# Module: Management
# Section: Internal Controls
# EM-525

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## Introduction

Determining the overall adequacy of internal controls is a key factor in assessing management of Farm Credit System (System) institutions. Internal controls are the processes established by the board of directors and management to provide reasonable assurance that specific objectives will be achieved and material deficiencies will be prevented or detected on a timely basis. The concept of reasonable assurance recognizes that the cost of a system of internal controls should not exceed the expected benefits. The evaluation of costs and benefits requires estimates and judgments made by management.

A strong internal control system provides the framework for the accomplishment of management objectives, safeguarding of assets, accurate financial reporting, and compliance with laws and regulations. Effective internal controls serve as checks and balances against undesired actions and, as such, provide reasonable assurance that institutions operate in a safe and sound manner. The lack of internal controls puts institutions at risk of mismanagement, waste, fraud, and abuse.

A prerequisite for effective internal controls is a strong internal control environment. The internal control environment represents the collective effect of various factors that establish, enhance, or mitigate the effectiveness of specific management processes. The control environment reflects the overall attitude, awareness, and actions of management.

As discussed in previous sections of the Management module, business planning and policies and procedures help define the institution's objectives, the strategies employed to achieve them, and the operating practices of the institution. Such direction enhances the board of directors' control over and accountability for operations, programs, and resources. This section focuses on the overall internal control environment and the internal control systems established to prevent and detect instances where specific policies and operating procedures are not being followed, or material operational deficiencies exist. For the purposes of this section, these internal control systems are the audit and review program and the management information system.

Examining internal controls for the institution's operational areas and management processes provides the examiner a basis for determining management effectiveness in conducting the affairs of the institution. The adequacy of internal controls is also a consideration in the planning and conducting of examination activities.

## Examination Objective

Determine the overall adequacy of the internal control environment and internal control systems.

## Internal Control Environment

Assessing an institution's overall internal control environment should be the examiner's first step in evaluating the adequacy of internal controls. Examiners should consider the following factors in making this assessment:

### Management Philosophy and Operating Style

Management philosophy and operating style can significantly affect the internal control environment of an institution. Management philosophy and operating style encompass a broad range of characteristics

applicable to both the board and executive management. Such characteristics may include the approach to taking and monitoring business risks; attitudes and actions toward financial reporting; use of policies and procedures; and emphasis on planning and meeting budget, profit, and other financial and operating goals. These characteristics have a significant influence on the control environment, particularly when the board of directors or management is dominated by one or a few individuals.

Organizational Structure

An institution's organizational structure provides the overall framework for the internal control needed to ensure effective planning, directing, and controlling of operations. The institution's size, diversity, and complexity of operations all affect the level of control required. For example, a small institution with effective management involvement may not need extensive control procedures. An organizational structure also includes consideration of the form and nature of an institution's major organizational units and related management functions and reporting relationships. In addition, the organizational structure should provide the framework for the assignment of authority and responsibility within the institution in an appropriate manner.

Methods of Assigning Authority and Responsibility

These methods affect the understanding of reporting relationships and responsibilities established within an institution. Methods of assigning authority and responsibility include consideration of:

- Policies regarding such matters as acceptable business practices, conflicts of interest, and codes of conduct;
- Assignment of responsibility and delegation to deal with such matters as organizational goals and objectives, operating functions, and regulatory requirements;
- Employee job descriptions delineating specific duties, reporting relationships, and constraints;
- Performance standards; and
- Computer systems documentation indicating the procedures for authorizing transactions and approving systems changes.

In assessing the methods of assigning authorities and responsibilities, consideration should be given to how certain duties are assigned. Generally, no one person should have authority to perform or approve all aspects of a particular function. For instance, the duties associated with the requisition, approval, execution, and recording of a particular transaction should not be assigned to the same person. In addition, duties concerned with the custody of assets should not be performed by someone who also maintains the records of those assets. Limiting overlapping duties can control the ability of one person to make significant errors or perpetrate significant irregularities without timely detection.

Personnel Policies and Practices

These policies and practices affect an institution's ability to employ sufficient, competent personnel to accomplish its goals and objectives. Personnel policies and practices include consideration of an institution's policies and procedures for hiring,
training, evaluating, promoting, and compensating employees, and giving them the resources necessary to discharge their assigned responsibilities.

Performance Accountability

Holding employees accountable for their performance is very conducive to establishing an effective control environment. Performance accountability encourages management to evaluate and review job performance, usually through a performance evaluation system. Evaluating and reviewing performance provides an internal control system to promote, monitor, and evaluate adherence to policies, procedures,

and regulations. It also allows for the detection and correction of weaknesses in operating systems and records, and provides management with a means of maintaining control over delegated duties.

