

Audit Roundtable

Telephone Seminar for Bankers and Auditors

Part 1— Risk Assessment and Internal Controls

Contents

Speaker Biographies

[John D. Hawke, Jr.](#)

[Mark L. O'Dell](#)

[Zane D. Blackburn](#)

[Wynne E. Baker](#)

[William J. Lewis](#)

[Craig A. Dabroski](#)

Electronic Polling Questions

Part 1—Risk Assessment and Internal Controls Presentation

[Risk Assessment, Sampling, and Materiality](#)

[Internal Controls and FDICIA](#)

Speaker Biographies

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 2,200 federally chartered commercial banks and about 54 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 3½ 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. He also 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 was 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.

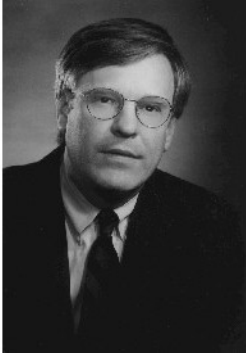
Mr. Hawke is a member of the Cosmos Club, the Economic Club of Washington, and the Exchequer Club of Washington.

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.

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 B.S. in mathematics and an M.B.A. from Colorado State University. He is also a chartered financial analyst.

Zane D. Blackburn

Chief Accountant

Office of the Chief Accountant



Mr. Blackburn is the chief accountant, Office of the Chief Accountant, Office of the Comptroller of the Currency. He is responsible for policy formulation and deliberations with financial institutions and other agencies on bank accounting issues. He also represents the OCC on the Federal Financial Institutions Examination Council's Reports Task Force. Additionally, he serves as the banking agencies' observer on the American Institute of Certified Public Accountants' Allowance for Loan Losses task force.

Mr. Blackburn began his career with the accounting firm of Ernst & Young. After serving six years with Ernst & Young, he joined the Securities and Exchange Commission (SEC). Upon completing six years with the SEC, two years were spent at the Department of Energy with the Financial Reporting Systems Project. In June 1981, he assumed his current position.

Mr. Blackburn was graduated from the University of Maryland with a B.S. in accounting. He is also a certified public accountant and a member of the American Institute of Certified Public Accountants.

Wynne E. Baker

Chairman, American Institute of Certified Public Accountants

Financial Services Expert Panel



Wynne E. Baker is the member in charge of KraftCPAs financial institution industry group. In addition to traditional audit and accounting services, the group provides compliance and loan reviews, directors' exams, stock valuations, analysis of mergers/acquisitions, and outsourced internal audit, among other services.

He was graduated from Tennessee Technological University in 1971 with a bachelor's degree in accounting. As well as being a certified public accountant, Mr.

Baker earned the chartered bank auditor certificate awarded by the Bank Administration Institute, is a "preferred examiner" under the American Bankers Association Preferred Audit Program, and is a certified financial services auditor awarded

by the National Association of Financial Services Auditors. He has been the recipient of numerous industry awards recognizing his distinguished service.

In addition, Mr. Baker currently serves as the chairman, American Institute of Certified Public Accountants (AICPA) Financial Services Expert Panel, and as chairman, AICPA Bank Regulatory Task Force and AICPA Banking Conference. He also has served in the following additional AICPA organizations: Banking and Savings Institutions Committee, Community Banking Task Force, Savings and Loan Committee, and Council. He also has provided leadership and service in the following organizations: National Association of Financial Services Auditors, Tennessee Technological University College of Business Administration Foundation, Tennessee Society of CPAs, and National Association of Accountants.

He is the author of the AICPA's premier bank course, "Introduction to Bank Accounting and Auditing," and was co-editor of the Handbook of Financial Management for Banks, published by McGraw-Hill and Company. Mr. Baker has assisted clients in buying failed banks from the FDIC and has consulted others who started new banks. He has also served as an expert witness in court cases related to bank failures. With 30 years of experience serving the financial institution industry, Mr. Baker has a national reputation as an authority in this area. He has conducted seminars across the nation and has published numerous articles on financial institution issues.

William J. Lewis

Audit Partner, Financial Services Practice

PricewaterhouseCoopers LLP, Washington, DC



Mr. Lewis is currently the audit partner, Financial Services Practice, at PricewaterhouseCoopers and is responsible for audits of several Washington-area financial institutions including Federal Home Loan Banks System, Navy Federal Credit Union, Pentagon Federal Credit Union, State Employees Credit Union of Maryland, and IDB /IIC Federal Credit Union. He is also the firm's representative on the AICPA's Regulatory Task Force, which includes regular interaction with accounting and policy making officials of the National Credit Union Association, Federal Deposit Insurance Corporation, OCC, Federal Reserve Board, and Office of Thrift Supervision.

