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Subject: **Management**

Section: 340

Internal Control

Summary: This Regulatory Bulletin transmits Examination Handbook Section 340, Internal Control, and replaces existing guidance found in the Handbook.

For Further Information Contact: Your OTS Regional Office or the Examination Programs Division of the OTS, Washington, DC. You may access this bulletin and handbook section at our website: **www.ots.treas.gov**

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SUMMARY OF CHANGES

OTS is issuing Examination Handbook Section 340, Internal Control. Change bars in the margins of the handbook section indicate revisions. We provide a summary of substantive changes below.

340 Internal Control

Definition of Internal Control: Re-emphasizes that the Committee of Sponsoring Organizations of the Treadway Commission (COSO) framework is the U.S. standard on internal control and that the COSO model is broadly applicable to public companies in complying with Section 404 of the Sarbanes-Oxley Act of 2002 (SOX).

Regulatory Concerns: Adds the type of control breakdowns typically seen in problem and failed institutions. Adds introduction regarding the SOX.

Sarbanes-Oxley Requirements: Adds an overview of SOX requirements. SOX includes provisions designed to improve the corporate governance, financial disclosures and auditing relationships of public companies, including public banking organizations. Savings associations with $500 million or more in total assets are subject to the provisions of Section 36 of the Federal Deposit Insurance Act and the FDIC's implementing regulations and guidelines at 12 CFR Part 363.

Enterprise Risk Management: Adds a discussion of COSO's 2004 release, Enterprise *Risk Management – Integrated Framework*, which expands on internal control and is interrelated with corporate governance.

Information Technology: Clarifies SAS 94 guidance.

Communication of Internal Control Matters: Adds a discussion of SAS 112, Communicating Internal Control Related Matters in an Audit (AU Section 325), which is effective for audits of financial statements for periods ending on or after December 15, 2006. SAS 112 supersedes SAS 60.

Adds a discussion of SAS 115, Communicating Internal Control Related Matters in an Audit, which is effective for audits of financial statements for periods ending on or after December 15, 2009. SAS 115 supersedes SAS 112.

Adds a discussion of SSAE 15, An Examination of an Entity's Internal Control Over Financial Reporting that is Integrated with an Audit of Its Financial Statements, which is effective for periods ending on or after December 16, 2008.

Audit of Internal Control Over Financial Reporting: Adds a discussion of the PCAOB Auditing Standard No. 5 applicable when an auditor is engaged to audit both an association's financial statements and management's assessment of the effectiveness of internal control over financial reporting. It also includes a discussion on management's responsibilities in an audit of internal control over financial reporting.

Internal Control Components: Adds two new areas to the control environment, Commitment to Competence and Board of Directors or Audit Committee Participation, and expands discussion in the other internal control components.

Integrated System of Internal Control: Adds a new discussion on the relationship and the synergy of the five internal control components.

Fraud: Adds guidance from the AICPA Manual on Forensic Accounting that on an examination of internal control, weaknesses in any of the five components will identify the association's exposure to fraud.

Examination Considerations: Revised heading. Includes a new bullet on management's failure to report on the association's internal control over financial reporting, or external auditors' failure to attest to the accuracy of management's report, which would warrant attention. Adds a new paragraph that addresses procedures at the beginning of the examination.

Management's Responses to Questionnaires: Adds a new paragraph regarding the review of the general questionnaires included with some of the handbook sections in conjunction with the internal control questionnaire.

Level II Procedures: Expands the last paragraph on consulting with the regional accountant.

References: Adds applicable references.

Program: Adds two new objectives regarding SOX and entity-wide objectives. Adds new procedures to address the requirements of FDICIA and Section 404 of SOX; corporate governance; fraud; and the Safety and Soundness Standards of 12 CFR Part 570, Appendix A.

Appendix A; Questionnaires: Revises the guidance to better correlate to the Questionnaires.

Internal Control Questionnaire: Adds a question regarding proper reporting of OTTI.

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Internal Control

OTS requires all savings associations, their affiliates, and subsidiaries to establish and maintain adequate systems of internal control. Financial institutions must have a process in place to identify, monitor, and control risk. Audits by public accountants and examinations by all the banking agencies place a great emphasis on evaluating the appropriateness of the processes in place.

In this section of the Handbook, we do the following:

- Define internal control.
- Describe regulatory concerns.
- Discuss directorate and auditor responsibilities, including enterprise risk management.
- Present components of internal control.
- Provide guidance on assessing internal control risk.
- Discuss limitations of internal control.
- Explain how to consider internal control in planning and performing an examination.

LINKS
Program
Appendix A

DEFINITION OF INTERNAL CONTROL

The Auditing Standards Board (ASB) definition of internal control is in Statement of Auditing Standard (SAS) No. 78 (AU Section 319), *Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS 55*. The definition incorporates the common critical elements of internal control systems in the Committee of Sponsoring Organizations of the Treadway Commission (COSO) report, Internal Control – Integrated Framework, issued in 1992.

The COSO framework is the U.S. standard on internal control. COSO and SAS 78 define internal control "as a process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of the following objectives:

- Effectiveness and efficiency of operations.
- Reliability of financial reporting.

- Compliance with applicable laws and regulations."

The COSO model serves as the basis for the internal control assessment and reporting requirements for depository institutions presented in Section 112 of the FDICIA. This model is also broadly applicable to public companies in complying with Section 404 of the Sarbanes-Oxley Act. We discuss the Section 404 requirements later in this Handbook Section.

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

- Safe and sound operations.
- The integrity of records, financial statements, and managerial reporting.
- Compliance with laws and regulations, and supervisory requirements.
- Decreased risk of unexpected losses.
- Decreased risk of damage to the association's reputation.
- Adherence to internal policies and procedures.
- Efficient operations and long-term profitability targets.

A system of strong internal control is the backbone of an association's management program. Strong internal controls help an association meet goals and objectives, and maintain successful, healthy operations. Conversely, a lack of reliable records and accurate financial information may cause an association to fail. 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 place high importance on internal control systems in light of past corporate scandals and financial institution failures. Some institutions failed primarily because they did not detect insider fraud or abuse due to deficient or nonexistent systems of internal control. The types of control breakdowns typically seen in problem and failed institutions can be grouped into five categories:

- Lack of adequate management oversight and accountability, and failure to develop a strong control culture within the institution.
- Inadequate recognition and assessment of the risk of certain banking activities, whether on- or off-balance sheet.
- The absence or failure of key control structures and activities, such as segregation of duties, approvals, verifications, reconciliations, and review of operating performance.

- Inadequate communication of information between levels of management within the institution, especially in the upward communication of problems.

- Inadequate or ineffective audit programs and monitoring activities.

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 controls appropriate to the size of the savings association, and the nature, scope, and risk of its activities.

Congress enacted the Sarbanes-Oxley Act of 2002 (SOX) to address failures in internal control, particularly over financial reporting. This law created a broad new oversight regime for auditors of public companies while prescribing steps to address specific failures and codifying the responsibilities of senior executive officers, directors, lawyers, and accountants. See Examination Handbook Section 310, Appendix A, for applicability of SOX requirements to financial institutions.

SOX created the Public Company Accounting Oversight Board (PCAOB), a private sector, nonprofit corporation, to oversee the auditors of public companies in order to protect the interests of investors and further the public interest in preparation of informative, fair, and independent audit reports.

Sarbanes-Oxley Requirements

Section 404 of SOX aims to strengthen the internal controls that underpin the accuracy and reliability of a company's published financial information. SOX includes a number of provisions designed to improve the corporate governance, financial disclosures and auditing relationships of public companies, including public banking organizations. Banking organizations are directly subject to SOX if they have a class of securities registered or they are required to file reports under the Securities Exchange Act of 1934.

Section 36 of the Federal Deposit Insurance Act (FDI Act) and Part 363 of the FDIC's regulations reflect SOX provisions and impose annual audit and reporting requirements on insured depository institution's with $500 million or more in total assets. Part 363 reporting requirements clarify what must be included in a Part 363 Annual Report for:

- Institutions with $500 million or more but less than $1 billion in total assets.

- Institutions with $1 billion or more in total assets.

- Other requirements applicable to all institutions subject to Part 363.

With certain exceptions, the Part 363 annual reporting requirements may be satisfied by an institution's holding company if services and functions comparable to those required of the institution are provided at the holding company level. We encourage the management, board of directors, and audit committee of each institution subject to Part 363 and independent public accountants that provide audit and attestation services to institutions subject to Part 363 to read and become familiar with the Part 363 regulatory text, the Guidelines and Interpretations in Appendix A, and the Illustrative Management Reports in Appendix B to obtain a complete understanding of the compliance requirements of Part 363.

Nonpublic savings associations with less than $500 million in total assets are not subject to SOX or Part 363 of the FDIC's regulations.

DIRECTORATE RESPONSIBILITIES

The board of directors has the primary responsibility of establishing and maintaining an adequate and effective system of internal control. An effective board generally has members who have financial or banking experience and an obligation to stay current with innovations in corporate governance. See discussion of the BOD's responsibilities in Examination Handbook Section 310, Oversight by the Board of Directors.

The association's board must report to the FDIC and the OTS on internal control over financial reporting and compliance with certain laws and regulations, as well as file annual audited statements under Section 112 of FDICIA.

The board is also responsible for approving and periodically reviewing the overall business strategy and significant policies of the association, and understanding the major risks the association takes. The board should set acceptable levels for these risks, and ensure that senior management takes the required steps to identify, measure, and monitor these risks in order to mitigate them to acceptable levels. To remain effective in the dynamic and ever broadening environment that associations operate in, the board of directors should periodically review the system of internal control and ensure management regularly assesses and updates it.

