

## *External and Internal Audit*

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### **Introduction**

The board of directors and senior management have the ultimate responsibility for the design, implementation, and monitoring of the FHLBank's risk management and internal control environment. The control environment provides the discipline and structure for the achievement of the primary objectives of the system of internal control. Specific examples of internal control are as follows:

- 1) Integrity and ethical values;
- 2) Management's philosophy and operating style;
- 3) Organizational structure;
- 4) Assignment of authority and responsibility;
- 5) Human resource policies and procedures; and
- 6) Competence of personnel.

Broadly defined, internal control is a process that and encompasses all activities of the FHLBank, reflects the attitude of the board of directors and senior management, and is designed to:

- 1) Provide reasonable assurance that assets are safeguarded, and financial and operational information is timely and reliable;
- 2) Detect and correct errors and irregularities in a timely manner;
- 3) Ensure compliance with policies, plans, procedures, laws and regulations; and
- 4) Promote the economical and efficient use of resources.

Control is an integral part of managing operations, and is any action taken by a manager to enhance the probability that established goals and/or objectives will be achieved. Those actions may be either preventive (to deter undesirable events from occurring), detective (to detect and correct undesirable events which have occurred), or directive (to cause or encourage a desirable event to occur).

It is the responsibility of FHLBank management at all levels to:

- 1) Identify and evaluate the exposures related to the conduct of the FHLBank's operations;
- 2) Specify and establish the policies, operating standards, procedures, systems, and other disciplines to be used to limit the risks associated with the exposures identified;
- 3) Establish practical controlling processes that require and encourage employees to perform their tasks in a manner that achieves a positive control result; and
- 4) Maintain the adequacy and effectiveness of the control processes that have been established.

Internal audit is an independent and objective assurance activity designed to add value and improve the organization's operations. It assists an organization in accomplishing its objectives by bringing a systemic, disciplined approach to evaluate and improve the

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effectiveness or risk management, control, and governance processes by providing objective analysis and constructive recommendations. For example, internal audit assists FHLBank management in maintaining effective internal controls by evaluating their effectiveness and efficiency and by promoting continuous improvement. .

Internal audit activities are performed in diverse legal and cultural environments; within organizations that vary in purpose, size, complexity, and structure. While differences may affect the practice of internal auditing in each environment, compliance with the International Standards for the Professional Practice of Internal Auditing (Standards) is essential if the responsibilities of internal auditors are to be met. If internal auditors are prohibited by laws or regulations from complying with certain parts of the Standards, they should comply with all other parts of the Standards and make appropriate disclosures.

Assurance services involve the internal auditor's objective assessment of evidence to provide an independent opinion or conclusions regarding a process, system, or other subject matter. The nature and scope of the assurance engagement are determined by the internal auditor. There are generally three parties involved in assurance services: (1) the person or group directly involved with the process, system, or other subject matter, *i.e.*, the process owner, (2) the person or group making the assessment, *i.e.*, the internal auditor, and (3) the person or group using the assessment, *i.e.*, the user. Examples may include financial, performance, compliance, system security, and due diligence engagements.

From time to time, the internal audit function might provide advisory or consulting services which are generally performed at the specific request of an engagement client. The nature and scope of the consulting engagement are subject to agreement with the engagement client. Consulting services generally involve two parties: (1) the person or group offering the advice, *i.e.*, the internal auditor, and (2) the person or group seeking and receiving the advice, *i.e.*, the engagement client. When performing consulting services the internal auditor should maintain objectivity and not assume management responsibility. Examples include counsel, advice, facilitation, and training. Notwithstanding, the examiner should closely review consulting activities of the internal audit department to ensure that such activities are not operational in nature and might compromise independent auditor objectivity and independence.

The purpose of the Standards is to:

- 1) Delineate basic principles that represent the practice of internal auditing as it should be;
- 2) Provide a framework for performing and promoting a broad range of value-added internal audit activities;
- 3) Establish the basis for the evaluation of internal audit performance; and
- 4) Foster improved organizational processes and operations.

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The responsibility of internal audit extends beyond that of external auditors with respect to the reliability and integrity of information. External auditors are primarily concerned with the internal control structure relevant to a financial statement audit, which includes an evaluation of the financial institution's ability to record, process, summarize, and report financial data consistent with the assertions in the financial statements, while internal audit is also concerned with controls over the effectiveness, economy, and efficiency of management decision-making processes that do not relate to a financial statement audit.

### *Audit Committee*

The audit committee is a committee of the board. Its function is to promote the independence of the external and internal auditors, and ensure that the directors exercise due care.

The audit committee is responsible for monitoring, overseeing, and evaluating the duties and responsibilities of management, internal audit, and the external auditors as those duties and responsibilities relate to the organization's processes for controlling its operations, and that all issues reported by the internal audit department, the external auditor, and other outside auditors have been satisfactorily resolved.

The specific powers, duties and responsibilities of the audit committee are detailed in a charter which should include, but is not limited to, the following:

- 1) Detailing committee composition, membership, terms of service, independence, qualifications, and meetings;
- 2) Reviewing and approving the audit committee charter periodically;
- 3) Direction of senior management to maintain the reliability and integrity of the accounting policies and financial reporting and disclosure practices of the FHLBank;
- 4) Reviewing the basis for the FHLBank's financial statements and the external auditor's opinion rendered with respect to such financial statements; and
- 5) Conducting oversight of the internal audit function by:
  - a) Selecting, evaluating and, where appropriate, replacing the audit director and ensuring that the audit director be removed only with the approval of the audit committee;
  - b) Requiring that the audit director report directly to the audit committee on substantive matters, and that the audit director shall be accountable to the audit committee and board of directors;

