

MAJOR TRENDS OF THE INTERNAL AUDIT FUNCTION IN CREDIT INSTITUTIONS

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Abstract:

Given that the economic landscape becomes more and more complex and dynamic, the internal audit plays an increasing role, being considered a pillar of the corporate governance structure of credit institutions. Failures of risk management have demonstrated the important role of internal audit and the need for it to evolve and to meet the multiple expectations of the stakeholders. Beyond the core assurance provided by internal audit relating to risk and controls, these expectations include providing a deeper insight and value, particularly in the areas of strategy achievement, emerging risks and use of advanced data analysis. This paper aims to identify the major challenges encountered by the internal audit function in credit institutions in the current period and the ways in which internal audit can respond to these challenges, to deliver according to the growing expectations on corporate governance and to actively support the organizations in achieving a steady and sound development.

Key words: Internal audit, risk management, credit institutions, internal control, corporate governance

JEL classification: G21, G32, M42

1. INTRODUCTION

For a long time, internal audit has been regarded mainly as a key element of the corporate governance' framework in banking institutions, representing „*the third line of defence*”, responsible with providing of an independent perspective with respect to the first two lines of defence: risk management and internal control framework.

Currently there are new expectations which raise the limit of what assumes good internal audit performance and which require changing the focus of the audit function, from testing and reporting the findings noted with respect to the internal control environment, to supporting the executive and non-executive management in achieving a more effective management of significant risks.

While the banking sector was the subject of many criticisms over the last years, it is necessary that internal audit functions have a proactive attitude and to increase its relevance for both the organizations and the banking sector as a whole.

Various studies (Deloitte, 2014; Protiviti, 2016) have highlighted the major challenges facing the internal audit functions, mainly acting in strong regulated sectors, such as banking. These important challenges include the extending of the role that the internal audit should play, the emergence of new risks needed to be managed by the organization, increased control exercised by stakeholders and resource pressure.

As developments and changes take place in banking institutions, it is imperative that the internal audit function to keep pace with these developments and to improve their capabilities, approaches, tools used, so that it can adequately serve the leadership and other stakeholders.

2. SCIENTIFIC RESEARCH METHODOLOGY

The objective of this paper is to identify critical areas and priorities at the same time, where internal audit should focus in the current period, in order to be able to fulfil its role to assist the organisation in achieving its objectives by carrying out an assessment of the internal control system, and by providing recommendations intended to lead to the improvement of risk management and corporate governance processes and ensuring compliance with the regulatory framework.

The used research methodology is mainly theoretical, combining the review of the scientific literature relating to the role, objectives and responsibilities of the internal audit in banking institutions with a critical analysis of some recent studies, publications, articles and studies related to the critical areas of the internal audit activity in banking institutions and the solutions that can be adopted for the overcoming the difficulties which internal audit is currently facing.

In the process of identifying both the challenges and the opportunities underlying in front of internal audit from banking institutions under present circumstances, we have investigated the studies, reports and recommendations, combining the documentation process with non-participatory observation in order to detect the critical areas needed to be covered by the internal audit, the factors rising major changes in the present and in the coming period and requirements to whom internal audit should respond for the overcoming the difficulties and leveraging the opportunities.

3. INTERNAL AUDIT AND BANKING INSTITUTIONS

According to the definition given by the Institute of Internal Auditors (IIA), taken up in Romanian legislation with the Resolution no. 48/2014, as amended and supplemented by CAFR Resolution no. 73/2014 "Internal auditing is an independent, objective assurance and consulting 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 evaluate and improve the effectiveness of risk management, control, and governance processes."

In the framework of "The internal audit function in banks" guide (2012) Basel Committee on Banking Supervision (BCSB) provides that the internal audit function constitutes „the third line of defence” in the bank, whose role is to independently assess the effectiveness and efficiency of internal control, risk management and corporate governance systems and the processes carried out by the business units and support functions and to supply assurance on these systems and processes".

The guide („The internal audit function in banks") stipulates the principles underlying the supervisors' expectations relating to an effective internal audit function, the relationship between supervisory authorities and internal audit functions and the evaluation carried out by the supervisory authorities in respect of the internal audit function, principles that address the following issues:

- Providing independent assurance to the board and superior management in relation to the quality and effectiveness of the internal control, risk management and governance systems and processes, supporting in this way the bank's management in protecting the organisation and its reputation;
- The independence of the audit function relating the audited activities, allowing the internal auditors to be objective in accomplishing their mission;
- Ensuring the necessary capabilities and experience for carrying out the audit engagement effectively;
- Ensuring the integrity of the audit function;
- Existence of Internal Audit Charter, providing the status and authority of the internal audit function within the Bank;
- Comprising into the internal audit function's scope of all the bank's activities (including those outsourced) and all the entities in the Group;
- Board's responsibility relating to the establishing and maintaining by the management of an adequate, effective and efficient control system and for granting the necessary support to the internal audit function in the performing its duties efficiently;
- Audit Committee's responsibility to monitor the internal audit function;
- Chief Audit Executive's responsibility to ensure the complying with sound internal audit standards and with the code of ethics;
- The responsibility of the internal audit function toward the board of directors and the audit committee in achieving the mandate;

