

# RESCINDED

Office of Thrift Supervision

February 13, 2002

Department of the Treasury

Regulatory Bulletin

**RB 32-23**

Handbook: **Thrift Activities**

Subject: **Management**

This rescission does not change the applicability of the conveyed document. To determine the applicability of the conveyed document, refer to the original issuer of the document.



**Sections: 340, 350, 355, 360**

## Thrift Activities Regulatory Handbook Update

**Summary:** This bulletin provides updates to Thrift Activities Regulatory Handbook Sections 340, Internal Control; 350, External Audit; 355, Internal Audit; and 360, Fraud and Insider Abuse. Please replace the existing handbook sections with the enclosed revised sections.

**For Further Information Contact:** Your Office of Thrift Supervision (OTS) Regional Office or the Supervision Policy Division of the OTS, Washington, DC. You may access this bulletin at our web site: [www.ots.treas.gov](http://www.ots.treas.gov). If you wish to purchase a handbook and a subscription to the updates, please contact the OTS Order Department at (301) 645-6264.

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### SUMMARY OF CHANGES

OTS is issuing updates to the following Thrift Activities Handbook Sections. Change bars in the margins of Section 360 indicate revisions. We restructured sections 340, 350, and 355 so we did not include change bars in those sections. We provide a summary of all substantive changes below. These handbook sections are in plain language.

#### **340 Internal Control**

We revised the narrative to expand and update discussions in many areas and add some new information:

- Specifically highlighted the objectives of internal control in order to establish the connection between them and the successful operation of an institution.
- Enhanced the examination considerations and applications discussion to better guide examiners in their review of this area.
- Identified a host of situations and actions that could suggest breaches in an institution's internal controls, warranting a closer look.
- Expanded the list of references to include several relevant accounting issuances, regulations, and laws.
- Added a discussion on regulatory concerns addressing the issue of a perceptible decrease in the effectiveness of internal controls and internal audits evidenced by a few high profile cases.
- Tied the need for an appropriate internal audit and internal controls directly to FDICIA and OTS regulation CFR Part 570.

- Added a discussion of directorate responsibilities to clarify the primary role a board plays in the internal control environment.
- Included a lengthy discussion on both the internal and external auditor's responsibilities. In the case of the external auditor, we establish through reference to SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit*, the direct responsibilities the external auditor has with respect to internal control.
- Discussed the need for heightened awareness on the part of the examiner when the association outsources the internal audit to the external auditor.
- Provided guidance on contractual issues when the same firm performs both internal and external audit duties.
- Included a discussion of the risks associated with the outsourcing of any function and the relationship to internal control and highlighted the OTS expectation that internal control will not suffer because the institution outsources an activity.
- Incorporated information about insider abuse and fraud in section 40 because of the recent flurry of high profile cases where insiders significantly defrauded their respective institutions, in some cases causing failures.

We modified the Internal Control Questionnaire and the Funds Transfer Questionnaire so that examiners may indicate whether they verified a given response. The regions should determine what items examiners should verify, at a minimum, on an examination. To help accomplish this we flagged minimum procedures. The regions may use the flagged items as a guideline when establishing minimum standards. As always, regional management has the option to establish any minimum verification procedures they feel are necessary.

### 350 External Audit

We changed the name of the section from Independent Audit to External Audit, reorganized the narrative, and added the following information:

- Included information on certain types of external audits: FDICIA-required, OTS-required, Agreed-Upon Procedures, and voluntary audits.
- Highlighted the policy that no less than a majority of outside directors must make up an audit committee.
- Added a discussion about access to peer review reports as required by FDICIA.
- Expanded the discussion of voluntary external auditing programs to reflect the interagency guidance, Interagency Policy Statement on External Auditing Programs of Banks and Savings Associations, issued on September 28, 1999 (TR-223). See new Appendix C. Added information on examiner access to external audit work papers.
- Added information on SEC-required audits, and related audit committee requirements.
- Added the suggestion that the regional offices should consider maintaining a tracking system of external audits.
- Provided guidance on how examiners may use and rely on external audit work papers and work products.

- Included a sample letter to request audit work papers as new Appendix D.
- Included a sample acknowledgement letter as Appendix E.
- Expanded the list of references to include several relevant auditing issuances.

## 355 Internal Audit

We expanded the narrative as shown below:

- Listed provisions that an internal audit program should include. Specifically, the provisions discuss requirements for audit charters and responsibilities for internal audit staff.
- Incorporated the interagency guidance on outsourcing arrangements, Interagency Policy Statement on the Internal Audit Function and Its Outsourcing, issued December 22, 1997 (CEO Memo 77).
- Incorporated the substantial requirements and limitations of the recently revised SEC rules imposed on the external auditor with respect to the providing of internal audit services to external audit clients. Among other things, where the external auditor provides internal audit services for an external audit client, those services are limited to an amount not greater than 40 percent of the total hours expended on such internal audit services (except where the organization has less than \$200 million in total assets).
- Provided guidance on areas under the Audit Plan that we believe examiners should carefully evaluate, including Board of Director or audit committee activities and management records.
- Expanded the list of references to include several relevant auditing standards.

We updated the Internal Audit Program and Level II procedures that address communication to and follow-up by management on any significant audit weaknesses, and developed Level III procedures that examiners can use when concerns about the internal auditor's work exist.

We updated and expanded examination considerations in the Internal Auditor Questionnaire (Appendix B) with regard to the internal audit function in various operational areas ranging from funds transfer activities to other liabilities.

## 360 Fraud and Insider Abuse

**Fraud, Insider Abuse, and Criminal Misconduct:** Adds fraud-related questions you can ask of institution management to get a sense of the institution's fraud history and the potential for fraud in the institution.

**Criminal Statutes:** Adds a section on 18 USC § 709 that places restrictions on advertising and names used by non-federal persons or entities.

**Importance of Internal Controls:** New section that incorporates CEO Memo 113, Internal Controls.

**Access to Savings Association Directors, Employees, Agents, and Books and Records:** New section that incorporates New Directions Bulletin 99-6.

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**Red Flags of Fraud and Insider Abuse:** Adds new bullets regarding the institution's organization and structure.

**Red Flags of Lending Abuse:** Adds predatory lending; deletes high concentrations of credit, loan concentrations, and loan documents signed outside of the institution as not applicable or outdated. Moves "close relationship between appraiser, lender, and/or borrower" to Red Flags of Appraisal Abuse.

**Red Flags of Check Fraud:** New section.

**Suspicious Activity Reports:** Adds a new section pursuant to the USA PATRIOT Act of 2001.

**References:** Updates to include 18 USC § 709; the interagency guidance, Check Fraud: A Guide to Avoiding Losses; and AICP guidance.

**Appendix A, Fraud Risk Evaluation Form:** Adds new factors to General Factors and predatory lending to Lending Factors; deletes concentrations of credit and document signing. Adds a section on Deposit Factors.

**Appendix B, Questions and Answers - Examination Obstruction:** Adds new appendix.



— Scott M. Albinson  
Managing Director, Supervision

**INTRODUCTION**

OTS requires all institutions, their affiliates, and subsidiaries to establish and maintain adequate systems of internal control. As financial institutions reposition their portfolios, they must have a process in place to identify, monitor, and control risk. Audits by public accountants and examinations by all the banking agencies have placed a greater emphasis on evaluating the appropriateness of the processes in place, and less reliance on transaction testing.

The Auditing Standards Board (ASB) revised its definition of internal control in Statement of Auditing Standard (SAS) No. 78, Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS 55, Consideration of Internal Control in a Financial Statement Audit. The revised definition incorporates the common critical elements of internal control systems in Committee of Sponsoring Organizations of the Treadway Commission (COSO) report, issued in 1992.

This section of the Handbook defines internal control, describes objectives and components of internal control, and explains how to consider internal control in planning and performing an examination. In general, when beginning an examination, first review and evaluate the adequacy and effectiveness of the internal control system. If you discover areas where internal controls are inadequate, expand the scope of examination to determine whether there are any safety and soundness concerns.

**OBJECTIVES**

An effective internal control system better ensures the following important attributes:

- Safe and sound operations.
- The integrity of records and financial statements.
- Compliance with laws and regulations.
- A decreased risk of unexpected losses.

- A decreased risk of damage to the institution's reputation.
- Adherence to internal policies and procedures.
- Efficient operations.

A system of strong internal control is the backbone of an institution's management program. Strong internal control helps an institution to meet goals and objectives, and to maintain successful, healthy operations. Conversely, a lack of reliable records and accurate financial information may hamper the long-term viability of an institution. An effective internal control system integrated into the organization's overall risk management strategy serves the best interest of the shareholders, board of directors, management, and regulators.

**REGULATORY CONCERNS**

Regulators are placing increasing importance on internal control systems in light of recent financial institution failures. Some institutions failed primarily because they did not detect insider fraud or abuse because they had deficient or nonexistent systems of internal control. The Federal Deposit Insurance Corporation Improvement Act (FDICIA) of 1991 required the banking agencies to establish certain safety and soundness guidelines. Appendix A of 12 CFR Part 570, Interagency Guidelines Establishing Standards for Safety and Soundness, includes a section on operational and managerial standards.

Under these standards, OTS requires management and the board of directors to implement and support effective internal control appropriate to the size of the association, its nature, and scope of activities.

**DIRECTORATE RESPONSIBILITIES**

The board of directors has the primary responsibility of establishing and maintaining an adequate and effective system of internal control. An effective

tive board generally has members who have financial or banking experience, and stature.

The board is responsible to report to the FDIC and the OTS (when it is the primary regulatory) on internal control over financial reporting and compliance with certain laws and regulations, as well as filing annual audited statements under section 112 or FDICIA.

The board is also responsible for approving and periodically reviewing the overall business strategy and significant policies of the institution, as well as understanding the major risks the institution takes. The board should set acceptable levels for these risks, and ensure that senior management takes the required steps to identify, measure, monitor, and control these risks. To remain effective in the dynamic and ever broadening environment that institutions operate in, the board of directors should periodically review and update the internal control system.

To oversee internal control and the external and internal audit function of an institution, an audit committee comprised of outside directors (or at least a majority of outside directors) is desirable. Insured depository institutions covered by Section 36 of the Federal Deposit Insurance Act (assets total \$500 million or more), as implemented by Section 12 CFR 363.1(a) must have an audit committee composed of only outside directors.

An active board or audit committee independent from management sets the institution's control consciousness. The following parameters determine effectiveness:

- The extent of its involvement in and its scrutiny of the institution's activities.
- The ability to take appropriate actions.
- The degree to which the board or audit committee asks difficult questions and pursues the answers with management.

For additional guidance on audit committee responsibilities, see Handbook Section 355, Internal Audit.

## AUDITOR RESPONSIBILITIES

### Internal Audits

Both the internal and external auditors play key roles in the monitoring of internal control systems. Each institution should have an internal audit function that is appropriate to its size, and the nature and scope of its activities. The internal auditor is typically very involved in the ongoing review and assessment of an institution's internal control. The board of directors should assign responsibility for the internal audit function to a member of management who has no operating responsibilities, and who is accountable for audit plans, programs, and reports. When properly structured and conducted, internal audits provide directors and senior management with vital information about any weaknesses in the system of internal control allowing management to take prompt, remedial action. Through directed reviews of the internal control systems and as part of the regular audit program, the internal auditor can be the first line of defense against a corrupted control system.

### External Audits

Established policies and practices look to the external auditor to play a significant and vital role in an institution's internal control systems. In this role, the external auditor performs examination procedures to attest to management's assertion that the internal control over financial reporting is functioning effectively, and that it is in compliance with designated laws and regulations. The external auditor may consider the work done by the internal auditor as part of the auditing procedures.

SAS No. 94, *The Effect of Information Technology on the Auditor's Consideration of Internal Control*, which amends SAS No. 55, provides guidance to auditors about the effect of information technology on internal control. It also establishes that an auditor should obtain an understanding of internal control sufficient to plan the audit and determine the nature, timing, and extent of tests to perform, including assessment of control risk. While this pronouncement places significant responsibility on the external auditor to look at internal control, the external auditor may

not extensively review controls over all areas of the institution, and may use different levels of testing depending on the risk of a specific area.

SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit*, provides guidance to the external auditor in identifying and reporting conditions that relate to an institution's internal controls observed during an audit of financial statements. The reportable conditions discussed in this pronouncement are matters coming to the attention of the auditor that, in the auditor's judgment, should be communicated to the audit committee because the conditions represent significant deficiencies in the design or operation of internal control. These conditions, in the opinion of the auditor, could adversely affect the institution's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. In some instances, a reportable condition may be of such magnitude to be a "material weakness." A material weakness in internal control is a reportable condition in which the design or operation of one or more of the internal control components does not sufficiently reduce the level of risk that material misstatements caused by error or fraud may occur, and employees in the normal course of business would not timely detect the misstatements.

Auditors generally do not search for reportable conditions or material weaknesses. They usually become aware of them through consideration of the components of internal control, application of audit procedures to balances and transactions, or during the course of the audit. The auditor makes a judgment as to which matters are reportable, taking into consideration various factors, such as an entity's size, complexity and diversity of activities, organizational structure, and ownership characteristics.

When examining the communication of internal control matters noted in an audit, be aware that there is no standard form of communicating reportable conditions or material weaknesses to the audit committee. Once the auditor has chosen to discuss reportable conditions or material weaknesses, the auditor may do so either through a formal presentation to the audit committee, or informally, through conversations. The auditor may

also submit written reports. Generally, the auditor will document oral communications by appropriate memoranda or notations in the working papers.

## INTERNAL CONTROL COMPONENTS

SAS No. 78 provides guidance on the independent auditor's consideration of an entity's internal control in an audit of financial statements in accordance with GAAS. SAS No. 78 recognizes the definition and description of internal control contained in the COSO report, and provides an overview of the framework and evaluation tools needed for a strong system of internal control. OTS urges institution management and boards of directors to consider SAS No. 78, or other recognized standards in developing and maintaining an effective system of internal control.

SAS No. 78 consists of five interrelated components derived from the way management runs a business, and integrated with the management process. The components are:

- Control environment
- Risk assessment
- Control activities
- Information and communication
- Monitoring.

Note, however, that the five components do not reflect how the institution considers and implements internal control.

## ASSESSING CONTROL RISK

Under SAS No. 78, control risk is the risk that the entity's internal control system will not prevent or detect on a timely basis a material misstatement. Assessing control risk is the process of evaluating the design and operating effectiveness of an entity's internal control. Although you do not ordinarily consider the individual components of internal control, you should consider the combined aspects of the five components listed above.

You can assess control risk in quantitative terms, such as percentages, or in nonquantitative terms that range from maximum to minimum.

### **Assessing Control Risk at the Maximum**

You should assess control risk at the maximum when there is risk that internal control will not prevent or detect material misstatements on a timely basis. In addition, you should review control risk at the maximum if management's representations conflict with controls or reduce the effectiveness, or you have concern that you cannot obtain sufficient competent evidential matter to evaluate the effectiveness of internal controls.

### **Assessing Control Risk at Less Than Maximum**

Assessing control risk below the maximum involves performing tests to evaluate the effectiveness of such internal control. Tests of controls should determine whether the control is suitably designed to prevent or detect material misstatements. These tests ordinarily include evidence obtained from the following actions:

- Conduct management inquiries.
- Inspect documents and reports to review how staff performs controls.
- Observe directly how management applies the controls.
- Retest how management applies the controls.

### **Overall Assessment**

The overall risk assessment should determine whether management takes the following actions:

- Supports fully the concept of effective internal control.
- Encourages their employees to comply with the controls.
- Designs an effective internal control system to monitor and correct noncompliance.

After examining the components and their risk, draw an overall conclusion as to the adequacy of

the institution's system of internal control and include the assessment in the report of examination. A system deemed inadequate is potentially in non-compliance with Appendix A of 12 CFR Part 570, Interagency Guidelines Establishing Standards for Safety and Soundness. OTS may notify an institution with an inadequate assessment of the need to file a plan of compliance as provided for under the regulations. The plan would establish the manner in which the institution will rectify its internal control deficiencies.

### **The Control Environment**

The effectiveness of internal controls rests with the people of the organization who create, administer, and monitor them. Integrity and ethical values are essential elements of a sound foundation for all other components of internal control. The commitment for effective control environment rests at the top. Reaching a conclusion about a financial institution's internal control environment involves a degree of subjectivity because of the intangible nature of measuring effectiveness

#### *Control Environment Assessment Process*

Draw conclusions as to the quality of risk management and assess the effectiveness of the control environment in the following areas:

#### Integrity and Ethical Values

Integrity and ethical values are the products of the institution's ethical and behavioral standards. How management communicates and reinforces these values in practice establishes the "tone" for the organization. Management should strive to remove or reduce incentives and temptations that might prompt employees to engage in dishonest, illegal, or unethical acts. Management must also communicate their values and behavioral standards to personnel through policy statements and codes of conduct.

#### Management Philosophy and Operating Style

Management's approach to taking business risks and their attitude toward financial reporting (conservative versus aggressive) and information processing weigh heavily in the control environment

ment. Consider the level of commitment by management and the board of directors to establish the necessary foundation on which to build an effective system of internal control. Management must have the will to make policies work or even the best-written policies on internal control lose effectiveness.

### Organizational Structure

The institution must have an organizational structure that supports its objectives. Management must plan, execute, control, and monitor institution objectives. It must establish key areas of authority and responsibility and appropriate lines of reporting.

### Assignment of Authority

Assignment of authority includes policies relating to the following areas:

- Appropriate business practices.
- Knowledge and experience of key personnel.
- Resources for carrying out duties.

### Human Resource Policies and Practices

Human resource practices send messages to employees regarding expected levels of integrity, ethical behavior, competence, and conflict of interests.

### **Risk Assessment**

All entities, regardless of size, encounter risk in their organizations. The ability to identify and manage these risks will affect an entity's ability to survive in a competitive market. In order to assess risk, management must first set objectives to quantify the amount of risk they can prudently accept.

Risks relevant to financial reporting include external and internal events, and circumstances that may adversely affect an institution's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. Such risks can arise or change due to the following circumstances:

- Operating environment changes
- New personnel
- New or revamped information systems
- Rapid growth
- New technology
- New lines, products, or activities
- Corporate restructuring
- Accounting pronouncements.

### *The Risk Assessment Process*

Determine whether management has identified and analyzed the risks, and has methodologies in place to control them. Consider also the following areas in assessing the risk process:

- Prevalence of external and internal factors that could affect whether strategic objectives are achieved.
- Effectiveness of systems used to manage and monitor the risks.
- Capacity of existing processes to react and respond to changing risk conditions.
- Level of competency, knowledge, and skills of personnel responsible for risk assessment.

### **Control Activities**

Control activities are the policies and procedures that help ensure management carries out its directives. Control activities should assure accountability in the institution's operations, financial reporting, and compliance areas.

### *The Control Activities Assessment Process*

Assessment of control activities relevant to an examination includes the elements discussed below.

### Performance Reviews

Management should establish policies and procedures to ensure control activities include reviews

of actual performance versus budgets, forecasts, and prior period performance.

Management should conduct independent checks or verifications on function performance and reconciliation of balances.

#### Information Processing

There are two broad groupings of information systems: General controls and Application controls.

Management should establish policies and procedures to ensure that general controls are commonly in place over the following areas:

- Data center operations.
- System software acquisition and maintenance.
- Security access.
- Application system development and maintenance.

Management should also establish policies and procedures for application controls, which apply to the processing of individual applications. These controls ensure valid, complete, properly authorized, and accurately processed actions.

#### Physical Controls

Management should establish safeguards and physical controls over the following activities:

- The physical security of assets, such as secured facilities.
- Access to books, and sensitive records and systems.
- Authorization for access to computer programs and data files.

#### Segregation of Duties

Management should reduce the opportunities to perpetrate and conceal errors, irregularities, or any wrongdoing. Management must assign different people the responsibility of authorizing

transactions, recording transactions, and maintaining custody of assets. For these safeguards, management should ensure that vacation requirements or periodic rotation of duties for personnel in sensitive positions occurs.

#### **Information and Communication Systems**

Management must identify, capture, and communicate information to enable people to carry out their responsibilities. Internally generated data, along with external events, activities, and conditions is necessary for a business to make informed decisions.

To be effective, management must communicate information to the people who need it to carry out their responsibilities. Management must design ways to downstream messages from the top, as well as upstream significant information.

An information system should provide sufficient detail to properly classify the transaction for financial reporting, and measure the value of the transactions in a manner that permits recording the proper monetary value in the financial statements in accordance with GAAP.

#### *Information and Communication Systems Assessment Process*

Communication involves an understanding of individual roles and responsibilities pertaining to internal control over financial reporting. Determine whether policy manuals, accounting and financial reporting manuals, and other memoranda effectively communicate internal control responsibilities.

Determine if management established systems to capture and impart pertinent and timely information in a form that enables staff to carry out their responsibilities. Also, determine whether the following safeguards exist:

- Accounting systems identify and record all valid transactions in the proper accounting period, ensure accountability for related assets and liabilities, and present transactions and related disclosures in the financial statements.

- Management information systems identify and capture relevant internal and external information in a timely manner.
- Contingency plans exist for information systems.

### Monitoring

Monitoring is a process that assesses the quality of the internal control performance over time. Management must build ongoing monitoring activities into the normal recurring activities of their institution, and monitor the internal control system on an ongoing basis to ensure that the system continues to be relevant and addresses new risks. In many cases, the internal auditor is responsible for monitoring the entity's activities and regularly provides information about the functioning of internal control, including the design and operation.

#### *The Monitoring Assessment Process*

Determine who oversees and assesses the monitoring process. Review the type of periodic evaluation of internal control that occurs. For example, is it by self-assessment or by independent audit? Check whether systems ensure timely and accurate reporting of deficiencies and whether there are processes to ensure timely modification of policies and procedures, as needed.

### LIMITATIONS OF INTERNAL CONTROL

When operating under the best of conditions, internal control provides only reasonable assurance to management and the board of directors that the institution is achieving its objectives. Reasonable assurances do not imply that the internal control systems will never fail. Many factors, individually and collectively, serve to provide strength to the concept of reasonable assurance. However, because of inherent limitations, management has no guarantee that, for example, an uncontrollable event, a mistake, or improper reporting incident could never occur. Thus, it is possible for the best internal control system to fail. The limitations inherent to internal control are:

- Judgment
- Breakdowns
- Management override
- Collusion
- Fraud
- Cost versus benefits.

We discuss each of these limitations below.

#### Judgment

Human judgment can limit the effectiveness of internal controls. Management makes business decisions based on the information at hand and under time constraints. With hindsight, these decisions may produce less than desirable results.

#### Breakdowns

The best internal control system can experience any of the following breakdowns:

- Misunderstood instructions
- Careless employees
- Inadequate training
- Time limitations.

#### Management Override

Management override means management overrules prescribed policies or procedures for illegitimate purposes with the intent of personal gain or to enhance the presentation of financial statements. Override practices include deliberate misrepresentations to regulators, lawyers, accountants, and vendors.

Do not confuse management override with management intervention. Management intervention represents management's actions that depart from prescribed policies for legitimate purposes. At times, management intervention is necessary to deal with nonrecurring and nonstandard transactions or events, that otherwise might be handled inappropriately by the control system.

**Collusion**

When two or more individuals act in concert to perpetrate and conceal an action from detection, they can circumvent any system of internal control.

**Fraud**

Fraud is a broad legal concept, and involves intentional illegal acts that generally cause misstatement in the financial statements. Management bears the primary responsibility for detecting fraud. Internal control systems implementation is part of management's fiduciary responsibilities to prevent fraud and abuse by insiders. While the primary objective of an examination is the qualitative analysis of the institution, fraud detection is certainly a goal when reviewing an institution's internal control system. Recent problems concerning insiders at some institutions have some commonalities. Potential red flags that could signal fraud include the following situations:

- Management that is hostile or uncooperative towards examiners.
- Significant insider transactions that the institution improperly approves or fails to fully document.
- Basic internal control deficiencies, such as failure to separate functions or rotate duties.
- Poor or incomplete documentation.
- Financial accounting systems and reports are unreliable, underlying controls are deficient, or the reconciliation process is lacking.
- Repeated and significant Thrift Financial Report reporting errors.
- Continuing unsafe and unsound conditions.

You should be aware of the potential warning signs of fraud and the examination and audit procedures that you should employ when warranted. Should you encounter any red flags you should bring the situation to the attention of Regional Accountant. For more information, see Thrift Ac-

tivities Handbook Section 360, Fraud and Insider Abuse.

**Costs versus Benefits**

The challenge is to find the right balance between the proper controls and the costs to design and implement internal controls. Excessive control is costly and counterproductive. Too few controls present undue risks.

**EXAMINATION APPLICATIONS****Internal Control and Funds Transfer Questionnaires**

The objective of examining the internal control of an institution is to assess the extent to which management has established internal control procedures and programs to identify and mitigate the institution's internal control risks. In planning the examination, be aware of the following situations that may suggest that there is a breach in the control system that warrants attention:

- Management does not implement effective procedures to correct internal deficiencies noted in audit reports.
- Management scales back or suspends the internal audit function.
- The internal auditor has an operational role in addition to audit responsibilities. For example, the internal auditor reports through operating management and not directly to the board of directors or a committee. Ideally, the internal audit function should be under the board of directors or the audit committee, and the internal auditor should report directly to them. The extent to which the internal auditor reports to management may warrant attention to ensure that such reporting does not impair the independence of the internal auditor.
- The institution's external audit firm lacks savings association or bank audit experience, or the auditors assigned have limited experience.
- The institution enters new areas of activity without first implementing proper controls, or

engages in new activities without experienced staff and appropriate controls in place.

- The institution fails to provide adequate reports to the board of directors.
- The institution does not have proper controls in high-risk areas.
- The institution often deviates from board-approved policies with exception documentation.
- The institution fails to effectively segregate duties and responsibilities among employees.

#### *Level I Procedures*

Review the list of objectives in the Internal Control Program, included in the Appendix of this Handbook section, and follow the Level I Procedures to design the examination. These procedures are generally sufficient when an institution has an effective internal audit function. Incorporate the following five basic components of SAS No. 78, discussed in detail in the next section, to assist your review of the effectiveness of the institution's internal control system:

- Size of the institution.
- Organization and ownership characteristics.
- Nature of the institution's business.
- Diversity and complexity of the institution's business.
- Methods of transmitting, processing, maintaining, and accessing information.
- Legal and regulatory requirements.

#### *Management's Responses*

OTS sends questionnaires to the institution as part of the PERK. Institution management answers the Internal Control Questionnaire and the Funds Transfer Questionnaire, which contain questions regarding the overall internal control system of the thrift. You should verify answers provided by

management to ensure that the answers accurately reflect the institution's activities.

In both the Internal Control and Funds Transfer Questionnaires, there are certain "flagged" questions that are the minimum verifications you should perform.

#### *Internal Audit Work Papers*

Examine samples of work papers from internal audits, and include samples from outsourced functions or director's examinations. The samples should be sufficient to provide a basis to validate the scope and quality of the institution's internal control system, and determine the amount of reliance, if any, you can place on the system.

Review also, whether the external auditor communicated any reportable conditions, either orally or in writing, to management. If you determine that external audit work papers are necessary for your review, contact the Regional Accountant before requesting external audit work papers, or other pertinent documents related to the external auditor's judgment about the institution's internal control. See Handbook Section 350 for requesting external audit work papers, Appendices D and E.

Make requests for work papers specific to the areas of greatest interest. The request may include related planning documents and other pertinent information related to the internal control areas in question. If management or the internal auditor refuses to provide access to the work papers, contact the Regional Accountant.

If the internal audit work papers review or the external auditor's communications with management on reportable conditions raises concerns about audit effectiveness, discuss the issues with management, the board of directors, and the audit committee. If issues remain unresolved regarding external audit work, consult the Regional Accountant.

#### *Level II Procedures*

Based on management's responses to questionnaires, or when an institution does not have an effective system of internal audit, or when wa r-

ranted based on examination findings, consider expanding the scope of the examination to include Level II procedures provided in the Internal Control Program. Also perform appropriate Level II procedures if the institution outsources any significant activities and Level I procedures are insufficient to determine how the institution controls the outsourced activity.

Issues that would require expanded procedures under Level II include:

- Concern about the competency or independence of internal auditors.
- No internal audit program is in place.
- Unexplained or unexpected changes occurring in the internal or external auditors, or significant changes occurring in the audit program.
- Inadequate controls in key risk areas.
- Deficient audit work papers in key risk areas, or work papers that do not support audit conclusions.
- High growth areas exist without adequate audit or internal control.
- Inappropriate actions by insiders to influence the findings and scope of audits.

If significant concerns remain about the adequacy of internal control, the next step, after completion of Level II procedures, should be to consider expanding the scope of the review to include procedures under Level III of the Internal Control Program. The following situations may warrant Level III procedures:

- Account records are significantly out of balance.
- Management is uncooperative or poorly manages the thrift.
- Management restricts access to records.
- Significant accounting, audit, or internal control deficiencies remain uncorrected from

previous examinations or from one audit to the next.

- Internal auditors are unaware of, or unable to sufficiently explain, significant deficiencies.
- Management engages in activities that raise questions about its integrity.
- Repeated violations of law affect audit, internal control, or regulatory reports.
- Other situations that you believe warrant further investigation.

Consult with the Regional Accountant to determine which procedures you should perform.

### **OUTSOURCING RISKS**

Institutions rely increasingly on services provided by third parties to support a wide range of activities. Outsourcing, both to affiliated companies or third parties, may help manage costs, improve and expand services offered, and obtain expertise not internally available. At the same time, reduced operational control over outsourced activities may expose an institution to additional risks.

Outsourcing involves some of the same operational risks that arise when an institution performs a function internally. Such risks include the following:

- Threats to the availability of systems used to support customer transactions.
- The integrity or security of customer account information.
- The integrity of risk management information systems.

Under outsourcing arrangements, however, the risk management measures commonly used to address these risks, such as internal controls, are generally under the direct control of the service provider, rather than the institution that bears the risk of financial loss, damage to its reputation, or other adverse consequences.

OTS expects institutions to ensure that controls over outsourced activities are equivalent to those

that the institution would implement if they conducted the activity internally. The institution's board of directors and senior management should understand the key risks associated with the use of service providers. They should ensure that an appropriate oversight program is in place to monitor each service provider's controls, condition, and performance. See discussion of outsourcing in Handbook Section 355, Internal Audit.

## REFERENCES

### United States Code (12 USC)

#### *Federal Deposit Insurance Act*

- § 1831            Contracts Between Depository  
                         Institutions and Persons Provid-  
                         ing Goods, Products, or Services
- § 1831p-1       Standards for Safety and Sound-  
                         ness

### Code of Federal Regulations (12 CFR)

- Part 363        Requirements For External Au-  
                         dits And Audit Committees
- Part 570        Appendix A, Interagency Guide-  
                         lines Establishing Standards for  
                         Safety and Soundness

## OTS References

Directors' Guide to Management Reports  
<http://www.ots.treas.gov/docs/48091.pdf>

## AICPA Professional Standards

*Statement of Auditing Standards (U.S. Auditing  
Standards (AU))*

- No. 55            Consideration of Internal Control  
                         in Financial Statement Audit (AU  
                         319)
- No. 60            Communication of Internal Con-  
                         trol Structure Related Matters  
                         Noted in an Audit (AU 325)
- No. 78            Consideration of Internal Control  
                         in a Financial Statement Audit:  
                         An Amendment SAS 55 (AU  
                         319)
- No. 94            The Effect of Information  
                         Technology on the Auditor's  
                         Consideration of Internal Control  
                         in a Financial Statement Audit  
                         (AU 319)

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# Internal Control Program

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## Examination Objectives

Determine whether existing controls reasonably ensure all of the following:

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

## Examination Procedures

Wkp.Ref.

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

## Level I

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 Questionnaire (PERK 002), the Internal Control Questionnaire (PERK 004), and the Funds Transfer Questionnaire (PERK 018). 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 notify the examiner assigned any area where there are possible weaknesses so the examiner can make any necessary scope changes.  

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2. Review management reports on internal controls and related attestations by independent accountants required by the Federal Deposit Insurance Corporation Improvement Act (FDICIA). Review the external audit internal control work papers or other communications regarding reportable conditions.  

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## Internal Control Program

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3. 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.

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 procedures for reporting.

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4. Determine whether management 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 changes.

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

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6. Verify that management enforces all critical policies.

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7. Review the general questionnaires as other examiners complete them during the examination to identify all critical internal control weaknesses noted. Discuss these weaknesses with appropriate management personnel, either personally or by the examiner responsible for the review of these areas.

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Wkp.Ref.

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

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9. Determine whether the association outsources any significant activities to third-party vendors. Review internal and external audit reports for identified problems or concerns regarding outsourced activity. Perform Level II procedures as appropriate.

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10. If the association uses its external auditors to conduct the internal audit, determine that the association maintains the integrity and quality of internal control.

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

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### Level II

You should perform Level II procedures when an association does not have an effective system of internal audit 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.

12. 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 and/or the FM.

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## Internal Control Program

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13. 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.

\_\_\_\_\_

14. 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.

\_\_\_\_\_

15. Assess the adequacy of information and communication systems.

\_\_\_\_\_

16. Determine whether management gives appropriate and timely attention to material control weaknesses once identified.

\_\_\_\_\_

17. 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 discussion of Outsourcing in Handbook Section 355.)

\_\_\_\_\_

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

\_\_\_\_\_

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

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## Internal Control Program

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20. Review director's, officer's, and employee's deposit accounts for any unusual activity.

\_\_\_\_\_

21. Ensure that your review meets the *Objectives* of this Handbook Section. State your finding and conclusions as well as appropriate re commendations for any necessary corrective measures, on the appropriate work papers and report pages.

\_\_\_\_\_

### 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 .
- The association is not audited by an independent party .
- The association does not have an internal audit program in place.

22. Verify cash on hand. Review cash items or any other assets or liabilities held in suspense accounts to determine proper and timely disposition.

\_\_\_\_\_

23. When control concerns exist in a given area or activit y, prove subsidiary records for targeted area to the general ledger such as loans, investments, or deposits.

\_\_\_\_\_

24. Verify the safekeeping of securities on hand or held by o thers.

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Wkp.Ref.

25. Review accrued interest accounts and test the computation and disposition of interest income.

\_\_\_\_\_

26. Verify loan balances for loans charged-off since the previous examination and the debit entries to the allowance account.

\_\_\_\_\_

27. Check supporting documentation for loans charged-off.

\_\_\_\_\_

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

\_\_\_\_\_

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

\_\_\_\_\_

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

\_\_\_\_\_

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

\_\_\_\_\_

32. 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.

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## Internal Control Program

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

\_\_\_\_\_

34. Review the timeliness of wire transfer verifications and reconciliations and verify that independent parties were involved in the process.

\_\_\_\_\_

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

\_\_\_\_\_

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

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## QUESTIONNAIRES

This discussion briefly addresses subjects in the Internal Control Questionnaire and Funds Transfer Questionnaire. The association completes these Questionnaires as part of the PERK. You should follow up with an interview and indicate on the form any answers that you verified. The association must explain negative responses and you should review through interview and observation any problems needing supervisory attention. Many of these topics are somewhat self-evident and the Handbook covers others in more detail in other sections.

### Internal Control Questionnaire

#### *Internal Audit*

Associations should have an internal auditing program that is appropriate to its size and the nature and scope of its activities. Associations should follow specific procedures to test accounting information and internal routine and controls. Preferably, the internal auditor should report findings to the board of directors or an audit committee consisting of outside directors. Internal audit reports should include suggested corrective actions to noted problems. The board or audit committee should ascertain whether management made adequate corrections when recommended. A full-time internal auditor should preferably serve the board or audit committee. If this is impractical, at least the board or audit committee should review the auditor's performance. It should set the salary to keep the auditor independent of the audit subjects, especially top management. Refer to Thrift Activities Regulatory Handbook Section 355, Internal Audit.

#### *General Items*

The records and systems should enable others to trace any given item as it passes through the association's books. Exception or large item reports list all transactions over a specific dollar amount, regardless of whether they involve cash, check, etc. The association should have a person not involved in the transaction review the report for unusual items. You may suggest to management that they

create such reports if the association does not currently prepare them.

#### *Cash and Cash Items*

Cash items are "near cash" checks received as deposits from customers. In the normal course of business, the association sends these items to a correspondent that collects them from the drawee institution. The association receives immediate credit for them. The correspondent will return some items as cash items in which the association will have to resend for collection again. The association may also return them to the depositor.

Checks drawn on uncollected funds in an association are a form of loans to depositors. Management should use software controls and a daily drawing on uncollected funds report to monitor these checks. You can identify these checks by deposit accounts with deposit totals for the past three days being greater than the balance for the day. Checks drawn on uncollected funds must be limited to prevent abuse by depositors unworthy of credit. Some associations reject all checks drawn on uncollected funds. If an association permits drawings on uncollected funds, then management should allow such drawings only after they make a credit decision on the creditworthiness of the depositor. You should determine how management controls or prevents checks drawn on uncollected funds.

Overdrafts are loans made by paying checks that draw a deposit account into a negative (debit) balance. Management should permit overdrafts only after it makes a credit decision on the customer (borrower). An officer should review overdraft activity every day for old, overly large, or inappropriate overdrafts.

Return items are checks deposited in an association, but drawn elsewhere and returned for some reason, usually non-sufficient funds (NSF). The normal procedure for handling return items is to call the depositor and ask if the depositor knows if the item will be good if sent for collection on that day, or if it should be bought back by the depositor. The appropriate staff person should record return items as return item assets if not debited to a

customer's deposit account. The association should not hold return items for days pending a decision. They may result in losses, if not paid soon. Management should maintain over and short accounts for each person with a cash drawer. If activity is minimal, then each entry should identify the person with the cash difference. Larger operations may have over and short accruals to compare actual performance with projections.

Management must ensure that accounting controls over all liquid assets prevent personal use by employees. Management's policies should not permit "IOUs" in cash or cash item totals. An appropriate staff person should record all cash and cash item transactions and review them daily to limit abuse.

#### *Association (Official) Checks*

Many associations use checks drawn on themselves (known variously as "on-us checks" or "official checks") for payment of expenses, interest, dividends, and loan proceeds. They may also sell them to customers as cashier's checks or money orders. The association must honor its own checks or risk its reputation. The association cannot reject its checks unless there is fraud. For these reasons, management must have policies in effect to control official checks.

One common control is to require two authorized signatures. If management does not require two signatures, someone without signature authority should control the unsigned blank checks. This person should fill out the check amount and payee based on an approved voucher. The approving officer should compare the voucher to the check before signing it. Ideally, the appropriate staff person should verify unused check supplies to a shipping invoice to ascertain that the supply has not been lost and subject to misuse. After checks are paid, someone should review the checks for authorized signatures and compare them with vouchers for alteration. Someone should reconcile copies of outstanding checks to vouchers and the respective liability accounts.

#### *Due From Banks*

Due from banks describes assets that consist of demand and time deposits maintained in other fi-

ancial institutions to facilitate the transfer of funds. Also called correspondent bank balances, these accounts enable the transfer of funds between financial institutions, resulting from the collection of cash items and cash letters, the transfer and settlement of securities transactions, the transfer of participating loan funds, the purchase or sale of federal funds, and from many other causes. Shortcomings in procedures and controls, as they relate to due from bank accounts, can lead to manipulation and shortages. The association must check incoming statements from banks to record copies in each instance to protect against fraud and errors.

#### *Investments and Securities*

Transactions in investment securities are typically large and involve liquid movable assets, thus making controls in this area very important. To ensure accurate records as well as discourage fraud, appropriate staff should implement the following controls:

- Document transactions and maintain them separately from the initiating officers and the executing traders (if the association has its own trading operation).
- Record all transactions and all holdings in a securities ledger system.
- Reconcile the transactions and the securities ledger to confirmations and broker statements daily.
- Reconcile transactions and the securities ledger to the general ledger at least monthly.
- Maintain accrual accounts to ensure income is collected.
- Review broker statements and confirmations and reconcile them to the books before they go to the investment officers (this action limits the chance of abuse by unauthorized officers in concert with brokers).

