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## **Internal Audit Proactiveness**

**Filling the Gaps for First & Second Line of Defense  
Presentation to ACAEBIN**

March 2023



# Outline

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Internal Audit Area of Focus in Financial Institutions

Current State of the three lines of defense (3LOD) framework

Challenges faced with the Three Lines of Defense (3LOD) Model

The Road Ahead

Internal Audit of the Future

Future State and Opportunities for Internal Audit



# Introduction

## Internal Audit Proactiveness: Filling the Gaps for First & Second Line of Defense

We have moved beyond “change is the only constant” to “an environment of ongoing disruption”.

*For business...*

**Purpose has become increasingly important**

**Learning at speed is essential**

**Stakeholders need more insight to navigate complexity**

*For Internal Audit...*

**Traditional ways of working lack relevance in today's world**

**Big bang transformations tend not to work**

**Haphazard analytics efforts undermine overall progress**

# Internal Audit Areas of Focus in Financial Institutions



Financial institutions, given their business and regulatory environments, tend to have well defined roles and responsibilities across the three lines of defence. However, the proliferation of risks and the increasing severity of risk events demands a rigorous approach to defining roles and responsibilities in the end-to-end risk management process.

Internal Audit is ideally positioned to lead this approach and to **advise the first- and second-lines regarding roles, responsibilities, priorities, and methods**

# Internal Audit Areas of Focus in Financial Institutions

Different groups within organizations play a distinct role within the 3LOD, from business units to compliance, audit, and other risk management personnel.

- ❑ Management (process owners) is the first line, with primary responsibility to own and manage risks associated with day-to-day operational activities. Other accountabilities assumed by the first line include design, operation, and implementation of controls.
- ❑ The second-line function enables this by providing compliance and oversight in the form of frameworks, policies, tools, and techniques to support risk and compliance management.
- ❑ The third-line function provides objective and independent assurance.

## The changing face of assurance and compliance monitoring

### Second and third line functions are immature in their role, remit, and capability

These organizations often have:

- 3LOD** Insufficient, independent, and objective assurance
- 2LOD** Immature second line oversight functions
- 1LOD** An over reliance placed on management

### Management place too much reliance on the third line of defense

Leading to an organization where:

- 3LOD** The last line of defense is the 'primary' source of assurance
- 2LOD** Second line functions are lacking effective compliance monitoring
- 1LOD** Management lacks ownership for risk and controls; 3LOD seen as the compliance function

### Assurance activities are not integrated

Leading to an organization where:

- 3LOD** Assurance efforts are duplicated
- 2LOD** The business is overly disrupted from uncoordinated assurance activities and siloed
- 1LOD** Value is left of the table; potential efficiencies and strategic approaches to digital, integrated assurance models are fragmented

# Current State Challenges on the Three Lines of Defense (3LOD) Model



Regardless of how mature and integrated the 3LOD model is within organizations, there are a few challenges that limit its effectiveness:

01

**Early-stage adoption** – In the early stages of the 3LOD framework, management does not have a strong awareness or ownership of risk and controls. There may be a risk function in place, but often its role is to facilitate the identification and monitoring of risks without insight or challenge by IA. Depending on the industry and sector, regulatory compliance risks are absorbed into both risk and IA functions, with specialist teams existing in pockets or one-off “silos” not seen as assurance functions nor well integrated within a broader risk management program

02

**Established lines of defense** – As the 3LOD becomes established, the focus on stakeholder management, developing internal capabilities, and delivering the assurance activities in the second-line functions often creates a silo mentality, leading to a lack of coordination, duplication of risk areas, gaps, and misaligned or conflicting assurance opinions. Where these positions become entrenched, the third line is often perceived as combative, reactionary, and retrospective in its approach.

03

**Maturing lines of defense** – In the face of increasing regulatory pressure, as well as businesses recognizing the opportunity to become more efficient and effective, we are seeing the strengthening of all three lines of defense, being driven from the board focus on emerging risks and core control disciplines.

# Current State Challenges on the Three Lines of Defense (3LOD) Model

## Maturing lines of defense

An example of this is in the United Kingdom, where financial services regulators are increasing the personal accountability of Senior Managers (including executive and nonexecutive directors) over the control environment. The result has been felt across all 3LOD as seen below:

- ❑ **The first line taking** an active role in the management of risk for its area; some are starting to embed first-line monitoring of controls (in larger institutions, this has led to first-line assurance teams).
- ❑ **Risk functions** are increasingly forward-looking in their assessments of emerging risks, scanning the horizon, using key risk indicators to highlight potential control failures and working with management to improve the design of controls.
- ❑ In addition to advising management on new regulatory risks and designing corresponding policies, compliance functions are undertaking increased regulatory monitoring reviews, which include regulatory controls testing. This is aligned with Deloitte's point of view, where the first and second lines take on greater ownership of their responsibilities as part of “**assurance by design**” and “automated core assurance.”
- ❑ This has left **IA functions** undertaking risk-based assurance reviews over the same risk areas as the second line, increasingly with a very similar assurance skill set, leading to a duplication of assurance activities between the 3LOD.

While these actionable and strategic steps are oriented towards an evolution in the 3LOD, there have been several negative side effects for more mature 3LOD models.

The first line can have audit fatigue due to duplicative testing from both second and third lines, resulting in less time to focus on the business at hand. There are also cases where the over-fitting or over-strengthening of the second line has resulted in issues because the first line stops performing activities, believing they have responsibility of the second line.

In times of crisis, many organizations fall into the trap of overreaction, whereby additional activities are added to the portfolio for the second and third lines. In such situations, the third line is best positioned to help their organizations avoid knee-jerk reactions and help draft a measured response that is risk-focused, pragmatic, and practical.



# The Road Ahead: What can CAEs and their organizations do in response to these challenges?



IA should focus its efforts on *shifting ownership of certain elements of risk management to the first and second lines* through *education and awareness-building*, highlighting the value and efficiencies that can be achieved.



By *leveraging digital assets and innovative methods*, IA and risk management could automate processes previously covered manually, or not covered at all by the IA plan.



IA should *increase its participation in coordinating and designing processes* that could help management and the *second line take ownership of these activities*, while addressing business risks and minimizing the audit fatigue due to the efforts of second and third line.