The board and senior management must establish a strong culture of compliance at the top of the association, oversee anti-fraud programs at the association, and set a proper ethical tone for governing the conduct of business. Staff members at all levels must demonstrate successful completion of an ethics program.

Enterprise Risk Management

COSO released *Enterprise Risk Management – Integrated Framework* in September 2004. Enterprise risk management expands on internal control to form a more robust framework to effectively identify, assess, and manage risk. Enterprise risk management is interrelated with corporate governance by providing information to the board of directors on the most significant risks and how the association is managing those risks.

Enterprise risk management reflects certain fundamental concepts. It is:

- A process – ongoing and flowing throughout an entity.

- Effected by people at every level of an organization.
- Applied in a strategy setting.
- Applied across the savings association, at every level and unit, and includes taking an entity-level portfolio view of risks.
- Designed to identify events potentially affecting the association and manage risk within the board's risk appetite.
- Able to provide management and the board reasonable assurance that the association is managing its risk.
- Geared to the achievement of objectives in one or more separate but overlapping categories. That is, a particular objective can fall into more than one category – strategic, operations, reporting, and compliance.

The intent of the *Enterprise Risk Management – Integrated Framework* is not to replace the internal control framework, but rather to incorporate the internal control framework within it. Savings associations may decide to look to this enterprise risk management framework both to satisfy their internal control needs and to move toward a more robust risk management process.

An integral part of effective enterprise risk management is an enterprise-wide program that looks at how activities in one area of the association may affect the legal and reputational risks of other business lines and across the association as a whole. Enterprise risk management should consider how compliance with laws, regulations, and internal policies, procedures, and controls should be enhanced or changed. This approach is in marked contrast to the silo approach, which considers the legal and reputational risks of activities or business lines in isolation without considering how those risks interrelate and affect other business lines.

Audit Committee

The audit committee oversees internal control and the external and internal audit functions of an association. An active board or audit committee independent from management sets the association's control consciousness. The following parameters determine the effectiveness of an audit committee:

- The extent of its involvement in and its scrutiny of the association'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 Sections 350, External Audit, and 355, Internal Audit.

AUDITOR RESPONSIBILITIES

Internal Audits

Both the internal and external auditors play key roles in monitoring the internal control systems. Each association 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 association'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 deficient control system. See Examination Handbook Section 355.

External Audits

Established policies and practices look to the external auditor to play a significant and vital role in an association's internal control systems. In this role, the external auditor performs procedures to attest to management's assertion that the internal control over financial reporting is functioning effectively when so engaged by the association (either because it is required by SOX or FDICIA, or voluntarily). The external auditor may consider the work done by the internal auditor as part of the auditing procedures.

Information Technology

SAS No. 94 (integrated in AU Section 319), *The Effect of Information Technology on the Auditor's Consideration of Internal Control*, which amends SAS No. 55, *Consideration of Internal Audit in a Financial Statement Audit*, provides guidance to external auditors about the effect of information technology on internal control. SAS 94 also establishes that an external 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. 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 association, and may use different levels of testing depending on the risk of a specific area.

Communication of Internal Control Matters

SAS 112, *Communicating Internal Control Related Matters Identified in an Audit*, supersedes SAS 60 and is effective for audits of financial statements of nonpublic companies. In particular, SAS 112:

- Defines the term *significant deficiency,* (which replaces the SAS 60 term reportable condition) as a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with

GAAP such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is *more than inconsequential* will not be prevented or detected.

— A misstatement is inconsequential if a reasonable person would conclude, after considering the possibility of further undetected misstatements, that the misstatement, either individually or when aggregated with other misstatements, would clearly be immaterial to the financial statements. If a reasonable person would not reach such a conclusion regarding a particular misstatement, that misstatement is more than inconsequential.

- Revises the definition of *material weakness* as a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected.

- Provides guidance on evaluating the severity of control deficiencies identified in an audit of financial statements. SAS 112 states that a *control deficiency* exists when the design or operation of a control does not allow management or employees in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis.

- Requires the auditor to communicate, in writing, to management and those charged with governance, significant deficiencies and material weaknesses identified in an audit.

SAS No.115, Communicating Internal Control Related Matters Identified in an Audit, was issued in October 2008 and supersedes SAS No. 112. SAS No. 115 is effective for audits of financial statements of nonpublic companies for periods ending on or after December 15, 2009. Earlier implementation is permitted. SAS 115 was issued to eliminate differences within the AICPA's Audit and Attest Standards resulting from the issuance of Statement on Standards for Attestation Engagements (SSAE) No. 15, An Examination of an Entity's Internal Control Over Financial Reporting That Is Integrated With an Audit of Its Financial Statements. SSAE No. 15 was issued October 2008 and is effective for integrated audit periods ending on or after December 15, 2008. SSAE No.15 establishes standards and provides guidance to practitioners performing an examination of nonissuer's internal control over financial reporting to the context of an integrated audit. SSAE No. 15 aligns the definitions of the various kinds of deficiencies in internal control and the related guidance for evaluating such deficiencies with the definitions and guidance in Public Company Accounting Oversight Auditing Standards No. 5, An Audit of Internal Control That Is Integrated with an Audit of Financial Statements. SAS No.115, in turn, aligns the definitions and related guidance for evaluating deficiencies in internal control with the definitions and guidance in SSAE 15. In particular, SAS No.115 retains the core standards included in SAS No. 112 but contains the following revised definitions of the terms material weakness and significant deficiency:

- A material weakness is a deficiency, or combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis.

- A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

SAS No. 115 revises the list of deficiencies in internal control that are indicators of material weakness to consist of:

- Identification of fraud, whether or not material, on the part of senior management.

- Restatement of previously issued financial statements to reflect the correction of a material misstatement due to error or fraud.

- Identification by the auditor of a material misstatement of the financial statements under audit in circumstances that indicate that the misstatement would not have been detected by the entity's internal control.

- Ineffective oversight of the entity's financial reporting and internal control by those charged with governance.

SAS No. 115 no longer includes a list of deficiencies that were included in SAS No. 112 that ordinarily would be considered at least significant deficiencies. It also provides a revised illustrative written communication to management and those charged with governance of material weaknesses and significant deficiencies.

As mentioned earlier, SSAE No. 15 establishes standards and provides guidance to practitioners performing an examination of a nonissuer's internal control over financial reporting (internal control) in the context of an integrated audit (an audit of an entity's financial statements and an examination of its internal control). SSAE No. 15 supersedes AT section 501, *Reporting on an Entity's Internal Control Over Financial Reporting*. And converges the standards practitioners use for reporting on a nonissuer's internal control with Public Company Accounting Oversight Board (PCAOB) Auditing Standard No. 5, *An Audit of Internal Control That Is Integrated with an Audit of Financial Statements*- the long standing guidance followed by auditors of institutions subject to reporting requirement for internal control over financial reporting under FDICIA. SSAE is effective for integrated audits for periods ending on or after December 15, 2008.

SSAE No. 15 essentially mirrors the guidance for public companies subject to Section 404 of the Sarbanes-Oxley Act (SOX 404) and their auditors who follow PCAOB Auditing Standard No. 5. SSAE No. 15 establishes more extensive testing and documentation requirements than was previously required under the old AT 501. FDICIA engagements for nonpublic institutions, as well as institutions not yet subject to the provisions of SOX 404, which were governed by AT 501 are now governed by SSAE No. 15. Therefore, privately owned institutions over $1 billion in total assets now need to approach their documentation and testing of internal controls over financial reporting in a similar manner to that of a public company.

Audits of public companies are subject to PCAOB AS No. 5. The SEC is in agreement with PCAOB AS No. 5.

Audit of Internal Control Over Financial Reporting

PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements* establishes requirements and provides direction that applies when an auditor is engaged to perform an audit of management's assessment of the effectiveness of internal control over financial reporting that is integrated with an audit of the financial statements.

PCAOB Auditing Standard No. 5 defines *internal control over financial reporting* as:

> "A process designed by, or under the supervision of, the company's principal executive and principal financial officers, or persons performing similar functions, and effected by the company's board of directors, management, and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles (GAAP) and includes those policies and procedures that:
>
> - Pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company.
> - Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with GAAP, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company.
> - Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the association's assets that could have a material effect on the financial statements."

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 generally accepted accounting standards. 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.

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

- Control environment
- Risk assessment

- Control activities
- Information and communication systems
- Monitoring.

The Control Environment

The effectiveness of internal controls rests with the people of the organization who create, administer, and monitor them. In varying degrees, internal control is the responsibility of everyone in the association. 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

The control environment sets the tone of an organization, influencing the control consciousness of its people. It is the foundation for all other components of internal control, providing discipline and structure. 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 essential elements of the control environment, affecting the design, administration, and monitoring of other components. Integrity and ethical values are the products of the association'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.

Commitment to Competence

Competence is the knowledge and skills necessary to accomplish tasks that define the individual's job. Commitment to competence includes management's consideration of the competence levels for particular jobs and how those levels translate into requisite skills and knowledge.

Board of Directors or Audit Committee Participation

The association's board of directors or audit committee significantly influences an association's control consciousness. Attributes include the board or audit committee's independence from management, the experience and stature of its members, the extent of its involvement in and scrutiny of activities, the appropriateness of its actions, the degree to which difficult questions are raised and pursued with management, and its interaction with internal and external auditors.

Management's 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. 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; otherwise even the best-written policies on internal control would not be effective.

Organizational Structure

The association must have an organizational structure that supports its objectives. Management must plan, execute, control, and monitor association objectives. It must establish key areas of authority and responsibility and appropriate lines of reporting. The appropriateness of an entity's organizational structure depends, in part, on its size and the nature of its activities.