Management should enforce policies that limit, by dollar amount, board-granted investment authorities. They should require dual approval for unusually large transactions. Management should make this policy clear to brokers doing business

with the association. Brokers should never have the authority to manipulate association assets without prior approval for every transaction. Investment advisors should advise the association, not the broker.

Brokers frequently engage in borrowing of customers' assets through repurchase agreements or use of customers' assets as collateral for their own trading. Management should only permit this for the most creditworthy dealers, who are typically the primary dealers in treasury issues subject to daily monitoring by the Federal Reserve.

To discourage unauthorized and unrecorded transactions (personal trading with association assets), the authorizing officer should initiate book entries for transactions by memo to the paying officer who books the transaction. Both parties perform their part of the transactions simultaneously on the clearing day. Therefore, all securities transactions should be delivery versus payment.

Most associations hold securities in safekeeping under delivery versus payment procedures. Management should permit free deliveries; those not requiring payment (such as a transfer from one safekeeping agent to another), only under contract specified dual approval to deter theft of the portfolio. When the association holds negotiable securities on premises, the securities should be under strict dual control at all times. Refer to Handbook Section 540, Investment Securities.

### *General Lending*

To control the income from loan originations, management should provide a written schedule of fees and interest rates for originators to follow. Loan administration personnel should test loan originations to assure compliance with policy. Associations must establish a lending limit in accordance with 12 CFR § 560.93, Lending limits, to prevent overlending to any one borrower. Loan administration should enforce the limit by ensuring that it does not fund loans in excess of the association's legal lending limit. The internal auditor should report any excess loans to the board of directors.

Management should base the allowance for loan and lease losses (ALLL) on an internal asset review (IAR). They should then periodically review the credit quality and collectability of the association's loans and leases. Staff members that review and grade assets as part of the IAR should not be responsible for originating or servicing activities.

Loan originators may request loan disbursements. Until loan administration verifies that the disbursement is in agreement with the contract and the loan complies with policies, management must not authorize the disbursement. Loan administration staff should obtain and verify credit information. They should not be involved in the loan origination. These are essential segregation of duties preventing loan officers from misapplying funds.

Internal lending limits are an extremely important control. The board of directors should implement all of the following safeguards:

- Set low individual lending limits for all officers.
- Require two or more officers to co-approve larger loans.
- Require advisory committees to co-approve especially complex or very large loans.

All loans not meeting strict board approved limits and policies should require prior board approval before commitment or funding.

A central loan (or liability) ledger should tie together all direct and indirect credits and commitments for each borrower. Otherwise, the association runs a risk of lending too much to one borrower in violation of internal policies or regulations.

### *Construction Lending*

Construction lending involves many disbursements to cover construction costs as construction progresses. The association must have a construction inspector on site to verify that requests for funds (draws) are legitimate. The inspector should check to make sure material is on site and that the contractor follows construction plans. It is also

prudent to occasionally alternate inspectors at each site. Their supervisor should occasionally perform a review inspection to ascertain that inspections are reliable. Before disbursement of funds, loan administration should match inspection reports to draws. They should compare them with construction plans to ensure that work is progressing accordingly. Loan administration should never authorize cash disbursements.

Staff should not make payments to third parties directly. To prove that a borrower received funds, the appropriate staff should make the payments to the borrower's account for payment of specific draws. Checks, however, may be payable jointly to the borrower and a supplier or subcontractor. When a contractor provides paid bills and materials' lien waivers, staff should compare them with draws to be certain that the loan funds will pay for actual expenses. Loan administration should compare progress from draws with construction plans to ensure that they are not funding cost overruns without due consideration. Refer to Thrift Activities Regulatory Handbook Section 213, Construction Lending.

#### *Loan Servicing and Recordkeeping Functions*

After loan approval, staff should take the following steps:

- Maintain records under careful control to ensure that collection will be possible if legal action is necessary.
- Keep all collateral secure, so it cannot be lost, stolen, or released to the borrower early.
- Place large dollar collateral under dual control so that employees do not release it in error or through collusion with a borrower.
- Maintain complete collateral documents to ensure perfected collectible liens.
- Control advance payments on loans with appropriate accounting procedures.
- Whenever possible, cross-collateralize loans with the same obligor, that is, all collateral should cover all loans of the obligor.

Loan administration must be careful to adjust interest rates according to contracts. Collection efforts should follow official procedures to avoid legal complications. Collectors should keep a log of all contacts with delinquent borrowers, detailing any promised action. Management should use insurance ticklers to ensure that borrowers pay insurance premiums on time.

#### *Accrued Interest Receivable*

To prevent diversion of interest earned by the association and to ensure that interest calculations are correct, the appropriate staff should perform audit tests on interest calculations.

#### *Advance Payments by Borrowers for Taxes and Insurance*

Borrowers often make regular payments to an association for real estate taxes and insurance on collateral real estate. The association credits these funds to escrow or impound accounts. Staff should analyze these accounts annually to make sure the association is receiving adequate funds to cover the next expense payments. As a further control practice, the association should send the borrower an annual statement of escrow account activity. It should involve the audit department in any customer disputes. Refer to the Mortgage Banking sections of this Handbook.

#### *Loans in Process*

The association typically places funds allocated for construction loans in a "loans-in-process" (LIP) account and pays draws from this account. Management should review, approve, and audit draws from LIP to ensure proper application of funds. Refer to Thrift Activities Regulatory Handbook Section 213, Construction Lending.

#### *Commercial Lending*

The variety and risks of commercial lending require administrative controls on both information and collateral. Management should put a tickler system into operation to ensure timely requests for financial statements from borrowers and guarantors, and to track exceptions. Qualified persons

should evaluate collateral and appraise it for adequacy. Management should control collateral release to prevent loss from untimely release. Refer to Thrift Activities Regulatory Handbook Section 214, Other Commercial Lending.

#### *Other Loans (unsecured, mobile homes, etc.)*

Loan administration must control the entire process of lending and collecting. When a government agency is involved in a loan, the association must strictly meet the requirements for the guarantee or participation or the agency is generally relieved of duty to honor the guarantee. The association should verify the amount of Federal Housing Administration reserve accounts annually with the Department of Housing and Urban Development.

Dealer paper refers to loans originated by a retail seller of merchandise that the association funds or purchases. In funding such loans, management must maintain strict segregation of duties to avoid loss, because the association has no control over the dealer's employees. The association must record collateral liens according to state law before another creditor records a lien. Management should inform the board of directors of charge-offs and recoveries to ensure that diversion of funds does not occur. The association must control and inspect collateral, because unlike real estate, merchandise is moveable. A financially healthy dealer can deteriorate quickly in an adverse economy. Thus, management should control collateral and carefully inspect it, since it may become the only source of payment.

Many manufacturers of mobile homes and other consumer items may have a variety of dealer financing plans that can distort the true dealer cost through rebates and volume discounts. Lending based on an invoice is, therefore, very risky. If the association finances inventory, the association must be familiar with the current wholesale market value of such inventory. Refer to Thrift Activities Regulatory Handbook Section 216, Floor Plan and Indirect Lending.

#### *Credit Quality Review*

Credit quality review, also known as the internal asset review or the internal classification review, is

a vital credit quality control program. Refer to Thrift Activities Regulatory Handbook Section 260, Classification of Assets.

#### *Deposit Account Loans*

Losses can be serious if the association does not adequately control loans secured by deposit accounts. Lack of control may result in serious problems. These problems include:

- Forged signatures on the loan documents.
- Misapplication of loan proceeds.
- Withdrawal of collateral deposits without paying the loan. Refer to Thrift Activities Regulatory Handbook Section 560, Deposits/Borrowed Funds.

#### *Real Estate Owned and Other Repossessed Assets*

The association must establish ownership of real estate, acquired because of debts previously contracted, according to local laws and customs under legal advice. Accounting practices require a prompt appraisal to determine the correct carrying value of the new association asset. Management must periodically inspect properties for needed maintenance to limit deterioration. If properties have material value, the association's management should bond collection and management agents, or at least ensure that they are bondable. The association should acquire hazard insurance, when available. Refer to Thrift Activities Regulatory Handbook Section 251, Real Estate Owned and Other Repossessed Assets.

#### *Real Estate Held for Investment*

Management should control each parcel separately to provide for informed decisions to hold or sell. They must maintain accounting controls to create reliable records. Refer to Thrift Activities Regulatory Handbook Section 230, Equity Investments, for more comments.

#### *Fixed and Other Assets*

While these assets may not require as much attention as others, management must maintain routine

accounting controls as support for the general ledger and tax returns. Refer to Thrift Activities Regulatory Handbook Section 250, Other Assets/Liabilities, and Section 252, Fixed Assets.

### *Deposit Accounts*

Due to the high volume of activity in deposit accounts, management may streamline routines for convenience and to minimize expense. To limit loss from errors and irregularities, management must ensure that controls are in place to recognize unusual transactions and limit loss. These controls should include:

- Officer approval and reviews for propriety regarding any unusually large transactions.
- Routine procedures and activity reviews that ensure segregation of duties and confirm transactions with customers when they open and close deposit accounts.
- Reconciliation of deposit ledgers to the general ledger daily.
- Testing of interest calculations periodically to ensure correctness.
- Testing of accrued interest accounts for adequacy to ensure no misapplication of funds, or under accrual of expense.
- Dual control of all deposit accounts used as collateral to prevent inappropriate withdrawals.
- Periodic advertisement of unclaimed balances.
- Crediting unclaimed balance accounts to the State according to State escheat laws. (Escheat laws limit the build-up of dormant accounts). Refer to Thrift Activities Regulatory Handbook Section 560, Deposits/ Borrowed Funds.
- Review of check kiting reports.

Service providers normally provide a check-kiting report (for example, “Kiting Suspect Report”) to associations that identifies potential check-kiting situations. The report shows those accounts with activity indicating the drawing upon uncollected funds, and the recur-

ring presence on the report by an account holder could indicate a kiting situation. However, the parameters for these reports may vary depending on whether the service provider allows the association to set up specific parameters; otherwise, a default setting may be used. Most of the account holders identified on the report are not involved in check kiting, but it does provide management with a good overview of the operation and possible check kiting. The service provider usually runs the report on a daily basis. Someone who does not have access to teller operations should review the report.

### *Deferred Credits*

Generally accepted accounting principles require recognition of loan origination fees as income over the life of the loan in accordance with SFAS No. 91. The association should carry such deferred income as a deferred credit. See the Thrift Activities Regulatory Handbook Section 251, Real Estate Owned and Other Repossessed Assets, for comments on accounting conventions for sale of these assets.

### *Other Liabilities*

Management should periodically review miscellaneous accounts to deter misuse. These accounts should be minimal.

### *Capital (Reserves, Undivided Profits, etc.)*

Management must carefully control all changes in the ownership records of the association through the officially designated registrar. Management should report all capital account entries to the board of directors. Refer to Thrift Activities Regulatory Handbook Section 110, Capital Stock and Ownership.

### *Letters of Credit*

These credit documents require strict controls similar to loans. Although letters of credit do not appear on balance sheets, they can result in liabilities for payment. A bona fide commitment for a letter of credit generally carries the same conti-

gency for liability as a letter of credit, if the holder can prove the authenticity of the commitment. Refer to the Thrift Activities Regulatory Handbook Section 215, Letters of Credit, for additional discussion.

### Funds Transfer Questionnaire

The transfer of funds is an essential activity for all depository institutions. It is, however, a source of extreme vulnerability to material loss from mistakes and fraud if not adequately controlled. Control procedures and fidelity bond coverage can limit the risk to capital. However, management should not use the bond deductible and coverage as a substitute for adequate controls. A quick review of the blanket bond deductible and coverage amount and any related policy riders will give you an idea of the reliance the association places on control procedures to limit risk from funds transfer activities.

In your review, you should ascertain the following information:

- Whether the transfers pose risk to capital.
- Whether management prescribes reasonable controls.
- That management confirms or tests the controls periodically.

Use of the Funds Transfer Questionnaire and examination procedures should provide you with enough information to make a reliable judgment on the adequacy of transfer controls.

This Appendix discusses the following:

- Background information.
- The transfer process.
- Common effective control procedures.

#### Background Information

Transfers may originate internally or externally. They can be among internal accounts or external accounts and can involve one customer or many

customers. Essentially, all transfers are instructions by an authorizer to debit an account at a institution for credit to another account at either the same or another institution.

For this discussion, funds transfer includes the transfer of control over funds, both internal and external, to an association. Two common examples of internal transfers are: loan fundings and deposit transfers among customers' accounts in the association. External transfers are payments involving more than one depository institution.

All associations engage in transfers. Most are involved in large transfers relative to their capital accounts, and blanket bond coverage with deductibles. Associations without correspondent banking departments and major corporate deposit accounts may not have a large volume of transactions.

Many routine control procedures exist that can limit risk from funds transfer activities. The procedures in use must be compatible with the following parameters:

- The volume of activity the association expects related to capital.
- Insurance coverage and deductibles.
- The size and diversity of the association's staff.

Association management must ensure that staff encrypts all data transmissions using algorithms. This protects information from improper disclosure or alteration. You can find additional text on electronic funds transfer systems in Section 10 of the Federal Financial Institutions Examination Council (FFIEC) Information Systems (IS) Examination Handbook used by OTS. However, it does not address control procedures required by funds transfer activities.

#### Transfer Process

Associations execute internal transfers through the accounting system. Internal transfers may be initiated on paper, by direct key entry, or through other computer links.

Associations may execute external transfers through any of the following means:

- Official (drawn on us) checks
- Drafts on correspondent accounts
- Customer depository transfer checks
- Customer checks or drafts
- Computer link to independent transfer systems
- Direct computer link to a correspondent
- Voice telephone (voice transmission) call to a correspondent.

Transfers may use various transmission mediums such as:

- Dial-up common carrier lines (telephone, telex, electronic mail)
- Dedicated lines
- Hard-wire terminals requiring no dial up
- Paper text
- Electronically transmitted-image facsimile (FAX)
- Voice
- Encrypted data.

These mediums may use various technologies such as wires, radio phone, cellular radio telephone, microwave, or fiber optic lines, each with different security and vulnerability. There are several wire transfer service providers:

- Fedwire
- CHIPS
- SWIFT
- The Federal Home Loan Banks
- Other correspondent banks
- Electronic mail services.

Each medium, method, technology, and service has strengths and weaknesses, and none are perfect.

Common Effective Control Procedures

A customer or association employee may initiate a transfer, which debits the customer's account. Appropriate association personnel must verify that the account holder authorized the customer debit. Management must ensure that authorizations include a written contract specifying how, when, and who can initiate transfers. A depository contract on a signature card may also detail authorizations. Authorizations may be specific or general. General authorizations may be blanket for any amount or repetitive for the same amount. A general authorization must include who may make transfers, how much the transfers can be, and when the transfer can occur.

Appropriate staff should record general authorizations in system controls for automatic confirmation of authorization. General authorization controls may require initiator and sender identification codes, unique passwords, cipher codes, set procedures, and limited channels of communication. Appropriate staff must initiate requests for transfers using contractually agreed upon means permitting confirmation before execution.

Preferably, before a sender executes any transfer requests originating in the association, appropriate association personnel must verify the initiator's authorization and provide an approval to the sender. Management should segregate the duties of initiating and executing a transfer. If prior approval is not practical, then management should establish a transaction ceiling – an amount above which a lack of prior approval will stop the transfer.

After execution of the transfer, appropriate association personnel should send notice of transfers to the account holders' address of record. Someone other than the initiator or executor should send the confirmation to prevent tampering. The initiator or another person should review transfer accounting entries for authenticity by comparing the transfer accounting entry with the approved request.

It is very important that funds transfer approval levels increase proportionately with the amount of

the transfer. For example, for transfers less than \$10,000, staff members or junior officers may make approval. For amounts of \$50,000 to \$100,000, a junior officer may authorize the transfer once they determine the transfer is valid. For amounts greater than \$100,000, the association should require dual officer approval. For amounts greater than \$1 million, dual senior level officers should approve the transfer with required callbacks from the receiving bank.

An example of a typical transfer is a customer phoning a request to transfer funds from a savings account to a checking account. The customer is an authorized drawee on both accounts. This is not problematic provided control procedures ensure that the authorizing customer is a drawee on both accounts. Management should instruct association employees to verify that a drawee authorized, in writing, any requested transfer from one customer's account to another customer's account, prior to making the transfer. Large or unusual transfers should require higher level approval before execution. Subsequent controls should include either a review of debits to ascertain that the debit and credit are between accounts with a common drawee, or that both an initiator and an approver have confirmed the drawee's authorization of the transfer.

To avoid misunderstandings with multiple drawee accounts, a drawee should sign a written authorization indicating that the association should honor telephone requests for transfers between accounts. Management should ensure that employees maintain a file of the written authorizations.

A typical two-party transfer is a debit to a checking account and credit to a utility or other creditor for a monthly billing. The appropriate employee executes the transfer using a draft supported by an authorization. Another typical two-party transfer is a debit to a loan or loans process account and a credit to a supplier or contractor. For all transfers from one drawee's account to another drawee's account, the association should have a written authorization or request from a drawee. The written authorization or request should specify the following information:

- The amount the drawee wants transferred.

- The account to debit (charge, or transfer money from).
- The account to credit (transfer money to).

The authorization may cover several specific transfers, a series of transfers, or one transfer.

Follow-up controls should include confirmation of signatures on authorizations or requests. A person independent of the initiation of a request should be involved in either the approval or the confirmation process. This assures segregation of duties and limits opportunities for collusion. For example, the initiator and sender of transfers should be separate; one individual should initiate the securities transaction while another individual executes it. Payment (settlement) should only occur upon confirmation of the initiated order to the executed trade ticket.

Transfers of funds outside of the association (external transfers) must be through accounts of the association at correspondents. The appropriate association personnel should initiate the transfer through regular communication channels.

Daylight overdrafts are overdrafts existing between the daily closing of accounting records. Even when daylight overdrafts are properly controlled, they are a credit risk. If inadequately controlled, daylight overdrafts may be a very serious transfer risk. When a correspondent permits daylight overdrafts, funds available for transfer may be virtually unlimited and may be unrecoverable. To facilitate maximum volume of transactions, controls on daylight overdrafts usually do not prevent excessive overdrafting; instead, they stop continued overdrafting after the association exceeds a certain limit. For this reason, internal controls on external transfers must be rigid and subject to frequent testing and review to discourage and prevent loss.

Refer to Thrift Activities Regulatory Handbook Section 580, Payments System Risk, for discussion of the setting of limits for daylight overdrafts.

A low-volume voice transmission operation must also have rigid controls. Voice recognition alone is unacceptable as a control. Generally, there is no witness to verify recognition and no call back to verify the location of the caller. Typical controls

require a four party callback or confirmation process on all external transfers. For example, once the association receives a customer request, appropriate personnel must confirm the request as authorized in writing by the customer, and approve it as confirmed. The sender then executes the request by transmission to a correspondent. The usual means is by a telephone call. The correspondent receiver hangs up the phone, and has an approver confirm the transfer request with a separate confirmer at the association, usually by a telephone call back. This process must involve four persons (two at each institution) to be a valid control procedure. It relies on segregation of duties to prevent collusion at either institution. Management should implement the following additional steps:

- Provide each person with a recognizable identity such as a name, code word, or number.
- Identify each transfer by sequence number known to both the sender and receiver.
- Record all calls.

Segregation of duties requires that wire transfer senders not be initiators or approvers. Senders should always look for the required approvals before sending a message. To control wire transfers, someone not involved in either initiating, approving, or sending messages should frequently review all messages. In low-volume PC operations, daily review of an unbroken printout of all messages (comparing the record of messages with the approved request forms) is a common control review.

Other common control safeguards include the following procedures:

- Limited signing authorities.
- Dual controls over forms.
- Supervisor's key controls on computer terminals.
- Unique passwords for transfer clerk (sender) and releaser.

It is common for institutions to number each message with an encoded sequence number and require use of a confidential test key to decode the number. For this control procedure to have integrity, the

holders of the test key should not have the ability to send or receive messages.

Management may require additional controls, such as limiting the funds available for transfer. Correspondent banks require this procedure for extremely weak institutions to prevent daylight overdrafts on correspondent accounts. A correspondent relationship may also require that the institution make all outgoing transfers from one specific account not used for incoming transfers. In addition, the correspondent banks may not permit daylight overdrafts. This procedure requires the sending association (respondent) to transfer funds from an operating account at the correspondent to a transfer account before transferring funds to another institution. The first transfer request makes funds available for transfer. The second transfer request executes the external transfer.

Someone without signature authority should control supplies of negotiable forms such as single signature official checks and drafts. This person must require an authorized voucher for release of a check or draft, preferably after it is prepared for signature. The appropriate staff should reconcile paid official checks to accounting records of vouchers and review them for authorized signatures.

Whenever check-signing procedures use signature machines, the signature plates should be under key control at all times, with dual control on dual signature machines and plates. Daily control procedures should include reconciling the signature counter totals to the number of check authorizations to ascertain that no one signed extra checks.

Daily independent reconciliation of wire transfers with correspondent accounts and general ledger accounts is an essential control to ensure detection of any errors or misapplications of funds. Any chances of retrieval of mis-sent funds diminish quickly. You should check whether the institution has routines that require action by two people to complete a transfer, one to receive or initiate the request and another to confirm authenticity. If the association makes transfers to offshore privacy havens, determine how management investigates the transfer for legitimacy.

Due to the detail involved, you should review the internal controls on funds transfers by interview and observation rather than by audit methods. Any procedures allowing one person to remove unlimited funds from an account without immediate detection should receive report comment and follow-up at the next examination. Initiate enforcement action to correct unsafe and unsound operating procedures whenever association management is uncooperative in resolving inadequate controls.

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A management official of the association should complete this questionnaire. If the association lacks an effective system of internal audit or control, the examiner should verify appropriate responses and initial in the verified column. The flagged questions are the suggested minimum verifications. Management must provide the examiner with an adequate written explanation of all "No" answers, with an appropriate reference to the question, and supply copies of applicable written procedures. If a question is not applicable to the association, respond with NA.

**Internal Audit**

Verified by Examiner		Yes	No
_____	1. Does the association have an internal audit program?	_____	_____
_____	2. Do the internal audit programs contain written, specific instructions for audit procedures for the internal auditor to perform?	_____	_____
_____	3. Does the board of directors or the audit committee review internal audit reports?	_____	_____
_____	4. Does the audit committee consist only of outside directors?	_____	_____
_____	5. Do internal audit reports suggest actions to correct internal control or procedural deficiencies?	_____	_____
_____	6. Is there a subsequent review to ascertain that the association implemented suggestions for corrective actions?	_____	_____
_____	7. Does the internal auditor report to or receive salary reviews by the audit committee or board of directors?	_____	_____
_____	8. Did the external auditor communicate any reportable conditions, either orally or in writing, to management, the board of directors, or the audit committee?	_____	_____

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**General Items**

- \_\_\_\_\_ 9. Does the association reconcile the following accounts to the general ledger at least daily (if activity is minimal, weekly or monthly reconciliations may be appropriate)? \_\_\_\_\_
- Loans in process
  - Suspense accounts
  - Accounts out of balance
- \_\_\_\_\_ 10. Does the association reconcile the following accounts to the general ledger at least monthly? \_\_\_\_\_
- Loans
  - Investment securities
  - Real estate owned
  - Borrowings
  - Checking and deposit accounts
- \_\_\_\_\_ 11. Does a person not involved in general ledger entries perform the reconciliations? \_\_\_\_\_
- Person responsible? \_\_\_\_\_
- \_\_\_\_\_ 12. Does a person not involved in the transactions periodically review and investigate activity on exception and/or large items report(s)? \_\_\_\_\_
- Person responsible? \_\_\_\_\_
- \_\_\_\_\_ 13. Does the association perform a regular review of insider activity for unusual activity and compliance with Regulation O? \_\_\_\_\_

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|--|--|-------|-------|
| <br>_____   | 14. Does the association appropriately capitalize and expense all items?   | _____ | _____ |
| <br>_____   | 15. Does the association periodically review deferred asset and liability accounts?  | _____ | _____ |
| <br>_____   | 16. Does the association clearly show the nature and purpose of each entry to the deferred asset and liability accounts?                         | _____ | _____ |
| <br>_____   | 17. What is the name and position of the person authorized to make entries to the deferred asset and liability accounts?                         |       |       |
|  |  Person responsible? _____                                      |       |       |
|  |  Position of person? _____                                     |       |       |
| <br>_____ | 18. Does the association balance and reconcile to third-party reports monthly any association assets that others service or hold in safekeeping? | _____ | _____ |
|  |  Person responsible? _____                                    |       |       |

**Cash and Cash Items**

- |  |   |       |       |
|--|---|-------|-------|
| _____  | 19. Does the association reject checks when the collected balance of the customer's demand deposit account is not sufficient to cover the item? | _____ | _____ |
| <br>_____ | 20. Are all personnel who have cash approval and disbursement authority required to take annual vacations of at least two consecutive weeks?    | _____ | _____ |
| _____  | 21. Does an independent officer review all overdraft activity?  | _____ | _____ |
|  |  Person responsible? _____                                   |       |       |
| <br>_____ | 22. Are controls in effect to prevent withdrawals of uncollected funds?   | _____ | _____ |
| _____  | 23. Does the association promptly record on the books returned items previously deposited?  | _____ | _____ |

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|--|---|-------|-------|
| <br>_____   | 24. Are procedures adequate to ensure that the association monitors and clears uncollected items?<br><br> Person responsible? _____  | _____ | _____ |
| _____  | 25. If the association maintains a petty cash fund, are all additions and withdrawals documented?   | _____ | _____ |
| _____  | 26. Does the association balance the petty cash fund periodically?  | _____ | _____ |
| _____  | 27. Does the association have procedures that prevent the use of liquid assets as compensating balances or collateral for personal loans of officers, directors, or employees?  | _____ | _____ |
| _____  | 28. Does the association record cash items appropriately in the general ledger?   | _____ | _____ |
| <br>_____ | 29. Does the association review teller and accounting system override reports and file maintenance summaries for unusual activity on a regular basis?<br><br> Person responsible for accounting overrides? _____<br><br> Person responsible for teller overrides? _____ | _____ | _____ |
| <br>_____ | 30. Are loan accounting systems included in the override reports?   | _____ | _____ |
| <br>_____ | 31. Are personnel who have control over cash barred from performing overrides?  | _____ | _____ |
| <br>_____ | 32. Do only designated personnel who have no control over cash approve and review overrides?  | _____ | _____ |
| <br>_____ | 33. Does the association, at both home and branch offices, perform daily cash reconciliations?  | _____ | _____ |
| <br>_____ | 34. Does a person without teller responsibilities perform the daily cash counts?  | _____ | _____ |
| <br>_____ | 35. Are overages and shortages properly recorded in a cash over and short account?  | _____ | _____ |

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\_\_\_\_\_ 36. Does the association maintain records showing the person involved in the cash over or short situation? \_\_\_\_\_

\_\_\_\_\_ 37. Does the association investigate and act upon all cash over and under amounts? \_\_\_\_\_

\_\_\_\_\_ 38. Does the association have appropriate controls over unissued deposit certificates, travelers' checks, savings bonds, food stamps, and other consigned items? \_\_\_\_\_

Person(s) responsible? \_\_\_\_\_

\_\_\_\_\_ 39. Does the association periodically reconcile consigned items? \_\_\_\_\_

Person responsible? \_\_\_\_\_

**Association (Official) Checks**

\_\_\_\_\_ 40. For checks signed by hand: Are two signatures (signer and approver) required on association (official) checks? \_\_\_\_\_

Names of persons authorized to sign? \_\_\_\_\_

\_\_\_\_\_ 41. For checks signed by hand: Are unsigned blank checks in the possession of an officer or employee who does not have singular signature authority? \_\_\_\_\_

Responsible officer or employee? \_\_\_\_\_

Position title? \_\_\_\_\_

\_\_\_\_\_ 42. For checks signed by stand-alone mechanical or electronic facsimile check signing machines connected to computers: Is the inventory of unsigned blank checks available verified daily and compared to the work of other positions that issue checks during the day? \_\_\_\_\_

Person(s) responsible? \_\_\_\_\_



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 \_\_\_\_\_ 50. Does the association keep the facsimile check writing machine under proper control? \_\_\_\_\_

***Due From Banks***

 \_\_\_\_\_ 51. The association receives bank statements:  
 Daily \_\_\_\_\_ Monthly \_\_\_\_\_ Quarterly \_\_\_\_\_

 \_\_\_\_\_ 52. Does the association reconcile bank accounts on a regular and timely basis? \_\_\_\_\_

 \_\_\_\_\_ 53. Are there any unreconciled bank accounts? \_\_\_\_\_  
 If so, what is the date of the latest reconciliation? \_\_\_\_\_

 \_\_\_\_\_ 54. Are there are any out of balance accounts? \_\_\_\_\_  
 If so, what is the date the association expects it to be reconciled?  
 \_\_\_\_\_

 \_\_\_\_\_ 55. Is the person who reconciles the bank statements independent of the deposit and check writing process? \_\_\_\_\_  
 Person responsible? \_\_\_\_\_

 \_\_\_\_\_ 56. Do checks drawn on bank accounts need more than one signature? \_\_\_\_\_

 \_\_\_\_\_ 57. Does a person who does not have signature authority periodically reconcile unsigned checks to the shipping invoice? \_\_\_\_\_  
 Person responsible? \_\_\_\_\_  
 How often? \_\_\_\_\_



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| <br>_____   | 67. Does a person who does not execute or book transactions receive confi r-<br>mations from the broker/dealer?<br><br> Person responsible? _____  | _____ | _____ |
| <br>_____   | 68. Does a person without transaction authority receive monthly statements<br>direct from the brokerage firm indicating all transactions during the pe-<br>riod?<br><br> Person responsible? _____   | _____ | _____ |
| _____  | 69. Are all securities transactions for delivery versus payment?  | _____ | _____ |
| _____  | 70. Does the association prohibit “free” deliveries in written contracts with<br>depositories and safekeeping agents unless approved by two senior offi-<br>cers?   | _____ | _____ |
| _____  | 71. Does the association hold securities on the premises under dual control?  | _____ | _____ |
| <br>_____ | 72. Is an independent party performing tests to determine that the yield on<br>investments actually received is in line with the weighted average coupon<br>of such assets?<br><br> Name of the independent party: _____<br><br> How often: _____<br><br> Date of last test: _____<br><br> Period analyzed: _____ | _____ | _____ |

**General Lending**

- |       |   |       |       |
|-------|---|-------|-------|
| _____ | 73. Does the association have and adhere to a written schedule of fees and<br>rates charged on new loans?               | _____ | _____ |
| _____ | 74. Does the association policy limit the number or amount of loans involving<br>any individual borrower or contractor? | _____ | _____ |

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|-------|--|-------|-------|
| _____ | 75. Is there a procedure of internal review to ensure compliance with the above policy by a person or persons who are independent of the loan approval function?   | _____ | _____ |
| _____ | 76. Are there procedures, and does staff follow the procedures, to periodically review and document the adequacy of the ALLL?  | _____ | _____ |
| _____ | 77. Are the persons that periodically review and document the adequacy of the ALLL independent of the loan approval function?  | _____ | _____ |
| _____ | 78. Does the association defer loan fees in accordance with generally accepted accounting principals (GAAP), and not recognize fees as current-period income?  | _____ | _____ |
| _____ | 79. Are lending officers prohibited from authorizing loan disbursements?   | _____ | _____ |
| _____ | 80. Do persons independent of the loan officer obtain or verify credit information?  | _____ | _____ |
| _____ | 81. Are lending authorities, granted by the board of directors, setting tiered dollar limits for individuals, co-approval limits for committees, and higher limits for approval by the board of directors? | _____ | _____ |
| _____ | 82. Is there a record system that lists the total of outstanding credits and commitments (direct and indirect) for each borrower?  | _____ | _____ |

***Construction Lending***

- |       |  |       |       |
|-------|--|-------|-------|
| _____ | 83. Are inspectors rotated at least every third inspection and for final draws?                                | _____ | _____ |
| _____ | 84. If the association does not rotate inspectors, does the inspector's supervisor perform review inspections? | _____ | _____ |
| _____ | 85. Is there segregation of duties between inspection and disbursement functions?                              | _____ | _____ |
| _____ | 86. Does the association prohibit disbursing loans in cash or to third parties?                                | _____ | _____ |

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|-------|--|-------|-------|
| _____ | 87. Does the association compare paid bills and lien waivers with items listed for disbursements?                          | _____ | _____ |
| _____ | 88. Does the association have safeguards to ensure that sufficient funds always remain available to complete construction? | _____ | _____ |

***Loan Servicing and Recordkeeping Functions***

- |       |   |       |       |
|-------|---|-------|-------|
| _____ | 89. Does the association support advances by written evidence or re-inspection of property?   | _____ | _____ |
| _____ | 90. Are all notes and other loan documents kept in a vault or fire-resistant cabinet and under a sign-out control system?                                   | _____ | _____ |
| _____ | 91. If the association holds additional collateral, do they safeguard it?   | _____ | _____ |
| _____ | 92. Does the association maintain a record of such collateral?  | _____ | _____ |
| _____ | 93. Does the association obtain written acknowledgment from the borrower for the pledging of savings accounts or the assignment of life insurance policies? | _____ | _____ |
| _____ | 94. Does the association adequately control advance loan payments if they do not immediately credit the advance to the loan account?                        | _____ | _____ |
| _____ | 95. Does the association test periodic adjustments to adjustable-rate mortgage loans for compliance with the terms of the note?                             | _____ | _____ |
| _____ | 96. Does the association have written collection policies and procedures that the board of directors approves?  | _____ | _____ |
| _____ | 97. Do collectors document the contact with borrowers and indicate promised action?   | _____ | _____ |
| _____ | 98. Are there procedures that ensure the maintenance of necessary hazard, flood, and other insurance coverages throughout the life of the loan?             | _____ | _____ |

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***Accrued Interest Receivable***

- \_\_\_\_\_ 99. Does the association perform tests to determine that it is receiving the appropriate interest? \_\_\_\_\_
- \_\_\_\_\_ 100. Does a person, independent of the cash receipt and bookkeeping for interest receivable, perform and document an analysis to determine if the yield on mortgages and investments actually received is in line with the weighted-average coupon rate of such assets? \_\_\_\_\_
-  \_\_\_\_\_ 101. Are accounting entries for accrued interest receivable supported by proper explanations evidencing the nature and purpose of each entry and signed by a responsible individual? \_\_\_\_\_

***Advance Payments by Borrowers for Taxes and Insurance***

- \_\_\_\_\_ 102. Is each escrow (impound) account analyzed at least once a year to ensure that the payments will cover the disbursement(s)? \_\_\_\_\_
- \_\_\_\_\_ 103. If this analysis results in a revision of monthly payments, is the revision made promptly and the borrower notified? \_\_\_\_\_
- \_\_\_\_\_ 104. Does the association inform borrowers at least annually of the balance in their account and the most recent year's transactions in that account? \_\_\_\_\_
- \_\_\_\_\_ 105. Do statements indicate that borrower's disputes regarding the balances of their escrow accounts be sent to internal audit or a department independent of escrow transactions? \_\_\_\_\_

***Loans in Process***

- \_\_\_\_\_ 106. Are loans in process reviewed periodically to determine whether the association makes disbursements on a timely basis and in accordance with the terms of loan agreements? \_\_\_\_\_
- \_\_\_\_\_ 107. Do personnel not responsible for the loans in process accounts conduct periodic tests to determine propriety of disbursements? \_\_\_\_\_

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***Commercial Lending***

- \_\_\_\_\_ 108. Does the association update borrower’s and guarantor’s financial statements at least annually? \_\_\_\_\_
- \_\_\_\_\_ 109. Do qualified individuals evaluate the collateral? \_\_\_\_\_
- \_\_\_\_\_ 110. Does the association inspect collateral periodically to ensure maintenance of sufficient value? \_\_\_\_\_
- \_\_\_\_\_ 111. Does the association release collateral only upon the approval of an officer or committee having a lending limit greater than or equal to the value of the collateral the association is releasing? \_\_\_\_\_
- \_\_\_\_\_ 112. If the association releases collateral upon payment of the loan, do they release the collateral only upon receipt of collected funds? \_\_\_\_\_

***Other Loans (unsecured, mobile homes, etc.)***

- \_\_\_\_\_ 113. Are the association’s procedures adequate to ensure compliance with the requirements of any government agency insuring or guaranteeing the loan? \_\_\_\_\_
- \_\_\_\_\_ 114. Does the association maintain an adequate loan register?  
  