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- c) Requiring that both the internal and external auditors have unrestricted access to the audit committee without the need for any prior management knowledge or approval;
  - d) Reviewing the scope of audit services required, significant accounting policies, significant risks and exposures, audit activities, and findings;
  - e) Monitoring the adequacy and timeliness of internal audit follow-up on findings;
  - f) Assessing the performance and determining the compensation of the audit director; and
  - g) Reviewing and approving the audit director's work plan.
- 6) Conducting oversight of the external audit function by:
- a) Approving the external auditor's annual engagement letter;
  - b) Reviewing the performance of the external auditor; and
  - c) Making recommendations to the board of directors regarding the appointment, renewal, or termination of the external auditor.
- 7) Providing an independent, direct channel of communication between the board of directors and the Bank's internal and external auditors;
- 8) Determining the extent to which internal and external auditors review the security for computer systems, facilities, and backup systems;
- 9) Evaluating responses by management to audit findings and reports, and monitoring management implementation of audit recommendations;
- 10) Conducting or authorizing investigations into any matters within the audit committee's scope of responsibilities;
- 11) Monitoring of compliance with FHLBank's conflict of interest policy and oversight of investigations of conflicts of interest and unethical conduct;
- 12) Providing reasonable assurance that senior management has established and is maintaining an adequate internal control system by:
- a) Reviewing the FHLBank's internal control system and the resolution of identified material weaknesses and reportable conditions in the internal control system, including the prevention or detection of management override or compromise of the internal control system; and
  - b) Reviewing the FHLBank's programs and policies designed to provide reasonable assurance of compliance with applicable laws, regulations, and policies and monitoring the results of the compliance efforts.

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- 13) Review of the policies and procedures established by senior management to assess and monitor implementation of the FHLBank's strategic business plan and the operating goals and objectives; and
- 14) Periodic reporting of its findings to the FHLBank's board of directors.

### *Evaluation of the Internal Audit Function*

To determine the adequacy and effectiveness of the internal audit function, and its compliance with the Standards, the examiner should evaluate specific standards that pertain to organizational status, professional competency and due professional care, management of the internal audit activity, nature and performance of internal audit activities and communication. These are detailed as follows:

#### 1) Organizational Status

Organizational status relates to the internal audit department's purpose, authority and responsibility within the organization to address board of director oversight and corporate governance, and to ensure the internal auditor's independence and objectivity. The organizational status of internal audit must be sufficient to permit accomplishment of the objectives. Proper organizational status enhances the independence and objectivity of internal audit. Without the support of the board of directors and senior management, the internal auditors may not receive the cooperation necessary to perform their tasks.

The purpose, authority, and responsibility of the internal audit should be formally defined in a charter, consistent with the Standards, and approved by the board of directors. The charter should (a) establish the internal audit activity's position within the organization; (b) authorize access to records, personnel, and physical properties relevant to the performance of engagements; and (c) define the scope of internal audit activities. Internal auditors may provide consulting services relating to operations for which they had previous responsibilities. The nature of assurance and consulting services provided to the organization should be defined in the charter.

Internal audit should be independent and objective in the performance of its work. Internal auditors should be free from interference in determining the scope of an audit, performing work, and communicating results. The audit director should report functionally and administratively to the audit committee. However, in some instances, the audit director may report functionally to the audit committee and administratively to the Chief Executive Officer.

Objectivity is an independent mental attitude which internal auditors should maintain in performing audits. Internal auditors should perform their work in such a manner that significant compromises are not made, or be placed in situations where they are unable to make objective professional judgments.

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Internal auditors should refrain from assessing specific operations for which they were previously responsible. Objectivity is presumed to be impaired if an auditor provides assurance services for an activity for which the auditor had responsibility within the previous year. Assurance engagements for functions over which the internal audit director has responsibility should be overseen by a party outside the internal audit activity.

If independence or objectivity is impaired in fact or appearance, the details of the impairment should be disclosed to appropriate parties. The nature of the disclosure will depend upon the impairment. If internal auditors have potential impairments to independence or objectivity relating to proposed consulting services, disclosure should be made to the engagement client prior to accepting the engagement.

### 2) Professional Competency and Due Professional Care

The audit engagement should be performed with proficiency and due professional care. Internal auditors should possess the knowledge, skills, and other competencies needed to perform their individual responsibilities. Internal audit, collectively, should possess or obtain the knowledge, skills, and other competencies needed to perform their responsibilities.

Internal auditors should have knowledge of key information technology risk and controls and available technology-based audit techniques to perform their assigned work. However, not all internal auditors are expected to have the expertise of an internal auditor whose primary responsibility is information technology auditing.

The internal audit director should decline the consulting engagement or obtain competent advice and assistance if the internal audit staff lacks the knowledge, skills, or other competencies needed to perform all or part of the engagement.

Due professional care does not imply infallibility. The internal auditor needs to consider:

- a) Extent of work needed to achieve the engagement's objectives;
- b) Relative complexity, materiality, or significance of matters to which assurance procedures are applied;
- c) Adequacy and effectiveness of risk management, control, and governance processes;
- d) Probability of significant errors, irregularities, or noncompliance; and
- e) Cost of assurance in relation to potential benefits.

In exercising due professional care, the internal auditor should consider the use of computer-assisted audit tools and other data analysis techniques. An internal auditor needs to be alert to the significant risks that may impact objectives, operations, and

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resources. However, assurance procedures alone, even when performed with due professional care, do not guarantee that all significant risks have been identified.

An evaluation of the experience and technical expertise of the internal auditors includes the following attributes:

- a) The internal auditors' knowledge, skills, and other competencies that are needed to perform their individual responsibilities such as education, work experience, and professional certifications.
- b) Enhancement of the auditors' knowledge, skills, and other competencies through continuing professional development such as informal or formal training seminars, and the obtainment of professional certifications.
- c) The development and maintenance of a quality assurance and improvement program that covers all aspects of the internal audit activity and continuously monitors its effectiveness.