Assignment of Authority and Responsibility

This factor includes how the board and senior management assign authority and responsibility for operating activities and establish reporting relationships and authorization hierarchies. It also 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 policies and practices relate to hiring, orientation, training, evaluating, counseling, promoting, compensating, and remedial actions. Human resource policies and practices send messages to employees regarding expected levels of performance, integrity, ethical behavior, and competence. Promotions driven by periodic performance appraisals demonstrate the association's commitment to the advancement of qualified personnel to higher levels of responsibility.

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 association'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 redesigned information systems
- Rapid growth
- New technology
- New business models, products, or activities
- Corporate restructurings
- New or expanded foreign operations
- New 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 the association achieves strategic objectives.
- 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, procedures, and practices established to help ensure that association personnel carry out board and management directives at every business level throughout the association. Control activities should assure accountability in the association's operations, financial reporting, and compliance areas. They include a range of activities as diverse as approvals, authorizations, verifications, reconciliations, review of operating performance, security of assets, and segregation of duties.

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 categories of controls for information systems:

- *General controls* apply to mainframe and end-user environments.

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

  — Data center and network operations.

  — System software acquisition and maintenance.

  — Access security.

  — Application system acquisition, development, and maintenance.

- *Application controls* apply to the processing of individual applications.

  Management should establish controls to ensure valid, complete, properly authorized, and accurately processed transactions.

Information technology (IT) examiners review information processing controls in IT examinations.

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.
- Granting access to systems, applications, and databases.

- Periodic counting and comparison with amounts shown on control records.

Segregation of Duties

Management must assign different people the responsibility of authorizing transactions and recording transactions, and maintaining custody of assets. Management also should ensure that personnel adhere to vacation requirements and periodic rotation of duties for personnel in sensitive positions. This segregation of duties should reduce the opportunities to perpetrate and conceal errors, irregularities, or wrongdoing.

An independent third party should periodically review this area to ensure segregation of duties is effective.

Information and Communication Systems

Information and communication systems support the identification, capture, and exchange of information in a form and time frame that enable people to carry out their responsibilities.

An information system consists of infrastructure (physical and hardware components), software, people, procedures, and data. Many information systems make extensive use of information technology.

Information systems produce reports containing operational, financial, and compliance-related information that make it possible to run and control the business. An association should have policies, procedures, and controls to ensure the confidentiality, integrity, and availability of its information.

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. There also needs to be effective communication with external parties, such as customers, suppliers, service providers, regulators, and shareholders.

Information and Communication Systems Assessment Process

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

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, liabilities, equity, income, and expense; 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.

- Association-wide business continuity plans and disaster recovery plans for the association's information systems. For additional guidance, see Examination Handbook Section 341, Information Technology Risks and Controls, and CEO Memo No. 269, FFIEC IT Examination Handbook, Business Continuity Planning.

Monitoring

Monitoring is a process that assesses the quality of the internal control performance over time. It involves assessing the design and operation of controls on a timely basis and taking necessary corrective actions. COSO issued an exposure draft in June 2008 titled *Guidance on Monitoring Internal Control Systems.*

Management must build ongoing monitoring activities into the normal recurring activities of their association, and monitor the internal control system on an ongoing basis to ensure that the system continues to be relevant and addresses new risks. Monitoring of key risks should also be part of the association's daily activities. In many cases, the internal auditor is responsible for monitoring the entity's activities, including key risks, 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 monitoring or periodic evaluation of internal control that occurs. For example, is it by self-assessment, by independent audit, or a separate risk management group? 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. Determine whether internal control deficiencies are reported to the appropriate person, with all serious matters reported to top management and the board.

Integrated System of Internal Control

There is synergy and linkage among these five internal control components, forming an integrated system that reacts dynamically to changing conditions. The internal control system intertwines with the association's operating activities and exists for fundamental business reasons. Internal control is most effective when management builds controls into the association's infrastructure and the controls become a part of the essence of the association. "Built in" controls support quality and empowerment initiatives, avoid unnecessary costs, and enable quick response to changing conditions.

There is a direct relationship between the three categories of objectives listed in the COSO and SAS 78 definition of internal control and the components. The objectives are what an association strives to achieve, and the components represent what the association needs to achieve the objectives. All components are relevant to each objectives category. When looking at any one category – the effectiveness and efficiency of operations, for instance – all five components must be present and functioning effectively to conclude that internal control over operations is effective.

After examining the components and their risk, draw an overall conclusion as to the adequacy of the association's system of internal control and, if appropriate, include the assessment in the report of examination. A system deemed inadequate is potentially in noncompliance with Appendix A of 12 CFR Part 570, Interagency Guidelines Establishing Standards for Safety and Soundness. OTS may notify an association with an inadequate risk assessment of the need to file a plan of compliance as the regulation provides. The plan would establish how the association will correct its internal control deficiencies.

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 association 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 in internal control
- 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 in Internal Control

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 association, fraud detection is certainly a goal when reviewing an association's internal control system. The opportunity to commit and conceal fraud exists when the association has assets susceptible to misappropriation and a lack of internal control to prevent and detect fraud.

An examination of internal controls with an eye to the weaknesses in any one of the five components of the system will identify the association's exposure to fraud. Next, you should look for symptoms suggesting that fraud is occurring or has occurred in those areas. For misappropriation of assets, fraud symptoms generally can be classified into the following categories:

- Accounting symptoms – unusual or suspicious items involving the organization's accounting records or related documents.
  - Source documents that have been manipulated.
    - Missing documents

    - ♦ Alterations of documents
    - ♦ Duplicate payments
    - ♦ Stale items on association reconciliations
    - ♦ Increased reconciling items.

  - — Journal entries where a fraudulent debit has been recorded.
    - ♦ Entries without supporting documentation.
    - ♦ Entries made by persons who do not normally make those entries.
    - ♦ Entries made near the end of the period.

  - — Accounting ledgers not in agreement with related accounts:
    - ♦ Ledger does not agree with underlying assets.
    - ♦ Subsidiary ledger does not agree with the control account.

- Analytical symptoms – relationships, procedures, or events that do not make sense. Relationships may be symptoms if they are too unusual or too unrealistic to be believable. Events and transactions may be symptoms if they (1) happen at odd times or places; (2) are performed by or involve people who would not normally participate; (3) involve odd procedures, polices, or practices; or (4) are performed or occur too often or too rarely.
  - — Unexplained shortages or adjustments in accounts.
  - — Significant increases or decreases in account balances.
  - — High numbers or amounts of past due accounts.
  - — Suspense accounts with high or continuing balances.
  - — Cash shortages or overages.
  - — Excessive late charges.
  - — Unreasonable expenses or reimbursements.

Problems concerning insiders at some associations 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 association 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. If you encounter any red flags, you should investigate the situation and consider whether to seek assistance from agency subject matter experts, (such as regional accountants, IT examiners, etc.). For more information, see Handbook Section 360, Fraud and Insider Abuse.

Costs versus Benefits

Management makes quantitative and qualitative estimates and judgments in evaluating the cost-benefit relationship of the association's internal control. 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 CONSIDERATIONS

The objective of examining the internal control of an association is to assess the extent management has established internal control procedures and programs to identify and mitigate the association's internal control risks. You should focus your efforts on the detection, exposure and correction of important weaknesses in the association's records, operating systems, and auditing procedures. Gather information through discussions with management and employees and observation of performance and procedures. You must apply common sense and technical knowledge to the specific situations of each association. You must consider the association's size, the number of employees, and the character of the association's operations. 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 or reports of examination.
- Management scales back or suspends the internal audit or risk management 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 association's external audit firm lacks depository institution audit experience, the auditors assigned have limited experience, or are geographically distant.

- Association management enters new areas of activity without first implementing proper controls, or engages in new activities without experienced staff and appropriate controls in place.

- Management fails to provide adequate reports to the board of directors.

- Management fails to report on the association's internal control over financial reporting and/or external auditors fail to attest to the accuracy of management's report.

- The association does not have proper controls in high-risk areas.

- The association often deviates from board-approved policies with exception documentation.

- The association fails to effectively segregate duties and responsibilities among employees.

- The association had a security breach that resulted in unauthorized access to or use of customer information.

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.

Level I Procedures

Review the list of objectives in the Internal Control Program and follow the Level I Procedures to design the examination. These procedures are generally sufficient when an association has an effective internal audit or risk management function.

Although the five components of internal control provide a useful framework for you to review the effect of an entity's internal control in an examination, they do not reflect how the association considers and implements internal control. Therefore, you should consider the five internal control components in the context of the following criteria:

- Size of the association.

- Organization and ownership characteristics.
- Nature of the association's business.
- Diversity and complexity of the association's business.
- The association's information technology environment, including all methods of capturing, transmitting, processing, maintaining, and accessing information. See Examination Handbook Section 341 for additional guidance.
- Legal and regulatory requirements.

Management's Responses to Questionnaires

OTS sends the Internal Control Questionnaire and the Funds Transfer Questionnaire to the association as part of the PERK. Association management completes the questionnaires, which contain questions regarding the overall internal control system of the association. You should verify answers provided by management to ensure that the answers accurately reflect the association's activities and the adequacy of its control environment.

In both the Internal Control and Funds Transfer Questionnaires, there are certain "flagged" questions that are the suggested minimum verifications you should perform through inquiry, observation, or testing, particularly if the association lacks effective controls.

You should also review the general questionnaires that correlate to certain handbook sections as examiners assigned these areas complete them. Identify all critical internal control deficiencies. Discuss these deficiencies with management and encourage them to take appropriate corrective action.

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 association'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 deficiencies, either orally or in writing, to management. If you determine that external audit work papers are necessary for your review, contact your field manager or the Regional Accountant before requesting external audit work papers, or other pertinent documents related to the external auditor's judgment about the association'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 or Legal division.

