

# Operational Controls

## Introduction

Effective date July 1997

## Section 4000.1

Operational risk arises from the potential that inadequate information systems, operational problems, breaches in internal controls, fraud, or unforeseen catastrophes will result in losses or compromise the financial integrity of the FBO.

The “O” component of ROCA assesses the effectiveness of the branch’s operational controls, including accounting and financial controls. The assessment is based on the expectation that branches should have a system of internal controls consistent with the size and complexity of their operations. This system is complemented by an independent internal audit function that may range from an internal system of self-checks to a system that includes head office audits or external audits. In this regard, internal audit and control procedures should ensure that operations are conducted in accordance with internal guidelines and regulatory policies. In addition, controls should be in place to ensure that all reports and analyses provided to the head office and branch senior management are timely and accurate.

An institution’s internal control structure is critical to the safe and sound functioning of the organization, in general, and to its risk management system, in particular. Establishing and maintaining an effective system of controls is one of management’s more important responsibilities. These controls include the enforcement of official lines of authority, and the appropriate separation of duties in areas such as trading, custodial, and back-office. Appropriately segregating duties is probably the most fundamental and essential element of a sound internal control system. Failure to implement and maintain adequate separation of duties is an unsafe and unsound practice and can lead to serious losses or compromise the financial integrity of the institution. Serious lapses or deficiencies in internal controls may warrant supervisory action, including formal enforcement action. When properly structured, internal controls promote effective operations, produce reliable financial and regulatory reports, safeguard assets, and ensure compliance with laws, regulations, and internal policies and procedures.

Ideally, internal controls are tested by an independent internal auditor who reports directly to the regional or head office. However, smaller institutions, where size and complexity do not

warrant a full scale internal audit function, may rely on regular reviews of essential internal controls conducted by other institution personnel. Personnel performing these reviews should be independent of the function they are assigned to review. Given the importance of appropriate internal controls to banking organizations of all sizes and risk profiles, the results of audits or reviews, whether conducted by an internal auditor or by other personnel, should be adequately documented, as should management’s responses to them. In addition, communication channels should exist that allow negative or sensitive findings to be reported directly to the FBO’s senior management.

Because the audit function is an integral part in the branch’s assessment of its internal control system, examiners must review the control environment at every examination. These reviews assist in the identification of significant risks, and facilitate a comprehensive evaluation of the branch’s internal control structure. These reviews also provide information for determining the procedures to be completed during the examination. In addition, examiners should evaluate the independence and competence of the personnel conducting control assessments and should meet with the internal auditors or other personnel and review internal control risk assessments, work plans, reports, and workpapers.

When examiners detect significant internal control weaknesses, affecting both the “O” component rating as well as the composite rating, special audit procedures may be required. Supervisory policy (SR 96-27) offers guidance for the implementation of special audit procedures intended to reduce the risk of losses due to misconduct or fraud, and to promote prompt correction of situations that can cause an unsafe and unsound banking environment. Significant internal control weaknesses in the operations of one office may be an indication that similar weaknesses exist at other offices of the FBO. To ensure proper supervision, the coordinating Reserve Bank, in consultation with other federal and state regulatory authorities, will determine to what extent the special audit procedures should be applied to the other U.S. operations of the FBO. In some cases, it may be acceptable to have the special audit procedures performed by the internal audit staff of the branch. However, if

the adequacy of the internal audit function is among the reasons why internal controls are considered to be less than satisfactory, the pro-

cedures must be conducted by regional or head office audit staff, or by external auditors as specified in SR 96-27.

This section provides guidelines and criteria for understanding and evaluating the work performed by internal and external auditors and home country regulators. For information on internal loan review, refer to the Credit Risk Management section of this manual.

### INTERNAL AUDITS

An internal audit program, fully adequate to the branch's asset size, complexity of operations, and type of risk exposures is a key factor in evaluating the branch. In instances where the branch is too small to support an internal auditor, alternative means of providing coverage must be substituted. One alternative would be periodic visits by head office or regional headquarters auditors who would perform an internal review or evaluation. Another option would be to outsource the internal audit function to an independent accounting or consulting firm whose scope includes a review of internal controls along with a financial review. No matter who administers the internal audit program, the guiding criteria on which to evaluate its adequacy should be the frequency and scope of the coverage of the branch's high risk areas based on a risk assessment. Its adequacy will have a bearing on the evaluation of the branch's operational controls and compliance components.

Internal auditors are responsible for assessing the soundness and adequacy of a branch's accounting, operating, and administrative controls. The assessment is intended to ensure that these controls promptly and accurately record transactions and properly safeguard assets against loss. Additional responsibilities of internal auditors should include determining the bank's compliance with applicable laws and regulations, evaluating the effectiveness of administrative controls and procedures, and evaluating the efficiency of operations.

Internal auditors perform tests and other procedures as part of their audit program that enable them to reach their conclusions. In many instances, audit programs include internal control questionnaires and audit procedures similar to those found in this manual. Detailed standards have been promulgated by professional associations of internal auditors, such as the Bank Administration Institute (BAI) and the Institute of Internal Auditors (IIA). These stan-

dards were used as a guide in developing the Internal, External, and Regulatory Audit Examination Procedures and Audit Function Questionnaire.

Some of the factors that should be considered by the examiner in reviewing and evaluating the internal audit function are the independence and competence of the internal auditors and the effectiveness of the audit program. In addition, the examiner should review the internal audit reports completed since the last examination and management's responses.

### Independence of Internal Auditors

The ability of the internal audit function to achieve its audit objectives depends, in large part, on the independence maintained by audit personnel. Frequently, the independence of internal auditors can be determined by the reporting lines within the organization and to whom or at what level audit results are reported. In most circumstances, the internal audit function at the branch is under the ultimate direction of the FBO's chief internal auditor and/or executive management or a committee thereof.

The auditor's responsibilities should be addressed in a job description with reporting lines delineated in the personnel policy and audit results documented in audit committee minutes. If possible, examiners should review these documents and the reporting process followed by the auditor in order to subsequently evaluate the tasks performed by the internal audit function. The internal auditor should be given the authority necessary to perform the job, including free access to any records necessary for the proper conduct of the audit. Furthermore, internal auditors generally should not have responsibility for supervising the accounting system, other aspects of the branch's accounting function, or any operational function.

### Competence of Internal Auditors

The responsibilities and qualifications of internal auditors may vary depending on the size and complexity of a branch's operations and on the emphasis placed on the internal audit function by the FBO. In many branches, the internal audit

function is performed by an individual or group of individuals whose sole responsibility is internal auditing. In other branches, particularly small ones, internal audit may be performed by head office or regional auditors.

The qualifications discussed below should not be viewed as minimum requirements but should be considered by the examiner in evaluating the work performed by the internal auditors or audit departments. Examples of the type of qualifications an internal audit department manager should have are:

- Academic credentials comparable to other branch officers, who have major responsibilities within the organization;
- Commitment to a program of continuing education and professional development;
- Audit experience and organizational and technical skills commensurate with the responsibilities assigned;
- Oral and written communication skills; and
- An understanding of the audit objectives and procedures performed by the audit staff.

In considering the competence of the internal audit staff, the examiner should review the educational and experience qualifications required by the FBO for filling positions in the internal audit department, certified proficiency by a professional association, and the ongoing training available for those positions. The examiner should also review and assess the ability of the auditor to check compliance with U.S. laws and regulations.

In a small branch, the internal audit function may be a one-person department hired on a full or part time basis. The internal auditor may plan and perform all procedures personally or may direct staff borrowed from other departments. In either case, the examiner should expect, at a minimum, that the internal auditor possesses qualifications similar to those of an audit department manager as previously discussed.

The final measure of the competence of the internal auditor is the quality of the work performed, the ability to independently communicate the results of that work, and the ability to follow up on deficiencies noted during the audit work. Accordingly, the examiner's conclusions with respect to an auditor's competence should also reflect the adequacy of the audit program and the audit reports.

## Internal Audit Program Adequacy and Effectiveness

The examiner should consider the following factors when assessing the adequacy of the internal audit program:

- Scope and frequency of the work performed;
- Risk-based assessments that tailor scope;
- Parties contributing to the audit program's objectives and scope;
- Documentation of the work performed;
- Conclusions reached and reports issued; and
- Management's response to audit findings.

The scope of the program of internal audit must be sufficient to attain the audit objectives, which should be established by parties independent of branch management. The frequency with which the audit procedures are performed should be based on an evaluation of the risk associated with each area of audit interest. Among the factors that the auditor should consider in assessing risk are the nature of the specific operation of the specific assets, liabilities and off-balance sheet activities under review, the existence of appropriate policies and internal control standards, the effectiveness of operating procedures and internal controls, and the potential materiality of errors or irregularities associated with the specific operation.

To further assess the adequacy and the effectiveness of the internal audit program, it would be ideal to obtain the audit work programs and analyses that clearly indicate the procedures performed, the extent of testing, and the basis for the conclusions reached; however, this information is not always available to the examiner.

Work programs serve as the primary evidence of the audit procedures performed and, as such, they should be written and should cover all areas of a branch's operations. Each program should provide a clear, concise description of the audit work required, and individual audit procedures should be presented in a logical manner. The detailed procedures included in the program will vary depending on, among other factors, the size and complexity of the branch's operations. Typical audit procedures include the:

- Use of surprise examinations, where appropriate;
- Maintenance of control over records selected for audit;

- Evaluation of the branch's policies and procedures and the system of internal control;
- Verification of selected transactions and/or balances by the review of supporting documentation, and/or direct confirmation and appropriate follow-up of exceptions.

The internal auditor should follow the specific procedures included in all work programs to reach audit conclusions that will satisfy the related audit objectives.

## Internal Audit Report Standards

The auditor has a responsibility to report the results of all audit work performed. Some auditors prefer to report only significant exceptions; however, this practice reinforces a negative view of the audit function. The auditor's responsibility to evaluate control systems and ongoing operations carries with it an obligation to report the results of that evaluation. Without a report, management does not have positive assurance that auditing is meeting its commitments. Consequently, management can only assume that adequate coverage is maintained and that the systems of control are functioning adequately, effectively, and efficiently.

Each audit report should contain an opinion on the adequacy, effectiveness, and efficiency of the systems of control and the quality of ongoing operations; the degree of compliance with previously evaluated systems of control, or an explanation of why an opinion cannot be expressed. Each auditor should develop standard language for rendering an opinion. Standardization of language minimizes misunderstanding and promotes recognition of circumstances that require responsive action. When an adverse opinion is expressed, the report shall contain a statement about the exposures that may exist in the absence of corrective action.

Every audit report should identify the area audited and disclose all matters that the auditor believes require responsive action by the recipient. Auditors should clearly distinguish between those matters to which they take exception and those that are reported for other reasons. The degree of detail reported is largely a matter of judgment, influenced greatly by the preferences of management. Sometimes, management prefers to have all audit findings reported, no matter how minor. At other times, management prefers

only a general description of significant findings. Auditors must bear in mind that their ultimate accountability demands that findings of major significance be brought to the attention of senior management at the branch and head office.

The standards do not require the auditor to recommend corrective action. In practice, however, auditors find that management often expects suggestions for corrective action, particularly when the technical aspects of controls are involved. By suggesting corrective action, the auditor demonstrates a positive approach to the organization's problems. In making suggestions, auditors should recognize that their recommendations may not be the only means of achieving the control purpose intended. The focus of concern should be the control purpose and not the particular means selected from a range of acceptable choices.

