

Internal Control Program

EXAMINATION OBJECTIVES

Determine whether the savings association has an adequate and effective system of internal control that reasonably ensures all of the following:

- Accurate and reliable accounts and records.
- Properly authorized transactions.
- Adequately safeguarded assets.
- Compliance with applicable laws and regulations and internal policies and procedures.
- Identification of weaknesses that require further examination (testing) and correction.

Determine the association's compliance with Section 404 of the Sarbanes-Oxley Act, Section 36 of the Federal Deposit Insurance Act, and 12 CFR Part 363 of the FDIC's regulations.

Determine whether management established clear entity-wide objectives and that they are consistent with its business plan, budget, and strategic plan.

EXAMINATION PROCEDURES

Perform the procedures that summarize the internal control review. The procedures require the input of other regulators on the team.

LEVEL I

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Level I procedures are typically sufficient when an association has an effective internal audit function in place and no findings develop that would cause an expansion of scope.

1. In consultation with the examiner in charge (EIC), review and evaluate the responses to the Management Attestation (PERK 02), the Internal Control Questionnaire (PERK 04), and the Funds Transfer Questionnaire (PERK 23). Follow up by reviewing appropriate internal audit work papers and by interviewing the internal auditors and operations staff to determine possible areas of internal control weaknesses. Perform this review as early in the examination as possible. Immediately

Exam Date:	
Prepared By:	
Reviewed By:	
Docket #:	

Internal Control Program

WKP. REF.

notify the EIC and the examiner assigned any area where there are possible weaknesses so the EIC can make any necessary scope changes.

2. Review management reports on internal control and related audit reports issued by independent accountants as required by the Federal Deposit Insurance Corporation Improvement Act (FDICIA) and, if applicable, Section 404 of the Sarbanes-Oxley Act (SOX). Review the external audit work papers on internal control or other communications regarding significant deficiencies. See [Handbook Section 350](#), [Appendices D](#) and [E](#), and discuss with your field manager or the Regional Accountant before requesting external audit work papers.
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3. Determine whether the board of directors stays current with innovations in corporate governance.
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4. Check for material weaknesses in internal controls by noting any deficiencies reported in the following:

- Recent internal and external audit reports.
- Related management letters.
- Management and the board of directors' responses.
- The most recent examination reports of all types and from all applicable regulators.
- Management's assessment and internal control attestations required by SOX and FDICIA.

Determine if management has corrected the deficiencies. Determine the reasons if management has not taken effective corrective action. If management has not taken effective corrective action or if new deficiencies developed, follow appropriate regional procedures for the next course of action.

Exam Date:	
Prepared By:	
Reviewed By:	
Docket #:	

Internal Control Program

WKP. REF.

5. Review the Matters Requiring Board Attention and Corrective Actions from the three or four previous ROEs to ensure that the board and management have taken appropriate corrective action where necessary and persistent problems have not recurred.

6. Determine whether management significantly modified its program of internal control through policy or procedural changes since previous examinations of all types. If so, evaluate the reasons for, and the validity of, such significant changes.

7. Determine whether the board of directors and management established an effective system of internal control and enforces the controls for subordinate organizations and other subsidiaries.

8. Verify that management enforces all critical policies.

9. Review the general questionnaires as examiners assigned other areas complete them during the examination to identify all critical internal control deficiencies noted. Discuss these deficiencies with management.

10. Verify that appropriate staff performs reconciliation of general ledger accounts with subsidiary ledgers, supporting documentation, or external confirmations often. Verify that appropriate staff reviews such reconciliation. Check whether the association promptly clears or resolves reconciling items. (You may do these verifications piecemeal as part of several other examination programs.)

Exam Date:	
Prepared By:	
Reviewed By:	
Docket #:	

Internal Control Program

WKP. REF.

11. Determine whether the association outsources any significant activities to third parties other than those related to information technology. Review internal and external audit reports for identified problems or concerns regarding outsourced activity. Perform Level II procedures as appropriate.

12. If the association uses its external auditors to conduct the internal audit, determine that the association maintains the integrity and quality of internal control. (Note that SEC independence rules prohibit outsourcing of the internal audit function to the institution's external auditors. Associations required to be audited under OTS or FDICIA regulations must follow SEC independence rules.)

13. Determine the presence and effectiveness of internal control activities in all major business lines.

14. If applicable, ensure the association complies with the enhanced financial disclosure requirements of the SOX.

15. Review Level II procedures and perform those necessary to test, support, and present conclusions derived from performance of Level I procedures.