- The independent review made by the internal audit function with respect to the effectiveness and efficiency of internal control, risk management and governance systems and processes conducted by business units and support functions and providing assurance to the management relating these systems and processes;
- Ensuring a consistent approach with regard to internal audit throughout the organization (banking group);
- In case of outsourcing the internal audit activities, the final responsibility for the internal audit function belongs to the board of directors;
- Communication between supervisory authorities and internal auditors must provide: discussion of the risk areas identified; understanding of the measures taken by the bank in order to reduce the risks; understanding shortcomings identified in relation to the monitoring the bank's actions towards these deficiencies;
- Periodically assessment made by the supervisory authorities related to the extent to which the audit function has sufficient status and authority and operates on the basis of sound principles;
- Reporting to the board of directors of the shortcomings found by the supervisory authorities in respect of the internal audit function and applying for remedial actions in a timely manner;
- Consideration of the extent to which the assessment of the internal audit function carried out by the supervisory authority has an impact on the assessment of bank' risk profile and the activity of the supervisory authority;
- Adoption by supervisory authorities, when necessary, of measures requiring to the bank's board and senior management the remediation in a timely manner of the deficiencies found in respect of the internal audit function and periodic reporting of progress to the supervisory authority.

In the "Corporate governance principles for banks" guide (Basel Committee on Banking Supervision, 2015), it also stipulated that the accountability of the internal audit function is to provide independent assurance to the board and to assist the board and the senior management in promoting an effective governance process and long-term stability of the bank.

In this respect, the internal audit function must hold a clearly defined mission, should be directly subordinated to the board and be independent of the audited activities. In order that auditors to be able to can carry out their engagements effectively and with objectivity, the internal audit function needs to have the required standing, skills, resources and authority within the bank.

Taking into account the importance of the internal audit system for healthy functioning banking, banking supervisory authorities shall assess the internal audit functions with regard to compliance with the policies and practices and the adoption by the management of appropriate measures for prompt remedy of the internal control deficiencies identified by internal audit.

According to "EBA Guidelines on Internal Governance" (2011), which indicates an internal governance model with three lines of defence, the internal audit function represents the third line of defence of the banking institution, being responsible for the provision of an independent review relating the two lines of defence: risk management and internal control framework.

EBA Guide stipulates the following responsibilities incumbent on internal audit:

- Assessing the extent to which internal control framework is effective and efficient;
- Unlimited access to documents and information in all operational units;
- Assessing the compliance of all activities and units with the approved policies and procedures, as well as the degree of adequacy and conformity of such policies and procedures with the requirements of the applicable laws and regulations; internal auditors should not be engaged in any audited activity;
- Review the processes which guarantee the safety of the methods and techniques, of the assumptions and sources of information used in the models used, as well as the quality and the use of the qualitative tools for the identification and assessment of risk; internal auditors should not be directly involved in designing or choosing the models or other risk management instruments;

- Performing the audit activity in accordance with national and international standards and in accordance with audit plans and detailed programs, approved by the audit committee, using a risk-based approach;
- Reporting directly to the governing body and/or the audit Committee the recommendations and the suggestions in order to improve the materiality of the internal controls and proper monitoring and reporting on their implementation

4. MAJOR CHALLENGES AND OPPORTUNITIES OF THE INTERNAL AUDIT FUNCTION IN THE PRESENT PERIOD

In March 2013, it was held in Washington, D.c. the eighth summit of the members of the Audit Committee Leadership Networks in North America (ACLN) and Europe (EACLN), at which there were discussed the challenges encountered by the internal audit, as well as the response of internal audit departments and audit committees at these challenges; a summary of these important aspects discussed, together with basic information and opinions of the members and experts are included in the ACLS ViewPoints-"Challenges of global internal audit".

Internal audit registered an increase of the importance in the conditions of the current complex and dynamic business environment, facing also many challenges, out of which the most important are:

- In terms of operating in a global environment (multiple countries, large distances between headquarters and business sites; multiple languages and culture), the main challenges include:

- human resources who understand not only the language but also the business rules and general culture in that region;
- various regulatory regimes requiring both tracking and interpreting new legislation and regulations, as well as an understanding of the legislative process and policy changes.