The timeliness with which audit findings are reported is very important and often critical for effective response. When timeliness is critical, the auditor should communicate findings promptly and not await the preparation and completion of a formal report. Findings should be communicated to the manager whose operation is directly affected and appropriate head office management.

The extent and frequency of audit reports required by head office varies with the organization. At least annually, however, the auditor for the branch should formally report to head office management directly responsible for the branch. Head office is entitled to a report that measures audit performance against plan and provides information normally required to establish accountability. The auditor should use this opportunity to promote an understanding of the audit function and how it serves the organization.

## Internal Audit Review

The Examination Procedures section describes the steps the examiner should follow when conducting a review of the work performed by the internal auditor.

The examiner's review and evaluation of the internal audit function is a key element in determining the scope of the examination. In most situations, the competence and independence of the internal auditors may be reviewed on an overall basis; however, the adequacy and

effectiveness of the audit program should be determined separately for each examination area.

The examiner should assess if the work performed by the internal auditor is reliable. It is often more efficient for the examiner to determine the independence and/or competence of the internal auditor before addressing the adequacy and/or effectiveness of the audit program. If the examiner concludes that the internal auditor possesses neither the independence nor the competence deemed appropriate, the examiner must also conclude that the internal audit work performed is not reliable. Accordingly, a review of such work may not be necessary.

The frequency of internal audit procedures should be based on an evaluation of the risk associated with each area of interest. There may be situations in which the associated risk is considered minimal due to the materiality of the amounts involved, the internal control procedures followed, the bank's history in a particular area, or other factors.

The examiner should indicate in the report of examination any significant deficiencies concerning the internal audit function. Furthermore, the examiner should review with management any significant deficiencies noted in the previous report of examination to determine if these concerns have been appropriately addressed.

## EXTERNAL AUDITS

The objective of an external financial audit is different from the objectives of an internal audit or a branch examination. The examiner is interested in the work performed by external auditors for three principal reasons. First, situations will arise where internal audit work is not being performed or where such work is deemed to be of limited or no value to the examiner. Second, the work performed by external auditors may affect the amount of testing the examiner must perform. Third, audits and other reports rendered by external auditors often provide the examiner with information pertinent to the examination of the branch. The major factors that should be considered in evaluating the work of external auditors are similar to those applicable to internal auditors, namely, the competence and independence of the auditors and the adequacy of the audit program.

Many U.S. branches and agencies of FBOs are required by state law or the head office to have certain audit procedures performed periodically.

For insured depository institutions, FDICIA, through its amendments to the FDIC Act, requires annual independent audits for all FDIC-insured banks and insured branches that have total assets in excess of \$500 million.

Independent audits enhance the probability that financial statements and reports to regulatory authorities and other financial statement users will be accurate and help detect conditions that could adversely affect banking organizations or the public. The independent audit process may also subject the internal controls and the accounting policies, procedures, and records of each banking organization to periodic review.

External auditors frequently conduct financial audits and certain other procedures and services. In the case of financial audits, these must be conducted by Certified Public Accountants (CPAs) in conformance with applicable professional standards. Occasionally, however, nonfinancial reviews may be performed by individuals who are not CPAs but who are familiar with the service or operational requirements in question. In other instances, head office may consider the internal audit program sufficient to satisfy the requirement. Head office should participate in the audits, at least to the extent of appraising the FBOs' policies and the procedures used to attain policy objectives, including the review of any applicable regulatory report of examination with the auditors.

External auditors and consultants are often engaged to conduct in-depth reviews of the operations of specific departments, such as commercial loans or data processing. Such reviews might focus on operations procedures, personnel requirements, or other specific areas of interest. Upon completion of such reviews, the auditors may recommend that the branch, among other things, strengthen controls and/or increase efficiency. External auditors and other specialists may be employed to assist management in specialized fields, such as taxation and management information systems.

## External Audit Opinions

The external auditor generates various types of opinions and other documents, which typically include:

- The standard unqualified opinion, generally a one-page document.

- A management letter in which the auditor confidentially presents detailed findings and recommendations to management.
- Reports from the auditor to regulators during the audit period.

The major types of standard audit opinions are not explicitly identified by the auditor. These opinions will generally not have a heading or other statement in the report that identifies its type. Terminology used in the report suggests the type of opinion issued. The major types of standard audit opinions and brief examples of corresponding text are as follows:

- *The unqualified opinion*—sometimes referred to as a “clean opinion.” This type states that the financial statements are “presented fairly” in conformity with GAAP and that the necessary audit work was done. This report is often referred to as the standard audit report and may include additional explanatory language regarding particular issues.
- *The qualified opinion*—indicates that financial statements are presented fairly in all material respects “except for” the effects of a particular matter. Such matters may include the lack of sufficient evidential matter, restrictions on the scope of audit work, or minimal departures from GAAP in preparing the financial statements. This type of report is not necessarily negative but indicates that the examiner should ask additional questions of management.
- A *disclaimer*—expresses no opinion on the financial statements. CPAs may issue a disclaimer when they have concluded that substantial doubt surrounds the means used to compile financial statements but that no conclusive evidence pinpointing the type of nonconformance to GAAP could be identified. This disclaimer is intended to indicate that the CPA is not assuming any responsibility for these statements.
- An *adverse opinion*—concludes that the financial statements are not presented fairly or are in “significant nonconformance with U.S. GAAP.” Disclaimers may also be issued when auditors have concluded that the scope of their review has been significantly restricted.

## Engagement Letters

A branch should require that external auditors submit engagement letters to the branch or its

head office before commencing their work. Such letters include, among other things, the scope of the audit, the period of time to be covered by the audit, and the reports expected to be rendered. In many cases, the highlights of these matters will be summarized in the body of the letter with greater detail being provided in schedules or appendices to the letter. Procedures may be specific by audit area. That is, the auditor may provide a capsulized description of procedures with regard to cash and due from banks, loans, deposits, etc. In addition, if there are any limitations on the scope of the audit, the letter may specify any auditing procedures that are to be omitted, such as confirmation of loans or deposits, if the auditor is expected to render an opinion on the branch’s financial statements.

## Review of the External Audit by the Examiner

The examination procedures section describes the steps to be followed by the examiner in conducting a review of the CPAs and the work they perform.

U.S. regulatory agencies have generally concluded that, in view of their objectives regarding the reliance to be placed on work performed by CPAs and in view of the professional and ethical standards of the public accounting professions, only in unusual situations should the examiner conduct an in-depth review of the competence and independence of the CPA or of the adequacy of the CPA’s audit. One situation that the examiner should investigate would be a recent change in CPAs by the FBO, particularly if the change was made after an audit was commenced.

It ordinarily will not be necessary to make specific tests to determine independence. However, there may be occasions when the examiner may have sufficient reasons to question the independence of a CPA or the quality of his or her work. For example, the examiner may become aware that, during the period of a CPA’s professional engagement, which includes the period covered by the financial statements on which the CPA has expressed an opinion, the CPA or a member of his or her firm—

- Had a direct financial interest in the FBO;
- Was connected with the FBO in a capacity equivalent to that of a member of management or was a director of the FBO;

- Maintained, completely or in part, the books and records of the FBO and did not perform audit tests with respect to such books and records; or
- Had a loan from the FBO (as discussed earlier).

In these and similar instances, the CPA would not have complied with professional standards.

The examiner should determine the scope of the CPA's audit or examination by reviewing the most recent report and management letter, if any, issued by the CPA. If the audit is in progress or will begin in the near future, the examiner should also review any engagement letter to the branch from the CPA. If available, the examiner also should obtain and review any adjusting journal entries suggested by the CPA at the conclusion of the examination. This procedure should be done to determine whether such entries were the result of breakdowns in the internal control structure and procedures for financial reporting.

Under certain circumstances, a CPA may issue a qualified or adverse opinion or may disclaim an opinion on a branch's financial statements. In such circumstances, the examiner should first determine the reasons for the particular type of opinion issued. If the matters involved affect specific areas of the branch's operations, a review of this work performed by the CPA may help the examiner understand the problem that gave rise to this opinion.

## Communication Between External Auditors and Examiners

On July 23, 1992, the Federal Reserve and the other federal bank and thrift regulatory agencies (FDIC, OCC, and OTS) issued an interagency policy statement on coordination and communication between external auditors and examiners. The policy statement provides guidelines regarding information that should be provided by federally-insured depository institutions to their external auditors and meetings between external auditors and examiners in connection with safety and soundness examinations. While the policy statement focuses on insured depository institutions and their external auditors, bank holding companies and U.S. branches of foreign banks that are examined by the Federal Reserve are encouraged to provide similar information to

their external auditors and to make similar arrangements regarding auditor attendance at meetings with examiners.

Generally Accepted Auditing Standards (GAAS) require that the external auditor can consider regulatory authorities as a source of competent evidential matter when conducting an audit of the financial statements of a banking organization. Accordingly, the external auditor may review communications from and make inquiries of the regulatory authorities.

Generally, the U.S. regulatory agencies encourage auditors to attend examination exit conferences upon completion of the examiner's field work or other meetings concerning examination findings between supervisory examiners and a branch's management. Branches should ensure that their external auditors are informed in a timely manner of scheduled exit conferences and other relevant meetings with examiners and of the FRB's policies regarding auditor attendance at such meetings.

When other conferences between examiners and management are scheduled (those that do not involve examination findings that are relevant to the scope of the external auditor's work), the branch should first obtain the approval of the appropriate regulatory agency for the auditor to attend the meetings. The Interagency Policy Statement of July 23, 1992, does not preclude regulators from holding meetings with management without auditor attendance or from requiring that the auditor attend only certain portions of the meetings.

The interagency policy statement was issued to improve coordination and communication between external auditors and examiners. Examination personnel should provide branches with advance notice of the start date of the examination, when appropriate, so management can inform external auditors in advance and facilitate the planning and scheduling of their audit work.

## Meetings and Discussions Between External Auditors and Examiners

An external auditor may request a meeting with regulatory authorities involved in the supervision of the branch, during or after completion of examinations, to inquire about supervisory matters relevant to the branch under audit. External auditors should provide an agenda in advance.

The regulatory authorities will generally request that management of the branch under audit be represented at the meeting. In this regard, examiners generally will only discuss with an auditor those examination findings that have been presented to bank management.

In certain cases, external auditors may wish to discuss with examiners matters relevant to the FBO, without bank management representation. External auditors may request such confidential meetings with the regulatory authorities and vice versa.

### Information Required to be Made Available to External Auditors

Section 112 of FDICIA pertains to depository institutions insured by the FDIC that have engaged the services of an external auditor to audit the banking organization within the past two years. It requires insured branches to provide the auditor with copies of the most recent Report of Assets and Liabilities (call report) and report of examination and pertinent correspondence or reports received from a U.S. regulatory agency. This information is to be provided to the external auditor by the insured branch under audit, not by a regulatory agency.

In addition, insured branches must provide the independent auditor with:

- A copy of any supervisory memorandum of understanding or written agreement between a federal or state banking agency and the FBO or branch put into effect during the period covered by the audit.
- A report of any formal action initiated or taken by a federal or state banking agency during such period or any civil money penalty assessed with respect to the FBO or branch or any institution-affiliated party.

Regulatory personnel should ascertain if the banking organization is in compliance with the requirements of section 112 of FDICIA (12 USC 1831m(h)) and report instances of noncompliance in the Compliance section of the report of examination.