The internal audit director should develop and maintain a quality assurance and improvement program that covers all aspects of the internal audit activity and continuously monitors its effectiveness. This program includes periodic internal and external quality assessments and ongoing internal monitoring. Each part of the program should be designed to help the internal audit activity add value and improve the organization's operations and to provide assurance that the internal audit activity is in conformity with the Standards and the Code of Ethics.

The process should include internal and external assessments. Internal assessments include ongoing reviews of the performance of the internal audit activity and periodic reviews performed through self-assessments by other persons within the organization, with knowledge of internal audit practices and the Standards.

External assessments, such as quality assurance reviews, should be conducted at least once every five years by a qualified, independent reviewer from outside the organization. The results of the external assessment should be reported to the audit committee and the board of directors.

### 3) Management, Nature and Performance of Internal Audit Activities

The evaluation of the management, nature and performance of internal audit activities should consider the following attributes:

- a) *Planning-development of the annual audit plan*

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The audit director should develop risk-based plans to determine the priorities of internal audit, consistent with the organization's goals. The annual audit plan should be based on a risk assessment. The input of senior management and the board should be considered in the process. The audit director should consider accepting proposed consulting engagements based on the engagement's potential to improve management of risks, add value, and improve the organization's operations. Those engagements that have been accepted should be included in the plan.

The frequency of the audit should be determined by reference to factors affecting risk. Specific examples include, but are not limited to identified weaknesses, organization environment and change, management oversight, adequacy of internal controls, policies and procedures, significance to the balance and income statements, transaction volume, adequacy of systems, regulatory requirements, change in market/business environment, and the adequacy of business contingency plans.

Audit work schedules should include:

- i) What activities are to be audited;
- ii) When they will be audited;
- iii) The audit work planned, and the nature of audit work performed by others;  
and
- iv) Reporting types and timeframes.

Matters to be considered in establishing audit work schedule priorities should include:

- i) The date and results of the last audit;
- ii) Financial exposure;
- iii) Potential loss and risk;
- iv) Requests by management;
- v) Major changes in operations, programs, systems, and controls;
- vi) Opportunities to achieve operating benefits;
- vii) Changes to and capabilities of the audit staff; and
- viii) New programs.

The work schedules should be sufficiently flexible to cover unanticipated demands on the internal auditing department. Internal audit staffing resources should be appropriate, sufficient, and effectively deployed to achieve the approved plan. The internal audit's plan and resource requirements, including significant interim changes should be reported to senior management and the audit committee for review and approval. Also, the impact of resource limitations should be reported.



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### *b) Policies and Procedures*

The audit director is responsible for the development and implementation of policies and procedures to guide the internal audit activity. The format and content should be appropriate to the size and structure of the internal audit department, and the complexity of its work. The following are examples of attributes that should be addressed:

#### *i) Corporate operating policies*

- (1) Governance-responsibilities of the board of directors and senior management;
- (2) Audit committee responsibilities and charter; and
- (3) Reporting to the audit committee.

#### *ii) Overview of the Internal Audit Department*

- (1) Internal audit department charter;
- (2) International Standards for the Professional Practice of Internal Auditing;
- (3) Code of Ethics;
- (4) Annual risk assessment and audit planning;
- (5) Coordination with external auditors;
- (6) Participation on management committees;
- (7) Quality assurance program;
- (8) Reports for management and the audit committee; and
- (9) Responsibilities of the audit director, audit manager, audit supervisor, and the auditor-in-charge.

#### *iii) Audit Projects*

- (1) Financial/operational audit;
- (2) Information technology audit;
- (3) System development audits;
- (4) Special projects;
- (5) Fraud/special investigations;
- (6) Interim reviews and key indicator systems;
- (7) Assistance to external auditors and regulatory examiners;
- (8) Budget assignment, tracking, and reporting;
- (9) Pre-planning of the audit engagement;
- (10) Engagement letter to management and opening conference;
- (11) Development and completion of internal control questionnaires;
- (12) Preliminary evaluation of internal controls;
- (13) Audit program;
- (14) Sampling techniques;
- (15) Testing of internal controls;

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- (16) Evaluation of findings;
- (17) Workpaper Standards;
- (18) Security of workpapers;
- (19) Supervisory review;
- (20) Record retention;
- (21) Exit and closing conference;
- (22) Audit reports and follow-up;
- (23) Project staff appraisals;
- (24) Post-audit feedback to the internal audit director; and
- (25) Post-audit survey with management.

### iv) Staff Development and Evaluation

- (1) Position descriptions;
- (2) Interviewing;
- (3) Professional certifications and training; and
- (4) Performance appraisals.

### v) Audit Administration

- (1) Personal conduct and independence;
- (2) Personal computer responsibilities;
- (3) Time reporting;
- (4) Travel and expense requirements;
- (5) Reference materials; and
- (6) Record retention.

### *c) Coordination of Audit Activities*

The audit director should share information and coordinate activities with other internal and external providers of relevant assurance to ensure proper coverage and minimize duplication of efforts.

### *d) Reporting to the Audit Committee and Senior Management*

The audit director should report periodically to the audit committee and senior management on the internal audit's purpose, authority, responsibility, and performance relative to its plan. Reporting should also include significant risk exposures and control issues, corporate governance issues, and other matters needed or requested by the board and senior management. The following are examples of attributes to be included and subjects to be addressed in the report:

- i) The status of the current audit plan and other audit matters such as audit department performance, personnel, training, and financial budgets;
- ii) Prior audit reports and management's responses;

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- iii) Summaries of significant risk exposures and control issues, corporate governance issues, and other matters needed or requested by the board and senior management such as new regulatory and/or accounting requirements, employee related issues, and contingent litigation;
  - iv) Tracking of previous reported findings and management's response; and
  - v) External auditor's reports, third-party examination reports and presentations, and SAS 70 reviews on key/critical outside service providers.
- 4) Nature of Audit Work (Risk Management, Control and Governance)

Internal audit should evaluate and contribute to the improvement of risk management, control, and governance processes using a systematic and disciplined approach.