The register, as a minimum, should contain the following: loan number, loan amount, date of loan or date of purchase, dealer, recourse or repurchase provisions, interest rate, and term. \_\_\_\_\_
- \_\_\_\_\_ 115. Do personnel who do not handle cash process loan applications and initial the notes? \_\_\_\_\_
- \_\_\_\_\_ 116. Do employees not connected with the granting or acquisition of loans collect and process receipts, and prepare delinquency lists? \_\_\_\_\_
- \_\_\_\_\_ 117. Are liens and other documents, including titles, promptly recorded? \_\_\_\_\_

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|-------|---|-------|-------|
| _____ | 118. Are there procedures that provide for board of directors approval of charge-offs and subsequent recoveries?  | _____ | _____ |
| _____ | 119. If the association holds additional or side collateral for unsecured loans, does the association also adequately document and safeguard the collateral and maintain a proper record?                             | _____ | _____ |
| _____ | 120. Does the association reference the FHA publication that lists companies and individuals who have not properly performed under FHA programs?  | _____ | _____ |
| _____ | 121. Floor planning loans:  | _____ | _____ |
|       | Does the association make unannounced inventory inspections on a rotating basis at least every 30 days?   | _____ | _____ |
| _____ | Do the inventory inspections include, as a minimum, the following: serial number verification of unit, inventory of equipment and furnishings, condition and location of unit, and units sold out of trust or rented? | _____ | _____ |
| _____ | Does the association maintain records of floor plan inspections?  | _____ | _____ |
| _____ | Does the association actually inspect demos at a subsequent date, if necessary?   | _____ | _____ |
| _____ | Does the association rotate inspectors or have a supervisor or auditor accompany them?  | _____ | _____ |
| _____ | Does the association inspect and appraise trade-ins for wholesale value?  | _____ | _____ |
| _____ | Does the dealer submit financial and operating statements monthly?  | _____ | _____ |
| _____ | Does the association retain title or lien control?  | _____ | _____ |
| _____ | Do floor plan agreements provide for periodic reductions (curtailments) in outstanding unit loan balances?  | _____ | _____ |

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|-------|---|-------|-------|
| _____ | 122. For dealer financing, does the dealer application include the following:   | _____ | _____ |
|       | ➤ Business address and location of all sales and storage lots?  |       |       |
| _____ | ➤ Names of all manufacturers represented and general description of units stocked?  | _____ | _____ |
| _____ | ➤ A statement as to whether each manufacturer subscribes to the Truth in Invoicing Practices Statement adopted by the Manufactured Housing Institute? | _____ | _____ |
| _____ | ➤ A statement as to the willingness of the dealer to sign recourse or repurchase agreements?  | _____ | _____ |
| _____ | ➤ Name and percentage of ownership of all persons with interests in the dealership?   | _____ | _____ |

**Credit Quality Review**

- |       |   |       |       |
|-------|---|-------|-------|
| _____ | 123. Does the association have a credit quality review program?   | _____ | _____ |
| _____ | 124. Does credit quality review include testing for compliance with regulation, association policy, officer lending limits, and association underwriting standards? | _____ | _____ |
| _____ | 125. Does credit quality review include classification or grading of assets?  | _____ | _____ |
| _____ | 126. Are the findings of the persons responsible for credit quality review reported directly to the board of directors?   | _____ | _____ |

**Deposit Account Loans**

- |       |  |       |       |
|-------|--|-------|-------|
| _____ | 127. Are sufficient controls in effect to prevent a loan approver from disbursing loan proceeds? | _____ | _____ |
| _____ | 128. Does the association flag pledged deposit accounts to prevent collateral from withdrawal?   | _____ | _____ |

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- \_\_\_\_\_ 129. Does withdrawal of pledged funds require a supervisory override? \_\_\_\_\_
- \_\_\_\_\_ 130. Are procedures in effect to ensure that the total loan and accrued interest does not exceed the balance amount of the deposit account? \_\_\_\_\_
- \_\_\_\_\_ 131. Are procedures in effect for initial and periodic positive mail confirmations with deposit loan customers? \_\_\_\_\_
- \_\_\_\_\_ 132. Are periodic monitoring reports adequate for the review of savings deposit loan activity? \_\_\_\_\_

***Real Estate Owned and Other Repossessed Assets***

- \_\_\_\_\_ 133. Does the association follow routine legal procedures that will result in a valid title to the property and evidence of such title? \_\_\_\_\_
- \_\_\_\_\_ 134. Does the association promptly value real estate that it acquires? \_\_\_\_\_
- \_\_\_\_\_ 135. Does the association use a current valuation to establish the sales price of a property? \_\_\_\_\_
- \_\_\_\_\_ 136. Does the association physically inspect properties at periodic intervals? \_\_\_\_\_
- \_\_\_\_\_ 137. Do such inspections indicate the condition of the property and occupancy status? \_\_\_\_\_
- \_\_\_\_\_ 138. Are there maintenance procedures in effect to ensure that properties will retain their market value? \_\_\_\_\_
- \_\_\_\_\_ 139. Does the association maintain separate subsidiary records for each parcel showing items capitalized, expenses, rentals, etc.? \_\_\_\_\_
- \_\_\_\_\_ 140. Does the association balance subsidiary ledgers for the individual properties to the general ledger at least monthly? \_\_\_\_\_
- \_\_\_\_\_ 141. Does the association maintain separate files for each parcel of real estate owned and are such files complete? \_\_\_\_\_

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- |       |   |       |       |
|-------|---|-------|-------|
| _____ | 142. Does the association maintain controls over the receipt of rental income?  | _____ | _____ |
| _____ | 143. Does the association’s advertising for the sale or rental of real estate owned comply with the provisions contained in the Department of Housing and Urban Development’s advertising guidelines? | _____ | _____ |
| _____ | 144. Are agents who collect rents and manage properties bonded?   | _____ | _____ |
| _____ | 145. Are security deposits properly controlled?   | _____ | _____ |
| _____ | 146. Does the association have procedures to ensure maintenance of hazard insurance?  | _____ | _____ |

***Real Estate Held for Investment***

- |       |   |       |       |
|-------|---|-------|-------|
| _____ | 147. Does the association maintain separate subsidiary records for each parcel showing items capitalized, expenses, rentals, etc.?        | _____ | _____ |
| _____ | 148. Does the association balance subsidiary ledgers for the individual properties to the general ledger at least monthly?                | _____ | _____ |
| _____ | 149. Does the association maintain complete, separate files for each parcel of real estate owned?   | _____ | _____ |
| _____ | 150. Does the association maintain adequate control over rental income?   | _____ | _____ |
| _____ | 151. Are agents who collect rents and manage properties bonded?   | _____ | _____ |
| _____ | 152. Are security deposits properly controlled?   | _____ | _____ |
| _____ | 153. Does the association maintain adequate controls over all disbursements?  | _____ | _____ |
| _____ | 154. Does a senior officer compare disbursements to determine whether they are for budgeted purposes and in line with the overall budget? | _____ | _____ |
| _____ | 155. If not, is the board of directors notified promptly of budget overruns?  | _____ | _____ |

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*Fixed and Other Assets*

- \_\_\_\_\_ 156. Does the association retain invoices in support of all additions to fixed asset accounts? \_\_\_\_\_
- \_\_\_\_\_ 157. Does the association ensure that the accounting department knows about any major retirement of fixed assets? \_\_\_\_\_
-  \_\_\_\_\_ 158. Does the association keep a detailed record of fixed assets? \_\_\_\_\_
-  \_\_\_\_\_ 159. Does the association retain depreciation schedules supporting each asset or class of assets? \_\_\_\_\_
- \_\_\_\_\_ 160. Does the association charge depreciation and amortization expenses at least quarterly? \_\_\_\_\_
- \_\_\_\_\_ 161. Does the association retain evidence of valid titles for all properties owned? \_\_\_\_\_
- \_\_\_\_\_ 162. If the association has rented space in its buildings, does it have adequate control over the recording and collection of rental income and the control and recording of expense? \_\_\_\_\_
- \_\_\_\_\_ 163. Are there record keeping procedures to ensure that the association maintains adequate supporting documentation for other assets acquired? \_\_\_\_\_
- \_\_\_\_\_ 164. Are journal entries prepared that show clearly the nature and purpose of each charge to expense from deferred accounts and evidence of approval by authorized personnel? \_\_\_\_\_
- \_\_\_\_\_ 165. Does the association have effective control procedures for all large disbursements to ensure their propriety? \_\_\_\_\_
- \_\_\_\_\_ 166. Does the association maintain subsidiary records for the various other asset accounts? \_\_\_\_\_

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*Deposit Accounts*

- |       |      |  |       |       |
|-------|------|--|-------|-------|
| _____ | 167. | Is there any limitation on the amount of withdrawal that employees may pay without officer approval?   | _____ | _____ |
|       |      | If so, what is the amount? _____   |       |       |
| _____ | 168. | Are procedures in effect to ensure the timely and accurate completion of the appropriate signature cards upon the opening of deposit accounts?   | _____ | _____ |
| _____ | 169. | Does the association segregate duties so that persons opening new certificate accounts do not have sole control over the receipt of cash, account data entry, and the preparation of certificates or receipts? | _____ | _____ |
|       | 170. | Does the association balance the deposit accounts before and after posting of interest to ascertain correctness of total amount posted?  | _____ | _____ |
| _____ | 171. | Does the association maintain general ledger subsidiary accounts for each class of accounts?   | _____ | _____ |
|       | 172. | Is an analysis made periodically to determine the adequacy of accrued interest earned and unpaid?  | _____ | _____ |
|       |      | How often? _____   |       |       |
|       |      | Last as of date? _____   |       |       |
|       |      | Person responsible? _____  |       |       |
|       | 173. | Does the person who performs the analysis have an account at the association?  | _____ | _____ |
|       | 174. | If so, who reviews the account of the person who performs the analysis?  |       |       |
|       |      | Person responsible? _____  |       |       |
| _____ | 175. | Does the association investigate and adjust differences between the accrual balance and the interest paid?   | _____ | _____ |

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- |       |  |       |       |
|-------|--|-------|-------|
| _____ | 176. Does the association reasonably estimate accruals for reporting purposes?   | _____ | _____ |
| _____ | 177. Are policies in effect to maintain compliance with state escheat laws?  | _____ | _____ |
| _____ | 178. Does the association flag dormant accounts so they can monitor activity?  | _____ | _____ |
| _____ | 179. Does the association waive significant amounts of account fees?   | _____ | _____ |
| _____ | 180. Does the association generate a demand deposit overdraft report?  | _____ | _____ |
| _____ | 181. Does the demand deposit overdraft report identify the name and position of the person(s) responsible for approving overdrafts?  | _____ | _____ |
| _____ | 182. Does the demand deposit overdraft report identify large borrowers and insiders?   | _____ | _____ |
| _____ | 183. Do designated personnel review the demand deposit overdraft reports?  | _____ | _____ |
|       | Person responsible? _____  |       |       |
|       | Approval limits? _____   |       |       |
| _____ | 184. Does the association generate a check-kiting report?  | _____ | _____ |
| _____ | 185. Is the check-kiting report prepared by an individual who does not have an account with the financial association or is the preparer's account independently reviewed? | _____ | _____ |
| _____ | 186. Does the check-kiting report identify insiders and major borrowers?   | _____ | _____ |
| _____ | 187. Is the person responsible for reviewing check-kiting reports independent of the preparation of the reports?   | _____ | _____ |
|       | Person responsible? _____  |       |       |
| _____ | 188. How often does the association review check-kiting reports?<br>_____  |       |       |

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*Deferred Credits*

- |       |      |   |       |       |
|-------|------|---|-------|-------|
| _____ | 189. | Does the association maintain records supporting the recognition of profits resulting from the sale of real estate owned? | _____ | _____ |
| _____ | 190. | Does the association maintain records supporting loan acquisition credits deferred and earned, by semiannual periods?     | _____ | _____ |
| _____ | 191. | Does the association amortize loan origination fees in accordance with FASB 91?   | _____ | _____ |

*Other Liabilities*

- |       |      |  |       |       |
|-------|------|--|-------|-------|
| _____ | 192. | Does the association maintain a detailed inventory or subsidiary records for the various other liability accounts? | _____ | _____ |
| _____ | 193. | Does a designated officer make periodic reviews of the activity in other liability accounts?                       | _____ | _____ |
|       |      | Designated officer: _____  |       |       |

*Capital (Reserves, Undivided Profits, etc.)*

- |       |      |   |       |       |
|-------|------|---|-------|-------|
| _____ | 194. | Does management review and the board of directors approve all transfers to and from the capital accounts?     | _____ | _____ |
| _____ | 195. | Does the association clearly explain and adequately document all transactions involving the capital accounts? | _____ | _____ |
| _____ | 196. | Does the corporate officer designated in the bylaws or by the board of directors control stockholder records? | _____ | _____ |
| _____ | 197. | Does the association promptly cancel surrendered stock certificates to prevent their reuse?                   | _____ | _____ |

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\_\_\_\_\_ 198. Does an officer designated in the bylaws or by the board of directors sign stock certificates? \_\_\_\_\_

**Letters of Credit**

\_\_\_\_\_ 199. Does the association have any outstanding unexpired letters of credit? \_\_\_\_\_

\_\_\_\_\_ 200. Has the board of directors adopted a written letter of credit policy? \_\_\_\_\_

\_\_\_\_\_ 201. Does the board review the policy annually and note the review in the minutes? \_\_\_\_\_

\_\_\_\_\_ 202. Does the association maintain a daily transaction journal that summarizes all outstanding letters of credit? \_\_\_\_\_

\_\_\_\_\_ 203. Who is responsible for the preparation and posting of subsidiary records and accounting for fee income?

    ▶ Person responsible? \_\_\_\_\_

    ▶ Title? \_\_\_\_\_

\_\_\_\_\_ 204. Has the association made commitments on letters of credit that they have not issued and for which the commitment period is unexpired? \_\_\_\_\_

\_\_\_\_\_ 205. Has the association issued any letters of credit on behalf of directors, officers, employees and their interests, or for other insiders? \_\_\_\_\_

    ▶ If so, please list: \_\_\_\_\_

\_\_\_\_\_ 206. Has the association issued or confirmed letters of credit to officers or directors of another financial institution? \_\_\_\_\_

\_\_\_\_\_ 207. Does the association's internal loan review process review letters of credit for adequacy of underwriting, documentation, and credit quality? \_\_\_\_\_

\_\_\_\_\_ 208. Are letters of credit of questionable quality listed on the association's problem asset list? \_\_\_\_\_

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\_\_\_\_\_ 209. Has the association had to pay a draft without receiving payment from a customer? \_\_\_\_\_

\_\_\_\_\_ 210. Has the association extended any loans because of letters of credit? \_\_\_\_\_

▾ List all loans extended because of letters of credit:

\_\_\_\_\_

\_\_\_\_\_ 211. Are there any outstanding lawsuits because of letters of credit? \_\_\_\_\_

**Prepared By:** \_\_\_\_\_

**Verified By:** \_\_\_\_\_

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A management official of the association should complete this questionnaire. If the association lacks adequate internal controls regarding funds transfers, the examiner should verify appropriate responses and initial in the verified column. The flagged questions are the suggested minimum verifications. Management must provide the examiner with an adequate written explanation of all "No" answers, with an appropriate reference to the question, and supply copies of applicable written procedures. If a question is not applicable to the association, respond with NA.

Verified by Examiner		Yes	No
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***Funds Transfer and Wire Transfer Controls***

- \_\_\_\_\_ 1. Indicate the method that the association uses to wire funds:  
 Fedline: \_\_\_\_\_  
 Money Transfer Workstation: \_\_\_\_\_  
 Voice: \_\_\_\_\_
- \_\_\_\_\_ 2. Average dollar volume and number of transfers: \_\_\_\_\_  
 Specify per day, week, month, or other: \_\_\_\_\_
- \_\_\_\_\_ 3. Average daily amount available for transfer, if limited: \_\_\_\_\_
- \_\_\_\_\_ 4. Peak amount available for transfer, if limited: \_\_\_\_\_
- \_\_\_\_\_ 5. Does the association have written wire transfer procedures? \_\_\_\_\_
- \_\_\_\_\_ 6. Do personnel consistently follow the procedures? \_\_\_\_\_
- \_\_\_\_\_ 7. Who is responsible for supervising the wire transfer activity to ensure compliance with the written procedures? \_\_\_\_\_
- \_\_\_\_\_ 8. Is an internal or independent audit performed of the wire transfer procedures? \_\_\_\_\_
- \_\_\_\_\_ 9. Does the association provide adequate training to personnel involved with the wire transfer process? \_\_\_\_\_

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_____	10. Does the association segregate securities-transaction-related duties among the buyer/seller, the trader, and settlement clerk?	_____	_____
_____	11. Are dual authorizations (maker, approver) required before the sending department acts upon internal wire transfer requests?	_____	_____
_____	12. Do procedures require that the association actually transfer collected funds out of the customer account before the wire transfer department makes outgoing transfer orders?	_____	_____
_____	13. Do personnel involved with wire transfers receive proper background screenings, including criminal record investigation?	_____	_____
_____	14. Are sendable funds limited by using separate correspondent accounts to send and to receive funds?	_____	_____
_____	15. Are controls to limit daylight overdrafts effective?	_____	_____
	 Briefly describe the controls: _____		
 _____	16. Does the association audit the wire transfer log periodically?	_____	_____
 _____	17. Does the association keep a complete log of wire transfer activity for audit?	_____	_____
_____	18. Does software provide a log of all wire transfer activity?	_____	_____
_____	19. If a data terminal is used, is an unbroken paper printout copy of all activity reconciled to requests daily?	_____	_____
_____	20. Are interim daily reconcilements and end-of-day reconcilements performed with all reconciling items cleared?	_____	_____
 _____	21. Does the association prohibit the person who performs end-of-day balancing from executing wire transfers?	_____	_____
_____	22. Is the person who executes wire transfers prohibited from access to cash (such as having a teller drawer)?	_____	_____

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_____	23. Does the association prohibit the person who reconciles the association's deposit account affected by wire transfer activity from executing wire transfers?	_____	_____
_____	24. Is a timely reconciliation made, by a person not involved in the wire transfer process, of wire transfer activity statements from a service provider compared with internal wire transfer activity records?	_____	_____
_____	25. Does the association keep a permanent record of all customer wire transfers listing the date, amount of the transfer, person authorizing the transfer, test code or PIN, and detailed instructions?	_____	_____
_____	26. Does the association restrict access to test codes to only those employees authorized to handle wire transfer requests?	_____	_____
_____	27. Does the association keep the test codes in a secure place?	_____	_____
_____	28. If the association uses code words do they change them periodically? <div style="margin-left: 20px;"> How often? _____</div>	_____	_____
_____	29. Does the association strictly forbid the transfer of uncollected funds?	_____	_____
_____	30. Does the association require dual officer approval for large-dollar transfers? <div style="margin-left: 20px;"> Who is authorized and what are the limits? _____</div>	_____	_____
_____	31. Does the association require customer and/or bank verification callbacks for voice wire transfers above an established dollar threshold? <div style="margin-left: 20px;"> Who is responsible for verification? _____</div>	_____	_____
_____	32. Does the association make all securities-transaction-related transfers only after the verified receipt of securities (delivery versus payment)?	_____	_____
_____	33. Does a person independent of the transaction approval or processing balance wire transfers at least daily?	_____	_____

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- |       |  |       |       |
|-------|--|-------|-------|
| _____ | 34. Does the association have a dual entry/release system for wire transfers?<br><br>For computerized systems, does one person input transfer instructions and another person verify and release the transfer?<br><br>For associations that call in wire instructions to a correspondent institution that performs the wire transfer, does one authorized person originate the call; then does the correspondent institution have a second person make a callback to a second authorized person to verify the authenticity of the wire instructions? | _____ | _____ |
| _____ | 35. Has the association made unusual, frequent, or sizable transfers offshore to Privacy Act Havens (such as Panama, Switzerland, the Netherlands Antilles, or the Cayman Islands)?  | _____ | _____ |
| _____ | 36. Does the association require that customer wire-transfer requests be in writing and signed by the customer wiring the funds?   | _____ | _____ |

***Wire Transfers Using Personal Computer Systems***

- |       |   |       |       |
|-------|---|-------|-------|
| _____ | 37. Does the association keep the personal computer executing wire transfers in an area that is physically secure from unauthorized employees and the public? | _____ | _____ |
| _____ | 38. Does each authorized user of the wire transfer system have a unique password known only to that user?   | _____ | _____ |
| _____ | 39. Do separate persons enter and release outgoing transfers with separate unique passwords?  | _____ | _____ |
| _____ | 40. Do employees adequately protect passwords to ensure that only the authorized user is aware of the password?   | _____ | _____ |
| _____ | 41. Does the system require users to change their password periodically?  | _____ | _____ |

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\_\_\_\_\_ 42. Are procedures (such as the system requiring two users' passwords) in place to ensure that one person enters the wire transfer and another person verifies it before releasing the wire transfer? \_\_\_\_\_

➡ If so, what is the time interval for going into waiting mode? \_\_\_\_\_

\_\_\_\_\_ 43. When each user finishes a series of transactions, and leaves the wire transfer terminal unattended, does the terminal go into a waiting mode where it is not possible to send outgoing wire transfers? \_\_\_\_\_

***Branch Procedures (Customer-Requested Wire Transfers)***

\_\_\_\_\_ 44. Does a branch procedures manual contain a clear and concise description of branch wire transfer procedures? \_\_\_\_\_

\_\_\_\_\_ 45. Are telephone requests from the branch office to the main office for two-party wire transfers accepted? \_\_\_\_\_

\_\_\_\_\_ 46. Briefly, describe the procedures the association uses to ensure that such requests are authentic. \_\_\_\_\_

\_\_\_\_\_ 47. Does the association identify all transfers by sequential code or encrypted passwords in prearranged order with correspondents? \_\_\_\_\_

\_\_\_\_\_ 48. Are third-party wire transfers by telephone confirmed by four-person call-back procedure (sender, receiver, approver, confirmer)? \_\_\_\_\_

\_\_\_\_\_ 49. Does the association record all calls? \_\_\_\_\_

\_\_\_\_\_ 50. Does each participant document callbacks? \_\_\_\_\_

\_\_\_\_\_ 51. Is a signed customer-authorization form required as a source document and proof of authorization for customer-requested wire transfers? \_\_\_\_\_

\_\_\_\_\_ 52. Do the forms indicate the date, time of day, wire-from- and wire-to-account instructions, and initials or signatures of personnel who processed the request? \_\_\_\_\_

\_\_\_\_\_ 53. Does the association retain customer authorization forms? \_\_\_\_\_

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*Internally Generated Wire Transfers (Department Requests for Wire Transfers)*

- |       |  |       |       |
|-------|--|-------|-------|
| _____ | 54. Does the association require that all departmental wire transfer requests be in writing, on a preprinted form?   | _____ | _____ |
| _____ | 55. Does the request form contain all necessary from-account and to-account information?   | _____ | _____ |
| _____ | 56. Do departmental request forms indicate the initials or signatures of the initiator and approver who authorized the wire transfer?  | _____ | _____ |
| _____ | 57. Do separate persons originate, approve, and send internally generated wire transfers?  | _____ | _____ |
| _____ | 58. Do department wire transfer telephone or facsimile requests made from remote locations require a callback to that location to ensure that the wire transfer request actually originated there? | _____ | _____ |
| _____ | 59. Recommend any improvements needed to prevent individuals from transferring funds to another's account while acting alone.  | _____ | _____ |

**Prepared By:** \_\_\_\_\_

**Verified By:** \_\_\_\_\_

**INTRODUCTION**

Accurate financial reporting is essential to an institution's safety and soundness. The board of directors and the audit committee are responsible for ensuring that their institution operates in a safe and sound manner. To achieve this goal and meet the safety and soundness guidelines implementing Section 39 of the Federal Deposit Insurance Act (FDI Act) (12 USCS 1831p-1) (see 12 CFR 510), the board of directors should ensure that their institution maintains effective internal control (see Handbook Sections 340, Internal Control, and 355, Internal Audit).

Management is responsible for effectively managing the institution's risks and making sound business decisions. They should also ensure that the financial statements fairly report the savings association's financial condition, results of operations, and cash flows, and that the institution prepares its financial statements in accordance with generally accepted accounting principles (GAAP).

Savings institutions must provide accurate and timely Thrift Financial Reports by law (12 USC 1464(v)). These reports serve an important role in risk-focused supervision programs, by contributing to pre-examination planning, off-site monitoring programs, and assessments of an institution's capital adequacy and financial strength.

The OTS encourages all institutions to have an external audit. Some institutions must have an audit of the institution's financial statements by an independent public accountant (external auditor), or the OTS may require an audit of an institution's financial statements by an external auditor under certain circumstances. All audits of savings associations, regardless of size, must comply with the requirements outlined for management, the board of directors, and the external auditor in the FDICIA-required audit section below.

For institutions that do not have an external audit, other acceptable external auditing programs include:

- A balance sheet audit in accordance with generally accepted auditing standards (GAAS) by an external auditor.
- Attestation procedures that result in an external auditor's report on an institution's internal control over financial reporting (attestation report).
- Agreed-upon procedures or state-required examinations.

**FDICIA-REQUIRED AUDIT****Audit of Savings Associations with \$500 Million or More of Total Assets**

Section 112 of the Federal Deposit Insurance Corporation Improvement Act (FDICIA) of 1991 and the Federal Deposit Insurance Corporation's (FDIC) implementing Regulation 12 CFR Part 363 requires savings associations with assets of \$500 million or more to obtain an audit of the financial statements by an independent public accountant.

Savings associations must comply with the provisions of the FDIC Regulation 12 CFR § 363.2, Annual Reporting Requirements. Savings associations should file the required reports with the FDIC and OTS (appropriate Regional OTS Office) in accordance with the provisions of this regulation.

Appendix B of this Section summarizes these provisions, and OTS audit requirements. Specific FDIC provisions in Appendix A of Part 363 are discussed below.

**Management:**

- Prepare a statement declaring its responsibility for the annual financial statements.
- Establish and maintain an adequate internal control and procedures for financial reporting.

- As of the end of the fiscal year, assess the effectiveness of the internal control and procedures for financial reporting.
- Assess the effectiveness of the internal control and procedures for compliance with federal laws and regulations relating to loans to insiders and dividend restrictions.

#### Board of Directors:

- Establish an audit committee consisting of outside directors who are independent of management. In no circumstances may an audit committee consist of less than a majority of outside directors. Exceptions to the independent membership requirement should be rare.
- Determine the duties of the audit committee that should, at a minimum, include reviewing the audit reports with the external auditor.

#### External Auditor:

- Attest to whether management's assertion about the effectiveness of the internal control over financial reporting is fairly stated.
- Participate in a peer review program that is acceptable to the FDIC.

In addition, the FDIC requires the following reports:

- A management report on internal controls (management internal control report).
- An external auditor's attestation report on management's assessment of the effectiveness of internal control over financial reporting in Accordance with Statements on Standards For Attestation Engagements (SSAE) No. 10, Attestation Standards: Revisions and Recodification (AT 101).

#### Information That Must Be Available to External Auditors

Section 931 of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), (12 USC § 1817(a)), requires FDIC-

insured associations that engage the services of an external auditor to audit the association within the past two years to provide copies of the following reports:

- The most recent report of condition, that is, the OTS Thrift Financial Report.
- The association's most recent Report of Examination (ROE).

In addition, savings associations must provide the external auditor with the following information:

- A copy of any supervisory agreement or memorandum of understanding or written agreement between a federal or state banking agency and the association that is in effect during the period covered by the audit.
- A report of any formal action taken by a federal or state banking agency during such period, or any civil money penalty assessed with respect to the association or any association-affiliated party.

Regulatory personnel should determine if the association is in compliance with § 931 of FIRREA and report instances of noncompliance to the Regional Accountant.

#### Changes in Auditors

The FDIC requires the board of directors to provide a notice of termination or engagement of the external auditor (see 12 CFR §§ 363.2 and 363.4). In addition, the external auditor must provide the notice of termination (see 12 CFR § 363.3(c)) to the FDIC. OTS may request that the institution send notice to the appropriate supervisory office.

#### Work Paper Reviews

The FDIC's policy is to review the audit work papers of Part 363 institutions that have been assigned, or expect to be assigned, a composite CAMELS rating of 4 or 5. The FDIC will coordinate the review with the institution's supervisory agency. For additional information on work paper reviews, see the discussion under Regulatory Concerns in this Handbook Section.

*Peer Review Reports*

FDICIA requires that firms performing audits on institutions with assets in excess of \$500M enroll in a peer review program, and that each firm files a copy of its peer review report with the FDIC. In a peer review program, one accounting firm basically examines another firm's quality control for accounting and auditing practices on selected engagements and functional areas. This review encompasses the organizational structure of the policies adopted and the procedures established by a firm to provide it with reasonable assurance that it complies with professional standards.

The Chief Accountant's office obtains copies of the peer review reports from the FDIC, and maintains an updated database that it periodically distributes to the Regional Accountants. OTS will make copies of the reports available upon request. If any firm has significant deficiencies noted in its peer review report, OTS staff will notify the Regional Accountant for further action.

**OTS-REQUIRED AUDIT****Audit of Savings Association Holding Companies with \$500 Million or More of Total Assets**

Under 12 CFR § 562.4, OTS requires a savings association holding company to obtain an audit of the financial statements by an external auditor when the total assets of the consolidated savings association subsidiary(ies) are \$500 million or more. The holding company should comply with the reporting requirements at Item 21, Financial Statements in the H-(b)11 Annual Report.

*Modification or Waiver*

OTS may grant a savings association holding company's request for a modification or waiver of the external audit requirement under any of the following circumstances:

- The savings association holding company engages in very limited activities other than control of subsidiary savings association(s) and

it submits the subsidiary savings association's separate external audited financial statements.

- The accounting basis of the holding company makes consolidated financial statements or an external audit impractical.
- The external audit would represent an unusual and unreasonable regulatory burden.

The savings association holding company must make a written request for a waiver to OTS's Regional Director or designee. The request must describe the circumstances that the savings association holding company believes warrant the proposed modification or waiver.

**Audit of Savings Associations That Receive a Composite CAMELS Rating of 3, 4, or 5**

OTS requires savings associations, without regard to size, that receive a composite CAMELS rating of 3, 4, or 5, as of its most recent safety and soundness examination, to obtain an audit of its financial statements by an external auditor.

*Required Reports*

In addition to the audited financial statements, the savings association must submit:

- Any audit-related reports including, but not limited to, internal control reports from the external auditor that contain conclusions and recommendations related to the audit.
- Any other OTS-requested supplemental information, or schedules.

OTS accepts the audited consolidated financial statements of the savings association holding company in lieu of separate audited financial statements of the savings association.

*Filing Requirements*

If OTS requires a savings association to obtain an audit, it must forward three copies of the required reports to the Regional Director or designee within 90 days of the fiscal year-end, or within 15 days of receipt, whichever is earlier.

When a savings association with a composite CAMELS rating of 3, 4, or 5 has assets of \$500 million or more, it must file either the required savings association audit report, or the consolidated savings association holding company audit report, with both the FDIC and OTS. The filings should comply with FDIC Regulation Part 363 and FDIC guidelines at Appendix A to Part 363.

#### *Waivers*

A savings association may dispense with an audit if OTS determines that an audit is not the most effective means to address the safety and soundness concerns that caused the composite CAMELS rating of 3, 4, or 5. The waiver provision only applies to OTS required audits. It does not apply to audits required by public securities filing requirements, or § 112 of FDICIA and the FDIC implementing Regulation 12 CFR Part 363. The savings association must make a written request for a waiver to the OTS Regional Director or designee. The written request must include:

- The basis for the composite CAMELS rating of 3, 4, or 5, and the specific reasons why the savings association believes an audit would not address the source of the safety and soundness concerns in the most effective manner; and
- As an alternative, specify procedures and describe how they will address the source of the safety and soundness concerns identified by the examination; or
- Indicate the reasons why they consider an alternative to an audit as unnecessary.

OTS will respond to a timely request for an audit waiver from the savings association.

#### Safety and Soundness Considerations for Granting Waiver Requests

OTS may grant a savings association's request for a waiver of the external audit requirement if the CAMELS rating of 3, 4, or 5 is due to safety and soundness concerns that an external audit would not effectively address.

Safety and soundness concerns may include areas of supervisory judgment. Often the association cannot reduce these areas to objective criteria that can be audited effectively. Safety and soundness concerns may represent areas in which you have specialized knowledge and expertise; or the concerns may represent areas normally not included in the scope of an external audit.

Under such circumstances, you may consider requesting specific procedures to address these areas. You may also rely on your judgment about other procedures that will specifically address your supervisory concerns. Examples of these areas include the following circumstances:

- Adequacy of capital levels.
- Deficient credit underwriting policies and loan documentation that management is correcting.
- Low level of earnings or poor quality of earnings whose source the examiners investigated in a recent examination and management is correcting.
- Liquidity, interest rate risk, and other safety and soundness or compliance matters.

While recognizing the limits of an external audit, there are circumstances when pervasive safety and soundness concerns warrant an external audit. These include, but are not limited to the following concerns:

- Identified weakness in the internal audit function or the internal control structure and procedures for financial reporting.
- Lack of confidence in the board of directors or management with regard to integrity, ethical values, competence, operating philosophy, and overall corporate governance exercised by the board.
- Questionable transactions with affiliates.

#### **Case-by-Case Safety and Soundness Required Audit**

OTS may require at any time, for any safety and soundness reasons identified by the Director, an

independent audit of the financial statements of, or the application of procedures agreed-upon by OTS to, a savings association, savings association holding company, or affiliate by an external auditor.

### Audit of De Novo Savings Associations

OTS generally requires an external audit as a condition of approval for de novo savings associations. The conditions of approval will describe the reporting and filing requirements.

### Notification by OTS of Audit Requirement

When OTS requires an entity to obtain an external audit for reasons other than its CAMELS rating or size, OTS's Regional Director will notify, in writing, the savings association or savings association holding company.

### Audit of Trust Activities

Audit requirements for institutions with permission to exercise fiduciary powers are in 12 CFR §§ 550.440 through 550.480. Those institutions should also refer to the Trust and Asset Management Regulatory Handbook for audit requirements, policies, and procedures.

## OTS-REQUIRED AGREED-UPON PROCEDURES

OTS may require a savings association, savings association holding company, or affiliates to obtain the services of an external auditor to perform agreed-upon procedures to address certain aspects of an entity's operations, operations at outside servicers, adherence to specified laws, regulations, policies and accounting principles, or other specific concerns.

OTS may require an entity to obtain specified procedures, under any of the following conditions:

- When the examination process will not address supervisory concerns for the specified element, account, items of the financial statements, outside servicer, or other matters.
- When the specified procedures could supplement the examination process.

- When an external audit is not the most effective means to address the specified element, account, items of the financial statements or other matters of supervisory concern.
- When identified or suspected insider abuses exist.
- When there is identified or suspected defalcation.
- When there is identified or suspected criminal activity.
- When objective criteria exist for reasonably measuring compliance with specified laws, regulations, and policies.

### Notification by the OTS

OTS's Regional Director, or designee, will notify the entity in writing, when we require it to engage the services of a qualified external auditor to perform agreed-upon procedures.

### Required Procedures and Reports

Once you determine that agreed-upon procedures are an effective means to address the safety and soundness concerns, identify the specific elements, accounts, items of the financial statements, or other matters that the external auditor and the institution must address.

OTS generally requires the external auditor to perform the procedures. The external auditor must report in accordance with GAAS for attestation engagements. OTS may also provide such procedures directly, or develop procedures in consultation with the external auditor.

### Filing Requirements

If OTS requires an entity to obtain agreed-upon procedures, the institution must forward three copies of the specified procedures report to the Regional Director, or designee, within 30 days of receipt of the report, or 30 days from the date of the procedures, whichever is less. The entity must also forward a copy of the signed engagement letter to the Regional Director, or designee, before the external auditor conducts fieldwork.

### Auditor Requirements For Required Audit or Required Agreed-Upon Procedures

The external auditor or other qualified person who performs the audit or the agreed-upon procedures must meet the following minimum requirements at OTS Regulation § 562.4(d)(1), (2), (3), and (4):

- Be registered or licensed to practice as a public accountant, and maintain good standing, under the laws of the state or other political subdivision of the United States where the home office of the entity is located.
- Agree in the engagement letter to provide copies to OTS of any work papers, policies, and procedures relating to services performed pursuant to § 562.4. See Appendix D for a sample letter to request audit work papers.
- Comply with the American Institute of Certified Public Accountants (AICPA) Code of Professional Conduct, and meet the Securities and Exchange Commission's (SEC) independence requirements.
- Receive, or be enrolled in, a peer review. The OTS accepts the following peer review guidelines:
  - The external peer review should be generally consistent with AICPA standards.
  - An organization independent of the auditor or firm being reviewed should conduct the review.
  - The organization should conduct a review at least as frequently as is consistent with AICPA standards.
  - The external peer review should include, if available, at least one audit of an insured depository institution or consolidated depository institution holding company. (The external auditor should make the peer review report available to the OTS upon request).
  - The auditor or firm under review should take corrective action required under any qualified peer review report on a timely basis.

### AUDITS REQUIRED BY SEC AND OTS FOR PUBLIC SECURITIES FILING PURPOSES

Holding companies of savings associations and subsidiaries of savings associations (service corporations and operating subsidiaries) that offer public securities must register and file appropriate documents with the SEC. If a savings association, rather than a holding company or subsidiaries, lists securities on a stock exchange and has more than 500 stockholders, it must register the securities, and file its reporting documents, with OTS under Section 12 of the Securities Exchange Act of 1934 ('34 Act). Section 12(i) of the '34 Act assigns the reporting functions to OTS for thrift securities and grants OTS the power to make rules and regulations to execute these functions. Section 3(a)(5) (15 USC § 77c(a)(5)) of the Securities Act of 1933 ('33 Act) exempts thrift securities from registration with the SEC under the '33 Act. The rules and regulations for public offerings of a savings association are in 12 CFR Part 563g.

Regulations under 12 CFR Part 563c establish the qualifications and independence requirements for an external auditor engaged to perform services for companies with a class of securities registered pursuant to the Securities Exchange Act of 1934. The qualifications and independence requirements in 12 CFR Part 563c are generally consistent to those issued by the SEC.

To perform these services, the external auditor should be registered and in good standing under the laws of the place of his or her residence or principal office. Neither the external auditor nor the associated auditing firm should have acquired, or have a commitment to acquire, any direct financial interest or any material indirect financial interest in the company. In addition, neither should be connected to the company as a promoter, underwriter, voting trustee, officer, or employee. At least annually, the external auditor should disclose to the audit committee in writing the relationship between the auditor and its related entities that, in the auditor's professional judgment, may reasonably bear on independence. The external auditor should further state that he or she is independent of the company, as well as discuss independence with the audit committee.

If the institution produces interim financial reports, the external auditor must review the financial statements prior to inclusion in the quarterly 10-Q reports using procedures in Statement on Auditing Standards (SAS) No. 71, *Interim Financial Information*. SAS No. 71, as amended by SAS No. 90, requires the external auditor to discuss the quality of the institution's accounting principles with the audit committee before filing the information. The auditor can limit the quarterly discussion to the impact of significant events, transactions, and changes in accounting estimates the auditor considered in performing the review procedures.

The audit committee has several responsibilities with regard to the external audit for public filing savings associations. For listed companies with a market capitalization above \$200 million, the audit committee, as part of proxy and information statements for meetings at which directors are elected, must report whether the audit committee performed the following functions:

- Reviewed and discussed audited financial statements with management.
- Communicated with the company's external auditor any matters required to be discussed under SAS No. 61, *Communications with Audit Committees*. SAS No. 61, as amended by SAS Nos. 89 and 90, requires the external auditor to discuss the "quality, not just the acceptability" of a company's accounting principles with the audit committee. The discussion must be "open and frank, and generally should include such matters as the consistency of the entity's accounting policies and their application, and the clarity and completeness of the entity's financial statements, which include related disclosures."
- Received the written disclosures and the letter from the external auditor, and discussed the external auditor's independence with the external auditor.
- Recommended to the board of directors that the company's annual report or Form 10K include the audited financial statements.

Savings associations must include certain information about their audit committee in a proxy

statement (Schedule A, Item 7). If the registered savings association has an audit committee, the proxy statement should provide the following items:

- Audit committee information required under SEC regulation 17 CFR Part 229.306 (Regulation S-K, Audit Committee Report).
- Board of director adoption of a written charter for the audit committee. The charter should specify the following:
  - The scope of the audit committee's responsibilities, and how it carries out its responsibilities.
  - That the external auditor is ultimately accountable to the board of directors and the audit committee.
  - That the board of directors and audit committee has the authority and responsibility to select, evaluate, and replace the external auditor.
  - A copy of the written charter, if any, as an appendix to the proxy statement at least once every three years.

If there is no audit committee, the names of the board committee performing the equivalent functions or the names of the entire board must appear.

The NYSE, AMEX, and NASD require listed companies to disclose whether audit committee members are independent. Under their rules, if a member is not independent, then the institution should disclose the nature of the relationship that makes the member not independent, and list the reasons for the board's determination. Even if not listed on one of the above exchanges, the institution should disclose whether audit committee members are independent. In 2000, the above exchanges expanded their definition of independence for audit committee members. In general, membership is precluded from the audit committee if any of the following apply to the individual:

- Is currently employed with the company or an affiliate.

- Is currently employed, or has held employment in the past three years, with the current parent of predecessor company.
- Is currently, or within the past three years, has been a member of the immediate family of a current executive officer of the company or an affiliate.
- Is currently an executive of another business organization where any of the company's executives serve on the organization's compensation committee.
- Is currently a partner, controlling shareholder, or executive officer of a business organization that has a business relationship with the company.
- Currently has a direct business relationship with the company.

These rules also require that at least three audit committee members, each of whom must be, or become, "financially literate," include one member with accounting or financial expertise. To be financially literate, the member should be able to read and understand financial statements, including a balance sheet, income statement, and cash flow statement.

## VOLUNTARY EXTERNAL AUDITING PROGRAMS

### Audit of Savings Associations with Less Than \$500 Million of Total Assets

#### *Audit Committees*

To ensure the adequacy of its internal and external auditing programs, OTS encourages the board of directors of each institution that is not otherwise required to do so to establish an audit committee consisting entirely of outside directors. If this is impracticable, the board should organize the audit committee so that outside directors constitute a majority of the membership.

The audit committee's duties may include reviewing the independence of the external auditor annually, reviewing and approving the annual audit

plans and external audit engagement, consulting with management, overseeing performance and setting expectations for the roles of both internal and external audits, seeking an opinion on an accounting issue, and overseeing the quarterly regulatory reporting process.

The audit committee may become involved in emerging issues, key business decisions, ventures, and associated risks. It may also maintain dialog with regulators. The audit committee should report periodically to the full board of directors.

At least annually, the board or audit committee should review the institution's activities that present significant financial reporting risks. The board or audit committee should consider the potential benefits of an audit of the institution's financial statements or the institution's internal control over financial reporting, or both. They should also consider additional procedures for a particular year or several years to cover areas of particularly high risk or special concern. The board should record their reasons supporting their decisions in the minutes.

Based on its review, the board should select an external auditing program that is appropriate for the institution considering its risks, size, and the nature, scope, and complexity of its activities. As an important component of an institution's overall risk management process, an external auditing program, as discussed in this Section, represents procedures performed, generally by an external auditor, to test and evaluate high-risk areas of an institution's business. The procedures should be sufficient for the external auditor to express an opinion on the financial statements or to report on the results of the procedures performed.