### CONFIDENTIALITY OF SUPERVISORY INFORMATION

While the policies of regulatory authorities gen-

erally require that external auditors be given access to the information described above, institutions and their auditors are reminded that information contained in examination reports and supervisory discussions—including any summaries or quotations—is confidential supervisory information and must not be disclosed to any party without the written permission of the issuing agency. Unauthorized disclosure of confidential supervisory information may lead to civil or criminal actions, fines, and other penalties.

### AUDIT PROGRAM OVERSIGHT

Because auditors' reporting lines may significantly affect the overall objectivity and thoroughness of the audit findings and conclusions, an analysis of their structure should be factored into the evaluation of the audit program's effectiveness. When internal and external auditors report solely to senior management of the branch, rather than head office management, their independence may be compromised. As a result, they will not, in all likelihood, maintain the same objectivity in evaluating the branch's operations. Auditors should certainly report relevant audit findings to branch management; however, organizational and official audit reporting lines should ensure auditors' independence and objectivity.

The independence of internal and external auditors is increased when they report to a separate audit officer, department, or committee not otherwise involved in the affairs of the branch. The auditors' independence is enhanced when some type of objective third party takes an active role in approving the internal and external audit scope and plan.

This independent party's duties may include overseeing the internal audit function, such as approving salary, hiring, and firing decisions relating to senior staff level positions; approving or recommending the appointment of external auditors and the scope of external audits and other services; providing the opportunity for auditors to meet and discuss findings apart from branch management; reviewing with management and external auditors the year-end financial statements; and meeting with regulatory authorities.

## MANAGEMENT'S RESPONSE TO THE AUDITS

Head office management should require that branch management respond formally to audit findings and take appropriate corrective action. The audit process is not complete until the auditor is satisfied that audit findings have received appropriate attention. By requiring management to respond formally to audit findings, head office contributes to the effectiveness of the audit function and increases the likelihood that the findings will receive appropriate attention. Auditors should not be accountable for implementation of corrective action, which is the responsibility of branch and head office management. However, the audit program's structure should include means of (1) securing management's plans to address audit comments and (2) verifying these plan's effectiveness in correcting identified problems.

It is imperative that management respond to all internal and external audits and regulatory examinations. Management responses should be timely and address all findings in the reports, unless specifically noted in the audit report that a response is not necessary. Responses should include concrete solutions that have already been put in place or that will be implemented in a timely manner. Repeat problems noted in the audit report are to be given the highest priority.

Head office and branch senior management should receive copies of management's responses, along with copies of the audit reports. The audit staff and head office should follow-up on the responses given by management to ensure that all matters are properly and effectively resolved in a timely manner. The examiners must also follow up on management's responses to ensure that responses are fully implemented.

## REGULATORY EXAMINATIONS

Home country regulators may examine their respective banks in the United States periodically. If these examinations occur, the examiner should find out the scope and frequency of the examinations and obtain a copy of any report, if available. If a copy of this regulatory report is available, the examiner should determine if there are any significant deficiencies or matters that have a bearing on the FBO's operations in the United States. As a matter of courtesy, the home country regulators should contact the U.S. bank supervisors before any on-site examinations and agree to meet with them before and after the conclusion of their examinations to share the scope and results of such visitations.

# Internal and External Audits

## Examination Objectives

Effective date July 1997

## Section 4010.2

---

1. To determine whether internal and external audit or regulatory examination functions exist and are consistent with the institution's size, complexity of operations, level of growth, and nature of weaknesses.
2. To evaluate the independence and competence of those who carry out the internal and external audit function.
3. To determine the adequacy of the procedures performed by the internal and external auditors.
4. To determine the adequacy of the frequency and scope of the audit program, which should include testing for compliance with applicable U.S. statutory and regulatory requirements.
5. To determine based upon the above criteria whether the work performed by internal and/or external auditors is reliable.
6. To recommend corrective action when policies, practices, procedures, or internal controls are deficient or when violations of laws or regulations have been noted.

# Internal and External Audits

## Examination Procedures

Effective date July 1997

## Section 4010.3

Some of these procedures will not be applicable to every branch, particularly at branches that do not have internal auditors on site.

Before reviewing any specific audit procedures, the examiner should first determine the independence and competence of the internal auditors. If the examiner believes the auditors are both independent and competent, he or she should then determine the acceptability of their work. Based on the answers to the audit function questions and on the auditors' work, the examiner must then determine the scope of the examination. At a minimum, the examiner should review the scope and frequency of the audit program and the results of the most recent audit.

The program and related supporting documentation should be completed in an organized manner and should be retained as part of the examination workpapers.

Upon completion of the program, the examiner should be able to formulate a conclusion on the adequacy of audit coverage. Conclusions involving weaknesses in the internal audit work being performed at the branch should be summarized for the report of examination. Significant recommendations should be discussed with branch management and noted in the questionnaire and in the report of examination. If recommendations are made verbally, a memorandum of the discussion with management should be prepared and included in the workpapers.

1. Determine whether the branch utilizes a system of self checks in lieu of a formal audit program. If so, determine the adequacy of this system and assess whether proper procedures are in place to ensure its independence from those responsible for implementing the system.
2. *Independence of the Audit Function*—Assess the independence of the internal auditor by reviewing the reporting lines within the organization and to whom or at what level audit results are reported. Interview the internal audit department manager and observe the operation of the audit department to determine its functional responsibilities and reporting lines. Interviews during the examination may not be practical if auditors are based in the home country or at another U.S.

branch. If auditors are based at the head office, the examining agency may wish to arrange a meeting with the auditors when they visit the United States.

3. *Auditors' and Audit Staff Qualifications*—Review the biographical data of and interview the internal audit department manager, to determine his or her ability to manage the internal audit department. Review the biographical data of the audit department staff to determine their qualifications for their delegated responsibilities.
4. *Content and Utilization of the Audit Scope and Frequency Schedule*—Review the audit schedule and ascertain that all high risk areas have adequate and timely coverage. Obtain input from members of the examination team who are reviewing individual areas to determine additional high risk areas. Determine whether the audit department's program is annually reviewed and approved by head office.
5. *Documentation of the work performed*—Review the audit work programs to ascertain that the work programs satisfy the audit objectives and indicate the procedures performed, the extent of testing, and the basis for the conclusions reached.
6. *Audit Department's Formal Reporting Procedures*—
  - a. Review the audit reports issued since the previous examination for:
    - the auditor's opinion on the adequacy, effectiveness, and efficiency of the systems of control and quality of ongoing operations;
    - the timeliness with which the findings were reported;
    - the identification of the areas audited; and
    - the disclosure of all matters that require attention.
  - b. Ascertain that the distribution of the audit report followed the required reporting lines.
  - c. Ascertain that a written response to the report was provided by the recipient in a timely manner and that it addressed the matters requiring attention.
  - d. Review the audit department's follow-up procedures for adequacy.

7. If CPAs and/or consulting firms have been engaged by the FBO for statement certification, branch reviews, or appraisal of the audit function, review the most recent reports and/or management letters to become aware of any important accounting or control problems.
8. If possible, review the most recent home country regulatory examination report.

# Internal and External Audits

## Audit Function Questionnaire

Effective date July 1997

Section 4010.4

Review the documentation, as instructed in the examination procedures, in order to answer the following audit function questions. Where appropriate, supporting documentation and pertinent information should be retained or noted under comments.

### ORGANIZATIONAL STRUCTURE OF THE AUDIT DEPARTMENT

1. Has the head office delegated responsibility for the audit function? If so, to whom?
2. Does the auditor report independently to the head office or a party with objective oversight of the audit function? Describe.
3. If not, to whom does the auditor directly report? Do these reporting lines jeopardize the independence of the audit function?
4. Are those in charge of the audit function qualified for their particular responsibilities?
5. Do individuals charged with audit oversight meet with and review reports issued by the auditor independent of branch personnel? If so, how often?
6. Do the minutes of any meetings of audit oversight groups indicate an appropriate interest in auditors' activities and findings?

### INDEPENDENCE OF THE AUDIT FUNCTION

7. Is the audit department functionally segregated from operations in the organizational structure?
8. Are the budget, performance, salary, and other benefits of the auditor established, reviewed, and/or approved independent of the branch? If not, describe.
9. Are the reporting procedures of the auditor independent of the influence of any personnel whose duties or responsibilities are covered in the audit's scope?
10. Do the responsibilities of the audit staff include any duties or back-up duties that compromise dual controls, e.g., preparation or approval of general ledger entries, official checks, daily reconcilements, etc.?

### AUDITOR'S QUALIFICATIONS

11. Are the auditor's academic credentials comparable to other branch officers having major responsibilities within the organization?
12. Is he/she certified (or in the process of becoming certified) as a Chartered Bank Auditor, Certified Internal Auditor, or Certified Public Accountant (CPA)? Does the auditor hold any other type of foreign country professional designation? If yes, which one(s)?
13. Does he/she communicate and relate well with all levels of personnel?
14. Does the auditor demonstrate a commitment to continuing education and a current knowledge of the latest developments in banking and auditing technology?

### AUDIT STAFF QUALIFICATIONS

The following questions need to be addressed if there is an audit staff on site at the branch:

15. Is the audit staff sufficient in number to perform its tasks in a timely and complete manner?
16. Is the staff adequately experienced in auditing and banking? What are the educational backgrounds of the staff?
17. Are members of the staff experienced in any specialized activities conducted by the branch, e.g., EDP, foreign exchange trading, trust, etc.?
18. Is there a formal audit training program in effect?
19. If needed, does management have plans to improve its audit capability?

### CONTENT AND UTILIZATION OF THE AUDIT FREQUENCY AND SCOPE SCHEDULE

20. Does the auditor perform a risk assessment? If not, how are the scope and frequency of audits determined? Is the resulting audit program formalized and on record as a commitment that can be analyzed and reviewed?

21. Are all important branch functions and services included in the audit scope?
22. Does the audit program include procedures necessary to reasonably ensure compliance with applicable U.S. laws and regulations, including the Bank Secrecy Act?
23. Does the internal audit department have access to all reports, records, and minutes?
24. Is the program periodically reviewed, where necessary, to adapt it to changing conditions?
25. Does the frequency and scope schedule require approval by a party with objective audit oversight? If so, by whom and has such approval been obtained?
26. Does the auditor periodically report his/her progress in completing the frequency and scope schedule to a party with objective audit oversight?
27. Do audit procedures ensure that items on the audit scope are looked at with sufficient detail to ensure adequate review?
28. Are controls on opening and closing general ledger and subsidiary accounts adequate and is the auditor formally advised of any changes?
29. If the branch has automated systems, does the program call for the application of independently prepared computer programs that employ the computer as an audit tool for surveillance and/or possible off-site testing?
30. Are all service-related activities not specifically manifested in general ledgers accounts subject to adequate periodic review, e.g., supervisory regulations, security, vacation policy, purchases, travelers checks, and safekeeping?
32. Is the auditor a member of an executive systems planning or steering committee? If not, does the auditor have access to and review the minutes of such committees?
33. Does an audit representative review the activities of systems design teams for audit and internal control requirements? Is the specialized training and experience of the audit staff sufficient to support effective reviews?
34. Does the audit department avoid over-participation in systems design, modification, and conversion?
35. Is the auditor's "sign-off" on new or modified systems restricted to control and audit trail features?