In 1990, he was appointed a Professional Accounting Fellow with the Office of the Comptroller of the Currency (OCC) where he participated in the study of significant accounting and disclosure issues and concepts affecting banks. Had an extensive role in the development of the OCC's Bank Accounting Advisory series, as well as certain banking bulletins, banking circulars, and various forms of examination guidance. At the OCC, was a member of the Accounting Subcommittee of the Federal Financial Institutions Examination Council (FFIEC) and its Reports Task Force, which is responsible for interpretation of and amendments to the FFIEC call reports.

As a partner in the Regulatory Advisory Services Group, Mr. Lewis provides technical support to the firm's Financial Services Practice members and clients on regulatory accounting, reporting, and capital adequacy matters. As part of these duties, he has assisted financial services clients in re-engineering internal audit, compliance and governance functions to meet regulation expectations as a result of senior management initiatives, regulatory examination, or in anticipation of such examination. He holds a B.S. in accounting from the University of Scranton, Pennsylvania.

Craig A. Dabroski

National Technical Director, Depository Institutions

Arthur Andersen LLP, Washington, DC



Craig Dabroski is the national technical director of Andersen's Financial Services Industry Office in Washington, D.C., and is a nationally recognized expert on depository institutions. He has 30 years of experience working with banks, bank holding companies, savings and loans, credit unions, and broker dealers. He monitors industry-related developments in generally accepted accounting practices and regulations, and is liaison to federal banking, thrift, and credit union regulatory agencies. He also monitors and supervises our responses to questions concerning international banking in the United States, and serves as faculty expert on depository institutions for our industry training programs. Mr. Dabroski has addressed many national and regional meetings of banking trade groups and organizations.

Mr. Dabroski is a member of the AICPA's Financial Institutions Regulatory Task Force, its Audit Guide Combination Task Force, and the Task Force for the AICPA Banking and Savings Institutions Conference.

Mr. Dabroski was previously the National Director of Business Development and Regulatory Liaison for CoreStates Capital Markets in Fort Lauderdale, Florida, where he was involved in all aspects of institutional sales and research of fixed-income securities and whole loan purchase, sale, and securitization activities. Prior to that, he was a senior vice president with two national thrift and bank-consulting firms, where he was director of strategic planning engagements aimed at improving profitability. His consulting experience includes mergers and acquisitions, branch transactions, conversions from mutual to stock, and mortgage banking operations.

Mr. Dabroski had previously spent 11 years with one of the big five firms in the financial institutions practice both as an auditor and as that firm's national director of banking/thrift industry regulatory relations. He spent one year (1981–1982) with the Federal Home Loan Bank Board in Washington, D.C., as the first Professional Accounting Fellow for the Board. While at the FHLBB, Mr. Dabroski authored the rules governing financial disclosures by publicly held thrifts.

He received his B.S. in accounting and master's in accounting science from the University of Illinois, Champaign-Urbana, Illinois. He received his CPA from Texas in 1972.

Electronic Polling Questions

ELECTRONIC POLLING QUESTIONS

1. How many people are at your listening site? Press:

- 1 for one person,
- 2 for two people,
- 3 for three people,
- 4 for four people,
- 5 for five people,
- 6 for six people,
- 7 for seven people,
- 8 for eight people, or
- 9 for 9 or more people listening at your site.

2. Which of the following categories best describes your company? Press:

- 1 financial institution,
- 2 public accounting firm,
- 3 law firm,
- 4 regulatory agency,
- 5 other

Presentation

Audit Roundtable

**Telephone Seminar for
Bankers and Auditors**

**Part 1—
Risk Assessment and
Internal Controls**

November 15, 2001

Presented by AICPA Regulatory Task Force

Risk Assessment, Sampling, and Materiality

PricewaterhouseCoopers

Bill Lewis

Risk Assessment — Materiality, Sampling, Audit Design and Approach

Risk Analysis Components

General Risk

- Client business risks (Inherent and Control)
- Audit risks (Detection)

Causes of risk

- Complexities
- Error/Misjudgments
- Fraud
- Misappropriation of assets

Approach to risk analysis

- Identification of inherent risk of material misstatement
- Understanding of mitigating control environment
- Evaluation of remaining risks
- Development of audit approach
- Risk analysis is a significant part of audit assurance
- The audit is a cumulative process

NOTES:

Inherent risk identification

- Understanding the nature of the client's business
 - Understanding reporting complexity risk, nature of generally accepted accounting principles (GAAP) relative to client
 - Understanding industry trends
 - Understanding key regulatory issues
 - Engagement team expertise
-
- Document specific inherent risks
 - Assess risk of fraudulent financial reporting
 - Assess risk of misappropriation of assets
 - Develop audit strategy factors relative to inherent risks

