Several years ago, financial services regulators and standards-setting bodies across the globe issued a flurry of standards that elevated the role of internal audit in financial institutions and set heightened performance standards that internal audit should meet. Heightened standards were considered necessary to address shortcomings persistent in internal audit functions before and throughout the financial crisis, such as their limited engagement with the critical issues firms faced and their inability to initiate change. While the new standards differ in application, they share a common purpose: to improve the relevance, capability and impact of internal audit, reflecting the material contribution internal audit can and should make to the safe and sound running of the financial system.

Most firms responded to heightened standards by comparing their current practice against the new requirements. This triggered deep reflection and the implementation of important change programs, some of which are still ongoing. It is clear that the changes have already had a positive effect. Internal audit today has an enhanced standing inside firms, and its operations and functioning have also improved. Regulators, audit committees and internal audit leadership teams are now asking: is the necessary transformation substantively complete or is there further change ahead?

To answer that question it is necessary to fully appreciate the extent to which regulators and other key stakeholders concluded that the scope and approach of internal audit, pre-crisis, was inadequate. The new standards have materially expanded the remit of internal audit and the performance standards it is expected to achieve. Repositioning and properly equipping internal audit function to meet their expanded remit requires major, ongoing change.

Risk Governance 2020

EY believes financial services firms face a sea change in how they approach risk governance. Internal audit has a major role to play in this change.

The transformation required will take a comprehensive, multi-year effort to substantially complete. To remain at the forefront of today’s market, firms should adopt an integrated approach that capitalizes on the value gained from upgrading risk governance: placing an equal focus on financial and nonfinancial risks in the short and long term, embedding evolving regulatory and supervisory expectations, and delivering tangible results in a cost effective manner. We call it Risk Governance 2020: a shift from satisfactory to effective and sustainable.
Other factors suggest that internal audit has much more change ahead. Firms’ risk-governance models are undergoing significant change, with a strong and effective three-lines-of-defense model at the heart of regulators’ intentions. Ongoing prudential and conduct regulatory reforms will continue to heavily impact internal audit, as will material changes to firms’ strategies and business models.

Taken together, the necessary transformation in internal audit requires the function to focus on the integrity of the risk-governance framework, use new methods and tools, develop a more dynamic people model, and contribute to sustainable firm economics and strengthened risk governance. The fact that the maturity of internal audit differs globally, as do the regulatory requirements that affect it, further adds to the complexity of the required transformation.

A successful transformation is critical. An effective internal audit is integral to sound risk governance and a key enabler for directors and executive management to fulfill their own governance responsibilities. Past failings in controls and risk management have cost firms and the industry dearly in fines, settlements and reputation. Strong board and senior management support for this transformation is important, as bold changes are required so internal audit can fulfill its elevated role.

The need for further transformation

In the wake of internal audit deficiencies pre-crisis, regulators and standards-setters have made clear that internal audit should have a broader role and remit than the one it had become boxed in to; a remit that embraces the entire governance, risk management and internal control framework of the institution. Central banks and regulators in the G20 set out their expectations in Financial Stability Board (FSB) papers including their “Thematic Review on Risk Governance” which stated that “an assessment [performed by internal audit] that is independent from the business unit and the risk management control function can assist the board in judging whether the risk governance framework, internal controls and oversight processes are operating as intended.” Country-level requirements have also become more demanding.

In recent years, firms have responded to higher regulatory expectations, seeking to strengthen their internal audit functions. While change continues, there are already signs that change will deliver a more impactful internal audit. For example, the results of a 2015 survey by the UK Chartered Institute of Internal Auditors (CIIA) highlighted the enhanced standing of internal audit professionals, improved reporting structures, better representation at key governance forums, more timely access to information and increased attention to areas of work highlighted as important in the CIIA Code. The survey’s findings align with global trends that show increases in internal audit budgets, staff seniority, and the depth and breadth of staff experience. Audit approaches and methodologies are now being revised to reflect new priorities and the expanded remit. Change of this kind is ongoing and remains essential for internal audit to be properly equipped to fulfill its new role.

