



FINANCIAL SERVICES

# Internal Audit of the Future Financial Institutions Look Ahead

ADVISORY



# Internal Audit of the Future



## Foreword

Internal Audit faces new challenges in today's business environment. Shareholders are demanding growth, regulators are expanding their scope of scrutiny, and new markets are constantly developing and evolving. To add value during rapidly changing times, internal audit needs more than ever to understand its role, prioritize its efforts, and operate from its core strengths.

To help address these issues, KPMG LLP (U.S.) hosted the first global "Internal Audit of the Future Share Forum," a gathering of internal audit directors representing nine leading international financial institutions. Held in New York, the event was an opportunity for internal audit directors to identify key business drivers for change in today's global financial services marketplace and to discuss how these conditions might influence the structure of a highly effective and efficient internal audit function in 2010.

The lively discussion encompassed better practices as well as current and future

expectations. Ingo Walter, professor at New York University's Stern School of Business, opened the discussions with a focus on the challenges that face the financial services industry in today's market. Participants considered how internal audit might evolve to help senior management meet those new challenges and add value, especially as business conditions and organizations continue to change. Share Forum participants agreed about the need to ensure that control frameworks and the control environments within their respective organizations are appropriate today and would enable them to grow with confidence over time.

We encourage you to circulate this paper with your internal audit group and to consider how these findings could help you identify your organization's key priorities. We believe this report can:

- (1) provide valuable information about trends and better practices for internal audit, today and in five years' time, and
- (2) offer insights to internal audit professionals seeking to develop themselves and their careers.

"Internal audit has gone from the backwater—from an inspection-focused, box-ticking environment—and is now on a massive journey to meet new challenges. What should our function be? If we can determine what it should be, we can shape it. Sarbanes-Oxley has pushed us into a box; do we want to stay there or get out? We need to create a vision of our own destiny."

"We need to focus on how we can take our function forward and add value to the business. We need to consider what our function should look like, alongside the regulatory agenda, and how we can influence that agenda."

Quotations by Share Forum participants.

## Share Forum Discussion: A Summary

The financial services environment is becoming immensely complex, with firms facing the accelerating challenges of growing regulatory pressures; increasingly complex products, markets and technology; the drive to control costs, and heightened investor expectations. These circumstances are demanding board members' focus and consideration while increasing their expectations of the business, including internal audit. In this environment, organizations can no longer afford internal audit departments that are largely "tick-box" functions.

With this context in mind, Share Forum participants explored the emerging role of internal audit and the resulting challenges departments face in maintaining a leading function over the next five years. This report summarizes this discussion. The key discussion points are noted below.

**Integrated assurance model.** Internal audit is experiencing a shift in its role from providing information to providing interpretation. It is offering, and is being expected to offer, increased synthesis and analysis of information to help management identify themes, trends, and business challenges. Boards and their audit committees are seeking a "real-time" overarching view of the control environment from internal audit, rather than reports on individual areas of the business. Increasingly, management will also rely on internal audit to provide a conclusion on the effectiveness of the control environment.

"The CEO and I are the only ones who see the whole picture. We need to fulfill our assurance role and provide our perspective."

The important step for internal audit is to create and provide its own "world-view" on a real-time basis—to develop what Forum participants discussed as an "integrated assurance model." To apply such a model, internal audit would gather and integrate assurances provided by others in the organization—by, for example, management, risk management, compliance, finance, IT, and others. Internal audit would then consider those assurances with its own work and provide to the board, management, the audit committee, and the regulators a view based on a broad ranging look at the control environment.

"Management can't wait five years for us to catch up. The CEO's expectation is real-time."

"I have to have a point of view. They turn to me after disclosures are made and ask if I think there are other things to be disclosed."

Internal audit reports would thereby help to provide comprehensive, value-based assurance, rather than information by function or risk area. If enterprise risk management (ERM) efforts are in place, they can help enable internal audit to integrate the perspectives of many business aspects with its own. Internal audit is ideally placed to serve this role, and if it has the processes and people in place, it can add new value to the business.

To be effective in this environment, participants agreed, internal audit needs technology systems enabling it to data-mine management information used for monitoring controls. Other prerequisites include use of a "common language" regarding risk and control issues and

consistent escalation criteria for determining when an issue becomes significant or material as well as a framework for structuring the internal audit process.

**Internal audit's challenge.** Build consensus between management and the board about how its role should evolve as well as communicate the value of an integrated audit approach.

