FS Regulatory Brief
Enhanced Internal Audit Standards

February 2013

Introduction

On January 23, 2013, the Board of Governors of the Federal Reserve System issued the *Supplemental Policy Statement on the Internal Audit Function and its Outsourcing* ("Supplemental Guidance" or "Guidance") to the Officers in Charge of Supervision at each Federal Reserve Bank. This additional guidance, which supplements the interagency guidance that was issued in 2003[1] ("2003 Policy Statement") that remains in effect, addresses characteristics, governance, and operational effectiveness of an institution's internal audit function ("internal audit").

The Supplemental Guidance is based on the supervisory experience during and following the recent financial crisis and addresses the areas that the Federal Reserve believes required improvement within internal audit. Further, the Guidance codifies certain auditor independence guidance and limitations placed on the external auditor.

It is critical for institutions to assess their internal audit function against this additional Guidance as the examiners will soon be applying this guidance to measure internal audit's effectiveness and the regulator's ability to rely on the internal audit function. For the largest institutions, adherence may not be too difficult if the internal audit function has already instituted changes as a result of other guidance that has been issued over the past few years since the financial crisis. However, for many institutions, changes will be necessary, especially in elevating the stature of internal audit personnel so they are in a better position to provide the appropriate credible challenge to the business units, and the compliance and risk management functions (i.e., the first and second lines of defense), as further discussed below.

[1] http://www.federalreserve.gov/boarddocs/SRLetters/2003/sr0305.htm

This **FS Regulatory Brief** briefly summarizes the Supplemental Guidance, highlights areas that warrant particular attention due to their importance to regulators, and suggests steps that institutions should begin taking now if they have not already begun improving their internal audit functions to meet regulatory expectations.

Summary of the Supplemental Guidance

The Supplemental Guidance is organized into the following five sections:

I. **Enhanced internal audit practices:** Discusses enhancements that an institution should incorporate into its internal audit function to address lessons learned from the recent financial crisis including more emphasis on the assessment of critical risk management functions, internal audit's responsibility to assess and challenge the appropriateness and reasonableness of management's policies and procedures, and identification of thematic macro control issues.

II. **Internal audit function:** Addresses the characteristics, governance, and operational effectiveness of an institution's internal audit function and encourages institutions to incorporate professional standards such as the Institute of Internal Audit Standards into their audit architecture. This section provides detailed guidance on the supervisor's expectations across the entire audit life cycle from overall governance (including roles and responsibilities of key constituents) to planning, execution and reporting standards.

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III. **Internal audit outsourcing arrangements:** Covers the responsibilities of an institution's board of directors and senior management to provide appropriate oversight of internal audit outsourcing arrangements and emphasizes the need to utilize the same quality standards as if the institution maintained an in-house internal audit function.

IV. **Independence guidance for the independent public accountant:** Addresses certain changes to Section 36 of the FDI Act enacted since the issuance of the 2003 Policy Statement. Further, the Supplemental Guidance discusses the restrictions on the services of an institution's external auditor which precludes the external auditor from performing internal audit services on either an outsourced or co-sourced basis.

V. **Examination guidance:** Discusses the supervisory assessment of an institution's internal audit function and the ability of examiners to rely on work performed by internal audit when they had deemed the internal audit function to be effective during their most recent prior examination

Applicability

The Supplemental Guidance is applicable to supervised institutions with greater than $10 billion in total consolidated assets, including state member banks, domestic bank and savings and loan holding companies, and US operations of foreign banking organizations. The Guidance is also consistent with the objectives of the Federal Reserve's consolidated supervision framework for large financial institutions with total consolidated assets of $50 billion or more. The Guidance does not apply to community banking organizations, defined as institutions supervised by the Federal Reserve with total assets of $10 billion or less.

Overall commentary – What warrants emphasis?

The Federal Reserve has provided this Supplemental Guidance to enhance regulated internal audit organizations' internal audit practices and to encourage them to adopt professional audit standards and other authoritative guidance. Federal Reserve examiners will make a determination as to whether internal audit is effective or ineffective based on the institution's application of the 2003 Policy Statement and this Supplemental Guidance.

The Guidance captures what the agencies have been focusing on in their recent reviews of internal audit functions in the larger institutions. The Guidance also incorporates many of the attributes of a "strong" internal audit function that the OCC large bank examiners expect in the largest banking organizations including elements such as: credible challenge by internal audit of management and processes; positive assurance statements with respect to critical risk management functions; and thematic issue analysis. We understand that the Federal Reserve may be issuing follow-up interpretive guidance on certain aspects of this Guidance over the next year.

Highlighted below are key areas from the Supplemental Guidance that warrant emphasis, organized into the following sections: Oversight, Process, Reporting, and People. It is critical that institutions reference the 2003 Policy Statement and Supplemental Guidance located on the Federal Reserve web site[2] when determining conformance with these standards.

Oversight

The Guidance emphasizes the importance of independence, the structure of the function, and the key roles and responsibilities of the audit committee and senior management. Elements that warrant emphasis are as follows:

- **Administrative reporting**: Administrative reporting by the chief audit executive ("CAE") should generally be with the CEO. If not, the rational for not having this reporting structure should be documented by the audit committee.

[2] http://www.federalreserve.gov/bankinforeg/srletters/sr1301a1.pdf

- **Audit committee communication**: Internal audit should have ongoing interaction with the audit committee, separate from formally scheduled meetings, in order to keep the audit committee current on issues and concerns of the function and for the audit committee to provide its oversight role.
- **Risk tolerance**: Internal audit should confirm that the board of directors and senior management are actively involved in setting and monitoring compliance with the institution's risk tolerance limits.