- In terms of intensifying focus on the risk and risk management, internal audit plays a critical role in addressing the following risks:

- IT Risks. Internal audit can play a major role in testing the security protocols and policies, both technically and procedurally. Internal audit may also contribute to the mitigation of the risks related to the implementation of the informatics systems. It can also help to reduce the risk of producing large-scale information systems and can provide assurance about the existence of the business continuity plans and crisis management;
- Compliance Risks. The challenges involved by the operation in multiple jurisdictions were amplified by the high pace of the changes regarding rules and regulations, which has increased the difficulty of monitoring, implementation and tracking the compliance with the rules.

The modalities presented whereby internal audit can react to these challenges include:

- Ensuring relevant statute of internal audit within the organisation, enabling it to act as a trusted and valuable player. It is mandatory to maintain objectivity and independence of the internal audit function.
- Ensuring a balance between regional presence and centralised control, either through decentralization-when it is necessary and effective presence of the audit teams with local expertise, either through centralization, when the presence of local audit teams is not efficient from cost-effectiveness point of view, or cannot be ensured an appropriate audit consistency, or by combining the two approaches;
- Ensuring the necessary resources for achieving the audit objectives through: staffing the audit department with the required qualified personnel; providing the staff training and development; partial outsourcing of the internal audit activity to obtain additional required resources or expertise, by calling in consultants, often from audit companies;
- Use of data or large data volumes analysis, which offer new opportunities for internal auditors in analysing the processes, policies, and systems, increasingly more leveraged

during the latest period. On the other hand, the analysis based on large volumes of data, which is very different from a regular audit process requires skills that are scarce for many of the audit function and involves additional costs.

At the end of 2013, **Deloitte**, one of four companies (Big Four) who provide auditing services for a large number of public companies, conducted a study ("the Head of Internal Audit Survey 2014-Capturing insight") in which there were highlighted the challenges faced by internal audit in terms of expanding role, emerging risks, enhancing the control accomplished by stakeholders and resource pressures.

The participants in this study come from companies acting in the following fields: financial services (45%), consumer and business technology (24%) and in the public sector (31%).

The main challenges faced by the internal audit functions during the current period are as follows:

- Conformity with laws and regulations, considering the numerous changes of regulations and legislative which have occurred at local and international levels. One of the most important areas over which the internal audit leaders are focusing is the profile risk of the organisation, and one of the risks that organizations have felt the need to reduce was one related to regulations and Government policies, which causes a significant change in the focus of the organisations to stronger regulatory;

- Reputational and brand risk, that should be considered in establishing the audit plans and defining the audit scope; 58% of respondents appreciated this risk as being one of the top five most important risks, sustained efforts being made to develop and promote the brand;

- Additional requirements from internal audit with regard to reporting;

- Additional risks emerged during current period, such as IT security, which implies the need of extending the audit scope in these areas and of holding the necessary capabilities in the fields of IT security, audit and data management;

- Extending the role of internal audit in the consulting area on risk issues, which raises the question of the balance that should be ensured between the independence of the function and the support that the internal audit should give to the business (business consulting; provision of services with regard to changes in process and counselling programs; independent due diligence; processes/policies development etc.), under the lack of clear indicators in this respect;

- Resources pressure: organizations have faced difficulties with regard to the identification of appropriate human resources, taking into account the increased orientation towards regulations, data protection and IT security which represent key risks for organizations.

The majority of respondents also highlighted an increase in the frequency of communications with operational units within the last years, which is reflected in a significant improvement to the incorporation of risk culture within organizations, particularly necessary under the terms of the regulatory framework in permanent evolution. Increase communication and direct contact with operational units has resulted in an increase of the confidence in internal audit, of its involvement in provision of advice on risk issues and in developing the capacity of creating partnerships with business, motivating the increase of the internal audit's duty as "trusted advisor" ("trusted advisor") for the organization.

In the study "Internal Audit Capabilities and Needs Survey" (2016) conducted annually by **Protiviti** (one of the most important consultancy firms on business risk and internal audit which works internationally) there is assessed the competence level of professionals and leaders in the internal audit field, identifying areas requiring improvements and supporting this way the sharing and maintaining of best practices for the internal audit profession. The report presented by Protivi based on the study (Internal Audit Capabilities and Needs Survey) conducted in 2016 shows the perceptions in respect of the risk of the chief audit executives from the financial services industry in the terms of new developments in global conditions, being established based on the feedback of about 1,300 audit executives and professionals from the financial services sector from U.S.A.

According to the opinions expressed by the respondents, audit areas that represent challenges for organizations and which they are trying to improve are:

➤ **Cybersecurity** - Valued as the most significant area that internal audit should address, as a result of the increasing concerns raised regarding cybercrime and systems vulnerability to unforeseen interruptions and to informatics attacks, under increasingly stringent regulations on ensuring adequate protection programmes against risks.

Although cyber security is the responsibility of the security director or of the IT director, risk management and internal audit functions plays an important role by working closely with senior management to ensure the cyber security of the organization.