NOTES:

Control risk assessment

Client's organization, roles and responsibilities

- Role of the board of directors
- Effectiveness of the organization and key management
- Human resource policies and procedures

Client's own risk assessment

- Reporting deficiencies
- Process surrounding management's own estimates
- Management planning process
- Budgetary controls process

Client's overall monitoring controls

- Audit committees
- Internal audit/compliance
- Change management processes
- Business line-level monitoring processes
- Integrity/ethical values

Determine whether control risk is high, moderate, or low

- If high, controls will not likely be relied upon and a substantive approach will be used to arrive at financial statement opinion
- If low, controls can be relied upon and controls will likely be tested as a basis for financial statement opinion
- Acceptable detection risk increases as the level of inherent and control risk decreases

NOTES:

Analytical procedures

Perform analytical procedures

Assess level of large, non-recurring, unusual, and complex transactions

Assess materiality

- **Material misstatement and the principal audit objective**
 - Differentiating error from fraud
 - Materiality varies according to institution's size
 - Materiality varies audit to audit for same institution

- **Planning stage materiality**
 - Consideration of control environment
 - Size and complexity of entity
 - Cumulative audit knowledge and experience
 - Recognize inverse relationship between materiality and audit risk, (i.e., low risk of large misstatements, higher risk of smaller misstatements)
 - Set an overall materiality level for each financial statement
 - Select smallest aggregate materiality level among statements
 - Estimate from experience likely occurrence levels
 - Select a per-occurrence materiality amount for aggregation

- **Execution stage materiality**
 - Continually assess planning judgments
 - Adjust materiality tolerances based on:
 - ✓ Size of adjustments found in testing
 - ✓ Number of items found in testing
 - ✓ Variances in financial statement components from those used in planning

Evaluating financial statements materiality taken as a whole (later)

Sample sizes and methods

- **Ultimate judgment rests with auditor. Determination includes:**
 - Relative risk
 - Nature/purpose of the test

- **Transaction testing of attributes**

- **Substantive testing of balances**
 - Experience with the control environment
 - Definition of attributes being tested
 - Tolerable error risk
 - Expected error level
 - Degree of client monitoring controls

- **Three areas often confused**
 - Sample size determination
 - Sample selection
 - Statistical evaluation of results

NOTES:

INTERNAL CONTROLS and FDICIA

Andersen
Craig Dabroski

Internal Controls and FDICIA

Management's Assertion

- Management's Assertion is prepared by management
- The role of the external auditor (EA) with respect to management's assertion
- Documentation of the work performed by the external auditor on testing management's assertions
- The examiner's objective with respect to reviewing work done by the external auditor with respect to management's assertion
- Situations where the external auditor is also employed in an outsourced arrangement

NOTES:

(FDICIA—Federal Deposit Insurance Corporation Improvement Act of 1991)

Material weaknesses versus reportable conditions

Definition of material weakness:

“SAS No. 60 defines a material weakness as a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.”

Also from the auditing standards:

“38. Evaluating whether a reportable condition is also a material weakness is a subjective process that depends on such factors as the nature of the accounting system and of any financial statement amounts or transactions exposed to the reportable condition, the overall control environment, other controls, and the judgment of those making the evaluation.”

- Actual experiences on material weaknesses versus reportable conditions.
- Reporting requirements for reportable conditions and material weaknesses.
 - How communicated to the client
 - To whom they are communicated
 - Written versus oral communications
 - Problems with issuing a letter that says “no reportable conditions” or “no material weaknesses”

NOTES:

Use of EA to opine on fairness of regulatory reports (call reports)

- 1991 Joint Proposal
- Disclosures in call report schedules that may be difficult to audit (RC-M and RC-C for example) based on interpretations of requirements.
- Internal controls over financial reporting encompass a significant percentage of the processes that are used to create the information included in the call reports.

Use of substantive testing

- Substantive testing versus testing of internal controls
- Judgment process used to decide upon which type of testing should be used
- Significant versus non-significant systems
- Testing methods — walk-through, observation, inquiry, etc.
- Documentation for decision process and testing results

Documentation related to FDICIA attestations

- Documentation by client of basis for conclusion
- Documentation by EA of testing of management attestations
- Separate testing of management attestation versus combined testing with financial statement audit
- Judgment process used to decide upon amount and type of testing of management attestation
- Various levels of documentation presented by bank on management attestation
- How documentation affects judgment of amount of testing to be done

NOTES:
