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**White Paper**

# Financial Services Focus on Internal Auditing Standards

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## Background

### Purpose

Regulators have raised the bar on their quality and performance expectations of internal auditors. There remain opportunities for Chief Audit Executives (CAEs) and other internal audit leaders within these entities to strengthen compliance with professional auditing standards, and to champion continued professional development of their internal audit cohort as a basis for strong internal audit performance.

### Background

Australia is recognised internationally as having one of the strongest financial services industries in the world. The industry is a key driver of the national economy and, in particular, economic growth.

Recurrent scandals across financial services entities over the last decade have caused significant reputational damage. These scandals have resulted in a sharper focus on governance, with changes to accountability, fairness, and consumer protection by the government, regulators, and, to a lesser extent, the entities themselves.

Coincident with these changes, regulators and other scrutineers have raised the bar on their quality and performance expectations of internal auditors in the financial services sector. Nevertheless, about 1 in 3 internal audit functions in financial services entities worldwide do not fully conform with professional auditing standards pertaining to 'quality and improvement' contained in the International Professional Practices Framework (IPPF).

## Discussion

### Issue

Throughout our daily lives, we rely on standards to underpin our health, wellbeing and quality of life. Reliable and accurate financial statements derive credibility from consistent and well-considered accounting and auditing standards. Our potable water undergoes stringent quality testing. Our energy providers must have a safe workplace. The food we are served has to be up to standard. Likewise, the building materials and workmanship in construction and infrastructure of our health, education, transport, security, and judicial infrastructure. As a developed nation, we wouldn't expect anything less!

Likewise, compliance with professional auditing standards is of value to regulators, boards, audit committees, the C-suite ... and ultimately the community. Nothing less than full compliance with professional auditing standards within the financial services sector will satisfy the expectations of regulators, the community and other stakeholders.

### History

Financial services sector is a major driver of economic growth.

The Australian Government Treasury has reflected<sup>i</sup> that, "Australia's financial services sector is the largest contributor to the national economy, contributing around \$140 billion to GDP over the last year. It has been a major driver of economic growth and, with 450,000 people employed here, will continue to be a core sector of Australia's economy into the future."

The Treasury further recognised<sup>ii</sup>, "The four major banks are amongst the world's largest banks by market capitalisation and all rank in the top 25 globally by safest banks. They are also some of the most profitable in the world."

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## Scandals in Australia's financial services sector

However, scandals across the Australian financial services sector over the last decade have caused significant reputational damage (see Exhibit 1). The scandals have impacted fundamental practices, products, advice, client dealings, regulatory compliance obligations, and other accountability, integrity and fairness provisions.

As a consequence of recurring scandals, the Australian Government recently announced a new Banking Executive Accountability Regime and this behaviour was the catalyst for a Royal Commission into the industry's conduct reported in 2019.

The Federal Treasurer commented<sup>iii</sup> that, "It's important for our economy and jobs that our banking system is strong, but it is also important that our banks are held to account and are fair."

### *Exhibit 1: Examples of Published Scandals before the Royal Commission*

- Insider trading
- Breaches of continuous disclosure
- Breaches of compliance standards
- Misconduct causing share price hike
- Sub-prime mortgage class action
- Mishandling of client money
- Fictitious trading entities
- Storm Financial class action
- Misleading product disclosures
- Misleading loan advertisements
- Bribery
- Theft
- Unethical practices
- Misleading and deceptive conduct
- Unauthorised trading
- Market manipulation
- Forging client signatures

The Royal Commission revealed further incidents.

## Raising the bar for internal audit performance

The 2015 common body of knowledge (CBOK) auditing survey of 14,518 respondents worldwide provided insights on the challenges associated with the elevation of internal audit within the financial services sector<sup>iv</sup>.

The financial services report reflected that, "Expectations of management, directors, regulators, and external auditors have raised the bar for internal audit performance. ... Internal

auditors in financial institutions often must go beyond what the Standards requires ...".

Audit staff satisfaction levels for certified auditors and professional IIA members have been found in some organisations to be well above the satisfaction ratings of non-certified auditors (see Exhibit 2). This has been attributed largely to their greater understanding and application of professional auditing standards.

### *Exhibit 2: Audit Staff Satisfaction Levels*

As a CAE, the author often conducted staff satisfaction surveys to gauge the mood of the team, recognising that internal audit staff are a critical stakeholder group<sup>v</sup> for any CAE.

Internal auditors with professional certifications and professional IIA membership consistently had a satisfaction level well above the others.

For instance, in the most recent survey, certified auditors (eg CIA, CFSA, CGAP, CISA) and professional IIA members delivered an overall satisfaction score of 95%, compared to 82% for non-certified auditors below the executive level (up from 90% and 80% from the prior survey).

*Note: Illustrative; not a published survey.*

## A view from the regulators

Internal auditors within Australia's financial services sector have an important role to play in ensuring their organisations have effective governance, accountability and fairness mechanisms in place.

