
Internal Control Program

Examination Objectives

Determine whether existing controls reasonably ensure all of the following:

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

Examination Procedures

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

Level I

Wkp. Ref.

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

1. In consultation with the examiner in charge (EIC), review and evaluate the responses to the Management Questionnaire (PERK 002), the Internal Control Questionnaire (PERK 004), and the Funds Transfer Questionnaire (PERK 018). Follow up by reviewing appropriate internal audit work papers and by interviewing the internal auditors and operations staff to determine possible areas of internal control weaknesses. Perform this review as early in the examination as possible. Immediately notify the examiner assigned any area where there are possible weaknesses so the examiner can make any necessary scope changes.

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2. Review management reports on internal controls and related attestations by independent accountants required by the Federal Deposit Insurance Corporation Improvement Act (FDICIA). Review the external audit internal control work papers or other communications regarding reportable conditions.
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3. Check for material weaknesses in internal controls by noting any deficiencies reported in the following:

- Recent internal and external audit reports.
- Related management letters.
- Management and the board of directors' responses.
- The most recent examination reports of all types.

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

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

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

6. Verify that management enforces all critical policies.

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

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

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

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

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

Level II

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

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

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

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

15. Assess the adequacy of information and communication systems.

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

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

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

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

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

21. Ensure that your review meets the Objectives of this Handbook Section. State your 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.
- The association is not audited by an independent party.
- The association does not have an internal audit program in place.

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

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

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

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

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

27. Check supporting documentation for loans charged-off.

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

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

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

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

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

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

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

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

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

Examiner's Summary, Recommendations, and Comments

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