

Supplemental Guidance on the Internal Audit Function and its Outsourcing

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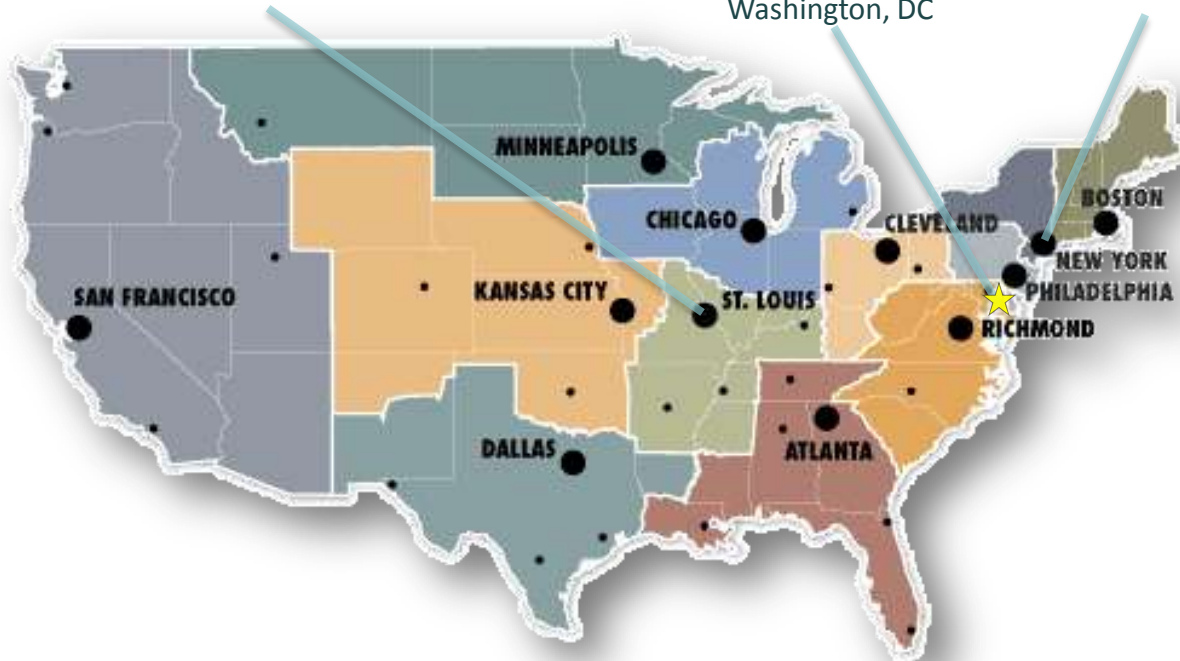
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References

- [SR letter 13-1/CA 13-1](#), “Supplemental Policy Statement on the Internal Audit Function and Its Outsourcing”
- [SR letter 12-17/CA 12-14](#), “Consolidated Supervision Framework for Large Financial Institutions”
- [SR letter 03-5](#), “Amended Interagency Guidance on the Internal Audit Function and its Outsourcing”

Refer to the Federal Reserve public website at www.federalreserve.gov and the tab “Banking Information and Regulation” and the subheading for “Supervision and Regulation Letters” to find these documents.

Background

- **Based on supervisory experience during and following the financial crisis, Federal Reserve staff identified enhancements that banking organizations (primarily large institutions) should incorporate into current internal audit practices .**
- **The existing guidance was updated to reflect current expectations.**
- **A key Federal Reserve priority is to evaluate the role of internal audit as an independent function and to look for opportunities for examiners to leverage the work of internal audit.**

Introduction

- The guidance is set forth in SR 13-1/CA 13-1, “[Supplemental Policy Statement on the Internal Audit Function and its Outsourcing](#).”
- The guidance supplements 2003 interagency guidance on internal audit and its outsourcing ([SR letter 03-5](#), “Amended Interagency Guidance on the Internal Audit Function and its Outsourcing”) and provides guidance on examiners’ ability to rely on an institution’s internal audit function.
- The guidance applies to Federal Reserve-supervised institutions with total consolidated assets greater than \$10 billion, including state member banks, domestic bank and savings and loan holding companies, and U.S. operations of foreign banking organizations (FBOs).

What's New

- **Guidance reflects:**
 - Enhancements that internal audit departments should be instituting post-crisis
 - Additional guidance pertaining to key aspects (attributes, governance, and operational effectiveness) of an institution's internal audit function

Enhanced Internal Audit Practices

Six key areas:

- Risk analysis
- Thematic control issues
- Challenging management and policy
- Infrastructure
- Risk tolerance
- Governance and strategic objectives

Enhanced Internal Audit Practices (Continued)

- **Risk analysis:**
 - Analyze the effectiveness of all critical risk management functions for individual risk dimensions and across business lines
 - Focus on nature and extent of compliance with established policies and procedures, plus the appropriateness for business activities and associated risks
- **Thematic control issues:**
 - Identify thematic macro control issues as part of risk assessment processes and the overall impact of the issues on the institution's risk profile
 - Identify patterns of thematic macro control issues through audit coverage and determine whether additional audit coverage is needed
 - Communicate thematic macro control issues to senior management, the board of directors, and audit committee