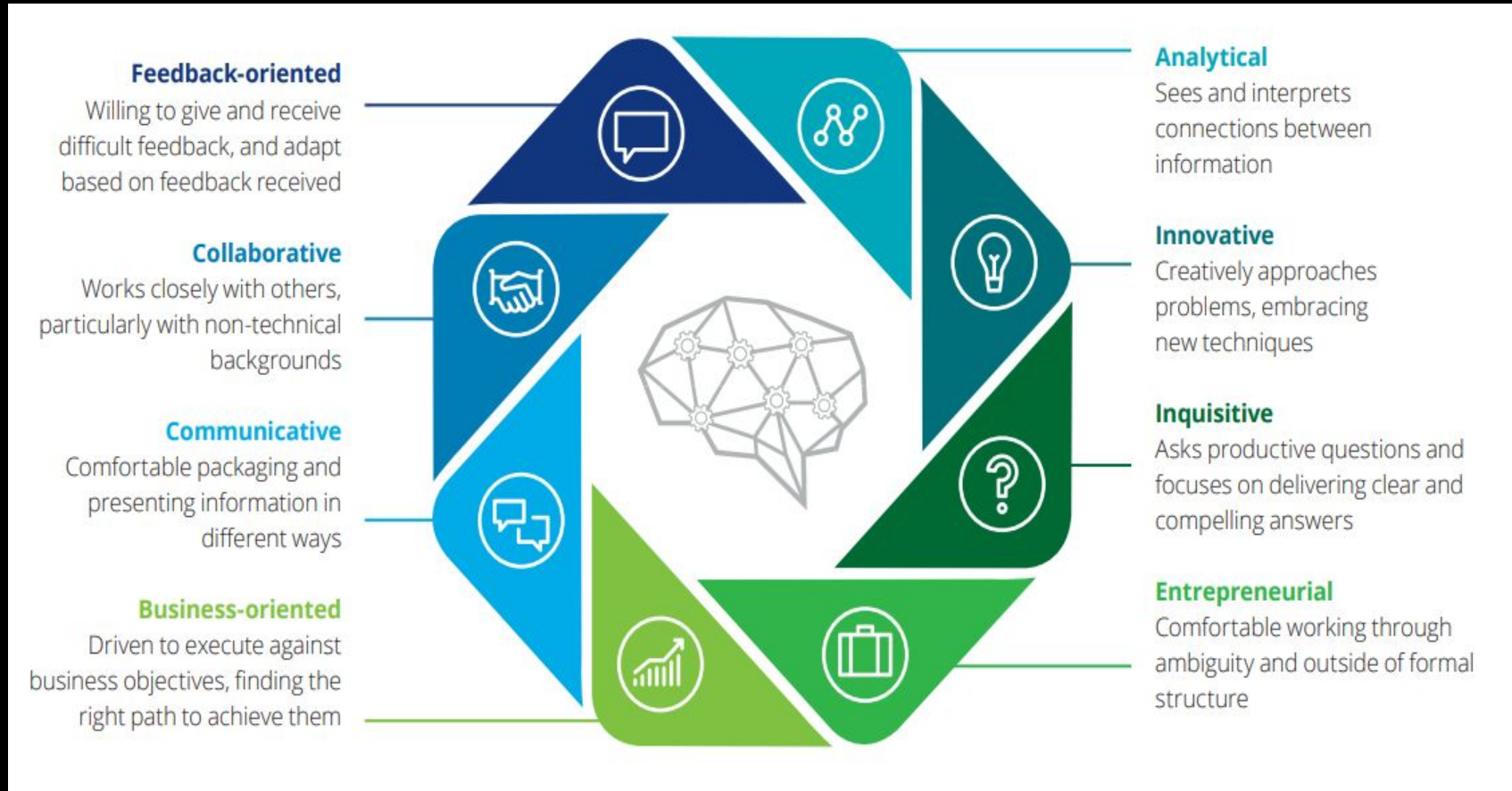
IA could *create opportunities to help implement assurance activities* into controls as they are designed. This approach **is called “assurance by design.”** There is a distinct possibility to automate and create workflows that many of the typical second-line activities and some first-line compliance activities can leverage (**“automated core assurance”**). This would allow IA (third line) to focus on the greatest risks while creating much-needed capacity.



In addition, the CAE should focus on the IA function in considering the importance of developing an *innovative mindset*. This is critical for organizations as they look to the future and develop forward-looking approaches for managing risk. The CAE should think about and define the *skills and attributes that drive innovative behavior*. It is interesting that the skills and characteristics in many ways are the same for what an innovative risk and control professional will need to be impactful in the future.



# Internal Audit of the Future – Innovative Mindset Framework



There are several enablers and accelerators that can be used to achieve these objectives, including:

- **Talent**; building the workforce of the future; and considering what type of work needs to get done, who is going to do the work, and where the work is going to be performed
- **Developing new, dynamic, and innovative approaches** for assessing risk, how audits are performed and delivered, and reporting results
- **Utilizing and integrating digital assets** into business as usual.

