

Secretariat of the Basel Committee on Banking Supervision

28 February, 2012

Bank for International Settlements

CH-4002 Basel, Switzerland

Subject: Comment letter on: The internal audit function in banks – consultative document

To: Members of the Accounting Task Force's Audit Subgroup of the Basel Committee on Banking Supervision

Thank you for the opportunity to comment on your consultative document, "The internal audit function in banks." I share your view that an effective internal audit function is a critical element of the governance activities of a bank and commend the task force for its efforts in updating this guidance.

By way of introduction, I am a retired partner of PricewaterhouseCoopers LLP ("PwC") and was formerly the chief auditor and head of credit review at a global bank. With PwC, I formed and led the Internal Audit Services Advisory practice, which focused at consulting with and reviewing internal audit functions. In that context, I personally led internal audit reviews and consulting engagements at global banks in the US, UK, Europe, Australia and Asia. I am currently a trustee of the Institute of Internal Auditors ("IIA") Research Foundation and was the 2011 recipient of the IIA's Bradford Cadmus Memorial Award.

I strongly support the consultative document and find it very thoughtful and robust. I continue to support the approach of the document in laying out principles relating to supervisory expectations for internal auditing. I believe these have and will continue to provide a useful framework for internal auditors, bank supervisors and directors.

I respectfully offer my comments on the consultative document related to one critical topic; the attributes of the head of internal audit. In a number of places in the text, the consultative document mentions the head of internal audit. In particular I note the narrative under Principle 2, which indicates, "The head of internal audit should demonstrate appropriate leadership and have the necessary skills to fulfill his or her responsibilities for maintaining the function's independence and objectivity." I also note Principles 3 and 4, which also discuss important qualifications for internal auditors. While I am in full agreement with those comments, I believe that the consultative document should further stress and discuss the head of internal audit and the attributes expected from a person in that role. Based on my direct, personal experience, I believe the importance of the attributes of the head of internal audit are

so significant to the overall effectiveness of the internal audit function, that they rise to the level of a principle and should be considered as such.

During my tenure with PwC, I had the opportunity to be involved personally with over 200 internal audit functions. One of my observations has been that the quality and effectiveness of an internal audit function starts with the quality and effectiveness of the head of internal audit. In fact, I would conclude that having a high quality, effective head of internal audit is a pre-condition to having an effective internal audit function. I cannot remember encountering an internal audit function in any industry that we would have considered “high quality,” “highly effective,” “strong” or any other reflection of the highest quality that did not have a head of internal audit who also exhibited very strong personal attributes. Conversely, I also encountered internal audit functions, including at large banks, which had high quality staff and robust internal procedures and policies but a weak head of internal audit. By “weak” I mean situations where, for example, the head of internal audit did not display appropriate judgment or was not willing to make tough calls or who had alienated themselves or could not communicate and work effectively with senior management. None of those internal audit functions, in the end, would have met anyone’s definition of being high quality or very effective.

I would also observe that in situations where an organization had a weak or ineffective head of internal audit, rarely, if ever, was the issue that the individual lacked appropriate technical skills. Rather, the problems revolved around personal attributes such as judgment, stature or the courage to make tough calls on audit issues.

Further, I agree strongly that oversight of the internal audit function and the head of internal audit are critical roles for the board or audit committee. In that regard, as outlined in the consultative document, their involvement in assessing the qualifications and performance of the head of internal audit is a significant activity. To assist both management and the audit committee in these assessments, it would be useful for the consultative document to describe the key attributes needed for an effective head of internal audit.

Similarly, the supervisory assessment of an internal audit function, as described in the consultative document, must consider the effectiveness of the head of internal audit. I believe this assessment could also benefit from the consultative document including more detail and focus on the importance and attributes of the head of internal audit.

Accordingly, I would suggest that the Audit Subgroup consider the possibility that the importance of the skills and attributes of the individual who is the head of internal audit may be at the level of a separate principle. This principle could be reflected by wording such as the following:

“The head of internal audit should possess the qualifications and personal attributes necessary to effectively discharge his or hers responsibilities as specified in the internal audit charter.”