LEVEL II

You should perform Level II procedures when an association does not have an effective system of internal control or when warranted based on examination findings. You should also perform appropriate Level II procedures if the association outsources any significant activities and Level I procedures are insufficient to determine how the association handles and controls the outsourced activity.

Exam Date:	
Prepared By:	
Reviewed By:	
Docket #:	

Internal Control Program

WKP. REF.

16. Determine whether the external auditor appropriately evaluated internal control by reviewing the engagement letter and management letter on internal controls. Review audit work papers only after consulting with the EIC, the FM and/ or the Regional Accountant.

17. Determine whether internal audit or alternate control reviews are sufficiently independent. Pay particular attention to independence issues when the association uses the external auditors to conduct the internal audit.

18. Determine the frequency of testing and reporting for compliance with laws and regulations. Determine whether the association gives appropriate attention and follow-up to violations of laws and regulations.

19. Assess the adequacy of information and communication systems.

20. Determine whether management gives appropriate and timely attention to significant deficiencies and material control weaknesses once identified.

21. Review outsourcing contracts with third-party vendors to determine their existence and that they are sufficiently detailed commensurate with the scope and nature of the outsourced activity. (See the Outsourcing discussions in [Handbook Sections 341](#) and [355](#).)

Exam Date:	
Prepared By:	
Reviewed By:	
Docket #:	

Internal Control Program

WKP. REF.

22. Determine that the third-party vendor has implemented internal control policies and procedures comparable to those that the association would use if the association conducted the activity internally.

23. Determine that the association properly documents and approves all insider and affiliated party transactions.

24. Determine whether staff members at all levels successfully complete an ethics program.

25. Review directors', officers', and employees deposit accounts for any unusual activity.

26. If you encounter red flags that could signal fraud concerning insiders, notify your supervisor and determine the need to contact subject matter experts, such as the Regional Accountant, IT examiner, etc. For more information, see [Handbook Section 360](#), Fraud and Insider Abuse.

27. If you determine the association's internal control system is inadequate, notify your EIC and field manager. OTS may determine that the association should file a plan of compliance with Appendix A of 12 CFR Part 570, Safety and Soundness Standards.

28. Ensure that your review meets the Objectives of this Handbook Section. State your findings and conclusions as well as appropriate recommendations for any necessary corrective measures, on the appropriate work papers and report pages.

Exam Date:	
Prepared By:	
Reviewed By:	
Docket #:	

Internal Control Program

WKP. REF.

LEVEL III

After consultation with the field manager you should perform agreed upon Level III procedures based on findings from Level I and Level II procedures. You should also consider Level III procedures when:

- Level I and II procedures are insufficient to draw sound conclusions.
 - An independent party does not audit the association.
 - The association does not have an internal audit program in place.
29. Verify cash on hand. Review cash items or any other assets or liabilities held in suspense accounts to determine proper and timely disposition.
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30. When control concerns exist in a given area or activity, prove subsidiary records for targeted area to the general ledger such as loans, investments, or deposits.
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31. Verify the safekeeping of securities on hand or held by others.
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32. Review accrued interest accounts and test the computation and disposition of interest income.
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33. Verify the loan balances for loans charged off since the previous examination and the debit entries to the allowance account.
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34. Check supporting documentation for loans charged off.
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Exam Date:	
Prepared By:	
Reviewed By:	
Docket #:	

Internal Control Program

WKP. REF.

35. Review loan recoveries and check the credit entries in the allowance account.

36. Review closed deposit accounts to determine that they were properly closed. Review dormant account activity for propriety.

37. Review deposit overdraft activity to determine legitimacy and adherence to policies.

38. Review the timeliness and adequacy of all bank account reconciliations.

39. Review all suspense accounts and ascertain explanations for large or unusual items. Determine that no one is using a suspense account to divert deposits, conceal impaired or worthless assets, or hide shortages.

40. Verify borrowed funds balances.

41. With the written concurrence of the field manager, conduct a direct verification of appropriate loan or deposit accounts.

42. Review the funds transfer verifications and reconciliations and verify that there is adequate segregation of duties.

Exam Date:	
Prepared By:	
Reviewed By:	
Docket #:	

Internal Control Program

WKP. REF.

43. Determine that association management properly supports and approves entries to the books and records and that they review unusual or large entries.

44. Request documentation for significant or unusual transactions. Review the tax return for disclosures.

EXAMINER'S SUMMARY, RECOMMENDATIONS, AND COMMENTS

Exam Date:	
Prepared By:	
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Docket #:	