#### *Types of External Auditing Programs for Voluntary Audits*

OTS encourages all OTS-regulated institutions to have a full-scope financial statement audit. In lieu of a full-scope financial statement audit, institutions not required to have an audit may elect a balance sheet audit or an attestation report on internal control assertions as the external auditing program. The external auditor performs these types of external auditing programs. Agreed-upon

procedures or state-required examinations are also acceptable.

#### *Financial Statement Audit*

In a financial statement audit, the external auditor expresses an opinion on the fairness with which the financial statements present, in all material respects, the financial position, results of operations, and cash flows, in conformity with GAAP. The auditor will also state if the audit was in accordance with GAAS. The auditor identifies those circumstances in which the institution did not consistently observe GAAP in the preparation of the financial statements for the current period, and should obtain reasonable assurance that material misstatements are detected.

#### *Balance Sheet Audit*

As an alternative, the external auditor may perform a balance sheet audit. A balance sheet audit is an audit of an institution's balance sheet and any accompanying footnotes. The external auditor performs the balance sheet audit in accordance with GAAS. It should be of sufficient scope to enable the auditor to express an opinion on the fairness of the balance sheet presentation in accordance with GAAP.

#### *Attestation Engagement*

Another alternative is an attestation engagement. In an attestation engagement, management evaluates and documents its review of the effectiveness of the institution's internal control over financial reporting in the identified risk areas as of a specific report date. Management should prepare a written assertion that specifies the criteria management used to evaluate the effectiveness of the institution's internal control for financial reporting in the identified risk areas. The written assertion should state management's opinion on the effectiveness of internal control for this specified financial reporting. Under SSAE No. 10, if management refuses to provide the external auditor with a written assertion, the auditor should include a reference to a scope limitation, and accordingly, modify his or her engagement report.

In an attestation engagement, the external auditor performs tests on the internal controls of the specified financial reporting in order to attest to management's assertion. If the external auditor concurs with management's assertion, even if the assertion discloses one or more instances of material internal control weakness, the auditor provides a report attesting to management's assertions.

#### *Agreed-Upon Procedures*

Agreed-upon procedures are procedures specified by the institution and the external auditor or other qualified person to test activities in certain areas. For state-required examinations, states may specify the procedures and require institutions to have these procedures performed annually by their directors or other independent persons.

Agreed-upon procedures do not involve reporting on the fairness of the institution's financial statements or attesting to the effectiveness of internal control over financial reporting. The external auditor or other qualified person presents the procedures and the findings or results of the procedures to the board or the audit committee so that they may draw their own conclusions regarding work performed.

The board of directors should consider whether an external auditor or other qualified person should perform the agreed-upon procedures or the procedures required for the state examination. If performed by an external auditor, the auditor must conduct the work under, and may be held accountable for departures from, professional standards. However, agreed-upon procedures engagements require different professional standards than those used for an audit of an institution's financial statements or its balance sheet.

OTS expects institutions that historically have had an audit of their financial statements by an external auditor or other type of external auditing program to continue to do so. For those that have another type of external auditing program, OTS expects them to continue to have the same, or a more extensive, external auditing program in the future.

### Requested Reports For Voluntary External Auditing Programs

*OTS requests that all savings associations and savings association holding companies that voluntarily obtain an audit of the financial statements, or have some other type of external auditing program performed, file any and all audit-related reports with the appropriate regional office.*

OTS also requests that all institutions notify the appropriate supervisory office when they initially engage an external auditor, or when they change or terminate the services of their auditor. See Appendix C, Interagency Policy Statement on External Auditing Programs of Banks and Savings Associations.

The preferable time for an institution to schedule the performance of an external auditing program is as of an institution's fiscal year-end. However, any quarter-end date that coincides with a regulatory report date provides similar benefits.

Generally, check whether the institution has filed its external auditing reports with its supervisory office. If not, you should request a copy of the most recent reports during the periodic safety and soundness examination.

### Auditor Selection

OTS requires that an external auditor who meets the minimum requirements described in 12 CFR § 562.4(d)(1), (2), and (3) for required audits conduct the voluntary audit of the financial statements. If an institution chooses a balance sheet audit or attestation engagement as its external auditing program, an external auditor who meets the minimum 12 CFR § 562.4(d)(1), (2), and (3) requirements should also perform these programs. Unlike required audits, the regulations do not require auditors performing voluntary audits to receive, or be enrolled, in a peer review.

Preferably, an external auditor will also perform agreed-upon procedures or procedures for a state-required examination. The external audit firm or other qualified persons selected to conduct an external auditing program and their staff carrying out

the work should have experience with financial institution accounting and auditing, or similar expertise, and should be knowledgeable about relevant laws and regulations.

### Review of Voluntary External Auditing Programs

In your review of voluntary external auditing programs, you should consider the following factors:

- An institution's size.
- The nature, scope, and complexity of its business activities.
- Its risk profile.
- Actions taken to remedy identified weaknesses.
- The extent of its internal audit program.
- Compensating controls.

You should exercise judgment and discretion in evaluating the adequacy of an institution's external auditing program. Reports from voluntary external audits and external auditing programs should receive the same level and type of review as those submitted pursuant to FDICIA-required and OTS-required audits.

## AUDIT OF FINANCIAL STATEMENTS BY AN EXTERNAL AUDITOR (AUDIT)

### Objective of Financial Accounting

The fundamental objective of financial accounting is to provide reliable financial information about economic resources and obligations of a business enterprise.

### Objective of an Audit

Similar to the objective of financial accounting, the fundamental objective of an audit conducted in accordance with GAAS is to determine whether the financial statements fairly present, in all material respects, the financial position, results of operations, and cash flows of the institution in accordance with GAAP.

The audit should provide reasonable assurance that the financial statements are free of material misstatements, whether caused by error or fraud. Informative disclosures in the financial statements must follow GAAP, or the report must state otherwise.

### Audit Standards

External auditors should follow the AICPA Code of Professional Ethics. It requires that auditors perform external audits according to GAAS. GAAS, as distinct from accounting standards, are concerned not only with the auditor's professional qualifications, but also the judgment the auditor exercises in the performance of an audit and with the quality of the audit procedures. There are three categories of GAAS:

- General standards.
- Fieldwork standards.
- Reporting standards.

The general standards require that the person, or persons, who performs the audit meet the following professional qualifications:

- Possess adequate technical training and proficiency.
- Maintain independence in mental attitude.
- Exercise due professional care in the performance of the audit and the preparation of the report.

Fieldwork standards include the following requirements:

- Adequately planned work.
- Properly supervised assistants, if any.
- Proper study and evaluation of existing internal controls to determine audit scope, audit procedures, and the extent of testing.
- Sufficient evidence to formulate an opinion on the financial statements under audit.

Reporting standards require that the external auditor state whether the institution presents its financial statements in accordance with GAAP.

### Limitations of Audits and Audited Financial Statements

Although auditing standards require the use of due care and professional skepticism, a properly designed and executed audit does not guarantee that the audit will detect all misstatements of amounts or omissions of disclosures in the financial statements. Moreover, an external audit is not designed or executed for regulatory purposes, and thus, does not guarantee that the auditor addressed OTS safety and soundness considerations. You should be cognizant of these and other limits inherent in an audit. The following examples illustrate some common limitations of audits:

- The auditor is not responsible for deciding whether an institution operates wisely. An unqualified audit report means that the association reports transactions and balances in accordance with GAAP. It does not mean that the transactions make business sense, that the association manages associated risks in a safe and sound manner, or that the association can recover balances upon disposition or liquidation.
- The auditor attempts to understand financial reporting internal controls sufficient enough to plan the audit, and determine the nature, timing, and extent of tests to perform. This does not mean that the external auditor extensively reviews controls over all areas. The external auditor may use various levels of testing depending on the risk of a specific area.
- The auditor's report states that the financial statements present fairly the financial position. This means that, given evidence and current environment, the association can recover reported assets in the normal course of business. It does not mean that underwriting standards, operating strategy, loan monitoring systems, and workout procedures are adequate to mitigate losses if the environment changes.
- GAAP financial statements offer only limited disclosures of risks and uncertainties, and other

safety and soundness factors on which an institution's viability depends.

### **REGULATORY CONCERNS**

The following documents are part of the supervisory process for monitoring savings associations:

- Audited financial statements along with the external auditor's report.
- External auditor's attestation report on internal control report over financial reporting, if applicable.
- External auditor's management letter.

When OTS or the FDIC requires an external audit, the audit must be completed on a timely basis. The regional office is responsible for determining that each association files a required audit report on a timely basis. The regional office should date stamp the required audit report upon receipt.

For required external audits, OTS policy requires savings associations to submit copies of the audit report, attestation report on internal control over financial reporting, and any other audit-related reports to the regional office. The regional office must maintain one complete set in the supervisory files (supervisory file copy) attached to the completed Audit-Related Report Checklist found in Appendix A of this Handbook Section. You should receive another set (examination file copy) with a copy of the appropriate checklists.

For all types of audits, required or otherwise, Regional staff should consider maintaining a tracking system of external audits by savings associations, which would include the name of the auditor, and various other information.

When OTS or FDIC requires an audit examination, examination managers are responsible for the review and timely follow-up of the various audit reports and correspondence. They should review audit reports, financial statements, reports on internal control and other audit-related reports within 90 days of receipt. Examination managers should add any items of supervisory interest to the supervisory concerns, objectives, and strategies section

of the regulatory profile. Based on this review, the examination manager should take the following steps:

- Set out the timing and nature of any required follow-up as indicated on the checklist.
- Update the activity agenda section of the regulatory profile to reflect any planned actions resulting from the review.
- Consult the Regional Accountant when the follow-up includes issues about GAAP, GAAS, or enforcement matters.

OTS will generally reject, as unsatisfactory, a report of audit disclaiming an opinion on the audited financial statement, unless the reason for the disclaimer is beyond the control of the association or the Regional Accountant approves it.

The regional office is also responsible for requesting external auditing program reports from institutions not required by regulation or otherwise to have an external auditing program.

Chapter 18 of the AICPA Audit and Accounting Guide, Audits of Banks and Savings Institutions (May 1, 2000), and AICPA Statement of Auditing Standards No. 58 describe the standard types of audit reports. The Regional Accountant maintains copies of these materials.

### **Audit Requirements**

Reports from voluntary external audits and external auditing programs should receive the same level and type of review as those submitted pursuant to FDICIA-required and OTS-required audits.

### **Independence of External Auditor**

The audit committee should hire and terminate the external auditor. To maintain independence from management, the external auditor ideally reports to the outside directors of the board. You should question the independence and objectivity of the external auditor when the auditor appears to be reporting to management, appears to be an advocate for management, or generally appears to be

working more for management than the board of directors.

Instances in which you should question independence include but are not limited to the following examples:

- Management approves the external auditor's presentations to the board
- Management prevents the external auditor from meeting with the board unless management was present
- The board of directors appears to lack the sophistication to understand or appropriately discuss audit or accounting issues with the external auditor
- The auditing staff does not have unrestricted access to the board or audit committee without management knowledge or approval.

Under these circumstances, you may decide to test the independence of the auditor through reviews of loan listings, contracts, stockholder listings, and other appropriate measures.

See also AICPA Interpretation (101-13) and rulings (101, 103, 104, and 105) regarding independence standards.

You should refer any concerns about independence to the Regional Accountant. The Regional Accountant may consult with the Chief Accountant.

### Review of Audit Work Papers

The purpose of reviewing external audit work papers is to gain insight into the external auditor's report on material weaknesses and reportable conditions regarding an institution's internal control and financial reporting practices. The auditor performs procedures that evaluate the reliability of financial statement assertions, which may also provide insight into certain assertions included in the Thrift Financial Report (TFR).

Examples of situations that might trigger an external audit work paper are:

- Reliance on external audit in lieu of an internal audit program.
- Unexpected or sudden changes in the external auditor.
- Significant changes in the external audit program.
- Significant safety and soundness concerns.
- Issues about independence, objectivity, or competence of the external auditor.

A review of the external audit work papers should help you accomplish the following:

- Perform financial analysis of the institution.
- Identify areas of supervisory concern or accounting complexity.
- Detect trends and information not otherwise revealed in the monitoring process.
- Determine the scope of the examination:
  - Reduce the scope of the examination in certain areas based on the extent, scope, and findings of the audit.
  - Expand the examination scope in certain high-risk areas based on the audit work.
  - Expand the scope in certain areas based on the auditor's findings that disclose matters of supervisory concern.
- Evaluate the institution's internal control over financial reporting.
- Identify areas where audit work can supplement examination procedures.
- Identify audit work that provides insight into certain financial statement assertions, or that is sufficient to enable you to limit certain examination procedures.
- Identify high-risk areas that require expanded procedures.

If work papers exist for lower-risk areas, such as confirming loans, and they appear accurate and

reliable, you may use them to avoid duplicating efforts to gain the same or similar information. However, when you use work papers in lieu of performing the actual work yourself, you are placing reliance on a work product not necessarily designed for regulatory purposes. Any reliance on work papers or work products for lower-risk areas should be exercised with caution. In high-risk areas where the audit work appears reliable, use the work papers only to design and supplement examination procedures accordingly.

The following instances are examples of cases where a review of the external audit work papers and conversations with auditors could assist you in performing examinations:

- An association has serious internal control problems. You should discuss the full extent of the problems with the auditor to determine whether you should expand the scope of the examination.
- An association has aggressive accounting practices. The audit work papers may document management's reasons for the aggressive practices. After the review, you should understand management's rationale, and assess whether a less aggressive accounting practice is more appropriate from a safety and soundness standpoint.
- An association holds servicing assets as well as residual assets from securitizations. The audit work papers may document management's valuation estimates, including the assumptions and methodologies used to value the servicing and residual assets. The audit work papers also indicate the audit procedures performed to test those estimates. After the review, you should understand management's approach and the exposure areas. If the findings are acceptable for safety and soundness reasons, you may use the information to plan and supplement the examination procedures in this area.

In each of the above examples, your review of the audit work papers and a discussion with the auditor will likely improve your understanding of the differences in judgment or of any fact that may require examination adjustments to the TFR. The examples also illustrate how you can focus exami-

nation resources on problem areas by using some of the audit evidence.

After reviewing work papers, refer any of the following concerns to the Regional Accountant:

- Regulatory reporting issues.
- The need for expanded or verification procedures.
- Questions about the application of GAAP or GAAS.
- Unacceptable diversity in practices.
- Deficiencies, in general.

The Regional Accountant will assist in choosing a course of action, which may be to discuss the issue with the auditor in an attempt to resolve it. In addition, the Regional Accountant may consult with other appropriate divisions, such as the Chief Accountant, Enforcement, and/or Compliance.

### Obtaining External Audit Work Papers

OTS policy requires external auditors to agree in the engagement letter to provide access to copies of any work papers, policies, and procedures relating to the services performed (12 CFR § 562.4(d)(2)).

The request for or access to the audit work papers should be in writing to the external auditor. Work papers are the property of the auditor, and your review of the work papers should be for informational purposes. Auditors are generally very cooperative, as they are interested in assessing the effect of examination concerns on the financial statements. The review of audit work papers and the discussion of significant items and complex transactions with the external auditors can help you assess whether the reporting is safe and sound.

Before allowing access to or releasing copies of the work papers, the auditor may request that you "acknowledge" certain representations and conditions set forth in a letter from the auditors. It is not unreasonable for the auditor to request that OTS examiners acknowledge receipt of documents. This is common business practice and proof of compliance with the examiner's request. However, any

attempt by an auditor to impose conditions, agreements, or understandings on you or the OTS is contrary to the auditor's agreement in the engagement letter.

OTS policy allows you to sign a document only to acknowledge receipt of an accounting firm's letter and any copies of work papers, policies, and procedures delivered with such letter. Do not sign any document that implies that OTS has agreed to any conditions in the letter.

Notify the Regional Accountant if any auditor seeks to avoid inclusion of the required agreement in the engagement letter under OTS Regulation 12 CFR § 562.4(d)(2), or to evade, or impose conditions, on the obligation to provide OTS access to or copies of work papers, policies, and procedures relating to services performed. A sample copy of a letter to request work papers is provided in Appendix D, and an acknowledgement letter is provided in Appendix E.

In limited circumstances, it may be appropriate to arrange a subpoena to gain access to the audit work papers. The Regional Accountant, or contracted experts, should review the subpoenaed work papers and provide written findings to the Regional Director.

#### *FDIC Policy for Audit Work Paper Review*

The FDIC issued guidance stating that it will review audit work papers for each insured institution subject to Part 363 that has been assigned, or expects to be assigned, a CAMELS rating of 4 or 5. In each case, the FDIC will contact the institution's primary federal regulator to arrange, if possible, a joint review of the work papers. When a savings association is an OTS-supervised institution, the FDIC indicates that it will contact the appropriate OTS supervisory office to determine in what manner, and which agency should notify the institution of the upcoming review. After the OTS supervisory office and the FDIC make that determination, one agency will inform the institution in advance that the agencies are contacting the auditor to request audit work papers. One agency will also notify the holding company.

#### **Communications with Auditors**

When conducting an audit of the financial statements of a savings association, the external auditor can consider, in accordance with GAAS, the regulatory authorities as a source of competent evidential matter. Accordingly, the external auditor may review communications from, and make inquiries of, the regulatory authorities. We encourage savings associations and their auditors to confer with OTS when they consider it appropriate. Such contacts may include meetings with you to assist in planning audits, or auditors may attend examination planning, interim, and exit conferences with association management and examiners. They may also attend other meetings between management or the board of directors (or a committee thereof) and examination personnel when you consider it appropriate.

You should provide associations with advance notice of the starting and completion dates of examinations so management can coordinate the audit fieldwork with the examination. Management should inform auditors in advance of scheduled examinations and meetings.

When requested by the association and the auditor, the examination manager may communicate examination findings prior to the completion of the examination. We encourage the examination manager to comply with such requests. This fosters better communications and improves the quality of financial reports. We also encourage you to communicate with auditors in the field after notifying the examination manager. You should communicate to the auditor all supervisory concerns and information except those involving confidential enforcement actions, such as imminent conservatorships or receiverships. As a general guideline, you should communicate interim examination findings whenever the following occurs:

- The examination process results in substantiated findings that significantly affect the financial information reported by the association.
- The association is about to report quarterly or annual financial information to the OTS or other outside parties, such as shareholders or the general public.

Obviously, under such circumstances, prompt communication is important. Material examination adjustments made shortly after an association issues a financial statement can cause significant public disclosure and securities problems.

The regional office should make examination work papers available to external auditors upon request. If you have not issued the ROE, stamp any copies of work papers provided to the external auditor as "DRAFT." To access work papers, the external auditor must make the request in writing to the examination manager. The examination manager may decline requests for good cause but such denials should be unusual. A reasonable denial would include the following situations:

- Specific work papers requested contain confidential litigation matters such as criminal referrals.
- Litigation against the auditor is pending or contemplated.

Finally, to obtain access to work papers, the auditor must sign a statement of consent to the Prohibition of Disclosure or Release notice.

#### **Prohibition of Disclosure or Release**

The report of examination, regulatory correspondence, and examination work papers are the property of OTS. OTS makes documents available to the independent audit firm for its confidential use relating to its audit of the savings association engaging the audit firm. Neither the audit firm nor any of its employees may disclose or make these documents, or any portion of them, public in any manner.

If an external auditor receives a subpoena or any legal process calling for the production of any OTS documents held by the auditor, the auditor must notify the Regional Director immediately. You should advise the attorney and, if necessary, the court of the above prohibition and refer them to § 510.5 of the OTS regulations.

## **REFERENCES**

### **Code of Federal Regulations (12 CFR)**

#### *FDIC Regulations*

Part 363 Annual Independent Audits and Reporting Requirements

#### *OTS Regulations*

Part 510 Miscellaneous Organizational Regulations  
 § 562.4 Audit of Savings Associations and Savings Association Holding Companies  
 § 563.170(a) Examinations and Audits  
 § 563.180 Suspicious Activity Reports and Other Reports and Statements  
 Part 563c Accounting Requirements

### **United States Code (12 USC)**

§ 1817(a) Report to Independent Auditor

### **FFIEC Guidance**

Interagency Policy Statement on External Auditing Programs of Banks and Savings Associations (September 22, 1999)

### **American Institute of Certified Public Accountants (AICPA)**

#### *Statement on Auditing Standards (SAS)*

No. 54 Illegal Acts by Clients (AU 317)  
 No. 55 Consideration of Internal Control in a Financial Statement Audit (AU 319)  
 No. 58 Reports on Audited Financial Statements (AU 508)  
 No. 60 Communication of Internal Control Structure Related Matters Noted in an Audit (AU 325)  
 No. 61 Communication With Audit Committees (AU 380)

No. 69	The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles in the Independent Auditor's Report (AU 411)		<i>Statement on Standards for Attestation Engagements (SSAE)</i>
No. 70	Reports on the Processing of Transactions by Service Organizations (AU 324)	No. 2	Reporting on an Entity's Internal Control Structure Over Financial Reporting (AT 400)
No. 71	Interim Financial Information (AU 722).	No. 3	Compliance Attestation (AT 500)
No. 79	Amendment to Statement on Auditing Standards No. 58, Reports on Audited Financial Statements (AU 508)	No. 4	Agreed-Upon Procedures Engagement (AT 600)
No. 82	Consideration of Fraud in a Financial Statement Audit (AU 316)	No. 6	Reporting on an Entity's Internal Control Over Financial Reporting: An Amendment to Statement on Standards for Attestation Engagements No. 2 (AT 400)
No. 89	Audit Adjustments (AU 420)	No. 9	Amendments to Statement on Standards for Attestation Engagements Nos. 1, 2, and 3 (AT 100, 400, and 500)
No. 90	Audit Committee Communications (AU 380)	No. 10	Attestation Standards: Revision and Recodification (AT 101), supersedes SSAE Nos. 1 through 9
No. 93	Omnibus Statement on Auditing Standards (AU 315)		
No. 94	The Effect of Information Technology on the Auditor's Consideration of Internal Control in a Financial Statement Audit (AU 319)		<i>AICPA Code of Professional Conduct (ET)</i>
		Sec. 100	Independence, Integrity, and Objectivity
		Sec. 100.15	Extended Audit Services (101-13)
		Sec. 191	Ethics Rulings on Independence, Integrity, and Objectivity
		Sec. 191.206	Member Providing Attest Report on Internal Controls (103)
		Sec. 191.208	Member Providing Operational Auditing Services (104)
		Sec. 191.210	Frequency of Performance of Extended Audit Procedures (105)

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## External Audit Program

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### Examination Objectives

To determine how audit procedures, findings, and recommendations affect the scope of the planned examination.

To evaluate how much the examiner can rely on the audit work to limit or supplement the examination scope.

To communicate with auditors to obtain a better understanding of high-risk or complex activities of the association.

To ensure that the auditor met regulatory requirements in the preparation and presentation of the audit report.

To determine if the association corrected deficiencies noted by the auditors.

To determine that the auditor's client is the board of directors and not management.

### Monitoring and Examination Procedures

Wkp.Ref.

#### Level I

##### *Supervisory Monitoring Procedures (Examination managers)*

1. Obtain copies of the audit report, report on system of internal control (report on internal control), engagement letter, audited financial statements, Securities and Exchange Commission (SEC) filings, and any other audit-related reports the regional office receives. (Also obtain a copy of all comments pertaining to any supervisory or compliance reviews performed by the regional accountant.)
  - Determine the type of opinion (unqualified, qualified, adverse, or disclaimer) rendered by the external auditor. If the external auditor rendered other than an unqualified opinion, find out why.

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**Exam Date:** \_\_\_\_\_  
**Prepared By:** \_\_\_\_\_  
**Reviewed By:** \_\_\_\_\_  
**Docket #:** \_\_\_\_\_

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## External Audit Program

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Wkp.Ref

2. Read the reports for supervisory issues (at a minimum, verify that the regulatory capital figures in the footnotes to the audited financial statements agree with the Thrift Financial Report (TFR) for the same period).

- Complete the Audit-Related Report checklist in Appendix A for audit-related reports.

\_\_\_\_\_

3. Determine whether any identified supervisory concerns require immediate follow-up. If not, use the checklists to document needed follow-up by examination personnel.

- Determine if there are any material weaknesses in internal control. Discuss any communication of weaknesses between management and the external auditor.

\_\_\_\_\_

4. Determine whether any supervisory concerns have subsequently been reported in the association's TFR or the examination.

\_\_\_\_\_

5. Update the regulatory profile for any identified supervisory concerns.

\_\_\_\_\_

### *Examination Planning Procedures*

6. Obtain the examination file copy of the Audit-Related Report checklist prepared since the last examination.

- Review the checklist for any documented supervisory concerns.
- Schedule field examination follow-up on documented supervisory concerns.

\_\_\_\_\_

7. Make inquiries of association management and the external auditor to determine whether the external auditor performed any special reviews of specific departments or areas of the association since the previous examination that the association did not supply to OTS.

**Exam Date:** \_\_\_\_\_

**Prepared By:** \_\_\_\_\_

**Reviewed By:** \_\_\_\_\_

**Docket #:** \_\_\_\_\_

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## External Audit Program

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Wkp.Ref.

- Obtain copies of the reports and discuss any supervisory concerns with the auditor and management.
  - Complete the Audit-Related Report checklist.
  - Update the regulatory profile for any identified supervisory concerns and required examination follow-up.
- 

8. Determine whether you can use the audit to supplement the examination procedures.
- Review the audit work papers to identify areas where the audit work can supplement examination procedures.
  - Identify audit work that you can rely on to limit examination procedures, keeping in mind the limitations on relying on audit work.
  - Consider the auditor's competence, integrity, independence, and knowledge of regulatory matters (consult the regional accountant).
  - Determine if the institution prepared a management report, and review management's assessment of the effectiveness of internal control structures and procedures as of the end of the fiscal year, and its compliance with laws and regulations during the year.
  - Determine if the external auditor has examined, attested to, or reported separately on management's assertions concerning the internal control structure for financial reporting.
  - Consider having the auditor perform specific procedures. (This request should coincide with the auditor's normal annual audit work whenever possible.)
- 

### *Examination Field Procedures*

9. Perform recommended follow-up for all items as indicated in the regulatory profile and the Audit-Related Report checklist.
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**Exam Date:** \_\_\_\_\_  
**Prepared By:** \_\_\_\_\_  
**Reviewed By:** \_\_\_\_\_  
**Docket #:** \_\_\_\_\_

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## External Audit Program

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Wkp.Ref

10. Discuss matters of supervisory concern and material transactions that require complex analysis with the external auditor.

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11. Ask association management and the external auditor about any account adjustments resulting from the most recent audit.

- Obtain a schedule of the adjustments.
  - Review the adjustments to identify entries that indicate poor accounting records or controls.
  - Review the adjustments to determine whether management has given appropriate attention to the affected areas and to determine whether management reported the adjustments on the TFR in the appropriate period. *Do not require restatement of the TFR unless the error is material.* An error is material if it is related to a failure of a capital requirement, a change in a PCA category, a change in a component rating, or has significance for regulatory reporting purposes.
- 

12. Review Level II procedures and perform those necessary to test, support, and present examination conclusions derived from performing Level I procedures.

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### Level II

#### *Examination Field Procedures*

13. If you plan a review of the audit work papers, arrange for the auditor to make the work papers available at the association's office. Only sign a document to acknowledge receipt of the copies of the work papers. (Alternatively, the accountant may request that you review the work papers in the auditor's office.)

- Gather evidence on identified matters as necessary to substantiate stated examination objectives.
- Prepare a list of work papers to copy, if needed.

**Exam Date:** \_\_\_\_\_  
**Prepared By:** \_\_\_\_\_  
**Reviewed By:** \_\_\_\_\_  
**Docket #:** \_\_\_\_\_

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## External Audit Program

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Wkp.Ref.

- Submit the list to the auditor and obtain a firm commitment on the delivery date, if needed.
  - Determine whether work papers support conclusions by the external auditor.
  - Modify the examination scope as considered necessary.
  - If there are questions or concerns about the application of generally accepted accounting principles or generally accepted auditing standards based on the work paper review, consult the regional accountant.
- 

14. Assess the CPA's independence and competence.

- Evaluate the independence, objectivity, and competence of those providing the external audit.
  - Determine if the institution has recently changed auditors. If so, discuss the reason for the change.
  - Make inquiries of the appropriate association officials concerning their knowledge of any improper relationship (stockholder, significant unsecured borrower, officer, or director) or business affiliations with the CPA.
  - Obtain and review loan listings, contracts, and stockholder listings to substantiate representations of independence, if circumstances warrant.
  - Determine that the audit committee of the board of directors verified that the audit engagement staff was independent and competent to audit the association.
  - Determine that the outside directors on the audit committee monitor the relationship between the auditor and management. The auditor works for the board of directors, not management. The auditor should not be an advocate for management.
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15. Review and determine whether the board of directors or its audit committee at least annually reviews and approves any policies pertaining to the institution's external audit function.

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**Exam Date:** \_\_\_\_\_  
**Prepared By:** \_\_\_\_\_  
**Reviewed By:** \_\_\_\_\_  
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## External Audit Program

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Wkp.Ref

16. Meet with the external auditor to discuss significant audit findings.

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

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**Exam Date:** \_\_\_\_\_  
**Prepared By:** \_\_\_\_\_  
**Reviewed By:** \_\_\_\_\_  
**Docket #:** \_\_\_\_\_

**Audit-Related Report Checklist**

Association		Docket #
Year End	Type of Report(s)	
Audit Firm	Office	

*Instructions:* The examination manager is responsible for the review of all audit-related reports required by 12 CFR § 562.4 and FDIC Part 363. Audit-related reports include report of audit, audited financial statements, reports on internal control, the management report on internal control, the accountant’s attestation report, and special agreed-upon procedures reports. Use this checklist to describe information of a supervisory nature and to communicate any supervisory follow-up to examiners. You may use one or more checklists for each annual audit. If immediate follow-up is not necessary, place this checklist in the examination file for follow-up by examiners in the next examination. You must complete this checklist within 90 days of receipt of the audit-related report. This checklist is optional for reports filed with OTS on a voluntary basis. File completed checklists in the supervisory file. *Document all responses on this checklist with attachments as needed.*

1. Assemble the most recent report of examination, thrift financial report, other regulatory reports, audited financial statements, and other audit-related reports.
2. Scan the report under review and note items of supervisory interest, such as, new line items or footnotes in audited financial statements that indicate a new type of transaction or exposure area for the association; material weaknesses reported in the system of internal control, etc.
3. Review the other documents assembled under item 1 above and note the extent of any OTS knowledge of the supervisory items identified in item 2 above.
4. Document required follow-up for items of supervisory concern.
5. Update the regulatory profile to reflect key audit information and any safety and soundness concerns.
6. Attach this questionnaire to the supervisory file copy and examination file copy of the audit report under review.



Reviewed by	Date
Follow-up completed by	Date
Examination Manager Approval	Date

Comparison of OTS and FDIC Annual External Audit Requirements

OTS 12 CFR 562.4

FDIC 12 CFR Part 363

Scope		
	<p>The OTS requires an external audit for safety and soundness purposes if a savings association has received a composite rating of 3, 4, or 5 under UFIRS. [12 CFR 562.4(a) and (b)(1)]</p> <p>The Director may waive the external audit requirement for a saving association if the Director determines that an audit would not provide further information on safety and soundness issues relevant to examination rating. [12 CFR 562.4(c)(2)]</p> <p>The OTS requires an external audit for a savings and loan holding company that controls savings association subsidiary(ies) with aggregate consolidated assets of \$500 million or more. [12 CFR 562.4(b)(2)]</p> <p>A savings association holding company may request a modification or waiver of the external audit requirement. [Handbook - Section 350; paragraph heading ‘OTS Required Audit: Audit of Savings Association Holding Companies with \$500 Million or More of Total Assets; Modification or Waiver’]</p> <p>The audited consolidated financial statement of the savings association holding company will be accepted in lieu of separate audited financial statements of the savings association. [Handbook - Section 350; paragraph heading ‘OTS Required Audit: Audit of Savings Associations that Receive a Composite CAMELS Rating of 3, 4, or 5; Required Reports’]</p>	<p>Insured depository institutions, including savings associations, with total assets of \$500 million or more at the beginning of each fiscal year after December 31, 1992. [12 CFR 363.1(a)]</p> <p>The audited financial statements (AFS) requirement may be satisfied by audited financial statements of the consolidated holding company. All other requirements of Part 363 may be satisfied at the holding company level if certain conditions are met. [12 CFR 363.1(b)]</p>

**OTS 12 CFR 562.4**

**FDIC 12 CFR Part 363**

<p><b>Auditing Standard</b></p>	<p>Generally accepted auditing standards (GAAS).</p>	<p>GAAS and the standards of section 37 of the Federal Deposit Insurance Act (FDIA). [12 CFR 363.3(a)]</p>
<p><b>Qualifications for Auditors</b></p>	<p>Certified public accountant (CPA) who is independent by AICPA and SEC standards and is enrolled in an FDIC-approved peer review program. CPA agrees in the engagement letter to provide OTS with access to and copies of any work paper, policies, and procedures relating to the services performed. [12 CFR 562.4(d)(1), (2), (3), and (4)]</p> <p>For voluntary audits the CPA does not have to be enrolled in a peer review program. [12 CFR 562.4(e)]</p>	<p>CPA who is independent by AICPA and SEC approved peer review program. [12 CFR 363 Appendix (13), (14), and (15)]</p>
<p><b>Filing and Notice Requirements</b>  <b>a) Savings Association</b></p>	<p>A savings association that is required to obtain an external audit for safety and soundness reasons should submit two copies to the Regional Director of the following: the audited financial statements, any reports from the CPA that make reference to the external audit, and other OTS requested supplemental information, or schedules. The required reports shall be forwarded to the Regional Director within 90 days of the fiscal year-end or within 15 days of receipt, whichever is earlier.</p>	<p>When an audit is required the FDIC requires the following reports:</p> <ul style="list-style-type: none"> <li>• AFS prepared in accordance with generally accepted accounting principles (GAAP).</li> <li>• Audit Opinion on AFS.</li> <li>• Management Report:             <ul style="list-style-type: none"> <li>— Statement of responsibility</li> <li>— Assessment of effectiveness of the internal control structure over financial reporting, and</li> <li>— Assessment of compliance with designated safety and soundness laws and regulations.</li> </ul> </li> <li>• Accountant’s attestation report on management’s assessment of effectiveness of internal control structure.</li> <li>• Any management letter, qualification, or other report(s) issued by the accountant relating to services provided pursuant to 12 CFR Part 363.</li> </ul>

OTS 12 CFR 562.4

FDIC 12 CFR Part 363

<p><b>Filing and Notice Requirements</b>  <b>a) Savings Association</b>  <i>(continued)</i></p>	<p>When a savings association has assets of \$500 million or more, it will instead file with the FDIC and OTS the reports required pursuant to FDIC Regulation Part 363 and FDIC guidelines at Appendix A to Part 363. [Handbook - Section 350; paragraph heading ‘External Audits’]</p> <p>A savings association holding company should comply with the reporting requirements at item 21, “Financial Statements” in the H-(b)21 Annual Report. [Handbook - Section 350; paragraph heading ‘Savings Association Holding Companies with \$500 Million or More of Total Assets’]</p> <p>Institutions that obtain voluntary audits are not required to file any reports or notices with the OTS.</p>	
<p><b>Audit Waivers</b></p>	<p>The savings association may make a written request for a waiver from the OTS safety and soundness audit requirement. OTS will waive the audit requirement if it determines that an audit is not the most effective means to address safety and soundness concerns that caused the composite CAMELS rating of 3, 4, or 5. [Handbook - Section 350; paragraph heading ‘Written Request for Waiver of External Audit Agreement’]</p> <p>A savings association holding company may request a modification or waiver of the external audit requirement. [Handbook - Section 350; paragraph heading ‘Savings Association Holding Companies with \$500 Million or More of Total Assets; Safety and Soundness Considerations for Granting Waiver Requests’]</p>	<p>No similar provision.</p>

OTS 12 CFR 562.4

FDIC 12 CFR Part 363

<p><b>Filing and Notice Requirements</b> b) Auditors</p>	<p>No requirement to provided notice of change in auditors (the FDIC has a notice requirement for institutions with \$500 million or more in assets).</p>	<p>Notice of engagement or change of accountant. [12 CFR 363.4]</p>
	<p>Make the peer review report available to examiner during examination, do not forward to OTS. [Handbook - Section 350; paragraph heading ‘Auditor Requirements For Required Audit or Required Agreed-Upon Procedures’]</p>	<p>Notice of termination of accountant. Peer Review Report. [12 CFR 363.3(c) and Statute]</p>
<p><b>Audit Committee Requirements</b></p>	<p>None</p>	<p>Must consist of members of the board who are independent of management<sup>1</sup>.  [12 CFR 363 Appendix (28) and (29)]  Institutions with assets of \$3 billion or more must have access to outside counsel and include members with banking and financial management expertise who are not large customers of the institution.</p>
<p><b>Documentation and Other Considerations for Audit Work Papers</b></p>	<p>The CPA agrees in the engagement letter (do not forward engagement letter to OTS) to provide OTS with access to and copies of any work papers, policies, and procedures relating to services performed. [12 CFR 562.4(d)(2)]</p>	<p>Copies of any work papers, policies, and procedures relating to services performed under 12 CFR 363 must be provided upon request. [12 CFR 363 Appendix (13)]  Peer review work papers must be retained for 120 days after peer review report is filed with FDIC. [12 CFR 363 Appendix (15(c))]</p>

<sup>1</sup> Members of the holding company’s audit committee may serve as the audit committee of any subsidiary institution if they are otherwise independent of management of the subsidiary.  
[12 CFR 363 Appendix (31)]

## FEDERAL FINANCIAL INSTITUTIONS EXAMINATION COUNCIL

INTERAGENCY POLICY STATEMENT ON EXTERNAL AUDITING PROGRAMS  
OF BANKS AND SAVINGS ASSOCIATIONS

## INTRODUCTION

The board of directors and senior managers of a banking institution or savings association (institution) are responsible for ensuring that the institution operates in a safe and sound manner. To achieve this goal and meet the safety and soundness guidelines implementing Section 39 of the Federal Deposit Insurance Act (FDI Act) (12 U.S.C. § 1831p-1),<sup>1</sup> the institution should maintain effective systems and internal control<sup>2</sup> to produce reliable and accurate financial reports.

Accurate financial reporting is essential to an institution's safety and soundness for numerous reasons. First, accurate financial information enables management to effectively manage the institution's risks and make sound business decisions. In addition, institutions are required by law<sup>3</sup> to provide accurate and timely financial reports (e.g., Reports of Condition and Income [Call Reports] and Thrift Financial Reports) to their appropriate regulatory agency. These reports serve an important role in the agencies' <sup>4</sup> risk-focused supervision programs by contributing to their pre-examination planning, off-site monitoring programs, and assessments of an institution's capital adequacy and financial strength. Further, reliable financial reports are necessary for the institution to raise capital. They provide data to stockholders, depositors and other funds providers, borrowers, and potential investors on the company's financial position and results of operations. Such information is critical to effective market discipline of the institution.

To help ensure accurate and reliable financial reporting, the agencies recommend that the board of directors of each institution establish and maintain an external auditing program. An external auditing program should be an important component of an institution's overall risk management process. For example, an external auditing program complements the internal auditing function of an institution by providing management and the board of directors with an independent and objective view of the reliability of the institution's financial statements and the adequacy of its financial reporting internal controls. Additionally, an effective external auditing program contributes to the efficiency of the agencies' risk-focused examination process. By considering the significant risk areas of an institution, an effective external auditing program may reduce the examination time the agencies spend in such areas. Moreover, it can improve the safety and soundness of an institution substantially and lessen the risk the institution poses to the insurance funds administered by the Federal Deposit Insurance Corporation (FDIC).

This policy statement outlines the characteristics of an effective external auditing program and provides examples of how an institution can use an external auditor to help ensure the reliability of its financial reports. It also provides guidance on how an examiner may assess an institution's external auditing program. In addition, this policy statement provides specific guidance on external auditing programs for institutions that are holding company subsidiaries, newly insured institutions, and institutions presenting supervisory concerns.

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<sup>1</sup> See 12 CFR Part 30 for national banks; 12 CFR Part 364 for state nonmember banks; 12 CFR Part 208 for state member banks; and 12 CFR Part 510 for savings associations.

