Internal/External Audits

Joint World Bank/Federal Reserve
System Seminar for Senior Bank Supervisors

Arthur Lindo
Federal Reserve Board
Presentation Topics

Internal Audit, Corporate Governance and Controls

The Role of External Audit in Banking Supervision

Current Trends
Effective internal control is a foundation of safe and sound banking organizations

- **Board of Directors and Senior Mgmt. are responsible for effective internal controls**

**Internal audit provides Directors & Mgmt. with vital information on**

- **Control effectiveness & operational efficiency**
- **Efforts may contribute to control certifications under Sarbanes-Oxley and FDICIA Sec. 112**
Direct lines of communication and reporting are needed to Audit Committee

- Audit committee should approve scope of IA activities, provide needed funding & oversight
- Prompt follow-up by Mgmt. of audit findings
Internal Audit, Corporate Governance and Controls

Primary Responsibility (SCARE)

- Safeguarding of Assets
- Compliance with policies, plans, procedures, laws and regulations
- Accomplishment of established objectives and goals for operations or programs
- Reliability and integrity of financial information
- Economical and efficient use of resources
US Internal Control Standards

**COSO** - Internal audit is part of ongoing monitoring of the internal control system. COSO provides reasonable assurance based on the following objectives:

- *Effectiveness and efficiency of operations*
- *Reliability of financial reporting*
- *Compliance with laws and regulations*
US Internal Control Standards

COSO framework identifies five elements of a system of internal control

• *Control environment*
• *Risk Assessments*
• *Control Activities*
• *Information and Communication*
• *Monitoring*
FDICIA 112 Requirements for Management

Applies to banks with assets over $500M

Management assessment of internal controls over financial reporting

– management must state its responsibility for establishing and maintaining an adequate internal control structure and procedures for financial reporting and

– annually assess the effectiveness of the internal control structure and procedures for financial reporting
FDICIA 112 Requirements for Management

Management assessment of internal controls over insider loans and dividend restrictions

Requires mgmt to obtain an external audit

Other requirements

• Affects composition of bank audit committees
• Requires reports to supervisor
Management assessment of internal controls

- *extends the FDICIA 112 management assessment to all publicly traded companies*
  - Applies to both domestic and foreign companies listed on US stock exchanges
- *publicly traded banks with assets of $500 million or more have applied this approach under FDICIA section 112 for past ten years*
Quarterly certification by CEO/CFO on significant changes in internal controls

- Now includes concept of disclosure controls
- Includes risk disclosures and other disclosures (such as MD&A)
- Management will be including this in its review of control adequacy, hence the internal auditor’s role may expand in this area
Sarbanes-Oxley Act of 2002

Impact on Internal Audit

An auditor cannot provide certain services to an audit client:

- Bookkeeping or other accounting records/financial statements services
- Financial information system design & implementation
- Appraisal or valuation services
- Actuarial services; legal & expert services unrelated to the audit
- Internal audit outsourcing services
- Management functions or human resources
- Broker or dealer, investment adviser, or investment banking services
- Any other service prohibited by the new public oversight board

Audit committee may approve services in certain cases
**Bank Audit Requirements**

Current bank audit requirements

- *First 3 years after FDIC insurance*
- *Newly-chartered national banks*
- *Banks subject to SEC reporting requirements*
- *Banks and bank holding companies (BHCs) with assets over $500 million or that are SEC registrants*

Most U.S. banks have independent audits
Role of External Auditors in Banking Supervision

Supervisors must understand the responsibility assumed by the auditor

- *Management has primary responsibility for financial statements, not the auditors*
- *Auditors do not have responsibility to detect all fraud and violations of law or regulations*
- *Under current rules, auditors may not be required to report certain problems*
Role of External Auditors in Banking Supervision

External auditors seek to provide reasonable assurance that financial statements are free of material misstatements by doing the following:

- Collect a sample of evidence that supports financial statement amounts and disclosures
- Assess the accounting principles used, significant mgmt. estimates, & F/S presentation
- Assess the internal control structure
# Roles and Responsibilities of internal and external audit and examinations

<table>
<thead>
<tr>
<th>Attributes</th>
<th>Internal Audit</th>
<th>External Audit</th>
<th>Examiners</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Works for:</strong></td>
<td>Board of Directors</td>
<td>Bank</td>
<td>Regulatory Agency</td>
</tr>
<tr>
<td><strong>Reports to:</strong></td>
<td>Varies...Board of Directors</td>
<td>Audit committee/Board of Directors</td>
<td>Regulatory Agencies</td>
</tr>
</tbody>
</table>
# Roles and Responsibilities of internal and external audit and examinations

<table>
<thead>
<tr>
<th>Attributes</th>
<th>Internal Audit</th>
<th>External Audit</th>
<th>Examiners</th>
</tr>
</thead>
<tbody>
<tr>
<td>Principal Objective</td>
<td>Describe the effectiveness of internal control</td>
<td>Attest financial statements fairly present financial position</td>
<td>Rate the safety and soundness of bank</td>
</tr>
<tr>
<td>Principal work product:</td>
<td><strong>Internal Audit Report</strong></td>
<td><strong>Audit Opinion</strong></td>
<td><strong>Examination Report</strong></td>
</tr>
</tbody>
</table>
# Roles and Responsibilities of internal and external audit and examinations

<table>
<thead>
<tr>
<th>Attributes</th>
<th>Internal Audit</th>
<th>External Audit</th>
<th>Examiners</th>
</tr>
</thead>
<tbody>
<tr>
<td>Follow up:</td>
<td>Written response to audit report</td>
<td>Review management letter at next on site</td>
<td>Response from management, or impose enforcement action</td>
</tr>
<tr>
<td>Time focus:</td>
<td>Ongoing</td>
<td>Past</td>
<td>Future</td>
</tr>
</tbody>
</table>

**Internal Audit**
- Follow up: Written response to audit report
- Time focus: Ongoing

**External Audit**
- Follow up: Review management letter at next on site
- Time focus: Past
FDICIA 112 Requirements for External Audit

Auditor attestation on management assessment of internal controls

Auditor must adhere to all independence requirements of the SEC
Sarbanes-Oxley Act of 2002
Impact on External Audit

Extends the FDICIA 112 attestation to all publicly traded companies

New independence rules

- Sec. 201. Prohibits 8-types of non-audit Services
- Sec. 202. Requires audit committee preapproval of all other non-audit services
- Sec. 203. Requires audit partner rotation every 5-years
Sarbanes-Oxley Act of 2002
Impact on External Audit

New independence rules (Con’t)

• **Sec. 204. Requires auditor to provide audit committees a report on**
  – all critical accounting policies and
  – alternative accounting treatments

• **Sec. 206. Requires a 1-year “cooling off” period for auditors seeking employment as CEO, CFO, Chief Accounting Officer, or Controller of a client**
Basel Committee Focus
Going Forward

Enhancing international accounting and auditing standards and practices
Basel Committee Activities

External Audit projects, with IAASB

- Enhanced bank external audit guidance
  - IAPS 1004 - Relationship of bank management, auditors and supervisors
  - IAPS 1006 -- Audits of commercial banks

Internal Audit projects

- Final Basel IA guidance (August 2001) and Survey (2002) of audit practices
Summary

Internal Audit, Corporate Governance and Controls

The Role of External Audit in Banking Supervision

Current Trends