## Internal Audit of the Future - Assure, Advise, Anticipate & Accelerate

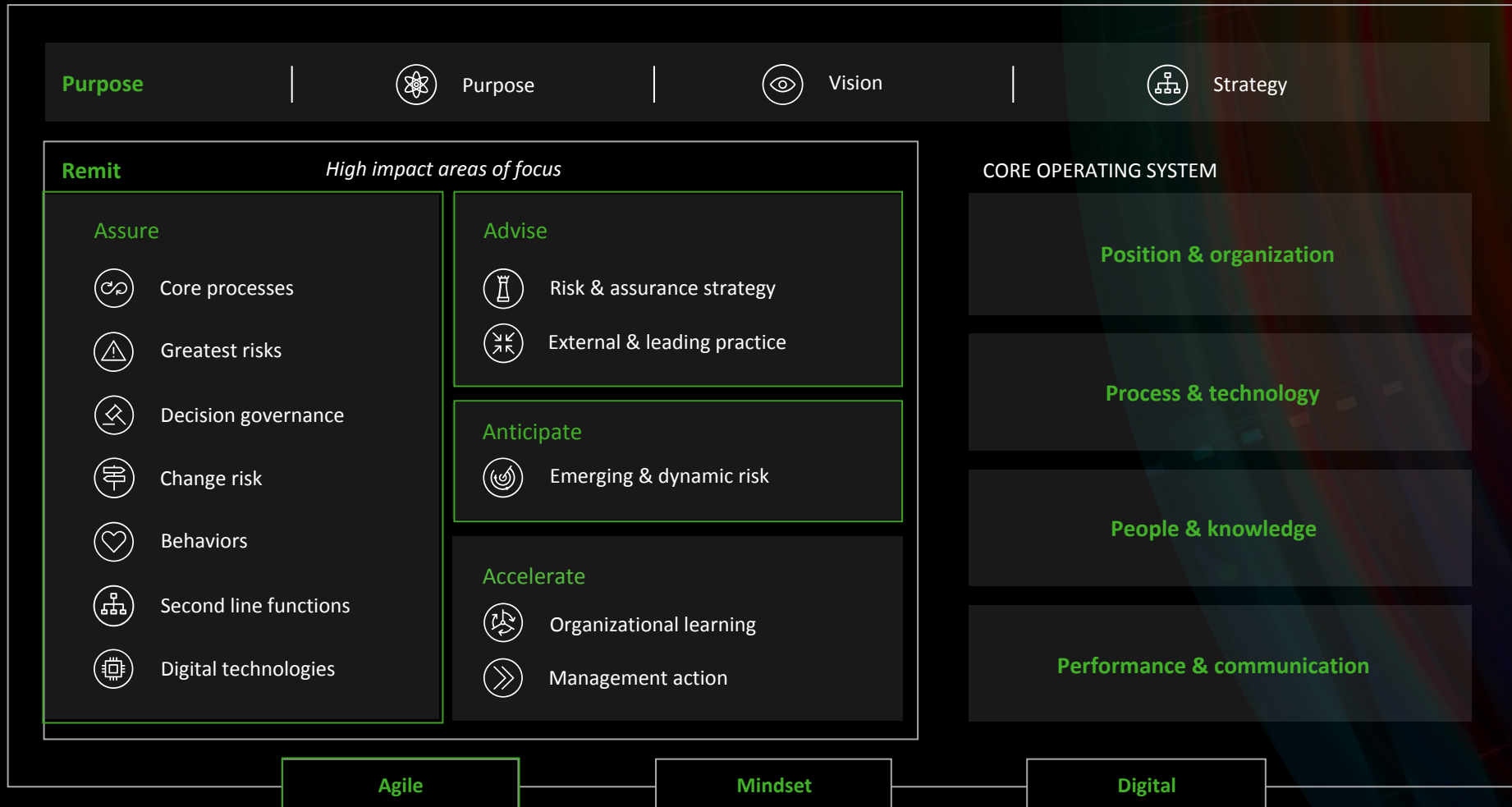
The future of internal audit relies on the value that Internal Audit stakeholders now want and need– **assure, advise, anticipate and accelerate.**

- ❑ **Assure** - Assurance remains the core role of Internal Audit. Yet the range of activities, issues, and risks to be assured should be far broader and more real-time than they have been in the past.
- ❑ **Advise** - Advising management on control effectiveness, change initiatives, enhancements to risk management and the design of assurance mechanisms falls well within Internal Audit's role and stakeholder expectations.
- ❑ **Anticipate** - Anticipating risks and assisting the business in understanding risks, and in crafting preventative responses, transforms Internal Audit from being a predominantly backward-looking to a forward-looking function.
- ❑ **Accelerate** - The speed at which organisations can learn and act very quickly to changes.



# Internal Audit – Assure, Advice & Anticipate

Purpose driven, digitally powered



## What stays the same?

### Assurance

at the core of Internal Audit's role, remit and value; providing organisations the confidence to grow responsibly

### Advice

timely and helpful advice to help management through challenge, insight, external perspectives and an objective point of view

### Anticipation

Forward looking, driving sustainable and future focused improvements in risk, governance and control

### Agility

embracing agile principles, values and mindsets to drive high performance, continuous improvement, innovation and stakeholder engagement