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

Level II Procedures

Based on management's responses to questionnaires, or when an association does not have an effective system of internal audit, or when warranted 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 association outsources any significant activities and Level I procedures are insufficient to determine how the association 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 or external 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.
- Rapid growth areas exist without adequate audit or internal control.
- Inappropriate actions by insiders to influence the findings and scope of audits.

After completion of Level II procedures, if significant concerns remain about the adequacy of internal control, 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 your EIC, field manager, or the Regional Accountant to determine which procedures you should perform. Where you determine that the association's internal control system is not adequate or effective for its specific risk profile, consult with your EIC, field manager, or Regional Accountant on appropriate corrective action.

OUTSOURCING RISKS

Associations 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 association to additional risks.

Outsourcing involves some of the same operational risks that arise when an association 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 association that bears the risk of financial loss, damage to its reputation, or other adverse consequences.

OTS expects associations to ensure that controls over outsourced activities are equivalent to those that the association would implement if they conducted the activity internally. The association'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 discussions of outsourcing in Handbook Sections 341 Information Technology Risks and Controls, and 355, Internal Audit; Thrift Bulletin (TB) 81, Interagency Policy Statement on the Internal Audit Function and its Outsourcing; TB 82a, Third Party Arrangements; and the FFIEC IT Examination Handbook.

REFERENCES

United States Code (12 USC)

Federal Deposit Insurance Act

§ 1831	Contracts Between Depository Institutions and Persons Providing Goods, Products, or Services
§ 1831p-1	Standards for Safety and Soundness

Federal Deposit Insurance Corporation Improvement Act (FDICIA)

§ 112	Independent Annual Audits of Insured Depository Institutions

Code of Federal Regulations (12 CFR)

74 FR 35726	Final Rule; Annual Independent Audits and Reporting Requirements (July 29, 2009)
Part 363	Requirements For External Audits and Audit Committees
Part 364 Appendix A	Interagency Guidelines Establishing Standards for Safety and Soundness
Part 562	Regulatory Reporting Standards
Part 570	Appendix A, Interagency Guidelines Establishing Standards for Safety and Soundness

Sarbanes-Oxley Act of 2002

§ 404	Management's Report on Internal Control Over Financial Reporting

OTS References

CEO Memo 173	Filing of Section 906 SOX Certifications with OTS
CEO Memo 174	Statement by the Federal Reserve Board, the Comptroller of the Currency, and the Office of Thrift Supervision on Application of Recent Corporate Governance Initiatives to Non-Public Bank Organizations
CEO Memo 180	SEC's Final Rule Discussing Reports on Internal Control That May Satisfy Both SEC Requirements and FDIC Part 363 Requirements
CEO Memo 245	Directors' Guide to Management Reports

CEO Memo 269	Information Technology Handbook, Updated Business Continuity Planning Booklet
TB 81	Interagency Policy Statement on the Internal Audit Function and its Outsourcing
TB 82a	Third Party Arrangements
Transmittal 388	SEC Extends Date Regarding the Internal Controls Requirements Mandated by Section 404 of SOX
Transmittal 392	SEC Issued Final Rule on Amendments to Rules Regarding Management's Report on Internal Control Over Financial Reporting

Closely Related Examination Handbook Sections

341	Information Technology Risks and Controls
350	External Audit
355	Internal Audit

FFIEC IT Examination Handbook

AICPA Professional Standards

Statement on Auditing Standards (SAS) (U.S. Auditing Standards (AU))

No. 55	Consideration of Internal Control in Financial Statement Audit (AU 319)
No. 60	Communication of Internal Control Structure Related Matters Noted in an Audit (AU 325)
No. 78	Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS 55 (AU 319)
No. 91	Federal GAAP Hierarchy
No. 94	The Effect of Information Technology on the Auditor's Consideration of Internal Control in a Financial Statement Audit (AU 319)
No. 112	Communicating Internal Control Related Matters Identified in an Audit

No. 115	Communicating Internal Control Related Matters Identified in an Audit (Supersedes SAS No. 112 and is effective for periods ending on or after December 15, 2009)
AU Section 319	Consideration of Internal Control in a Financial Statement Audit
AU Section 325	Communications About Control Deficiencies in an Audit of Financial Statements

Audit and Attest Standards

AT 501	Reporting on an Entity's Internal Control Over Financial Reporting
SSAE 15	An Examination of an Entity's Internal Control Over Financial Reporting that is Integrated with an Audit of its Financial Statements (Supersedes AT 501 and is effective for periods ending on or after December 15, 2008)

Public Company Accounting Oversight Board (PCAOB)

Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements

Internal Control Program

EXAMINATION OBJECTIVES

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

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

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

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

EXAMINATION PROCEDURES

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

LEVEL I

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

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

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

2. Review management reports on internal control and related audit reports issued by independent accountants as required by the Federal Deposit Insurance Corporation Improvement Act (FDICIA) and, if applicable, Section 404 of the Sarbanes-Oxley Act (SOX). Review the external audit work papers on internal control or other communications regarding significant deficiencies. See Handbook Section 350, Appendices D and E, and discuss with your field manager or the Regional Accountant before requesting external audit work papers.

3. Determine whether the board of directors stays current with innovations in corporate governance.

4. Check for material weaknesses in internal controls by noting any deficiencies reported in the following:

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

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

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

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

7. Verify that management enforces all critical policies.

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

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

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

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

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

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

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

LEVEL II

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

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

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2. 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.

3. 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.

4. Assess the adequacy of information and communication systems.

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

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

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

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

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

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

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

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

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

LEVEL III

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

- Level I and II procedures are insufficient to draw sound conclusions.
- An independent party does not audit the association.
- The association does not have an internal audit program in place.

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

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

3. Verify the safekeeping of securities on hand or held by others.

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

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

6. Check supporting documentation for loans charged off.

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

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

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

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

11. 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.

12. Verify borrowed funds balances.

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

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

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

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

EXAMINER'S SUMMARY, RECOMMENDATIONS, AND COMMENTS

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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 flagged questions are the suggested minimum verifications. The association must explain negative responses and you should review through interview and observation any problems needing supervisory attention. For additional guidance in a certain area, see the referenced handbook section. Some of the handbook sections include more detailed questionnaires that may assist you in your interviews of management.

Internal Control Questionnaire

The Internal Control Questionnaire covers the following areas.

Internal Audit

Savings associations should have an internal audit 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 Handbook Section 355, Internal Audit, and the Internal Audit Questionnaire (355Q).

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.

Dual control is the concept in which one person verifies or approves the work of another. The purposes of involving the second individual are to ensure that proper authority for the transaction or activity is given, that the transaction or activity is properly recorded, and that proper settlement is made. Dual control in automated systems should be used in the same manner as in manual systems. Supervisory holds should be placed on customer accounts requiring special attention. For example, dormant accounts, collateral accounts, and accounts with large uncollected funds normally have holds that require the action of two people to remove. When a hold on an account is added/ removed or when a transaction requiring supervisory approval is completed on an automated system, exception reports will be printed and should be reviewed by a designated person not involved with the transaction. Used conscientiously, automated dual control methods are superior to the manual procedures.

Management should ensure that policies require personnel who have cash approval and disbursement authority take annual vacations and restrict employee access to the association's internal systems ruing their vacation absence.

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 for checks signed by hand 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.

The association should have certain controls in place for checks signed by stand-alone mechanical or electronic facsimile check signing machines connected to computers: an approval process for checks in excess of a certain dollar amount, the association's copy of the check voucher initialed by the person preparing the check, and for those checks in excess of a certain amount, the check vouchers initialed by a person authorized to approve them. 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.

When planning for the purchase of laser check printing software, management should match the laser check printing needs of the association to software that has the desired level of controls, an acceptable level of risk, and a cost efficient price.

Due From Banks

Due from banks describes assets that consist of demand and time deposits maintained in other financial 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 applicable).
- 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, associations should hold securities in safekeeping under delivery versus payment procedures. To deter theft of the portfolio, management should prohibit free deliveries, i.e., those not requiring payment (such as a transfer from one safekeeping agent to another), unless the contract specifies dual approval. When the association holds negotiable securities on premises, the securities should be under strict dual control at all times. An independent party should perform tests to determine that the yields on investments actually received are in line with the weighted average coupon of such assets. Refer to Handbook Section 540, Investment Securities, and the Investment Securities Questionnaire (540Q).

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 over lending 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 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.

Qualified and adequately trained individuals not involved in the loan production processes should review appraisals and evaluations. An association must establish more in-depth review procedures for appraisals of large, complex, or out-of-area commercial real estate credits and for those appraisals and evaluations ordered by agents of the association, such as loan brokers or another financial services institution. Even small associations that cannot achieve absolute lines of independence should implement effective internal controls to ensure that no single person has sole authority to render credit decisions involving loans on which they ordered or reviewed the appraisal or evaluation. Further, lending officials, officers, or directors should abstain from any vote of approval involving loans for which they performed the appraisal or evaluation.

Refer to Examination Handbook Sections 201, 208, and 212, and the accompanying questionnaires.

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 materialmens' lien wavers, 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 Handbook Section 213, Construction Lending, and the Construction Lending Questionnaire (213Q).

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. If the association has automated accounting entries for accrual of interest, they should explain what testing they do to be sure that the computer-generated figures are correct.

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 upcoming expenses. If the analysis results in a revised monthly payment, the association should make the revision promptly and notify the customer. 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 Handbook Section 750, Mortgage Banking.

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 Handbook Section 213, Construction Lending, and the Construction Lending Questionnaire (213Q).

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 Handbook Section 214, Other Commercial Lending, and the accompanying questionnaire (214Q).

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 contingency for liability as a letter of credit, if the holder can prove the authenticity of the commitment. Refer to Handbook Section 215, Letters of Credit, and the accompanying questionnaire (215Q).

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 portable. 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 Handbook Section 216, Floor Plan and Indirect Lending, and the accompanying questionnaire (216Q).