<sup>2</sup> This Policy Statement provides guidance consistent with the guidance established in the "Interagency Policy Statement on the Internal Audit Function and its Outsourcing."

<sup>3</sup> See 12 USC 161 for national banks; 12 USC 1817a for state nonmember banks, 12 USC 324 for state member banks; and 12 USC 1464(v) for savings associations.

<sup>4</sup> Terms defined in Appendix A are italicized the first time they appear in this policy statement.

The adoption of a financial statement audit or other specified type of external auditing program is generally only required in specific circumstances. For example, insured depository institutions covered by Section 36 of the FDI Act (12 U.S.C. § 1831m), as implemented by Part 363 of the FDIC's regulations (12 CFR part 363), are required to have an external audit and an audit committee. Therefore, this policy statement is directed toward banks and savings associations which are exempt from Part 363 (i.e., institutions with less than \$500 million in total assets at the beginning of their fiscal year) or are not otherwise subject to audit requirements by order, agreement, statute, or agency regulations.

## OVERVIEW OF EXTERNAL AUDITING PROGRAMS

### Responsibilities of the Board of Directors

The board of directors of an institution is responsible for determining how to best obtain reasonable assurance that the institution's financial statements and regulatory reports are reliably prepared. In this regard, the board is also responsible for ensuring that its external auditing program is appropriate for the institution and adequately addresses the financial reporting aspects of the significant risk areas and any other areas of concern of the institution's business.

To help ensure the adequacy of its internal and external auditing programs, the agencies encourage the board of directors of each institution that is not otherwise required to do so to establish an audit committee consisting entirely of outside directors.<sup>5</sup> However, if this is impracticable, the board should organize the audit committee so that outside directors constitute a majority of the membership.

### Audit Committee

The audit committee or board of directors is responsible for identifying at least annually the risk areas of the institution's activities and assessing the extent of external auditing involvement needed over each area. The audit committee or board is then responsible for determining what type of external auditing program will best meet the institution's needs (refer to the descriptions under "Types of External Auditing Programs").

When evaluating the institution's external auditing needs, the board or audit committee should consider the size of the institution and the nature, scope, and complexity of its operations. It should also consider the potential benefits of an audit of the institution's financial statements or an examination of the institution's internal control structure over financial reporting, or both. In addition, the board or audit committee may determine that additional or specific external auditing procedures are warranted for a particular year or several years to cover areas of particularly high risk or special concern. The reasons supporting these decisions should be recorded in the committee's or board's minutes.

If, in its annual consideration of the institution's external auditing program, the board or audit committee determines, after considering its inherent limitations, that an agreed-upon procedures/state-required examination is sufficient, they should also consider whether an independent public accountant should perform the work. When an independent public accountant performs auditing and attestation services, the accountant must conduct his or her work under, and may be held accountable for departures from, professional standards. Furthermore, when the external auditing program includes an audit of the financial statements, the board or audit committee obtains an opinion from the independent public accountant stating whether the financial statements are presented fairly, in all material respects, in accordance with generally accepted accounting principles (GAAP). When the external auditing program includes an examination of the internal control structure

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<sup>5</sup> Institutions with \$500 million or more in total assets must establish an independent audit committee made up of outside directors who are independent of management. See 12 U.S.C. 1831m(g)(1) and 12 CFR 363.5.

over financial reporting, the board or audit committee obtains an opinion from the independent public accountant stating whether the financial reporting process is subject to any material weaknesses.

Both the staff performing an internal audit function and the independent public accountant or other external auditor should have unrestricted access to the board or audit committee without the need for any prior management knowledge or approval. Other duties of an audit committee may include reviewing the independence of the external auditor annually, consulting with management, seeking an opinion on an accounting issue, and overseeing the quarterly regulatory reporting process. The audit committee should report its findings periodically to the full board of directors.

## EXTERNAL AUDITING PROGRAMS

### Basic Attributes

External auditing programs should provide the board of directors with information about the institution's financial reporting risk areas, e. g., the institution's internal control over financial reporting, the accuracy of its recording of transactions, and the completeness of its financial reports prepared in accordance with GAAP.

The board or audit committee of each institution at least annually should review the risks inherent in its particular activities to determine the scope of its external auditing program. For most institutions, the lending and investment securities activities present the most significant risks that affect financial reporting. Thus, external auditing programs should include specific procedures designed to test at least annually the risks associated with the loan and investment portfolios. This includes testing of internal control over financial reporting, such as management's process to determine the adequacy of the allowance for loan and lease losses and whether this process is based on a comprehensive, adequately documented, and consistently applied analysis of the institution's loan and lease portfolio.

An institution or its subsidiaries may have other significant financial reporting risk areas such as material real estate investments, insurance underwriting or sales activities, securities broker-dealer or similar activities (including securities underwriting and investment advisory services), loan servicing activities, or fiduciary activities. The external auditing program should address these and other activities the board or audit committee determines present significant financial reporting risks to the institution.

### Types of External Auditing Programs

The agencies consider an annual audit of an institution's financial statements performed by an independent public accountant to be the preferred type of external auditing program. The agencies also consider an annual examination of the effectiveness of the internal control structure over financial reporting or an audit of an institution's balance sheet, both performed by an independent public accountant, to be acceptable alternative external auditing programs. However, the agencies recognize that some institutions only have agreed-upon procedures/state-required examinations performed annually as their external auditing program. Regardless of the option chosen, the board or audit committee should agree in advance with the external auditor on the objectives and scope of the external auditing program.

*FINANCIAL STATEMENT AUDIT BY AN INDEPENDENT PUBLIC ACCOUNTANT.* The agencies encourage all institutions to have an external audit performed in accordance with generally accepted auditing standards (GAAS). The audit's scope should be sufficient to enable the auditor to express an opinion on the institution's financial statements taken as a whole.

A financial statement audit provides assurance about the fair presentation of an institution's financial statements. In addition, an audit may provide recommendations for management in carrying out its control

responsibilities. For example, an audit may provide management with guidance on establishing or improving accounting and operating policies and recommendations on internal control (including internal auditing programs) necessary to ensure the fair presentation of the financial statements.

*REPORTING BY AN INDEPENDENT PUBLIC ACCOUNTANT ON AN INSTITUTION’S INTERNAL CONTROL STRUCTURE OVER FINANCIAL REPORTING.* Another external auditing program is an independent public accountant’s examination and report on management’s assertion on the effectiveness of the institution’s internal control over financial reporting. For a smaller institution with less complex operations, this type of engagement is likely to be less costly than an audit of its financial statements or its balance sheet. It would specifically provide recommendations for improving internal control, including suggestions for compensating controls, to mitigate the risks due to staffing and resource limitations.

Such an attestation engagement may be performed for all internal controls relating to the preparation of an annual financial statements or specified schedules of the institution’s regulatory reports.<sup>6</sup> This type of engagement is performed under generally accepted standards for attestation engagements (GASAE).<sup>7</sup>

*BALANCE SHEET AUDIT PERFORMED BY AN INDEPENDENT PUBLIC ACCOUNTANT.* With this program, the institution engages an independent public accountant to examine and report only on the balance sheet. As with the audit of the financial statements, this audit is performed in accordance with GAAS. The cost of a balance sheet audit is likely to be less than a financial statement audit. However, under this type of program, the accountant does not examine or report on the fairness of the presentation of the institution’s income statement, statement of changes in equity capital, or statement of cash flows.

*AGREED-UPON PROCEDURES/STATE-REQUIRED EXAMINATIONS.* Some state-chartered depository institutions are required by state statute or regulation to have specified procedures performed annually by their directors or independent persons.<sup>8</sup> The bylaws of many national banks also require that some specified procedures be performed annually by directors or others, including internal or independent persons. Depending upon the scope of the engagement, the cost of agreed-upon procedures or a state-required examination may be less than the cost of an audit. However, under this type of program, the independent auditor does not report on the fairness of the institution’s financial statements or attest to the effectiveness of the internal control structure over financial reporting. The findings or results of the procedures are usually presented to the board or the audit committee

<sup>6</sup> Since the lending and investment securities activities generally present the most significant risks that affect an institution’s financial reporting, management’s assertion and the accountant’s attestation generally should cover those regulatory report schedules. If the institution has trading or off-balance sheet activities that present material financial reporting risks, the board or audit committee should ensure that the regulatory report schedules for those activities also are covered by management’s assertion and the accountant’s attestation. For banks and savings associations, the lending, investment securities, trading, and off-balance sheet schedules consist of:

<u>Area</u>	<u>Reports of Condition and Income Schedules</u>	<u>Thrift Financial Report Schedules</u>
Loans and Lease Financing Receivables	RC-C, Part I	SC, CF
Past Due and Nonaccrual Loans, Leases, and Other Assets	RC-N	PD
Allowance for Credit Losses	RI-B	SC, VA
Securities	RC-B	SC, SI, CF
Trading Assets and Liabilities	RC-D	SO, SI
Off-Balance Sheet Items	RC-L	SI, CMR

These schedules are not intended to address all possible risks in an institution.

<sup>7</sup> An attestation engagement is not an audit. It is performed under different professional standards than an audit of an institution’s financial statements or its balance sheet.

<sup>8</sup> When performed by an independent public accountant, “specified procedures” and “agreed-upon procedures” engagements are performed under standards, which are different professional standards than those used for an audit of an institution’s financial statements or its balance sheet.

so that they may draw their own conclusions about the quality of the financial reporting or the sufficiency of internal control.

When choosing this type of external auditing program, the board or audit committee is responsible for determining whether these procedures meet the external auditing needs of the institution, considering its size and the nature, scope, and complexity of its business activities. For example, if an institution's external auditing program consists solely of confirmations of deposits and loans, the board or committee should consider expanding the scope of the auditing work performed to include additional procedures to test the institution's high risk areas. Moreover, a financial statement audit, an examination of the effectiveness of the internal control structure over financial reporting, and a balance sheet audit may be accepted in some states and for national banks in lieu of agreed-upon procedures/state-required examinations.

#### Other Considerations

*TIMING.* The preferable time to schedule the performance of an external auditing program is as of an institution's fiscal year-end. However, a quarter-end date that coincides with a regulatory report date provides similar benefits. Such an approach allows the institution to incorporate the results of the external auditing program into its regulatory reporting process and, if appropriate, amend the regulatory reports.

*EXTERNAL AUDITING STAFF.* The agencies encourage an institution to engage an independent public accountant to perform its external auditing program. An independent public accountant provides a nationally recognized standard of knowledge and objectivity by performing engagements under GAAS or GASAE. The firm or independent person selected to conduct an external auditing program and the staff carrying out the work should have experience with financial institution accounting and auditing or similar expertise and should be knowledgeable about relevant laws and regulations.

### SPECIAL SITUATIONS

#### Holding Company Subsidiaries

When an institution is owned by another entity (such as a holding company), it may be appropriate to address the scope of its external audit program in terms of the institution's relationship to the consolidated group. In such cases, if the group's consolidated financial statements for the same year are audited, the agencies generally would not expect the subsidiary of a holding company to obtain a separate audit of its financial statements. Nevertheless, the board of directors or audit committee of the subsidiary may determine that its activities involve significant risks to the subsidiary that are not within the procedural scope of the audit of the financial statements of the consolidated entity. For example, the risks arising from the subsidiary's activities may be immaterial to the financial statements of the consolidated entity, but material to the subsidiary. Under such circumstances, the audit committee or board of the subsidiary should consider strengthening the internal audit coverage of those activities or implementing an appropriate alternative external auditing program.

#### Newly Insured Institutions

Under the FDIC Statement of Policy on Applications for Deposit Insurance, applicants for deposit insurance coverage are expected to commit the depository institution to obtain annual audits by an independent public accountant once it begins operations as an insured institution and for a limited period thereafter.

### Institutions Presenting Supervisory Concerns

As previously noted, an external auditing program complements the agencies' supervisory process and the institution's internal auditing program by identifying or further clarifying issues of potential concern or exposure. An external auditing program also can greatly assist management in taking corrective action, particularly when weaknesses are detected in internal control or management information systems affecting financial reporting.

The agencies may require a financial institution presenting safety and soundness concerns to engage an independent public accountant or other independent external auditor to perform external auditing services.<sup>9</sup> Supervisory concerns may include:

- Inadequate internal control, including the internal auditing program;
- A board of directors generally uninformed about internal control;
- Evidence of insider abuse;
- Known or suspected defalcations;
- Known or suspected criminal activity;
- Probable director liability for losses;
- The need for direct verification of loans or deposits;
- Questionable transactions with affiliates; or
- The need for improvements in the external auditing program.

The agencies may also require that the institution provide its appropriate supervisory office with a copy of any reports, including management letters, issued by the independent public accountant or other external auditor. They also may require the institution to notify the supervisory office prior to any meeting with the independent public accountant or other external auditor at which auditing findings are to be presented.

## **EXAMINER GUIDANCE**

### Review of the External Auditing Program

The review of an institution's external auditing program is a normal part of the agencies' examination procedures. An examiner's evaluation of, and any recommendations for improvements in, an institution's external auditing program will consider the institution's size; the nature, scope, and complexity of its business activities; its risk profile; any actions taken or planned by it to minimize or eliminate identified weaknesses; the extent of its internal audit program; and any compensating controls in place. Examiners will exercise judgment and discretion in evaluating the adequacy of an institution's external auditing program.

Specifically, examiners will consider the policies, processes, and personnel surrounding an institution's external auditing program in determining whether:

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<sup>9</sup> The Office of Thrift Supervision requires an external audit by an independent public accountant for savings associations with a composite rating of 3, 4, or 5 under the Uniform Financial Institution Rating System, and on a case-by-case basis.

- The board of directors or its audit committee adequately reviews and approves external auditing program policies at least annually.
- The external auditing program is conducted by an independent public accountant or other independent auditor and is appropriate for the institution.
- The engagement letter covering external auditing activities is adequate.
- The report prepared by the auditor on the results of the external auditing program adequately explains the auditor's findings.
- The external auditor maintains appropriate independence regarding relationships with the institution under relevant professional standards.
- The board of directors performs due diligence on the relevant experience and competence of the independent auditor and staff carrying out the work (whether or not an independent public accountant is engaged).
- The board or audit committee minutes reflect approval and monitoring of the external auditing program and schedule, including board or committee reviews of audit reports with management and timely action on audit findings and recommendations.

#### Access to Reports

Management should provide the independent public accountant or other auditor with access to all examination reports and written communication between the institution and the agencies or state bank's supervisor since the last external auditing activity. Management also should provide the accountant with access to any supervisory memoranda of understanding, written agreements, administrative orders, reports of action initiated or taken by a federal or state banking agency under section 8 of the FDI Act (or a similar state law), and proposed or ordered assessments of civil money penalties against the institution or an institution-related party, as well as any associated correspondence. The auditor must maintain the confidentiality of examination reports and other confidential supervisory information.

In addition, the independent public accountant or other auditor of an institution should agree in the engagement letter to grant examiners access to all the accountant's or auditor's work papers and other material pertaining to the institution prepared in the course of performing the completed external auditing program.

Institutions should provide reports<sup>10</sup> issued by the independent public accountant or other auditor pertaining to the external auditing program, including any management letters, to the agencies and any state authority in accordance with their appropriate supervisory office's guidance.<sup>11</sup> Significant developments regarding the external auditing program should be communicated promptly to the appropriate supervisory office. Examples of those developments include the hiring of an independent public accountant or other third party to perform external auditing work and a change in, or termination of, an independent public accountant or other external auditor.

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<sup>10</sup> The institution's engagement letter is not a "report" and is not expected to be submitted to the appropriate supervisory office unless specifically requested by that office.

<sup>11</sup> When an institution's financial information is included in the audited consolidated financial statements of its parent company, the institution should provide a copy of the audited financial statements of the consolidated company and any other reports by the independent public accountant in accordance with their appropriate supervisory office's guidance. If several institutions are owned by one parent company, a single copy of the reports may be supplied in accordance with the guidance of the appropriate supervisory office of each agency supervising one or more of the affiliated institutions and the holding company. A transmittal letter should identify the institutions covered. Any notifications of changes in, or terminations of, a consolidated company's independent public accountant may be similarly supplied to the appropriate supervisory office of each supervising agency.

### Appendix A – Definitions

*Agencies.* The agencies are the Board of Governors of the Federal Reserve System (FRB), the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC), and the Office of Thrift Supervision (OTS).

*Appropriate supervisory office.* The regional or district office of the institution’s primary federal banking agency responsible for supervising the institution or, in the case of an institution that is part of a group of related insured institutions, the regional or district office of the institution’s federal banking agency responsible for monitoring the group. If the institution is a subsidiary of a holding company, the term “appropriate supervisory office” also includes the federal banking agency responsible for supervising the holding company. In addition, if the institution is state-chartered, the term “appropriate supervisory office” includes the appropriate state bank or savings association regulatory authority.

*Audit.* An examination of the financial statements, accounting records, and other supporting evidence of an institution performed by an independent certified or licensed public accountant in accordance with generally accepted auditing standards (GAAS) and of sufficient scope to enable the independent public accountant to express an opinion on the institution’s financial statements as to their presentation in accordance with generally accepted accounting principles (GAAP).

*Audit committee.* A committee of the board of directors whose members should, to the extent possible, be knowledgeable about accounting and auditing. The committee should be responsible for reviewing and approving the institution’s internal and external auditing programs or recommending adoption of these programs to the full board.

*Balance sheet audit performed by an independent public accountant.* An examination of an institution’s balance sheet and any accompanying footnotes performed and reported on by an independent public accountant in accordance with GAAS and of sufficient scope to enable the independent public accountant to express an opinion on the fairness of the balance sheet presentation in accordance with GAAP.

*Engagement letter.* A letter from an independent public accountant to the board of directors or audit committee of an institution that usually addresses the purpose and scope of the external auditing work to be performed, period of time to be covered by the auditing work, reports expected to be rendered, and any limitations placed on the scope of the auditing work.

*Examination of the internal control structure over financial reporting.* See Reporting by an Independent Public Accountant on an Institution’s Internal Control Structure Over Financial Reporting.

*External auditing program.* The performance of procedures to test and evaluate high risk areas of a institution’s business by an independent auditor, who may or may not be a public accountant, sufficient for the auditor to be able to express an opinion on the financial statements or to report on the results of the procedures performed.

*Financial statement audit by an independent public accountant.* See Audit.

*Financial statements.* The statements of financial position (balance sheet), income, cash flows, and changes in equity together with related notes.

*Independent public accountant.* An accountant who is independent of the institution and registered or licensed to practice, and holds himself or herself out, as a public accountant, and who is in good standing under the laws of the state or other political subdivision of the United States in which the home office of the institution is located. The independent public accountant should comply with the American Institute of Certified Public Ac-

accountants' (AICPA) Code of Professional Conduct and any related guidance adopted by the Independence Standards Board and the agencies. No certified public accountant or public accountant will be recognized as independent who is not independent both in fact and in appearance.

*Internal auditing.* An independent assessment function established within an institution to examine and evaluate its system of internal control and the efficiency with which the various units of the institution are carrying out their assigned tasks. The objective of internal auditing is to assist the management and directors of the institution in the effective discharge of their responsibilities. To this end, internal auditing furnishes management with analyses, evaluations, recommendations, counsel, and information concerning the activities reviewed.

*Outside directors.* Members of an institution's board of directors who are not officers, employees, or principal stockholders of the institution, its subsidiaries, or its affiliates, and who do not have any material business dealings with the institution, its subsidiaries, or its affiliates.

*Regulatory reports.* These reports are the Reports of Condition and Income (Call Reports) for banks, Thrift Financial Reports (TFRs) for savings associations, Federal Reserve (FR) Y reports for bank holding companies, and the H-(b)11 Annual Report for thrift holding companies.

*Reporting by an independent public accountant on an institution's internal control structure over financial reporting.* Under this engagement, management evaluates and documents its review of the effectiveness of the institution's internal control over financial reporting in the identified risk areas as of a specific report date. Management prepares a written assertion, which specifies the criteria on which management based its evaluation about the effectiveness of the institution's internal control over financial reporting in the identified risk areas and states management's opinion on the effectiveness of internal control over this specified financial reporting. The independent public accountant is engaged to perform tests on the internal control over the specified financial reporting in order to attest to management's assertion. If the accountant concurs with management's assertion, even if the assertion discloses one or more instances of material internal control weakness, the accountant would provide a report attesting to management's assertion.

*Risk areas.* Those particular activities of an institution that expose it to greater potential losses if problems exist and go undetected. The areas with the highest financial reporting risk in most institutions generally are their lending and investment securities activities.

*Specified procedures.* Procedures agreed-upon by the institution and the auditor to test its activities in certain areas. The auditor reports findings and test results, but does not express an opinion on controls or balances. If performed by an independent public accountant, these procedures should be performed under generally accepted standards for attestation engagements (GASAE).

Dated: September 22, 1999.

**Keith Todd,**

*Executive Secretary,*

*Federal Financial Institutions Examination Council.*

DRAFT: SAMPLE LETTER TO REQUEST AUDIT WORK PAPERS



Office of Thrift Supervision  
Department of the Treasury

1700 G Street, N.W., Washington, DC 20552 • (202) 906-6000

Mr./Ms. \_\_\_\_\_  
Accounting Firm  
Address  
City, State, Zip Code

Dear Mr./Ms. \_\_\_\_\_:

The Office of Supervision (OTS) requires, under its regulation 12 CFR 562.4(d)(2), that the independent public accountant, engaged in an external audit of a savings association, agree in the engagement letter to provide OTS with access to and copies of any work papers, policies, and procedures relating to the services performed. The OTS has a program to review auditors' work papers to enhance its supervision of savings associations. The OTS has selected your client, \_\_\_\_\_ (name of institution and city), \_\_\_\_\_ for a work paper review.

Please make all the original work papers relating to the audit of this institution or its parent holding company for the year ended \_\_\_\_\_ (date) available for review. In addition to the requested work papers, we may request to review your firm's policies and procedures relating to this audit.

To limit the burden of the work paper review, we will conduct our review at a site of your choice. The review process may be expedited if an individual who is familiar with the audit is available to respond to inquiries. We have or will advise \_\_\_\_\_ (name of officer of the client institution) of \_\_\_\_\_ (name of institution) of this request.

Examiner \_\_\_\_\_ (name) at \_\_\_\_\_ (telephone number) will contact your office within the next several days to make arrangements for the review.

Sincerely,

Examiner in Charge

cc: Chief Executive Officer  
Regional Accountant

[Letterhead of Accounting Firm]

[Date]

[Name of Regulator]

Pursuant to your responsibilities as federal regulator and examiner of (name of financial institution), you have requested copies of certain of our working papers in connection with our report on the (name of company's) financial statements for the year ending (date). The copies are identified as follows:

- (Describe the working papers)

These materials contain non-public [confidential/exempt] examination-related information under 12 C.F.R. Part 510 [or other applicable regulation] and we request that they be treated in accordance with that regulation.

[Signature of Firm Member]

#### ACKNOWLEDGMENT OF RECEIPT

[Name of Regulator]

By: \_\_\_\_\_

Date: \_\_\_\_\_

**INTRODUCTION**

Appraising the effectiveness of an institution's internal audit function is integral to evaluating an institution's maintenance and effectiveness of internal control, and the integrity of its financial records.

Pursuant to Section 39 of the Federal Deposit Insurance Act, the interagency guidelines for safety and soundness state that each institution should have an internal audit function that is appropriate to its size and nature, and scope of its activities. All large thrifts and those with complex operations should have an internal audit function. Regardless of size, thrifts should consider the need for an internal audit function.

A strong internal audit function should provide the following elements within the internal audit program:

- Adequate monitoring of the institution's internal control system.
- Independence and objectivity.
- Qualified personnel.
- Adequate testing and review of information systems.
- Adequate documentation of tests and findings of any corrective actions.
- Verification and review of management's actions to address material weaknesses.
- Review by the institution's audit committee or board of directors of the effectiveness of the internal audit systems.

This Section of the Handbook describes the objectives of, and the work performed by, internal auditors and offers guidelines for regulatory staff in evaluating their work. You should use it in conjunction with Handbook Section 340, Internal Control.

**INTERNAL AUDIT FUNCTION**

Use of an internal audit function for control and monitoring purposes is consistent with the description set forth by the Institute of Internal Auditors (IIA). The IIA's Standards for the Professional Practice of Internal Auditing state that an internal audit is:

- an independent, objective assurance and consulting activity designed to add value and improve on 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. The practice of professional internal auditing goes beyond examining accounting controls, records, and financial statements, and reports.

A savings association's internal audit program should consist of the policies and procedures that govern its internal audit functions, including risk-based audit programs and outsourced internal audit work, if applicable. While smaller savings associations' audit programs may not be as formal as those found in larger more complex savings associations, all institutions' internal audit program should incorporate the following:

- An audit charter or mission statement that sets forth the audit department's purpose, objectives, organization, authority, and responsibilities. The charter should include a discussion about the scope of the audit committee responsibilities and how it carries out those responsibilities. The audit committee or board should periodically assess the internal audit function, and take appropriate action to ensure its ongoing reliability and effectiveness.
- An audit plan that addresses goals, schedules, staffing budget, reporting, and, if applicable, financial budgets.

- A policies and procedures manual for audit work programs and, if applicable, risk-based auditing or risk assessments and outsourcing of internal audit work.
- A program for training audit staff, including orientation and in-house and external training opportunities.
- A quality assurance program, performed by internal or external parties, to evaluate the operations of the internal audit department. This may include ongoing reviews of the performance of the internal audit activity, or periodic reviews performed through self-assessment, or by other persons within the organization with knowledge of internal auditing practices. A qualified, independent reviewer or review team outside the organization may also conduct external assessments.

Internal auditors should evaluate the efficiency and adequacy of the internal audit system, and test the continuing effectiveness and maintenance of controls. An adequate internal audit function should also incorporate the following:

- Procedures to determine the reliability of information produced within the institution and the effectiveness of internal policies and procedures. For example, internal auditors often help formulate and revise policies and procedures to plan and implement safeguards and controls, including ensuring appropriate evidence and audit trails.
- Recommendations to assist management in attaining the most efficient administration of institution operations. Internal auditors also evaluate the following:
  - Compliance with laws and regulations.
  - Effectiveness of administrative controls and procedures.
  - Efficiency of operations (also called operational auditing).
- Information to enable management to fulfilling its responsibilities under statutes, regulations, and directives such as those required by Sections 112 and 132 of Federal Deposit

Insurance Corporation Improvement Act (FDICIA) and 12 CFR Part 363.

- Procedures to ascertain the adequacy of controls to minimize risk of losses. One procedure is for internal auditors to appraise the soundness and adequacy of accounting, operating, and administrative controls. The appraisal process ensures that the association records transactions promptly and accurately, and properly safeguards assets.
  - For example, a critical internal audit responsibility/procedure is to determine the adequacy of valuation allowances by reviewing the system and procedures for internal asset review and credit quality classifications.

## INDEPENDENCE OF INTERNAL AUDITORS

Internal auditors must maintain independence within the organization. The higher the level the auditor reports to within the organization, the greater the likelihood of achieving effective independence. The institution's policies should give the auditor the authority necessary to perform the job. That authority should include free access to any records necessary for the proper conduct of the audit.

Ideally, the internal auditor should report directly to an audit committee comprised of non-employee members of the board of directors. Reporting at this level should allow the auditor the greatest access to all levels of the institution, and assure prompt and independently objective consideration of audit results. It also enables the auditor to assist the directors in fulfilling their responsibilities.

The board of directors or its audit committee should regularly receive a report of all audit activity. This report should include the status of all audits on the internal audit schedule, and summaries of all audits completed during the period including audit conclusions. In addition, this report should provide the resolution status of previous internal audit findings and recommendations. If the internal auditor does not report to the board or its audit committee, the reporting line should be to an individual with no financial or

operational responsibilities. Inadequate independence of internal auditors is cause for critical OTS examination report comments. Instances in which an internal auditor reports to management may warrant further consideration and assurance that independence of the internal auditor is not compromised.

Internal auditors' responsibilities and qualifications may vary, depending on the size of the institution and complexity of operations. The internal audit function is generally a full-time job of an individual or group, but may be a part-time job in smaller institutions. The institution may also outsource some or all of its internal audit work.

Large institutions often designate a chief auditor to supervise the work of an internal audit staff. In small institutions, the responsibility for internal audit may rest with officers or other employees designated as part-time auditors.

Small institutions with few employees and less complex operations may not have an internal auditor on staff. Nevertheless, the institution can ensure that it maintains an objective internal audit function by implementing a comprehensive set of independent reviews of significant internal controls. The person given this task should not also be responsible for managing or operating those controls.

### INTERNAL AUDIT OUTSOURCING

Financial institutions are increasingly contracting with independent public accounting firms or other outside professionals to perform work traditionally conducted by internal auditors. These arrangements are frequently referred to as "internal audit outsourcing," "internal audit assistance," "audit integration," "audit co-sourcing," or "extended audit services." Outsourcing arrangements create a variety of safety and soundness issues that will vary with the size, complexity, scope of activities, and risk profile of the bank and the nature of the outsourcing arrangement.

Financial institutions generally enter into internal audit outsourcing arrangements to gain operational or financial efficiencies by engaging a vendor to:

- Assist its internal audit staff when the bank's internal auditors lack the expertise required for an assignment. Such assignments are most often in specialized areas such as information technology, fiduciary, mortgage banking, and capital markets activities. The vendor normally performs only certain agreed-upon-procedures in specific areas and reports findings directly to the institution's internal audit manager.
- Perform the entire internal audit. The institution's only internal audit staff may be an audit manager. The vendor usually assists the board and audit manager in determining the critical risks to be reviewed during the engagement, recommends and performs audit procedures approved by the internal auditor, and jointly with the internal auditor, reports significant findings to the board of directors or its audit committee.

In any outsourced arrangement, the institution should meet the following guidelines:

- An employee (generally an internal auditor or internal audit manager or director) who is independent and responsible should manage the relationship with the vendor.
- The directors have the responsibility for ensuring that any outsourcing arrangement is competently managed and that it does not detract from the scope or quality of an institution's internal audit work, overall internal control structure of the institution, or audit and control evaluations.
- The board and management perform sufficient due diligence before entering into the outsourcing arrangement to verify the vendor's competence and objectivity, and during the arrangement to determine the adequacy of the vendor's work and compliance with contractual requirements.
- The arrangement does not compromise the role or independence of a vendor if the vendor also serves as the institution's external auditor.

If the institution outsources the internal audit function, or any portion of it, determine the effectiveness of and reliance to be placed on the

outsourced internal auditing. You should obtain copies of the following documents:

- Outsourcing contracts or engagement letters.
- Outsourced internal audit reports and associated work papers.
- Policies on outsourced audit, if any.

Review the outsourcing contracts, engagement letters, work papers, and policies to determine whether they adequately do the following:

- Set the scope and frequency of work the outside vendor will perform.
  - Outsourced internal audit reports and internal audit work papers should be adequately prepared in accordance with the audit program and the outsourcing agreement.
  - Work papers should disclose the specific program steps, calculations, or other evidence that supports the procedures and conclusions set forth in the outsourced reports.
  - The scope of the outsourced internal audit procedures should be adequate regarding the procedures and testing performed, and the internal audit manager should approve the process.
  - The institution should revise the scope of outsourced audit work appropriately when the institution's environment, activities, risk exposures, or systems change significantly.
- Set the manner and frequency of reporting to the institution's audit manager, senior management, and audit committee or board of directors about the status of work.
  - The institution should subject the vendor to objective performance criteria such as whether an audit is completed on time and whether overall performance meets the objectives of the audit plan.
    - Key institution employees and the vendor should clearly understand the lines of communication and how the institution will address internal control or other problems noted by the vendor.
    - Results of outsourced work should be well documented and reported promptly to the board of directors or its audit committee by the internal auditor, the vendor, or both jointly.
- Establish a process for changing terms of the service contract, especially for expansion of audit work if the auditor finds significant issues.
- State that internal audit reports are the property of the institution, that the vendor will provide copies of related work papers the institution deems necessary, and that authorized employees of the institution will have reasonable and timely access to work papers prepared by the outside vendor.
- Identify the locations of outsourced internal audit reports and related work papers.
- Grant OTS examiners immediate and full access to outsourced internal audit reports and related work papers.
- Prescribe an alternative dispute resolution process for determining who bears the cost of consequential damages arising from errors, omissions, and negligence.
- State that outside vendors, if subject to SEC or other independence guidance, such as that issued by the AICPA, will not perform management functions, make management decisions, or act or appear to act in a capacity equivalent to that of an employee of the institution.
- Review the performance and contractual criteria for the vendors and any internal evaluations of the vendor, and determine if the board or audit committee performed sufficient due diligence to satisfy themselves of the vendor's competence before entering into an outsourcing arrangement.

- Determine if procedures exist to ensure that the vendor maintains sufficient expertise to perform effectively throughout the arrangement.
- Determine whether the vendors are independent, and disclose any potential conflicts of interest. If a vendor is an independent public accountant who also performs the institution's external audit, potential conflicts of interest may exist.

— The board should be familiar with AICPA Interpretation 102-2 about conflicts of interest under AICPA Rule 102, which discusses integrity and objectivity of independent public accountants performing outsourced internal audit work.

If you determine that you cannot rely on the vendor's work, discuss that assessment with the Regional Accountant, the board, bank management, and the affected party before finalizing the report of examination.

### Independence Issues and Outsourcing

The institution's board of directors, management, auditor, and OTS should pay particular attention to independence issues if both of the following occur:

- A savings association, holding company, or affiliate outsources internal audit work to its external auditor, and
- The internal audit work relates to internal accounting controls, financial systems, or financial statements.

Management should address independence issues and any other potential conflicts of interest that may arise when one firm performs both internal and external audit services.

The reason for the concern is that an auditor generally relies, at least to some extent, on the internal control system when performing the external audit. If the outside vendor that provides the internal audit services is also the external auditor, then the external auditor could be relying on his or her own work. Thus, the arrangement introduces significant questions about the independence of the external auditor, both in appearance and in fact.

Such an arrangement may compromise the role or independence of a vendor. In cases where the same firm performs internal and external audit work, institutions may consider requesting that the audit firm use different accounting firm employees to perform the internal audit and external audit duties. (See Examiner Guidance in Appendix A.)

OTS follows the Securities and Exchange Commission (SEC) regulations that impose substantial requirements and limitations on a savings association, a holding company, or an affiliate that outsource any internal audit work to its external auditor. OTS regulation 12 CFR Part 562.4 states that an independent public accountant must perform the external audit, whether required or otherwise, of a savings association, a holding company, or affiliate. Under this regulation, independent public accountants are subject to the independence requirements and interpretations of the SEC and its staff.

The SEC independence rules (17 CFR Parts 210 and 240) include substantial requirements and limitations with respect to providing any internal audit services to external audit clients. The effective date related to internal audit-related services is August 5, 2002.

Under the SEC independence rules, when the external auditor provides any internal audit services (including both (a) internal audit services related to internal accounting controls, financial systems, or financial statements, and (b) operational internal audit services) for an external audit client, the SEC requires management to do the following:

- Acknowledge in writing to the external auditor and the audit committee (or if there is no such committee, then the board of directors) management's responsibility to establish and maintain a system of internal accounting.
- Designate a competent employee or employees, preferably within senior management, to be responsible for the internal audit function.
- Determine the scope, risk, and frequency of internal audit activities, including those the external auditor will perform.

- Evaluate the findings and results arising from the internal audit activities, including those the external auditor performed.
- Evaluate the adequacy of the internal audit procedures performed, and the findings resulting from the performance of those procedures, by among other things, obtaining reports from the external auditor.
- Not rely on the external auditor's work as the primary basis for determining the adequacy of its internal controls.

In addition, where the external auditor provides internal audit services related to internal accounting controls, financial systems, or financial statements for an external audit client, the SEC limits these services to an amount not greater than 40 percent of the total hours expended on such internal audit activities in any one fiscal year. However, this limitation does not apply where the client company has less than \$200 million in total assets.

The AICPA also provides a list of activities that impair independence for its members. OTS considers the AICPA guidance on independence to be applicable to all independent public accountants performing external or internal audit work.

If you find sufficient reason to question a vendor's independence, objectivity, competence, or failure to meet OTS and SEC standards, discuss the situation with the Regional Accountant. If appropriate, request through the institution that the vendor make additional work papers available, and meet with the vendor to discuss concerns.

To provide uniform guidance on the internal audit function and outsourcing, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Federal Reserve Board, and the Office of Thrift Supervision issued the Interagency Policy Statement on the Internal Audit and Its Outsourcing on December 22, 1997. (Although the text of this handbook section incorporates the guidance, see Appendix A for the full text of the Interagency Policy Statement.)

## COMPETENCE OF INTERNAL AUDITORS

An audit manager, whether working alone or with staff, should possess the following qualifications:

- Academic or other credentials comparable with those of other institution officers with major responsibilities in the organization.
- Commitment to a program of continuing education and professional development.
- Audit experience, and organizational and technical skills commensurate with the responsibilities including proficiency in applying internal audit standards, procedures, and techniques.
- Strong oral and written communication skills.
- Ability to properly supervise each audit and provide suitable instructions to help meet a audit objectives.

To understand fully the flow of data and the underlying operating procedures, the internal audit function manager must have proper education, training, and understanding of key areas of bank operations. College courses, various industry sponsored courses, and significant prior work experience in various departments of an institution may provide adequate education.

Certification as a certified internal auditor or a certified public accountant may serve as further evidence of having the appropriate credentials. The internal audit function manager must maintain a program of continuing education.

The audit staff should also possess certain minimum qualifications and skills commensurate with the complexity of the institution's operations. Any member of the audit staff in a supervisory position should possess adequate knowledge of audit objectives and an understanding of the audit procedures performed by the staff.

The final measures of internal auditors' competence and performance are the quality of the work performed, and the ability to communicate the results of that work. The adequacy of the audit program, the quality and completeness of internal

audit work papers, and the clarity and comprehensiveness of internal audit reports reflect evidence of an auditor's competence and performance.

### THE AUDIT PLAN AND PROGRAMS

The overall audit plan, which consists of various departmental and functional audit programs, must attain the audit committee or the board of director's desired objectives. The audit committee or board should approve the audit plan at least annually. In assessing the adequacy of the annual audit plan and completed audit programs, evaluate the following areas:

- The audit plan's scope, frequency, and depth including any internal rating system as it relates to the institution's size, the nature and extent of its banking activities, and the institution's risk profile.
- Board of directors' or audit committee minutes, or summaries thereof. Determine whether the audit committee or board of directors formally approves the internal audit function's objectives, the audit program and schedule, and monitors the activities of the internal audit department to follow the approved programs and schedules. The audit committee or the board should approve any significant changes to the program or schedule.
- Management's records supporting any assertions concerning the effectiveness of internal controls over financial reporting and compliance with designated laws and regulations. Management should set its standards for measuring the adequacy and effectiveness of internal controls over financial reporting based on risk analyses or assessments, control assessments, audit report findings, and other various resources including established standards such as those set by the AICPA.
- Content of the individual audit programs.
- Documentation of the work performed.
- Conclusions reached and reports issued.
- Procedures for follow-up to ensure the association take corrective action.

A characteristic of a good internal audit plan is a proactive approach. It should have an early warning system to detect and evaluate risks, determine scope, frequency, and depth of audit procedures needed, and adjust the audit plan accordingly.

In assessing risk, the auditor should consider the following factors:

- The nature and relative size of the specific operation and related assets and liabilities, including off-balance sheet transactions.
- The existence of appropriate policies and internal control standards.
- The effectiveness of operating procedures and internal controls.
- The potential materiality of errors or irregularities associated with the specific operation.

Audit programs are an integral part of the audit work papers, and serve as the primary evidence of the audit procedures performed. Before developing or revising the audit program, the internal auditor should have a thorough understanding of the operations of the department or function. The auditor should prepare or revise a written audit program for each area of an institution's operations before beginning the audit work.

Each program should contain a clear, concise description of the internal control objectives, degree of risk if internal controls fail, and the procedures to follow in testing such controls. An individual audit program may encompass several departments/functions of an institution, a single department, or specific operations within a department.