*a) Risk Management and Control*

Internal audit assists the organization in maintaining effective internal controls by evaluating their effectiveness and efficiency and by promoting continuing improvement. Based on the results of the risk assessment, internal audit evaluates the risk exposures and applicable controls relating to FHLBank's risk management, governance, operations, and information systems responsible for:

- i) Reliability and integrity of financial and operational information;
- ii) Compliance with policies, laws, regulations and contracts;
- iii) Safeguarding of assets; and
- iv) Effectiveness and efficiency of operations.

During advisory engagements, internal auditors should address risks and controls consistent with the engagement's objectives and be alert to the existence of other significant risks or control weaknesses. In addition, internal auditors should incorporate knowledge of risks and controls gained from advisory engagements into the process of identifying and evaluating significant risk exposures of the organization.

Internal auditors evaluate the extent to which operating and program goals and objectives have been established and conform to those of the organization. In addition, the review should include the extent to which results are consistent with established goals and objectives to determine whether operations and programs are being implemented or performed as intended.

Adequate criteria are needed to evaluate controls. Internal auditors should ascertain the extent to which management has established adequate criteria to determine whether the objectives and goals have been accomplished. If adequate, internal auditors should use such criteria in their evaluation. If inadequate, internal auditors should work with management to develop appropriate evaluation criteria.

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### *b) Governance*

Internal auditors should assess and make appropriate recommendations for improving the governance process in its accomplishment of the following objectives:

- i) Promoting appropriate ethics and values within the organization;
- ii) Ensuring effective organizational performance management and accountability;
- iii) Effectively communicating risk and control information to appropriate areas of the organization; and
- iv) Effectively coordinating the activities of and communicating information among the board, external and internal auditors and management.

Internal auditors should evaluate the design, implementation, and effectiveness of the organization's ethics-related objectives, programs and activities.

### 5) Performance of Audit Work

An evaluation of the effectiveness and efficiency of internal audit work includes the following attributes:

#### *a) Planning Considerations*

The internal auditor is responsible for the planning and conducting the internal audit, subject to supervisory review and approval. The preplanning process includes an evaluation of various attributes that include, but not limited, to the following:

- i) In planning the engagement, internal auditors should consider the objectives of the activity being reviewed and the means by which the activity controls its performance.
- ii) The internal auditor's identification and assessment of the significant risks and controls relevant to the activity under review and the means by which the potential impact of the risks is kept to an acceptable level.
- iii) The adequacy and effectiveness of the activity's risk management and control systems compared to a relevant control framework or model, and opportunities for making significant improvements to the activity's risk management and control systems.

Internal auditors should establish an understanding with engagement clients that address objectives, scope, respective responsibilities, and other client expectations. For significant engagements, this understanding should be documented.

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### *b) Engagement Objectives*

Objectives should be established for each engagement. Internal auditors should conduct a preliminary assessment of the risks relevant to the activity under review. Engagement objectives should reflect the results of the risk assessment. The internal auditor should consider the probability of significant errors, irregularities, noncompliance and other exposures when developing the engagement objectives. The engagement objectives should address risks, controls and governance processes to the extent agreed upon by the client.

### *c) Engagement Scope*

The established scope should be sufficient to satisfy the objectives of the engagement. The scope of the engagement should include consideration of relevant systems, records, personnel, and physical properties, including those under the control of third parties.

If significant consulting opportunities arise during an assurance engagement, a specific written understanding as to the objectives, scope, respective responsibilities and other expectations should be reached and the results of the consulting engagement communicated in accordance with consulting standards.

In performing consulting engagements, internal auditors should ensure that the scope of the engagement is sufficient to address the agreed-upon objectives. If internal auditors develop reservations about the scope during the engagement, these reservations should be discussed with the client to determine whether to continue with the engagement.

### *d) Engagement Resource Allocation*

A determination of staffing resources necessary to achieve the engagement objectives should be performed. Staffing should be based on the complexity of the engagement, time constraints, and available resources.

### *e) Engagement Work Programs*

Internal auditors should develop work programs that achieve the engagement objectives. The audit programs should be recorded and establish the procedures for identifying, sampling, analyzing, evaluating, and recording information during the engagement. The audit program should be approved prior to its implementation, and any adjustments approved in a timely manner. Work programs for engagements may vary in form and content depending upon the nature of the engagement.

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### *f) Performing the Engagement*

Internal auditors should identify and record information or produce evidence that achieves the engagement's objectives and supports the auditors' analyses, conclusions, and results. Specific information or evidence includes the following:

- i) *Sufficient information*-is factual, adequate, and convincing so that a prudent, informed person would reach the same conclusions as the auditor;
- ii) *Competent information*-is reliable and attainable through the use of appropriate audit techniques;
- iii) *Relevant information*-supports audit findings and recommendations and is consistent with the objectives for the engagement; and
- iv) *Useful information*-helps the organization meet its goals.

The audit director should control access to the workpapers. Approval should be obtained from senior management and/or legal counsel prior to the releasing such records to external parties, as appropriate. Record retention procedures should be established that are consistent with the organization's and industry guidelines and regulatory requirements.

### *g) Engagement Supervision*

The engagement should be supervised to ensure the objectives are achieved, quality is assured, and the experience and competency of the internal audit staff is developed. Evidence of supervisory review should be documented in the workpapers.

### *h) On-going monitoring and key business activities*

The audit director should implement a process to monitor critical business activities and key performance indicators continuously such as exception reports and interim reviews, coordinating with other risk management functions, developing the audit plan based on risk priorities and being involved in technology projects.

## 6) Communication

### *a) Audit Reports*

Audit reports are a culmination of the work that was performed. Although audit reports do not have a prescribed format, there are several types of reports that could be utilized, which include:

- i) *Formal*-with carefully structured formats;
- ii) *Informal*-in letters or memoranda to operating management; and,

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iii) *Interim*-with brief statements of conditions requiring immediate action.

The audit report should be accurate, objective, clear, concise, constructive, complete, and timely. If appropriate, satisfactory performance should be acknowledged. The report should include the engagement's objectives and scope as well as applicable conclusions, recommendations, action plans, and where appropriate, contain the internal auditor's overall opinion. The audit director or designee is responsible to review and approve the final audit report before issuance and should decide to whom the report will be distributed.

Communication of the progress and results of engagements will vary in form and content depending upon the nature of the engagement and the needs of the client. In addition, risk management, control and governance issues may be identified. Whenever, these issues are significant to the organization, they should be communicated to senior management and the board.

If a final communication contains a significant error or omission, the internal audit director should communicate corrected information to all parties who received the original information. When noncompliance with the Standards impacts a specific engagement, communication of the results should disclose the:

- i) *Standard(s)* with which full compliance was not achieved;
- ii) *Reason(s)* for noncompliance; and,
- iii) *Impact* of noncompliance on the engagement.

b) *Monitoring Results and Follow-up*

The audit director must establish a process to monitor and follow-up on the findings that were communicated to ensure that corrective action has been effectively implemented or that senior management has acknowledged and accepted the risk of not taking action. If the audit director believes that senior management has accepted a level of risk that is unacceptable to the organization, a discussion must be held with senior management. If the decision regarding residual risk is not resolved, the matter must be reported to the audit committee and the board of directors.

### **Regulatory Environment**

The primary authorities governing, or relevant to, external and internal audit activities of the FHLBanks are set forth below. The discussion does not address the application of authorities other than the FHLBank Act and the regulations, interpretations and issuances of the Finance Board to the FHLBanks. The examiner should ensure that the application of such authorities to an FHLBank has been considered by the FHLBank and its legal counsel.

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1) ***Rules and Regulations of the Federal Housing Finance Board, which include the following parts and sections relevant to external and internal audit activities:***

Part 917 of the Finance Board regulations addresses powers and responsibilities of FHLBank boards of directors and senior management. In particular, Section 917.3, Risk Management, Section 917.4 Bank Member Products Policy, and Section 917.6, Internal Control System, are pertinent.

Section 917.5 requiring the FHLBank's board of directors to have a strategic business plan that describes how the business activities of the FHLBank will achieve its mission consistent with Part 940 (Core mission activities).

Section 917.7, addresses the powers, duties, composition, and responsibilities of the audit committees. These responsibilities should be detailed in a charter and approved by the board of directors. The charter should be re-approved at least every three years.

Section 917.8, requires the board of directors to be responsible for the adoption of the FHLBank's annual operating expense budget and capital expenditures, and with the FHLBank's responsibility to protect both its members and the public interest by keeping its costs to an efficient and effective minimum.

Section 989.3, addresses the preparation and completion of the FHLBank's financial statements, and the distribution of financial information and other information to the Finance Board and the Office of Finance.

2) ***Advisory Bulletins of the Federal Housing Finance Board*** that provide guidance relating to the topic of internal audit are the following:

Advisory Bulletin AB 96-1, dated February 29, 1996, provides that to maintain independence; the audit committee is responsible for the selection, compensation, and performance evaluation of the audit director.

Advisory Bulletin AB 02-5, dated April 8, 2002, provides that to maintain independence; the internal audit function should not take an ownership role and manage or coordinate the annual risk assessment of the FHLBank.

Advisory Bulletin 05-05 dated May 18, 2005, which provides guidance on the risk management responsibilities of the board, senior management and risk management.

3) ***Federal Housing Finance Board Resolution*** numbered 92-568.1, dated July 22, 1992, which sets forth minimum standards for the functioning of the internal audit department, the audit committees, and minimum standards for the audit director.



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- 4) ***Statements of Financial Accounting Standards adopted by the Financial Accounting Standards Board (FASB)*** establish standards of financial accounting and reporting governing the preparation of financial reports and are officially recognized as authoritative by the Securities and Exchange Commission and American Institute of Certified Public Accountants (AICPA).
- 5) ***Securities and Exchange Commission*** is the primary regulator of the United States securities markets and requires public companies to disclose meaningful financial information to the public and enforces the securities laws.
- 6) ***American Institute of Certified Public Accountants Professional Standards*** is the national, professional organization for certified public accountants. Its mission is to provide members with the resources, information and leadership that will enable them to provide professional services to benefit the public as well as employers and clients. In fulfilling its mission, the AICPA works with state accountants' organizations and gives priority to those areas where public reliance on accounting skills is most significant. The AICPA Auditing Standards Board issues Statements of Auditing Standards (SAS) utilized by the auditing profession. Specific examples include, but are not limited to, the following:

SAS 55, Consideration of Internal Control in a Financial Statement Audit, requires external auditors to obtain an understanding of internal control on every engagement. This includes an evaluation of the control environment, risk assessment, control activities, information and communication, and monitoring.

SAS 65, The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statement, encourages external auditors to consider internal audit activities such as organizational status, audit plans, scope of audit work, competence, objectivity, professionalism, and providing assistance to the external auditors when planning and performing the financial statement audit.

SAS 90, Audit Committee Communications, establishes a requirement that certain matters related to the conduct of an audit are communicated to the audit committee, and requires the external auditor to ensure that the audit committee receives additional information regarding the scope and results of the audit that may assist the audit committee in overseeing the financial reporting and disclosure process for which management is responsible.