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. The association's credit quality review should include testing for compliance with regulation, association policy, officer lending limits, and association underwriting standards. Refer to 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.

To prevent withdrawal of collateral, the association should flag pledged deposit accounts and require a supervisory override for withdrawal of pledged funds. It should have procedures in place to ensure that the total loan and accrued interest does not exceed the balance amount of the deposit account. Refer to Handbook Section 560, Deposits/ Borrowed Funds, and the accompanying questionnaire (560Q).

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.

The association should maintain separate files for each parcel of real estate owned and maintain subsidiary records for each parcel showing items capitalized, expenses, rentals, etc. The association should balance subsidiary ledgers for the individual properties to the general ledger at least monthly. 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 and ensure maintenance of hazard insurance, when available. Refer to Handbook Section 251, Real Estate Owned and Other Repossessed Assets, and the accompanying questionnaire (251Q).

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 Handbook Section 230, Equity Investments, and the Equity Investments Questionnaire (230Q).

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 Handbook Section 250, Other Assets/Liabilities, Section 252, Fixed Assets, and the Fixed Assets Questionnaire (252Q).

Demand Accounts

Associations must limit checks drawn on uncollected funds 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 nonsufficient 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.

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 recurring 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 on the report are not involved in check kiting, but the report 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.

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 Handbook Section 560, Deposits/ Borrowed Funds, and the accompanying questionnaire (560Q).

Deferred Income

Generally accepted accounting principles require recognition of net loan origination fees/costs as income over the life of the loan in accordance with SFAS No. 91. The association should maintain records supporting loan fees/ costs deferred and earned/ expensed.

Other Liabilities

Management should maintain a detailed inventory or other subsidiary records for the various other liability accounts. They should also periodically review miscellaneous accounts to deter misuse.

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 Handbook Section 110, Capital Stock and Ownership.

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 whether:

- Fund transfers pose risk to capital.
- Management implemented effective controls.
- Management confirms or tests the controls periodically.

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

Transfers may originate internally or externally and can involve one customer or many customers. Internal transfers are between the institution and its customers, such as loan fundings and deposit transfers among customers' accounts. External transfers are payments involving more than one depository institution.

Essentially, all transfers are instructions by an authorizer to debit an account at an institution for credit to another account at either the same or another institution. All associations engage in transfers and many are involved in large transfers relative to their equity capital and blanket bond coverage. Associations without correspondent banking departments and major corporate deposit accounts may not have a large volume or dollar amount 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 conducts related to capital.
- Insurance coverage and deductibles.
- The size and diversity of the association's staff.

Due to the detail involved, you should review the internal controls on funds transfers by interview and observation. Any procedures allowing one person to remove unlimited funds from an account without immediate detection deserves 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.

Association management should encrypt all data transmissions using algorithms. This protects information from improper disclosure or alteration. You can find additional guidance on electronic funds transfer systems in the Wholesale Payment Systems and Retail Payment Systems booklets of the Federal Financial Institutions Examination Counsel (FFIEC) Information Technology (IT) Examination Handbook.

Internal Transfers

Associations execute ***internal transfers*** through the accounting system and may initiate a transfer on paper, by direct key entry, or through the Internet.

An example of a typical internal 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. General authorization controls may require initiator and sender identification codes, unique passwords, cipher codes, set procedures, and limited channels of communication.

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.

Two-party Transfers

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 either approve or confirm the 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.

External Transfers

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.

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
- Internet
- Paper
- Electronically transmitted-image facsimile (FAX)
- Voice.

These mediums may use various technologies such as wires, radiophone, cellular radio telephone, microwave, or fiber optic lines, each with different security and vulnerability. Wire transfer service providers include:

- Fedwire Funds Service
- 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.

Daylight overdrafts are overdrafts existing between the daily closing of accounting records. Associations usually do not prevent overdrafting as this could inhibit legitimate business transactions. Rather, associations establish limits that prevent additional overdrafting beyond the approved threshold. If inadequately controlled, daylight overdrafts may be a serious financial risk because funds available for transfer may be virtually unlimited and unrecoverable. Even when daylight overdrafts are properly controlled, they pose a credit risk. For these reasons, internal controls on external transfers must be rigid and subject to frequent testing and review to discourage and prevent loss.

Refer to Handbook Section 580, Payments Systems Risk, for discussion of the setting of limits for daylight overdrafts.

In a low-volume voice transmission operation, a customer submits a wire transfer request and an association employee initiates the funds transfer through a correspondent. This type of 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.

External funds transfers typically require a four-party callback or confirmation process. 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.

Other common control safeguards include the following procedures:

- Limited signing authorities.
- Dual controls over forms.
- Unique passwords for 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 respondent 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.

Daily independent reconcilement 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 missent funds diminish quickly. You should check whether the association 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.

The association should keep a complete log of wire transfer activity and audit it periodically.

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	Verified by Examiner		Yes	No	NA

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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 the responses and enter their initials 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.

Please provide the requested information by Click Here and Type

	Verified by Examiner			Yes	No	NA

Internal Audit

				Yes	No	NA
	______	4.1	Does the association have an internal audit program?	☐	☐	☐
	______	4.2	Does the board of directors or the audit committee review internal audit reports?	☐	☐	☐
	______	4.3	Does the audit committee consist only of outside directors?	☐	☐	☐
	______	4.4	Do internal audit reports suggest actions to correct internal control or procedural deficiencies?	☐	☐	☐
	______	4.5	Is there a subsequent review to ascertain that the associa-	☐	☐	☐

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	Verified by Examiner		Yes	No	NA

	Verified by Examiner		Yes	No	NA
		tion implemented suggestions for corrective actions?			
	_____	4.6 Does the internal auditor report to or receive salary reviews by the audit committee or board of directors?	☐	☐	☐
	_____	4.7 Did the external auditor communicate any internal control deficiencies, either orally or in writing, to the association?	☐	☐	☐

[Type Management Response Here]

General Items

			Yes	No	NA
_____	4.8	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	☐	☐	☐
_____	4.9	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	☐	☐	☐
_____	4.10	Does a person not involved in general ledger entries perform	☐	☐	☐

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	Verified by Examiner			Yes	No	NA
			the reconciliations?			
	______	4.11	Does a person not involved in the transactions periodically review and investigate activity on exception and/or large items report(s)?	☐	☐	☐
	______	4.12	Does the association perform a regular review of insider activity for unusual activity and compliance with Regulation O?	☐	☐	☐
	______	4.13	Does the association periodically review deferred expense/ income accounts?	☐	☐	☐
	______	4.14	Does the association clearly show the nature and purpose of each entry to the deferred expense/ income accounts?	☐	☐	☐
	______	4.15	Is there one person authorized to make entries to the deferred expense/ income accounts?	☐	☐	☐
	______	4.16	Does the association balance and reconcile to third-party reports monthly any association assets that others service or hold in safekeeping?	☐	☐	☐

[Type Management Response Here]

Cash and Cash Items

	______	4.17	Are all personnel who have cash approval and disbursement authority required to take annual vacations according to association policy?	☐	☐	☐
	______	4.18	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?	☐	☐	☐
	______	4.19	Are general ledger entries related to cash items reviewed by supervisory personnel who do not also prepare the general ledger entries related to cash items?	☐	☐	☐
	______	4.20	Are cash items recommended for charge off reviewed and	☐	☐	☐

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	Verified by Examiner			Yes	No	NA
			approved by an officer with no operational responsibilities?			
	______	4.21	Does the association review teller and accounting system override reports and file maintenance summaries for unusual activity on a regular basis? Indicate the frequency, for example, daily, weekly, etc.	☐	☐	☐
	______	4.22	Are loan accounting systems included in the override reports?	☐	☐	☐
	______	4.23	Are personnel who have control over cash barred from performing overrides?	☐	☐	☐
	______	4.24	Do only designated personnel who have no control over cash approve and review overrides?	☐	☐	☐
	______	4.25	Does the association, at both home and branch offices, perform daily cash reconciliations?	☐	☐	☐
	______	4.26	Does a person without teller responsibilities perform the daily cash counts?	☐	☐	☐
	______	4.27	Are overages and shortages properly recorded in a cash over and short account?	☐	☐	☐
	______	4.28	Does the association maintain records showing the person involved in the cash over or short situation?	☐	☐	☐
	______	4.29	Does the association investigate and act upon all cash over and short amounts?	☐	☐	☐
	______	4.30	Does the association have appropriate controls over unissued deposit certificates, travelers' checks, savings bonds, food stamps, and other consigned items?	☐	☐	☐
	______	4.31	Does the association periodically reconcile consigned items?	☐	☐	☐

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	Verified by Examiner			Yes	No	NA
	_____	4.32	Is daily access to the automated teller machine (ATM) made under dual control?	☐	☐	☐
	_____	4.33	When maintenance is being performed on a machine, with or without cash in it, is a representative of the institution required to be in attendance?	☐	☐	☐
	_____	4.34	Are combinations and keys to the machines controlled?	☐	☐	☐
			What are the controls?			
	_____	4.35	Are personal identification numbers (PINs) mailed separately from cards?	☐	☐	☐
	_____	4.36	Are association personnel who have custody of cards prohibited from also having custody of PINs at any stage (issuance, verification, or reissuance)?	☐	☐	☐
	_____	4.37	Are captured cards under dual control of persons not associated with association operation card issuance or PIN issuance?	☐	☐	☐
	_____	4.38	Are blank plastics and magnetic stripe readers under dual control?	☐	☐	☐

[Type Management Response Here]

Association (Official) Checks

	_____	4.39	For checks signed by hand: Are two signatures (signer and approver) required on association (official) checks?	☐	☐	☐
	_____	4.40	Are unsigned blank checks in the possession of an officer or employee who does not have singular signature authority?	☐	☐	☐

