related risk
- Focus on Strategic Thinking
- Develop and Track KPIs

### **QUESTIONS?**

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