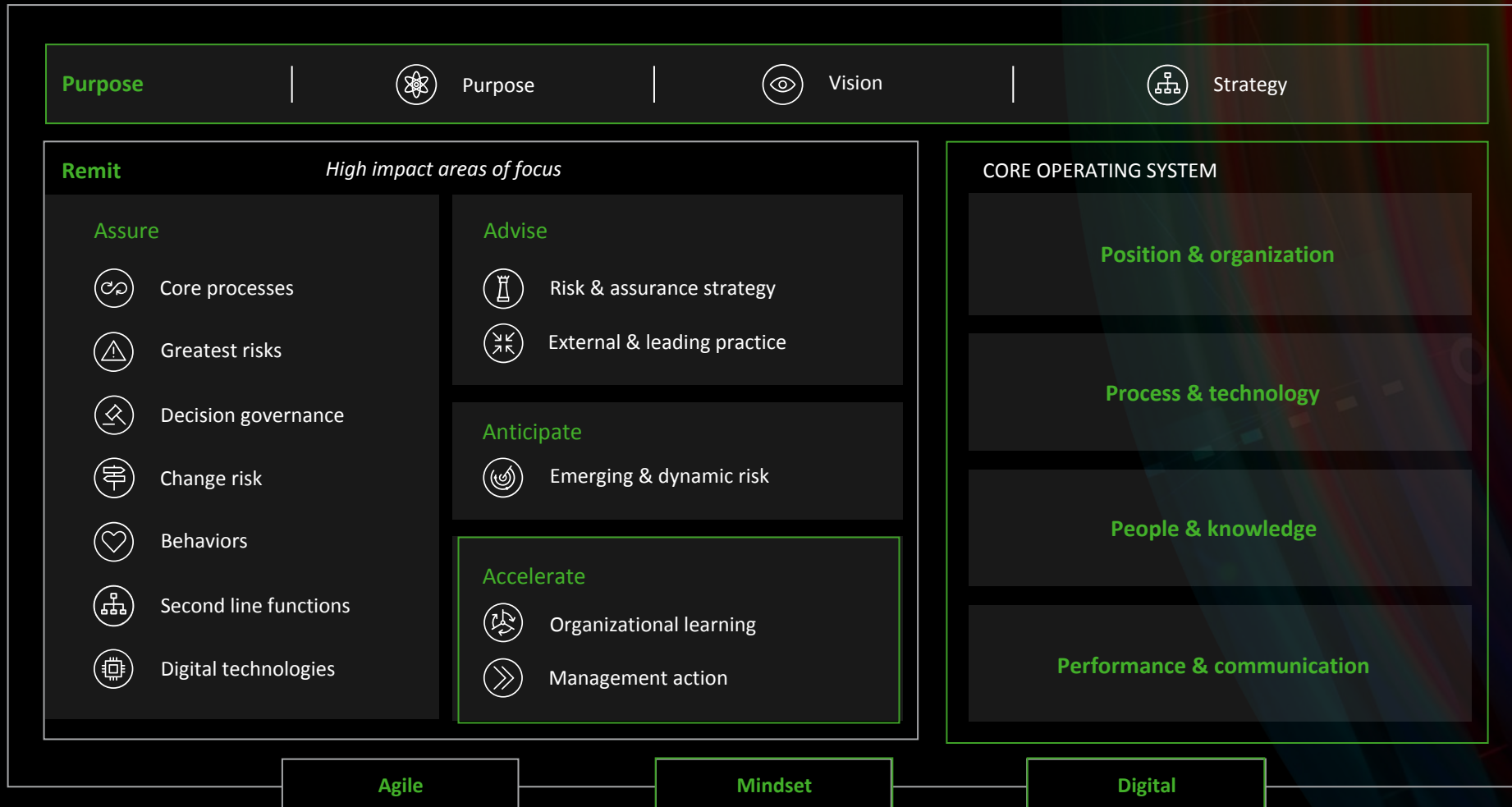
### Skill, capabilities and enablers

maintaining a focus on learning and development, top-flight teams, soft skills, high impact reporting and how IA works within the three lines model



# Internal Audit – Accelerate

Purpose driven, digitally powered



## What's new?

### Starts with purpose

aligning Internal Audit's role and remit with the organization's purpose, a new orientation for many functions

### Challenges Internal Audit functions to add Accelerate

(a fourth "A") to the remit to support organizational learning and management action in ways that match today's pace of change

### Fully embraces the use of digital technologies across the lifecycle

To help drive insights, collaboration, quality and productivity

### Promotes a continuous improvement mindset

that enables agility and digitalization through encouraging purposeful and structured focus on incremental improvement

### Outlines the key principles and building blocks

that functions need to consider as they design, build, and evolve their operating models

# Purpose

# Internal Audit Proactiveness

## Purpose

Purpose has become increasingly important for organisations and their stakeholders, with evidence showing purpose driven organisations can...

- Strengthen brand recognition and protection;
- Generate new revenue streams and achieve premium pricing;
- Generate faster growth and return on equity;
- Reduce safety incidents and increase employee engagement; and
- Attract top talent;

...yet aligning Internal Audit's role and remit with the organisation's purpose is a new orientation for many functions.





# Internal Audit Proactiveness

Purpose

*Why should  
Internal Audit  
care about  
purpose?*



Maximize value through  
more intentional and  
specific outcomes



Create stronger engagement  
and advocacy for Internal  
Audit's role



Attract top talent; who  
want to work for purpose  
driven organizations



Make smarter, purpose  
driven, investments in IA's  
functional development





# Internal Audit Proactiveness

Purpose



## ***Considerations for internal audit***



How does Internal Audit play its part helping the organisation achieve its purpose?



How does the organisation's purpose shape and influence Internal Audit's role and remit?



Does Internal Audit comment on whether the organization is achieving its purpose?



# Accelerate

# Internal Audit Proactiveness

## Accelerate

The speed at which organisations can learn and act is critical. Yet in order to learn, organisations need to have trust, transparency and psychological safety.



# 70%

of CEOs do not have complete confidence in their organizations' ability to pivot and adapt to disruptive events

# 1/3

CEOs are not confident that their organizations have maintained trust between leaders and employees



# Internal Audit Proactiveness

## Accelerate

What more can Internal Audit do to help accelerate management learning and action?

### ACT WITH SPEED

- Dial up Agile...
- Stable teams
- Visualise work
- Incremental reporting
- Continuous improvement

### GO BEYOND THE AUDIT

- Post audit workshops
- External & leading practice perspectives
- Assurance by design
- Education and awareness
- Insight reporting
- Knowledge sharing

### CHANGE THE CULTURE

- Help create psychological safety
- Words and actions matter; adjust your language and approach
- Dual rated reports
- Influence the right response to IA's messages

# Digital

# Internal Audit Proactiveness

## Digitalising Internal Audit



### Digital Internal Audit ●

*The integration and embedment of digital assets or enablers (technologies, channels and ways of working) to transform existing operational processes, and increase the value offered to stakeholders.*

*It requires a cultural shift and a mindset of experimentation, innovation and challenging the status quo.*

*Digital enablement and transformation is the journey of IA functions to truly embed Digital assets and ways of working into their function in line with their vision and strategy.*

# Internal Audit Proactiveness

## Digitalising Internal Audit



<b>Purpose &amp; remit</b>	Purpose, vision & strategy	Internal Audit Charter					
	Role and remit						
<b>Position &amp; organization</b>	Independence and objectivity	Position within the three lines model					
	Reporting lines	Approach to the IPPF					
<b>Process &amp; technology</b>	Policies and procedures	Audit universe	Audit Plan Development	Audit planning	Rating criteria	Use of digital technologies	Audit Management System
	Methodology	Risk assessment	Audit toolkit	Audit delivery and oversight	Follow-up	Data analytics	Virtual working
<b>People &amp; knowledge</b>	Ethics and personal independence	Resourcing models	Scheduling	Performance management			
	Knowledge, skills and capabilities	Recruitment	Learning and development	Knowledge management			
<b>Performance &amp; communication</b>	Audit reporting	Quality Assurance	Operational Management Information				
	Audit Committee reporting	Stakeholder relationship management	Continuous improvement and innovation				



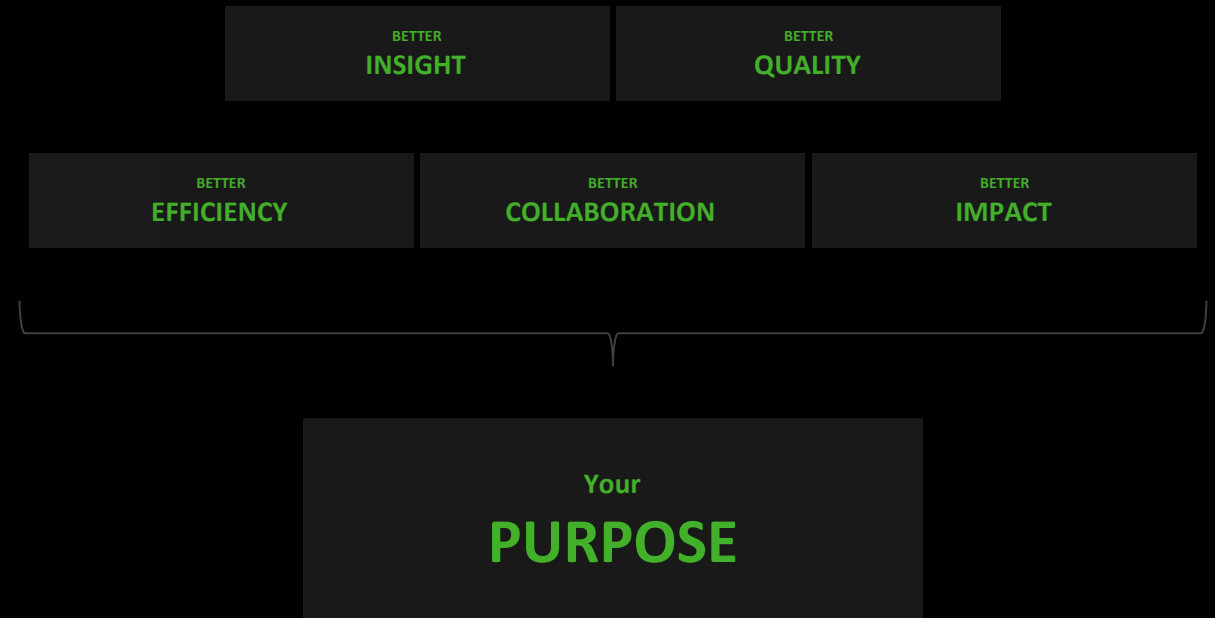
# Internal Audit Proactiveness

## Digitalising Internal Audit



**Digital is not the goal...**

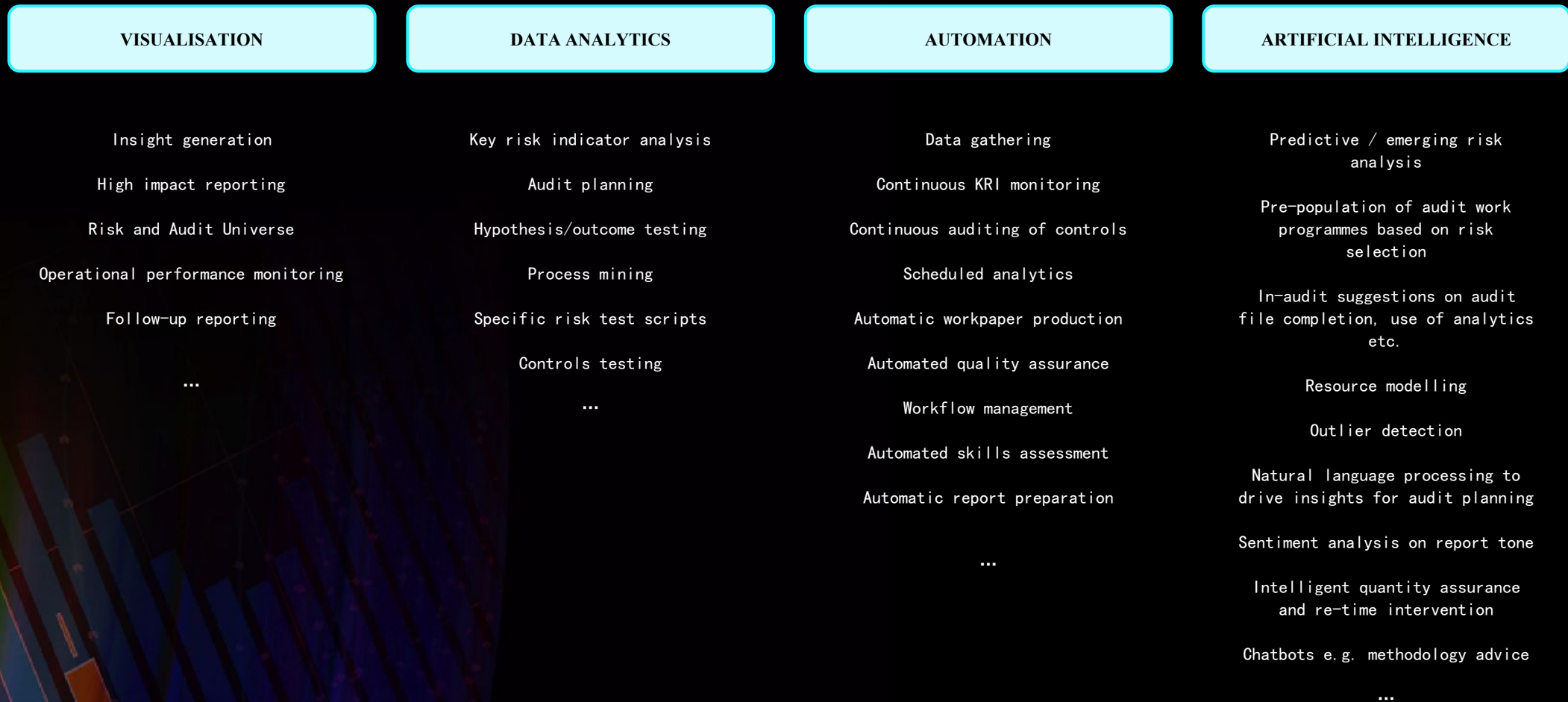
**...it's what it can help you  
achieve**



# Internal Audit Proactiveness

## Digital techniques

Digital is much broader than just a function's use of analytics to support audit delivery. Digital is how an internal audit function leverages and applies the capabilities which technology can unlock across the function's ways of working. Example and common capabilities for internal audit can include...



# Internal Audit Proactiveness

## Digital platforms

Another key element to a function's digital capability are the technology platforms in which it uses and engages with. Whilst not an exhaustive list, function's should consider how they leverage and combine digital techniques and platforms to be truly digital.

### CLOUD & ENTERPRISE PLATFORMS

Real-time collaboration e.g. multiple users can work on the same document, at the same time

Workflow notification e.g. automated notification when staff have responded to review comments, etc.

Virtual teaming - work across borders and with third parties on the same platforms

...

### SOFTWARE AS A SERVICE

Task management and visualisation

Resource management

Follow-up

Analytics

Surveys

AMS plug-ins e.g. real-time and intelligent methodology guidance and training / walkthroughs

...