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	Verified by Examiner		Yes	No	NA
	_____	4.41 Is the inventory of unsigned blank checks available verified daily and compared to the work of other positions that issue checks during the day?	☐	☐	☐
	_____	4.42 Is there an approval process for checks in excess of a certain dollar amount?	☐	☐	☐
		If so, what is the amount?			
	_____	4.43 Is the association's copy of the check voucher initialed by the person preparing the check?	☐	☐	☐
	_____	4.44 Does the association have controls in place to ensure that the employee fills out the amount of the check and payee information before the signatures are on the checks?	☐	☐	☐
	_____	4.45 Is the supply of unused checks periodically reconciled to the shipping invoice by persons without signature authority?	☐	☐	☐
		How often?			
	_____	4.46 Does a person independent of the check writing function review the paid (canceled) checks for proper signatures and reconcile the checks to vouchers?	☐	☐	☐
		How often?			
	_____	4.47 Does the association periodically reconcile outstanding checks to vouchers and liability accounts?	☐	☐	☐
	_____	4.48 Does the association periodically transfer all outstanding six-month old association checks to a liability account?	☐	☐	☐
	_____	4.49 Does the association keep the facsimile check writing machine under proper control?	☐	☐	☐

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_____ 4.50 For checks laser printed from a computer system: Does the association have appropriate preventive controls in place, such as auto encryption and dual login? ☐ ☐ ☐

[Type Management Response Here]

Due From Banks

_____ 4.51 The association receives bank statements:

☐ Daily ☐ Monthly ☐ Quarterly

_____ 4.52 Does the association reconcile bank accounts on a regular and timely basis? ☐ ☐ ☐

- How often?

_____ 4.53 Are there any unreconciled bank accounts? ☐ ☐ ☐

- If so, which accounts?

_____ 4.54 Are there are any out of balance accounts? ☐ ☐ ☐

- If so, which accounts?

_____ 4.55 Is the person who reconciles the bank statements independent of the deposit and check writing process? ☐ ☐ ☐

_____ 4.56 Do checks drawn on bank accounts need more than one signature? ☐ ☐ ☐

_____ - If so, is this required only for checks above a predetermined amount? ☐ ☐ ☐

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______ 4.57 Does a person who does not have signature authority periodically reconcile unsigned checks to the shipping invoice? ☐ ☐ ☐

How often?

[Type Management Response Here]

Investments and Securities

______ 4.58 Are supporting documents, such as brokers' confirmations and account statements for recorded purchases and sales, checked or reviewed subsequently by persons who do not also have sole custody of securities or authorization to execute trades? ☐ ☐ ☐

______ 4.59 Is the preparation and posting of security and open contractual commitments, purchase, sale, and redemption records performed or reviewed by persons who do not also have sole custody of securities or authorization to execute trades? ☐ ☐ ☐

______ 4.60 Does the association maintain an investment security ledger or worksheet that details all securities held and all security transactions? ☐ ☐ ☐

______ 4.61 Are the security ledger totals for principal and accrued interest balanced to the general ledger at least monthly by a person who does not have sole custody of securities? ☐ ☐ ☐

______ 4.62 Does the association have procedures to ensure that they collect all income due on the investment security portfolio promptly? ☐ ☐ ☐

______ 4.63 Does the association have procedures that will indicate any relationship between brokers who purchase securities for the association and association officers, directors, or employees? ☐ ☐ ☐

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	Verified by Examiner		Yes	No	NA
	_____	4.64 If the board of directors authorized an officer to have sole authority to purchase and sell securities, is the authority limited to fixed dollar amounts, above which a second officer must approve the transaction before its commitment?	☐	☐	☐
		Authorized person(s):			
		Limits:			
	_____	4.65 Does the association prohibit broker/dealers from having discretionary trading authority?	☐	☐	☐
	_____	4.66 Does the association place all orders only with broker/dealers not affiliated with investment advisors retained by the association?	☐	☐	☐
	_____	4.67 Does the association engage in reverse repurchase agreements and lending of securities only with firms designated by the Federal Reserve Board as primary dealers in government securities?	☐	☐	☐
	_____	4.68 Does the association hold securities in safekeeping under delivery versus payment procedures?	☐	☐	☐
	_____	4.69 Does the association prohibit “free” deliveries in written contracts with depositories and safekeeping agents unless approved by two senior officers?	☐	☐	☐
	_____	4.70 Does the association hold securities on the premises under dual control?	☐	☐	☐
	_____	4.71 Is an independent party performing tests to determine that the yield on investments actually received is in line with the weighted average coupon of such assets?	☐	☐	☐
		Name of the independent party:			

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	Verified by Examiner		Yes	No	NA

- How often:

- Date of last test:

- Period analyzed:

			Yes	No	NA
_____	4.72	Does staff follow established procedures to periodically review and document for appropriateness "other than temporary impairment" (OTTI) and "permanent impairment" in investment securities?	☐	☐	☐
		- Does management have established procedures and documentation standards in accordance with FASB Staff Position No. 115-2 showing how they determined the amounts of credit risk OTTI and non-credit risk OTTI and that they properly reported these amounts?	☐	☐	☐

[Type Management Response Here]

General Lending

			Yes	No	NA
_____	4.73	Does the association have and adhere to a written schedule of fees and rates charged on new loans?	☐	☐	☐
_____	4.74	Does the association maintain a loans to one borrower (LTOB) schedule?	☐	☐	☐
_____	4.75	Is there a procedure of internal review to ensure the accuracy of the LTOB schedule?	☐	☐	☐

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	_____	4.76 Are there procedures, and does staff follow the procedures, to periodically review and document the appropriateness of the ALLL?	☐	☐	☐
	_____	4.77 Are the persons that periodically review and document the adequacy of the ALLL independent of the loan approval function?	☐	☐	☐
	_____	4.78 Are lending officers prohibited from authorizing loan disbursements?	☐	☐	☐
	_____	4.79 Do persons independent of the loan officer obtain or verify credit information?	☐	☐	☐
	_____	4.80 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?	☐	☐	☐
	_____	4.81 Is there a record system that lists the total of outstanding credits and commitments (direct and indirect) for each borrower?	☐	☐	☐
	_____	4.82 Are appraisals in writing, dated, and signed?	☐	☐	☐
	_____	4.83 Do appraisals meet the minimum standards of OTS' regulation and USPAP, including the appraisal's purpose, market value, effective date, and marketing period and the sales history of the subject property?	☐	☐	☐
	_____	4.84 Are appraisals received before the association makes its final credit decision?	☐	☐	☐

[Type Management Response Here]

Construction Lending

	_____	4.85 Are inspectors rotated at least every third inspection and for	☐	☐	☐

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	Verified by Examiner		Yes	No	NA
		final draws?			
	_____	4.86 If the association does not rotate inspectors, does the inspector's supervisor perform review inspections?	☐	☐	☐
	_____	4.87 Is there segregation of duties between inspection and disbursement functions?	☐	☐	☐
	_____	4.88 Does the association prohibit disbursing loans in cash or to third parties?	☐	☐	☐
	_____	4.89 Does the association support construction advances by written evidence or re-inspection of property?	☐	☐	☐
	_____	4.90 Does the association compare paid bills and lien waivers with items listed for disbursement?	☐	☐	☐
	_____	4.91 Does the association have safeguards to ensure that sufficient funds always remain available to complete construction?	☐	☐	☐

[Type Management Response Here]

Loan Servicing and Recordkeeping Functions

_____	4.92 Are all notes and other loan documents kept in a vault or fire-resistant cabinet and under a sign-out control system?	☐	☐	☐
_____	4.93 If the association holds additional collateral, do they safeguard it?	☐	☐	☐
_____	4.94 Does the association maintain a record of such collateral?	☐	☐	☐
_____	4.95 Does the association obtain written acknowledgment from the borrower for the pledging of savings accounts or the assignment of life insurance policies?	☐	☐	☐
_____	4.96 Does the association adequately control advance loan payments if they do not immediately credit the advance to the	☐	☐	☐

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loan account?

_____	4.97	Does the association test periodic adjustments to adjustable-rate mortgage loans for compliance with the terms of the note?	☐	☐	☐
_____	4.98	Does the association have written collection policies and procedures that the board of directors approves?	☐	☐	☐
_____	4.99	Do collectors document the contact with delinquent borrowers and indicate promised action?	☐	☐	☐
_____	4.100	Are there procedures that ensure the maintenance of necessary hazard, flood, and other insurance coverages throughout the life of the loan?	☐	☐	☐

[Type Management Response Here]

Accrued Interest Receivable

_____	4.101	Does the association perform tests to determine that it is receiving the appropriate interest?	☐	☐	☐
_____	4.102	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?	☐	☐	☐
_____	4.103	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?	☐	☐	☐

[Type Management Response Here]

Advance Payments by Borrowers for Taxes and Insurance

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	_____	4.104 Is each escrow (impound) account analyzed at least once a year to ensure that the payments will cover the disbursement(s)?	☐	☐	☐
	_____	4.105 If this analysis results in a revision of monthly payments, is the revision made promptly and the borrower notified?	☐	☐	☐
	_____	4.106 Does the association inform borrowers at least annually of the balance in their account and the most recent year's transactions in that account?	☐	☐	☐
	_____	4.107 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?	☐	☐	☐

[Type Management Response Here]

Loans in Process

	_____	4.108 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?	☐	☐	☐
	_____	4.109 Do personnel not responsible for the loans in process accounts conduct periodic tests to determine propriety of disbursements?	☐	☐	☐

[Type Management Response Here]

Commercial Lending

	_____	4.110 Does the association update borrower's and guarantor's financial statements at least annually?	☐	☐	☐
	_____	4.111 Do qualified individuals evaluate the collateral?	☐	☐	☐
	_____	4.112 Does the association inspect collateral periodically to ensure	☐	☐	☐

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	Verified by Examiner		Yes	No	NA

maintenance of sufficient value?

