

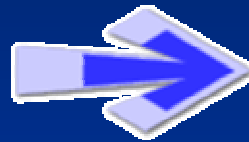
3rd Annual Regional and Community Bankers Conference

The Federal Reserve Bank of
Boston



Disclaimer

NEVER WRONG



DON'T COMPLETELY
RELY UPON

Recent Developments in Audit Practice

SOX, FDICIA 112, Other

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Supervisory Examiner



Sarbanes-Oxley

PCAOB Standard - Section 404



PCAOB Standard

- Audit of the financial statements and on internal controls is integrated and inseparable.
- Internal control is not a “one-size-fits-all” concept and companies will implement controls in different ways based on their size and complexity.
- Outlines management’s responsibilities and documentation requirements.
- Outlines the auditor’s responsibilities and required communications
- Establishes criteria for evaluating deficiencies.



Integrated Audit Objectives

- To express an opinion on the financial statements
- To express two opinions on internal controls over financial reporting, requiring:
 - An evaluation and opinion on management's assessment of the effectiveness of internal control over financial reporting
 - An evaluation and opinion on the effectiveness of internal control over financial reporting



Definition – Internal Control over Financial Reporting

- A process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with GAAP and includes policies and procedures that:
 - Pertain to the maintenance of records that, in reasonable detail, accurately reflect the transactions and dispositions of the assets of the company



Definition – Internal Control over Financial Reporting (Continued)

- 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 company's assets that could have a material effect on the financial statements.



Definition – Control Deficiency

- 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.
 - A deficiency in design exists when a) a control necessary to meet the control objective is missing or b) an existing control is not properly designed so that even if the control operates as designed, the control objective is not always met.



Definition – Control Deficiency (Continued)

- A deficiency in operation exists when a properly designed control does not operate as designed, or when the person performing the control does not possess the necessary authority or qualifications to perform the control effectively.



Significant Deficiency

- A control deficiency that adversely affects the company's ability to initiate, authorize, record, process, or report external financial data reliably in accordance with GAAP.
- Could be a single deficiency or a combination of deficiencies that results in more than a remote likelihood that a misstatement of the annual or interim financial statements that is more than inconsequential will not be prevented or detected.



Material Weakness

- A significant deficiency, or a combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected.
- A material weakness = Adverse Opinion



Management's Responsibilities

- Accept responsibility for the effectiveness of the company's internal control over financial reporting.
- Evaluate the effectiveness of the company's internal control over financial reporting using suitable control criteria.
- Support its evaluation with sufficient evidence, including documentation.
 - SEC has stated that failure to document is failure to comply.
- Present a written assessment about the effectiveness of the company's internal control over financial reporting as of the end of the company's most recent fiscal year.



Management's Documentation Requirements

- **The design of controls over all relevant assertions related to all significant accounts and disclosures in the financial statements**
- **Information about how significant transactions are initiated, authorized, recorded, processed and reported**
- **Sufficient information about the flow of transactions to identify where material misstatements due to error or fraud could occur**
- **Controls designed to prevent or detect fraud, including who performs the controls and the related segregation of duties**
- **Controls over period-end financial reporting process**
- **Controls over safeguarding of assets**
- **The results of management's testing and evaluation**



Auditor's Responsibility

- Plan the audit
- Evaluate management's assessment process
- Obtain an understanding of the internal control over financial reporting
- Evaluate design effectiveness
- Test and evaluate operating effectiveness of controls
- Use work of others
- Evaluating deficiencies and forming an opinion on the effectiveness of internal control over financial reporting



Auditor Evaluation of the Effectiveness of the Audit Committee's Oversight

Not a separate evaluation – part of audit evaluation of the control environment and monitoring components

- Independence from management
- Clearly articulated responsibilities
- Level of involvement and interaction with the external and internal auditor.
- Responsiveness to issues raised by the external or internal auditor