The enhancements made thus far are to be applauded. However, three critical drivers suggest that internal audit faces yet more transformational change ahead:

- The reform of risk governance. The recent regulatory focus has been on strengthening corporate governance and risk governance up to the board level. As a report from the Basel Committee on Banking Supervision states, “As part of the overall corporate governance framework, the board is responsible for overseeing a strong risk governance framework. An effective risk governance framework includes a strong risk culture, a well-developed risk appetite articulated through the RAS [risk appetite statement], and well defined responsibilities for risk management in particular and control functions in general.”

Strengthening the three-lines-of defense model has been at the heart of risk-governance reforms. In releasing new requirements, regulators have implicitly highlighted that the model has often become corrupted in application: first-line accountability has been undermined; the second line has become overburdened by taking on first-line roles and not sufficiently focused on its unique risk-aggregation and independent-challenge and advice roles; and both second and third lines have become drawn into designing and testing front-line controls. As EY has pointed out, addressing these changes will take several years: “This is no trivial task, and the core work in building a more integrated risk governance approach may take three to five years.”

This transformational journey will have a significant effect on internal audit. It will need to assess how well the governance framework is working as a whole and will need to report on the embedding of risk-appetite frameworks across all dimensions of risk, the quality and reliability of risk information, and the effectiveness of governance in all parts of the business. Internal audit professionals will have to put themselves in the shoes of the board of directors to assess risk oversight and how culture and behaviors aligns with risk appetite. In addition, as the risk management capability of first and second lines develops, internal audit needs to keep pace so they can audit first and second lines effectively.

3 “Surfing the Wave,” Chartered Institute of Internal Auditors, July 2015.
This work calls for people with skills and experience not traditionally found in internal audit functions.

**Implications of ongoing regulatory reform in prudential and conduct.** Ongoing regulatory reforms continue to drive other major changes. In the prudential area, firms have made significant efforts to adhere to new capital, liquidity and leverage requirements. Yet, regulators are now pushing to have these changes fully embedded in the firm’s governance model. Put simply, “not only must a bank’s ratios be right, but so must its governance, systems and controls. These must be rigorous, embedded into business as usual and based on relevant, accurate and timely data so that the bank can apply analytics to anticipate, mitigate and manage risk.”

Substantial change is underway to business process, and IT systems and underlying data facilitate this. Boards and supervisors expect rigorous testing to demonstrate that governance, systems and controls are effective.

The fast-evolving conduct regulatory agenda is equally important, with far-reaching implications for firms and internal audit. As EY has noted, “banks will need to show not only that they are in compliance, but they are in control... the emphasis needs to shift from curing breaches to anticipating where risks may arise and preventing them from occurring.” The regulators’ conduct-risk agenda links directly to firm strategies. Regulators want firms to validate their businesses model and business processes to ensure they do not create excessive conduct or compliance risks. Improvements firms are making to culture, behaviors and the alignment of incentives to risk management are an integral part of being in control.

Internal audit is being heavily affected by prudential and conduct agendas, sometimes with more than half of its work now linked to regulatory requirements. Independent testing of models is a prime example. Many new reforms require internal models used by firms to be subject to robust and independent validation. Internal audit functions need to assess whether such testing has been performed rigorously, carry out their own tests as required and understand the implications of the results, reporting their findings to the relevant board committees. On the conduct agenda, internal audit is increasingly focused on aspects of conduct risk and aspects of culture. Addressing the wider aspects of conduct including forward-looking risks, systems and data implications, and the ramifications for business models is altogether more challenging.

**Change to business models.** Perhaps the most important driver of change for internal audit is the fundamental change taking place to business models. Financial services firms face formidable challenges to redesign, implement and manage a business model that generates sustainable returns that are acceptable to investors and meets growing supervisory requirements. The significant reduction in financial leverage since the financial crisis, combined with increases in compliance costs and the impact of competition from new entrants, have brought in questions about the long-term sustainability of many firms’ business models. Cost-reduction programs offer scope to address these issues in the short term, but firms may require radically different structures and operating models to lower operating costs far enough.