Process

Many of the elements highlighted within the Supplemental Guidance relate to enhancements in internal audit processes. Enhancements that warrant emphasis are as follows:

- **Appropriateness of activities:** In addition to focusing on the compliance with policies, procedures, laws and regulations, internal audit should assess whether the processes are appropriate and reasonable taking into account the institution's risk profile.
- **Critical risk management functions:** Internal audit should assess the effectiveness and appropriateness of critical risk management functions and the institution's overall risk management framework.
- **Involvement in change activities**: Internal audit should be involved in significant change activities in the organization to help ensure an effective internal control structure is maintained.
- **Strategic objectives**: Internal audit should evaluate the adequacy and effectiveness of controls in achieving an organization's strategic objectives.
- **Audit plan**: Audit plans and related reporting to the audit committee must take into account the most significant risks that the organization is facing. Further, for audit plans that evaluate risks annually to focus on the most significant risks, there should be a mechanism in place to identify when a significant risk will not be audited in the specified timeframe as well as a requirement to notify the audit committee and seek its approval of any exception to the framework (i.e., high risk areas that are not part of the plan). High risk areas generally should be assessed every 12 to 18 months.
- **Internal audit work papers**: Comprehensive supervisory review should be performed on all audit work, including any outsourced internal audit procedures by an experienced audit manager.
- **Continuous monitoring ("CM")**: Internal audit is encouraged to utilize formal CM practices during the year to support adjustments to the audit plan or universe as they occur. Computer assisted auditing techniques are useful tools to highlight issues that warrant further consideration within the CM process.
- **Thematic/cross institutional control issues**: Internal audit should identify, assess, report and act upon thematic macro and cross institutional control issues.
- **Issue remediation**: Internal audit should ensure that management considers the level and significance of the risk when assigning resources to remediate issues identified by internal audit.
- **Issue validation**: Prior to closing out an issue, internal audit should perform validation work to ensure the issue has been resolved. The extent of work is dependent on the rating of the issue. Further, issue validation should be tested over an appropriate period of time to ensure the sustainability of the remediation.
- **Retrospective review processes**: Internal audit should ensure that management conducts a post-mortem and "lessons learned" analysis when an adverse event occurs. Further, internal audit should assess this analysis and ensure that management is taking appropriate action to remediate identified issues. In certain situations, internal audit should conduct their own post-mortem outlining the remediation procedures necessary within the business and within internal audit processes.

Reporting

Similar to the OCC's expectations, the Supplemental Guidance also emphasizes the importance of enhanced reporting to the audit committee. Elements that warrant emphasis are as follows:

- **Audit committee reporting**: Internal audit should provide the audit committee an opinion on the adequacy of risk management processes, including effectiveness of management's self-assessment and remediation of identified issues (at least annually) and other information on institutional and industry trends.
- **Risk assessment**: A high-level summary of the risk assessment results should be provided to the audit committee which includes the most significant risks facing the institution as well as how these risks have been addressed in the internal audit plan.

People

The Guidance emphasizes the need for auditors to have a wide range of skills including audit, industry specific, educational, professional certifications and other experiences. The Guidance highlights certain tactical steps that had not been included in the OCC's expectations. Elements that warrant emphasis are as follows:

- **Skills assessment:** Internal audit should perform knowledge gap assessments at least annually to evaluate whether current staff have the knowledge and skills commensurate with the institutions strategy and operations.
- **Training**: Internal audit should have a process for evaluating and monitoring the quality and appropriateness of its training program. Further, the Guidance suggests that auditors receive a minimum 40 hours of training per year.
- **Internal personnel transfers**: Internally recruited internal auditors should not audit activities for which they were previously responsible for their first year within the function.
- **Compensation**: Compensation schemes should not provide incentives for internal auditors to act contrary to the objectives of the function.
- **Outsourcing internal audit**: Organization's contingency plans should take into consideration the extent to which reliance is placed upon outsourcing of internal audit.

What should institutions be doing now?

Chief audit executives and audit committees need to ensure that their function's activities are improved and meet the expectations set forth in the 2003 Policy Statement and the Supplemental Guidance, as examiners will be applying this guidance in assessing an internal audit function's effectiveness. An institution's internal audit function generally would be considered effective if the institution's internal audit structure and practices are consistent with the 2003 Policy Statement and this Guidance. Internal audit overall processes could be deemed effective even though some aspects of the function require enhancement, as long as they are not a critical part of the function and internal audit has detailed plans to remediate. Examiners may rely on internal audit if the internal audit function was deemed effective at the most recent examination.

We recommend that organizations' internal audit departments formally assess their internal audit framework against the attributes included in the Supplemental Guidance and the 2003 Policy Statement. Internal audit may consider supplementing existing gap assessments that have already been performed with respect to the OCC's expectations of a strong audit function and the June 2012 guidance issued by the Basel Committee on Banking Supervision as there is overlap across the documents.

Upon completion of the gap assessment, internal audit should:

- Report any gaps (in priority order) to their audit committee and senior management along with remediation plans, related timelines to remediate and any funding/resource requirements to close the gaps. The gap assessment should be formerly approved by the audit committee and be actively supported by the board and executive management.
- Discuss any gaps noted with their examiners to obtain their agreement with conclusions and related remediation plans.
- Report ongoing progress to the audit committee, senior management and the regulators on internal audit's progress to remediate the gaps identified.

Based on our experience, we would expect that many internal audit functions may find the need for the following:

- Elevating the stature of audit personnel so they are better able to provide credible challenge across the organization and assess the more complex functions within the institution.
- Reviewing and updating internal audit policies and procedures to be in line with the Guidance.
- Improving reporting and communication to the audit committee and senior management.
- Deploying more continuous risk assessment activities to ensure internal audit's focus is relevant.
- Expanding overall scope and depth of audit activities across the institution and the second line of defense.

Additional information

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