### Continuous auditing and technology.

To provide this new level of service, internal audit should refine its risk assessment processes and enhance significantly its use of technology and continuous auditing techniques. Many organizations already use continuous auditing in their approach to a wide variety of areas, including branch networks, risk indicators, large homogenous loan portfolios, and credit cards. Continuous audit is expected to be a major area for development and expansion for almost all organizations during the next five years.

In this environment, with so many departments involved, robust communication across the organization is increasingly important. Such communication includes face-to-face meetings with stakeholders as well as more frequent and improved reports that highlight emerging risks and control assessments based on the continuous auditing methods being applied.

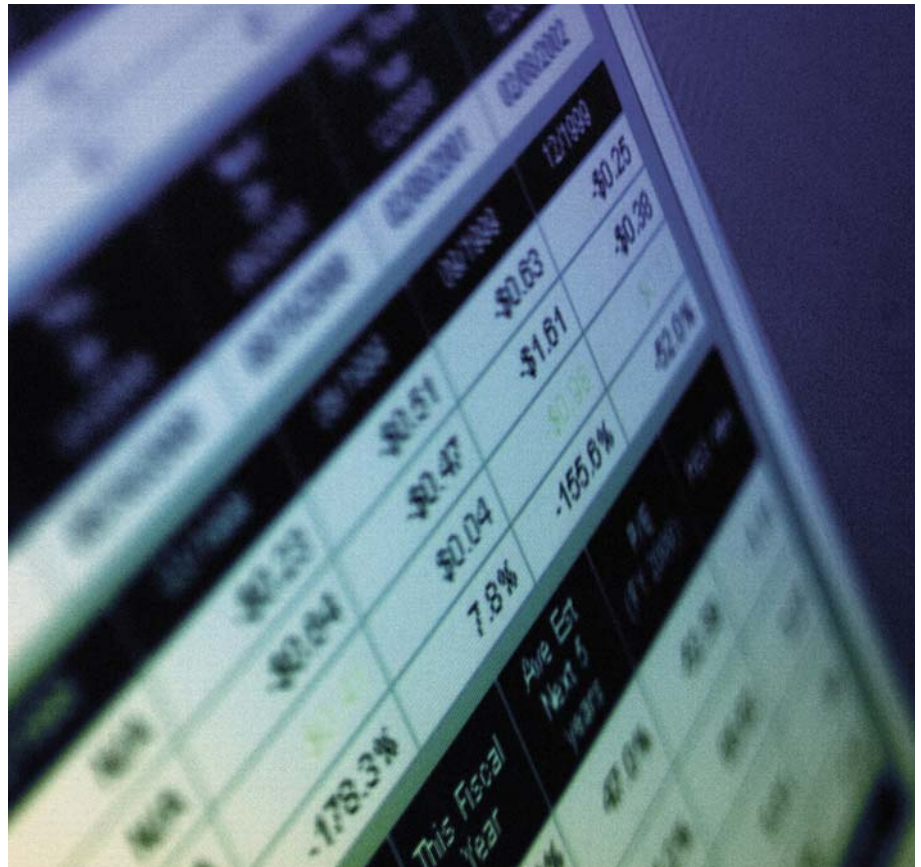
"We need to demonstrate to the investment community the value of control."

"We're going to need to do more before-the-fact assurance—that is, focus on control design, the structure of controls, and the environment in which they operate."

**Internal audit's challenge.** Refine its skill sets and risk assessment and audit planning processes, especially the cycle based approach. Also, enhance significantly its use of technology and continuous auditing techniques.

**Internal audit's role.** The Forum confirmed that internal audit adds value by providing assurance to management and by supporting the board and the audit committee in fulfilling their oversight responsibilities. In so doing, internal audit should:

- Assess and report on management's efforts with regard to the appropriateness, effectiveness, and efficiency of the system of internal control, and determine whether governance processes ensure compliance with policies, standards, procedures, and applicable laws and regulations.
- Provide an independent assessment of whether risks are appropriately managed along with recommendations designed to strengthen the organization's control environment.



“There is tremendous value-add to assurance, and we need to work with management to define that value and communicate it more effectively.”

“We’re always consulting, but we’re doing it as we’re providing assurance.”

The key is to help provide focused (i.e., risk-based) assurance in a manner that meets stakeholder expectations. Participants agreed that the value added by internal audit needs to be demonstrable; thus, how added value is defined and measured should be clearly articulated and supported by all parties. Adopting a top-down, risk-based approach—to iden-

tify the highest risk areas on which internal audit would help provide assurance—would help internal audit ensure that it meets stakeholder needs and demonstrates the value it adds.