#### AUDIT DEPARTMENT'S FORMAL REPORTING PROCEDURES

36. Does the auditor submit formal reports? If so, to whom?
37. Do the reports convey to the reader the auditor's general observation of the condition of the operation of the department or function?
  - a. Do they adequately reflect the scope of the audit?
  - b. Do they contain an opinion of the auditor regarding the adequacy, effectiveness, and efficiency of internal controls?
  - c. Do they call for a prompt response, where appropriate?
38. Are exceptions and recommendations resolved and implemented on a timely basis?
39. Are audit reports submitted promptly?
40. Does branch management respond to all internal and external audits?
  - a. Are management's responses completed promptly? Are they written?
  - b. Does the head office or branch senior management receive copies of management's responses?

#### AUDIT DEPARTMENT PARTICIPATION IN REVIEWING SYSTEMS DESIGN PROJECTS AND MAJOR OPERATIONAL PROCEDURE CHANGES OR MODIFICATIONS

The following questions will be addressed by IS examiners:

31. Is there a formal or informal procedure for notifying the auditor of contemplated new systems or systems modifications in the early planning stages?

### EXTENT TO WHICH AUDIT COMPUTER PROGRAMS ARE USED AND THEIR EFFECTIVENESS

The following questions are to be addressed if audit computer programs are used:

41. What audit computer programs are used and what are their purposes?
42. Is any member of the audit staff qualified to write and/or appraise the quality of audit computer programs?
43. Is the auditor satisfied that he/she has sufficient "free access" to the computer files?
44. Are audit programs run on the auditor's request?
  - a. If operators run audit programs, are they supervised by the auditor?
  - b. If not, how are they controlled?
45. Do direct verification programs allow the auditor flexibility in selecting the criteria to be used in determining the sample?
46. Have procedures been established for the development and maintenance of documentation for audit computer programs? Are they adhered to?
47. Are changes to audit programs controlled?

### EXTERNAL AUDIT ACTIVITIES

The following questions are to be addressed if an external audit has been performed:

48. Where state or federal regulations or stock exchange listing require an independent CPA audit, did the branch comply?
  - a. Was an opinion rendered by the accounting firm and if so, was it unqualified?
  - b. If the opinion was qualified, has the auditor taken appropriate action in the resolution of any deficiencies?
49. Does the FBO's policy prohibit loans to its external auditor or the engagement of an external auditor who is a shareholder? If not, has head office considered the materiality of any existing transactions regarding the auditor's independence?

50. Has an external auditor been engaged to perform special reviews of specific departments or areas of the branch since the previous examination? If deficiencies were cited, have they been corrected?
51. Has the same public accounting firm been engaged for the prior two years? If not, obtain a reason for change.
52. Have management letters from the external auditors or other reports from consultants been presented to management since the last examination?
53. Do deficiencies in management letters receive appropriate attention?
54. Are the notes pertaining to the financial statements reviewed for any information that may allude to significant accounting or control problems?
55. Does the report of examination and/or the management letter submitted by the public accounting firm comprehensively define the scope of the examination conducted?
56. Do the external auditors receive a copy of the most recent statutory and/or regulatory examination report(s) and reports of assets and liabilities, as may be required or appropriate? Do they receive copies of pertinent correspondence, including supervisory letters and management's responses, if any, between the branch and the examining authority?

### HOME COUNTRY REGULATORY EXAMINATION ACTIVITIES

57. Do home country regulators periodically examine the branch in the United States? If so, do they produce a report? If yes, then the following questions will be addressed.
58. Does the branch's internal auditor have access to examination reports produced by the home country regulators?
59. Does the branch investigate the reasons for adverse comments and recommendations in the examination reports?

# Internal and External Audits

## Audit Guidelines

Effective date July 1997

## Section 4010.5

### AUDIT MANUAL

1. Has responsibility for the establishment and maintenance of the audit manual been clearly assigned?
2. Does the audit manual require approval by the head office, the audit committee, or others? If so, has such approval been obtained?
3. Is the content of the audit manual independent of adverse influence of other interests, such as operating management or independent CPAs?
4. Is the audit manual current and are procedures for keeping the manual current adequate?
5. Does the audit manual contain the scope and objective of each audit?
6. Does it require that valid deviations from audit procedures be officially approved by audit management?
7. Do audit procedures provide for the follow-up of exceptions noted in previous audits?
8. Does it prescribe that each audit procedure be cross-referenced to the appropriate audit workpapers?
9. Must an auditor initial each program step as testimony of his/her performance?
10. Does it prescribe that full control be established at the time of entry over the records selected for audit?
11. Is proof of control records required?
12. Are direct verification programs covering all forms of customer deposit, loan, safe-keeping, collateral, collection, and trust accounts included?
13. Are flow charts called for as evidence of thorough analytical auditing?
14. Do the procedures employ scientific sampling techniques with acceptable reliability and precision?
15. Does the audit manual provide for the resolution of exceptions and deficiencies?
16. Does the audit manual contain provisions for report format and content and an expression of the opinion of the auditor regarding the adequacy, effectiveness, and efficiency of internal controls?
17. For each audit, do audit procedures provide a documented method of assuring audit management that a proper study and evalu-

ation of existing internal controls has been made, such as through the use of an internal control questionnaire or memorandum?

18. Does the audit manual include a provision for a review and update of the procedures for each audit, where required, upon its completion?
19. Does the audit manual make provision for the maintenance of a permanent file for audits conducted?
20. Does the audit manual contain provisions for the formal, standardized preparation and maintenance of workpapers?
21. Are applicable statutory and regulatory requirements included in the audit procedures?

### MAINTENANCE OF AUDIT RECORDS

22. Are workpapers arranged and maintained in two groups for filing and reference in:
  - a. The current file?
  - b. The permanent file?
23. Is a reasonable retention schedule and departmental index maintained for audit records?
24. Are audit procedures complied with during each audit?
25. Do the workpapers contain evidence of all significant deviations from audit procedures with the approval of audit management?
26. Are procedures for preparing and maintaining workpapers adhered to?
27. Do workpapers contain a copy of the audit report, an adequate index, an internal control questionnaire, audit procedures, and other appropriate material?
28. Are workpapers numbered, indexed, and cross referenced to audit procedures and the workpaper index?
29. Is each workpaper dated and initialed by the preparer? Are sources of data clearly shown? Are tick marks explained?
30. From the workpapers, can it be determined how various sample sizes were determined, judgment or scientific, including range and confidence level?

31. Do workpapers show that supervisory personnel of the audit department have reviewed the workpapers and resultant findings?
32. Are all significant and/or unresolved exceptions noted in workpapers required to be included in the report?
33. Is the branch in compliance with applicable statutory and/or regulatory requirements?

U.S. branches of foreign banking organizations are expected to have a fully effective system of internal controls similar to those required of U.S. banks. Although internal controls should provide for an internal audit program (which is separately covered in Section 4010 of this manual), this section applies to the review and evaluation of a branch's existing internal control environment. An examiner should review the internal audit program in conjunction with the review of internal controls in order to fully understand the branch's internal control system. The concept of operational efficiency and the related control procedures are not addressed in this manual because such considerations generally fall outside the responsibilities of an examiner. That, however, is not intended to inhibit or prevent an examiner from commenting on operational inefficiencies, particularly in instances where inefficiencies have a significant impact on the condition or risk standing of a branch.

### INTERNAL CONTROL STRUCTURE

The internal control structure consists of the policies and procedures established to provide reasonable assurance that specific objectives will be achieved. The Statement on Auditing Standards No. 55, "Consideration of the Internal Control Structure in a Financial Statement Audit" (effective January 1, 1990), describes the three elements of an internal control structure. These elements are: the control environment, the accounting system, and control procedures. The elements, as described below, need to be considered in the review and evaluation of a branch's internal control system.<sup>1</sup>

The *control environment* reflects the overall attitude, awareness, and actions of branch and head office management regarding the importance of control and its emphasis. The control environment includes the following:

- Management's philosophy and operating style.

- The branch's organizational structure.
- The functioning of committees
- Methods of assigning authority and responsibility.
- Management's control methods for monitoring and following up on performance, including internal auditing.
- Personnel policies and practices.
- Various external influences that affect a branch's operations and practices, such as examinations by bank regulatory agencies.

The *accounting system* consists of the methods and records established to identify, assemble, analyze, classify, record, and report a branch's transactions and to maintain accountability for the related assets and liabilities. An effective accounting system gives appropriate consideration to establishing methods and records that will:

- Identify and record all valid transactions.
- Describe, on a timely basis, the transactions in sufficient detail to permit proper classification of transactions for financial reporting.
- Measure the value of transactions in a manner that permits recording their proper monetary value in the financial statements.
- Determine the time period in which transactions occurred to permit recording of transactions in the proper accounting period.
- Properly present the transactions and related disclosures in the financial statements.

*Control procedures* are those policies and procedures, in addition to the control environment and accounting system, that management has established to provide reasonable assurance that specific branch objectives will be achieved. Control procedures have various objectives and are applied at various organizational and data processing levels. They may also be integrated into specific components of the control environment and the accounting system. Control procedures should include:

- *Authorization of transactions and activities*—Transactions and activities should be approved by appropriate management.
- *Segregation of duties*—By assigning different people the responsibilities of authorizing transactions, recording transactions, and maintaining custody of assets, the chance of any

1. The description of the three elements of an internal control structure was taken from the "Codification of Statements on Auditing Standards" published by the American Institute of Certified Public Accountants, 1990 (Source: Statement on Auditing Standards No. 55).

person being in a position to both perpetrate and conceal errors or irregularities in the normal course of his/her duties, is reduced.

- *Dual controls*—Requiring two different people to perform one sensitive task, such as opening the vault or signing checks, also reduces the risk of defalcation. When two individuals must act in collusion to conduct fraud or defalcation, it is much less likely to occur.
- *Job descriptions*—In all departments, job descriptions should be well-defined and provide for logical flow of work. If employees have responsibilities for other offices or affiliates of the FBO, particularly those that share facilities with the branch, these responsibilities should be clearly defined and, when appropriate, disclosed or made clear to branch customers and the public in general.
- *Policies*—Policies regarding hiring practices, annual salary reviews, merit increases, performance evaluations, promotions, and vacations should be established and clearly understood. Adequate procedures should be in place to ensure that screening procedures are applied to personnel hired for sensitive positions. Any doubts about an individual's qualifications should be resolved before an employee is hired.
- *Consecutive absence*—Branch policy should require employees in sensitive positions to be absent from their duties for a minimum number of days. Prudent banking practice dictates that employees in sensitive positions be absent for ten consecutive days. In some instances, absence due to a business trip may be acceptable; however, it is necessary for someone else to perform the employee's duties for that period of time. In establishing the policy, branches should follow any applicable laws, regulations, or guidelines of their licensing or insuring authority(ies).
- *Documents and records*—Adequate documents and records should be used to ensure the proper recording of transactions and events, such as monitoring the use of pre-numbered shipping documents.
- *Accessibility safeguards*—Adequate safeguards over access to and use of assets and records, such as computer programs and data files, should be in place.
- *Reconciliations*—Independent checks on performance and proper valuation of recorded amounts, such as clerical checks, reconciliations, comparison of assets with recorded accountability, computer-programmed con-

trols, management review of reports that summarize the detail of account balances, and user review of computer-generated reports should be conducted.

The applicability and importance of specific control environment factors, accounting methods and records, and control procedures that a branch establishes should be considered in the context of:

- The branch's size.
- Its organization characteristics.
- The nature of its business.
- The diversity and complexity of its operations.
- Its methods of processing data.
- Its applicable legal and regulatory requirements.