By stating this as a separate principle, the Audit Subgroup could then describe and discuss in the consultative document, the critical attributes that should be evident in an effective head of internal audit. I offer examples of some key attributes for the head of internal audit that the Audit Subgroup

could consider, based on an article (attached) that I co-authored with Dr. Larry Rittenberg. These key attributes are;

- Stature and presence
- A strategic audit focus
- The ability to exercise sound judgment and communicate clearly on audit issues
- The development of human resources
- Management of technical audit activities
- An understanding of the organization's strategies and risks

Key aspects of each of these attributes are discussed briefly in an exhibit at the end of the article and I have not therefore repeated them in this comment letter. I do not present these examples as the only key attributes that the Audit Subgroup could consider but they do reflect attributes that Dr. Rittenberg and I both believe are critical for a head of internal audit. I would also emphasize that personal attributes such as those detailed above are critical for the head of internal audit to possess to then be in a position to operate an effective internal audit function.

In summary, I believe it would be helpful for all interested parties, including internal auditors, banking supervisors, management and directors, to have this topic highlighted in the consultative document including;

- 1) raising the qualifications and attributes of the head of internal audit to the level of a principle, and,
- 2) adding appropriate supporting discussions and descriptions of critical attributes for a head of internal audit to the consultative document.

I believe highlighting the critical attributes of a head of internal audit is sufficiently critical to deserve consideration by the Audit Subgroup.

Respectfully submitted;

A handwritten signature in black ink that reads "Richard J. Anderson". The signature is fluid and cursive, with the first and last names being more prominent.

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One attachment

A Strategic Player

*Reprinted with permission from
Journal of Accountancy, July 2006*

Hiring and inspiring a chief audit executive

by Larry E. Rittenberg and Richard J. Anderson

Executive Summary

- Many companies are raising the expectations for their chief audit executives (CAEs) to include operating at more strategic levels of risk management and corporate governance. Successful CAEs must partner effectively with the audit committee and other members of the senior management team to achieve their objectives.
- To be effective, CAEs need to demonstrate a solid understanding of the company's business, core strategies, risk appetite and risk tolerance. CAEs must be willing to raise difficult issues with senior management and the audit committee—even if such actions prove unpopular.
- The CAE should maintain an ongoing dialogue with the audit committee. This will build a relationship and help the committee stay on top of significant risk and control issues.
- One of the chief attributes of an effective CAE is the ability to attract and develop talent and build a high-quality staff. In many organizations internal audit is a source of management talent for other departments.

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Internal audit traditionally has been a behind-the-scenes player, helping audit committees perform their duties and serving as a management watchdog. But today it plays a vital role in efforts to improve corporate governance and internal controls. To fulfill this role, the chief audit executive (CAE) needs to provide assertive leadership that strengthens the organization's commitment to tough internal controls. CAEs must partner with senior management and the audit committee to help them fulfill their broad responsibilities for effective governance, risk management and control. This article offers a broad view of the skills and qualifications CAEs need and information that management and audit committees will find useful when filling this critical position.

Audit committees, whose governance responsibilities have expanded significantly since the Sarbanes-Oxley Act, are turning to internal audit for strategic and tactical support. The same is true for senior management. PCAOB Auditing Standard no. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with An Audit of Financial Statements*, has sharpened the focus on the internal audit function and its ability to help senior management, audit committees and external auditors achieve their reporting objectives. At the same time, internal audit cannot sacrifice its long-standing role in promoting risk management and using operational audits to improve organizational efficiency.

CAE Technical Qualifications

In addition to executive-level interpersonal skills and solid business judgment, most companies are looking for these qualifications in a CAE candidate:

- At least 10 years of relevant management experience with an accounting firm and/or a similarly sized company.
- CPA and/or CIA designation.
- Strong technical accounting and auditing skills.
- Internal audit expertise.
- Knowledge of Sarbanes-Oxley and PCAOB, FASB and SEC pronouncements.
- Deep understanding of the industry and related business risks.
- Track record of leadership and ability to stand behind tough decisions.

The Ideal Candidate

When hiring a CAE, companies should look for someone who combines strong management and leadership skills with solid technical expertise. This ideal candidate is more than just a technical auditor. When looking for a new audit chief—or evaluating the performance of an existing one—the audit committee and senior management should focus on three critical qualifications:

The candidate's ability to earn the respect of the audit committee and senior management. Because internal auditors must be comfortable operating at a strategic level, a CAE must be perceived as a trusted adviser to both the audit committee and senior management. However, because internal control goes beyond financial reporting, operational managers need to accept internal audit as leaders in addressing risk and governance in a way that goes beyond mere policing and testing of internal controls. Sample questions to ask a candidate: In what kind of situations have you advised management or the audit committee on a strategic issue? How would you reconcile the sometimes divergent roles of auditor and adviser? What activities would you initiate to position yourself as an adviser to the audit committee?