**Internal audit's challenge.** Maintain its focus on its assurance role, and make sure the value it adds is demonstrable.

**Balancing stakeholder expectations.**

Internal audit should seek to strike a balance between meeting the internal needs of the board and management and meeting the needs of external stakeholders including the organization's various regulators. The regulatory/supervisory system can be a key driver of the internal audit agenda. Internal audit can add value by emphasizing the role it can play in helping organizations, and regulators, restore confidence in reported information.

Participants indicated that, for the majority of them, internal audit has a direct relationship with the regulator. The challenge for organizations, and for internal audit specifically, will be to work with both internal stakeholders and the regulators to facilitate overall understanding of the organization's risks and the role of internal audit in the risk management process. Ideally, in satisfying the expectations of shareholders and management, internal audit would also meet the needs of the regulator. If the balance is right, the assurance internal audit provides would be inherently valuable (and valued) because it would meet defined stakeholder expectations. The challenge is to make sure that internal audit's focus is well understood, well communicated, and has the agreement of all concerned.

In addition, regulatory mandates such as Sarbanes-Oxley and Basel II are expected to drive control improvements within organizations and thereby enhance management's understanding of risk events and the organization's relationships with regulators and investors. The regulatory focus is increasing internal audit's influence and its access across the organization, thereby putting a new focus on the role internal audit plays and the "comfort" its work provides across the organization.

**Internal audit's challenge.** Balance the expectations of stakeholders and the impact of the different work requirements on internal audit's resource model.

**Risk-based approach.** New and heightened expectations of internal audit from internal and external stakeholders could cause internal audit's efforts to be sub-optimally prioritized and its capacity to help provide assurance could appear insufficient. Further, the pace of change in the business environment within which organizations and internal audit operate means an increasingly dynamic organizational risk profile. Now, more than ever, internal audit needs to adopt a true risk-based approach to meet stakeholder expectations.

"We can't afford to become the old inspection groups of 20 years ago."

**Internal audit's challenge.** Evolve its risk assessment and the audit plan continuously to keep them aligned with developing risks and to ensure that those risks are addressed in a timely basis, thereby helping to drive a fully risk-based approach.

**The right people.** Internal audit has a wide variety of customers seeking different types of assurance. To help meet expectations, it needs strategic thinkers who understand business issues, perceive the risks to the achievement of business objectives, can evaluate related control implications and communicate these effectively to senior management. These resources should be capable of identifying, analyzing, and interpreting themes not only from internal audit's own work but also from base data gathered by management and other assurance functions within the organization. At the same time, it will always need people who can perform audits to meet stakeholder requirements—a model requiring resources that are detail-oriented and proficient in audit execution.

"We need to hire from a pool that can do analysis."

"Internal audit has an education role to play. The business doesn't have enough knowledge of sustainable controls."

An evolving challenge will be to balance these two types of resources and put in place appropriate recruiting and career development mechanisms to ensure progression of internal audit staff from providing audit execution to strategic partners of business management. One risk is attrition of internal audit talent to the business. However, appropriately managed, this can be used to the mutual advantage of internal audit and the business. The participants highlighted an increased interest in using internal audit as a "training ground"—an entry point to facilitate attracting high-quality applicants.





These auditors would then spend time in internal audit gaining an understanding of various aspects of the business before specializing in a particular area.

To date, internal audit career progression plans tended to be informal other than within the function. An increasing number of organizations are imposing formal requirements to ensure that all senior management trainees spend a period of time in internal audit. It is expected that trainees will gain not only a broader understanding of the business, but it will also enhance their appreciation of the importance of a robust control culture.

**Internal audit's challenge.** Achieve the appropriate mix of people skills.

## Potential Action Steps for Internal Audit

Although Forum participants did not specifically ask for or agree to any recommendations, KPMG's work in governance and internal audit suggest the following action steps:

- Develop reporting templates and processes that capture the benefit of internal audit's own work and the combination of the assurance provided by others in the organization; develop from that effort a single view on the control environment and provide it to the board, management, and the audit committee
- Hire and retain not just people with strong audit skills but also people with strong analytical skills combined with relevant business knowledge and capabilities.
- Become champions of the integrated assurance model and thereby seek to persuade the board, audit committee, and their stakeholders of the various ways in which this model will drive benefits for the organization
- Help the organization mature its control framework as one means of demonstrating alignment with the business as well as to add value
- Develop methodologies and techniques to enable internal audit to help ensure that it works with other assurance functions in moving toward a single view of risk

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