In this regard, the internal audit directors and the internal audit function must increase the awareness and knowledge relating the cyber security threat and applicable regulations, in order to be able to establish a cyber security strategy and to include in that annual audit plans actions relating to cyber security.

➤ **Effective risk management** - In order to meet regulatory requirements and changes in the environment in which they operate, organisations must have more efficient and more effective risk management and compliance functions which, as well as the business functions, to deliver value to the organization by being fast, effective and forward-looking. At the same time, it is necessary to maintain the focus on integration the risk appetite and risk culture within the organization, enabling the development of a flexible risk management philosophy.

Regarding risk management, the greater challenge of the internal audit lies in the ability to determine its role within a flexible risk management philosophy and how it can contribute to the consolidation and independently testing of risk appetite and risk culture within the organisation. Chief audit executives and internal audit functions have a key role in promoting a healthy risk culture, underlying the risk management framework of any organization. In order to achieve this, the chief audit executives and internal audit functions should ensure that they have obtained a full understanding with regard to the organizations' risk appetite and risk framework and to monitor the incorporation of risk management into business lines. Auditors must also ensure the auditing of the strategic planning process, in order to verify that three or four years plans consider the risk appetite or risk capacity.

➤ **Risk model management and data analysis** - Internal auditors appreciated the risk model management as one of the top areas in which they need to improve their technical knowledge, considering their duty to check whether the financial institutions have implemented exhaustive practices regarding the management of risk model, which include governance, processes, policies, conformity with policies and documentation.

Organizations should ensure that they have the necessary capabilities within audit teams, as well as sufficient staff to carry out the evaluation of model risk components, the difficulties faced being amplified by the scarcity of skilled resources in this area. Some banks have started to draw staff with the necessary expertise in the internal audit teams, while others resort to external resources to support the audit team of the bank.

Internal audit has a significant role in providing assurance that the organization has implemented an effective risk management model (MRM) policy, which should be also formally integrated into the annual internal audit plan.

Chief audit executives and internal audit functions should also improve the level of knowledge with regard to the data analysis tools in order to improve the efficiency and capabilities through the use of more advanced techniques, such as continuous monitoring and indicators. The use of data analysis by the internal audit function is in continuous evolution, driven by the internal audit's goal to take decisions based of relevant to help it in using audit time more efficiently and more effectively.

Although it is recognized the potential of the data analysis, the implementation and utilisation of their increasingly facilities continue to be a challenge to the internal audit functions.

➤ **Mobile Applications** - In line with the above mentioned technological development, the survey shows the focus of the risks related to the development of audit, management and use of mobile applications offered by financial institutions, taking into account the development of the

mobile banking and payments made through mobile applications offered by banks in order to meet their clients' expectations to benefit from more comfort through the use of the mobile channel. The rapid developments in this field, the involvement of third-parties - providers of mobile telephony services, as well as countless risks involved in such new technologies represent major challenges both for banks, as well as for internal audit functions, which should support organizations to manage effectively the risks involved by these new channels, processes and technologies. For this internal audit needs to be informed regarding the latest technologies that will be implemented in their organizations and that these take into account all the potential risks involved.

5. CONCLUSIONS

The role of internal audit is to examine and to express an opinion on the adequacy of risk management systems within the corporate governance structures, including the risk culture and risk appetite of the bank.

At the same time, while the banking institutions are faced with a complex and dynamic risk, internal audit functions are confronted with a growing list of challenges, which are priorities for the next period, out of which the most important are: cybersecurity, model risk, mobile applications, and integrating risk appetite and risk culture within a flexible philosophy of risk management. Simultaneously with the increase in the list of priorities of the internal audit, and internal auditors' need to enhance their knowledge in key areas, such as cybersecurity and model risk continue to grow.

Internal Auditors must continue progress in collaboration with the business lines, with management and with the other two lines of defence, to improve surveillance and to support the management in better understanding of the risks, making a more efficient risk management and achieving strategic goals of the organization.

In conditions of scarcity of skilled personal in priority areas for audit, it is necessary for organizations to consider making additional investments in technology, providing audit tools helpful for achieving the priority objectives, in the context of new technologies that will be adopted by the banks to become more competitive on the market.

In these circumstances, the role of internal audit, the third line of defence within the system of corporate governance, is changing. Experience has shown that in times of crisis and challenge, there are opportunities that can be exploited. The new "Corporate governance principles for banks" issued by the Basel Committee in 2015 highlight the role of internal audit to provide independent assurance to support leadership in promoting effective governance process and the long-term soundness of the bank. In the current period, internal audit should respond to the challenge, to accept current trends that are significant for internal audit and to raise the level to meet the increasingly requirements relating to banking governance.

By improving their knowledge and increasing their efficiency and effectiveness, the internal audit functions will be able to support organizations in achieving a steady sound development, becoming an important strategic partner.

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