The effectiveness of the overall audit plan depends on a variety of factors. To plan effectively, the auditor must consider the factors described above, along with many of those outlined in Thrift Activities Regulatory Handbook Section 060, Examination Strategy, Scoping, and Management.

Most audit programs should address the following audit procedures:

- Surprise audits where appropriate.
- Maintenance of control over records selected for audit.
- Review and evaluation of the institution's policies and procedures and the system of internal controls.
- Reviews of laws, regulations, and rulings.
- Sample selection methods and results.
- Proof of reconciling detail to related control records.
- Verification of selected transactions and balances through examination of supporting documentation, direct confirmation and appropriate follow-up of exceptions, and physical inspection.

The internal audit work papers must document the work performed by the auditor. Work papers should contain completed audit work programs and analyses that clearly indicate the procedures performed, the extent of testing, and the basis for the conclusions reached.

Upon completion of the procedures outlined in audit programs, the internal auditor should be able to reach conclusions that will satisfy the audit objectives. The internal auditor must effectively interpret these conclusions documented in the work papers. Audit report findings must be consistent with the documented conclusions. Reports should include, when appropriate, recommendations for remedial action. The overall audit plan must also provide for follow-up procedures to ensure that the association takes corrective action.

The internal auditor must communicate all findings and recommendations in a clear, concise manner, pinpointing problems and suggesting solutions, and submit reports as soon as practicable. Auditors should route reports to those officials who have both the responsibility and authority to implement suggested changes. If full audit reports do not go to the board of directors, the auditor should prepare summary reports for the board's review. Prompt and effective management response to the auditor's recommendations is the final measure of the effectiveness of the audit pro-

gram. The auditor should inform the audit committee or board of management's responses to audit findings and recommendations.

### **Information Systems and Technology Audit Review**

The institution's internal audit program should have qualified personnel review, test, and evaluate the information systems and technology environment. The Federal Financial Institutions Examination Counsel (FFIEC) Information Systems Handbook contains examination policies and procedures that govern the assessment of the information systems and technology audit function by all financial institution regulators.

The internal audit program should provide audit coverage of significant information systems and technology risk exposures. This would include systems development projects and computer production activities involving on-premise computing (for example, on stand-alone and networked microcomputers), in-house computer centers, and third-party vendors (for example, service bureaus). The scope of the internal audit program should also address information system and technology-related threats from outside sources (for example, unauthorized access to the institution's or their service provider's on-line banking operation).

### **FEDERAL DEPOSIT INSURANCE CORPORATION IMPROVEMENT ACT (FDICIA) - SECTION 112**

In May 1993, the Board of the FDIC approved the initial regulations and guidelines implementing the management reporting, audit committee, and annual independent audit requirements of § 112 of FDICIA. Congress amended the statute by passing the Economic Growth and Regulatory Paperwork Reduction Act (EGRPRA) of 1996. The regulations apply to insured depository institutions with total assets of \$500 million or more. The requirements for these institutions include the following:

- Reporting to the FDIC and OTS (when it is the primary regulator) on internal control over financial reporting and compliance with certain

laws and regulations, as well as filing annual audited statements.

- An annual audit by an independent public accountant (external auditor).
- An audit committee consisting of outside directors, who must be independent of management. For institutions holding over \$3 billion in assets, two of the outside directors must have banking and financial management expertise, neither can be a large customer of the institution, and they must have independent access to the audit committee's outside counsel.

### Management Assertions

To assist management in determining strategies related to management's reporting on both the effectiveness of internal control over financial reporting and compliance with designated laws such as FDICIA and regulations, the internal auditor may:

- Test the effect of key controls identified as a basis for management's assertions.
- Perform agreed-upon procedures to test compliance with laws and regulations.
- Establish a system to monitor the internal control system and identify changes needed in the control environment.

Management may use the internal auditor's work to facilitate its assertion that the internal control over financial reporting is effective. The internal auditor's procedures must be sufficient for management to rely on them for such assertions.

The external auditor performs examination procedures to attest to management's assertion that the internal control over financial reporting is functioning effectively. The external auditor may consider the work done by the internal auditor as part of the auditing procedures.

### REGULATORY CONCERNS

Your review and evaluation of the internal audit function is key in determining the scope of the examination. You should separately determine the

adequacy and effectiveness of the audit program for each area of examination interest.

The internal auditor's work may provide useful information in setting the scope of the examination. You should judge the independence and competence of the internal auditor before addressing the overall adequacy and effectiveness of audit programs, and the work performed. If, for example, you conclude that the internal auditor possesses neither the appropriate independence nor the competence, you cannot rely upon the work for scoping purposes.

To test the adequacy of the internal audit work, follow the Internal Audit Program Level I and II procedures. Level I procedures describe the use of the Internal Audit Questionnaire.

Under Level II procedures, you may review work papers that document and test procedures performed by internal auditors. In some cases, such a review may be sufficient to substantiate conclusions about the quality and reliability of the internal audit function. The Internal Auditor Questionnaire from the PERK package should provide pertinent information. See Appendix B. Findings from the internal audit work paper reviews will also help you determine whether further verification procedures and testing are necessary under Level III procedures.

After reviewing work papers and testing procedures, report the following weaknesses in internal audit-related management and internal controls to the Regional Accountant:

- Absence of or inadequacy of an internal audit function in a large institution or an institution with complex operations.
- An inadequate internal audit plan.
- Instances in which the internal auditor does not have full access to records or otherwise lacks independence.
- Lack of internal auditor competence and/or expertise.
- Instances in which the internal auditor reports to operational officers rather than the board of

directors or audit committee of outside directors.

- Audit committees not properly established or non-functioning, such that they are unable to initiate corrective action.

**Other Internal Audit Resources**

The institution may also provide you with a Global Audit Information Network (GAIN) report purchased from the Institute of Internal Auditors or a similar product by another vendor. Generally these products are Internet-based and may provide information about general organization statistics, audit staff profiles, quality assurance practices, audit committee information, scope of internal audit activities, audit planning, risk assessments, and other audit information you may find useful. OTS does not endorse these products or require institutions to use them, but if such information is available, consider requesting it to review for scoping your examination.

**REFERENCES**

**Code of Federal Regulations (12 CFR)**

Part 562 Regulatory Reporting Standards

**Internal Audit Guidance**

\*The Institute of Internal Auditors’ Standards for the Professional Practice of Internal Auditing

\*Financial Managers Society’s Financial Institutions Internal Audit Manual, 2000-200

Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees (1999)

\* Internal audit staff may have these documents in-house.

**American Institute of Certified Public Accountants**

*Statements on Auditing Standards (U.S. Auditing Standards (AU)*

- No. 41 Working Papers, Providing Access to or Photocopies of Working Papers to a Regulator, AU 339)
- No. 55 Consideration of the Internal Control Structure in a Financial Statement Audit (AU 319)
- No. 58 Reports on Audited Financial Statements (AU 508)
- No. 60 Communication of Internal Control Structure Related Matters Noted in an Audit (AU 325 and 9325)
- No. 61 Communication with Audit Committees (AU 380)
- No. 78 Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS 55 (AU 319)
- No. 82 Consideration of Fraud in a Financial Statement Audit (AU 316)
- No. 89 Audit Adjustments (AU 420)
- No. 90 Audit Committee Communications (AU 380)
- No. 94 The Effect of Information Technology on the Auditor’s Consideration of Internal Control in a Financial Statement Audit (AU 319)

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# Internal Audit Program

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## Examination Objectives

To determine whether the internal audit function is consistent with the institution's size, complexity of operations, level of growth, investment and operations risk profile, nature and severity of previous examination findings.

To evaluate the independence, expertise, and competence of internal auditing staff.

To determine the adequacy of the procedures performed by the internal auditors.

To evaluate the internal auditor's identification of areas of risk within the institution and structuring of the overall audit approach to cover these areas of risk.

To determine whether the internal auditor's work and reports are reliable.

To determine if the internal auditor has an effective system for following up on problems and recommendations, and if the institution has taken corrective action for deficiencies noted by the internal auditor.

To determine the overall effectiveness of the internal audit function in strengthening internal controls and in monitoring adherence to controls, procedures, and regulatory requirements by management and employees.

## Examination Procedures

Wkp.Ref.

### Level I

1. Evaluate the scope of the internal audit work based on the answers to the Internal Auditor Questionnaire, review the internal audit plan, including adjustments to the plan based on any early warning system that detects risks, any prior internal audit report ratings, and the results of previous reviews of the auditor's work. Review minutes of the audit committee. Discuss with regulatory staff assigned the review of the board minutes, possible areas of concern that the internal audit staff should have addressed.

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2. Interview the internal audit staff and observe the operation of the audit function to determine its organizational responsibilities. Be alert to any information indicating lack of independence of the internal audit staff, including whether management places any

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restrictions on the audit programs or imposes any unreasonable scheduling or budgetary restraints. Determine whether the auditor maintains independence in appearance, and approaches the audit process in an ethical and professional manner.

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3. If the institution outsources its internal audit function, review the contract to ensure the arrangement is consistent with interagency guidelines (Appendix A, Interagency Policy Statement on the Internal Audit Function and its Outsourcing; and Sections 310 and 340). Consult with the regional accountant for additional guidance.
- 

4. Review the internal audit department for the existence of any operational duties regarding auditors, any family ties with non-audit employees, or any other relationships incompatible with maintaining an independent internal audit function.
- 

5. Review the audit plan for completeness and for evidence of compliance with proper board or audit committee approval procedures. Ensure the audit committee or the board performs periodic assessments of the internal audit function and takes appropriate action to ensure ongoing reliability and effectiveness.
- 

6. Review the organization chart and the institution's chart of accounts. Note whether the internal auditor considers all existing service corporations, subsidiaries, joint ventures, and significant accounts. Ensure that the internal audit staff performed an assessment of risk for each audit area.
- 

7. During the initial review of the internal audit function, review audit manual(s) and associated material to determine whether prescribed procedures are sufficient for accomplishing the audit objectives.
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8. Determine whether the institution modifies internal audit programs in a timely manner to keep pace with changes in institution activities, economic environment, technology, and regulations.

\_\_\_\_\_

9. Review audit reports by internal auditors and determine whether management provided satisfactory responses and adopted any recommended changes. Determine the reason for any recommendations not addressed by management.

\_\_\_\_\_

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

\_\_\_\_\_

### Level II

11. Determine if the institution recently changed internal auditing personnel. If so, discuss the reasons for such change with management. Pay particular attention to any disagreements between the prior auditor and the institution regarding matters of accounting principles or practices, financial statement disclosures, internal controls, or auditing procedures and findings. Determine the validity of reasons given for any such changes. Consider contacting an auditor who the association terminated or who resigned.

\_\_\_\_\_

12. Review a representative sample of audit reports and associated work papers to determine that they are adequate, prepared in accordance with the audit program, in compliance with prescribed procedures, and properly documented. Determine that the auditor tests the reliability of information produced in the institution. Determine who gets the reports. Answer the questions on the Internal Auditor Questionnaire to assist in your review of the audit program.

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13. Check for progress in correcting any earlier reported areas with significant weakness. Identify the responsible party to make the correction and the time frame.

\_\_\_\_\_

\_\_\_\_\_

14. Check the adequacy of information on the audit function available to management and the board of directors or its audit committee.

\_\_\_\_\_

\_\_\_\_\_

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

\_\_\_\_\_

\_\_\_\_\_

### Level III

Level III procedures should be considered if after completing both Level I and II procedures you are unable to make firm assessments of the effectiveness of the institution's internal audit function. Be sure to apprise the EIC or FM of the need to perform Level III procedures.

16. If concerns about the auditor's work exist, check the accuracy of selected audit findings by duplicating the procedures of the auditor. For example, on a test basis, review loan files that the auditor reviewed, following the same procedures. If findings differ significantly, review your findings with management and/or the audit committee. Test for evidence of insider abuse, known or suspected defalcation, known or suspected criminal activity, and questionable transactions with affiliates.

\_\_\_\_\_

\_\_\_\_\_

17. Determine if the internal audit department's role in automated or manual systems design is adequate. Review uses of the computer and determine if internal audit staff have access to the files for audit purposes.

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18. For internal audit personnel hired since the last examination (or for the entire audit staff if not previously examined), review personnel files for information such as: level of education attained, significant work experience, certification as an internal auditor or a public accountant, and membership in professional associations. In a large internal audit department, the initial review should include the department manager and a sample of audit supervisors and staff. Consider adequacy of internal audit staff's qualifications, experience, and knowledge of key areas of operation, particularly if the institution has changed its primary business line or type of lending.
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## Internal Audit Questionnaire

### General Questionnaire

Review reports and the appropriate programs and work papers of the auditors in order to answer the following audit function questions. Where appropriate, retain supporting documentation and pertinent information or note it under "Comments."

*Explain all "No" answers.*

- |   | Yes | No |
|---|-----|----|
| 1. Has the auditor devised an overall audit plan identifying areas of risk? .....   |     |    |
| 2. Do programs and questionnaires exist for each area? .....  |     |    |
| 3. Is the independence of the internal auditor assured, based upon review of documentation such as the function's charter or the organization chart of the institution? .....         |     |    |
| 4. If the institution outsources responsibility for the internal audit function, does the outside contractor remain independent and not act in a capacity equivalent to management? . |     |    |
| • Does the arrangement comply with current AICPA guidance? .....  |     |    |
| 5. Where the auditor used operating personnel, is there documentation showing that:   |     |    |
| • Either the auditor, or someone the auditor directs, closely supervised the operating personnel's work? .....  |     |    |
| • They did not audit records of the department to which they are assigned or their own work? .....  |     |    |
| 6. Does the internal auditor meet with the directors at least annually to discuss written reports of audit? .....   |     |    |
| How often? _____  |     |    |

- |  | Yes | No |
|--|-----|----|
| 7. Do audit programs include tests of physical and accounting controls performed in the following (minimum) areas: |     |    |
| • Cash?.....   |     |    |
| • Consigned items and other nonledger control accounts? .....  |     |    |
| • Investments? .....   |     |    |
| • Loans? .....   |     |    |
| • Loans and participations sold and purchased?.....  |     |    |
| • Allowances for credit losses?  |     |    |
| • Deposits? .....  |     |    |
| • Confirmation of loans and deposits? .....  |     |    |

*Note: Detailed questions concerning the internal audit staff work in each of these areas follow.*

#### Cash

- |  | Yes | No |
|--|-----|----|
| 1. Does the internal audit staff count and balance cash on hand? ..... |     |    |
| • How often? _____   |     |    |
| • Do they make cash counts on a surprise basis? .....                  |     |    |
| 2. Do they test bank account reconciliations for accuracy? .....       |     |    |
| 3. Do they test cash receipt procedures? .....                         |     |    |
| 4. Do they test cash disbursement procedures? .....                    |     |    |

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## Internal Audit Questionnaire

- Do they review cash control records and trace any apparently large or unusual cash movements to or from a department or branch? .....

Yes	No

### Funds Transfer Activities

- Does the internal auditor review the wire transfer function for segregation of duties involving receipt, processing, settlement, accounting, and reconciliation?.....
- Does the internal auditor test staff compliance with credit and personnel procedures, operating instructions, and internal controls?
- Does the internal auditor review overnight drafts? .....


### Due From Banks

- Does the internal auditor test the bank reconciliation including the Federal Reserve Bank? .....
- Do they receive cut-off bank statements as of the examination date and an appropriate date subsequent to the examination date for use in testing bank reconciliation? .....
- Does the internal auditor review all returned items for an appropriate period subsequent to the examination date? .....
- Does the internal auditor confirm due from banks?.....
- Does the internal auditor check the accuracy and completeness of reports submitted to the Federal Reserve for calculation of required reserve balances? .....


### Consigned Items and Other Nonledger Control Accounts

- Does the internal auditor balance and confirm consignment items? .....
- Does the internal auditor test income from the sale of consignment items?.....
- Does the internal auditor test rental income for safe deposit boxes? .....
- Does the internal auditor check vault entry records for signature(s) of authorized persons?.....
- Does the internal auditor examine safekeeping/custodial accounts or confirm them with an outside custodian?.....
- Does the internal auditor test the completeness of safekeeping/custodial items and records by examining supporting documentation or by confirming with customers? .....
- Does the internal auditor test closed safekeeping/custodial accounts? .....
- Does the internal auditor test fee income for safekeeping/custodial accounts?.....
- Does the internal auditor test collection items by examining supporting documentation, subsequent receipt of payments, disbursement to customers of funds collected, or by confirming with customers? ...
- Does the internal auditor test collection fee income? .....

Yes	No

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## Internal Audit Questionnaire

### Investments

	Yes	No
1. Does the internal auditor verify that the board adopted written investment policies that include the institution's investment limits, each trader's limits, etc.? .....		
2. Does the internal auditor examine or confirm all investment securities? .....		
3. Has the internal auditor ascertained that securities transactions are in keeping with stated portfolio objectives? .....		
Has the internal auditor also:		
• Reviewed the securities dealers with whom the institution conducts securities activities? .....		
• Reviewed objectionable investment portfolio transactions? .....		
4. Does the internal auditor test that all investment securities transactions are authorized? .....		
5. Does the internal auditor verify investment securities balances (including physical count of securities located in the institution, and confirm institution ownership and control of securities held in custody outside the institution)? .....		
6. Does the internal auditor verify the book and market values of investment securities? .....		
7. Does the internal auditor reconcile the accrued interest accounts to detail, and check computations of interest income? .....		
8. Does the internal auditor test the gain and loss on investment securities sold during the period? .....		

	Yes	No
9. Does the internal auditor review hedging activities (forward commitments, futures, options, and interest rate swaps) for compliance with internal policies and procedures and strategies? .....		
10. Does the internal auditor check for compliance with laws and regulations applicable to those savings institutions engaging in the purchase or sale of securities instruments for their own account or for the account of customers (including providing commodity advice to customers)? .....		
11. Does the internal auditor check for compliance with the FFIEC "Supervisory Policy Statement on Investment Securities and End-User Derivatives Activities?" .....		
12. Does the internal auditor check for compliance with the repurchase agreement provision of the Government Securities Act for non-dealer entities? .....		
<i>Retail Nondeposit Investment Sales</i>		
1. Does the internal auditor check the monitoring and resolution of customer complaints?		
2. Does the internal auditor test customer accounts for proper disclosures? .....		
3. Does the internal auditor check for conflicts of interest? .....		
4. Does the internal auditor review the saving association's compensation program for retail nondeposit investment product sales? .....		
5. If the savings association has a separate compliance program for retail nondeposit investment product sales, did the internal auditor review the adequacy of the compliance program? .....		

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## Internal Audit Questionnaire

6. Where the savings association offers retail nondeposit investment products through an independent third-party vendor, did the internal auditor review vendor adherence to the governing agreement? .....

Yes	No

7. Did the internal auditor ascertain that the sales activities were in keeping with established policies and procedures, applicable laws, and regulations, and the February 15, 1994, "Interagency Statement on Retail Sales of Nondeposit Investment Products?" .....

Yes	No

*Subordinate Organizations and Affiliates*

1. Does the internal auditor review and test the investment in and the transactions with related organizations? .....

Yes	No

2. Does the internal auditor determine that investments, advances, or transactions with affiliates are consistent with covenants of debt or other instruments as approved by the board of directors or bank management? .....

Yes	No

*Derivatives*

The level of internal auditor expertise should be consistent with the level of activity and degree of risk assumed by the savings association. In some cases, a savings association may need to outsource internal audit coverage of derivative activities to ensure that the persons performing the audit work possess sufficient depth and experience.

1. Does the internal auditor assess the adequacy and reasonableness of information obtained and used in risk management systems (market, credit, liquidity, and operation and systems)? .....

Yes	No

2. Does the internal auditor validate the data integrity of significant market, liquidity, and risk management models? .....

Yes	No

3. Does the external auditor determine that contract documentation is properly maintained and safeguarded, and ascertain that legal counsel has properly reviewed documents? .....

Yes	No

4. Has the external auditor confirmed the effectiveness of internal control systems used for derivatives transaction processing and valuation? .....

Yes	No

5. Has the external auditor checked compliance with laws, rules, regulation, proper accounting, and taxation considerations? ..

Yes	No

6. Has the internal auditor ascertained the savings association staff performs derivative activities within the guidelines provided by bank policies and procedures?

Yes	No

*Loans*

(Loans include commercial loans, installment loans, floor plan loans, credit card loans, home equity, and construction).

1. Does the internal auditor determine if the institution maintains up-to-date documentation showing lending policies and procedures? .....

Yes	No

2. Does the internal auditor determine whether compliance with policies and procedures is adequate? .....

Yes	No

3. Does the internal auditor test delinquency lists? .....

Yes	No

• How often? \_\_\_\_\_

4. Does the internal auditor test interest and accrual computations? .....

Yes	No

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## Internal Audit Questionnaire

	Yes	No		Yes	No
• How often? _____			<i>Loans and Participations Sold or Purchased</i>		
5. Does the internal auditor verify loan and escrow (impound) account balances (including confirmation procedures)?.....			1. Do the internal auditor's work papers indicate the extent of audit procedures performed and conclusions reached? .....		
• Does the internal auditor physically inspect collateral, if applicable?.....			2. Does the internal auditor confirm:		
• Has the internal auditor tested the pricing of negotiable collateral, if applicable?.....			• Significant balances of loans and participations sold or purchased? .....		
6. Does the internal auditor examine notes and other legal documentation for authorized approvals and compliance with policies?.....			• Significant terms of purchase or sales agreements? .....		
7. Do the internal auditor's work papers disclose:			3. Do the internal auditor's work papers indicate the methods used to determine the adequacy of auditing procedures on loans serviced by others? .....		
• The number and percent of new loan files examined compared with the total originated during the period?.....			4. Do the internal auditor's procedures include, when appropriate, obtaining letters from servicing organizations' auditors confirming the extent of their audit procedures? .....		
• The number and percent of files applicable to previous audit periods examined compared with the total number outstanding as of the audit date? .....			5. For loans purchased, do the internal auditor's procedures verify that:		
• The basis used for selection of loan accounts for inspection and the specific documents inspected?.....			• The underwriting meets the institution's underwriting standards? .....		
8. Does the internal auditor note all material exceptions? .....			• The institution obtains, reviews, and retains all pertinent documents? .....		
9. Does the internal auditor determine the adequacy of insurance coverage and ensure that the institution names itself as loss payee? ...			<i>Mortgage Banking Activities</i>		
10. Does the internal auditor verify the loan-in-process accounts?.....			1. Does the internal auditor test book and fair-market values of mortgage servicing assets?		
11. Does the internal auditor review the sales of repossessed collateral/foreclosed mortgages to determine the propriety of the entries made to record the sales? .....			2. Does the internal auditor verify the appropriateness of hedge accounting?.....		
			3. Does the internal auditor test the accuracy of tracking systems by verifying that documentation was on hand, or in process of being received, for loans awaiting sales and those being serviced? .....		

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## Internal Audit Questionnaire

	Yes	No
<ul style="list-style-type: none"> <li>• Did the internal auditor follow up on any exceptions outstanding over 120 days? ..</li> </ul>		
4. Does the internal auditor test impairment analyses? .....		
5. Does the internal auditor determine the accuracy of financial reporting systems and other management information systems?.....		
6. Does the internal auditor check compliance with established policies and procedures, accounting procedures, laws, rules, and regulations? .....		
<i>Leasing Activities</i>		
1. Does the internal auditor confirm leases and related balance sheet accounts? .....		
2. Does the internal auditor review the leases and other legal documentation? .....		
3. Does the internal auditor test the computation of depreciation expense, interest expense, or rental income? .....		
4. Does the internal auditor test the computation of any gain or loss on sales and disposals of property and trace the sales proceeds to cash receipts records?.....		
5. Does the internal auditor determine that account balances accurately reflect any deferred tax liability or asset? .....		
6. Does the internal auditor review insurance coverage and determine that property damage coverage is adequate in relation to book value and that liability insurance is in effect?		

### *Allowances for Credit Losses*

	Yes	No
1. In determining the adequacy of the general and specific allowances for credit losses, including the allowance for loan and lease losses (ALLL):		
<ul style="list-style-type: none"> <li>• Does the internal auditor verify loan balances for the loans charged off since the last audit? .....</li> <li>• Does the internal auditor examine the supporting documentation for loans charged off? .....</li> <li>• Does the internal auditor reconcile loan recovery detail amounts to credit entries in the appropriate general ledger accounts?.....</li> <li>• Does the internal auditor assess whether the ALLL is adequate to provide for losses for the remaining life of all classified loans and for the next 12 months for the loans that are not classified? .....</li> </ul>		
2. Does the internal auditor verify that the institution uses a board-approved method to determine the need for and adequacy of allowances for credit losses? .....		
<ul style="list-style-type: none"> <li>• Does this methodology comply with OTS policy, GAAP, and industry practice? .....</li> </ul>		
3. Is an adequate record available indicating which assets the internal auditor reviewed for classification and when? .....		
4. Does the internal auditor consider self-classifications of loans in determining the adequacy of the allowances for credit losses? .....		

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## Internal Audit Questionnaire

	Yes	No		Yes	No
5. Does the internal auditor test the recording of deferred tax credits (charges) if the deduction for loan losses on the thrift's tax return was different from that charged to operations?.....			<ul style="list-style-type: none"> <li>• Account transfers? .....</li> <li>• Interest (dividend) computation? .....</li> </ul>		
<i>Deposits: Demand, Time Deposit Savings Accounts, and other Transaction Accounts</i>			<i>Confirmation of Loans, Demand, Time Deposit Savings Accounts, and Other Transaction Accounts</i>		
1. Does the auditor maintain up-to-date documentation showing savings policies and practices?.....			1. Does the internal auditor use an adequate method to determine the extent of confirmation? .....		
2. Is the extent of the internal auditor's tests to determine compliance with board-approved policies and practices adequate? .....			2. Do the internal auditor's work papers show the number and percent (both by number and dollar amount) of loans and deposit accounts confirmed?.....		
3. Does the internal auditor address the following (minimum) areas for dual control and segregation of duties:			<ul style="list-style-type: none"> <li>• What basis does the internal auditor use to select accounts to confirm? _____</li> <li>• Is it appropriate?.....</li> </ul>		
• Inactive accounts? .....			3. If the internal auditor uses statistical sampling, do the work papers disclose:		
• Closed accounts: Does the internal auditor test closed accounts and determine that they were properly closed?.....			<ul style="list-style-type: none"> <li>• The method used? .....</li> <li>• A selection system with a random start?</li> <li>• The confidence level achieved? .....</li> </ul>		
• Dormant accounts: Does the internal auditor test account activity in dormant accounts, bank-controlled accounts, employee/officer accounts, and accounts of employees'/officers' business interests?			4. Does the internal auditor report all material exceptions? .....		
• Passbooks and certificates?.....			5. Does the internal auditor review overdraft accounts and determine collection potential?.....		
• Certificates of deposit: Does the internal auditor account for numerical sequence of pre-numbered certificates of deposits?			<i>Official Checks</i>		
• Opening accounts?.....			1. Does the internal auditor reconcile account balances?.....		
• Closing accounts? .....					
• Loans on deposits? .....					

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## Internal Audit Questionnaire

	Yes	No
2. Does the internal auditor determine the validity and completeness of outstanding checks? .....		
3. Does the internal auditor examine documentation supporting paid checks? .....		
4. Does the internal auditor test certified checks to customers' collected funds balances? .....		
<i>Other</i>		
1. Does the internal auditor test borrowings for approval and regulatory compliance? .....		
• How often? _____		
• Does the internal auditor confirm borrowed funds? .....		
• Does the internal auditor examine supporting legal documents, disclosures, and collateral custody agreements, and determine compliance with applicable laws and regulations? .....		
• Does the internal auditor review the minutes of the stockholders' and board of directors' meetings for approval of all borrowing requiring such approval? .....		
• Does the internal auditor verify changes in capital notes outstanding? .....		
• Does the internal auditor review the accrued interest accounts and test computation of interest expense? .....		
2. Does the internal auditor review the adequacy of the scope of auditing procedures for Other Liabilities and Deferred Credits? .		

	Yes	No
• Does the internal auditor confirm balances of "other liability" accounts (including tests for unrecorded liabilities as of a given date)? .....		
• Does the internal auditor review the operation and use of any "inter-office" account? .....		
• Does the internal auditor review suspense accounts to determine that appropriate staff clears all items on a timely basis? ..		
3. Does the internal auditor review whether the scope for auditing real estate owned (REO) accounts is adequate? .....		
• Does the internal auditor review procedures to ensure that the institution purchases appropriate hazard insurance? .....		
• Does the internal auditor review current appraisal procedures, market values, and sales prices? .....		
• Does the internal auditor review foreclosure procedures including whether the institution has proper title? .....		
• Does the internal auditor verify expenses to maintain properties, and confirm rental income? .....		
• Does the internal auditor review monthly reconciliations of the properties to the general ledger? .....		
• Does the internal auditor review REO reports to the board of directors? .....		
4. Does the internal auditor's scope for auditing fixed assets include the following procedures:		

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## Internal Audit Questionnaire

	Yes	No		Yes	No
<ul style="list-style-type: none"> <li>Examining support for additions, sales, and disposals?.....</li> </ul>			<i>Income and Expense</i>		
<ul style="list-style-type: none"> <li>Reviewing property transactions with "bank-affiliated personnel?" .....</li> </ul>			1. Does the internal auditor's scope adequately address all significant income and expense accounts?.....		
<ul style="list-style-type: none"> <li>Verifying property balances? .....</li> </ul>			<ul style="list-style-type: none"> <li>Does the internal auditor test income and expenses by examining supporting documentation for authenticity and proper approval? .....</li> </ul>		
<ul style="list-style-type: none"> <li>Testing computation of depreciation expense? .....</li> </ul>			<ul style="list-style-type: none"> <li>Does the internal auditor test accruals by either recomputing amounts or examining documents supporting such accruals?....</li> </ul>		
<ul style="list-style-type: none"> <li>Testing computation of gain or loss on property sales and disposals and tracing sales proceeds to cash receipts records? .....</li> </ul>			<ul style="list-style-type: none"> <li>Test computations for gains and losses on disposals, and for amortizations? .....</li> </ul>		
<ul style="list-style-type: none"> <li>Determining that any deferred tax liability or asset, evolving from the use of different depreciation methods for book and tax purposes is properly reflected on the bank's books? .....</li> </ul>			<ul style="list-style-type: none"> <li>Review inter-office transactions and suspense accounts to determine whether all items included were temporary? .....</li> </ul>		
<i>Accounts Receivable</i>			<i>Capital Stock</i>		
1. Does the internal auditor perform any of the following procedures:			1. If an institution acts as its own transfer agent and/or registrar, does the internal auditor account for all stock certificates (issued and unissued) and reconcile par value of outstanding shares to appropriate general ledger control accounts? .....		
<ul style="list-style-type: none"> <li>Confirm loan balances?.....</li> </ul>			2. If an institution has an outside transfer agent and/or registrar, did the internal auditor confirm activity and verify that shares were issued since the previous audit? .....		
<ul style="list-style-type: none"> <li>Review, or confirm with outside custodian, notes and other legal documentation including collateral? .....</li> </ul>			3. Does the internal auditor review capital changes?.....		
<ul style="list-style-type: none"> <li>Review the accrued interest accounts and check computation of interest income? ..</li> </ul>			<i>Dividends</i>		
<i>Other Assets</i>			1. Does the internal auditor verify computation of dividends paid and/or accrued on stock?		
1. Does the internal auditor perform any of the following procedures:					
<ul style="list-style-type: none"> <li>Confirm balances and examine support for additions and disposals? .....</li> </ul>					

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## Internal Audit Questionnaire

	Yes	No
2. Does the internal auditor review the minutes of the board of directors' meetings to verify the propriety and accrual of the dividend payment? .....		
<i>Information System Services</i>		
1. Does the internal auditor perform periodic audit procedures for significant automated applications to determine that workflow is processed accurately and is in conformity with operating manuals?.....		
2. Does the internal auditor control or periodically review dormant accounts? .....		
3. Does the internal auditor review unposted items?.....		
<i>Payment System Risk</i>		
1. Does the internal auditor test the bank's self-assessment? .....		
2. Does the internal auditor review the reasonableness of any de minimis cap? .....		
3. Does the internal auditor ascertain compliance with established bank policy?.....		

### *Asset Management*

1. Does the internal auditor test fee income and client reimbursement? .....
2. Does the internal auditor examine asset management client contracts? .....
3. Does the internal auditor check for compliance with applicable laws, regulations, and rulings?.....
4. Does the internal auditor ascertain adherence with established bank policies and procedures? .....

### *Branches*

1. Has the internal auditor performed appropriate audit procedures in the branches during a reasonable audit cycle that are at least as comprehensive as those listed in the applicable areas above? .....

	Yes	No

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**BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM  
FEDERAL DEPOSIT INSURANCE CORPORATION  
OFFICE OF THE COMPTROLLER OF THE CURRENCY  
OFFICE OF THRIFT SUPERVISION**

**INTERAGENCY POLICY STATEMENT ON THE  
INTERNAL AUDIT FUNCTION AND ITS OUTSOURCING**

**December 22, 1997**

**INTRODUCTION**

Effective internal control<sup>1</sup> is a foundation for the safe and sound operation of a banking institution or savings association (hereafter referred to as institution). The board of directors and senior managers of an institution are responsible for ensuring that the system of internal control operates effectively. Their responsibility cannot be delegated to others within the institution or to outside parties. An important element of an effective internal control system is an internal audit function. When properly structured and conducted, internal audit provides directors and senior management with vital information about weaknesses in the system of internal control so that management can take prompt, remedial action. The agencies' long-standing examination policies call for examiners to review an institution's internal audit function and recommend improvements if needed. In addition, more recently, the agencies adopted Interagency Guidelines Establishing Standards for Safety and Soundness, pursuant to Section 39 of the Federal Deposit Insurance Act (FDI Act).<sup>2</sup> Under these guidelines, each institution should have an internal audit function that is appropriate to its size and the nature and scope of its activities.

In addressing various quality and resource issues, many institutions have been engaging independent public accounting firms and other outside professionals (hereafter referred to as outsourcing vendors) to perform work that has been traditionally done by internal auditors. These arrangements are often called "internal audit outsourcing," "internal audit assistance," "audit co-sourcing," and "extended audit services" (hereafter, collectively referred to as outsourcing).

Such outsourcing may be beneficial to an institution if it is properly structured, carefully conducted, and prudently managed. However, the federal banking agencies have concerns that the structure, scope, and management of some internal audit outsourcing arrangements may not contribute to the institution's safety and soundness. Furthermore, the agencies want to ensure that these arrangements with outsourcing vendors do not leave directors and senior managers with the impression that they have been relieved of their responsibility for maintaining an effective system of internal control and for overseeing the internal audit function.

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<sup>1</sup> In summary, internal control is a process, brought about by an institution's board of directors, management and other personnel, designed to provide reasonable assurance that the institution will achieve the following internal control objectives: efficient and effective operations, including safeguarding of assets; reliable financial reporting; and, compliance with applicable laws and regulations. Internal control consists of five components that are a part of the management process: control environment, risk assessment, control activities, information and communication, and monitoring activities. The effective functioning of these components is essential to achieving the internal control objectives.

<sup>2</sup> For national banks, Appendix A to Part 30; for state member banks, Appendix D to Part 208; for state nonmember banks, Appendix A to Part 364; for savings associations, Appendix A to Part 570.

This policy statement sets forth some characteristics of sound practices for the internal audit function and the use of outsourcing vendors for audit activities. In addition, it provides guidance on how these outsourcing arrangements may affect an examiner's assessment of internal control. It also discusses the effect these arrangements may have on the independence of an external auditor who also is providing internal audit services to an institution. Finally, this statement provides guidance to examiners concerning their reviews of internal audit functions and related matters. This policy statement applies to bank holding companies and their subsidiaries, FDIC-insured banks and savings associations, and U.S. operations of foreign banking organizations.

## THE INTERNAL AUDIT FUNCTION

### Director and Senior Management Responsibilities

The board of directors and senior management are responsible for having an effective system of internal control – including an effective internal audit function – and for ensuring that the importance of internal control is understood and respected throughout the institution. This overall responsibility cannot be delegated to anyone else. They may, however, delegate the design, implementation and monitoring of specific internal controls to lower-level management and the testing and assessment of internal controls to others. In discharging their responsibilities, directors and senior management should have reasonable assurance that the system of internal control prevents or detects inaccurate, incomplete or unauthorized transactions; deficiencies in the safeguarding of assets; unreliable financial and regulatory reporting; and deviations from laws, regulations, and the institution's policies.

Some institutions have chosen to rely on so-called “management self-assessments” or “control self-assessments,” wherein business line managers and their staff evaluate the performance of internal controls within their purview. Such reviews help to underscore management's responsibility for internal control, but they are not impartial. Directors and senior managers who rely too much on these reviews may not learn of control weaknesses until they have become costly problems – particularly if directors are not intimately familiar with the institution's operations. Therefore, institutions generally should also have their internal controls tested and assessed by units without business-line responsibilities, such as internal audit groups.

Directors should be confident that the internal audit function meets the demands posed by the institution's current and planned activities. Directors and senior managers should ensure that the following matters are reflected in their internal audit function.

*Structure.* Careful thought should be given to placement of the audit function in the institution's management structure. The function should be positioned so that directors have confidence that the internal audit function will perform its duties with impartiality and not be unduly influenced by managers of day-to-day operations. Accordingly, the manager of internal audit should report directly to the board of directors or its audit committee, which should oversee the internal audit function.<sup>3</sup> The board or its audit committee should develop objective performance criteria to evaluate the work of the internal audit function.<sup>4</sup>

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<sup>3</sup> Institutions subject to Section 36 of the FDI Act must maintain independent audit committees (i.e., comprised of directors that are not members of management). For institutions not subject to an audit committee requirement, the board of directors can fulfill the audit committee responsibilities discussed in this policy statement.

<sup>4</sup> For example, the performance criteria could include the timeliness of each completed audit, comparison of overall performance to plan, and other measures.

*Management, staffing, and audit quality.* The directors should assign responsibility for the internal audit function to a member of management (hereafter referred to as the manager of internal audit or internal audit manager) who understands the function and has no responsibilities for operating the business. The manager of internal audit should be responsible for control risk assessments, audit plans, audit programs and audit reports.

- A control risk assessment (or risk assessment methodology) documents the internal auditor's understanding of the institution's significant business activities and their associated risks. These assessments typically analyze the risks inherent in a given business line and potential risk due to control deficiencies. They should be updated as needed to reflect changes to the system of internal control or work processes, and to incorporate new lines of business.
- The audit plan is based on the control risk assessment and includes a summary of key internal controls within each significant business activity, the timing and frequency of planned internal audit work, and a resource budget.
- An audit program describes the objectives of the audit work and lists the procedures that will be performed during each internal audit review.
- An audit report generally presents the purpose, scope and results of the audit, including findings, conclusions and recommendations. Work papers should be maintained that adequately document the work performed and support the audit report.

The manager of internal audit should oversee the staff assigned to perform the internal audit work and should establish policies and procedures to guide the audit staff.<sup>5</sup> The internal audit function should be competently supervised and staffed by people with sufficient expertise and resources to identify the risks inherent in the institution's operations and assess whether internal controls are effective. Institutions should consider conducting their internal audit activities in accordance with professional standards, such as the Institute for Internal Auditors' (IIA) Standards for the Professional Practice of Internal Auditing. These standards address the independence, professional proficiency, scope of work, performance of audit work, and management of internal audit.

*Scope.* The frequency and extent of internal audit review and testing should be consistent with the nature, complexity, and risk of the institution's on- and off-balance-sheet activities. At least annually, the audit committee should review and approve the internal audit manager's control risk assessment and the scope of the audit plan, including how much the manager relies on the work of an outsourcing vendor. It should also periodically review internal audit's adherence to the audit plan. The audit committee should consider requests for expansion of basic internal audit work when significant issues arise or when significant changes occur in the institution's environment, structure, activities, risk exposures, or systems.<sup>6</sup>

*Communication.* To properly discharge their responsibility for internal control, directors and senior management should foster forthright communications and critical examination of issues so that they will have knowledge of the internal auditor's findings and operating management's solutions to identified internal control weaknesses. Internal auditors should report internal control deficiencies to the appropriate level of management.

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<sup>5</sup> The form and content of policies and procedures should be consistent with the size and complexity of the department and the institution: many policies and procedures may be communicated informally in small internal audit departments, while many larger departments require more formal and comprehensive written guidance.

<sup>6</sup> Major changes in an institution's environment and conditions may compel changes to the internal control system and also warrant additional internal audit work. These include: (a) new management; (b) areas or activities experiencing rapid growth; (c) new lines of business, products or technologies; (d) corporate restructurings, mergers and acquisitions; and (e) expansion or acquisition of foreign operations (including the impact of changes in the related economic and regulatory environments.)

ment as soon as they are identified. Significant matters should be promptly reported directly to the board of directors (or its audit committee) and senior management. In periodic meetings with management and the manager of internal audit, the audit committee should assess whether internal control weaknesses or other exceptions are being resolved expeditiously by management. Moreover, the audit committee should give the manager of internal audit the opportunity to discuss his or her findings without management being present.

### **U.S. Operations of Foreign Banking Organizations**

The internal audit function of a foreign banking organization (FBO) should cover its U.S. operations in its risk assessments, audit plans, and audit programs. The internal audit of the U.S. operations normally is performed by its U.S. domiciled audit function, head-office internal audit staff, or some combination thereof. Internal audit findings (including internal control deficiencies) should be reported to the senior management of the U.S. operations of the FBO and the audit department of the head office. Significant, adverse findings also should be reported to the head office's senior management and the board of directors or its audit committee.

### **Small Financial Institutions**

An effective system of internal control, including an independent internal audit function, is a foundation for safe and sound operations, regardless of an institution's size. As discussed previously in this policy statement, Section 39 of the FDI Act requires each institution to have an internal audit function that is appropriate to its size and the nature and scope of its activities. The procedures assigned to this function should include adequate testing and review of internal controls and information systems.

It is management's responsibility to carefully consider the level of auditing that will effectively monitor the internal control system after taking into account the audit function's costs and benefits. For many institutions that have reached a certain size or complexity of operations, the benefits derived from a full-time manager of internal audit or auditing staff more than outweigh its costs. However, for certain smaller institutions with few employees and less complex operations, these costs may outweigh the benefits. Nevertheless, a small institution without an internal auditor can ensure that it maintains an objective internal audit function by implementing a system of independent reviews of key internal controls. The employee conducting the review of a particular function should be independent of the function and able to report findings directly to the board or audit committee.

## **INTERNAL AUDIT OUTSOURCING ARRANGEMENTS<sup>7</sup>**

### **Examples of Arrangements**

An outsourcing arrangement is a contract between the institution and an outsourcing vendor to provide internal audit services. Outsourcing arrangements take many forms and are used by institutions of all sizes. The services under contract can be limited to helping internal audit staff in an assignment for which they lack expertise. Such an arrangement is typically under the control of the institution's manager of internal audit and the outsourcing vendor reports to him or her. Institutions often use outsourcing vendors for audits of areas requiring more technical expertise, such as those of electronic data processing and capital markets activities. Such uses are often referred to as "internal audit assistance" or "audit co-sourcing."

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<sup>7</sup> The guidance in the preceding section of this policy statement ("The Internal Audit Function") also applies to internal audit outsourcing arrangements.

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Some outsourcing arrangements may require an outsourcing vendor to perform virtually all internal audit work. Under such an arrangement, the institution may maintain a manager of internal audit and a very small internal audit staff. The outsourcing vendor assists staff in determining risks to be reviewed, recommends and performs audit procedures as approved by the internal audit manager, and reports its findings jointly with the internal audit manager to either the full board or its audit committee.

### **Additional Considerations for Internal Audit Outsourcing Arrangements**

Even when outsourcing vendors provide internal audit services, the board of directors and senior managers of an institution are responsible for ensuring that the system of internal control (including the internal audit function) operates effectively. When negotiating the outsourcing arrangement with an outsourcing vendor, an institution should carefully consider its current and anticipated business risks in setting each party's internal audit responsibilities. The outsourcing arrangement should not increase the risk that a breakdown of internal control can occur.

To clearly set forth its duties from those of the outsourcing vendor, the institution should have a written contract, often referred to as an engagement letter. At a minimum, the contract should:

- Set the scope and frequency of work to be performed by the vendor;
- Set the manner and frequency of reporting to senior management and directors about the status of contract work;
- Establish the protocol for changing the terms of the service contract, especially for expansion of audit work if significant issues are found;
- State that internal audit reports are the property of the institution, that the institution will be provided with any copies of the related work papers it deems necessary, and that employees authorized by the institution will have reasonable and timely access to the work papers prepared by the outsourcing vendor;
- Specify the locations of internal audit reports and the related work papers;
- State that examiners will be granted immediate and full access to the internal audit reports and related work papers prepared by the outsourcing vendor;
- Prescribe the method for determining who bears the cost of consequential damages; arising from errors, omissions and negligence; and
- State that outsourcing vendors that are subject to the independence guidance below will not perform management functions, make management decisions, or act or appear to act in a capacity equivalent to that of an employee.

*Management.* Directors and senior management should ensure that the outsourced internal audit function is competently managed. For example, larger institutions should employ sufficient competent staff members in the internal audit department to assist the manager of internal audit in overseeing the outsourcing vendor.

*Communication.* Communication between the internal audit function and directors and senior management should not diminish because the bank engages an outsourcing vendor. All work by the outsourcing vendor should be well documented and all findings of control weaknesses should be promptly reported to the institution's manager of internal audit. Decisions not to report the outsourcing vendor's findings to directors and senior management should be the mutual decision of the internal audit manager and the outsourcing vendor. In deciding what issues should be brought to the board's attention, the concept of "materiality," as the term is

used in financial audits, is generally not a good indicator of which control weakness to report. For example, when evaluating an institution's compliance with laws and regulations, any exception may be important.

*Vendor Competence.* Before entering an outsourcing arrangement the institution should perform enough due diligence to satisfy itself that the outsourcing vendor has sufficient staff qualified to perform the contracted work. Because the outsourcing arrangement is a personal services contract, the institution's internal audit manager should have confidence in the competence of the staff assigned by the outsourcing vendor and receive prior notice of staffing changes. Throughout the outsourcing arrangement, management should ensure that the outsourcing vendor maintains sufficient expertise to perform effectively its contractual obligations.

*Contingency Planning.* When an institution enters into an outsourcing arrangement (or significantly changes the mix of internal and external resources used by internal audit), it increases its operating risk. Because the arrangement might be suddenly terminated, the institution should have a contingency plan to mitigate any significant discontinuity in audit coverage, particularly for high risk areas. Planning for a successor to the prospective outsourcing vendor should be part of negotiating the latter's service contract.

### Independence of the External Auditor

*This section of the policy statement applies only to an outsourcing vendor who is a certified public accountant (CPA) and who performs a financial statement audit or some other service for the institution that requires independence under AICPA rules.<sup>8</sup>*

Many institutions engage certified public accounting firms to audit their financial statements and furnish other attestation services requiring independence. A certified public accounting firm that provides other services for its client (such as consulting, benefits administration or acting as an outsourcing vendor) risks compromising the independence necessary to perform attestation services. The professional ethics committee of the American Institute of Certified Public Accountants (AICPA) has issued rulings and interpretations specifically addressing whether a certified public accountant that furnishes both audit outsourcing and external audit or other attestation services to a client can still be considered independent.<sup>9</sup>

Section 36 of the FDI Act and associated regulations require management of every insured depository institution with total assets of at least \$500 million to obtain an annual audit of its financial statements by an independent public accountant, report to the banking agencies on the effectiveness of the institution's internal controls over financial reporting and on the institution's compliance with designated laws and regulations (management report), and obtain a report from an external auditor attesting to management's assertion about these internal controls (internal control attestation report). In order to satisfy these requirements, the institution's board of directors must select an external auditor that will satisfy the independence requirements established by the AICPA, and relevant requirements and interpretations of the Securities and Exchange Commission.

Questions have been raised about whether external auditors who perform an audit of the institution's financial statements or provide any other service that requires independence can also perform internal audit services and

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<sup>8</sup> Although outsourcing arrangements involving CPAs who are not performing external audit or attestation services for a client are not subject to this independence guidance, they are subject to the other sections of this policy statement.

<sup>9</sup> In May 1997, the AICPA and the Securities and Exchange Commission announced the formation of the Independence Standards Board (ISB), a private-sector body intended to establish independence standards for auditors of public companies. Any future standards established by the ISB should be considered in initiating or evaluating outsourcing arrangements with CPAs.

still be considered independent. The federal banking agencies are concerned that outsourcing arrangements may involve activities that compromise, in fact or appearance, the independence of an external auditor.

The AICPA has issued guidance to CPAs (Interpretation 101-13 and related rulings) on independence that addresses these issues. Under Interpretation 101-13, the CPA's performance of services required by the outsourcing arrangement "would not be considered to impair independence with respect to [an institution] for which the [CPA] also performs a service requiring independence, provided that [the CPA or the CPA's firm] does not act or appear to act in a capacity equivalent to a member of [the institution's] management or as an employee." The interpretation lists activities that would be considered to compromise a CPA's independence. Included are activities that involve the CPA "authorizing, executing, or consummating transactions or otherwise exercising authority on behalf of the client."<sup>10</sup>

Also, the AICPA's Ruling No. 103 sets forth three criteria for evaluating the independence of a CPA who concurrently provides internal audit outsourcing services and the internal control attestation report under Section 36 of the FDI Act. One criterion requires that management "does not rely on [the CPA's] work as the primary basis for its assertion and accordingly has (a) evaluated the results of its ongoing monitoring procedures built into the normal recurring activities of the entity (including regular management and supervisory activities) and (b) evaluated the findings and results of the [CPA's] work and other separate evaluations of controls, if any." Accordingly, a CPA's independence would be impaired if the CPA provides the primary support for management's assertion on the effectiveness of internal control over financial reporting. A copy of the interpretation and rulings is attached to this policy statement.

*Agencies' Views on Independence.* The agencies believe that other actions compromise independence in addition to those in Interpretation 101-13. Such actions include:<sup>11</sup>

- Contributing in a decision-making capacity or otherwise actively participating (e.g., advocating positions or actions rather than merely advising) in committees, task forces, and meetings that determine the institution's strategic direction; and
- Contributing in a decision-making capacity to the design, implementation, and evaluation of new products, services, internal controls or software that are significant to the institution's business activities.

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<sup>10</sup> Other examples of outsourcing activities that would compromise a CPA's independence that are listed in Interpretation 101-13 include:

- Performing ongoing monitoring activities or control activities (i.e., reviewing loan originations as part of the client's approval process or reviewing customer credit information as part of the customer's sales authorization process) that affect the execution of transactions or ensure that transactions are properly executed, accounted for, or both and performing routine activities in connection with the client's operating or production processes that are equivalent to those of an ongoing compliance or quality control function;
- Reporting to the board of directors or audit committee on behalf of management or the individual responsible for the internal audit function;
- Preparing source documents on transactions;
- Having custody of assets;
- Approving or being responsible for the overall internal audit work plan, including the determination of the internal audit risk and scope, project priorities, and frequency of performance of audit procedures;
- Being connected with the client in any capacity equivalent to a member of client management or as an employee (for example, being listed as an employee in client directories or other client publications, permitting himself or herself to be referred to by title or description as supervising or being in charge of the client's internal audit function, or using the client's letterhead or internal correspondence forms in communications).

<sup>11</sup> The agencies believe that this guidance is consistent with the AICPA interpretation.

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**EXAMINATION GUIDANCE****Review of the Internal Audit Function and Outsourcing Arrangements**

Examiners should have full and timely access to an institution's internal audit resources, including personnel, work papers, risk assessments, work plans, programs, reports, and budgets. A delay may require examiners to widen the scope of their examination work and may subject the institution to follow-up supervisory actions.

Examiners will assess the quality and scope of the internal audit work, regardless of whether it is performed by the institution's employees or by an outsourcing vendor. Specifically, examiners will consider whether:

- The board of directors (or audit committee) promotes the internal audit manager's impartiality and independence by having him or her directly report audit findings to it;
- The internal audit function's risk assessment, plans and programs are appropriate for the institution's activities;
- The internal audit function is adequately managed to ensure that audit plans are met, programs are carried out, and results of audits are promptly communicated to interested managers and directors;
- The institution has promptly responded to identified internal control weaknesses;
- Management and the board of directors use reasonable standards when assessing the performance of internal audit;
- The internal audit plan and program have been adjusted for significant changes in the institution's environment, structure, activities, risk exposures or systems;
- The activities of internal audit are consistent with the long-range goals of the institution and are responsive to its internal control needs; and
- The audit function provides high-quality advice and counsel to management and the board of directors on current developments in risk management, internal control, and regulatory compliance.

The examiner should assess the competence of the institution's internal audit staff and management by considering the education and professional background of the principal internal auditors.

*Additional Aspects of the Examiner's Review of Outsourcing Arrangements.* Examiners should also determine whether:

- The arrangement maintains or improves the quality of the internal audit function and the institution's internal control;
- Key employees of the institution and the outsourcing vendor clearly understand the lines of communication and how any internal control problems or other matters noted by the outsourcing vendor are to be addressed;
- The scope of work is revised appropriately when the institution's environment, structure, activities, risk exposures or systems change significantly;
- The directors have ensured that the outsourced internal audit function is effectively managed by the institution;

- The arrangement with the outsourcing vendor compromises its role as external auditor; and
- The institution has performed sufficient due diligence to satisfy itself of the vendor's competence before entering into the outsourcing arrangement and has adequate procedures for ensuring that the vendor maintains sufficient expertise to perform effectively throughout the arrangement.

If the examiner's evaluation of the outsourcing arrangement indicates that the outsourcing arrangement has diminished the quality of the institution's internal audit function, the examiner should consider adjusting the scope of the examination. The examiner also should bring that matter to the attention of senior management and the board of directors and consider it in the institution's management and composite ratings.

### Concerns about Auditor Independence

When an examiner's initial review of an outsourcing arrangement raises doubts about the external auditor's independence, the examiner first should ask the institution and the external auditor to demonstrate that the arrangement has not compromised the auditor's independence. If the examiner's concerns are not adequately addressed, the examiner should discuss the matter with a appropriate agency staff.

If the agency's staff concurs that the independence of the external auditor appears to be compromised, the examiner will discuss his or her findings and the actions the agency may take with the institution's senior management, board of directors (or audit committee), and the external auditor. These actions may include referring the external auditor to the state board of accountancy and the AICPA for possible ethics violations, and barring the external auditor from engagements with regulated institutions. Moreover, the agency may conclude that the organization's external auditing program is inadequate and that it does not comply with auditing and reporting requirements, including Section 36 of the FDI Act and related guidance and regulations.

## AICPA Professional Rulings and Interpretations Referenced in the Interagency Policy Statement

### RULINGS UNDER RULE OF CONDUCT 101

#### 103. Member Providing Attest Report on Internal Controls

**.206 Question** - If a member or a member's firm (member) provides extended audit services for a client in compliance with interpretation 101-13 [ET section 101.15], would the member be considered independent in the performance of an attestation engagement to report on the client's assertion regarding the effectiveness of its internal control over financial reporting?

**.207 Answer** - Independence would not be impaired with respect to the issuance of such a report if all of the following conditions are met:

1. The member's activities have been limited in a manner consistent with interpretation 101-13 [ET section 101.15].
2. Management has assumed responsibility to establish and maintain internal control.
3. Management does not rely on the member's work as the primary basis for its assertion and accordingly has (a) evaluated the results of its ongoing monitoring procedures built into the normal recurring activities of the entity (including regular management and supervisory activities) and

(b) evaluated the findings and results of the member's work and other separate evaluations of controls, if any.

#### 104. Member Providing Operational Auditing Services

**.208 Question** - As part of an extended audit engagement, a member or member's firm (member) may be asked to review certain of the client's business processes, as selected by the client, for how well they function, their efficiency, or their effectiveness. For example, a member may be asked to assess whether performance is in compliance with management's policies and procedures, to identify opportunities for improvement, and to develop recommendations for improvement or further action for management consideration and decision-making. Would the member's independence be considered to be impaired in performing such a service?

**.209 Answer** - The member's independence would not be considered to be impaired provided that during the course of the review the member does not act or appear to act in a capacity equivalent to that of a member of client management or of an employee. The decision as to whether any of the member's recommendations will be implemented must rest entirely with management.

#### 105. Frequency of Performance of Extended Audit Procedures

**.210 Question** - In providing extended audit services, would the frequency with which a member performs an audit procedure impair the member's independence?

**.211 Answer** - The independence of the member or member's firm would not be considered to be impaired provided that the member's activities have been limited in a manner consistent with interpretation 101-13 [ET section 101.15] and the procedures performed constituted separate evaluations of the effectiveness of the ongoing control and monitoring activities/procedures that are built into the client's normal recurring activities.

### INTERPRETATION 101-13 UNDER RULES OF CONDUCT 101: EXTENDED AUDIT SERVICES

**.15 101-13 - Extended audit services.** A member or a member's firm (the member) may be asked by a client, for which the member performs a professional service requiring independence, to perform extended audit services. These services may include assistance in the performance of the client's internal audit activities and/or an extension of the member's audit service beyond the requirements of generally accepted auditing standards (hereinafter referred to as "extended audit services").

A member's performance of extended audit services would not be considered to impair independence with respect to a client for which the member also performs a service requiring independence, provided that the member or his or her firm does not act or does not appear to act in a capacity equivalent to a member of client management or as an employee.

The responsibilities of the client, including its board of directors, audit committee, and management, and the responsibilities of the member, as described below, should be understood by both the member and the client. It is preferable that this understanding be documented in an engagement letter that indicates that the member may not perform management functions, make management decisions, or act or appear to act in a capacity equivalent to that of an employee.

A member should be satisfied that the client understands its responsibility for establishing and maintaining internal control and directing the internal audit function, if any. As part of its responsibility to establish and maintain internal control, management monitors internal control to assess the quality of its performance over

time. Monitoring can be accomplished through ongoing activities, separate evaluations or a combination of both. Ongoing monitoring activities are the procedures designed to assess the quality of internal control performance over time and that are built into the normal recurring activities of an entity and include regular management and supervisory activities, comparisons, reconciliations and other routine actions. Separate evaluations focus on the continued effectiveness of a client's internal control. A member's independence would not be impaired by the performance of separate evaluations of the effectiveness of a client's internal control, including separate evaluations of the client's ongoing monitoring activities.

The member should understand that, with respect to the internal audit function, the client is responsible for –

- Designating a competent individual or individuals, preferably within senior management, to be responsible for the internal audit function.
- Determining the scope, risk and frequency of internal audit activities, including those to be performed by the member providing extended audit services.
- Evaluating the findings and results arising from the internal audit activities, including those performed by the member providing extended audit services.
- Evaluating the adequacy of the audit procedures performed and the findings resulting from the performance of those procedures by, among other things, obtaining reports from the member.

The member should be satisfied that the board of directors and/or audit committee is informed of roles and responsibilities of both client management and the member with respect to the engagement to provide extended audit services as a basis for the board of directors and/or audit committee to establish guidelines for both management and the member to follow in carrying out these responsibilities and monitoring how well the respective responsibilities have been met.

The member should be responsible for performing the audit procedures in accordance with the terms of the engagement and reporting thereon. The day-to-day performance of the audit procedures should be directed, reviewed, and supervised by the member. The report should include information that allows the individual responsible for the internal audit function to evaluate the adequacy of the audit procedures performed and the findings resulting from the performance of those procedures. This report may include recommendations for improvements in systems, processes, and procedures. The member may assist the individual responsible for the internal audit function in performing preliminary audit risk assessments, preparing audit plans, and recommending audit priorities. However, the member should not undertake any responsibilities that are required, as described above, to be performed by the individual responsible for the internal audit function.

Performing procedures that are generally of the type considered to be extensions of the member's audit scope applied in the audit of the client's financial statements, such as confirming of accounts receivable and analyzing fluctuations in account balances, would not impair the independence of the member or the member's firm even if the extent of such testing exceeds that required by generally accepted auditing standards. The following are examples of activities that, if performed as part of an extended audit service, would be considered to impair a member's independence:

- Performing ongoing monitoring activities or control activities (for example, reviewing loan originations as part of the client's approval process or reviewing customer credit information as part of the customer's sales authorization process) that affect the execution of transactions or ensure that transactions are properly executed, accounted for, or both, and performing routine activities in connection with the client's operating or production processes that are equivalent to those of an ongoing compliance or quality control function.

- Determining which, if any, recommendations for improving the internal control system should be implemented.
- Reporting to the board of directors or audit committee on behalf of management or the individual responsible for the internal audit function.
- Authorizing, executing, or consummating transactions or otherwise exercising authority on behalf of the client.
- Preparing source documents on transactions.
- Having custody of assets.
- Approving or being responsible for the overall internal audit work plan including the determination of the internal audit risk and scope, project priorities and frequency of performance of audit procedures.
- Being connected with the client in any capacity equivalent to a member of client management or as an employee (for example, being listed as an employee in client directories or other client publications, permitting himself or herself to be referred to by title or description as supervising or being in charge of the client's internal audit function, or using the client's letterhead or internal correspondence forms in communications).

The foregoing list is not intended to be all inclusive.

[Effective August 31, 1996]

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The financial institution’s internal auditor or person in charge of internal controls who does not have operational responsibilities should complete this questionnaire. An outside contractor or the internal audit department of an affiliate who performs internal control review functions for the financial institution may also complete this questionnaire.

Check here if the financial institution does not have an internal audit function : \_\_\_\_\_ If checked, stop here.

*The examiners will complete minimum procedures (indicated by a flag) if the institution does not have an independent internal audit function or there is a “no” response given below. Independent means that the staff responsible for internal audit does not have operational responsibilities and they report directly to the audit committee or board of directors. Minimum procedures are set forth in the Internal Control Program in Section 340, Internal Control. Examiners will note completed work with a work paper reference at the flag(s) below.*

The \_\_\_\_\_ internal auditor \_\_\_\_\_ outside contractor \_\_\_\_\_ internal audit department of an affiliate completed this questionnaire.

List the name, address, and telephone number of the primary contact at the institution and the name, address, telephone number, and email address for any persons outside the institution who prepared this report:

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Yes      No

**Internal Control Department**

1. List the chief internal auditor’s name, any related professional designation(s), and number of years of financial institution and auditing experience.  
  
\_\_\_\_\_
2. List the other employees in the internal audit department and the audit experience of each.  
  
\_\_\_\_\_
3. How long has the chief auditor worked for the institution, and how long has this person held the present position?  
  
\_\_\_\_\_
4. Whom does the chief auditor report to functionally? Administratively?  
  
\_\_\_\_\_
5. Does the external CPA firm rely on work performed by the internal audit department in determining the extent of their compliance or substantive testing?      \_\_\_\_\_
6. Did the audit department discover any frauds or embezzlements since the last OTS examination? If yes, please attach information for review.      \_\_\_\_\_
7. Are work papers accessible for review by examiners?      \_\_\_\_\_

**General**

8.  Does the audit department test general ledger entries for appropriate support and approval?      \_\_\_\_\_
9.  Does the audit department review expense disbursements for appropriate support and approval?      \_\_\_\_\_

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		<u>Yes</u>	<u>No</u>
10.	 Does the audit department review procedures to determine that subsidiary accounts are reconciled promptly to the general ledger, including suspense accounts? (This can be as frequently as daily depending upon the volume and significance.)	_____	_____
11.	 On a test basis, do audit procedures include the review of the approval and documentation for entries to the books of the financial institution?	_____	_____
12.	Do audit procedures include a review of the institution assets, or assets securitized by the institution, that others hold or service?	_____	_____
13.	 Does the audit department balance a listing of assets others hold or service monthly, and confirm balances annually?	_____	_____
14.	 Do audit procedures include the review of insider and affiliated party transactions for proper documentation and approval?	_____	_____
<b>Cash and Cash Items</b>			
15.	 Do audit procedures include a review of internal controls in this area?	_____	_____
16.	State the audit frequency in this area for the main office and the branches.  _____		
17.	How frequently does the audit department perform surprise cash counts?  _____		
18.	Does the audit department trace cash items to their final disposition?	_____	_____
19.	How frequently do audit procedures require testing for adherence to established teller cash limits?  _____		
20.	 Do audit procedures require testing for adherence to dual control policies where applicable?	_____	_____

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	<u>Yes</u>	<u>No</u>
21.  Do audit procedures include review of the use of supervisory overrides relating to teller operations?	_____	_____
22. List the dates of the last audits in this area.  _____		
<b>Due From Banks</b>		
23.  Do audit procedures include a review of internal controls in this area?	_____	_____
24. State the audit frequency for this area.  _____		
25. Does the auditor request cut-off statements and canceled checks when auditing this area?	_____	_____
26. When auditing this area, which reconcilements are proved such as audit date, most recent, etc.?  _____		
27.  Does the audit department undertake a review to ensure that the institution reconciles all bank accounts when they receive the statement?	_____	_____
28.  Does the institution trace outstanding reconciliation items from the last audit to final disposition, noting unusual aging and number of reconciling items?	_____	_____
29. How frequently does the audit department review drafts for propriety?  _____		
30. Do audit procedures include tracing selected items from the general ledger to the source (originating department)?	_____	_____
31. List the dates of the last audits of this area.  _____		

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		<u>Yes</u>	<u>No</u>
<b>Investment Portfolio</b>			
32.	 Do audit procedures include a review of internal controls in this area?	_____	_____
33.	State the audit frequency for this area.  _____		
34.	Does the audit department establish control over the vault(s) containing physical securities at the beginning of surprise audits (or announced audits)?	_____	_____
35.	 Is there physical verification of the securities to the subsidiary ledger?	_____	_____
36.	 Do audit procedures include reconciling the subsidiary ledger(s) to the general ledger control account(s) as of the audit date or a recent date?	_____	_____
37.	 Do audit procedures include confirming securities held in safekeeping outside the institution?	_____	_____
38.	Were all securities in safekeeping outside the institution confirmed during the last audit?	_____	_____
39.	Do audit procedures include reviewing the par value of inventory for compliance with limits on authorized holdings?	_____	_____
40.	What was the date of the last audit of this area?  _____		
<b>Demand Deposits</b>			
41.	 Do audit procedures include a review of internal controls in this area?	_____	_____
42.	State the audit frequency in this area.  _____		
43.	Do audit procedures require confirmation of a sample of demand accounts including dormant accounts?	_____	_____

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		<u>Yes</u>	<u>No</u>
44.	If the answer above is yes, are positive confirmations used?	_____	_____
45.	 Do audit procedures require a review of dormant activity and compliance with the es-cheat laws currently in effect?	_____	_____
46.	 On a test basis, do audit procedures require a review of returned and holdover items for propriety and evidence of subsequent clearance of material items?	_____	_____
47.	 Do procedures provide for a review of the handling of uncollected funds and ki ting?	_____	_____
48.	 Do procedures provide for a review of director, officer, and employee accounts for large or unusual transactions relative to their salary?	_____	_____
49.	List the last audit date for this area.  _____		

**Time Deposits**

50.	 Do audit procedures include a review of internal controls in this area?	_____	_____
51.	State the audit frequency in this area.  _____		
52.	Do audit procedures require confirmation of a sample of time accounts including dormant accounts?	_____	_____
53.	If the answer above is yes, are positive confirmations used?	_____	_____
54.	 Do audit procedures require a review of dormant activity and compliance with the es-cheat laws currently in effect?	_____	_____
55.	How frequently does the audit department test interest accrued and paid to accounts?	_____	_____
56.	Does the audit department use audit software in the testing referred to in the question above?	_____	_____

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	<u>Yes</u>	<u>No</u>
57. List the last audit date for this area.  _____		
<b>Loans</b>		
58.  Do audit procedures include a review of internal controls in this area?	_____	_____
59. State the audit frequency in this area.  _____		
60. Do audit procedures require confirmation of a sample of loan accounts?	_____	_____
61. If the above is yes, are positive confirmations used?	_____	_____
62. Does the audit department’s responsibilities include evaluating the adequacy of the loan loss reserves?	_____	_____
63.  On a test basis, does the audit department review the approvals for loan disbursements and charged-off loans?	_____	_____
64. How frequently does the audit department test income and related accrued interest and unearned discount?	_____	_____
65. Does the audit department use audit software in the testing referred to in the question above?	_____	_____
66. Do audit procedures include a test check of the inventory of original notes, deeds of trust, car titles, and negotiable collateral for loans in the portfolio?	_____	_____
67. List the last audit date for this area  _____		
<b>Wire Transfers</b>		
68.  Do audit procedures include a review of internal controls in this area?	_____	_____

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		<u>Yes</u>	<u>No</u>
69.	State the audit frequency in this area.  _____		
70.	Does the audit department test wire transfers to ensure timely verifications and reconciliations?	_____	_____
71.	Does the audit department undertake a review to ensure that wire transfer process involves independent parties?	_____	_____
72.	Does the audit department test wire transfers to ensure compliance with written procedures?	_____	_____
73.	List the last audit date for this area  _____		

**INTRODUCTION**

Fraud and insider abuse significantly contributed to many thrift failures during the late 1980s and early 1990s, and caused substantial losses at many others. Because of this, several federal agencies now work closely together to combat fraud and insider abuse at financial institutions.

The Interagency Bank Fraud Working Group includes the five federal banking agencies, the Department of Justice (DOJ), and the Federal Bureau of Investigation (FBI). Representatives from these government agencies work together to establish policies to improve interagency cooperation and to resolve criminal investigation and prosecution problems.

All the agencies now use a uniform interagency Suspicious Activity Report (SAR) form. This is a form that federally insured financial institutions use to report suspected violations of federal criminal law and suspicious transactions related to money laundering offenses and Bank Secrecy Act violations. In addition, all the federal banking regulators have regulations that require insured institutions and service corporations to file SARs.

DOJ maintains the Significant Referral Tracking System. This system tracks the progress of SARs that the federal financial regulators designate as most significant. The DOJ provides tracking of their progress in local U.S. Attorneys' Offices.

To facilitate these interagency efforts, OTS designates a criminal referral coordinators. Their function is to coordinate reports of suspected criminal activities and provide assistance to the FBI and DOJ in criminal investigations and prosecutions.

**FRAUD, INSIDER ABUSE, AND CRIMINAL MISCONDUCT**

Fraud is the intentional misrepresentation of a material fact(s), or a deception, to secure unfair or unlawful gain at the expense of another. Either

insiders or outsiders, or both acting in concert, can perpetrate fraud on financial institutions.

Every year, thrifts lose a significant amount of money due to insider abuse and criminal misconduct. The FBI estimates that insiders of financial institutions steal eight times more money than is stolen through bank robberies and burglaries.

The term insider abuse refers to a wide range of activities by officers, directors, employees, major shareholders, agents, and other controlling persons in financial institutions. The perpetrators intend to benefit themselves or their related interests. Their actions include, but are not limited to, the following activities:

- Unsound lending practices, such as inadequate collateral and poor loan documentation.
- Excessive concentrations of credit to certain industries or groups of borrowers.
- Unsound or excessive loans to insiders or their related interests or business associates.
- Violations of civil statutes or regulations, such as legal lending limits or loans to one borrower.
- Violations of criminal statutes, such as fraud, misapplication of bank funds, or embezzlement.

In addition to criminal misconduct, insider abuse includes other actions or practices that may harm or weaken an institution, but that do not violate criminal statutes. While every criminal violation by an insider constitutes insider abuse, not all insider abuse constitutes criminal misconduct. In most problem financial institutions where regulators find insider abuse, they also find a variety of unsafe and unsound banking practices and mismanagement that may involve criminal acts. While a thin line often separates a criminal act from an abusive act, OTS has the responsibility and the

authority to act against all insider abuse, whether criminal or not.

Many of the largest cases of financial institution fraud involved insiders. If the insider is in a key position, the amount of loss can be significant enough to cause the institution to fail. Often, these individuals perform criminal acts using subordinates who do not question their instructions. In some instances, however, the subordinates may be astute enough to know that what the insiders instructed them to do is questionable or wrong and may freely discuss the situation if the regulators simply inquire.

During formal and informal discussions with employees, you should listen carefully and be attuned to signals of possible illegal activity by others within the institution. Often, discovering fraud is a matter of talking with the right person who knows what is occurring. Inside abusers often start with small transactions, and engage in increasingly larger transactions as their confidence level rises. Because of this, the early detection of insider abuse is an essential element in limiting risks to the insurance fund.

Generally you should bring up fraud as part of another discussion. Once you have established some rapport, you should first ask, as appropriate to the person you are interviewing, general questions, and then more specific questions:

- What kind of history does the association have with fraud in general, including defalcations and employee thefts?
- During the examination, what specific areas should we examine to ensure that there are no major fraud problems?
- Has anyone else ever asked you to do something that you thought was illegal or unethical?
- If someone wanted to commit fraud against the association, what would be the easiest way to do it?
- Is the association in any kind of financial trouble that would motivate someone to commit fraud?

- Is anyone in any personal financial difficulty that you are aware of?
- Have you ever committed fraud against the company?

### Criminal Statutes

The following criminal statutes apply to financial fraud:

#### *18 USC § 215*

Kickbacks and bribes. Section 215 makes it unlawful for any officer, director, employee, agent, or attorney to solicit, accept, or give anything of value with intent to corrupt, in connection with any transaction or business of any financial institution.

Significant Aspects:

- Intent to corrupt requires intent to receive a personal financial benefit or to direct to another person such benefit.
- Applies to noncustomer transactions, for instance, suppliers.
- Applies where a person makes a payment after the fact to reward another person for a prior act.
- Can apply where a third party receives the benefit if the intent is to influence the insider.

#### *18 USC § 657*

Theft, embezzlement, or willful misapplication of an insured institution's funds by an officer, director, agent, or employee with intent to defraud the institution.

Significant Aspects:

- Applies to check kites, nominee borrowers, and in some cases unauthorized loans.
- Violation of internal policies, violation of regulations, and personal benefit to the insider.

*18 USC § 1001*

Knowingly and willfully falsifying or concealing a material fact or making a false statement or making or using false writing knowing it to be false.

*18 USC § 1006*

False entries and reports or statements. Includes material omissions, with intent to injure or defraud an insured institution or deceive an OTS regulator. The statute also covers an officer's, agent's, or employee's receipt of any benefits from an institution transaction with intent to defraud.

Significant Aspects:

- Misstatement should be material.
- Often used in conjunction with misapplication statutes such as 18 USC § 657.

*18 USC § 1014*

False statement, oral or written (for instance, loan applications), made knowingly for the purpose of influencing OTS or any federally insured institution. False statements apply to any application, purchase agreement, commitment, loan (or any change or extension of same), including willfully overvaluing land, property, or security.

Significant Aspects:

- Usually used against borrowers for submitting false financial statements.
- Statute applies to all persons, not just insiders.

*18 USC § 1344*

Bank fraud: A scheme or artifice to defraud a federally insured institution or take money, funds, credit, assets, security, or other property by misrepresentation.

Significant Aspects:

- Applies to most activities that are violations under the statutes.

- Generally must find deceit, trickery, deception, falsehood, or failure to provide information when there is an obligation to do so.

*18 USC § 1517*

Obstructing an examination. It is a crime to corruptly obstruct or attempt to obstruct an examination of a financial institution.

Significant Aspects:

- The examination must be one that an agency of the United States, with examination jurisdiction, is conducting.

Applies to whoever corruptly obstructs or attempts to obstruct.

*18 USC § 709*

This criminal statute applies restrictions on advertising and names used by non-federal persons or entities.

Significant Aspects:

- Prohibition, except where permitted by law, of the use of several words relating to federal entities without authority.
- Restrictions include the use, except where permitted by the laws of the United States, of the words national, Federal, United States, reserve, or deposit insurance as part of the business or firm name of a person, corporation, partnership, business trust, association, or other business entity engaged in the banking, loan, building and loan, brokerage, factorage, insurance, indemnity, savings or trust business.
- Restrictions also apply to many other words, acronyms, advertisements or representations.

**CONFLICTS OF INTEREST**

There remains a continuing need for regulatory personnel to scrutinize all conflict of interest transactions in the context of OTS's Conflicts of Interest regulation § 563.200. You should, accordingly, comment on and request appropriate

corrective action on any actual or apparent conflict of interest situation that adversely affects the institution, even though a regulation may not specifically address the conflict. You should also comment on and request appropriate corrective action whenever people involved in a conflict situation participate in or exercise an undue influence over the approval of the transactions.

### IMPORTANCE OF INTERNAL CONTROLS

Savings associations facing increased competition often consider implementing new strategies including cutting costs, offering different products, and pursuing other activities that have higher yields. While OTS recognizes that savings associations must adapt to changing business conditions, it is critically important that management maintain strong internal controls.

The following are some examples of unsafe, unsound, and sometimes fraudulent activities that have caused savings associations to suffer significant financial losses due to breakdowns in internal controls:

- Unauthorized and unsupervised overdrafts of customers' checking accounts.
- Unauthorized loans and falsified loan records.
- Employee embezzlements involving check kiting schemes.
- Unauthorized withdrawals from a correspondent account.
- Unreported teller shortages.

Inadequate internal controls also contribute to losses associated with a shift from traditional activities to higher risk commercial and consumer lending. In addition, in face of increasing competition and shrinking margins many associations desire to cut costs, particularly in areas not directly tied to income. Associations must direct expense control to areas that do not compromise critical policies and procedures governing internal controls.

### *Internal Control Regulatory Requirements*

The Federal Deposit Insurance Corporation Improvement Act of 1991 required the banking agencies to establish certain safety and soundness guidelines. Appendix A of 12 CFR Part 570, Interagency Guidelines Establishing Standards for Safety and Soundness, includes a section on operational and managerial standards. Pursuant to the standards, each savings association must have internal controls and an internal audit appropriate to the size of the association and the nature and scope of its activities. Pursuant to FDIC regulation 12 CFR § 363.5, Audit Committees, insured depository institutions with total assets of \$500 million or more must have an audit committee composed of outside directors who are independent of management.

### *Internal Control System*

When determining the effectiveness of an association's internal control system, you must be particularly alert to the following situations:

- Management does not implement effective procedures to correct internal control deficiencies noted in reports prepared by the internal auditors or the independent accountants.
- Management scales back or suspends the internal audit function.
- The internal auditor has dual, operational responsibilities that compromise the internal audit function.
- The internal auditor reports to management instead of directly to the board of directors or an audit committee.
- The association's independent audit firm does not have banking audit experience. A similar problem may exist when a nationally recognized accounting firm assigns auditors to a savings association audit who are not familiar with banking procedures and practices.
- The association discontinues the annual independent accountant's audit.

- The association does not have proper controls in high-risk lending areas (this could be the result of poor policies, frequent exceptions to policy, or understaffing).
- The association engages in new lending activities with inadequate or unqualified staff.
- The association often deviates from board-approved policies without exception documentation.
- The association fails to effectively segregate duties and responsibilities among employees.
- The association fails to provide adequate reports to the board of directors.

#### *Internal Control System Critical Components*

There are a number of common critical components in internal control systems that are applicable to all savings associations. The Committee of Sponsoring Organizations of the Treadway Commission (COSO) issued a report<sup>1</sup> that identified five critical components of a good internal control framework:

- Control environment
- Risk assessment
- Control activities
- Accounting, information, and communication systems
- Self assessment.

COSO defines internal control as a process to achieve the following objectives:

- Effectiveness and efficiency of operations including safeguarding assets.

<sup>1</sup> Savings associations may obtain the COSO “Internal Control – Integrated Framework” (Product code #990009) from the Order Department, American Institute of Certified Public Accountants, Harborside Financial Center, 201 Plaza Three, Jersey City, NJ 07311-3881. Toll-free telephone 1-888-777-7077; FAX 1-800-362-5066.

- Reliability of financial reporting.
- Compliance with applicable regulations.