Establishing and maintaining an internal control structure is an important management responsibility. To provide reasonable assurance that a branch's objectives will be achieved, the internal control structure should be under ongoing supervision by management to determine that it is operating as intended and that it is modified, as appropriate, for changes in conditions.

## INTERNAL CONTROL OBJECTIVES

In general, good internal control exists when no one is in a position to make significant errors or perpetrate significant irregularities without timely detection. Therefore, a system of internal control should include those procedures necessary to ensure timely detection of failure of accountability, and such procedures should be performed by competent persons who have no incompatible duties. The following standards are encompassed within the description of internal control.

*Existence of Procedures*—The existence of prescribed internal control procedures is necessary but not sufficient for effective internal control. Prescribed procedures that are not actually performed do nothing to establish control. Consequently, the examiner must give thoughtful attention not only to the prescribed set of procedures but also to the practices actually followed. This step can be accomplished through

inquiry, observation, testing, or a combination thereof.

*Competent Performance*—For internal control to be effective, the required procedures must be performed by competent persons. Evaluation of competence undoubtedly requires some degree of subjective judgment because attributes, such as intelligence, knowledge, and attitude are relevant. Thus, the examiner should be alert for indications that employees have failed so substantially to perform their duties that a serious question is raised concerning their abilities.

*Independent Performance*—Employees who have access to branch assets should not also (a) have access to the related accounting records, (b) perform related review operations, or (c) immediately supervise the activities of other employees who maintain the records or perform the review operations. Otherwise, such employees may be able both to perpetrate and conceal defalcations. Therefore, duties concerned with the custody of assets are incompatible with recordkeeping duties for those assets, and duties concerned with the performance of activities are incompatible with the authorization or review of those activities. In judging the independence of a person, the examiner must avoid looking at that person as an individual and presuming the way in which he or she would respond in a given situation. For example, an individual may be the sole check signer and an assistant may prepare monthly branch reconciliation. If the assistant appears to be a competent person, it may seem that an independent reconciliation would be performed and anything amiss would be reported. Such judgments are potentially erroneous. No established tests exist by which the psychological and economic independence of an individual in a given situation can be judged. The position must be evaluated, not the person. If the position in which the person acts is not an independent one, in itself, then the work should not be presumed to be independent, regardless of the apparent competence of the person in question. In the example cited above, the function performed by the assistant should be viewed as if it were performed by the supervisor. Hence, incompatible duties are present in that situation.

## EXAMINATION PROCEDURES

An effective way to begin an on-site review of

internal controls is to identify the various key functions applicable to the area under review. For each position identified, the following questions should be asked:

- Is this a critical position? That is, can a person in this position either make a significant error that will affect the recording of transactions or perpetrate material irregularities of some type?
- If an error is made or irregularity perpetrated, what is the probability that normal routines will disclose it on a timely basis? That is, what controls exist that would prevent or detect significant errors or the perpetration of significant irregularities?
- What are the specific opportunities open to the individual to conceal any irregularity, and are there any mitigating controls that will reduce or eliminate these opportunities?

Although all employees within a branch may be subject to control, not all have financial responsibilities that can influence the accuracy of the accounting and financial records or have access to assets. It is those positions, with the ability to influence the records and with access to assets, with which the examiner is primarily concerned. Once those positions have been identified, the examiners must exercise their professional knowledge of branch operations to conceive of any possibilities open to a person holding a particular position. The question is not whether the individual is honest but whether situations exist that might permit an error to be concealed. By directing attention to such situations, an examiner will also consider situations that may permit unintentional errors to remain undetected.

When reviewing internal controls, an essential part of the examination is alertness to indications that adverse circumstances may exist. Adverse circumstances may lead employees or officers into courses of action they normally would not pursue. An adverse circumstance to which the examiner should be especially alert is when the personal financial interests of key officers or employees depend directly on operating results or financial condition. Although the review of internal control does not place the examiner in the role of an investigator or detective, an alert attitude toward possible conflicts of interest should be maintained throughout the examination. Branches staffed by members of the same family, branches completely dominated by a strong personality, or departments in

which supervisors rely unduly on their assistants require special alertness on the part of the examiner. These and other similar circumstances should be considered in preparing the questionnaire. It is not the formality of the particular factor that is of importance but rather its effect on the overall operation under review. When circumstances that may affect answers to the basic questions exist, a notation of the circumstances should be made along with conclusions concerning their impact on the examination.

The examiner should also be alert for deviations from established policies, practices, and procedures by branch personnel. Examples of such deviations include situations when instructions and directives are not revised to reflect current practices, employees find short cuts for performing their tasks, changes in organization and activities that may influence operating procedures in unexpected ways, and employees duties are rotated in ways that have not been previously considered. These and other circumstances may serve to modify or otherwise change prescribed procedures giving the examiner an inadequate basis for evaluating internal control.

Furthermore, the examiner should consider other existing accounting and administrative controls or other circumstances that might counteract or mitigate an apparent weakness or impair an established control. Controls that mitigate an apparent weakness may be a formal

part of the branch's operating system, such as budget procedures that include a careful comparison of budgeted and actual amounts by competent management personnel. Mitigating controls also may be informal. For example, in small branches, management may be sufficiently involved in daily operations to know the purpose and reasonableness of all expense disbursements. That knowledge, coupled with the responsibility for signing checks, may make irregularities by non-managers unlikely, even if disbursements are otherwise under the control of only one person.

Sometimes, when a substantial portion of the accounting work is accomplished by computer, the procedures are so different from conventional accounting methods that the principles discussed herein seem inapplicable. Care should be taken to resist drawing such a conclusion. The discussion of internal control presented here and its evaluation is purposely stated in terms sufficiently general to apply to any system. Perpetration of defalcations requires direct or indirect access to appropriate documents or accounting records. As such, perpetration requires the involvement of people and, under any system, computerized or not, there will be persons who have access to assets and to records. Those with access may include computer operators, programmers, their supervisors, and other related personnel.

# Internal Control

## Examination Objectives

Effective date July 1997

## Section 4020.2

---

1. To determine the adequacy of the internal control structure (i.e. the control environment, accounting system, and control procedures) in relation to the branch's size and complexity.
2. To determine the level of adherence to procedures and systems.
3. To evaluate whether the system of controls is regularly reviewed to keep pace with changes in the branch's business or strategic plan as well as laws and regulations.
4. To recommend corrective action when internal control policies, practices, or procedures are deficient or when violations of laws or regulations have been noted.

# Internal Control Examination Procedures

Effective date July 1997

## Section 4020.3

---

1. Using methods such as reviewing completed examiner workprograms and accompanying workpapers, directly observing and discussing policies and procedures with branch personnel, and testing when appropriate, determine the following:
  - a. The adequacy of policies and any deviations from established policies, practices, and procedures by branch personnel (including personnel policies);
  - b. The effectiveness of the accounting system to:
    - identify and record transactions; and,
    - provide sufficient detail to properly classify, value, and record the date of transactions for financial reporting;
  - c. The adequacy of internal control procedures given the type and level of risks posed by the size and complexity of the branch;
  - d. The lines of authority and responsibility for reviewing, approving, and monitoring adherence to policies and procedures;
  - e. The existence of adequate job descriptions for all employees;
  - f. The competence of persons performing the required procedures;
  - g. The separation of duties of persons who have access to branch assets;
  - h. Any indications of adverse circumstances or conflicts of interest surrounding employees or officers which could lead them into courses of action they would normally not pursue;
    - i. Any internal control deficiencies or violations of law noted; and
    - j. Any other comments regarding the adequacy of internal controls.
2. Discuss findings with senior management of the branch. During the discussion, elicit management's responses for corrections of deficiencies and/or violations.
3. Write, in appropriate report format, general remarks regarding internal control that may include:
  - a. The quality of internal control policies, practices, and procedures;
  - b. The lines of authority and responsibility for reviewing, approving, and monitoring adherence to policies and procedures;
  - c. The general adherence to internal control policies, practices, and procedures;
  - d. The competency and independence of personnel performing the internal control procedures; and,
  - e. Any deficiencies and violations noted.

The purpose of an emergency preparedness plan is to identify the actions to be taken to minimize financial business loss in the event of a disaster. All financial institutions, including a branch, are expected to have an emergency preparedness plan, which has been approved by senior management at the branch and/or appropriate management levels at its head office. When a branch experiences an emergency or disaster situation in the United States, the assistance the head office can provide may be limited due to geographic distance and differences in time zones. Therefore, a branch must be self-sufficient and have adequate contingency plans in place to restore operations. The emergency preparedness plan ("plan") should contain pre- and post-emergency operations procedures, and the actions required during the emergency. The procedures should be tested and the results documented. The plan should address the continuity of management, the reconstruction of essential records, an alternate operating headquarters, and the protection of personnel. In addition, the plan should give a time table for reconstruction of the critical operations.

### CONTINUITY OF MANAGEMENT

Continuity of management is critical to the decision-making process during an emergency and, therefore, should be documented in the plan, along with necessary telephone numbers. The emergency preparedness plan should also ensure that an officer is available in a post-emergency situation to take official action.

### RECONSTRUCTION OF ESSENTIAL RECORDS

Contingency plans should address the restoration of electronic data processing (EDP) facilities and the restoration of other areas within the branch, including communications, electronic funds transfer, signature cards and customer

records, documentary evidence of credit extensions, contingent liabilities, and funds placement. The plan should indicate how the required records will be restored or recovered, where the appropriate support from outside vendors will be obtained, and how much manpower will be needed to restore operations. Written agreements with outside vendors should be in force and copies readily accessible.

### ALTERNATE OPERATING HEADQUARTERS

An alternate operating site should be designated in a different city or vicinity from the branch. In selecting an alternate operating site, consideration should be given to having a separate power grid, different water main, and central telephone stations from the branch. The optimal alternate site could be another banking site of the FBO, located in a different state, which would be able to provide EDP and communications support. The alternate site should be remote enough so that it can be used in the event of a local disaster (i.e., fire, flood, earthquake, hurricanes, civil disturbance, etc.). In the event this type of alternate site is not available, or is prohibitively expensive, the emergency preparedness plan should have in-depth and well-thought out procedures to restore branch operations at another location in a timely manner.

### PROTECTION OF PERSONNEL

Because most branches do not own their premises, security and shelter protection for personnel is partially dependent on the owner of the premises. Building evacuation and emergency operation procedures should be detailed in the branch's plan and be readily accessible to all personnel. Training in panic control, evacuation procedures, and self-protection should be given to branch personnel at least annually.

# Emergency Preparedness Measures

## Examination Objectives

Effective date July 1997

## Section 4030.2

---

1. To determine if the emergency preparedness policies, practices, procedures, and internal controls are adequate.
2. To determine if branch officers are operating in conformance with the established guidelines from head office.
3. To determine whether the level of training among branch officers and employees is adequate for them to properly perform their emergency responsibilities.
4. To recommend corrective action when policies, practices, procedures, or internal controls are deficient or when violations of laws or regulations have been noted.

