



**Comptroller of the Currency
Administrator of National Banks**

**Issues in Community Bank Audit and
Internal Controls: The OCC Approach**

Virtual Seminar

Wednesday, November 1, 2000

11:00 am – 12:30 pm Eastern

10:00 am – 11:30 am Central

9:00 am – 10:30 am Mountain

8:00 am – 9:30 am Pacific

Presented by:

John D. Hawke, Jr.

John Bodnar

Mark O'Dell

Kit Sugiyama

John D. Hawke, Jr.

Comptroller of the Currency

John D. Hawke, Jr. was sworn in as the 28th Comptroller of the Currency on December 8, 1998. After serving for 10 months under a Recess Appointment, he was sworn in for a full five-year term as Comptroller on October 13, 1999.

The Comptroller of the Currency is the Administrator of National Banks. The Office of the Comptroller (OCC) supervises 2,600 federally chartered commercial banks and about 66 federal branches and agencies of foreign banks in the United States comprising more than half of the assets of the commercial banking system. The Comptroller also serves as a Director of the Federal Deposit Insurance Corporation, the Federal Financial Institutions Examination Council, and the Neighborhood Reinvestment Corporation.



Prior to his appointment as Comptroller, Mr. Hawke served for 3-1/2 years as Under Secretary of the Treasury for Domestic Finance. In that capacity he oversaw the development of policy and legislation in the areas of financial institutions, debt management and capital markets, and served as Chairman of the Advanced Counterfeit Deterrence Steering Committee and as a member of the board of the Securities Investor Protection Corporation. Before joining Treasury, Mr. Hawke was a Senior Partner at the Washington, D.C. law firm of Arnold & Porter, which he first joined as an associate in 1962. At Arnold & Porter he headed the Financial Institutions practice, and from 1987 to 1995 he served as Chairman of the firm. In 1975 he left the firm to serve as General Counsel to the Board of Governors of the Federal Reserve System, returning in 1978.

Mr. Hawke graduated from Yale University in 1954 with a B.A. in English. From 1955 to 1957 he served on active duty with the U.S. Air Force. After graduating in 1960 from Columbia University School of Law, where he was Editor-in-Chief of the Columbia Law Review, Mr. Hawke was a law clerk for Judge E. Barrett Prettyman on the United States Court of Appeals for the District of Columbia Circuit. From 1961 to 1962 he served as counsel to the Select Subcommittee on Education in the House of Representatives.

From 1970 to 1987 Mr. Hawke taught courses on federal regulation of banking at the Georgetown University Law Center. He has also taught courses on bank acquisitions

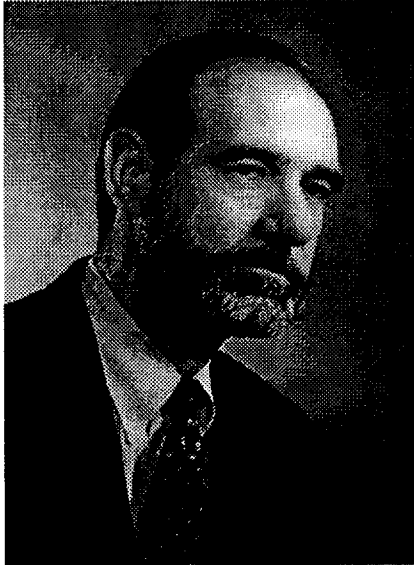
and financial regulation and serves as the Chairman of the Board of Advisors of the Morin Center for Banking Law Studies.

In 1987 Mr. Hawke served as a member of a Committee of Inquiry appointed by the Chicago Mercantile Exchange to study the role of futures markets in connection with the stock market crash in October of that year.

Mr. Hawke has written extensively on matters relating to the regulation of financial institutions, and is the author of "Commentaries on Banking Regulation," published in 1985. He was a founding member of the Shadow Financial Regulatory Committee, and served on the committee until joining Treasury in April 1995.

Mr. Hawke is a member of the Cosmos Club, the Economic Club of Washington and the Exchequer Club of Washington.

Born in New York City on June 26, 1933, Mr. Hawke resides in Washington, D.C. He was married in 1962 to the late Marie R. Hawke and has four adult children, Daniel, Caitlin, Anne and Patrick, and one grandchild, Spencer Patrick Hawke.