Generally accepted auditing standards incorporate in the AICPA Statement on Auditing Standards No. 78, Consideration of Internal Control in a Financial Statement Audit, the common critical elements of internal control systems contained in COSO. OTS urges savings association directors and management to review at least the major concepts described in the COSO report or other recognized standards and compare them to their association’s internal control systems. Good internal control processes are only effective if properly understood and strictly followed. The board of directors must establish internal control systems policy and properly monitor implementation of the policy. Management must properly implement internal control systems according to board policy. In addition, internal and external auditors should vigorously check the appropriateness and effectiveness of savings associations’ internal controls. See Thrift Activities Handbook Section 340, Internal Control.

#### **Access to Savings Association Directors, Employees, Agents, and Books and Records**

A number of federal statutes entitle you to prompt and unrestricted access to savings association directors, employees, agents, books, and records. In some instances, association management attempted to delay or limit your access to information with the intent to conceal fraud, derogatory information, or insider abuse. Such obstruction, however, more often occurs due to a lack of understanding by association personnel. In either case, you can usually promptly resolve access problems by reviewing the appropriate statutory requirements with association management. You must recognize obstruction and consider it a red flag indicating potentially serious problems, and take steps to prevent it.

#### *Tools to Prevent Examination Obstruction*

The following statutes and regulations grant you prompt and complete access to savings association directors, employees, agents, and books and records.

- 12 USC § 1464(d)(1)(B)(ii) requires associations to give you prompt and complete access to its officers, directors, employees, and agents, and to all relevant books, records, or documents of any type during an examination.
- 12 USC § 1464(d)(1)(B)(iii) requires associations to give you prompt and full access to all records and staff for regulatory purposes at all other times.
- 12 USC § 1467a(b)(4) provides you with authority to examine savings and loan holding companies.
- 12 USC § 1467a(b)(3), 12 CFR § 563.170(c) requires institutions and their holding companies to maintain complete records of their business and make them available to you wherever they are located.
- 12 USC § 1464(d)(7)(D)(i) and 1831v, and 12 CFR § 563.170(e) provides you with access to the records and staff of service providers unless the service provider is functionally regulated.
- 12 USC § 1464(d)(1)(B)(i), 1467a(b)(4) and 1831v allows you unrestricted access to records of affiliates (including holding company subsidiaries) whose affairs affect insured institutions, unless the affiliate is functionally regulated.

When appropriate, you should remind associations that OTS may use its enforcement tools to obtain management's compliance with these access provisions. These tools include cease and desist orders, removal and prohibition orders, and civil money penalty assessments. In addition, examination obstruction may subject management to criminal prosecution under 18 USC § 1517.

#### *Red Flags of Examination Obstruction*

Recognizing and refusing to tolerate obstruction is critical to preparing an accurate report of examination. It is important that you promptly notify your EIC or field manager of an association's attempt to obstruct your examination. If you try to ignore it, the evasion generally gets worse, as do the problems concealed by the obstruction.

Appendix B of this handbook section consists of a number of examination obstruction questions and answers.

#### Examples of Obstruction

- **Delaying Tactics.** Savings associations sometimes do not provide requested information within a reasonable time. For example, the association may tell you that:
  - The only staff member who knows the location of the records is unavailable right now – and continues to be unavailable.
  - An association employee urgently needs a particular computer with the necessary records for other purposes.
  - The records are off site and there will be a delay in obtaining them.

Your response should be polite but firm; under federal statutes, unreasonable delays are impermissible. 12 USC § 1464(d)(1)(B)(ii).

- **Screening Tactics.** Associations may try to prescreen the documents you need to review requiring that you request documents or staff in advance. The association's intent may be to review or sanitize requested documents before you see them. Screening is impermissible. 12 USC § 1464(d)(1)(B)(ii) and 12 CFR § 563.170(c).
- **Alteration of Records.** Association employees may attempt to alter records before your review to prevent you from discovering significant losses, fraud, or insider abuse. The employees may remove key documents from files, destroy records, or create required records (known as file stuffing). Two associations used these illegal tactics recently and criminal prosecutions followed. If you suspect records alteration, notify your EIC, field manager, or regional counsel. 18 USC §§ 1005 and 1006.
- **Removal of Records.** In several notorious cases, management removed important documents from association offices and hid them off site from examiners. You can only discover

this conduct when you remain alert to the fact that obstruction may be occurring, and persistently follow up on employee comments and cross references to missing documents in other files. Removal of records violates several of the civil and criminal statutes cited above. If you suspect that this has occurred, you should notify your EIC, field manager, or regional counsel of your concerns.

- Withholding Information based on Assertions of Privilege. Associations, their attorneys, or their accountants may attempt to prevent you from accessing documents based on assertions of privilege or confidentiality. Because rulings on privilege claims can turn on specific facts, you should consult with your regional counsel whenever an association raises privilege claims. Generally, associations cannot properly use these assertions to bar you from attending executive board of director sessions or reviewing minutes of its meetings, including draft minutes. These assertions also may not prevent you from reviewing records of the association's operations, such as documents relating to loans that may be the subject of ongoing litigation between the association and third parties. The documents may be in the offices of the association's litigation counsel. You are entitled to review such documents wherever they are. 12 USC § 1464(d)(1)(B)(ii) and 12 CFR § 563.170(c).
- Attacks on your credibility. Associations sometimes attempt to neutralize negative examination findings by attacking the credibility of individual examiners. Your best defense to this tactic is prevention. Use good judgment, comply with OTS policy, and make it a practice to have another examiner present during important or potentially hostile meetings with association employees.

### *Stopping Examination Obstruction*

You must promptly stop examination obstruction. We have found repeatedly that obstruction is a red flag for a variety of more serious problems. You cannot always identify and address these serious problems, however, until the association stops the obstruction.

Whenever you meet any of the types of obstruction noted above, you should immediately discuss the problem with senior management and seek a quick resolution of what could be a simple misunderstanding. You should explain to senior management the statutory basis for gaining access to all records. If you do not obtain access or if the association does not resolve the situation, you should inform your EIC or field manager. They will work with you, the ARD, and the regional counsel to address the problem. Any continued obstruction will involve other attorneys of the Chief Counsel's office as appropriate.

The following are several tools available for a prompt and complete remedy. The right response depends on the type and seriousness of the obstruction you meet and the Chief Counsel's suggestions as to the best way to proceed.

- Reviewing with the association's board of directors the applicable statutes that compel prompt and complete access of records and politely insisting on compliance. This course might involve arranging a meeting of the board with the field manager, ARD, RD, and/or regional counsel.
- Delivering a supervisory letter instructing the association to promptly comply with examiner requests for information or face formal enforcement action.
- Filing in the local United States District Court for an Order requiring that the association provide the requested information immediately. 12 USC § 1464(d)(1)(B)(iv).
- Issuing a temporary cease and desist order requiring that inaccurate or incomplete records be restored immediately to a complete and accurate state. 12 USC § 1818(c)(3)(A).
- In extreme cases, or where OTS has exhausted other remedies, appointing a conservator or receiver based on the association's concealment of records and obstruction of the examination. 12 USC § 1821(c)(5)(E).
- Where appropriate, or in conjunction with the remedies listed above, filing a suspicious activity report to the Department of Justice. Such

filings may be for obstructing an examination, making false entries to defraud the association or deceive regulators, or concealing assets from an association's conservator, receiver, or liquidating agent. These illegal actions are subject to 18 USC §§ 1005, 1006, 1517, and 1032.

## DETECTING FRAUD AND INSIDER ABUSE

Because perpetrators do not always carefully plan and discreetly carry out fraud, if you are alert to certain warning signs you may be able to detect it. It is essential, however, that you are knowledgeable of the warning signs and are alert to circumstances where fraud may exist, either by insiders or outsiders. Once you suspect fraud you should thoroughly investigate the circumstances surrounding a suspected activity.

The primary problem that you face in detecting fraud is the limited time and resources available to conduct an examination. Certainly, if you are aware of it and it is material, you should devote the time necessary to determine the appropriate action. However, when you only mildly suspect it, such as with a hunch, it is difficult to justify expanding the examination scope. To assist you in assessing an institution's risk of fraud, this section attaches a Fraud Risk Evaluation Form (Appendix A) and includes the following subsection: Red Flags of Fraud and Insider Abuse. When you consider the risk of fraud to be high you may expand your examination scope in the appropriate areas.

You must be alert to situations that may be conducive to fraud and insider abuse. If a situation exists where an officer or employee is able to control a sizable transaction from beginning to completion, you should notify the board of directors. The board should immediately correct the situation. You should not think of internal control weaknesses, poor loan documentation, improper internal audit reporting relationships, etc., only as technical violations, but also as potential opportunities for large frauds. Such weaknesses should receive appropriate treatment in the report of examination and should result in effective supervisory action.

## Red Flags of Fraud and Insider Abuse

Experience has taught OTS staff that certain common elements are often present in cases of fraud and insider abuse. The following listings are warning signs of possible fraud and insider abuse:

### *General*

- Dominant officer with control over the institution or a critical operational area.
- Internal audit restrictions or unusual reporting relationships (the internal auditor not reporting directly to the board or audit committee).
- Lack of written or inadequately written policies.
- Lack of adherence to written policies.
- Unusual or lavish fixed assets (for example, aircraft or art work).
- Management attempts to unduly influence examination or audit findings.
- Material internal control deficiencies.
- Frequent changes of auditors.
- High internal audit department turnover.
- Alteration of records.
- Withholding of records.
- Delaying tactics in providing documents or records.
- Large transactions with small out-of-town banks.
- Ownership or control vested in a small group.
- Difficulty in determining who is in control.
- Overly complex organizational structure, managerial lines of authority, or contractual arrangements without apparent business purpose.
- Inaccurate, inadequate, or incomplete board reports.

- Discontinuation of key internal reports.
- No vacation taken by employee or officer.

#### *Management Level*

- Routinely contests exam findings by filing appeals, complaining to congresspersons, or directly or indirectly contacting agency officials.
- Routinely accuses you of being unfair, acting overzealously, or making errors.
- Fails to provide actual documents – only provides copies.
- Hires ex-agency officials when faced with enforcement actions.
- High turnover of officials.
- Motivation to engage in fraudulent financial reporting – significant portion of management's compensation is contingent upon aggressive targeted financial achievements, stock prices, or earnings.
- Use of aggressive accounting practices or tax-motivated behavior.
- High degree of competition in the community accompanied by declining margins of profit or customer demand.

#### *Exam Level*

- Inability to generate cash flows from operations.
- Assets, liabilities, revenues, or expenses based on significant estimates that involve subjective judgments or uncertainties.
- Unusually rapid growth in comparison to other institutions.
- High vulnerability to interest rate changes.
- Inadequate monitoring of significant controls.
- Lack of timely and appropriate documentation for transactions.

- Significant unexplained items on reconciliations.
- Falsified bank documents.
- Weak loan administration and out of balance loan accounts.
- Repeated regulatory violations including significant Thrift Financial Report violations year after year.
- Significant related party transactions not in the ordinary course of business.
- Significant bank accounts in tax haven jurisdictions.
- Weak internal controls and risk management such as, inadequate overall internal control design, inadequate procedures to assess and apply accounting principles, absence of controls for certain transaction activities, evidence that a system fails to provide accurate output, or evidence of design flaws, among others.
- Known criminal referrals.

#### *Red Flags of Lending Abuse*

- Poorly documented loans and appraisals.
- Lack of an acceptable past due or watch list.
- Lack of, or unsigned, borrower financial statements.
- Questionable loan disbursement transactions.
- Loan funds disbursed to a third party.
- Corporate loans with no endorsements or guarantors.
- Large pay-down of problem loans prior to an audit or examination.
- Large overdrafts.
- Refinancing of debt in a different department.
- Loans secured by flipped collateral.
- Nominee loans.

- Loans of unusual size or with unusual interest rates or terms.
- Loans with unusual, questionable, or no collateral.
- Loan review restrictions.
- Questionable, out-of-territory loans.
- Evergreen loans (loans continuously extended or modified).
- A considerable number or amount of insider loans.
- Construction draws with no or inadequate inspection reports.
- Construction inspections conducted by unauthorized or inappropriate persons.
- Market study on proposed project not on file.
- Loan approvals granted to uncreditworthy employees.
- Lack of independence between the approval and disbursement functions.
- Frequent sales of collateral (land flips) indicating related party transactions.
- Predatory lending practices.

#### *Red Flags of Appraisal Abuse*

- No appraisal or property evaluation in file.
- One appraisal in file, but appraisers billed institution for more than one.
- Unusual appraisal fees (high or low).
- No history of property or prior sales records.
- Market data located away from subject property.
- Unsupported or unrealistic assumptions relating to capitalization rates, zoning change, utility availability, absorption, or rent level.
- Valued for highest and best use, which is different from current use.

- Appraisal method using retail value of one unit in condo complex multiplied by the number of units equals collateral value.
- Use of superlatives in appraisals.
- Made for borrower.
- Appraisals performed or dated after loan.
- Close relationship between appraiser, lender and/or borrower.

#### *Red Flags of Check Fraud*

Check fraud is one of the largest challenges facing financial institutions. Forty-three percent of the Suspicious Activity Reports between April 1996 and September 1997 related to check fraud, counterfeit checks, and check kiting. A 1996 study by the Federal Reserve estimated financial institutions suffered losses of \$615.4 million involving 529.1 thousand cases in 1995. Savings associations accounted for \$67.5 million of the losses and 65.4 thousand of the cases. The Check Fraud Working Group, a subgroup of the Interagency Bank Fraud Working Group prepared a booklet in February 1999, *Check Fraud: A Guide to Avoiding Losses*. In the booklet, the Check Fraud Working Group identifies and discusses in detail the following check fraud schemes:

- Altered checks.
- Counterfeit checks.
- Forged checks.
- Checks drawn on closed accounts.
- Identity assumption.
- Fraud by bank insiders.
- Telemarketing fraud.
- Check fraud by gangs.

Savings associations can take the following preventive measures to reduce check fraud:

- Establish and maintain strong organizational controls.

- Ensure that effective internal controls are actively in place to prevent check fraud by insiders.
- Provide effective check fraud prevention programs through education and training for front-line personnel, managers, and operations personnel.
- Furnish a special section in teller manuals about check fraud that includes a detailed list of common warning signs.
- Establish guidelines for check cashing.
- Provide specialized training for new account representatives and establish guidelines for opening new accounts.

### Suspicious Activity Reports (SAR)

#### *Filing Requirements*

Paragraph (d)(3) of OTS regulation § 563.180, Suspicious Activity Reports and Other Reports and Statements, requires savings associations<sup>2</sup> and their service corporations to report suspicious activities. They are to file SARs with the appropriate federal law enforcement agencies and the Department of Treasury by sending them to the Financial Crimes Enforcement Network (FinCEN) of the Department of the Treasury. The regulation requires a filing after the discovery of a known or suspected federal criminal violation that involves any of the following persons or transaction:

- Any officer, director, employee, agent, or other institution-affiliated person.
- Transaction(s) aggregating \$5,000 or more in funds or other assets, when there is a factual basis for identifying a suspect.
- Transaction(s) aggregating \$25,000 or more even though a suspect is unidentified.

- Transaction(s) aggregating \$5,000 or more that involve potential money laundering, or violations of the Bank Secrecy Act.

Section 563.180(d)(5) requires a savings association or service corporation to file an SAR no later than 30 calendar days after the date of initial detection. If there is no identified suspect on the date of detection, however, an association or service corporation may delay a filing up to an additional 30 days to identify a suspect. If a violation requires immediate attention, such as when it is ongoing, an association or service corporation must by telephone immediately notify an appropriate law enforcement authority and OTS. They must also file a timely SAR.

Section 563.180(d) also does the following:

- Encourages savings associations and their service corporations to file a copy of the SAR with state and local law enforcement agencies where appropriate.
- Provides that institutions need not file SARs for robberies and burglaries that they report to appropriate law enforcement authorities.
- Requires that institutions retain copies of SARs, and supporting documentation, for five years from the date they file them.
- Advises that failure to file a SAR in accordance with this section may subject the savings association, or service corporation, its officers, directors, employees, agents, or other institution-affiliated parties to supervisory action.
- Advises that the law shields financial institutions and their employees from civil liability when they report suspicious activities.

Financial Crimes Enforcement Network (FinCEN) inputs the information reported in SARs into a central database, which is accessible only to federal and state financial institution regulators and law enforcement agencies. The usefulness of the database depends on the completeness and accuracy of the reported information. Accordingly, you should ensure that associations are accurately and fully completing SARs.

<sup>2</sup> Section 563.180(d) treats a savings association and its operating subsidiaries as one unit.

*Examiner and Regional Reporting Requirements*

Savings associations and their service corporations have the primary responsibility to file SARs. You must, however, complete and file a SAR when the required filing institution has either failed to do so or has not properly completed or filed it. When necessary, you should seek filing guidance from your supervisors or regional legal or enforcement personnel, including guidance concerning Right to Financial Privacy Act issues.

USA PATRIOT Act of 2001

In October 2001, President George W. Bush signed anti-terrorism legislation that gives law enforcement authorities an array of new powers to use in the nation's campaign against terrorism. The new law, called The USA PATRIOT Act of 2001, contains sweeping new surveillance powers for law enforcement agencies, but some of these new powers will expire in four years.

The new law's money laundering provisions will accomplish the following:

- Bolster law enforcement's ability to find and destroy the financing of terrorist organizations, whether in banks or in underground "hawala" systems.
- Establish a government-industry partnership to stop terrorist funding in real-time.
- Track any terrorist money kept in secret offshore havens and increase foreign cooperation with U.S. efforts.
- Require banks to monitor certain accounts held by non-U.S. citizens.
- Give the government the power to require foreign banks to reveal customers transaction information under certain conditions.
- Make it a crime to smuggle currency in excess of \$10,000 and to knowingly falsify a customer's identity when making a transaction or opening an account with a financial institution.
- Create a highly secure Web site within the FinCEN, giving financial institutions the

means to notify authorities quickly when a suspicious transaction takes place. Further measures would update counterfeiting laws to address technological advances used in the counterfeiting of U.S. currency.

You should be aware of the new law when examining institutions for fraud, internal control (especially wire transfers), or when reviewing SARs. If you have concerns or questions see Compliance Handbook Section 400, Bank Secrecy Act.

*Confidential Individual Information System*

In addition to contributing to and using the FinCEN database, OTS utilizes its own automated system, the Confidential Individual Information System (CIIS), to record information on individuals. The recorded information concerns the following types of events:

- Enforcement actions.
- Referrals to a professional organization for disciplinary reasons.
- Liability suits, investigations as to unusual transactions.
- Certain application activity (such as acquisition or change of control, and procurement of a charter).

Other federal agencies and state authorities may access CIIS information, with the approval of the OTS national administrator or a region's CIIS administrator.

**Regional Fraud and Insider Abuse Program**

Each region must maintain a written fraud and insider abuse program, and should designate a person to be a Criminal Referral Coordinator to administer the program. The coordinator should act as a contact person or liaison to develop and maintain both internal and external fraud and insider abuse operations and communications.

While the extent of a regional program will be dependent on the incidences of fraud and insider abuse within the region, at a minimum each region

(operations or legal) is responsible to do the following:

- Monitor and review regional SARs entered into the FinCEN system, particularly those that involve institution-affiliated persons or significant losses. As appropriate, communicate to the staff the reported suspicious activities.
- Ensure that institutions (and OTS staff, when necessary) complete and file accurate and timely SARs, including the providing of assistance and advice in such filings.
- Exchange information with and provide assistance to the FBI, Department of Justice, and other agencies, and ensure that appropriate persons follow up promptly on important SARs.
- Participate with local interagency bank fraud working groups that meet within the region.
- Ensure compliance with the Right to Financial Privacy Act as it relates to providing information and documentation to law enforcement and other government agencies.
- Work with OTS regional counsel office and OTS Enforcement Division in matters that relate to investigations for criminal prosecution or civil enforcement actions.
- Be able to provide background information reports on regional fraud and insider abuse cases, including prosecutions in progress and the outcome of important institution-affiliated person cases.

Regional directors are responsible to ensure that regional staff receives adequate training to accomplish the examination objectives and procedures set forth in this handbook section.

**REFERENCES**

**United States Code (12 USC)**

§ 3401 Right to Financial Privacy Act of 1978

**United States Code (18 USC)**

§ 215 Kickbacks and Bribes  
 § 657 Theft, Embezzlement, or Willful Misapplications of Funds  
 § 709 False Advertising or Misuse of Names to Indicate Federal Agency  
 § 1001 General False Statements  
 § 1006 False Entries or Reports  
 § 1014 False Statements  
 § 1344 Bank Fraud  
 § 1517 Obstructing Examination of Financial Institution

**Code of Federal Regulations (12 CFR)**

Part 215 Regulation O, Loans to Executive Officers, Directors and Principal Shareholders of Member Banks  
 § 561.14 Controlling Person  
 § 561.18 Director  
 § 561.24 Immediate Family  
 § 561.35 Officer  
 § 563.33 Directors, Officers, and Employees  
 § 563.41 Loans and other Transactions with Affiliates and Subsidiaries  
 § 563.43 Loans by Savings Associations to their Executive Officers, Directors and Principal Shareholders  
 § 563.130 Prohibition on Loan Procurement Fees  
 § 563.170(a) Examinations and Audits  
 § 563.180(d) Suspicious Activity Reports  
 § 563.200 Conflicts of Interest

**Office of Thrift Supervision Bulletins**

RB 20 Proper Investigation of Applicants and Increased Communication Between OTS and other Financial Institution Regulatory Agencies

**Interagency Guidance and Forms**

*Check Fraud: A Guide to Avoiding Losses* (February 1999)  
Suspicious Activity Report Form

**American Institute of Certified Public Accountants**

Statement on Auditing Standards, No. 82, Consideration of Fraud in a Financial Statement Audit (February 1997) (AU 316)

The Auditor's Responsibility to Consider Fraud and Error in an Audit of Financial Statements – International Standards on Auditing (ISA No. 8240, Appendix 3)

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# Fraud and Insider Abuse Program

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## Examination Objectives

To recognize warning signs of fraud and insider abuse and to take appropriate measures to follow -up on possible instances of such activity.

To determine if the institution's internal control system is applicable to officers and directors as well as other employees.

To determine the institution's risk exposure associated with each significant instance of fraud or abuse.

To identify weaknesses in the institution's internal controls through detection and analysis of any patterns of fraud or abuse.

To properly report suspected criminal misconduct uncovered during the examination to appropriate law enforcement authorities.

To determine if the institution is reporting suspected criminal acts as § 563.180(d) requires.

To determine if the institution is properly completing SARs.

To determine if the institution has an adequate program of follow -up with law enforcement authorities regarding SARs it has filed.

## Examination Procedures

Wkp.Ref.

### Level I

1. Review the adequacy of the institution's policies and procedures with respect to conflicts of interest. Determine whether the institution requires directors, officers, and employees to sign a Code of Ethics statement.

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2. Discuss the issue of fraud and insider abuse with the internal auditors and, if necessary, the external auditors to assess whether they have any concerns. Determine if they have made any reports on suspected fraud to the board or others.

\_\_\_\_\_

**Exam Date:** \_\_\_\_\_  
**Prepared By:** \_\_\_\_\_  
**Reviewed By:** \_\_\_\_\_  
**Docket #:** \_\_\_\_\_

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## Fraud and Insider Abuse Program

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3. Review the results of the questionnaires to determine if adequate controls are in place to mitigate fraud. Assess the adequacy of controls that would prevent officers and directors from perpetrating fraud.

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4. Review the results of the various examination programs to determine if problems exist that may be symptomatic of fraud. In cases where fraud may be likely, investigate such problems to determine the cause of the problem (for example, poor staff training, errors, poor judgment).

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5. Review the institution's policies and procedures on reporting suspected criminal activity to law enforcement agencies and its board of directors for compliance with § 563.180(d).

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6. Review the institution's SARs, including those that OTS has filed, to determine if any patterns of criminality exist.

- Identify multiple SARs on individual suspects, location of violation (for example, loan center, savings branch), or type of violation.
- Analyze any apparent pattern of fraud or abuse to determine if enhanced internal controls would deter any future abuse.

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7. Review all significant SARs, other reports, and patterns to determine if the institution has properly identified and addressed all related financial, operational, and legal risks; for example, valuation allowances established, internal controls strengthened, etc.

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8. Assess the institution's risk of fraud by reviewing the red flag warning signals and conditions in the institution. You should do this in conjunction with performing other examination programs and procedures, completing the Fraud Risk Evaluation Form

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(Appendix A) and, if necessary, by other appropriate means. You should notify your supervisor when you have rated any individual fraud risk score 4 or 5, and you believe that there is significant potential for insider abuse or fraud.

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9. Consult with other examination crewmembers concerning the need to expand examination scope within certain areas based on an indication of a higher than acceptable risk of fraud within certain areas of the institution.
- 

10. Notify the regional legal staff if any person attempts to obstruct the examination, in possible violation of criminal statute 18 USC 1517.
- 

11. Obtain a list of deposit and loan accounts of directors, officers, and other affiliated persons. Test check these accounts for preferential rates and, for deposit accounts, appropriate board approval of any overdrafts.
- 

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

### Level II

13. Choose a sample of SARs that the institution has filed. Review each sample SAR to determine its accuracy, completeness, timeliness, and propriety.
- 

14. Complete the following procedures if you have identified any instance of suspected criminal misconduct:

- Immediately notify the EIC and field manager.

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- Consult with appropriate regional office staff or counsel to determine a course of action, including preparation of a SAR.
- Obtain input from regional office legal staff on Right to Financial Privacy Act issues during the preparation of every SAR.

The following elements are particularly important in preparing a successful SAR:

- A chronology of events.
- A summary of suspected violations.
- A list of key participants or affiliates.
- A list of potential helpful witnesses.
- Any supporting documentation.

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15. Review the institution's independent audit reports to determine if specific procedures exist to detect fraud, as the American Institute of Certified Public Accountants (AICPA) rules require.

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16. Review the institution's program of follow-up with law enforcement authorities to determine if timely and adequate follow-up is being conducted on significant SARs.

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17. For institutions with composite ratings of 4 or 5, determine if, in possible violation of 12 USC § 1828(k), the institution has done either of the following:

- Made, or has entered into an agreement to make, any golden parachute or indemnification payments.
- Prepaid any salary, or any liability or legal expense, in anticipation of insolvency and with a view towards preventing the proper use or purpose of assets.

Notify the regional legal staff if the institution has done either one.

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## Fraud and Insider Abuse Program

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18. Ensure that your review meets the *Objectives* of this Handbook Section. State your findings and conclusions, and appropriate recommendations for any necessary corrective measures, on the appropriate work papers and report pages.
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### Fraud Risk Evaluation Form

Institution	Docket No.
Prepared by	Date
Reviewed by	Date

**Instructions**

This form documents your overall assessment of the level of fraud risk within the institution. Rate each risk factor from 1 to 5 with 1 indicating the lowest level of concern and 5 indicating the highest level of concern.

An individual factor rated 4 or 5 indicates that the institution is vulnerable to fraud. If fraud conditions or circumstances other than the factors listed below indicate a higher risk than normal, describe them on a separate sheet and attach it to this form. After you consider all relevant factors you should make an overall assessment of fraud risk and indicate its effect, if any, on the scope of the examination.

General Factors	Indicator		Comment or Description <sup>1</sup>	Risk Factor
	Lower	Higher		
Top management operating style	Effective board oversight	Domination of decisions by a single person		
Financial reporting	Conservative; accurate	Liberal; questionable; inaccurate		
Management turnover, including senior accounting personnel	Nominal	High		
Emphasis on meeting earnings projections	Little	Very high		
Profitability relative to industry	Adequate and consistent	Inadequate or inconsistent		
Growth within last three years	Stable	Rapid		
Financial condition	Healthy	Distressed		
Oversight of branches and subsidiaries	Centralized; strong oversight	Decentralized; weak oversight		
Indicators of going-concern problems	No serious indications of failure	Failure a distinct possibility		
Disagreements with auditors or examiners	None	Many		
Difficult-to-audit transactions or balances	Few	Many		
Misstatements detected in prior audits or examinations	Few and immaterial	Significant or material misstatements		
Examiner relationship with management	Cordial and constructive	Confrontations		
Response to supervision	Very responsive	Unresponsive		
Disclosures of director's and officer's outside interests	Fully disclosed	Not disclosed		
Background checks made on new directors, officers, and employees	Checked and verified	Not checked		
Internal auditor restrictions	None; auditor performs full scope reviews	Auditor works with restrictions, or on limited projects		
Internal auditor reporting	Reports to board or audit committee	Reports to management		

General Factors	Indicator		Comment or Description	Risk Factor
	Lower	Higher		
Internal audit department turnover	None or minimal	High		
Policies and procedures	Well developed for all areas of operations	None or poorly developed		
	Applied equally to employees and management	Not followed or circumvented by management or key employees		
Unusual or lavish fixed assets	None	Boats, aircraft, artwork, condos, etc.		
Internal controls	Sound system of controls	Material control deficiencies; or controls do not apply to top management		
Response of management in providing documents to examiners	Documents provided quickly	Long delays in getting documents		
Transactions with other financial institutions	Appropriate for business activities	Large transactions with small out of state banks		
Board reports	Accurate and complete	Inaccurate; inadequate; incomplete		
Organizational structure	Simple	Overly-complex		
Aggressive accounting practices/tax-motivated behavior	Few	Many		
Regulatory violations	Few	Many		
Criminal Referrals	Few	Many		
Falsified bank records	None	Many		

**Lending Factors**

Loan documentation	Well-documented loans and credit quality	Poorly documented loans		
Loan performance tracking	Close review of problem credits by management and the board	No (or erroneous) past due or watch list reports		
Borrower financial statements	Borrowers' financial position well documented	No (or unsigned) financial statements		
Loan disbursements	Well documented; approved by an independent officer	Questionable; approved by loan officer		
Corporate loans	Proper endorsements and guarantees	No (or inadequate) endorsements and guarantees		
Resolution of problem loans	Well documented and reasonable	Questionable pay-downs prior to examination or audit		
Overdrafts	Properly approved; reasonable amounts	Large questionable overdrafts		
Refinancing	Well documented; properly approved	Poorly documented; refinanced by a different department		
Nominee loans	No nominee loans	Nominee loans made		
Loan terms	Loan size, rates and maturities appropriate	Loans of unusual size, rates, and maturities		
Evergreen/non-amortizing loans	No evergreen/nonamortizing loans	Several large evergreen/nonamortizing loans		
Real property sales history	Well-documented history of sales and ownership	No history of sales or ownership		
Out of territory loans	No out of territory loans	Many out of territory loans		
Brokered loans	No brokered loans	Loans from brokers		
Adequacy of collateral	Loans adequately collateralized when appropriate	Large loans with unusual, questionable, or no collateral		
Collateral sales history	Collateral sales history is reasonable	Frequent sales; flipped collateral		
Loans to directors, officers, and employees	Properly underwritten and reported to the board of directors	Loans to uncreditworthy directors, officers, or employees		

Lending Factors	Indicator		Comment or Description	Risk Factor
	Lower	Higher		
Lending authority	Large approval limits are vested in the board or its committee	Large approval limits given to individuals or to inexperienced or inappropriate employees		
Third-party disbursements	Disbursements made to borrowers	Disbursements made to third parties		
Construction disbursements	Property inspected by independent institution officer prior to disbursement	No or poorly documented inspections; no rotation of inspectors		
Asset performance	Very low percentage of delinquent/nonperforming/classified assets	High percentage of delinquent/nonperforming/classified assets		
Independent loan review function	Effective; independent loan review function	No (or ineffective) loan review		
Speculative, high-risk lending activities	Institution has conservative lending practices	Institution engages in high-risk lending activities		
Predatory lending practices	None	Institution engages in predatory lending practices		

**Deposit Factors**

Concentrations of deposits	No concentrations of deposits	High concentration of deposits by individuals, firms, or public entities		
Brokered deposits	No brokered deposits	High level of brokered deposits		
Training for all personnel on effective check fraud prevention	Comprehensive training program for all personnel on check fraud prevention	No training on check fraud prevention		
Check cashing guidelines	Comprehensive check cashing guidelines	No check cashing guidelines		
New accounts	Comprehensive guidelines for opening new accounts	No guidelines for opening new accounts		
Signature cards	Signature cards secure, permanent, and updated	No control over signature cards		
Account changes	Account changes require identification and written requests	No controls over account changes		
Dormant accounts	Dormant account activity requires extra approvals or mandatory holds	No controls on dormant accounts		

<sup>1</sup> Required if factor is rated 4 or 5.

**We modified the examination scope in the following areas in consideration of the risk factors identified above:**

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## Questions and Answers - Examination Obstruction

**Question: What should I do if an association tells me that the documents that I need are inaccessible because they are in remote storage off site?**

*Answer:* Advise the association that it must give you the documents' specific location and immediate and complete access to wherever the association stored the documents. 12 USC §1464(d)(1)(B)(ii) and 12 CFR § 563.170(c).

**Question: What should I do if an association refuses to provide me with access to any records until the OTS Director requests access, since 12 USC § 1464(d)(1)(B)(ii) uses the phrase, "upon request by the Director"?**

*Answer:* As an examiner appointed by the Director, you have the delegated authority to act on the Director's behalf in the examination of federally insured thrifts. 12 USC §§ 1462a(h)(4), 1463(a)(1) and 1464(a). Your request for records meets these statutory requirements; the association must provide you with prompt and complete access.

**Question: What should I do if an association asserts privilege and refuses to provide me with access to documents about a large, nonperforming commercial property loan because the borrower has sued the institution?**

*Answer:* Consult with your EIC, field manager, or regional counsel, as this is not a matter protected from regulatory review by an attorney-client privilege. The association must immediately instruct its counsel to provide you with prompt and complete access to all documents and records concerning the status of this loan. 12 USC § 1464(d)(1)(B)(ii) and 12 CFR § 563.170(c).

**Question: What should I do if an association tells me it has no underwriting records on a large, real property loan?**

*Answer:* Advise the association that OTS will cite it for violation of 12 CFR §§ 560.100, 560.101, and/or 563.170(c), and proceed with a more thorough review of this asset. Remain alert to the possibility that the documents exist but are being withheld. Staff comments or documents in other files might indicate the missing association records were created. Like withholding documents, failure to create and maintain critical documents is a red flag indicating possible fraud, insider abuse, or financial manipulation. Keep your EIC or field manager apprised of your findings.

**Question: What should I do if I request documents during a focused, special limited examination and the association denies me access because it is not a regularly scheduled, full -scope examination?**

*Answer:* Federal law requires associations to provide examiners, including safety and soundness, compliance, trust, and information systems examiners, prompt and complete access to all association records and employees during any type of examination. The statute does not limit the authority to examinations of a specific length, scope, or type. 12 USC § 1464(d)(1)(B)(ii).

**Question: What should I do if I request accounting records on a particular transaction and the association's auditor denies me access based on an assertion of accountant-client privilege?**

*Answer:* There is no such generally recognized privilege. The auditor must provide you with prompt and complete access to the documents. Notify your regional counsel and regional accountant because this may be an ethical or contractual breach by the auditor.

**Question: What should I do if an association denies my request outside an examination for access to the documents necessary to perform a status update on a large, troubled loan?**

*Answer:* You are working to determine the condition of the association in the course of supervision. The association must give you prompt and complete access to all relevant documents and records of any type. 12 USC § 1464(d)(1)(B)(iii).

**Question: What should I do if an association tells me that I may review copies of loan files maintained by computer, but may not review originals because the originals are stored off site in a remote facility for safekeeping and cannot retrieve the originals without considerable expense.**

*Answer:* This is an impermissible screening tactic. As yet, you have no assurances that the copies are exactly the same as the originals or that the originals have all the required disclosures and signatures. You have no assurances that the originals ever existed, or still exist. Additionally, the association's computer may be tracking which documents you are retrieving, permitting the association to review and "correct" any problems with the originals before you see them. The association must provide you with prompt and complete access to all relevant documents of any type, especially originals, wherever those documents may be. 12 USC § 1464(d)(1)(B)(ii) and 12 CFR § 563.170(c).

**Question: What should I do if an association's board of directors refuses to allow me to observe their meetings, citing reasons such as highly confidential merger discussions, personnel issues, or the like?**

*Answer:* 12 USC § 1464(d)(1)(B)(ii) and 12 CFR § 563.170(c) obligate the association to allow you to attend the meetings. Additionally, you may remind the directors that 12 CFR § 510.5 prohibits you, as an examiner, from disclosing or permitting the disclosure of proprietary or confidential association information obtained through OTS examination and supervision functions.

**Question: What should I do if an association designates a particular employee to assist the examination team to find and locate documents, but that employee is frequently unavailable to assist?**

*Answer:* It may be appropriate for the association to designate an individual to assist the examination team, as long as the arrangement provides you with "prompt and complete" access to records and staff. You should insist upon access to information within a reasonable time. In some circumstances, a "reasonable" time may require immediate access to information. In all cases, because of examination schedules, the association must arrange to comply quickly with your information requests.

**Question: What should I do if an association requires that outside counsel review requested documents for privilege before producing them for my review, or that an attorney be present when I wish to interview an employee?**

*Answer:* In both cases, alert your EIC, field manager or regional counsel. In the first case, insist that counsel's review be conducted quickly and without unreasonably delaying your access to the documents. Insist upon a copy to the original documents and a written list of any requested documents withheld based on a claim of privilege. In the second case, requiring association counsel to be present is an impermissible restriction on your access to information. You should inform management that you would not agree to any such restrictive condition on your right to interview and obtain information from any officer, employee, or agent of the association.

**Question: What do I do if the thrift holding company is an insurance company regulated by a state Insurance Commissioner?**

*Answer:* Continue with your holding company exam as you normally would. (You may use information from, or provided to the state Insurance Commissioner. Regional offices should request this information in advance.) The Gramm-Leach-Bliley Act (GLBA) does not apply to holding companies or insured depository institutions themselves. Therefore, you may perform a full examination of the holding company. 12 USC §§ 1831v(c) and 1467a(b)(4).

**Question: What do I do if I discover extensive business records of a functionally regulated affiliate at the holding company, along with other records that I have access to?**

*Answer:* You may review any records maintained on holding company premises. Generally, the GLBA limits the circumstances under which you may go on the premises of a functionally regulated entity. The GLB also limits your ability to order documents or talk to the staff of a functionally regulated entity. The GLB does not prevent you from reviewing records maintained on holding company or thrift premises. 12 USC § 1831v(a).

**Question: What do I do if I determine, in the course of an examination, that an insurance subsidiary of a thrift holding company may pose a material risk to the safety and soundness of the association? The functionally regulated affiliate provides low premium, large limit coverage for high risk items (concentrations of hurricane coverage along the Southeast Atlantic) and places its portfolio in high risk investments (junk bonds)?**

*Answer:* You should have already reviewed the publicly available records, externally audited financial statements, information available at the holding company's premises, and any available state insurance commissioner's or regulator's examinations and other reports about the functionally regulated affiliate. You or your supervisor should have discussed your concerns with the commissioner's or regulator's office. Highlight the bases for your concerns in the documents available and discuss the information with your supervisor, regional counsel, and (possibly) the regional director. Together you will determine whether these facts warrant an on-site OTS examination of the functionally regulated affiliate. You should document your work paper files to indicate which of the GLBA criteria you base the justification for your examination. If there is the potential for enforcement action, such as the issuance of a subpoena, you should include regional enforcement counsel in your discussions.

**Question: What should I do if the association engages in transactions with an affiliate that is functionally regulated and all of the TWA records are on the functionally regulated affiliate's premises?**

*Answer:* We enforce the rules concerning the association's transactions with affiliates. Therefore, the association must provide you with "prompt and complete" access to all relevant documents and staff concerning any transaction involving the association wherever they may be, even if located on the premises of a functionally regulated affiliate. You may require an association to obtain and keep records necessary for it to oversee the transactions. 12 USC § 1464(d)(1)(B)(ii) and 12 CFR § 570(c). Your review of the association's TWA materials at their storage site does not constitute the examination of a functionally regulated affiliate under the GLBA. An association or a thrift holding company cannot shield its documents or transactions from your review by storing them at the offices of a functionally regulated affiliate.

**Question: What should I do if I need to interview a dual employee, a person who is employed both by the association and a functionally regulated affiliate?**

*Answer:* You may interview the employee concerning matters within the scope of his or her duties and responsibilities on behalf of the association.