# Emergency Preparedness Measures

## Examination Procedures

Effective date July 1997

## Section 4030.3

1. Obtain the branch's emergency preparedness program and determine whether it addresses the following:
  - a. Continuity of Management
    - Succession plans for senior officers and administrative personnel;
    - The designation of a senior level officer responsible for re-opening the branch;
    - The informing of designated substitute personnel of their duties under the plan.
  - b. Record and Asset Protection and Reconstruction
    - The duplication and remote storage of essential records;
    - The remote storage of important PC applications;
    - Procedures for the reconstruction or recovery of records and post-emergency procedures, and the testing of these procedures;
  - c. Alternate Location
    - The designation of an alternate location which is sufficiently removed from the main site and written agreements for the use of the alternate site;
    - The notification of the alternate site to customers and third party contractors in the instances when the alternate site is used;
    - Plans for emergency operations at its alternate location, and the testing of such plans;
    - The maintenance of copies of these plans at each site, and the requirement that all officers have copies;
    - Plans for personnel assembly at the alternate site or at rendezvous points;
    - Senior level management monitoring of conditions at the alternate site and reporting back regularly to head office and local regulatory authorities.
  - d. Personnel Protection
    - Group employee training regarding operation of the emergency preparedness plan, panic control, evacuation procedures, and self-protection, and the documentation of such training;
  - e. Other
    - Distribution of the plan to appropriate employees.
2. Determine if the branch's contingency program has been approved by appropriate management levels at the head office, and how frequently the program is reviewed.
3. Determine the type of training branch personnel receive for emergency situations and assess their knowledge of their responsibilities in the event of an emergency.
4. Determine how frequently the branch tests its emergency preparedness program, and how deficiencies are tracked after tests are completed.
5. Determine if the branch has designated an emergency/security officer.
6. Determine if resolutions have been adopted by head office to enable available or surviving branch officers to take official action.
7. Determine if copies of these resolutions and the emergency preparedness plan have been stored off-site for safe-keeping and are readily accessible.
8. Determine if, in the case of an emergency, the re-opening team will receive regular updates from local authorities as to when the original premises can be accessed.
9. Determine if there are arrangements to notify head office, the regulatory authorities, customers and vendors of the re-opening of the original premises when it occurs.

Cash accounts include U.S. and foreign coin and currency on hand and in transit, clearings, and cash items.

### CASH

Most branches maintain a certain amount of U.S. currency and some may have foreign currency on hand. Each branch should establish policies and procedures appropriate for the level of cash maintained at the branch.

### CLEARINGS

Clearings are checks, drafts, notes, and other items that a branch has cashed or received for deposit that are drawn on other local banks and are cleared directly with them. Such items usually can be exchanged more efficiently among local banks, than through correspondent banks or the Federal Reserve System. Some branches also provide clearing services for other foreign banks, including central banks.

### CASH ITEMS

Cash items are checks or other items in the process of collection that are payable in cash

upon presentation. A separate control of all such items usually is maintained on the branch's general ledger and is supported by a subsidiary record of individual amounts and other pertinent data.

In addition to those items carried in the separate account entitled cash items on the general ledger, some branches will have several sources of internal float, in which irregular cash items can be concealed. Such items include any memoranda slips; checks returned by other banks; checks of officers, employees, and their interests; checks of affiliates; debits purporting to represent currency or coin shipments; notes, usually past-due; and all aged and unusual items of any nature that might involve fictitious entries, manipulations or uncollectible accounts.

If the cash items are not in the process of collection, they should be included on the branch's books in an appropriate account and shown under other assets. These are items that are payable upon presentation but which the branch has elected to accumulate for forwarding to the payor on a periodic basis. If the items are not immediately payable in cash upon presentation or if they were not paid when presented and, after a predetermined period of time, require further collection effort, they also should be included in a noncash asset account, such as cash items not in process of collection and shown under other assets.

# Cash Accounts

## Examination Objectives

Effective date July 1997

## Section 4040.2

---

The following should be undertaken only if warranted by significant cash volume or activity.

1. To determine if the policies, practices, and procedures and internal controls regarding cash accounts are adequate.
2. To determine if officers and employees are operating in conformance with established guidelines.
3. To determine the scope and adequacy of the internal and external audit function.
4. To recommend corrective action when policies, practices, procedures, or internal controls are deficient or when violations of law or regulations have been noted.

# Cash Accounts

## Examination Procedures

Effective date July 1997

## Section 4040.3

The purpose of this section is to determine whether the branch has established appropriate policies and procedures to ensure compliance with the regulations and provide for an effective internal control environment.

This section will not be applicable to branches that do not maintain cash on premises.

1. Based on the evaluation of internal controls and any applicable comments by internal and external auditors, determine the scope of the examination.
2. If included in the scope of the examination, complete or update the Cash Accounts section of the Internal Control Questionnaire.
3. Test for compliance with policies, practices, procedures, and internal controls in conjunction with performing the remaining examination procedures. Obtain a listing of any deficiencies noted in the most recent review by internal or external auditors and determine if appropriate corrections have been made.
4. Obtain a detailed listing of all cash items, including any bank items that are carried in the general ledger under other assets. Verify listings to general ledger balances and scan for propriety and conformity to branch policy.
5. Determine, by discreet corroborative inquiry of responsible branch officials and review of documentation, whether defalcations and/or mysterious disappearances of cash since the preceding examination have occurred. If so, have they been properly reported, pursuant to current requirements of the applicable bank supervisory agencies?
6. Review foreign currency control ledgers and dollar book value equivalents for:
  - a. Accuracy of calculations and booking procedures.
  - b. Unusual fluctuations.
  - c. Concentrations.
  - d. Unusual items.
7. In keeping with the scope of the examination, review compliance with the Financial Recordkeeping and Reporting of Currency and Foreign Transactions Act, 31 CFR 103. Examination policies and procedures in this regard may be found in the Federal Reserve's *Bank Secrecy Act Manual* and other similar examination material prepared by the other federal and state banking agencies.
8. Prepare comments on deficiencies or violations of law or regulations noted above for inclusion in the examination report.
9. Prepare a complete set of workpapers to support conclusions reached. Include any information that will facilitate future examinations.

# Cash Accounts

## Internal Control Questionnaire

Effective date July 1997

## Section 4040.4

Review the branch's internal controls, policies, practices, and procedures for cash accounts. The system should be documented in a complete and concise manner and should include, where appropriate, narrative descriptions, flowcharts, copies of forms used, and other pertinent information.

1. Regarding vault control:
  - a. Is a register maintained that is signed by the individuals opening and closing the vault?
  - b. Is the vault under dual control?
  - c. Are combinations changed periodically and every time there is a change in custodianship?
2. Does an officer or other designated individual review the disposition of all cash items over a specified dollar limit?
3. Does the branch have an adequate charge-off policy for uncollected cash items?
4. Do the branch's present procedures forbid the holding of overdraft checks in the cash item account?
5. Are all cash items reviewed at least monthly at an appropriate level of management?
6. Are cash items recommended for charge off, reviewed, and approved by a branch officer with no operational responsibilities?
7. Are returned items:
  - a. Handled by an independent section of the department or delivered unopened to personnel not responsible for preparing cash letters or handling cash?
  - b. Reviewed periodically by responsible supervisory personnel to determine that items are being handled correctly by this section and are clearing on a timely basis?
  - c. Scrutinized for employee items?
  - d. Reviewed for large or repeat items?
8. Are holdover items:
  - a. Appropriately identified in the general ledger?
  - b. Handled by an independent section of the department?
  - c. Reviewed periodically by responsible supervisory personnel to determine that items are clearing on a timely basis?
9. Are foreign currency control ledgers and dollar book value equivalents posted accurately?
10. Is each foreign currency revalued at least monthly and are profit and loss entries passed to the appropriate income accounts?
11. Are revaluation calculations, including the rates used, periodically reviewed for accuracy by someone other than the foreign currency tellers?
12. Does the internal or external auditor periodically review revaluation calculations, including the verification of rates used and the resulting general ledger entries?

### CONCLUSION

13. Is the information covered by this ICQ adequate for evaluating internal controls in this area? If not, indicate any additional examination procedures deemed necessary.
14. Based on the information gathered, evaluate the internal controls in this area (i.e. strong, satisfactory, fair, marginal, unsatisfactory).

# Cash Accounts

## Audit Guidelines

Effective date July 1997

## Section 4040.5

### CASH

1. Immediately upon arrival, determine the location of all cash and cash items to be controlled.
  2. Establish control over all necessary items (consider the use of seals) and, using appropriate sampling techniques, select funds to be counted and assign personnel to the various funds. There should be no movement of cash or securities in to or out of the vault area unless such movement is controlled by an examiner. All compartments in the vault should be sealed (including lockers reported to contain other than cash) until all items are counted and control is no longer necessary. (Note: Sealing of vaults containing other than cash is to be performed by examiners responsible for those areas.)
  3. Inquire if the branch has incoming or outgoing cash shipments and confirm such amounts. If bagged items are on hand, note contents without counting and control bags to armored car pick-up, etc., and confirm balances with the recipient on a test basis. This step applies to Payroll Cash, Change Fund Cash, Mutilated Money, Fed Shipments, etc. Examine on a test basis subsequent payments for bagged cash.
  4. Obtain a copy of the teller's proof sheets as of the close of business for the day of the examination, and retain them for the workpapers.
  5. Count and verify cash (both U.S. currency and foreign currency) to the proof sheets. Count foreign currency in separate totals for each currency. If after-hours transactions have been conducted, the debit and credit totals must be included in the reconciliation between actual cash counted and the closing cash figure reflected on the teller's proof sheets. The custodian of the cash and the examiner must both remain with the cash until the verification procedure is completed.
  6. Transcribe cash count information to a blank cash sheet and retain for the workpapers. Upon completion of the count, obtain the teller's signature on the workpaper and release control over the fund. If a material difference is discovered by the examiner, the cash should be immediately recounted by the teller in the presence of the examiner. If the difference is not resolved, an officer should be called in to count the cash, and both the officer and the teller should be required to sign the cash sheet reflecting the actual amount of cash counted.
  7. Review all after-hours items to ensure their validity and trace the items to their final disposition.
  8. Detail all items on the cash sheet other than cash found in the cash compartments, even though they may not be required in the reconciliation process.
  9. Prepare a listing of proof sheets and verify or reconcile the total to the branch's daily statement and to the general ledger as of the examination date. (Note: The branch's daily cash form may be appropriate for this purpose.)
  10. Review the teller's proof sheets for the day and ascertain that all balances are reasonable in relation to operating requirements and/or branch policy. Note any balances in excess of reasonable amounts in the workpapers for subsequent discussion with an appropriate branch official.
  11. For each foreign currency held, verify approximate U.S. dollar carrying values by obtaining current bid bank note rates for the foreign currencies on hand. Using those rates, convert each foreign currency into U.S. dollar equivalents. The resulting U.S. dollar values should be verified with the amount shown on the branch's general ledger for reasonableness.
  12. Check the accuracy of foreign currency revaluations and that resulting profit or losses are properly posted to appropriate income accounts. (Foreign cash may be revalued with other foreign currency ledger and future exchange contracts by the branch's accounting/auditing department.)
- ### CASH ITEMS
13. Prepare lists of outstanding items.
  14. Verify totals to the daily statement controls and to the general ledger.

15. Using an appropriate sampling technique, select items for review of supporting documentation and request confirmation of payor.
16. Review all cash items selected to determine if they are legitimate, that they are being processed on a current basis, and that they contain no items from officers or employees.
17. Scrutinize any additional cash items that are not segregated in a control account to ensure their validity.
18. Investigate, through inquiry or other appropriate means, any unusual, stale, or recurring items and confirm their reasonableness or final disposition. All items not in the process of collection should be transferred to an appropriate noncash suspense account.
19. Prepare a list of items recommended for charge off and ascertain that appropriate entries are made.
20. Release control of the cash items.
23. Prepare and mail a positive confirmation request for each individual item selected. The receiving bank will balance the individual items to the cash letter total and will list any return items or other exceptions. During this process the auditor should be alert for unusual items, such as employee checks that have been deliberately misrouted.
24. Place confirmation requests in the related cash letters and maintain control over the cash letters until they are picked up for delivery.
25. Cross-reference the control copies of the confirmations to the schedule noted in step 21.
26. Control all returned (answered) confirmations and investigate and resolve any reported differences. Include all confirmations in the workpapers and document the disposition of all exceptions.

## CLEARINGS

21. Prepare a schedule of all clearings by bank name and cash letter total. Determine that the combined total agrees to the final recap and to the general ledger.
22. Select a number of individual clearing amounts for confirmation.
27. Beginning on the audit date and for a period of 3 business days subsequent to the audit date, obtain all incoming returned items. Review the items and investigate any old or unusual items. Ascertain whether any items relate to officers or employees.

# Consigned Items and Other Nonledger Control Accounts

Effective date July 1997

Section 4050.1

Branches may provide a number of customer services, which normally do not result in assets and liabilities subject to entry on the general ledger. These customer services may include providing customer safekeeping, renting safe deposit boxes, selling travelers' checks, providing collection services, and providing custodian accounts. It is the branch's responsibility to properly maintain and safeguard all consigned items. Branches can ensure the necessary control and review of consigned items through the use of nonledger control or memorandum accounts. These nonledger control accounts consist of ledger cards for customer safekeeping and safe deposit box facilities, inventory listings for travelers' checks, registers for collection items, and registers for custodian accounts. It is essential that branch policy provides for proper internal controls, operating procedures, and safeguards. In all cases, control totals must be generated and the function balanced daily. Proper insurance protection must also be obtained to protect against claims arising from mishandling, negligence, mysterious disappearance, or other unforeseen occurrences. A brief description of the customer service activities involving consigned items is provided below.

## CUSTOMER SAFEKEEPING

*Safe Deposit Boxes*—The branch and the customer enter into a contract whereby the branch receives a fee for renting safe deposit boxes of various sizes. In return for that fee, the branch assumes the responsibility of exercising reasonable care and precaution against loss of the box's contents. When a loss does occur, unless the branch can demonstrate it has maintained the required standard of care, it could be held liable. The required standard of care is defined as that which would be taken by a reasonably prudent and careful person engaged in the same business. Two different keys are required to open the box and the customer and the branch each have one. The customer is not required to disclose the contents of the box to the branch. Generally, the branch may only gain access to the box without the presence of the customer with a court order.

*Safekeeping*—In addition to items held as collateral for loans, branches occasionally hold

customers' valuables for short periods of time while customers are on vacation or temporarily out of the area. Although it is a convenience for branch customers, many financial institutions attempt to discourage the practice by emphasizing the benefits of a safe deposit box. When it is not possible or practical to discourage a customer, the same procedures that are employed in handling collateral must be followed. Items to be stored should be inventoried by two persons and maintained under dual control in the branch's vault. A multi-copy, pre-numbered, safekeeping receipt should be prepared with a detailed description of the items accepted. Sealed packages with contents unknown to the branch should never be accepted for safekeeping. The branch may or may not charge a fee for the service but if it is the branch's policy to engage in such activity, a definite fee schedule should be adopted.

*Custodian Accounts*—Branches may act as custodians for customers' investments such as stocks, bonds, or gold. That service may involve simply physically storing the investments and recording sales, purchases, dividends, and interest or it may be expanded to include actually managing the account. Managing the account would include advising when to sell or buy certain investments and meeting the recording requirements. The examiner should refer to Section 3430, "Private Banking" and their respective agencies for guidance on advisory investment management activities.

## COLLECTION ITEMS

The collection department is one of the most diversified areas in the branch. It engages in receiving, collecting, and liquidating items, which generally require special handling and for which credit normally is given only after final payment is received. Insofar as collection items are concerned, the branch acts as agent for its customers or correspondents and receives a fee for that service. The importance and value of customer assets under branch control demand the use of accounting procedures adequate to provide a step-by-step historical summary of each item processed. An audit trail must be developed to substantiate the proper handling of

all items and to reduce the branch's potential liability.

## CONSIGNED ITEMS

The most common item held on consignment by branches is an inventory of unissued travelers' checks. Travelers' checks have gained widespread popularity because of the possibility of refund if they are lost or stolen. They are issued for a fee or commission shared by the consignor and the issuing institution. Generally, a working supply of unissued travelers' checks is maintained at the teller line or selling station, and a reserve supply is maintained under dual control in the branch's vault.

Rarely does the branch receive sufficient revenues to cover its cost of handling the above-mentioned transactions. However, branches that choose to compete at a retail level often must offer a full range of services. Such a branch assumes the responsibility and the related contingent liability to properly maintain the assets of others and to properly record all transactions involved with the above functions. If an employee should, by fraud or negligence, permit unauthorized removal of items held for safekeeping or issue travelers' checks improperly, the branch may be held liable for losses realized. Therefore, it is imperative that branches offering these retail services maintain adequate bonding on all employees wherever contingent liabilities exist.

# Consigned Items and Other Nonledger Control Accounts

## Examination Objectives

Effective date July 1997

Section 4050.2

---

1. To determine if the policies, practices, procedures, and internal controls regarding consigned items and other nonledger control accounts are adequate.
2. To determine if branch officers and employees are operating in conformance with the established guidelines.
3. To determine the scope and adequacy of the audit function.
4. To recommend corrective action when policies, practices, procedures, or internal controls are deficient.

# Consigned Items and Other Nonledger Control Accounts

## Examination Procedures

Effective date July 1997

## Section 4050.3

---

1. If selected for implementation, complete or update the Consigned Items and Other Nonledger Control Accounts section of the Internal Control Questionnaire.
2. Based on the evaluation of internal controls and the work performed by internal/external auditors, determine the scope of the examination.
3. Test for compliance with policies, practices, procedures, and internal controls in conjunction with performing the remaining examination procedures. Obtain a listing of any deficiencies noted in the latest review by internal/external auditors from the examiner assigned to Internal and External Audits and determine if appropriate corrections have been made.
4. Obtain a listing of consigned items and other nonledger control accounts from the branch.
5. Scan any existing control accounts for any significant fluctuations and determine the cause of fluctuations.
6. Prepare in appropriate report form and discuss with appropriate officer(s) any recommended corrective action when policies, practices, or procedures are deficient.
7. Update the workpapers with any information that will facilitate future examinations.

# Consigned Items and Other Nonledger Control Accounts

## Internal Control Questionnaire

Effective date July 1997

## Section 4050.4

Review the branch's internal controls, policies, practices, and procedures for consigned items and other nonledger items. The branch's system should be documented in a complete and concise manner and should include, where appropriate, narrative descriptions, flow charts, copies of forms used, and other pertinent information. Items marked with an asterisk require substantiation by observation or testing.

### SAFE DEPOSIT BOXES

1. Has counsel reviewed and approved the lease contract in use that covers the rental, use, and termination of safe deposit boxes?
- \*2. Is a signed lease contract on file for each safe deposit box in use?
3. Are receipts obtained for keys to the safe deposit box?
4. Are officers or employees of the branch prohibited from acting as a deputy or having the right of access to safe deposit boxes, except their own or one rented jointly with a member of their family?
5. Is the guard key to safe deposit boxes maintained under absolute branch control?
6. Does the branch refuse to hold, for renters, any safe deposit box keys?
7. Is each admittance slip signed in the presence of the safe deposit clerk and are the time and date of entry noted?
8. Are admittance slips filed numerically?
9. Are vault records noted for joint tenancies and co-rental contracts requiring the presence of two or more persons at each access?
10. Are the safe deposit boxes locked when permitting access, and is the renter's key removed and returned to the customer?
11. Is the safe deposit clerk prohibited from assisting the customer in looking through the contents of a box?
12. Does the safe deposit clerk witness or confirm the re-locking of the box?
13. Is each vault booth, after being used but before being assigned to another renter, examined by an attendant to be sure the previous renter did not leave anything of value behind?

14. Has a standard fee schedule for this service been adopted?
15. Are all collections of rental income recorded when received?
16. Are all safe deposit boxes, where the lessee is delinquent in rent, flagged or otherwise marked so that access will be withheld until rent is paid?
17. Is a file maintained of all attachments, notices of bankruptcy, letters of guardianship, and letters testamentary, which have been served on the branch?
18. Is an acknowledgment of receipt of all property and a release of liability signed upon termination of occupancy?
19. Are locks changed when boxes are surrendered, whether or not keys are lost?
20. Is drilling of boxes witnessed by two individuals?
21. Are the contents of drilled boxes inventoried, packaged, and placed under dual control?
- \*22. Are all extra locks and keys maintained under dual control?
- \*23. Are such items segregated from branch-owned assets and maintained under dual control?
24. Is there a set charge or schedule of charges for this service?

### ITEMS IN SAFEKEEPING

25. Do branch policies prohibit holding items in safekeeping free of charge?
26. Are duplicate receipts issued to customers for items deposited in safekeeping?
27. Are the receipts prenumbered?
- \*28. Is a safekeeping register maintained to show details of all items for each customer?
- \*29. Is a record maintained of all entries to custodial boxes or vaults?
30. Does the branch refuse to accept sealed packages when the contents are unknown?
31. If the branch has accepted sealed packages for safekeeping and the contents are not described, has the approval of the branch's counsel been obtained?
32. When safekeeping items are released, are receipts obtained from the customer?

## CUSTODIAN ACCOUNTS

(Note that in a bank, these accounts may be handled by the bank's trust department and would thus be reviewed in a separate examination of that department. However, fiduciary activities of U.S. branches of FBOs should be included in safety and soundness examinations.)

33. Does the branch have written contracts on hand for each account that clearly define the functions to be performed by the branch?
34. Has branch counsel reviewed and approved the type and content of the contracts being used?
35. Does the branch give customers duplicate receipts with detailed descriptions, including dates of coupons attached, if applicable, for all items accepted?
36. Are those receipts prenumbered?
37. Do branch procedures prohibit its holding any investments not covered by a sale or purchase order in this department?
38. Are all orders for the purchase and sale of investments properly authorized in the account contract or signed by customers?
39. For coupon securities held by the branch:
  - a. Is a tickler file or other similar system used to ensure prompt coupon redemption on accounts where the branch has been authorized to perform that service?
  - b. Are procedures in effect to prevent clipping of coupons where the branch is not authorized to conduct that service?
  - c. Have procedures been adopted to ensure prompt customer credit when coupon proceeds or other payments are received?
- \*40. Are all investment items handled in this area maintained under dual control?
41. Have procedures been established for withdrawal and transmittal of items to customers?
- \*42. Does an officer review and approve all withdrawals before the transaction is effected?
43. Has a standard fee schedule for this service been adopted?
- \*45. Are permanent registers or memorandum accounts maintained for incoming and outgoing collection items?
46. Are serial numbers or prenumbered forms assigned to each collection item and all related papers?
- \*47. Are all incoming tracers and inquiries handled by an officer or employee not connected with the processing of collection items?
48. Is a record kept to show the various collection items that have been paid and credited as a part of the day's business?
49. Is an itemized daily summary made of all collection fees showing collection numbers and amounts?
50. Are employees handling collection items periodically rotated, without advance notification, to other branch duties?
- \*51. Is the employee handling collection items required to make settlement with the customer on the same business day that payment of the item is received?
52. Does the branch have an established policy of not allowing the customer credit until final payment is received?
- \*53. Have procedures been established, including supervision by a branch officer, for sending tracers and inquiries on unpaid collection items in the hands of correspondents?
54. In the event of nonpayment of a collection item, is the customer notified and is the item promptly returned?
55. Are the files of notes entered for collection clearly and distinctly segregated from branch-owned loans and discounts?
56. Are collection notes maintained under memorandum control, and is the control balanced regularly?
57. Are collection files locked when the employee handling such items is absent?
- \*58. Are vault or locked storage facilities provided for collection items containing negotiable documents?
59. Does the collection teller turn over all cash to the paying teller at the close of business each day and start each day with a standard change fund?
60. Has a standard fee schedule been adopted for this service?
61. Is the fee schedule always followed and, if not, is proper officer approval obtained for any deviations?