### APPLICATION PROGRAMMING INTERFACE

Data independence - IA can access and pull data independently from management

Real-time data feeds enable continuous risk monitoring

The ability to easily take snapshots of data over time can allow new insights to emerge

...

### AUDIT MANAGEMENT SYSTEM

Audit Universe management

Audit Plan management

Audit delivery documentation

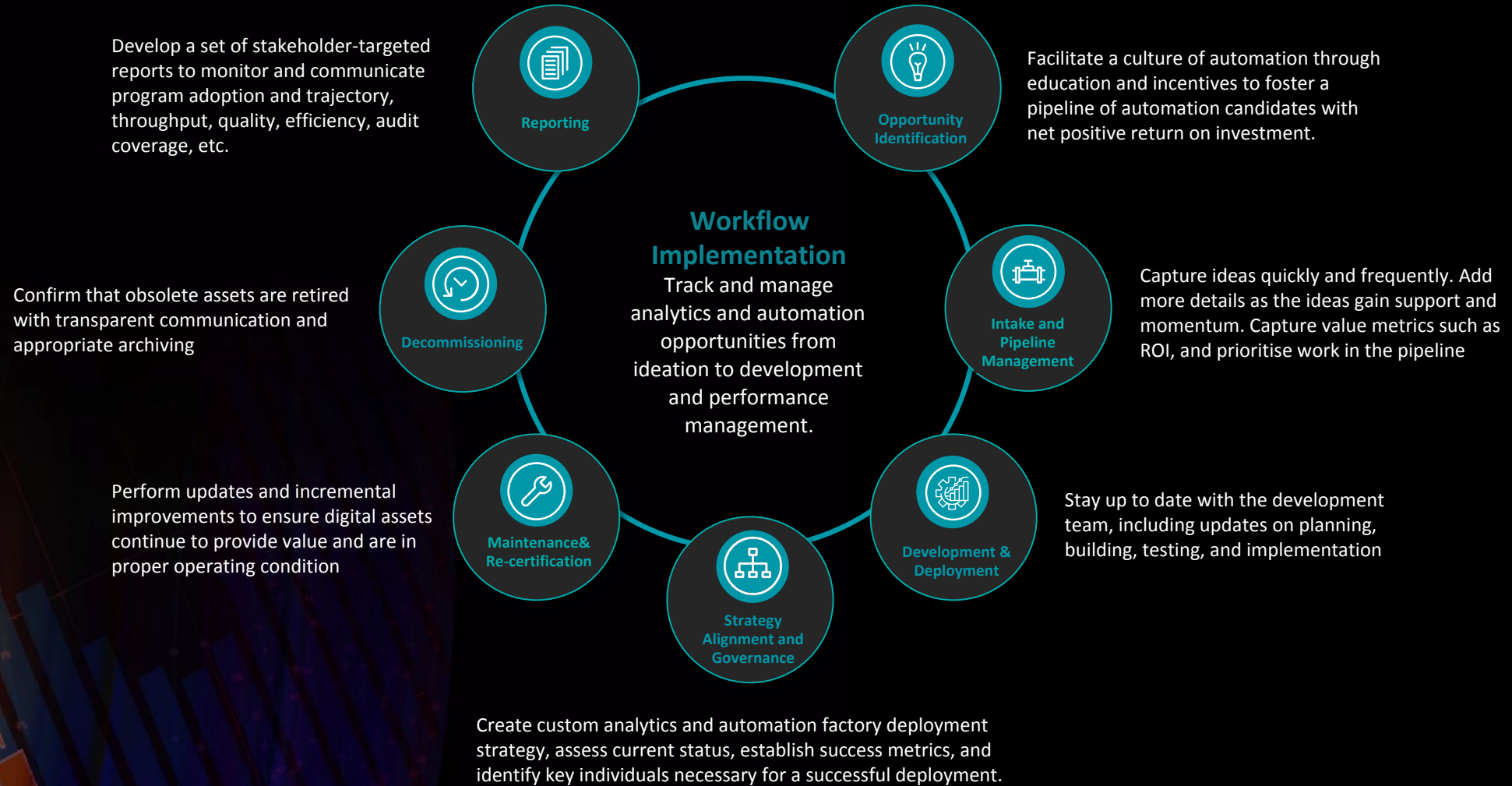
Knowledge management repository

Quality Control - creating minimum standards in AMS for data governance

...

# Internal Audit Proactiveness

Take a systematic approach to digitalization



# Core operating system



# Are you optimised to deliver impact?



**Purpose**



**Role and remit**



**Mindset**

Are your ways of working designed and optimised to support specific outcomes?

CORE OPERATING SYSTEM

**Position & organization**

**Process & technology**

**People & knowledge**

**Performance & communication**

# Internal Audit Proactiveness

Core operating system

*Are you optimised to deliver impact?*

<b>Purpose &amp; remit</b>	What purpose, outcome, impact and value?	Through which types of work and services?
<b>Position &amp; organization</b>	Organised in which way to deliver?	In which locations?
<b>Process &amp; technology</b>	Supported by which processes?	Using which enabling technologies?
<b>People &amp; knowledge</b>	Requiring which resources and skills?	Requiring what data and information?
<b>Performance &amp; communication</b>	For which stakeholders?	Via which communication channels?

*To maximize impact, Internal Audit must design its operating model and ways of working to support specific outcomes*



# Internal Audit Proactiveness

Core operating system

*Are you optimised to deliver impact?*

*Internal Audit leaders should consider the full breadth of the life cycle*

<b>Purpose &amp; remit</b>	Purpose, vision & strategy	Internal Audit Charter					
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# Mindset

# Internal Audit Proactiveness

## Embracing digital: mindset is half the battle

Mindset is half the battle



**Promote a culture of innovation**  
Make it safe to experiment



**Get tech savvy**  
Dial up your education and awareness of digital technologies



**Keep everything on the table**  
Don't limit your digital vision to just analytics



**Celebrate desired behaviours**  
Encourage your teams to bring ideas





# Internal Audit Proactiveness

## Innovation needs an agile mindset

For Internal Audit to anticipate risks and opportunities effectively, it requires agile and digital capabilities – and the right mindset.

The right mindset is one of continuous learning - experimenting and iterating at a faster pace, with ongoing communication and embedded agile methods. This mindset enables the function to pursue incremental improvements in their ways of working that generate lasting and relevant change.