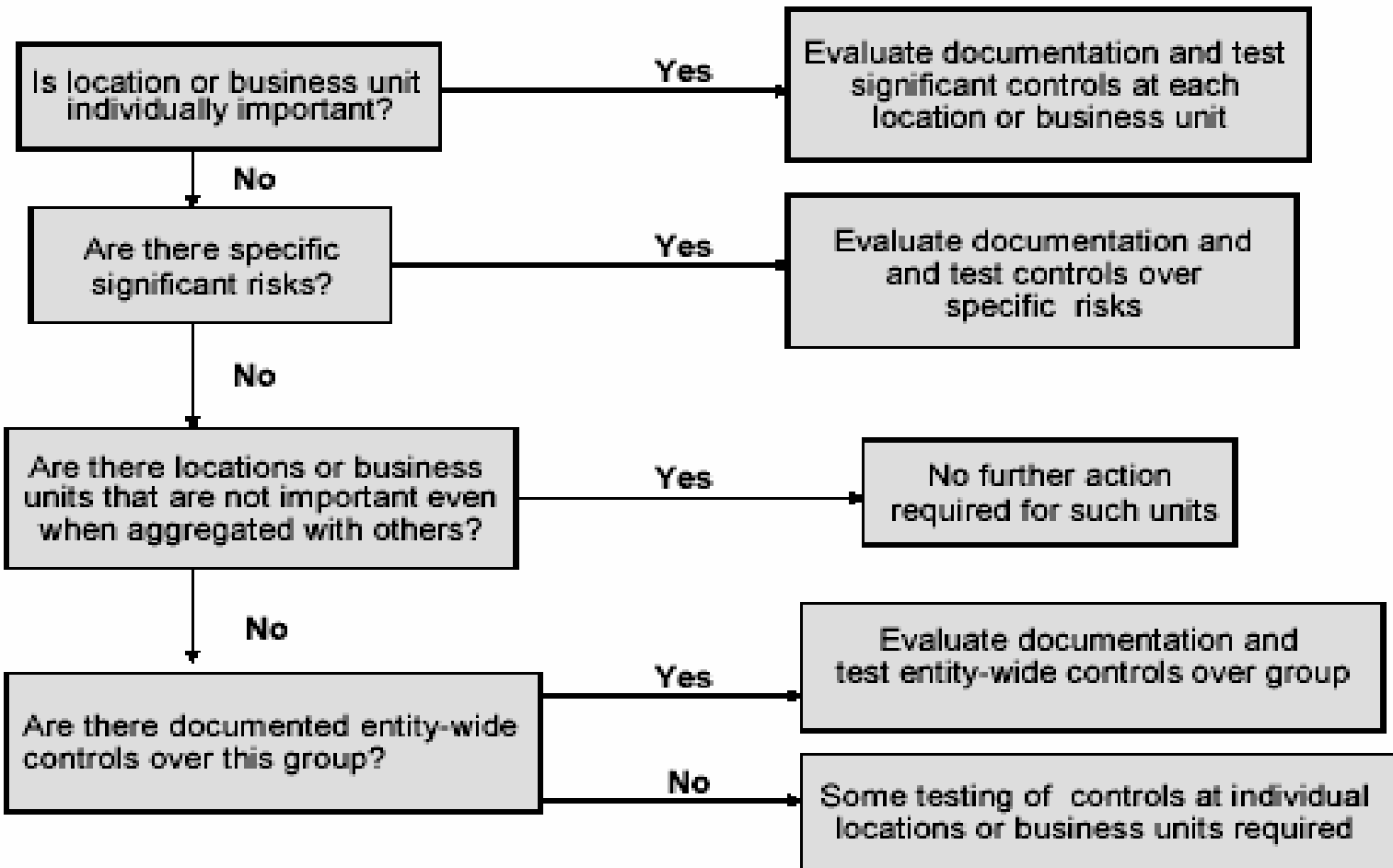
Ineffective oversight by the audit committee should be regarded as at least a significant deficiency and is a strong indicator of a material weakness. If such exists, auditor must communicate it in writing to the board of directors.



Enterprise-wide Risk Assessments



Multi-location Testing Considerations



COSO Draft Enterprise Risk Framework

Internal Environment

Risk Management Philosophy – Risk Culture – Board of Directors – Integrity and Ethical Values – Commitment to Competence – Management’s Philosophy and Operating Style – Risk Appetite – Organizational Structure – Assignment of Authority and Responsibility – Human Resource Policies and Practices

Objective Setting

Strategic Objectives – Related Objectives – Selected Objectives – Risk Appetite – Risk Tolerance

Event Identification

Events – Factors Influencing Strategic Objectives – Methodologies and Techniques – Event Interdependencies – Event Categories – Risks and Opportunities

Risk Assessment

Inherent and Residual Risk – Likelihood and Impact – Methodologies and Techniques Correlation



COSO Draft Enterprise Risk Framework (Continued)

Risk Response

Identify Risk Responses – Evaluate Possible Risk Responses – Select Responses – Portfolio View

Control Activities

Integration with Risk Response – Types of Control Activities – General Controls – Application Controls – Entity Specific

Information and Communication

Information – Strategic and Integrated Systems - Communication

Monitoring

Separate Evaluations – Ongoing Evaluations



FDICIA 112 Issues



Observed Non-compliance with Section 36, Part 363 of the Federal Deposit Insurance Act

- Management reports not containing all statements of their responsibilities and assessment's
- Independent auditor's attestation report on management's assertions dated prior to the date of management's report
- Annual reports not filed or incomplete
- Independent auditor's management letter and attestation report not filed or not filed timely



Observed Non-compliance with Section 36, Part 363 of the Federal Deposit Insurance Act

- Notice of the engagement, resignation, or dismissal of the independent public accountant not filed or not filed timely
- Reasons for the engagement, resignation, or dismissal of the independent public accountant not adequately explained
- Audit committees did not document the annual assessment of independence of existing and potential audit committee members.



Weaknesses Observed Relative to External Audits of BSA



Independent Audit Weaknesses Relative to BSA Reviews

- The audit scope was driven by what the financial institution was willing to pay.
- Audit personnel were not fully experienced in BSA.
- Audit review consisted of a process review with little or no testing.