SAS 99 (Consideration of Fraud in a Financial Statement Audit) establishes procedures and provides guidance to external auditors in fulfilling their responsibility, as it relates to fraud, in an audit of financial statements.

- 7) ***Sarbanes-Oxley Act and regulations and interpretations of the Securities and Exchange Commission thereunder.***

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The statute was enacted in response to various corporate scandals and addresses various corporate governance requirements that relate to the responsibilities of corporate boards of directors, the external and internal audit function, and the quality of management's attestation of internal controls pertaining to the accuracy of financial reporting.

- 8) ***Public Company Accounting Oversight Board (PCAOB)*** is a private-sector, non-profit corporation, created by the Sarbanes-Oxley Act to oversee the auditors of public companies in order to protect the interests of investors and further the public interest in the preparation of informative, fair, and independent audit reports.
- 9) ***Government Auditing Standards*** provides standards for audits of government organizations. The standards pertain to auditors' professional qualifications, the quality of audit effort, and the characteristics of professional and meaningful audit reports.
- 10) ***Institute of Internal Auditing (IIA)*** was organized in 1941 to develop and promote the professional status of internal auditing. The IIA recently adopted a Professional Practices Framework (PPF) that updates and expands previous IIA guidance for internal auditors. The internal audit activity is part of a system of internal control, and contributes significantly to the overall governance structure of the corporation. Management, directors, investors, and external auditors will be affected by the new framework. The PPF includes both new and updated audit standards and provides a framework for internal audit activities to engage with other mechanisms of corporate governance.

The IIA's definition of internal auditing reflects the broad duties of internal auditors in their organizations. The definition's encompassing nature allows for future development of the role of the internal audit. The new definition is as follows:

*“Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes.”*

The IIA adds consulting activities to the more traditional assurance services in characterizing the work that internal auditors perform. In addition, the definition emphasizes the concept that internal auditing should add value to the organization. Finally, besides the familiar topic of internal control, two additional areas, risk management and governance are specifically mentioned.

The IIA Code of Ethics has two components: “principles” and “rules of conduct.” The four principles are: *integrity, objectivity, confidentiality, and competency*. The

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rules of conduct amplify the principles and detail specific internal audit behaviors that are either mandated or prohibited. These principles are defined as follows:

- a) *Integrity*-The integrity of internal auditors establishes trust and provides the basis for reliance on their judgment. Their work is to be performed with honesty, diligence and responsibility.
- b) *Objectivity*-Internal auditors are to exhibit the highest level of professional objectivity in gathering, evaluating, and communicating information about the activity or process being examined. Internal auditors make an assessment of all relevant circumstances and should not be unduly influenced by their own interests or by others in forming judgments;
- c) *Confidentiality*-Internal auditors are to respect the value and ownership of information they receive and should not disclose information without appropriate authority, or use the information for personal gain.
- d) *Competency*-Internal auditors are to apply the knowledge, skills, and experience needed in the performance of their duties and responsibilities that are necessary to comply with the International Standards for the Professional Practice of Internal Auditing.

The International Standards for the Professional Practice of Internal Auditing (Standards) is a group of specific standards and guidelines that address audit methodology and practices such as purpose, authority, responsibility, independence, objectivity, scope of work, professional proficiency, quality assurance, management of the internal audit department, nature of work, and performance of audit work.

There are three sets of mandatory standards for both assurance and consulting work which are as follows:

- a) Attribute standards describe appropriate features of individuals and units performing internal audit work.
- b) Performance standards pertain to the execution of each individual internal audit engagement.
- c) Implementation standards elaborate on the attribute and performance standards and relate those standards to specific types of audits. Implementation standards may address issues associated with particular industries, regions, or types of services.

Practice advisories (PAs) provide internal auditors with guidance that is endorsed by the IIA but not mandatory. The PAs describe best practices that may aid the internal auditor in implementing the ISPPPIAs. Development and practice aids constitute the

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largest element of the PPF. The aids offer training and education to internal auditors through continuing education courses, research reports, and other products and services.

### **FHLBank Environment**

Within the FHLBanks, to ensure adequate coverage of the major risks and to minimize duplication of effort, the external and internal auditors coordinate the timing and scope of their audits. In many cases, external auditors rely on the work of the internal auditor to gain comfort on the control environment and gain efficiencies over the number and depth of substantive tests needed to perform its audit.

The specific number of internal auditors, reporting structure of the audit function, background, experience, education and professional certifications, audit methodologies and practices may vary. In addition, due to staffing limitations and required technical expertise, specific engagements such as the audit of computer systems may be outsourced.

If an internal audit engagement is outsourced, examiners should consider reviewing the objectives detailed in the engagement letter, scope of review, audit committee approval, coordination with internal auditors and senior management, testing and the reporting the results to senior management, corrective action, and reporting to the audit committee and the board of directors. Examiners should also consider the number and type of outsourced audits when assessing the adequacy of resources and expertise of the internal audit function.

When evaluating the adequacy of the internal audit function, examiners should consider reviewing the internal auditor's procedures against actual practices. The examiners should be alert to potential weaknesses or deficiencies that relate to audit independence, risk assessment, development of the audit universe and annual plan, audit programs, testing methodologies, workpaper documentation, evaluation of findings, supervision of the work performed, audit reports, communication to FHLBank management and the board of directors.

### **Risks Associated with the External and Internal Audit Programs**

#### ***1) Lack of Sound Corporate Governance (Board of Directors, Audit Committee, and Senior Management Oversight)***

- a) The internal audit program is not an integral part of the organization and does not have the full support of or appropriate oversight by the board of directors, the audit committee and senior management. Internal Audit's role is unclear and not considered in overall governance, risk management, new product, service and systems deployment, changes in strategic plans, and organizational and structural changes.

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- b) The audit committee does not provide sufficient oversight of the external auditor's independence as indemnification clauses are included in the firm's engagement letter.
- c) The audit committee is not effective in its oversight of the audit program. Reports and information submitted to the committee are insufficient or not fully understood. The committee fails to follow-up on control and risk weaknesses that were reported by the internal and external auditors or hold senior management accountable.
- d) The audit committee has a passive role in audit planning or selection and/or oversight of the external audit engagement, and is not involved in determining the respective roles of the internal and external auditors. Engagement letters describing the work to be performed by the external auditors are incomplete or not understood by the board of directors.
- e) Inappropriate influence by senior management on the internal/external audit process which compromises the internal/external auditor's independence and objectivity.
- f) The management of the internal audit function is weak, evidenced by lack of competence or independence, or inadequate scope of review, and this risk is not mitigated by strong internal controls. Audit policies and procedures exist, but are inadequate in light of FHLBank's size, complexity, and risk profile.

Audit programs, processes, reports and information systems are ineffective in addressing significant control or risk issues. Outsourced or co-sourced internal audit duties or assignments are ineffective and have not been appropriately managed. Internal audit does not have the experience/knowledge to understand and review the outsourced audit's report findings.

- g) Internal audit ratings or assessment definitions inadequately defined or non-existent. Audit reports are unclear and do not accurately reflect the ratings and assessments based on the work performed. Significant rating and assessment differences exist with the identified findings. Internal audit programs and workpapers do not adequately support the work performed, findings and conclusions, and the final audit report.
- h) Internal audit staff is inexperienced or lacks the technical expertise to complete the audit assignments. Audit assignments are not properly supervised. Staff training is inadequate, and significant turnover has impacted the completion of the annual audit plan.
- i) Poor reputation in the marketplace due to material losses or fraudulent transactions impacting FHLBank's financial condition, which were the result of

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significant exposures and control weaknesses not being properly identified, reported and corrected.

- j) Internal audit's work plan does not routinely cover significant risks or programs in the Bank or has not looked at certain areas of Bank operations or risks in number of audit cycles.

### **Examination Guidance**

A work program for External and Internal Audit accompanies this narrative. What follows below are illustrative examples of attributes that should be considered by the examiner in completing the analyses required in that work program. In determining the extent of review and testing to be conducted in completing each analysis called for in the work program, the examiner should take into account his or her assessment of the quality and effectiveness of the external and internal audit programs relating to the identification and evaluation of the significant risks facing the FHLBank.

#### ***1) External auditor's communications to senior management and the audit committee***

Evaluate the effectiveness of external auditor's engagement letters, formal reports, and management letters that have been communicated to senior management in identifying and addressing significant risks to the FHLBank. Assess communications with the audit committee for their effectiveness in focusing the audit program on areas of high risk and the extent and effectiveness of coordination between external and internal audit activities. Specific attributes to consider are as follows:

- a) Indemnification clauses which limit or release the external auditor from liability for negligent acts are excluded from the engagement letter;
- b) Annual report that discloses the external auditor's opinion on the presentation of the financial statements, and when applicable the external auditor's report on management's assertions over financial reporting;
- c) Management letters that address other matters or issues to senior management;
- d) Report to the audit committee which includes, but is not limited to, the following:
  - (1) Responsibility of the independent external auditors, and communications to the audit committee;
  - (2) Scope and results of the annual audit, internal audit reliance and management cooperation;
  - (3) Report on compliance with certain laws and regulations and on internal controls over financial reporting as well as significant accounting, auditing and reporting matters;
  - (4) Emerging accounting and reporting issues, regulatory matters, and other services rendered; and
  - (5) Independence.

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- e) Summary of required communications to the audit committee that addresses the following subjects:
- (1) Significant accounting policies, including the external auditor's judgment of the quality of the accounting policies and the consistency of the application of those policies and alternative accounting treatments with Generally Accepted Accounting Principles (GAAP);
  - (2) Management judgments and accounting estimates, audit adjustments, potential effects on the financial statements of any significant risks and exposures;
  - (3) Fraud and other illegal acts and deficiencies in internal control;
  - (4) External auditor's responsibility under Generally Accepted Auditing Standards and independence;
  - (5) Material uncertainties related to events and conditions, including going concern issues;
  - (6) Other information in documents containing audited financial information;
  - (7) Disagreements with management and difficulties encountered in performing the audit;
  - (8) Consultations with other accountants;
  - (9) Major issues discussed with management prior to retention; and
  - (10) Responsibilities of the audit committee.

### **2) *Significant changes***

Identify significant changes that have been implemented or are under consideration relating to the external audit and internal audit programs. Examples of significant changes could include staffing resources, outsourcing specific projects, automating the audit process, postponing planned audits projects, revising the audit universe and risk-based methodology.

### **3) *Purpose, authority and scope of responsibility of internal audit department activities***

Evaluate the independence, scope of responsibility and objectivity of internal audit department activities and their adequacy in light of identified risks to the FHLBank. Specific attributes include, but are not limited to, the following:

- a) The purpose, authority, responsibility of internal audit has been formally defined in a charter that has been approved by the audit committee;
- b) The charter establishes the internal audit department's position within the FHLBank, authorizes unrestricted access to records, personnel, and physical properties relevant to the performance of audits, defines the scope of internal audit activities, addresses consulting activities and is periodically reviewed by the audit committee;

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- c) The internal auditor reports directly to the audit committee on substantive matters and is ultimately accountable to the audit committee and the board of directors; and
- d) A code of ethics has been adopted that adequately addresses the principles and rules of conduct that are relevant to the profession and practice of internal auditing.

### **4) *Internal auditors' professional proficiency***

Assess the internal auditors' professional proficiency that pertains to knowledge, skills and other competencies needed to perform their duties and responsibilities and their effectiveness in carrying out those responsibilities. Specific examples to consider include the following:

- a) Current backgrounds such as education, experience, training and professional certifications of the audit staff;
- b) Knowledge of key information technology risks and controls and available technology-based audit techniques to perform their assigned work, which may be short of the level of expertise expected of an internal auditor whose primary responsibility is information technology auditing. This knowledge should include sufficient expertise to review the work of an IT contractor or outsourced audit; and
- c) On-going training programs to address the continuing professional development of the audit staff.

### **5) *Management of internal audit department activities***

Evaluate the internal audit director's methodology for managing the audit department and whether internal audit contributes materially to the improvement of the organization's risk management, control and governance. These activities include, but are not limited to, the following:

- a) An audit universe and annual audit plan that are based on a risk assessment, include input of senior management and the board of directors, and consider consulting assignments;
- b) Internal audit resources that are appropriate, sufficient and effectively deployed to achieve the audit plan;
- c) Policies and procedures to that are an adequate guide the audit staff and the development of the audit staff;
- d) The work of the internal audit function is adequately coordinated with that of the external auditors and outside consultants to ensure proper coverage and minimize duplication of efforts;
- e) Periodic reports are provided to the board of directors and senior management on the internal audit performance relative to the annual audit plan which set out significant risk exposures and control issues, corporate governance issues, and



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- other matters needed or requested by the board of directors and senior management; and
- f) Audit plan covers significant risks of the Bank and these areas are routinely audited.

### **6) *Internal auditors' work***

Assess the adequacy of the internal auditors' work in evaluating the effectiveness of the FHLBank's risk control environment, particularly the identification and management of the principal risks facing the Bank. As part of the assessment, also evaluate preplanning, fieldwork, supervision, reporting, follow-up and consulting services which include, but is not limited to, the following:

- a) A systematic and disciplined approach is used to evaluate the institution's risk management, control and governance processes responsible for:
- (1) Reliability and integrity of financial and operational information;
  - (2) Accomplishment of established goals and objectives;
  - (3) Compliance with policies, laws, regulations and contracts;
  - (4) Safeguarding of assets; and
  - (5) Effectiveness and efficiency of operations.
- b) The audit engagement or consulting service includes the development of a plan that includes the scope, objectives, timing and resource allocations;
- c) Fieldwork includes the identification, analysis, evaluation, and recording of sufficient, reliable, relevant and useful information to support the conclusions and the engagement's objectives;
- d) The engagement is properly supervised to ensure that the objectives are achieved, quality of work is assured and the staff is developed;
- e) The results of the engagement are communicated to appropriate levels of management and include the objectives, scope as well as applicable opinion, conclusions, recommendations and action plans;
- f) A follow-up process has been established to monitor and ensure that management actions have been effectively implemented or that senior management has accepted the risk of inaction; and
- g) Reporting to the board of directors for resolution of matters posing residual risk that is considered unacceptable for the organization.

### **7) *External and internal assessments of quality assurance and improvement programs for internal audit department activities***

Evaluate the development, maintenance, and effectiveness of external and internal quality assurance and improvement programs for internal audit department activities. Contact the Federal Housing Finance Board's accounting policy group to obtain any applicable information from their external auditor workpaper review regarding the

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assessment of the internal audit function. Additional attributes to review include, but are not limited to, the following:

- a) Internal assessments, including ongoing reviews of the performance of the internal audit or consulting engagement such as the supervision of the engagement, review of workpapers and the final report, and surveys with FHLBank senior management;
- b) External assessments, such as quality assurance reviews;
- c) External auditor's opinion on internal audit reliance that was reported to the audit committee; and
- d) On-going training program to promote the continuing professional development of the audit staff.

### **8) *Audit committee oversight***

Assess the audit committee's qualifications, responsibilities and oversight of the external auditors' and internal auditors' activities. Evaluate their role in focusing the audit program on the most significant risks facing the FHLBank as well as implementation and administration of whistleblower policies and procedures to comply with SARBOX requirements.

- a) Qualifications of audit committee members;
- b) Formal definition of the purpose, authority and responsibility of the audit committee in a charter, approved by the board of directors, complying with Section 917.7 of the Finance Board Section regulations and re-approved at least every three years;
- c) Performance and compensation of the internal audit director;
- d) Adequacy of information reported to the audit committee which includes, but is not limited to, the following:
  - (1) Minutes of the prior meeting that have presented to and approved by the audit committee;
  - (2) Status of the current audit plan and other audit matters, such as performance, personnel, training and budgets;
  - (3) Prior audit and consulting reports and management's responses;
  - (4) Summaries of significant risk exposures and control issues, corporate governance issues and other matters needed or requested by the board of directors or senior management, such as new regulatory or accounting requirements, employee related issues and contingent litigation;
  - (5) Tracking and reporting the status of previously reported findings;
  - (6) External auditors' and third-party reports, presentations and SAS 70 reviews on key/critical service providers; and
  - (7) Performance of executive sessions.
- e) Periodic reporting by the audit committee chairman to the board of directors; and
- f) Implementation and administration of whistleblower policies and procedures

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complying with SARBOX requirements.

### **9) *Assessment of External-Internal Audit Activities***

Summarize the results of external-internal audit activities examined in a separate memorandum. The memorandum should clearly and specifically describe the basis and analysis for the assessment. The memorandum should discuss the quality and effectiveness of external-internal activities within the context of corporate governance (strong, satisfactory, supervisory concern, unacceptable). A memorandum must be prepared irrespective of whether the examiner's assessment is positive or negative.

### **10) *Items requiring follow-up at the next on-site visitation***

Identify key issues that have been communicated to the audit committee chairman and the internal audit director (written or oral) that require follow-up during the next on-site visitation.