INTERNAL GOVERNANCE AND ROLE OF INTERNAL AUDIT IN FINANCIAL INSTITUTIONS. CASE STUDY: RISK BASED PLANNING

Florin Andrei
Academy of Economic Studies (Department of Money and Banking, Faculty of Finances, Insurance, Banking and Stock Exchange), Bucharest, Romania
fl.andrei@yahoo.com

Abstract: *The global financial crisis from 2008 was considered a trigger to reshape the financial systems and to enhance the risk management practices. Considering the developments and new guidelines that are now used it can be observed a "positive" effect of the crisis, in particular to strengthen the risk management culture and governance in all aspects. Comparing to 2008 year, the improvements that have been made to the risk management systems can be easily observed in the financial institutions.*
For the scope of the article, the subject of this review will be focused on the internal audit function. The main aspect is to capture the new practices that are now used in order to contribute to a performing internal governance system. A case study will be presented in order to better understand how the internal audit function is designed and acting as a "line" of defence in the internal governance system. Also, it is in the scope of the article to issue some recommendations for future developments of the audit function in order to better manage its mission and the objectives. A risk based model used in the planning activities is presented.
The financial institutions improved significantly their internal governance system. The internal audit function is now better integrated in the internal structures and clear lines of communication were settled.
As the conclusion of the article is illustrating, the internal governance was frequently not sufficiently developed causing a failure in the risk management systems from the systemically financial institutions.
The content of the article has practical applicability, as the results and the recommendations could be used in the design of an audit function within a financial institution.

Keywords: governance; audit; crisis; institutions; systemic; planning.

JEL classification: M42 – Auditing.

1. Introduction

The article aims to issue some recommendations for future developments of the audit function in order to better manage its mission and the objectives.
The paper addresses two main issues: the issuance of the new guidelines and their implementation in order to assure a better governance system and some future proposals that can have a practical applicability in audit planning.
Considering the evolution of the risk management systems after the financial crisis, it was observed an increased importance of the internal governance. The new regulations and guidelines issued by the Basel Committee and European Banking Authority addressed the internal governance as one of the main causes of the financial crisis. The risk management systems implemented within the internal governance represent now an important subject for the financial institutions. Also, this is one of the hot topics on the agenda of the supervisors.
Internal Audit, as part of the internal control system and governance of the institutions/companies is now having an increased role within the organization. New

concepts and lines of defense were defined and implemented within the organizations in order to assure a better risk mitigation and a strong risk management system.

2. Governance, methodologies and concepts

The internal governance is defined and requested according to the article 22 of the Directive 2006/48/EC which states that "every credit institution has robust governance arrangements, which include a clear organisational structure with well defined, transparent and consistent lines of responsibility, effective processes to identify, manage, monitor and report the risks it is or might be exposed to, adequate internal control mechanisms, including sound administrative and accounting procedures, and remuneration policies and practices that are consistent with and promote sound and effective risk management"(Article 22 of the Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions, Bruxelles, June 14th, 2006.).

Internal governance is important for an institution (even is a financial, or non-financial one) considering the fact that is a key element of the good performance.

Lehman Brothers collapse which marked the beginning of the financial crisis was the starting point in enhanced supervision from the national/international supervisors. A series of new guidelines were issued with the main scope of efficient and effective internal governance. As example, Basel Committee for Banking Supervision issued on October 4th, 2010 the paper "Principles for enhancing corporate governance". The main objective was to correct the weakness that resulted in an inefficient internal governance system. Even if the internal governance in-efficiency was not the main cause of the financial crisis, definitely is one of the triggers.

The financial crisis inquiry report mentioned as a conclusion that "dramatic failures of corporate governance and risk management at many systemically important financial institutions were a key cause of this crisis. (Financial crisis inquiry report, submitted by The Financial Crisis Inquiry Commission, US Government, January 2011, Washington, DC.)"

Speaking about internal governance and internal audit it is to be mentioned the connection between these two concepts, the internal control system. A strong internal control system which includes an independent and efficient internal audit function, contributes to efficient and reliable internal governance.