_____	4.113	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?	☐	☐	☐
_____	4.114	If the association releases collateral upon payment of the loan, do they release the collateral only upon receipt of collected funds?	☐	☐	☐

[Type Management Response Here]

Letters of Credit

_____	4.115	Does the association have any outstanding unexpired letters of credit? ➧ If so, please list names and amounts:	☐	☐	☐
_____	4.116	Does the association maintain a daily transaction journal that summarizes all outstanding letters of credit?	☐	☐	☐
_____	4.117	Is there a person responsible for the preparation and posting of subsidiary records and accounting for fee income?	☐	☐	☐
_____	4.118	Does the association track commitments made on letters of credit that they have not issued?	☐	☐	☐
_____	4.119	Has the association issued any letters of credit on behalf of directors, officers, employees, and their interests? ➧ If so, please list names and amounts:	☐	☐	☐
_____	4.120	Has the association issued or confirmed letters of credit to officers or directors of other financial institutions?	☐	☐	☐

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If so, please list names, amounts, and financial institutions:

Verified by Examiner	No.	Question	Yes	No	NA
_____	4.121	Does the association's internal loan review process review letters of credit for adequacy of underwriting, documentation, and credit quality?	☐	☐	☐
_____	4.122	Are letters of credit of questionable quality listed on the association's problem asset list?	☐	☐	☐
_____	4.123	Does the association have procedures in place to ensure that they do not pay a draft without receiving payment from a customer?	☐	☐	☐
_____	4.124	Has the association extended any loans because of letters of credit?	☐	☐	☐

If so, list all loans extended because of letters of credit:

Verified by Examiner	No.	Question	Yes	No	NA
_____	4.125	Are there any outstanding lawsuits related to letters of credit?	☐	☐	☐

If so, list all lawsuits related to letters of credit:

[Type Management Response Here]

Other Loans (unsecured, mobile homes, etc.)

Verified by Examiner	No.	Question	Yes	No	NA
_____	4.126	Are the association's procedures adequate to ensure compliance with the requirements of any government agency insuring or guaranteeing the loan?	☐	☐	☐
_____	4.127	Does the association maintain an adequate loan register?	☐	☐	☐

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	Verified by Examiner			Yes	No	NA
			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.			
	_____	4.128	Do personnel who do not handle cash process loan applications and initial the notes?	☐	☐	☐
	_____	4.129	Do employees not connected with the granting or acquisition of loans collect and process receipts, and prepare delinquency lists?	☐	☐	☐
	_____	4.130	Are liens and other documents, including titles, promptly recorded?	☐	☐	☐
	_____	4.131	Are there procedures that provide for board of directors approval of charge-offs and subsequent recoveries?	☐	☐	☐
	_____	4.132	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?	☐	☐	☐
	_____	4.133	Does the association reference the FHA publication that lists companies and individuals who have not properly performed under FHA programs?	☐	☐	☐
	_____	4.134	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 sub-	☐	☐	☐

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	Verified by Examiner		Yes	No	NA
		sequent 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?	☐	☐	☐
	_____ 4.135	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?	☐	☐	☐

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Credit Quality Review

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	Verified by Examiner		Yes	No	NA
	______	4.136 Does the association have a credit quality review program?	☐	☐	☐
	______	4.137 Does credit quality review include testing for compliance with regulation, association policy, officer lending limits, and association underwriting standards?	☐	☐	☐
	______	4.138 Does credit quality review include classification or grading of assets?	☐	☐	☐
	______	4.139 Are the findings of the persons responsible for credit quality review reported directly to the board of directors?	☐	☐	☐

[Type Management Response Here]

Deposit Account Loans

	______	4.140 Are sufficient controls in effect to prevent a loan approver from disbursing loan proceeds?	☐	☐	☐
	______	4.141 Does the association flag pledged deposit accounts to prevent collateral from withdrawal?	☐	☐	☐
	______	4.142 Does withdrawal of pledged funds require a supervisory override?	☐	☐	☐
	______	4.143 Are procedures in effect to ensure that the total loan and accrued interest does not exceed the balance amount of the deposit account?	☐	☐	☐
	______	4.144 Are procedures in effect for initial and periodic positive mail confirmations with deposit loan customers?	☐	☐	☐
	______	4.145 Are periodic monitoring reports adequate for the review of savings deposit loan activity?	☐	☐	☐

[Type Management Response Here]

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Real Estate Owned and Other Repossessed Assets

Verified by Examiner	No.	Question	Yes	No	NA
_____	4.146	Does the association follow routine legal procedures that will result in a valid title to the property and evidence of such title?	☐	☐	☐
_____	4.147	Does the association promptly value (fair value less cost to sell) real estate that it acquires?	☐	☐	☐
_____	4.148	Does the association use a current valuation to establish the sales price of a property?	☐	☐	☐
_____	4.149	Does the association physically inspect properties at periodic intervals?	☐	☐	☐
_____	4.150	Do such inspections indicate the condition of the property and occupancy status?	☐	☐	☐
_____	4.151	Are there maintenance procedures in effect to ensure that properties will retain their market value?	☐	☐	☐
_____	4.152	Does the association maintain separate subsidiary records for each parcel showing items capitalized, expenses, rentals, etc.?	☐	☐	☐
_____	4.153	Does the association maintain records supporting the recognition of profits or losses resulting from the sale of real estate owned?	☐	☐	☐
_____	4.154	Does the association balance subsidiary ledgers for the individual properties to the general ledger at least monthly?	☐	☐	☐
_____	4.155	Does the association maintain separate files for each parcel of real estate owned and are such files complete?	☐	☐	☐
_____	4.156	Does the association maintain controls over the receipt of rental income?	☐	☐	☐
_____	4.157	Does the association's advertising for the sale or rental of real estate owned comply with the provisions contained in	☐	☐	☐

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	Verified by Examiner			Yes	No	NA
			the Department of Housing and Urban Development's advertising guidelines?			
	_____	4.158	Are agents who collect rents and manage properties bonded?	☐	☐	☐
	_____	4.159	Are security deposits properly controlled?	☐	☐	☐
	_____	4.160	Does the association have procedures to ensure maintenance of hazard insurance?	☐	☐	☐

[Type Management Response Here]

Real Estate Held for Investment

_____	4.161	Does the association maintain separate subsidiary records for each parcel showing items capitalized, expenses, rentals, etc.?	☐	☐	☐
_____	4.162	Does the association balance subsidiary ledgers for the individual properties to the general ledger at least monthly?	☐	☐	☐
_____	4.163	Does the association physically inspect properties at periodic intervals?	☐	☐	☐
_____	4.164	Do such inspections indicate the condition of the property and occupancy status?	☐	☐	☐
_____	4.165	Does the association maintain complete, separate files for each parcel of real estate owned?	☐	☐	☐
_____	4.166	Does the association maintain adequate control over rental income?	☐	☐	☐
_____	4.167	Are agents who collect rents and manage properties bonded?	☐	☐	☐
_____	4.168	Are security deposits properly controlled?	☐	☐	☐

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_____ 4.169 Does the association maintain adequate controls over all disbursements? ☐ ☐ ☐

_____ 4.170 Does a senior officer compare disbursements to determine whether they are for budgeted purposes and in line with the overall budget? ☐ ☐ ☐

_____ — If not, is the board of directors notified promptly of budget overruns? ☐ ☐ ☐

[Type Management Response Here]

Fixed and Other Assets

_____ 4.171 Does the association retain invoices in support of all additions to fixed asset accounts? ☐ ☐ ☐

_____ 4.172 Does the association ensure that the accounting department knows about any major retirement of fixed assets? ☐ ☐ ☐

_____ 4.173 Does the association keep a detailed record of fixed assets? ☐ ☐ ☐

_____ 4.174 Does the association retain depreciation schedules supporting each asset or class of assets? ☐ ☐ ☐

_____ 4.175 Does the association charge depreciation and amortization expenses at least quarterly? ☐ ☐ ☐

_____ 4.176 Does the association retain evidence of valid titles for all properties owned? ☐ ☐ ☐

_____ 4.177 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? ☐ ☐ ☐

_____ 4.178 Are there recordkeeping procedures to ensure that the association maintains adequate supporting documentation for other assets acquired? ☐ ☐ ☐

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	______	4.179 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?	☐	☐	☐
	______	4.180 Does the association have effective control procedures for all large disbursements to ensure their propriety?	☐	☐	☐
	______	4.181 Does the association maintain subsidiary records for the various other asset accounts?	☐	☐	☐
	______	4.182 Does the association follow its written documentation of its depreciation and capitalization policies?	☐	☐	☐

[Type Management Response Here]

Demand Accounts

🚩	______	4.183 Does the association generate a demand deposit overdraft report?	☐	☐	☐
🚩	______	4.184 Does the demand deposit overdraft report identify the name, position, and approval limits of the person(s) responsible for approving the overdrafts?	☐	☐	☐
🚩	______	4.185 Does the demand deposit overdraft report identify large borrowers and insiders?	☐	☐	☐
	______	4.186 Does an independent officer review all overdraft activity?	☐	☐	☐
	______	4.187 Does the association reject checks when the collected balance of the customer's demand deposit account is not sufficient to cover the item?	☐	☐	☐
🚩	______	4.188 Are controls in effect to prevent withdrawals of uncollected funds?	☐	☐	☐
	______	4.189 Does the association promptly record on the books returned items previously deposited?	☐	☐	☐

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______ 4.190 Are procedures adequate to ensure that the association monitors and clears uncollected items? ☐ ☐ ☐

______ 4.191 Does the association generate a check-kiting report? ☐ ☐ ☐

______ 4.192 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? ☐ ☐ ☐

______ 4.193 Does the check-kiting report identify insiders and major borrowers? ☐ ☐ ☐

______ 4.194 Is the person responsible for reviewing check-kiting reports independent of the preparation of the reports? ☐ ☐ ☐

[Type Management Response Here]

Deposits and Borrowed Funds

______ 4.195 Is there any limitation on the amount of withdrawal that employees may pay without officer approval? ☐ ☐ ☐

- If so, what is the amount?