The impact of the “Fourth Industrial Revolution,” viewed as a profound shift for technologies, governance, distribution and manufacturing, coupled with the fast-changing nature of the financial services landscape, will intensify this challenge. Innovations in cognitive computing will change how firms interact with customers and how they define and deliver products and services. Process automation and robotics offer the potential to have consistently applied processes with fewer errors. Concurrently, financial innovation is disaggregating the value chain across financial services, with smaller players conducting elements that traditionally would have been done by one firm.

The scale and pace of business model change requires more fundamental change in internal audit for its work to remain relevant and timely. Internal audit will have to get ahead of the curve in its ability to assess and react to new risks, necessitating changes to staffing models based on traditional skills sets and hierarchies. It will also need to leverage heavy automation and more efficient auditing techniques.

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7 Ibid.
8 “Risk culture: The critical role of internal audit,” EY, 2015.
Meeting the challenge

Further transformation of internal audit is needed in four key areas:

Focusing on the integrity of the risk-governance framework

The starting point for internal audit to function at full potential is refocusing its scope and mandate. Transitioning internal audit functions to assess and report on the entire risk-governance framework, and to be truly independent of it, requires significant support from executive management and the board (and its relevant committees). The other lines of defense have to genuinely step up to their responsibility for risk management, and internal audit must be allowed to focus on the risk-governance framework and the largest risks, rather than dedicating disproportionate resources to low-risk areas or work that should be done in lines one or two. Internal audit has to leverage its ongoing evaluations of risk governance to identify where the first and second line are not performing their roles and responsibilities effectively and demand change.

Once internal audit is no longer constrained, it will refocus its attention on the things that matter:

- **Testing the framework, not the controls.** Boards are rightly concerned that the internal-control mechanisms they have put in place are proven to be effective through rigorous testing. Under the three-lines-of-defense model, the first line is responsible for understanding risks, putting in place internal controls, and performing the necessary procedures to satisfy themselves, and it must be able to evidence that they are operationally effective. Independent second-line functions perform a challenge and advice role and ensure that executive management and the board have a complete picture of the firm’s aggregate residual risks. Internal audit should assess the effectiveness of the overall framework.

Unfortunately, internal audit has too often been used to fulfill part of the first-line internal controls design and testing or second-line challenge roles, thereby becoming part of the governance and effectively conducting self-review. Instead, internal audit needs to reposition itself to perform the type of work that enables it to express an independent and objective view on the effectiveness of the risk management processes operated by first- and second-line functions. Only by exception should internal audit be the first to test. The purpose of independent internal-audit testing changes from providing original evidence concerning control effectiveness to validating management testing and the conclusions they draw from it. Direct testing, including re-performance tests, will continue to be an important component of internal audit evidence gathering especially in high risk areas, but the purpose of testing and the methods and tools internal audit deploys to perform such testing will change.

- **Not taking anything as given.** In some ways, the previously constrained mandate and scope of internal audit greatly curtailed its ability to evaluate the full context for risks and controls. Traditionally, a firm’s strategy, business mix, or suite of products and services was taken as a given; internal audit focused on business processes to manage risks that arose as a consequence. This is no longer adequate. For example, internal audit now needs to assess the design, marketing, distribution, pricing and sales process to form a view about the nature and operating cost of controls required to keep the level of conduct and reputational risk associated with the product aligned to risk appetite. The same is true of model assumptions: it is no longer reasonable to simply assess the governance, decision-making process, and controls around models; the underlying assumptions also need validating.

- **Being involved early, not after key design decisions have been made.** The pace of change and financial-technology innovation necessitates internal audit being engaged at the outset of designing new projects, technologies, products and services. This ensures that their input has the most impact and allows internal audit to ensure that technical requirements for continuous monitoring are built in from the beginning. However, this is a double-edged sword: more impact, but more need to ensure that internal audit remains sufficiently independent so it doesn’t impair its ability to audit in the future.

- **Creating risk-based, not coverage-based, audit plans.** A hangover from the past limiting the role of internal audit is the expectation that internal audit cover all areas of the firm over a multiyear cycle, with less risky areas subject to standard, albeit less frequent, audits. There is some logic to this expectation: there have been many examples of purportedly low-risk entities – often non-core or geographically far from the firm’s headquarters – that have caused material regulatory problems. Unfortunately, the demand for full-coverage audit cycles can be excessive when compared to the coverage required solely on materiality grounds. Usually, it means that internal audit is spending a portion of its resources on unimportant risks or bolstering control processes that should be performed by management.