Internal control system, as defined by European Banking Authority, "should ensure effective and efficient operations, adequate control of risks, prudent conduct of business, reliability of financial and non-financial information reported, both internally and externally, and compliance with laws, regulations, supervisory requirements and the institutions internal rules and decisions. The internal control framework should cover the whole organisation, including the activities of all business, support and control units (Article 24, Para. 2, Section 3, Title 2, of the EBA Guidelines on Internal Governance, GL 44, London, September 27th, 2011.)"

Considering the above mentioned definition, an integrated internal control system, must be sound documented, transposed and implemented in a clear way and made available and known to all parties involved.

3. Three lines of defense model – a new approach

A new concept was defined by the International organizations and implemented by the financial and non-financial institutions, three lines of defense model. The main provision of the new model is related to a segregation of responsibilities between the control functions. Institute of Internal Auditors (IIA) mentions that "the Three Lines of Defense model provides a simple and effective way to enhance communications on risk management and control by clarifying essential roles and duties. It provides a fresh look at operations, helping to assure the ongoing success of risk management initiatives, and it is appropriate for any organization — regardless of size or complexity (Institute of Internal Auditors,

Position Paper issued on January 2013, Global Headquarters 247 Maitland Avenue Altamonte Springs, Florida 32701 USA.)."
The main control functions identified in a financial institution are the following:

- First line of control is generally represented by the business and support units (e.g. Branches from a Bank, Operations functions from a Bank that acts to support the Branch personnel in the daily activities);
- Second line of control is represented by the control functions established within an institution. Such functions are represented by Risk Control function, Security function, Compliance function, Risk Management, Financial Control and Quality;
- Third line of defense is represented by Internal Audit function which has the role to verify all the other control functions and to give assurance over the internal control system in place. Thus the internal control system should be both, effective and efficient.

A diagram of the three lines of defense model is presented below:

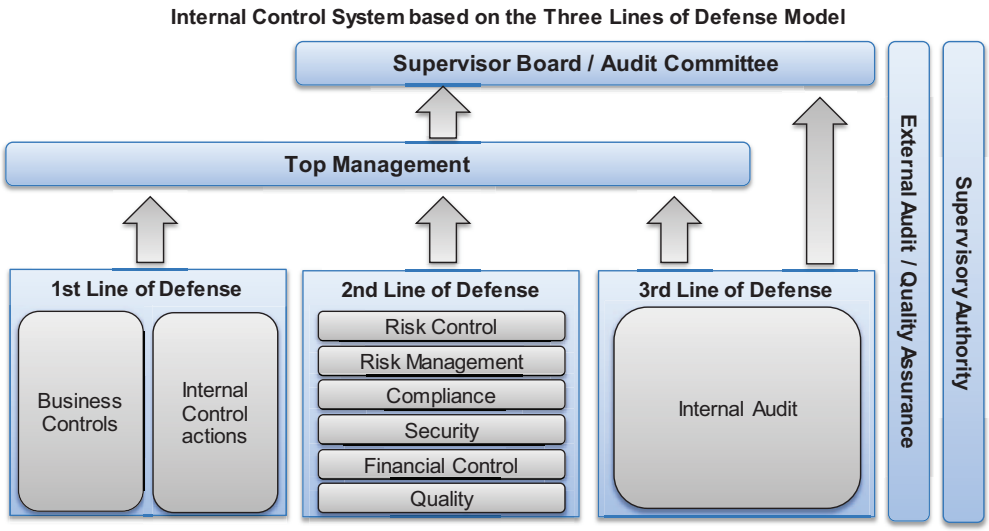

Figure1: diagram of the three lines of defense model.
Source: Adapted from Institute of Internal Auditors, Position Paper issued on January 2013, Global Headquarters 247 Maitland Avenue Altamonte Springs, Florida 32701 USA.

The interaction of the second and third level control functions with the Management of the institution is ensured through different reporting lines. The control functions should inform the Management bodies about any deficiencies identified related to the internal control system and also about the causes and the risks incurred also including, if the case, a dedicated analysis. Recommendations and follow-up actions should also be taken into consideration for the deficiencies presented.
In line with the definition issued by the Institute of Internal Auditors, „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 (Institute of Internal Auditors official

website, http://www.theiia.org/guidance/standards-and-guidance/ippf/definition-of-internal-auditing/).”