External Influences

External influences are influences established and exercised by parties outside the institution that affect the institution's operations and practices. These parties include FCA, external auditors, the Federal Farm Credit Banks Funding Corporation (for banks), and Farm Credit Banks (for associations). While external influences are outside the institution's authority, such influences can heighten management's consciousness of and attitude toward the conduct and reporting of an institution's operations. Outside parties may also prompt management to establish specific internal control structure policies or procedures. For example, FCA Regulation 12 CFR § 618.8430 requires each System institution's board of directors to adopt an internal control policy which provides adequate direction to the institution in establishing effective control over and accountability for operations, programs, and resources.

External influences also can have an adverse result on the effectiveness of internal controls. For example, competitive pressures may result in lending staff relaxing or even circumventing certain credit standards. Additionally, key officers or employees may take inappropriate actions when their personal financial interests overly depend on the short-term operating results or financial condition of the institution. Examiners should be alert to circumstances outside the institution that may lead employees, officers, and even directors, to pursue actions that could adversely affect the institution.

## Audit and Review

The audit and review program is an integral component of an institution's internal control environment. Its primary purpose is to determine and report to the board of directors whether management and employees are performing their duties in a prudent manner and in compliance with applicable policies, procedures, laws, and regulations.

The audit and review program is generally considered an internal control that detects problems, weaknesses, or errors after they occur. This characteristic is important to note in differentiating between the audit and review program and other internal controls. For instance, internal control procedures are incorporated into the plans, policies, and procedures of each major operating function of the institution. These controls are typically preventive in nature and are designed to be followed by staff within the function. In contrast, the audit and review program reviews transactions and decisions after the fact and by personnel outside the function being audited/ reviewed. Internal control procedures and considerations for each major functional area of operations are further discussed in the respective sections of the FCA Examination Manual.

An effective audit and review program also is a preventive internal control. Weaknesses can be minimized by determining the adequacy of internal controls established in each functional area of operations. An effective audit and review program is designed to test and evaluate the internal controls established in high-risk areas of operations and to substantially lessen the risk that potentially serious problems will occur.

All institutions should adopt an effective audit and review program. Generally, the audit and review program should consist of a continuous and full-time internal review, coupled with a well planned and executed external auditing program. While the objectives of an internal and external audit/review program may differ, each program is appraised based on similar standards. These standards, as well as the general objectives of each program, are discussed below.

General Standards

Regardless of whether an audit or review is conducted internally or externally, certain general standards apply in measuring the overall adequacy of such a program. These same standards also apply to reviewers primarily engaged in the review of loan assets and credit administration.

Competence--The staff assigned to conduct an audit or review should collectively possess adequate

professional proficiency for the tasks required.

Independence--In all matters relating to the audit or review work, auditors/reviewers should be free from personal and external impairments to independence, should be organizationally/functionally independent, and should maintain an independent attitude and image.

Due Professional Care--Due professional care should be used in conducting the audit/review and in preparing related reports. Exercising due professional care means using sound judgment in establishing the scope, selecting the methodology, and choosing tests and procedures for the audit/review. This standard also requires each person within the audit/review function to observe the applicable standards in conducting audits and reviews.

Planning--All audit and review work should be adequately planned. This includes defining the objectives and planning how they can be attained while establishing a balance between scope, timeframes, and staff days to be spent to ensure optimum use of resources. Also important is developing an overall strategy for the expected conduct and scope of the audit/review.

Supervision--Supervision involves directing the efforts of assistants who are involved in accomplishing the objectives of the audit/review and determining whether those objectives were accomplished. The work completed by assistants should evidence that a supervisory review was performed which determined the adequacy of the work and evaluated the results.

Evidential Matter--Sufficient, competent, and relevant evidence is to be obtained to afford a reasonable basis for the auditor/reviewer's judgments and
conclusions regarding the area(s) under audit/review. A record of the work performed should be retained in the form of working papers.

Reporting--Written reports are to be prepared giving the results of each audit or review. Reports should be written in a clear and concise manner and include a full discussion of findings. The underlying causes of weaknesses, conclusions, and recommendations for corrective action should also be discussed, preferably by the auditor/reviewer but at least by management. Reports should be distributed to the board of directors or its audit committee in a prompt manner to allow appropriate corrective actions to be taken.

