‘No Creditor Worse Off’: Resolution Mechanisms Update

Also in this issue
- Black Swans Mean Business (Part II)
- OTC Clearing Evaluation (Part II)
- Your Internal Audit: Is it Delivering For You?
- Understanding Model Validation
- Islamic Finance: Unique Risk Management Challenges and the Impact of Basel III
Your Internal Audit: Is It Delivering for You?

Global Risk Update Editor-in-Chief Dennis Cox in this article looks at the key challenges that face internal audit and considers why it is important to review the function on a regular basis.

Banking and other regulations are always looking for more things for the internal auditors to do. Internal audit is the third line of defence and even has its own paper from the Bank for International Settlements (BIS). Generally the bank’s Board and financial regulators rely upon the internal audit function to provide independent assurance as to the operations of the firm, notifying where there are weaknesses and ensuring that management design and implement appropriate solutions.

These days many CEOs and Heads of Audit Committees are questioning whether their internal audit function actually is any good. Does it do what the Board and regulations expect them to do? Do they do it well? Is this function being independently assessed? Who is auditing the auditors?

The Objectives of an Independent IA Assessment

An independent assessment of internal audit will provide senior management with the assurance that the internal audit function actually achieves its objectives; that it conducts its work with rigour and understanding efficiently and competently; that it reports appropriately and provides the independent assurance that is required; and that it is up to date and has the skills that it needs to achieve its objectives.

Of course your IA function achieves this, you say. However our experience has been that in many cases audit functions, even of major firms, could be significantly improved and could deliver a better, more complete and more efficient service. This is not a sales pitch – the regulators are putting the pressure on the banks and financial institutions and results are not being achieved to their satisfaction. An independent review of the internal audit function is an imperative to commercial viability these days, too.

The real question for any firm is what should such a review focus on? If it needs to add value to the business it needs to do a thorough and efficient job. Many internal audit functions are still only partly embracing the risk based approach and few fully appreciate the value that they could add. Some of the problems are common and these could easily be addressed by a thorough review of the function.

These include ensuring the following:

Completeness of the Audit Universe

There is an obligation on internal audit to audit the entire institution and all of its subsidiaries, yet we often find that significant gaps in the audit universe occur. Audit universes have generally been built over a period of time. They are historic documents added to from time to time but not always systematically updated to ensure it is aligned to the prevailing structures and business of the firm.

The audit universe needs to cover all of the operations of the business, all of its structures and committees and all of its outsourced relationships. The failure to ensure that all
committees are addressed in the audit universe is a common weakness. Another interesting area is finance. Many internal audit functions work in the mistaken belief that they do not need to review finance since that is the role of the external auditors. This in some cases springs from a misunderstanding of the role of the external auditor by the internal auditor.

External audit undertakes work to establish that the accounts of the firm show a true and fair view of the business. To better appreciate the issue we should perhaps say fairly fair and fairly true since there is no requirement to profess accuracy. The auditors look at the annual reporting process and how the financial statements are prepared and then conduct such work as they require to achieve the level of assurance that is needed. They do not look at people’s roles or the efficiency of systems, nor do they look at accounting procedures leading to reporting at period ends other than the year end unless requested to do so. Since the preparation of the annual accounts is an exercise that is very different to the monthly cycle of financial reporting they can provide the Board with almost no assurance relative to internal financial reporting processes performed throughout the year.

It is therefore important that the internal auditors work in this area.

They will need to know the controls over accounting that operate throughout the year, not just at the year end. They will need to verify management accounting systems and controls as well as budgeting and capital management. That these matters are either not addressed or are only receiving limited attention is clearly a concern.

**The Limited Audit Assignment Scope**

There are many problems found here starting with a skills shortage: Often the internal auditors conclude that they do not have the skills to undertake certain tasks, for example, the legal department or mathematical modelling. Where this is the case we find that the internal auditors will conduct work in ‘known’ areas excluding all of the areas where they are not comfortable due to limited expertise. They generally do not state in their audit reports that certain areas have not been addressed with the result that the Board and its subsidiary Audit Committee will incorrectly assume that such matters have been addressed. By failing to specifically highlight the weakness in the audit approach the audit function is not letting the senior management have the opportunity to consider whether additional audit work should be commissioned or additional skilled resources acquired by internal audit.

**Time:** When an audit commences there is often a broad scope agreed for the assignment. This may be driven by the audit committee, the limited resources or ignorance as to the real size of the assignment. In such cases the internal auditor has a problem – too many things to do and too little time to do them. They will then cut corners or start to exclude specific areas. That areas have not been addressed is rarely mentioned in the audit report and the area does not then get addressed in a subsequent audit. It just gets forgotten.

**Reporting:** Too many audit functions are focused on what might best be described as ‘process auditing’, that is, taking procedures from the procedures manuals and ensuring that they are complied with by the relevant staff. Such audits often ignore supervision and management focussing all activity at the lowest levels only. There is, of course, nothing wrong with doing this but it is what may be missed that is the problem.