As, previously mentioned, a strong internal control system is based on an efficient internal audit function. Generally speaking, the role of the audit function is to provide assurance to the Top Management and Supervisory Board. The main concern is to check the quality of the control system, risk management and governance systems and processes by helping to reduce the risk of losses and possible reputational impacts.

Internal audit function is responsible to evaluate the following:

- Compliance with regulations and laws, as well as supervisory/group requirements;
- Management information systems and processes reliability, effectiveness and integrity;
- Efficiency and effectiveness of the whole internal control system as designed by the institution, as well as the risk management and governance system.

4. Case study: Risk model used in audit planning activities.

The internal audit function uses risk assessments in their work planning as to identify the areas and processes that should be evaluated. In this way the riskier areas are assessed more often.

In the following lines is presented a risk based model used in the planning activities in internal auditing. The scope of the model is to identify the bank’s branches that should be audited in the following year using a risk based approach sustained by risk indicators. As a summary, the four phases relevant in the risk assessment are detailed as follows:

- Phase 1: Identification of processes relevant for branches in accordance with the annual risk assessment;
- Phase 2: Identification and evaluation for the relevant processes of their inherent risk;
- Phase 3: Assembly of existing risk indicators for the processes relevant for branches. In this phase the indicators that measure the key risks will be selected in order to measure the branches risk assessment.
- Risk indicators are allocated only to processes rated with high or very high inherent risk. For medium and low risk rated processes, risk indicators are not required, but where considered relevant it can be taken into consideration.
- Phase 4: Calculation and presentation the selected indicators in a panel as to analyze the risky areas from the branches and to make a prioritization of the audits.

For each risk indicator a target level was set (e.g. Average of the values registered, thresholds) based on the professional judgment. The deviation from the average or the threshold exceeded was considered as a trigger in order to identify the risky areas from each Branch. All deviations/overruns will assigned a number of strike points (judgmental determined) in order to reflect the risk associated. Having the result of the strike points assigned, the branches are ranked per decreasing audit need. The below table is presenting examples of risk indicators and their evaluation in the risk assessment process.

Table 1: Risk indicators and their evaluation

Process	Inherent risk	Risk indicator relevant for Risk Assessment	Calculation method	Period under review
Credit Portfolio	Very High	Increase of portfolio in the Branch	Threshold exceeded / 3 point assigned	Previous two years
Management of Credit Risk	High	Default rate	Average deviation / 1 strike point assigned	Previous two years
Management of Operational Risk	High	Number of operational risk	Average deviation / 1 strike point	Previous two years

Process	Inherent risk	Risk indicator relevant for Risk Assessment	Calculation method	Period under review
		events registered	assigned	
Anti-money Laundering	High	Number of suspicious transactions reported	Threshold exceeded / 2 points assigned	Previous two years
Fraud Management	High	Number of fraud cases reported	Threshold exceeded / 2 points assigned	Previous two years
Payment transactions	Very High	Number of payments performed	Threshold exceeded / 1 point assigned	Previous two years
Human resources	High	Personnel turnover rate	Threshold exceeded / 2 point assigned	Previous two years

Source: Authors performance

The audit need was established taking into consideration the following three factors:

- Risk assessment: the ranking of the branches will be made in accordance with points assigned for each branch from the risk indicator assessment;
- Five years audit cycle: will take into account the date of the last audit performed as to cover the audit cycle.

Within this exercise it was presented a risk based approach in audit planning when selecting the branches from a Bank. This model can have practical application as it can be used by the audit functions to identify their audit units that must be audited.

5. Conclusion

As the studies presented in the article are mentioning, the internal governance was not sufficiently developed causing a failure in the risk management system implemented in the financial institutions.

After the financial crisis, the financial institutions improved significantly their governance system, generally as a requirement from the Supervisors. The internal control system was re-designed and the control functions are now sufficiently integrated within the institution governance framework. Internal audit, as a third level control function must permanently cooperate with first and second level of control and to check the quality of the control system, risk management and governance systems and processes by helping to reduce the risk of losses and possible reputational impacts. Generally speaking, Internal Audit gives assurance to Top Management and Board of Supervision about the key processes and risks.

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