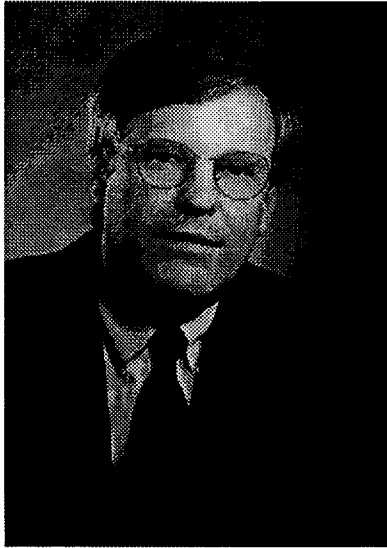
**John A. Bodnar
Deputy Comptroller
Southwestern District**

John A. Bodnar was appointed the District Deputy Comptroller for the Office of the Comptroller of the Currency's (OCC's) Southwestern District office in Dallas, Texas, in July 1997.

Mr. Bodnar is responsible for supervising community and mid-size national banks in Arkansas, Louisiana, Oklahoma and Texas. In those states he is the OCC's principal contact with members of the banking industry, the broader financial services industry, trade groups, the news media, public interest groups and other members of the general public. He also represents the OCC in discussions with federal, state, and local government officials, and federal and state regulators.

Mr. Bodnar had been the District Administrator for the Southwestern District since 1983, and since January 1997 served as Acting Deputy Comptroller in the Southwestern District. Previous responsibilities include supervising problem national banks and overseeing examinations in the OCC's New York office. He serves on the OCC's National Risk Committee. Mr. Bodnar joined the OCC as an examiner in 1967.

Mr. Bodnar received a B.S. degree and a M.B.A. in Finance from Seton Hall University, South Orange, New Jersey.



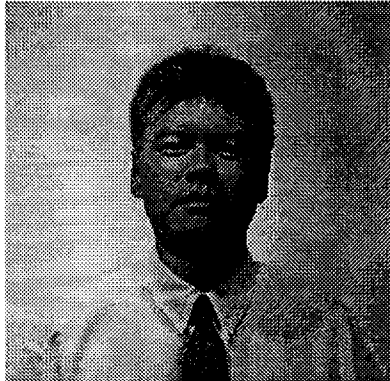
Mark L. O'Dell
Deputy Comptroller
Bank Supervision Policy

Mark L. O'Dell serves as the Deputy Comptroller for Core Policy in the Washington office of the Office of the Comptroller of the Currency. Mr. O'Dell joined the OCC in 1978 and was commissioned as a national bank examiner in 1983.

Since then, he has held increasingly responsible supervision positions, including field office analyst, multinational bank analyst, a member of the OCC's London multinational examination staff, shared national credit coordinator at Citibank, Director for Analysis in the OCC's Multinational Banking Division, and Director for Bank Technology.

Prior to his current assignment, Mr. O'Dell was the Director for Year 2000 Bank Supervision Policy. He assumed his current position as Deputy Comptroller for Core Policy in January 2000. The Core Policy department is the focal point for the OCC's core policy platforms that govern how the OCC supervises national banks. Mr. O'Dell oversees policies and activities that include the OCC's supervision by risk philosophy and its supporting systems and core examination procedures for large and community banks.

Mr. O'Dell received a BS in mathematics and an MBA from Colorado State University. He is also a Chartered Financial Analyst.



Kit Sugiyama
Assistant Deputy Comptroller
Denver South Field Office

Kit Sugiyama is the Assistant Deputy Comptroller for the Denver South Field Office in Colorado. He joined the Office of the Comptroller of the Currency in 1974 and was commissioned as a national bank examiner in 1979. He has served as a field examiner in the following duty locations: Duluth, MN; Kansas City, MO; Omaha, NE; and Denver, CO. He was a problem bank analyst for the Kansas City District Office from 1983 through 1985.

Currently Mr. Sugiyama supervises a staff of 14 examiners and a portfolio of 33 community banks.

Mr. Sugiyama received a BS in business administration from Whittier College, Whittier, CA.



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Issues in Community Banks Audits and Internal Controls The OCC Approach

Audit and Internal Controls

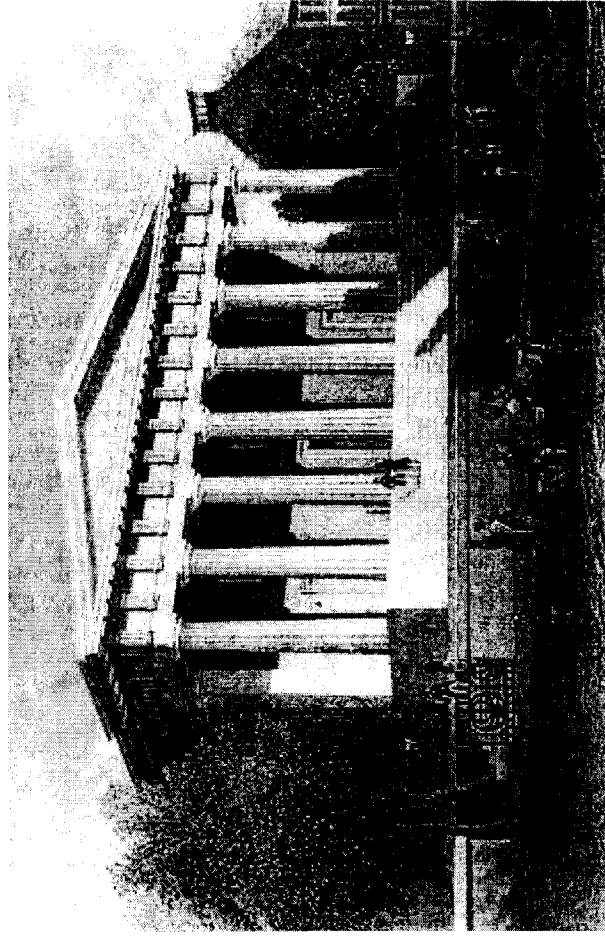
Agenda

- **Welcome**
- **Regulatory Perspective**
- **Regulatory Expectations**
- **OCC Initiatives**
- **Q&A**



Welcome

- **Purpose of the Conference Call**
- **Introductions**
- **Importance of Audit and Internal Controls**



Regulatory Perspective

- **Why the Re-emphasis on Audit and Internal Controls?**
 - Emerging technology risks
 - New product and services
 - OCC speeches and issuances
- **Recent Examination Findings**
 - Dual Controls
 - Rotation of duties
 - Independent reconciliation
 - Separation of duties



Regulatory Perspective (Continued)

- **Characteristics of a System of Sound Internal Controls**
 - **1992 Committee of Sponsoring Organizations of the Treadway Commission**
 - **OCC Guide to Internal Controls**



Regulatory Perspective (Continued)

- **Internal Audit**
 - **Increasing use of outsourcing**
 - **Examination findings**
 - > **Independence**
 - > **Turnover**
 - > **Training**
 - > **Lack of follow-up**



Regulatory Expectations

- **OCC Audit and Internal Control Examination Objectives**
 - **Objectives**
 - **Focus of examination work**
 - **ROE comments**
- **Three Step Assessment Process**
 - **Work paper review**
 - **Expanded procedures**
 - **Verification procedures**



Regulatory Expectations (Continued)

- **Review of Audit Work Papers**
 - **Internal audit**
 - **External audit**
- **Resources/Regulatory Issuances:**
 - **Handbooks**
 - **Interagency statements**
 - **COSO materials (Treadway Commission)**



OCC Initiatives

- **ICQ/Verification Procedures**
 - “Database” on CD
 - Use during examinations
- **Banker’s Toolkit**
- **Training Initiatives**
 - Examiner training
 - Industry Roundtables

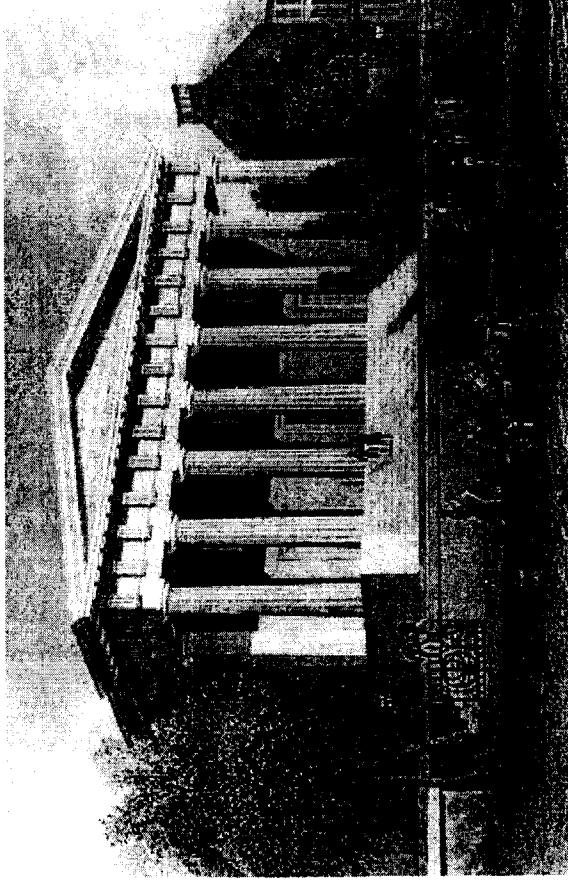


OCC Initiatives (Continued)

- **OCC Examination Assessments**
 - “Strong,” “Satisfactory,” or “Weak”
 - ROE Comments
 - MRAs for significant weaknesses
 - or deficiencies
 - Examiner follow-up
 - Focus on high risk areas



Audit and Internal Controls



Questions and Answers



Comptroller of the Currency
Administrator of National Banks

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Issues in Community Banks Audits and Internal Controls The OCC Approach



Comptroller of the Currency
Administrator of National Banks

Internal Controls

A Guide for Directors

Internal Controls

A Guide for Directors

OFFICE OF THE COMPTROLLER OF THE CURRENCY
Washington, D.C.

September 2000

PREFACE

Weak or ineffective internal controls, such as inadequate record keeping, external audit, or loan review, has caused operational losses in many banks and has contributed to the failure of others. Some of these cases involved insider fraud that could have been prevented or discovered through effective control mechanisms before the fraud resulted in loss to the bank. The Office of the Comptroller of the Currency (OCC) also has identified cases resulting in bank losses in which internal control weaknesses included improper and untimely reconciliations of major asset or liability accounts. In others, the bank did not institute or follow normal separation of duties between the physical control of assets and liabilities and the record-keeping functions involving those assets and liabilities.

Despite rapid changes in technology, the fundamental concepts behind effective internal controls remain the same. Effective internal controls form the foundation for a bank's system of risk management. They also safeguard bank assets; help the board and management guard against fraud and financial mismanagement; and ensure compliance with laws, regulations, and the institution's own policies.

To help the board and management meet their responsibilities, this pamphlet emphasizes the importance of establishing and maintaining effective internal controls. It also provides a description of basic control components and includes a series of questions that can assist directors and management in evaluating and improving their bank's internal control systems.¹ This guide supplements the OCC publications, *The Director's Book—The Role of a National Bank Director* and *Red Flags in Board Reports—A Guide for Directors*.

INTERNAL CONTROLS— CRITICAL COMPONENTS

The formality of any control system will depend largely on a bank's size and the complexity of its operations. Even though a community bank's operations are likely to be less formal and less structured, a bank's internal control system should be as effective as those at more complex and larger banks.

In 1992, the Committee of Sponsoring Organizations of the Treadway Commission (COSO)² outlined five essential components of any internal control system.³ The five components are:

1. control environment
2. risk assessment
3. control activities
4. accounting, information, and communication systems, and
5. self-assessment or monitoring

Each component is discussed below in more detail and is accompanied by a series of questions that address fundamental control activities.

While this list is not all-inclusive, negative answers to these questions can help identify fundamental internal control weaknesses.

1. Control Environment

While each component is important, the first—control environment—is the foundation for all the others. The control environment reflects the overall attitude, awareness, and actions of the board and management concerning the importance of control activities. Overall, the control environment provides discipline and structure for the bank's entire operations.

The elements of a control environment include:

- Integrity and ethical values of personnel.
- Commitment to competence.
- Board of directors and/or audit committee participation.
- Overall influence of management's philosophy and operating style.
- Appropriate and adequate organizational structure.
- Clear assignment of authority and responsibility.
- Effective human resource policies and practices.

Control Environment—Questionnaire

Yes No

Does the board periodically review policies and procedures to ensure that proper controls have been instituted?

Is there a system in place to monitor compliance with policies and procedures and to report to the board instances of noncompliance?

When instances of noncompliance are reported, does the board take appropriate follow-up action and ensure effective action through testing?

Does management provide the board and the board's representatives complete access to bank records?

Are board decisions made collectively and not controlled by one dominant individual?

Does the board receive appropriate information from the bank's accounting, information, and communication systems to make informed and timely decisions?

- Does the board receive adequate information about the internal risk assessment process?
- Does the board review the qualifications and independence of the bank's internal and external auditors?
- Do the bank's internal and external auditors report their findings directly to the board or to the audit committee?
- Do the internal and/or external auditors periodically assess the adequacy of the bank's internal control systems?
- Are policies regarding the importance of internal control and appropriate conduct communicated to all employees?
- Do codes of conduct or ethics policies exist?
- Do audit or other control systems exist to periodically test for compliance with codes of conduct or ethics policies?

2. Risk Assessment

Risk assessment is the process the board and management use to identify and analyze risks that could keep the bank from achieving planned objectives. The assessment should help determine what the risks are, how they should be managed, and what controls are needed. Risks can arise or change because of circumstances such as:

- A change in the bank's operating environment.
- New personnel.
- New or revamped information systems.
- Rapid growth.
- New technology.
- New or expanded lines of business, products, or activities.

- Mergers or other corporate restructuring.
- Changes in accounting requirements.

Risk Assessment—Questionnaire

Yes No

- Do the board and management appropriately evaluate risks when planning for new products or activities?
- Do the board and management discuss and appropriately consider control issues when planning for new products and activities?
- Are audit personnel or other internal control experts involved in control discussions when the bank is developing new products and activities?
- Do management and the board involve audit personnel or other internal control experts in the risk assessment process?
- Are technology issues considered and appropriately addressed?
- Are there sufficient staff members who are competent and knowledgeable to manage current and proposed bank activities, and have they been provided with adequate resources?

3. Control Activities

Control activities include the policies, procedures, and practices established to help ensure that bank personnel carry out board and management directives. These activities help ensure that the board and management manage and control risks that could affect bank operating performance or cause financial loss. Policies governing control activities should ensure that bank officers who perform internal control functions in addition to their operational duties do not evaluate their own work.

Control activities are applied at various organizational and functional levels and include:

Operational performance reviews. These control activities include risk assessments and reviews of actual financial performance versus budgets, forecasts, and prior-period performance. In performing these reviews, the bank relates various sets of data—operational, risk related, or financial—to one another. The bank uses these comparisons to analyze the bank’s actual versus projected performance to identify reasons for significant variances and to determine whether any specific bank activity should be adjusted.

Information processing. Banks perform a variety of control activities to verify the accuracy and completeness of transactions and to determine that they were properly authorized. Information systems control activities can be broadly grouped into two categories: general controls and application controls. General controls commonly include controls over data center operations, system software acquisition and maintenance, access security, and application system development and maintenance. These controls apply to mainframes, servers, end user workstations, and internal or external networks. Application controls apply to programs the bank uses to process transactions and help ensure that transactions are valid, properly authorized, and accurate.

Physical controls. Generally, these activities ensure the physical security of bank assets. They include safeguarding assets and records, limiting access to computer programs and data files, and periodically comparing actual asset or liability values with those shown on control records.

Segregation of duties. Banks establish segregation of duties by assigning different people the responsibilities for authorizing transactions, recording transactions, and maintaining custody of assets. Such segregation is intended to make it impossible for any person to be in a position to both perpetrate and conceal errors or irregularities in the normal course of his or her duties.

Control Activities—Questionnaire

Yes No

Do policies and procedures exist to ensure critical decisions are made with appropriate approval?

Do processes exist to ensure independent verification of an appropriate sample of transactions to ensure integrity?

Do processes exist to ensure ongoing and independent reconciliation of asset and liability balances, both on- and off-balance-sheet?

Are key risk-taking activities appropriately segregated from reconciliation activities?

Do processes exist to ensure that policy overrides are minimal and exceptions are reported to management?

Does a vacation policy for critical employees ensure their absence for at least a consecutive two-week period?

Is there a system in place to ensure that duties are rotated periodically?

Is separation of duties and dual control over bank assets emphasized in the organizational structure?

Are systems in place to ensure that personnel abide by separations of duty?

4. Accounting, Information, and Communication Systems

Accounting, information, and communication systems identify, capture, and exchange information in a form and time frame that enable bank personnel to carry out their responsibilities. Accounting systems include methods and records that identify, assemble, analyze, classify, record, and report a bank's transactions. Information systems produce reports on operations, finance, risk management, and compliance that enable management and the board to manage the bank. Communication systems impart information throughout the bank and to external parties such as regulators, examiners, shareholders, and customers.

Accounting, Information, and Communication Systems—Questionnaire

Yes No

- Do accounting systems properly identify, assemble, analyze, classify, record, and report an institution's transactions in accordance with GAAP?
- Are the reports generated for operational, financial, managerial, and compliance-related activities sufficient to properly manage and control the institution?
- Do accounting, information, and communication systems ensure that the bank's risk-taking activities are within policy guidelines?
- Do all personnel understand their roles in the control system?
- Do all personnel understand how their activities relate to others?
- Do all personnel understand their accountability for the activities they conduct?

5. Self-Assessment or Monitoring

Self-assessment or monitoring can provide oversight of a bank's control system performance. Management monitors internal controls to consider whether they are operating as intended and that they are appropriately modified when conditions change. Self-assessment, in the form of periodic evaluations of a department's controls by a person responsible for that area, is one type of oversight mechanism. For community banks, a clear and focused internal audit program can be a key defense against control breakdowns or fraud by providing independent assessments of the internal control system's quality and effectiveness.

Self-Assessment or Monitoring—Questionnaire

Yes No

- Does the board review the actions management takes to deal with material control weaknesses and verify that those actions are objective and adequate?
- Do audit reports contain sufficient detail?
- Are audit reports timely enough to allow for resolution and appropriate action?
- Does the board or audit committee approve the selection of key internal audit personnel?
- Does the board or audit committee approve the overall scope of review activities (such as audit or loan coverage)?
- Does the board or audit committee review results of audits?
- Does the board or audit committee approve the system of internal controls?

- 1. Does the board or audit committee periodically review audit or other key control systems?
- 2. Is line management held accountable if they do not follow up satisfactorily or effectively on control weaknesses?

OTHER RESOURCES AND PUBLICATIONS REGARDING INTERNAL CONTROL

AICPA Audit and Accounting Guide, “Banks and Savings Institutions.”

AICPA Statement on Auditing Standards 55, “Consideration of the Internal Control Structure in a Financial Statement Audit.”

AICPA Statement on Auditing Standards 78, “Consideration of the Internal Control Structure in a Financial Statement Audit: An Amendment to SAS 55.”

Committee of Sponsoring Organizations of the Treadway Commission (COSO), *Internal Control—Integrated Framework: Volume 1, Executive Summary; Volume 2, Framework; Volume 3, Reporting to External Parties; and Volume 4, Evaluation Tools.*

The Institute of Internal Auditors, *Control Self-Assessment: Making the Choice.*

OCC Bulletin 99-37, Interagency Policy Statement on External Auditing Programs. (<http://www.occ.treas.gov/ftp/bulletin/99-37.doc>)

OCC Bulletin 98-1, Interagency Policy Statement on Internal Audit Programs and Internal Audit Outsourcing. (<http://www.occ.treas.gov/ftp/bulletin/98-1.txt>)

Basel Committee on Banking Supervision paper, “Framework on Internal Control Systems in Banking Organizations.”

Office of the Comptroller of the Currency Program Evaluation

*This form is electronically tallied. Please mark only one circle for each question.
Do not mark outside the circles.*

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Scale Definition: P - Poor F - Fair G - Good VG - Very Good E - Excellent

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Presenter: Overall Effectiveness

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9. How many people listened at your site?
- 1 2 3 4 5 6-10 11-15 16-20 21+
10. Would you participate in another virtual seminar?
- Y N

What was your overall impression of the program and the virtual seminar format? What topics would be of interest to you in the future? Additional Comments?

Name of Participant (optional): _____

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