**Structure:** If there is a regional structure to a multi-branch retail bank then the business is typically managed through central and/or regional management. If branch audits do not include an examination of the
centralised management functions then audit results are likely to focus on how branches are actually functioning rather than how they should be functioning. This renders the audit findings of limited benefit and results in key business areas not being properly addressed. It could even cause duplicate controls that are not cost effective to be implemented.

**Process:** The process-based audit rarely extends beyond a main computer system. Such audits conclude whether systems inputs are complete and accurate which is valuable information. That is not the problem. Again it is not what is done it is what is not done that is the concern. When information is extracted from a computer system and used in reporting purposes it is often manipulated in user developed tools via applications such as Word, Excel and Access. In many firms all reporting relies on such user developed applications yet the process audit fails to get to this level of detail and address possible control weaknesses and reporting errors to which such applications are prone. From our experience audit committee papers rarely have the level of rigour that senior management would expect.

**Contentious Issues**

The internal auditor is invariably in a difficult position. His/her role is to assess parts of the business to the best of their ability often where they are not expert. Of course they do their best but if there is a contentious issue will they really deal with it raising it to the right level and ensuring that it is dealt with effectively?

From our experience we often find relevant issues that have been identified by the auditors and appear within the audit files but are not in the final report. What happens in such cases is that the audit findings are challenged by the business unit and if the auditor is not entirely confident in the respective subject matter, they are dropped. In other cases the finding is not one for the head of the business unit to address who asks for it to be deleted from their report never to appear again.

The Head of Internal Audit is crucial in this regard. If the auditors believe they have a relevant issue the finding should be kept in the audit report and accept business unit management’s disagreement thereby enabling senior management to draw their own conclusions on the seriousness of the issue. Failing to report in this way does not enable senior management to manage and support audit as necessary. Separate sections for findings that need multiple or different levels of response is a good practice.

**Auditing Judgement**

Following on from the above concern is the issue of auditing the judgements exercised by management. Audit functions may decide that judgement is not within their scope, yet the Board and regulators are increasingly looking for the internal auditors to include a review of judgement in their audits.

There are many areas within a business where judgement is key to the work that the firm conducts such as credit underwriting, investing, strategy and law. Without assessing judgement the audit becomes little more than a review of the processes conducted. Of course there are always two approaches that could be taken; in the first approach the auditor seeks to establish that the person exercising judgement has reliable and complete information on which to base a decision. If they had such information then the auditor would conclude that they have achieved their objective.
The second approach is increasingly that the expectation of the Board and the regulator is that the auditor should assess the decision made, seeing that it is properly justified and appears reasonable in the circumstances. Failing to achieve this part of the internal audit scope undermines the true value of the audit. The auditing of judgement is often avoided due to the risk of the expert questioning the knowledge of the auditor. Asking the expert to justify their decision, documenting it adequately and justifying why other choices were rejected is all part of efficient management. The auditor is only asking the questions senior management would ask and the audit findings may well be illuminating.

**Auditing Efficiency**

We have all seen audit findings that have not been properly thought through but the cost of implementing the proposed control vastly exceeds the risk that is being addressed. Auditors may consider that they only need to focus on whether procedures are conducted and offset the risk, not whether their recommendations are really adding value to the firm itself.

Clearly the Board is seeking assurance that the procedures operated by the firm are cost effective and not an onerous and unnecessary burden. We rarely see audit functions recommending that controls that do not add value should be removed. While it is understandable that there is a degree of reticence due to the enhanced risk of being wrong, by failing to address such issues the auditors are doing themselves and the Board an injustice. Efficiency auditing should be conducted by internal audit just as it is within other sectors and as required by the new standards promulgated by the Bank for International Settlements.

**The Audit Reports**

The audit report is the key document prepared by the internal audit function. It documents the improvements that the internal auditors have identified as a result of their work in the interests of the business. We find many problems in practice as described below.

Executive summaries often have little to do with the content of the audit report itself. The executive summary is not the place to introduce new recommendations. It has neither an action section nor a follow up. The summary should reflect and be referenced into the key matters within the audit report.

It is often all too evident that different teams have produced different sections of the report using different formats. Failure to standardise actually means that the various committees will question the quality of a function that could not even follow a standard set of processes.

The quality of an audit report is not related to its length. Voluminous background is not read by senior management and is known by the business unit, so who is it for? Making the report shorter and ‘punchier’ will gain greater attention and highlight internal audit’s ability to focus on key matters of real importance.

These are just a few of the issues we have identified in practice, often leading to a major changes within the internal audit function being required to enhance the value it adds to the firm. Risk-based auditing is not just about reducing the level of audit work, rather it ensures that the firm gets the greatest return on the resources it invests in internal auditing. By spending more time auditing those areas where the risks are greater, the incidence of unexpected losses can be reduced and efficiency of the business improved while also strengthening the risk and control environments. The Bank for International Settlements has recommended that a firm should commission a review of the internal audit function periodically. Such a review can add tremendous value to the business and should be conducted at least every three years.

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