______ 4.196 Does the association have a written "know-your-customer" policy? ☐ ☐ ☐

- Do new-account applications require sufficient information to clearly identify the customer? ☐ ☐ ☐
- Are "starter" checks issued only after the verification of data on new transaction-account applications? ☐ ☐ ☐
- Are checkbooks and statements mailed only to the address of record? If not, is a satisfactory explanation and description obtained for any other mailing address (post of- ☐ ☐ ☐

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	Verified by Examiner		Yes	No	NA
		fice boxes, a friend or relative, etc.)?			
		Are the employees responsible for opening new accounts trained to screen depositors for signs of check kiting?	☐	☐	☐
	_____	4.197 Are procedures in effect to ensure the timely and accurate completion of the appropriate signature cards upon the opening of deposit accounts?	☐	☐	☐
	_____	4.198 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?	☐	☐	☐
	_____	4.199 Does the association balance the deposit accounts before and after posting of interest to ascertain correctness of total amount posted?	☐	☐	☐
	_____	4.200 Does the association maintain general ledger subsidiary accounts for each class of accounts?	☐	☐	☐
	_____	4.201 Is an analysis made periodically to determine the adequacy of accrued interest earned and unpaid?	☐	☐	☐
	_____	4.202 Does the person who performs the analysis have an account at the association?	☐	☐	☐
	_____	If so, does a person independent of the analysis review the account of the person who performs the analysis?	☐	☐	☐
	_____	4.203 Does the association investigate and adjust differences between the accrual balance and the interest paid?	☐	☐	☐
	_____	4.204 Does the association reasonably estimate accruals for reporting purposes?	☐	☐	☐
	_____	4.205 Are policies in effect to maintain compliance with state escheat laws?	☐	☐	☐
	_____	4.206 Does the association flag dormant accounts so they can	☐	☐	☐

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	Verified by Examiner		Yes	No	NA

monitor activity?

_____ 4.207 Does the association waive significant amounts of account fees? ☐ ☐ ☐

_____ 4.208 Does the association maintain subsidiary records for each type of borrowing, including proper identification of the obligee? ☐ ☐ ☐

_____ 4.209 Is the preparation, addition and posting of the subsidiary borrowed funds records performed or adequately reviewed by persons who do not also:

- Handle cash? ☐ ☐ ☐
- Issue official checks and drafts? ☐ ☐ ☐
- Prepare all supporting documents required for payment of debt? ☐ ☐ ☐

[Type Management Response Here]

Deferred Income

_____ 4.210 Does the association defer net loan fees/ costs in accordance with generally accepted accounting principals (GAAP) and not recognize fees/ costs as current-period income/ expense? ☐ ☐ ☐

_____ 4.211 Does the association maintain records supporting loan acquisition credits deferred and earned, by semiannual periods? ☐ ☐ ☐

_____ 4.212 Does the association recognize loan origination fees in accordance with FASB 91? FASB 91 requires that when the loan is held for investment, commitment fees and loan origination fees net of direct loan costs should be deferred and recognized as an adjustment to interest income over the life of the loan using the interest method. ☐ ☐ ☐

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Other Liabilities

				Yes	No	NA
	_____	4.213	Does the association maintain a detailed inventory or subsidiary records for the various other liability accounts?	☐	☐	☐
	_____	4.214	Does a designated officer make periodic reviews of the activity in other liability accounts?	☐	☐	☐

[Type Management Response Here]

Capital (Common Stock, Additional Paid-in-Capital, Retained Earnings, Accumulated Other Comprehensive Income

			Yes	No	NA
_____	4.215	Does management review and the board of directors approve all transfers to and from the capital accounts?	☐	☐	☐
_____	4.216	Does the association clearly explain and adequately document all transactions involving the capital accounts?	☐	☐	☐
_____	4.217	Does the corporate officer designated in the bylaws or by the board of directors control stockholder records?	☐	☐	☐
_____	4.218	Does the association promptly cancel surrendered stock certificates to prevent their reuse?	☐	☐	☐
_____	4.219	Does an officer designated in the bylaws or by the board of directors sign stock certificates?	☐	☐	☐

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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.

Please provide the requested information by Click Here and Type

	Verified by Examiner			Yes	No	NA

Funds Transfer and Wire Controls

				Yes	No	NA
⚑	_____	1.	Indicate the method that the association uses to wire funds: Electronic: ______________ Manual: ________________			
⚑	_____	23.2	Average dollar volume and number of transfers: Specify per day, week, month, or other:			
⚑	_____	23.3	Average daily amount available for transfer, if limited:			
⚑	_____	23.4	Peak amount available for transfer, if limited:			
⚑	_____	23.5	Does the association have written wire transfer procedures?	☐	☐	☐
	_____	23.6	Who is responsible for supervising the wire transfer activity to ensure compliance with the written procedures?			

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	Verified by Examiner			Yes	No	NA
	_____	23.7	Is an internal or independent audit performed of the wire transfer procedures?	☐	☐	☐
	_____	23.8	Does the audit department test wire transfers to ensure timely verifications and reconciliations?	☐	☐	☐
	_____	23.9	Are dual authorizations (maker, approver) required before the sending department acts upon internal wire transfer requests?	☐	☐	☐
	_____	23.10	Do procedures require that the association actually transfer collected funds out of the customer account before the wire transfer department makes outgoing transfer orders?	☐	☐	☐
	_____	23.11	Does the association keep a complete log of wire transfer activity for audit?	☐	☐	☐
			Is the wire transfer activity log audited periodically?	☐	☐	☐
	_____	23.12	Are interim daily reconcilements and end-of-day reconcilements performed with all reconciling items cleared?	☐	☐	☐
	_____	23.13	Does the association prohibit the person who performs end-of-day balancing from executing wire transfers?	☐	☐	☐
	_____	23.14	Is the person who reconciles the association's deposit account affected by wire transfer activity prohibited from executing wire transfers?	☐	☐	☐
	_____	23.15	Does the association keep a record of all customer wire transfers listing the date, amount of the transfer, person authorizing the transfer, test code or PIN, and detailed	☐	☐	☐

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	Verified by Examiner			Yes	No	NA
			instructions?			
	_____	23.16	If the association uses code words, do they change them periodically? ◆ How often?	☐	☐	☐
	_____	23.17	Does the association strictly forbid the transfer of uncollected funds?	☐	☐	☐
	_____	23.18	Does the association require dual officer approval for large-dollar transfers? ◆ Who is authorized and what are the limits?	☐	☐	☐
	_____	23.19	Does the association require customer and/or bank verification callbacks for voice wire transfers above an established dollar threshold? ◆ _____________Who is responsible for verification?	☐	☐	☐
	_____	23.20	Does a person independent of the transaction approval or processing balance wire transfers at least daily?	☐	☐	☐
	_____	23.21	For associations that call in wire instructions to a correspondent institution that performs the wire transfer, after an authorized person originates the call, does the correspondent institution make a callback to a second authorized person to verify the authenticity of the wire instructions?	☐	☐	☐
	_____	23.22	Does the association require that customer wire-transfer requests be in writing and signed by the customer wiring	☐	☐	☐

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	Verified by Examiner			Yes	No	NA
			the funds?			
	_____	23.23	Does the association maintain adequate records as required by the Bank Secrecy Act?	☐	☐	☐
	_____	23.24	Does a person not involved in the wire transfer process perform a timely reconciliation of the wire transfer activity statements from a service provider with the internal wire transfer activity records?	☐	☐	☐
	_____	23.25	Do the reports, which the association obtains from its funds transfer vendor accurately reflect those individuals currently granted access to the vendor's systems and their functions?	☐	☐	☐
	_____	23.26	If any association employees or third-party vendors have remote access via dial-up line or virtual private network (VPN) to the funds transfer system, does the association have appropriate mitigating controls in place?	☐	☐	☐

Branch Procedures (Customer-Requested Wire Transfers)

	_____	23.27	Does a branch procedures manual contain a clear and concise description of branch wire transfer procedures?	☐	☐	☐
	_____	23.28	Are telephone requests from the branch office to the main office for two-party wire transfers accepted?	☐	☐	☐
	_____		➔ Briefly, describe the procedures the association uses to ensure that such requests are authentic.			
	_____	23.29	What documentation is required as a source document and proof of authorization for customer-requested wire transfers?			

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	Verified by Examiner			Yes	No	NA
	_____	23.30	Does the documentation indicate the date, time of day, wire-from- and wire-to-account instructions, and association personnel who processed the request?	☐	☐	☐

Internally Generated Wire Transfers (Department Requests for Wire Transfers)

	_____	23.31	How does the association document departmental wire transfer requests?			
	_____	23.32	Does the documentation contain all necessary from-account and to-account information?	☐	☐	☐
	_____	23.33	Does the documentation for departmental requests indicate the initiator and approver who authorized the wire transfer?	☐	☐	☐
	_____	23.34	Do separate persons originate, approve, and send internally generated wire transfers?	☐	☐	☐
	_____	23.35	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?	☐	☐	☐
	_____	23.36	Does the association have controls in place that require action by two people to complete a transfer, one to receive or initiate the request and another to confirm authenticity?	☐	☐	☐

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Prepared By:
(Name of Management Official)

Verified By:
(Name of Examiner)