Internal audit should spend more time on high-risk areas and should use a comprehensive set of continuous monitoring techniques – rather than standard audits for every entity – to ensure integrity and enable fast responses when risk increases. In so doing, it will continue to meet its responsibility to maintain an accurate and complete audit universe. Where regulators in certain jurisdictions require internal audit to perform specific types of work that would not be done on a risk-based plan, it should, of course, be done. However, non-optional activities of this kind should be flagged as such in the audit plan.
Using new methods and tools

Internal audit staff will have to make important changes to their ways of working. To a large degree, internal-audit methods have remained structurally similar for many years, including features like the annual audit plan, standardized audit engagements, reporting protocols and follow-up procedures. Adaptations to these methods made in recent years will not keep up with the pace and scale of change occurring in firms and the industry at large.

Future changes will likely include:

- **An additional set of building blocks:** The concept of a flexible audit plan responsive to changes in risk profile is now well-established, but the extent of flexibility is very likely to increase. Changes to internal audit reporting protocols will be required to address timeliness concerns, accelerate issues to resolution more quickly, and enable that key stakeholders, such as the audit committee, to discern the most from least important. The mechanics of the audit process, between planning and reporting, will also evolve. Even the concept of the individual audit may change as functions move to more continuous approaches and differing types of coverage.

- **A greater dependence on judgment:** Post-crisis, new types of internal audit work have begun, such as risk culture and the evaluation of model assumptions. Such areas ultimately require internal audit professionals to apply more judgment on outcomes; seeking out objective criteria will only get one so far. Doing so credibly and consistently will require new techniques and skills.

- **More use of data analytics:** Accessing data and data analytics to independently verify testing and to enable continuous monitoring will have to become normal practice if internal audit is to have hard evidence upon which conclusions can be based available quickly. Analytics that seek out abnormalities that require further investigation need to be enhanced to utilize fast-emerging new data-analytic techniques and capabilities. Internal audit will have to use, as well as audit, data-analytic frameworks.

- **New elements related to digital:** As digital innovation further drives change within firms, new risks will be introduced, through digital-change programs, social media, and cloud computing. Cyber and data-protection risks will grow. Internal audit will need to adapt its risk assessments, audit plans and audit techniques.

Adopting a more dynamic people model

The largest challenge that internal audit will face in the future is its ability to deploy audit staff of the right caliber. To credibly address new regulatory requirements for routine opinions on the design and effectiveness of the risk governance framework, it should “be performed by individuals with the skills needed to produce a reliable assessment.”

Until recently, staffing models were relatively consistent across financial services and have been resistant to change. The vast majority of work is executed by full-time members of the internal audit team, organized in a pyramid structure with junior members executing the majority of testing. Many more people leave internal audit to join the business than the other way around, even for short periods. Third-party providers commonly are asked to fill skills and resource gaps and only account for a small percentage of headcount. Recruitment tends to be from outside and aimed at maintaining the pyramid structure. Attempts to change the model have been slowed by the fact that internal audit is seeking to improve its skills when other functions are competing for staff with specialist expertise, creating an even more intense war for talent.

The status quo in untenable. If anything, skills shortages in the market necessitate more, not less, creative talent strategies including:

- **Flatter structures:** Firms are already reviewing staffing requirements and concluding that they need flatter structures. Long-term, the pyramid model will give way as internal audit changes so it is a place where talented people thrive and aspire to be. Flatter structures allow internal audit professionals to become more accustomed to interacting with senior executives, non-executive directors and regulators, which will improve their communication, presentational and advocacy skills.

- **Growing and developing specialisms:** Internal audit cannot afford to be less skilled than the second-line functions they are required to audit or be content with a learn-on-the-job approach when genuine specialism is required. More specialist and senior professionals will be required to execute audit work, not just review the work of others. They will need sound professional judgment to deliver balanced, but credible, opinions. Staff learning and development will need a serious upgrade, a long-overdue requirement as internal audit functions have typically invested no more than 5% of their budget in staff development. More extensive staff-rotation arrangements should be used to allow business-line staff to join internal audit temporarily, and vice versa, subject to independence considerations.