Internal Audit leaders can promote that mindset by creating an environment of psychological safety to drive innovation, rapid prototyping and experimentation, and using digital tools and agile methods in its work. At its best, this creates an organizational culture of continuous learning and improvement.



# Internal Audit Proactiveness

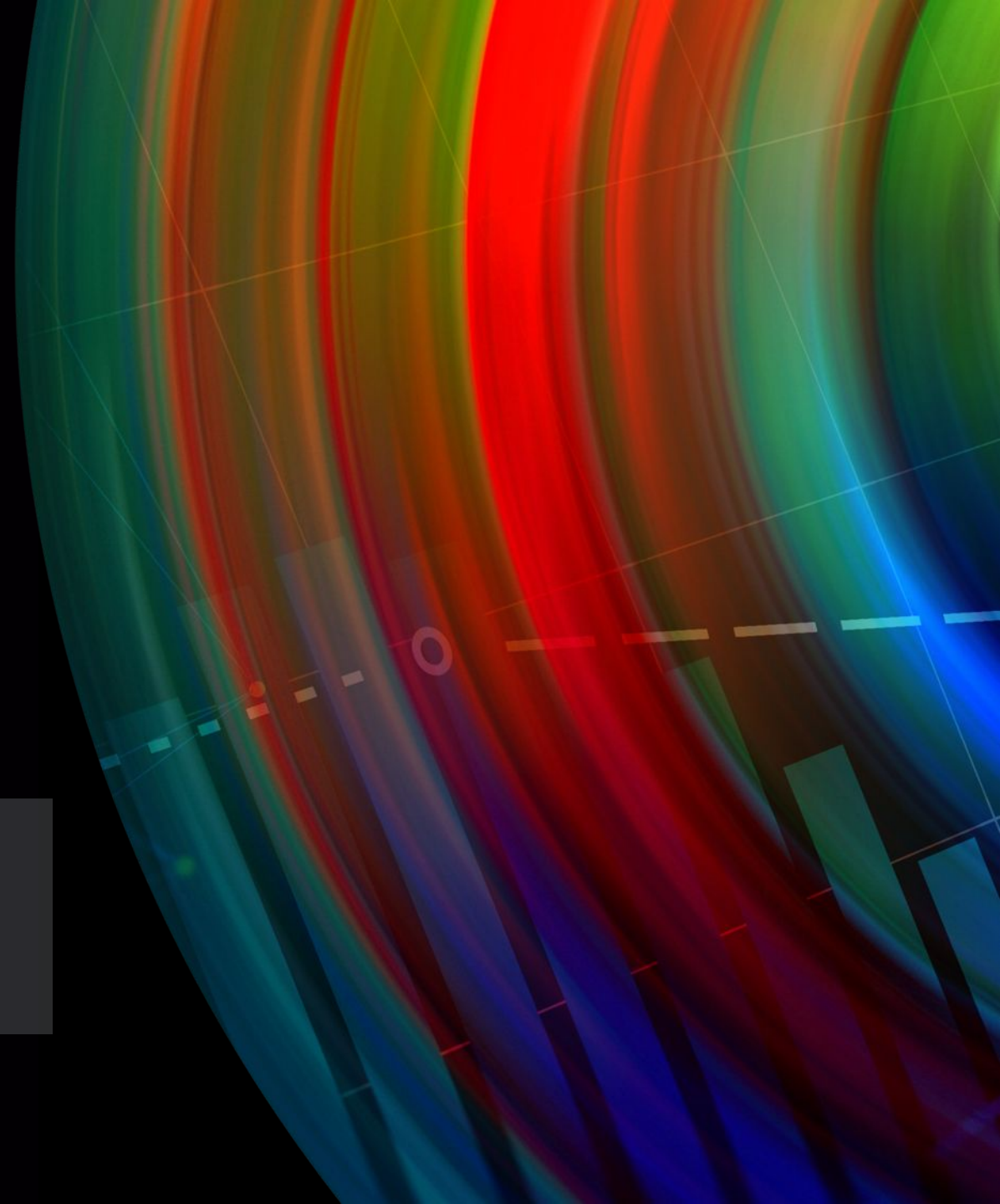
Key considerations for CAE's?

**How clearly defined is your function's purpose?**

*...and can your team and stakeholders articulate this?*

**What should Internal Audit's remit be in helping to accelerate organizational learning and action?**

**What more can and should Internal Audit functions do to digitalize?**



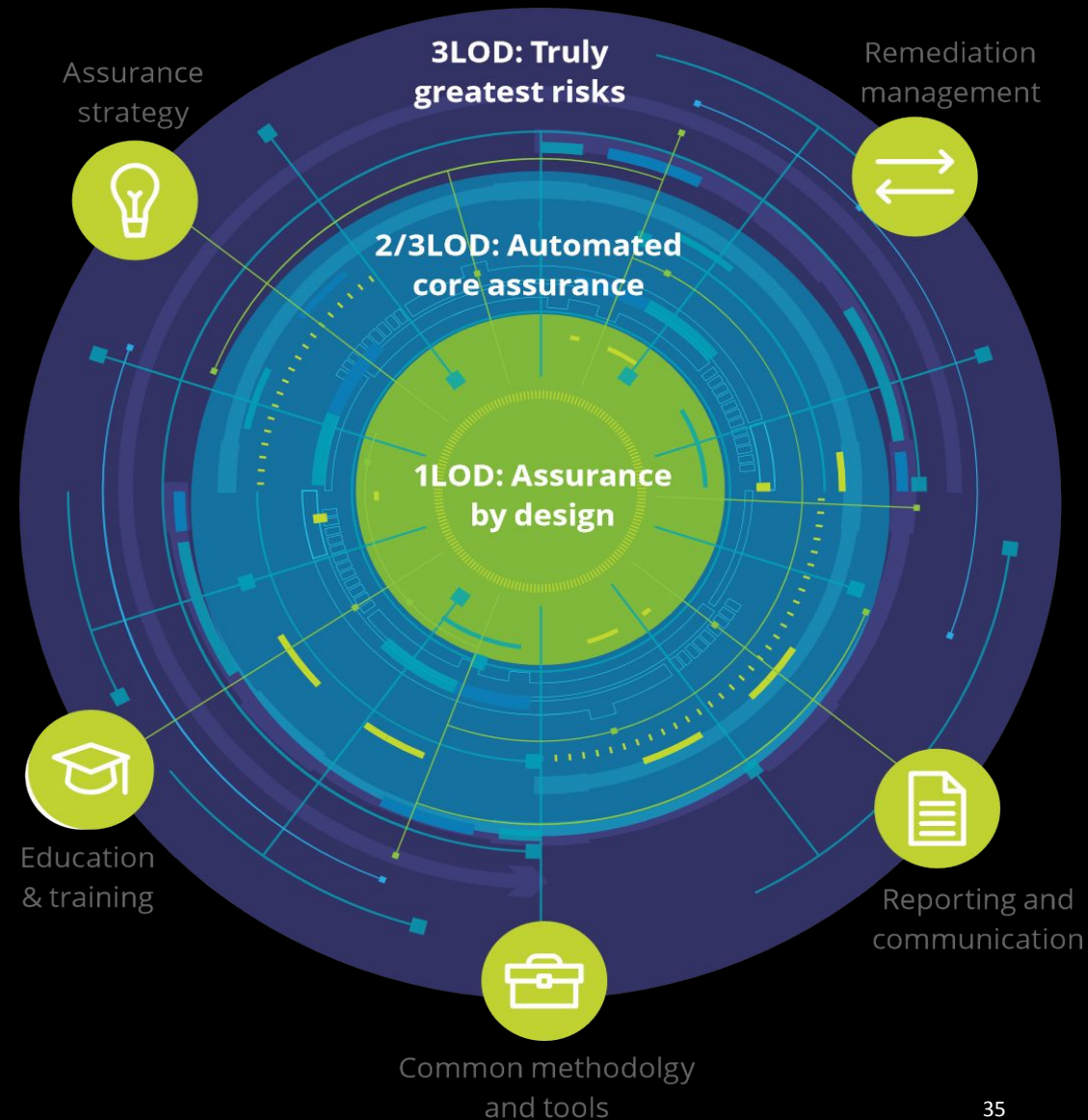
# Future State and Opportunities for Internal Audit