Internal Audit and Review Programs

The internal audit and review program of an institution should provide the board of directors, as well as the entire institution, ongoing oversight and feedback on the adequacy of operations. This aspect of the internal audit and review program allows the board to detect weaknesses in a timely manner and take appropriate corrective actions.

Internal audit and review programs vary considerably among System institutions. For instance, in a small institution it is not uncommon to find that the internal auditor/reviewer is a one-person department who may personally plan and perform all audits or reviews, or may direct staff borrowed from other departments. Since it may not be practical for a smaller institution to employ a full-time internal auditor/reviewer, the responsibility for conducting audits/reviews may also be assigned to officers on a part-time or rotating basis. Another alternative would be contracting the services required from an outside source, such as the funding bank, a nearby institution, the external auditor, or others.

Generally, the audit and review program is comprised of two separate functions, the audit function and the review function. Audit activities are designed to determine the adequacy of internal accounting controls and other operating practices, while review activities are established to assess the adequacy of loan assets, lending practices, and collateral evaluations. The review function usually is referred to as the internal credit review process, which is further discussed in the Loan Portfolio Management section of the Assets module.

FCA Regulation 12 CFR § 618.8430 requires System institutions to adopt internal audit procedures that evidence responsibility for the review of internal controls. At a minimum, internal audit programs should address the items required by the regulation. The board of directors should also use the program to make

other inquires into the institution's operations as deemed appropriate. In determining the appropriate audit coverage for the institution, the board of directors should consider the operational areas of high concern. Based on the assessment, the board may direct inquires into the following:

- Determining compliance with applicable laws, rules, and regulations;
- Evaluating the adequacy of and compliance with board policies; and
- Evaluating the efficiency of operations.

The scope of the audit/review must be sufficient to attain the audit objective. The frequency with which procedures are performed should be based on an evaluation of the risk associated with each area of audit interest. In assessing risk, the auditor/reviewer should consider the nature of the specific operation and related assets and liabilities, the existence of appropriate policies, the effectiveness of operating procedures and internal controls, and the potential materiality of errors and irregularities associated with the specific operation.

In applying the general standards of an audit/review program, examiners need to consider the following:

Competence--The internal audit/review department manager should possess the proper education and training. College courses are one source; however, adequate education may be achieved through participation in courses sponsored by industry groups or through in-house training programs. Significant work experience in various departments of an institution also may provide adequate training. Certification as a Chartered Bank Auditor, Certified Internal Auditor, or Certified Public Accountant could provide evidence of meeting education and experience requirements. In addition to prior education, the manager should be committed to a program of continuing education that may include attending technical meetings and seminars and reviewing current literature on auditing and banking. The manager's skills may be demonstrated through the use of techniques such as internal control and other questionnaires, testing (including statistical sampling), flowcharting, and computer programming.

The audit/review staff should have the education and experience required by the institution for their positions and the ongoing training necessary to remain current in the profession. In addition, any member of the staff functioning as a supervisor should possess an adequate knowledge of procedures performed by the staff.

The quality of work performed and the ability to communicate the results of that work also indicate competence. Accordingly, conclusions with respect to an auditor's/reviewer's competence also should reflect the adequacy of the program and reports.

Independence--An indication of auditor/reviewer independence may be obtained by determining where he or she is located administratively within the organization and to whom, or to what level, the results of the work performed are reported. The internal audit/review function should be under the direction of the board of directors or its audit committee. The auditor/reviewer's independence is compromised when reporting is not to the board or when the board is not involved in the auditor/reviewer's performance evaluation. In addition, internal auditors/reviewers should not develop and install procedures, prepare records, or engage in any other activity which they would normally review and appraise. These activities could be construed to compromise the auditor/reviewer's independence.

External Audit Program

Audits performed by a qualified public accountant complement an institution's internal audit and review program and assist the board of directors in meeting its fiduciary responsibilities. A qualified public accountant is a person who holds a valid and unrevoked certificate, issued to such person by a legally constituted State authority, identifying such person as a certified public accountant (CPA). At a minimum, each System institution should have its financial statements audited in accordance with generally accepted auditing standards (GAAS). FCA Regulation 12 CFR § 621.4 requires an audit of the financial statements at least annually. In addition, sound business practices dictate more frequent or comprehensive audit coverage as needed.

A financial statement audit conducted in accordance with GAAS is generally limited to audit activities necessary to support an opinion on the financial statements. The various audit opinions expressed include:

Unqualified--States that the financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows of the entity in conformity with generally accepted accounting principles (GAAP).

Explanatory Language Added to the Auditor's Standard Report--While not affecting the auditor's unqualified opinion on the financial statements, may require that the auditor add an explanatory paragraph or other explanatory language to the report.

Qualified Opinion--States that, except for the effects of the matter(s) to which the qualification relates, the financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows of the entity in conformity with GAAP.

Adverse Opinion--States that the financial statements do not present fairly the financial position, results of operations, or cash flows of the entity in conformity with GAAP.

Disclaimer of Opinion--States that the auditor does not express an opinion on the financial statements.

In the case of a qualified, adverse, or disclaimer of opinion, the CPA should set forth all material reasons for issuing the particular report form. As to limitations of scope, the report should specify any generally accepted auditing procedures that were omitted and the reasons for omission. If the omission was requested by the institution, that should be specified.

Statement of Auditing Standards No. 31, Evidential Matter, states that most of the independent auditor's work in forming an opinion on financial statements consists of obtaining and evaluating evidential matter concerning the assertions in such financial statements. The auditor evaluates the effectiveness of an institution's internal control structure policies and procedures in determining the risk of material misstatement in financial statement assertions.

The policies and procedures that are relevant to a financial statement audit pertain to the institution's ability to record, process, summarize, and report financial data consistent with the assertions in the financial statements. While GAAS requires auditors to report significant deficiencies in the design or operation of these policies and procedures, internal control structure policies and procedures not relevant to the audit need not be considered or reported to the institution.

External auditors should consider information contained in regulatory and examination reports as a source of competent evidential matter in conducting audits of financial statements. As such, CPA firms are required to make certain inquiries to institution management relative to its regulator and should review regulatory reports. Similarly, FCA examiners should communicate with the external auditor to determine the reliability of the audit work and to identify any weaknesses in the institution's financial reporting and internal controls.

Since the scope of a financial statement audit may not include an evaluation of all internal controls, the board of directors or its audit committee should determine that the program will provide sufficient substantive coverage of the institution's risk areas and other areas of concern, particularly when the reliability of the internal audit/review is in question. Additional external auditing procedures by a qualified public accountant may be appropriate for a specific year or several years to cover particularly high risk or specialized areas such as asset/liability management, taxation, and management information systems. Board or audit committee meeting minutes should include a discussion of the engagement terms for the audit and the scope of the audit to be performed.

Institutions should require auditors to submit engagement letters to the board of directors before commencing their work. Such letters include, among other things, the scope of the audit, the period of time to be covered by the audit, and the reports expected to be rendered. In many cases, the highlights of these matters will be summarized in the body of the letter, with greater detail being provided in schedules or

appendices to the letter. Procedures may be specific by audit area. That is, the auditor may provide a capsulized description of procedures with regard to cash, investments, loans, etc. In addition, if there are any limitations on the scope of the audit, the letter should specify any auditing procedures which are to be omitted, such as confirmation of loans or investments.

In view of the professional and ethical standards of the public accounting profession, an in-depth review of the competence and independence of the CPA or the adequacy of the CPA's audit is generally not necessary. However, because of location and size, some CPAs and CPA firms may not maintain sufficient banking practice or possess the industry knowledge necessary to conduct acceptable audits. In these instances, examiners may need to assess the competency of the CPA. Particular attention should be given to workpapers dealing with accounting and control issues that are unique to lending.

Examiners should investigate an institution's recent change in CPAs, particularly if the change was made after an audit was commenced. FCA Regulation 12 CFR § 621.4 requires institutions that change accountants to notify FCA 15 days after the end of the month in which the change took place. The regulation also requires that certain information concerning the change be submitted to FCA and included in the institution's Annual Meeting Information Statement and Annual Report to Shareholders for the year in which the change of accountants took place.

Examiners should also be alert for institution disagreement with the accountant's opinion. FCA Regulation 12 CFR § 621.4 requires institutions to immediately notify the Chief Examiner of any disagreement with its accountant and to furnish FCA with certain written documentation required by this regulation.

Ordinarily, it will not be necessary to make specific tests to determine independence. However, there may be occasions when sufficient reason exists to question the independence or the quality of work of a CPA. FCA Regulation 12 CFR § 621.2(i) defines the requirements of a qualified CPA, including the requirement for independence. Independence is considered to be questionable if, for example, during the period of a CPA's engagement, which includes the period covered by the financial statements on which the CPA has expressed an opinion, the CPA or a member of his or her firm:

- Had a direct financial interest in the institution;
- Was connected with the institution in a capacity equivalent to that of a member of management or was a director;
- Maintained, completely or in part, the books and records of the institution and did not perform audit tests with respect to such books and records; or
- Had a loan from the institution that was considered to be material relative to the net worth of the borrower.

In such instances, and others casting doubt on the auditor's independence, the CPA would not have complied with professional standards and would not be considered qualified. Consequently, the institution would not have complied with FCA Regulation 12 CFR § 621.4 which requires an annual audit of financial statements by a qualified public accountant.

### Management Information System

An effective management information system (MIS) provides management with the information needed to make decisions, plan, monitor, and oversee operations. The MIS is discussed here to highlight its importance as an internal control in monitoring and overseeing operations.

The MIS refers to the system used by an institution to obtain, generate, and report information needed to conduct operations effectively. The MIS incorporates both automated and manually operated systems, as well as the manner in which information flows through an organization and is reported to the board of directors and management.

The board of directors is responsible for determining the institution's information needs and the most effective means of obtaining it. Consequently, the board should communicate its expectations to management through formal written policies. The policies should identify what is to be reported and when. Also, sufficient policy direction should be in place to ensure that the information is accurate, complete, and presented in a usable format. Policies also should address the extent to which automation and integration of the various information sources and systems should be pursued in an attempt to enhance reliability, usability, and efficiency.

Board direction should specifically address the information needed to monitor and oversee operations. Monitoring and oversight is required to ensure the institution is progressing toward stated objectives, and weaknesses in operations are identified and corrected. Because the MIS is a key control function over operations, the board of directors periodically should review the adequacy of the MIS in meeting these objectives. In completing this review, the board should consider if the MIS provides sufficient data to:

- Monitor performance relative to the business plan and policy objectives;
- Monitor compliance with the operating parameters, delegated authorities, and reporting requirements outlined in policies;
- Monitor compliance with laws, regulations, and sound business practices;
- Determine the financial condition and performance of the institution;
- Determine the condition of the loan portfolio, other major assets, and liabilities;
- Identify operational deficiencies that increase the risk of loss or reduce efficiencies; and
- Determine the status of corrective actions on previously identified weaknesses.

The amount of information and the frequency of reporting needed in a particular area are dependent on the inherent risk in that aspect of operations and the overall effect on the safety and soundness of the institution. Specific information needs and reporting requirements for each functional area of operations are further discussed in the respective sections of this manual.

### Examination Procedures

Examining an institution's overall internal control environment and internal control systems is generally an effective first step in the examination of any institution. The understanding gained from this activity can provide the perspective needed to plan effectively and conduct an examination. Not only do factors like management philosophy and operating style, organizational structure, and personnel practices affect the scope of an examination, but the work conducted by an adequate audit and review program can be relied upon to reduce the number of areas to be examined. Also, an effective, accurate, and reliable MIS can assist examiners in evaluating the overall condition of an institution and identifying key safety and soundness issues.

Examiners also should consider the adequacy of specific internal control systems and procedures within each major operating function of the institution. A basic understanding of an institution's operating functions, and attendant risks within each function, can be determined by examining an organizational chart and noting where key areas of responsibility are assigned. Since System institutions are primarily engaged in the business of lending, the lending function is one of the major operating functions in an institution. Other functions might include financial operations, human resource management, collateral custodian, administrative, audit and review, and regulatory reporting.

Once the major operating functions have been identified, an assessment of the control system within each function can be made. Examiners should determine if the systems are set up effectively to prevent undesirable activities and whether the systems are operating as designed. This is accomplished by identifying the critical control procedures within each system and testing the procedures to determine if they

are being followed. This examination activity typically is completed by the examiner assigned to evaluate that area of operations. A description of the various internal control procedures and considerations applicable to each function is provided in the respective sections of this manual.

The following list of procedures is provided to assist examiners in the evaluation of internal controls. The procedures are divided into five parts to reflect the different examination procedures applicable to each of the following areas:

- Internal control environment;
- Internal control systems;
- Audit and review;
- MIS; and
- Internal control overall evaluation.

Consistent with risk-based examination principles, examiners should add, delete, or modify procedures as needed based on the particular circumstances of the institution. Information obtained from previous examinations and through monitoring activities can assist the examiner in developing conclusions.

Internal Control Environment

1. Determine the effect of the board's and management's philosophies and operating styles on the institution's internal control environment by considering the following factors:

    a. Approach to taking and monitoring business risks;

    b. Attitudes and actions toward financial reporting;

    c. Use of policies and procedures;

    d. Emphasis on planning and meeting budget, profit, and other financial and operating goals; and

    e. Influence/domination by one or a few individuals on the entire organization.

2. Determine the effect of the institution's organizational structure on the institution's internal control environment by considering the following factors:

    a. Size, diversity, and complexity of operations;

    b. Form and nature of major organizational units and related management functions and reporting relationships; and

    c. The extent of centralization/decentralization of operations in key functions.

3. Evaluate the institution's methods of assigning authority and responsibility by reviewing the following areas:

    a. Policies regarding such matters as acceptable business practices, conflicts of interest, and codes of conduct;

    b. Assignment of responsibility and delegation to deal with such matters as organizational goals and objectives, operating functions, and regulatory requirements;

    c. Employee job descriptions delineating specific duties, reporting relationships, and constraints;

    d. Computer systems documentation indicating the procedures for authorizing transactions and approving systems changes;

e. How certain duties are assigned, e.g., no one person should have authority to perform or approve all aspects of a particular function;

f. Whether the duties associated with the requisition, approval, execution, and recording of a particular transaction are assigned to the same person;

g. Whether the duties concerned with the custody of assets are performed by someone who also maintains the records of those assets; and

h. The extent to which overlapping duties are limited to control the ability of one person to make significant errors or perpetrate significant irregularities without timely detection.

4. Determine the effect of personnel policies and practices on the institution's internal control environment by considering the following factors:

   a. The ability to employ sufficient competent personnel to accomplish the institution's goals and objectives; and

   b. The hiring, training, evaluation, promoting, and compensating of employees, and giving them the resources necessary to discharge their assigned responsibilities.

5. Determine whether management has established an adequate performance evaluation system to hold employees accountable for their performance.

6. Evaluate the impact of external influences on the institution's internal control environment by considering the following factors and their effect on operations:

   a. The influence exercised by external auditors, the Federal Farm Credit Banks Funding Corporation, and Farm Credit Banks;

   b. The competitive environment;

   c. The extent to which the personal financial interests of key officers or employees depend directly on the operating results or financial condition of the institution; and

   d. Any other circumstances that may lead employees, officers, and directors to pursue actions that could adversely affect the institution.

7. Summarize findings from the assessment of the internal control environment.

8. Identify the factors that have a significant effect, either positive or negative, on the effectiveness of management processes or functions.

9. Advise those examiners responsible for evaluating the affected processes or functions of the factors identified and potential effect.

10. Determine the collective effect of the various factors identified above on establishing, enhancing, or mitigating the effectiveness of management processes and functions.

<u>Internal Control Systems</u>

(Note: Steps 1 through 5 typically are completed to determine the scope of examination, while steps 6 through 12 are completed in conjunction with the area examined.)

1. Review the board's internal control policy for adequacy and compliance with FCA Regulation 12 CFR § 618.8430.

2. Identify the major operating areas within the institution.

3. Assess each major operating area and determine which aspects of operations expose the institution to the greatest risks.

4. Review internal audit/review reports and management letters submitted by the external auditor for any weaknesses disclosed in the institution's operations and internal control systems.

5. Select those areas of operations that pose the greatest risks to the institution and assess the adequacy of internal control systems established to control those risks.

6. Assess the adequacy of the internal control system established in each area of operations examined by determining if sufficient controls are in place to **prevent** unacceptable performance, weaknesses, or irregularities. Such controls could include:

   - Strategic and operating plans;
   - Board policies;
   - Management procedures;
   - Delegated authorities; and
   - Audit and review program.

7. Assess the adequacy of the internal control system established in each area of operations examined by determining if sufficient controls are in place to **detect** unacceptable performance, weaknesses, or irregularities. Such controls could include:

   - MIS and reporting to the board;
   - Supervisory review; and
   - Audit and review program.

8. Obtain any flowcharts that outline internal control systems established in each area examined to document and describe the components of the system. An example of flowcharting an internal control system for a particular area of operations is provided in the Supplement section of this module.

9. Consider the effect, or potential effect, of the internal control environment on the internal control system established and determine the prospects for the system's continued effectiveness or ineffectiveness.

10. Substantiate the effectiveness of both preventive and detective critical control components through observation and testing. (Note: The level of observation and testing needed can be reduced to the extent the work performed by the auditor/reviewer is found to be reliable and sufficient.)

11. Discuss any weaknesses with the examiner-in-charge (EIC) and examiners assigned to other areas which may be affected.

12. Summarize and conclude on the adequacy of the internal control system established for the area of operations examined.

<u>Audit and Review</u>

1. Determine if the internal audit and review program provides the board of directors ongoing oversight and feedback on the adequacy of operations by considering the following factors:

   a. Employment of a full-time internal auditor/reviewer;

   b. Operation of an effective program of internal audit and review; and

   c. Regular reporting to the board on the results of audits/reviews.

2. Review the internal audit and review reports to determine if weaknesses are detected in a timely manner and appropriate corrective actions are taken.

3. Discuss the internal credit review process with the examiner assigned to examine this area to determine the adequacy of this aspect of the internal audit and review program.

4. Evaluate compliance with FCA Regulation 12 CFR § 618.8430(b) which requires the adoption of internal audit procedures that evidence responsibility for the review of internal controls.

5. Determine if the board of directors uses the internal audit and review program to make appropriate inquires into the following areas:

   a. The high-risk areas of operations and those areas of high concern;

   b. Compliance with applicable laws, rules, and regulations;

   c. Compliance with board policies;

   d. Adequacy of board policies;

   e. Efficiency of operations; and

   f. The adequacy of internal controls established in each functional area of the institution's operations.

6. Review the auditor/reviewer's working papers to determine if the scope and work completed was sufficient to attain the audit and review objectives.

7. Determine if the frequency of internal audit/review activities are sufficient by considering the following factors:

   a. The risk associated with each area of audit/review interest;

   b. The nature of the specific operation and related assets and liabilities;

   c. The existence and effectiveness of appropriate policies, procedures, and internal controls;

   d. The potential materiality of errors and irregularities associated with the specific operation/function; and

   e. Coverage in previous or planned internal and external audit/review activities.

8. Determine if the internal auditor/reviewer and audit/review staff are competent by reviewing the following factors:

   a. Educational background;

   b. Participation in courses sponsored by industry groups such as the Banking Institute of America, American Banking Association, etc., or through in-house training programs;

   c. Work experience in various departments of an institution;

   d. Certification as a Chartered Bank Auditor, Certified Internal Auditor, or Certified Public Accountant;

   e. Commitment to continuing education;

f. Use of techniques such as internal control and other questionnaires, testing (including statistical sampling), flowcharting, and computer programming; and

g. The quality of work performed and the ability to communicate the results of that work.

9. Determine if the audit function and auditor are independent by reviewing the following factors:

   a. Where and to what level the results of the work performed are reported;

   b. Whether the internal audit function is under the direct supervision of the board of directors; and

   c. The audit function's involvement in developing and installing procedures, preparing records, or engaging in any other activity which they would normally review and appraise.

10. Compare deficiencies identified by FCA examination and monitoring activities to weaknesses disclosed by the internal audit and review program.

11. If the internal audit/review program failed to identify deficiencies similar to those disclosed by FCA, determine the cause for such discrepancy.

12. Determine the adequacy of actions taken by the board of directors to correct deficiencies identified by the internal audit/review program.

13. Conclude on the overall adequacy of the internal audit and review program.

14. Notify examiners responsible for examining other areas of operations of weaknesses in the internal audit/review program that may affect their examination activities.

15. Determine if the board requires auditors to submit engagement letters before commencing their work.

16. Review the board and/or audit committee meeting minutes to determine if:

   a. A discussion of the engagement terms for the external audit is included;

   b. All internal and external audit and review reports are provided to the board or audit committee;

   c. The board or audit committee adequately follows up to ensure management properly responds to findings in a timely manner; and

   d. A reporting mechanism is established to allow the board or audit committee to track the status of all outstanding audit and examination findings at any given time.

17. Determine if the terms of engagement established by the board were based on factors such as:

   a. The institution's risk areas and other areas of concern;

   b. The audit coverage of the internal audit and review program; and

   c. The reliability of the internal audit and review program.

18. Where the internal audit function lacks the expertise needed to audit high-risk or specialized areas, such as asset/liability management, taxation, and MIS, determine if the board's use of external auditors is appropriate.

19. Review the terms of engagement to determine the time period to be covered and the reports to be rendered. Also, determine if the audit coverage is adequate, complements the institution's internal

audit and review program, and assists the board of directors in meeting its fiduciary responsibilities.

20. Determine if there are any limitations on the scope of the audit and whether any auditing procedures are to be omitted, such as confirmation of loans or investments.

21. Evaluate the CPA's independence by determining if any of the following conditions existed during the period of the CPA's engagement:

    a. The CPA had a direct financial interest in the institution;

    b. The CPA was connected with the institution in a capacity equivalent to that of a member of management or was a director;

    c. The CPA maintained, completely or in part, the books and records of the institution and did not perform audit tests with respect to such books and records; or

    d. The CPA had a loan from the institution that was considered to be material relative to the net worth of the borrower.

22. Determine if the institution has its financial statements audited, at least annually, by a qualified public accountant in accordance with GAAS (FCA Regulation 12 CFR § 621.4).

23. Review the opinion rendered on the financial statements to determine if:

    a. A qualified, adverse, or disclaimer of opinion was given and the reasons for issuing the particular report form; and

    b. The scope was limited or generally accepted auditing procedures were omitted and the reasons for omission.

24. Review any management letters issued to the institution and note exceptions, deficiencies, or issues raised by the external auditor requiring additional follow-up.

25. Meet with the external auditor to discuss audit coverage, findings, or issues raised during their audit.

26. Through discussions or a review of working papers, determine if the auditor evaluated the effectiveness of the institution's internal control structure policies and procedures in preventing and detecting material misstatements.

27. Evaluate the adequacy of the board's corrective actions on any problems cited by the external audit.

28. Notify examiners responsible for examining other areas of operations of weaknesses disclosed by the external audit that may affect their examination activities.

29. If discussions or a review of engagement terms, opinions, or management letters discloses that the institution has engaged a CPA or CPA firm which lacks the expertise or industry knowledge necessary to conduct acceptable audits, further review competency by evaluating the auditor's professional background and workpapers.

30. Investigate recent changes in CPAs, particularly if the change was made after an audit was commenced.

31. Determine if the institution adequately notified FCA within 15 days after the end of the month in which the change took place in accordance with FCA Regulation 12 CFR § 621.4.

32. Determine if the institution disclosed changes in the auditor in the institution's Annual Meeting Information Statement and Annual Report to Shareholders for the year in which the change of

accountants took place.

33. Determine if the institution immediately notified the Chief Examiner of any disagreement with its accountant and furnished FCA with the written documentation required by FCA Regulation 12 CFR § 621.4.

34. Conclude on the overall adequacy of the audit and review program in determining and reporting to the board of directors whether management and employees are performing their duties in a prudent manner and in compliance with applicable policies, procedures, laws, and regulations.

35. Based on examination procedures completed above, conclude on whether the audit and review program substantially reduces the risk of potentially serious problems not being detected by the institution.

Management Information System

1. Review the board's policies to determine if they identify the institution's information needs and the most effective means of obtaining the needed information.

2. Review the board's plans and policies to determine if they adequately address the information needed to monitor and oversee operations, including the frequency of such reporting.

3. Evaluate the adequacy of policy direction to ensure that information is accurate, complete, and presented in a usable format.

4. Determine if board policies address the extent to which automation/integration of the various information sources should be pursued to enhance reliability, usability, and efficiency.

5. Determine if the information reported to the board is sufficient to monitor and oversee the following areas:

    a. Performance relative to business plan and policy objectives;

    b. Compliance with the operating parameters, delegated authorities, and reporting requirements outlined in policies;

    c. Compliance with laws, regulations, and sound business practices;

    d. Financial condition and performance of the institution;

    e. Interest rate risk and asset/liability management practices;

    f. Condition of the loan portfolio and other major assets;

    g. Operational deficiencies that increase the risk of loss or reduce efficiencies; and

    h. Status of corrective actions on previously identified weaknesses.

6. Confer with the examiners assigned to other areas of examination to determine if the specific information needs and reporting requirements for each functional area of operations are adequate.

7. Determine if the board of directors periodically reviews the adequacy of the MIS in meeting the institution's objectives.

8. Complete the Field Information Systems Examination Program to determine the adequacy and effectiveness of internal controls over information systems environment and security.

9. Summarize findings and conclude on the adequacy of the MIS as an internal control.

10. Discuss examination findings with examiners assigned to other areas affected by the MIS and ensure findings and conclusions are consistent.

Internal Control Overall Evaluation

1. Weigh the results of examination work in the areas of the internal control environment, internal control systems, audit and review, and MIS. Draw tentative conclusions on the overall adequacy of internal controls, giving consideration to cause, effect, materiality, and results of other related examination work.

2. Discuss items of concern, scope of work performed, and conclusions with the EIC and with the appropriate institution manager. Obtain a response regarding the cause(s) of deficiencies or weaknesses and anticipated corrective actions.

3. Prepare a leadsheet or other summary document to provide workpaper support for the work performed and the conclusions reached.