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10 Ibid.
• **Increasing the use of external talent:** Too often, internal audit uses a “top-up” approach to external sourcing to acquire cheaper staff to execute less-important work. This sub-optimizes spend on external resources. If anything, external specialists should be used to supplement the expertise available on the in-house team and further enhance independence and objectivity of higher-risk audit work. Building external talent into such audits also supports skills transfer to in-house talent.

• **Deploying new centers of excellence:** Many large firms already use centers of excellence from which all global audit work is controlled, together with offshore capabilities that usually support broader coverage. As the mix of work performed by internal audit functions changes and data-analytic capabilities become commonplace, new opportunities will emerge to source staff in new centers of excellence.

**Contributing to sustainable firm economics**

Critics of internal audit’s past performance have said the function too often lacks a strong sense of commerciality or materiality, auditing from the textbook of theoretical control standards, and always recommending additional control activities are performed (rarely fewer). Management is fully aware that internal audit can escalate matters to the board, and thus internal audit findings carry significant weight. Yet, the cost implications of implementing findings and maintaining additional controls is significant.

Naturally, the primary criteria for evaluating internal audit should be the degree to which it has properly assessed and, through its work and the implementation of its findings, strengthened the firm’s risk management. However, the audit committee should also evaluate the degree to which internal audit has performed in terms of its own contribution to the firm’s economics. Together, these factors constitute what could be called “better internal audit” and include:

• **Driving cost-effective improvements:** Internal audit should be highly cognizant of its responsibility to agree on actions that drive cost-effective improvements aligned with the firm’s strategic objectives. These actions should be commercially sensible and should demonstrably strengthen risk management in areas where it is genuinely required. Internal audit should remain equally as alert to opportunities to reduce the firm’s operating costs, such as eliminating redundant or low-value controls.

• **Managing its own budget effectively:** Most internal audit functions report additional demands on their resources attributable to their enhanced mandate and new or expanded work explicitly required by the new regulatory guidance. Budgets have been increased to fund new hires who bring additional skills. However, internal audit is not fully immune from cost-reduction initiatives that are commonplace across the industry. Internal audit must exercise strong stewardship over its operating budget, albeit it is usually immaterial in the context of firm’s overall operating costs. Doing so sets a strong example. Internal audit will be pushed to deliver more for less, by performing work using innovative techniques, technology enablement and shorter reporting cycles. It means cutting out work that should not be performed on materiality grounds, such as areas where the likelihood of the risk appetite being exceeded is small, and not doing work that should be done by the first or second line.

However, internal audit should not manage itself to be cost-neutral. While being cost-effective and cost-conscious is important, internal audit has to perform its core role effectively. If that requires more investment in some areas, so be it. The overall aim is to strengthen risk governance and reduce the likelihood of future regulatory intervention.
Board and senior management support for change

Transitioning internal audit to operate across the entire risk-governance framework will require strong and enduring support from the board and executive management, and those stakeholders have to remain committed to change and aligned in their objective. The journey for many has begun, but it has a long way to go. Along the way, stakeholders will rightfully ask, “Are we there yet?” But leaders in internal audit will answer the way parents do when asked the same: “No, we are not there; in fact there’s a long way still to go.”

After all, it would be too easy to trivialize the scale and scope of change that is required in internal audit. Some will reason that material change is not needed. Others will say much of the needed change has already taken place. Still others will remain unconvinced that changes required in the first and second line that allow internal audit to reposition itself will occur and may believe that internal audit can’t front-run those changes. The same skeptics are not confident that boards, senior executives or regulators are fully behind the changes they purport to support. Such skepticism may be warranted. Long-tenured internal audit executives may say they heard this all before. The profession has been trying to reinvent itself for decades.

However, this time feels different. No one wants a repeat of the controls failures that have characterized the industry since the financial crisis started to unfold. The public, regulators and shareholders will not tolerate it a second time. Equally, no one in the internal audit profession wants to remain an observer of weak governance or once again hear “Where was internal audit?” after the next crisis. Internal audit should proactively play its part in driving necessary change.

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EY’s Risk Governance 2020: a shift from satisfactory to effective and sustainable

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