The regulators have established well-determined foundations and expectations. For instance:

- The Basel Committee on Banking Supervision<sup>vi</sup> has principles covering internal audit functions in banks. Amongst these, it recognises the importance of professional competence and compliance with sound internal auditing standards.
- All APRA-regulated institutions are required to comply with the Prudential Standard CPS 510<sup>vii</sup> on Governance. Amongst others, an APRA-regulated institution must have an independent and adequately resourced internal audit function (unless they gain an exemption).
- These regulatory expectations are not new. Some years ago, the well-respected former APRA Chairman Dr John Laker observed<sup>viii</sup>, "It is in difficult situations ... the Institute of Internal Auditors comes to centre stage. Professional

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standards and support from the Institute can be a vital help in stiffening the spine of the internal auditors involved. On this score, we strongly commend the work of the Institute in Australia in improving the education and awareness of internal auditors and promoting the status of the internal audit function. That is work that, brick by brick, is helping to raise corporate governance standards in Australia, to the benefit of stakeholders and the community generally.”

APRA has demonstrated that it ‘walks the talk’ when it comes to compliance with internal auditing standards. In its 2015-16 annual report<sup>x</sup>, APRA reported on its assurance arrangements reflecting, in part, that “An external quality assessment, conducted by the Institute of Internal Auditors in February 2016, found that APRA’s Internal Audit function had achieved ... the highest possible rating.”

## Response to the Royal Commission

In February 2019, IIA-Australia Chief Executive Officer Peter Jones welcomed the wide-ranging recommendations in the final report by the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry. Mr Jones said it was important for all senior internal auditors subject to the Banking Executive Accountability Regime (BEAR) to be properly qualified and conform to the IPPF<sup>xiii</sup>.

## Quality imperatives

The 2015 CBOK survey included 2,543 responses from within the financial services sector worldwide. Of these, 72% indicated that they were compliant with standards, with a further 22% indicating partial compliance, and the remaining 6% being non-compliant. Overall compliance was reported as higher within the financial services sector than non-financial services respondents, and had improved incrementally since the prior CBOK survey in 2010.

Financial services respondents in 2015 indicated compliance with most of the individual standards with a compliance rate of over 80% for most of the individual standards. The exceptions being communicating the acceptance of risks (Standard 2600 – Communicating the Acceptance of Risks) at 77% and quality assurance and improvement (Standard 1300 – Quality Assurance and Improvement Program) at 65%.

Under Standard 1300, the CAE must develop and maintain

a Quality Assurance and Improvement Program (QAIP) that covers all aspects of the internal audit activity. This means that a QAIP is designed to enable an evaluation of the internal audit activity’s conformance with the definition of internal auditing and the Standards, and an evaluation of whether internal auditors apply the code of ethics. The program also assesses the efficiency and effectiveness of the internal audit activity and identifies opportunities for improvement.

A recent study established that 94% of stakeholders believe there is value for internal auditors to conform to the standards<sup>x</sup>. Despite widespread support for mandatory requirements, one-third of internal audit functions in the financial services sector do not conform with professional standards related to internal audit quality, including the key features (Exhibit 3). Firm action is needed by audit committees and CAEs to satisfy the compliance expectations of regulators and other stakeholders.

## Exhibit 3 – Key Features of a Quality Assurance and Improvement Program



## Auditor professional development

One of the CBOK reports<sup>xi</sup> released in 2016 noted, “To provide credible assistance and constructive challenge to management, internal auditors must be perceived as professionals. Professionalism requires conforming to a set of professional standards.”

The successful implementation of a QAIP relies on a formal link to continuous improvement and staff training activities. In turn, continued professional development is a shared responsibility between the employer and employee.

Another of the CBOK reports<sup>xii</sup> observed, “To be effective, CAEs must embrace continuous improvement and develop internal auditors that are insightful, proactive and future-focused. This starts with establishing a comprehensive workforce plan, which in turn leads to a professional development plan for each member of the internal audit function.” The three-pillar solution to filling competency gaps is illustrated in Exhibit 4.

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Exhibit 4 – Three pillar solution to filling competency gaps

Buy	Build	Retain
Recruit selectively to achieve a well-balanced audit team	Maintain a structured professional development plan	Nurture a professional learning environment

A critical success factor in nurturing a professional learning environment is to encourage and support internal audit staff to complete under-graduate and post-graduate studies, undertake certification programs (like CIA, CFSA, CGAP, CISA), and achieve professional membership of the IIA.

### Professional membership

Professional IIA Membership provides a measure of the individual internal auditor's competence, experience and commitment to implementing the IPPF internal audit standards and continuing professional education.

### Action Steps

What is your level or interest?		
Board or ARC Member	CAE or Audit Leader	Auditor
Direct the CAE to comply with professional auditing standards (through inclusion of a specific requirement in the Internal Audit Charter)	Ensure the Internal Audit Charter contains a provision to comply with professional auditing standards and reflect these in the Audit Manual	Understand the mandate and provisions of the Internal Audit Charter and how it affects your planning, fieldwork, reporting and evidence of quality assurance
Ensure the Quality Assurance and Improvement Program (QAIP) covers all aspects of the internal audit activity	Establish staff training and awareness processes to ensure audit staff fully comprehend and apply professional auditing standards	Gain a comprehensive understanding of the International Professional Practices Framework (IPPF) through self-study or attendance at a suitable training course
Review an annual internal QAIP Report from the CAE	Establish arrangements to monitor and implement changes to professional auditing standards	Become a member of IIA-Australia to maintain current IPPF knowledge and to derive further member value (see Exhibit 5)
Review the periodic External Quality Assessment Report (at least once every five years) and monitor implementation of recommendations	Establish a documented audit methodology that is consistent with the International Professional Practices Framework (IPPF)	Maintain contemporary internal auditing skillsets through ongoing professional development (which is a shared responsibility with employer)
Review an annual assertion statement on compliance with standards (see example on IIA-Australia website)	Monitor compliance with professional auditing standards and provide an annual assertion to the ARC that includes external service providers	Keep abreast of emerging risks, issues and practices through professional outreach activities (eg attend complimentary IIA webinars and member meetings)
Review at least annually both the Internal Audit Staff Profile and Professional Development Plan	Compile an Internal Audit Staff Profile and maintain a Professional Development Plan for audit staff	Consider achieving professional member status of IIA-Australia, complete a certification, or undertake the graduate certificate course

The IIA-Australia member retention rate of almost 90% is comparable to global professional association benchmarks, and is reflective of the value and benefits that members derive (see Exhibit 5). In a world of constant change, it is imperative for auditors to be connected and supported by a profession that continues to advance.

Exhibit 5: Member Value Proposition

The IIA-Australia Member Value Proposition is to:

- Connect internal auditors with other internal audit professionals.
- Support internal auditors' personal and professional development goals.
- Advance the profession and practice of internal auditing.

IIA membership represents an investment in an internal auditors ongoing professional development.

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## Conclusion

### Summary

Whilst Australia's financial services industry is strong by global standards, its reputation has suffered as a consequence of recurring scandals. Further regulatory changes are afoot. Stronger corporate governance arrangements are expected to benefit stakeholders and the community generally.

Internal auditors have a crucial role to play in strengthening corporate governance, within their mission of enhancing and protecting organisational value by providing risk-based and objective assurance, advice, and insight. They are well-positioned to do so, and have the support of regulators. And they are expected to be independent and credible advisors to the board, audit committee, chief executive, regulators, and the C-suite.

### Conclusion

Compliance with professional internal auditing standards, appropriately validated by quality assurance arrangements, helps to establish the credibility of internal audit.

In some financial services entities, internal auditors need to strengthen their foundations for professionalism by demonstrating their conformance to professional internal auditing standards. One area in particular is the need to maintain quality assurance and improvement standards to an acceptable level. This relies on a formal link to continuous improvement and staff training activities.

Nurturing a professional learning environment involves, in part, encouraging and supporting internal audit staff to complete internal auditing studies, undertake auditor certification programs, and achieve professional membership of the IIA.

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## Purpose of White Papers

A White Paper is an authoritative report or guide that informs readers concisely about a complex issue and presents the issuing body's philosophy on the matter. It is meant to help readers understand an issue, solve a problem, or make a decision.

## Author's Biography

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Bruce has been a member of the IIA since 1984 and was an IIA-Australia Board Director from 2012 to 2018. He spent nearly 30 years within the financial services sector, which included extensive internal auditing responsibilities in Australia, United States and United Kingdom spanning commercial banking, merchant banking and central banking. He ultimately held CAE roles at the State Rail Authority of NSW, Integral Energy Australia, and the Australian Taxation Office. He is currently a company director and audit committee chairman and independent member.

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## About the Institute of Internal Auditors–Australia

The Institute of Internal Auditors (IIA) is the global professional association for Internal Auditors, with global headquarters in the USA and affiliated Institutes and Chapters throughout the world including Australia.

As the chief advocate of the Internal Audit profession, the IIA serves as the profession's international standard-setter, sole provider of globally accepted internal auditing certifications, and principal researcher and educator.

The IIA sets the bar for Internal Audit integrity and professionalism around the world with its 'International Professional Practices Framework' (IPPF), a collection of guidance that includes the 'International Standards for the Professional Practice of Internal Auditing' and the 'Code of Ethics'.

IIA–Australia ensures its members and the profession as a whole are well-represented with decision-makers and influencers, and is extensively represented on a number of global committees and prominent working groups in Australia and internationally.

The IIA was established in 1941 and now has more than 200,000 members from 190 countries with hundreds of local

area Chapters. Generally, members work in internal auditing, risk management, governance, internal control, information technology audit, education, and security.

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