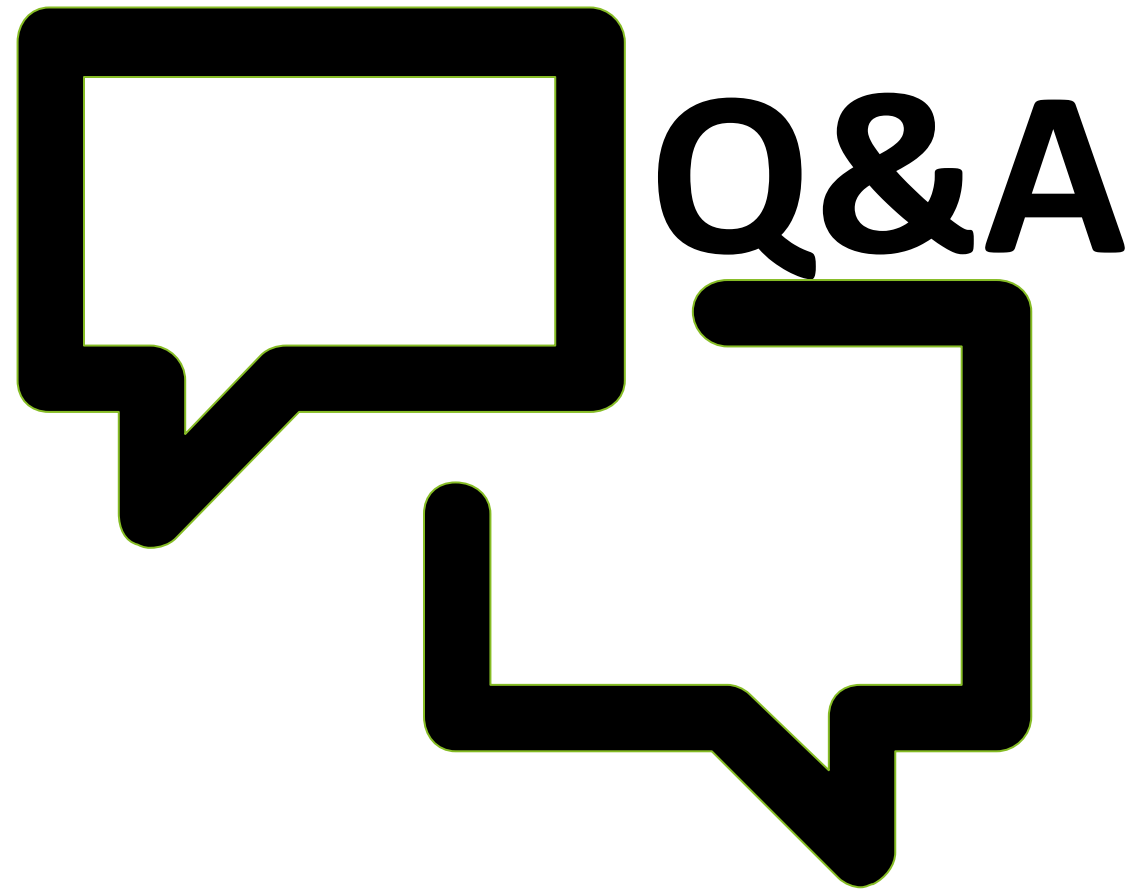
- ❖ Internal Audit (IA) functions with the strongest impact in their organizations are those which are *adapting to change; collaborating; and making investments in digital assets, analytics, and automation*.
- ❖ IA is in a great position to assist with integrating assurance activities, particularly in helping the first line take greater ownership of controls and embedding means of self-assurance. Combined with enhanced technology, this would enable **modernization by the second line** to allow for real-time monitoring.
- ❖ Although IA cannot place full reliance on the work performed by the first and second lines, **it can leverage the monitoring results**, perform agile testing of controls, and provide assurance and advice on the **“truly greatest risks.”** To do this, IA will elevate itself to *become a more strategic and holistic assurance provider, and risk advisor, collaborating with the other lines and having a seat at the table*, a clear line of sight earlier in the process.
- ❖ For IA to be perceived as **protecting, building, and preserving value**, it needs to truly **assure, advise, anticipate and accelerate**. The IA of the future will play an active role in educating stakeholders and sharing tools, insights, and knowledge. Effective IA functions with a dynamic and forward-looking mindset are likely to be viewed positively by key stakeholders.

## The future is now.

There is a great opportunity for the profession to redefine itself and cement its position as not only a provider of assurance, but also a function that **assures, advises, anticipates and accelerates**.

## Tomorrow's three lines of defence









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