The range of skills, including personal independence and objectivity. An effective CAE needs to demonstrate a solid understanding of the company's business, core strategies, risk appetite and risk tolerances. He or she must be able to exercise sound business judgment and partner effectively with senior management while at the same time remaining both independent and objective. The need for independence and objectivity is fundamental. CAEs must be willing to raise difficult issues with both senior management and the audit committee, even if that proves unpopular. To gain management respect, CAEs must make tough calls and stand by them. However, CAEs who describe all issues as *significant* will quickly lose support.

While auditing often is correctly viewed as a technical function, the softer audit skills are equally critical. Interpersonal skills are particularly important in building effective working relationships with management and the audit committee. CAEs must be able to think strategically about the internal audit function, its mission and its strategic resources, including attracting highly qualified staff. CAEs must have a vision for the internal audit function that accepts change as part of an ongoing process throughout the organization. Staffing must mirror the critical issues the organization faces and often requires sophisticated and knowledgeable audit staffs to address the company's risks effectively.

One of the chief attributes of effective CAEs is the ability to attract and develop talent and to build a high-quality staff whose members can work effectively in teams. In many organizations internal audit also serves as a source of management talent for other departments. To help the CAE perform this sourcing role, it's important to make it clear he or she functions as a member of top management. Sample questions to ask a candidate: What is internal audit's role in an organization? Can you describe a situation where you raised a critical issue to management and how you handled it? How would you partner with management while maintaining your independence and objectivity? What approach would you take to attract and develop high-quality staff?

The right focus. The strategic CAE also must take the lead in advising the audit committee on emerging risk and control issues. In recent years two key factors—the passage of Sarbanes-Oxley and the implementation of reform legislation—have focused audit committee attention on financial risks. However companies face many additional risks and audit committees are becoming more sensitive to enterprise-wide risk. As a result, internal audit must look more broadly at risk to help the audit committee understand the risk-monitoring and mitigation activities the company already has in place and the effectiveness of its overall risk management processes. Sample questions to ask a candidate: How would you assess the risks the organization faces? Are you familiar with the COSO enterprise risk management framework and how would you apply it? How would you use technology to enhance your ability to monitor risks? How will you help the audit committee be aware of emerging risks?

In part, the CAE's role is a balancing act: He or she must simultaneously serve as the eyes and ears of the audit committee as well as be a member of and partner to executive management. To serve both parties effectively, CAEs must be seen as business partners rather than “corporate cops.” To be an effective extension of the audit committee, CAEs need to maintain an open and objective view of management, be seen by it as fair and respect the opinions expressed. On the corporate side, CAEs need to gain the respect and confidence of executive and operational management as a prerequisite to being viewed internally as a member of senior management and being included in meetings that address risk and strategy across the organization.

AICPA Resource

AICPA Audit Committee Toolkit

Guidelines for Hiring the Chief Audit Executive (CAE)

www.aicpa.org/audcommctr/toolkitsnpo/Hiring_CAЕ.htm.

Additional Things to Consider

Here are some key questions to which management and audit committees need to get satisfactory answers when considering CAE candidates who can help the internal audit group adopt a more proactive role in risk management and governance. In candidate interviews and in discussions with their references, companies should use probing questions to develop an understanding of whether the candidates have:

- The presence and experience to fit into the management ranks at the appropriate level.
- The knowledge and business sense required to serve as a trusted adviser to both senior management and the audit committee.
- A track record of sound judgment and decision making.
- A sufficient understanding of the business and its risks to ensure the audit process is properly focused and responsive to risk.
- The personal strength and confidence to stand up to and earn the respect of senior management.

Once on Board

After an organization has hired a high-caliber CAE, the audit committee and top management can do much to enhance his or her stature and effectiveness. Supportive steps for the audit committee chair, in particular, to consider are:

- *Maintaining ongoing access and dialogue with the CAE outside audit committee meetings.* Such communication strengthens the bond between the audit chair and the CAE and helps the committee stay on top of significant risk and control issues.
- *Asking senior management to attend an audit committee meeting to address issues the CAE raises.* Such a request reinforces the significance of the issues and emphasizes that responsibility for resolving the issues lies with management, not the CAE.
- *Including the CAE in appropriate committee activities, such as training.* In some organizations, audit committee members and the CAE attend joint training and conferences to identify new practices or approaches and to strengthen working relationships.
- *Periodically meeting with the CAE's direct reports or the entire audit department.* Such meetings give internal audit staffers first-hand exposure to audit-committee concerns and give audit committee members a better appreciation of staff quality.
- *Holding executive sessions with the CAE.* Such interchange ensures an open exchange of views on issues and risks identified by the CAE and management's response.