Enhanced Internal Audit Practices (Continued)

- **Challenging management and policy:**
 - Challenge management to adopt appropriate policies and procedures and effective controls
 - If controls are ineffective, report deficiencies to the audit committee and recommend remediation, including restricting business activity until controls are effective
- **Infrastructure:**
 - Review significant changes in infrastructure, and notify management of potential internal control issues (e.g., software applications and management information system reporting)

Enhanced Internal Audit Practices (Continued)

- **Risk tolerance:**
 - Understand risks in the institution and ensure that the board of directors and senior management are actively involved in setting and monitoring compliance with the institution's risk appetite
 - Perform testing for compliance with limits
- **Governance and strategic objectives:**
 - Evaluate governance at all levels within the institution and all business lines
 - Evaluate the adequacy and effectiveness of controls related to risks with governance, operations, and information technology in relation to the achievement of strategic objectives
 - Communicate concerns to senior management and the board of directors

Key Aspects of the Internal Audit Function: Attributes

- **Independence**
 - Reporting lines for domestic institutions (direct - audit committee, administrative - chief executive officer) and foreign banking organizations (FBOs) - head office audit
- **Professional competence and staffing**
 - Sufficient business knowledge
 - Effective training program for internal audit staff (generally a minimum of 40 hours per year)
- **Objectivity and ethics**
 - No conflicts
 - Code of ethics
- **Internal audit charter**
 - Include responsibilities

Key Aspects of the Internal Audit Function: Corporate Governance

- **Board of directors and senior management responsibilities**
 - Retain oversight for outsourced activities
- **Audit committee responsibilities**
 - Oversight of the internal audit function
- **Role of the chief audit executive (CAE)**
 - Manage all aspects of internal audit
 - Maintain quality assurance (QA) program

The Adequacy of Internal Audit's Methodology

- **Audit methodology**
 - Risk assessment methodology to include cross-institutional, thematic control issues
 - Address the role of continuous monitoring
- **Audit universe**
 - Include all entities
 - Factors can include general ledger (G/L), cost centers, new product approval, organization charts, department listing and major systems
 - Document and review for significant changes and update the audit universe at least annually

The Adequacy of Internal Audit's Methodology (Continued)

- **Audit risk assessment**
 - Should be well-documented and dynamic
 - Include thematic control issues, risk tolerance and governance and revise for changing market conditions
 - Consider quantitative, qualitative and other factors
- **Audit plan**
 - Based on risk assessment – revised annually – may be a cycle or focus on most significant risks
 - High-risk areas audited within 12 to 18 months
- **Continuous monitoring**
 - Formal documented processes to identify risk changes

Internal Audit Performance and Monitoring Processes

- **Audit scope**
 - Analysis of risks and controls to determine audit steps
- **Audit work papers**
 - Documentation of work performed and support for conclusions
 - Sampling methodology, minimum sample sizes, and rationale
 - Details on all phases of audits
- **Audit report**
 - Timely communication of issues and follow-up
 - Key components: executive summary, conclusion and rationale

Internal Audit Performance and Monitoring Processes (Continued)

- **Audit issues tracking**
 - Monitor open issues including agreement on resolution and time frames – identify root causes of issues
 - Report compliance with time frames
 - Level of validation: depends on risk level
- **Retrospective review processes – post-mortem**
 - Audit – evaluate management’s post-mortem – perform own analysis and changes required to audit processes
- **Quality assurance (QA) processes**
 - Well-designed internal QA; external QA every 5 years

Internal Audit Outsourcing Arrangements

- **Considerations for internal audit outsourcing arrangements:**

Topic	Guidance
General	Audit committee: maintains ownership of internal audit (written contract; confidentiality clauses)
Vendor competence	Audit committee and CAE: responsible for selection and retention
Contingency planning	Need contingency processes if significant reliance on outsourcing
Quality of audit work	Consistent with in-house work

Key Aspects of the Internal Audit Function: Guidance for Independent Public Accountants

- **Revisions to banking laws:**
 - Incorporates July 2009 changes to section 36 of the Federal Deposit Insurance Act
 - External auditor prohibited from performing internal audit work for audit clients (Sarbanes-Oxley Act, section 201)

Key Aspects of the Internal Audit Function: Examination Guidance

- **Determining overall effectiveness of internal audit**
 - Coverage effective or ineffective
 - Overall processes may be effective with some comments
- **Relying on the work performed by internal audit**
 - Internal audit must be deemed effective to allow reliance
 - Annual reassessment to include:
 - Adequacy and independence of the audit committee
 - Independence and quality of audit staffing
 - Quality and scope of audit risk methodology, plan, and risk assessment
 - Adequacy of audit programs and work paper standards
 - Reliance in a specific area will depend on scope and timing of work

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