Adopting a Strategic Mind-Set

Once a company has a CAE in place, it's time for the CAE and the audit committee to make sure internal audit has adopted a strategic, high-level mind-set as opposed to a tactical orientation that focuses on basic transactional or compliance issues. To assure this is happening, there are some key questions the audit committee should ask, including

- Does internal audit's risk assessment include the significant risks the company faces and is the audit plan directly linked to those risks?
- Does management view the issues internal audit is raising as significant and give them proper attention?
- Is the CAE conversant and involved with the company's developing business issues and initiatives?
- Does the CAE understand our business, its strategies, our expectations and those of senior management, so internal audit can respond effectively?
- Is the audit plan sufficiently responsive to emerging risks and changes in the organization's risk profile?
- Are the company's internal audit activities being conducted in accordance with the Institute of Internal Auditor's International Standards for the Professional Practice of Internal Audit?

If the answer to any of these questions is "no," the CAE, the audit committee chair and top management should meet to make sure all parties understand what the company expects and come to an agreement on a strategy for meeting these expectations.

Practical Tips

- Make sure the CAE candidate you hire fits into the management ranks at the appropriate senior level and has the necessary high-level knowledge to be a trusted adviser to both senior management and the audit committee.
- Maintain ongoing communications with the CAE, including activities outside normal meeting such as joint training sessions with audit committee members.
- Have the audit committee meet regularly with the CAE's direct reports and hold executive sessions with the CAE to ensure an open assessment of issues and risks.

The Right Person for the Job

Audit committees and senior management can optimize the value a company gets from internal audit by putting a well-qualified CAE at the helm. Recent regulatory changes have focused some internal audit functions on narrower compliance-oriented activities, endangering their ability to contribute to effective governance and risk management. Organizations must make sure they have a clear, strategic vision of internal audit and a CAE with the right skills and stature to implement that vision. They need to consider a CAE's qualifications carefully, paying particular attention to skills beyond just technical ones. The organization also must evaluate the effectiveness of the CAE and the audit function in a manner consistent with its strategic expectations. The exhibit below provides an example of a framework companies can use as a starting point to develop their own expectations.

Exhibit: Key Performance Criteria for CAEs

The audit committee and executive management should make certain they have a common view of the criteria for evaluating the CAE's performance. While each company's list will be customized, here are some key areas to consider in developing a framework.

Stature and presence

The CAE must have the professional presence and stature to function as a trusted adviser. The CAE should develop and maintain strong relationships internally with executive and senior management, and externally with the audit committee, board, regulators and external auditors. The CAE must maintain continuous and proactive communication with all key constituents while keeping an appropriate level of objectivity and independence. The CAE also must have the personal strength to make tough calls and stick by them.

Strategic audit focus

The CAE should develop a vision for a strategic internal audit process, addressing the key business strategies and risks to the organization. Strategies should align the audit coverage with risks, including identifying and reacting to emerging risks and issues. The CAE should have a strong knowledge of industry/peer audit practices. The CAE must be capable of operating and viewing issues at a strategic level.

Ability to exercise sound judgment and communicate clearly on audit issues

The CAE should exercise sound business judgment, prioritize issues and make sure they are handled at the appropriate level. The CAE should raise and communicate in a timely and clear manner significant issues to the audit committee and management with

recommendations as to which deserve their immediate attention. The CAE should maintain an appropriate process to ensure the company takes corrective actions in a timely manner.

Development of human resources

The CAE should attract and develop talent for the internal audit function and the organization as a whole, and create an environment in which internal audit is viewed as a desirable assignment for the long term. Internal audit's activities should be aligned with the organization's overall human resources strategies to optimize the employees' experiences. The environment also should foster a culture that enables the internal audit function to fulfill its role and add value to the organization.

Management of technical auditing activities

The CAE should ensure the company's audit plan and other critical audit initiatives are being conducted in accordance with applicable professional standards and reflect current business risks and audit requirements as well as emerging industry trends. For critical transactions and initiatives, the CAE should ensure the financials properly reflect the economic substance of the activity. The CAE should ensure the internal audit function has access to appropriate resources and technical skills to execute its mandate.

Understanding of the organization's strategy

The CAE should make sure the organization understands and addresses its risks. Sometimes the biggest risk is the failure to innovate. A CAE must understand the organization's strategy, how it will measure performance in following those strategies and how to overcome any roadblocks.