## COLLECTION ITEMS

44. Is access to the collection area controlled?  
If so, indicate how?

62. Is a permanent record maintained for registered mail?

and put in the vault at night over weekends or holidays or is it otherwise protected?

67. Are remittances for sales made on a regularly scheduled basis, if not daily?

### CONSIGNED ITEMS

\*63. Is the reserve stock of consigned items maintained under dual control?

64. Are working supplies kept to a reasonable minimum, i.e., two or three days' supply, and adequately protected during banking hours?

\*65. Is a memorandum/control account maintained for consigned items?

\*66. Is the working supply safeguarded when the employee handling such items is absent

### CONCLUSION

68. Is the information covered by this ICQ adequate for evaluating internal controls in this area? If not, indicate any additional examination procedures deemed necessary.

69. Based on the information gathered, evaluate the internal controls in this area (i.e. strong, satisfactory, fair, marginal, unsatisfactory).

# Consigned Items and Other Nonledger Control Accounts

## Audit Guidelines

Effective date July 1997

## Section 4050.5

---

### SAFE DEPOSIT BOXES

1. Compare the number of rental contracts in force to the total number of safe deposit boxes.
2. Determine the current status of rental payments on all boxes rented.
3. Determine the reasons for any deviation from established fee schedules.
4. Using an appropriate sampling method, test check vault entry records for proper signature(s) of authorized persons.
5. Inspect and reconcile the following to inventory control records maintained by the branch:
  - a. Keys for unrented boxes.
  - b. Extra locks and keys kept for replacement purposes.
  - c. Contents of any drilled safe deposit boxes.
6. Obtain numbers of safe deposit boxes utilized by the branch and prepare a workpaper detailing all items contained therein.

### SAFEKEEPING

7. Control all items held in safekeeping through use of seals or otherwise.
8. Obtain the safekeeping register to verify that receipt forms are issued in numerical sequence and to account for all numbers issued. Also, check unused forms for the next number to be issued, and test completeness of numerical sequence of unissued forms.
9. Using an appropriate sampling technique, select items for test and:
  - a. Verify the items selected and check the vault contents to the receipt copies on hand.
  - b. If any items selected for review are held in safekeeping elsewhere, confirm their existence by direct communication.
  - c. If any of the items selected for review appear altered or there seems to be a discrepancy between the receipt and what is held in the vault, independently confirm the items with customers.

10. Using an appropriate sampling technique, select certain closed items for examination and:
  - a. Examine the register form and customer's release.
  - b. Compare customer's signature on release to other signature copy on file.
  - c. If any of the items appear altered or unusual, confirm correctness of information with owners.
11. Review policies, fee schedule, and procedures for collection of fees for these services and perform appropriate tests to ensure compliance. Confirm that branch policies prohibit holding items in safekeeping free of charge.

### CUSTODIAN ACCOUNTS

12. Control all items held in custodian accounts through the use of seals or otherwise.
13. Using an appropriate sampling technique, select accounts for review and:
  - a. Examine the contract for each account selected.
  - b. Verify the vault contents to the receipt copy on hand.
  - c. Review transactions and determine compliance with written contractual authorizations.
  - d. If items in an account selected for review are held in safekeeping elsewhere, confirm by direct communication.
  - e. If any items in the accounts selected appear altered or if there appears to be a discrepancy between the receipt and what is held in the vault, confirm the items held with customers.
14. Using an appropriate sampling technique, select closed accounts for review and:
  - a. Review the register form and customer's release.
  - b. Compare the customer's signature on release to the signature copy on file.
  - c. If any of the account items appear altered or unusual, confirm correctness of information with owners.
15. Review policies and procedures for collection of fees for this service and perform appropriate tests to ensure compliance.

## COLLECTION ITEMS

16. In the event that permanent registers or memorandum controls are maintained, prepare a trial balance of each account so controlled. Review the register and determine whether:
  - a. all collections are indexed in the register.
  - b. complete histories of the origin and final disposition of each collection item are recorded.
  - c. receipts are issued to customers for all items received for collection.
17. In the case of unusual, altered, or long outstanding items, prepare and mail confirmation requests to customers.
18. Using an appropriate sampling technique, select representative items and:
  - a. Review all supporting documents.
  - b. To the extent possible, determine the authenticity of each item selected, and trace and clear each item through final payment, including appropriate credit to customer.
19. Test postings of collections on detailed records to determine that disbursement of funds collected is in accordance with customers' instructions.
20. Determine that credit is given promptly, on the same day received, for all collections settled.
21. Test appropriate records to determine that collection of fees for this service is in

accordance with established policy and that branch income accounts are being credited on a daily basis.

## CONSIGNED ITEMS

22. Control all items held on consignment through the use of seals or otherwise.
23. Inventory unissued and spoiled items on hand and confirm totals to memorandum/control accounts maintained at the branch.
24. Compare and reconcile memorandum accounts to latest consignor statement.
25. Prepare and mail to consignor, a confirmation request on items inventoried.
26. Follow up and clear any confirmation exceptions.

## OTHER NONLEDGER CONTROL ITEMS NOT COVERED ABOVE

27. Perform verification procedures considered appropriate in light of any special circumstances encountered.
28. Prepare a workpaper documenting procedures used, conclusions reached, and recommendations made.

# Payments System Risk and Electronic Funds Transfer Activities

Effective date July 1997

## Section 4060.1

Branches and other depository institutions use payment systems both to transfer funds related to their own operations and to transfer funds on behalf of their customers. The need for same-day settlement transactions has precipitated financial institutions' increased reliance on electronic funds transfer (EFT) systems. Financial institutions commonly use their EFT operations to make and receive payments, buy and sell securities, and transmit payment instructions to correspondent banks worldwide. In the United States, most of the dollar value of all funds transfers is concentrated in two electronic payment systems: Fedwire, which is a Federal Reserve service, and the Clearing House Interbank Payments System (CHIPS), which is a private settlement system owned and operated by the New York Clearing House Association. The flow of funds through these systems is extremely large compared to the reserve and clearing-account balances maintained by the financial institutions participating in the systems.

The efficiency of a payments system depends to a large extent, on the certainty of settlement of payments. Final settlement occurs when payment obligations between payments system participants are extinguished with final and irrevocable funds. In cash transactions payments, payment and settlement occur simultaneously. On occasion, settlement may not occur on the same day. Without settlement, the recipient of a payment faces the uncertainty of not receiving the value of funds that has been promised. The exposure to this uncertainty is generally referred to as payments system risk. The examiner's role is to ensure that branches effectively monitor and control their exposure to this risk.

The amount and subsequently the velocity of funds transfers that must be settled exposes a branch to many types of specific risk under the general category of payments system risk. In particular, there is liquidity risk, which is the risk that a counterparty may be temporarily unable to cover its obligation to the bank at the time settlement is supposed to occur. There is also credit risk, which is the risk that another participant in the payments system will fail to settle at the end of the day. The provision of intraday credit (often referred to as daylight overdrafts or daylight credit) exposes participants to payments system risk because the provider of the credit may be unable to collect final funds from the receiver at the time pay-

ment is due or at all. On those occasions when payments are not settled on the same day, daylight overdrafts may result in overnight (or interday) overdrafts.

## TYPES OF PAYMENTS SYSTEMS

The many thousands of payments made each day result in transfers of balances among banks and between banks and Federal Reserve Banks. Additionally, branches make their own payments in connection with carrying out the business of banking. Branches can make interbank payments through accounts that they hold with a correspondent bank.

### Electronic Funds Transfer Systems

#### *Fedwire*

The Federal Reserve System operates a national funds-transfer system, Fedwire, and acts as a clearinghouse for transactions executed over the system. Fedwire provides for the electronic transfer of immediate and irrevocable payments between participating institutions and functions as both a clearing and settlement facility for funds and securities transfers, which average more than \$1 trillion per day.

The Fedwire funds-transfer system is a real-time, gross-settlement, credit-transfer system. Each funds transfer is settled individually on the books of the appropriate Federal Reserve Bank as it is processed and is considered a final and irrevocable payment. A depository institution that sends a funds transfer irrevocably authorizes its Reserve Bank to charge its account for the transferred amount and further authorizes the Reserve Bank of the receiving institution to transfer the same amount to the account of the receiving institution. The Federal Reserve guarantees immediate availability of funds. Once the Federal Reserve Bank credits the receiving institution's account or delivers the advice of payment, the Federal Reserve Bank will not reverse credit for the payment. Therefore, there is no settlement risk to the recipient of a Fedwire transfer. The Federal Reserve Bank assumes the risk if the sending bank does not settle its position at the Reserve Bank at the end of the business day. If the sending branch does not

settle its position at the Reserve Bank at the end of the business day, the Federal Reserve may be at risk for daylight overdrafts. The use of daylight overdrafts is not encouraged, and banks are subject to credit limits and specific charges set by the Federal Reserve. Furthermore, such daylight overdraft privileges can be revoked at any time.

Branches can access Fedwire in several ways. Many large branches link branch computer facilities and the Federal Reserve over leased telephone lines. Lower volume users usually have dial-up access using microcomputers and Fedline software. Some users are off-line, requiring a separate call to the Federal Reserve for each transaction.

### CHIPS

The Clearing House Interbank Payments System (CHIPS) is a funds-transfer network owned and operated by the New York Clearing House Association (NYCHA) to deliver and receive U.S. dollar payments between domestic or foreign banks that have offices located in New York City. The network consists of a small number of settling participants (large U.S.-chartered banks that settle end-of-day balances with each other) and a larger number of nonsettling participants who maintain accounts with one of the settling banks. Although a large volume of CHIPS payments are for settlement of U.S.-dollar foreign-exchange contracts and Eurodollar investments, there are a significant number of domestic business-related transactions. The interbank settlement of payments will normally be completed by the end of the business day. Unlike Fedwire, a credit received through CHIPS may not be a final settlement and can be reversed later in the day. To avoid such reversals, CHIPS has a number of risk-management tools in place. Nevertheless, the receiving institution is subject to some level of intraday credit exposure through the sending institution (or its settling participant) until final settlement is achieved at the end of the business day.

### Manual Systems

Not all financial institutions employ an electronic funds transfer system. Branches which execute only a small number of EFT transactions may execute EFTs by a telephone call to a

correspondent bank. This is an acceptable practice as long as the branch has adequate internal control procedures.

### Message Systems

The message systems employed by institutions and corporations to originate payment orders are indispensable components of funds-transfer activities. Unlike payments systems, which transmit actual debit and credit entries, message systems process administrative messages and instructions to move funds. The actual movement of the funds is then accomplished by initiating the actual entries to debit the originating customer's account and credit the beneficiary's account. If the beneficiary's account or the beneficiary bank's account is also with the originator's bank, the transaction is normally handled internally through "book entry." If the beneficiary-related accounts are outside the originating customer's bank, the transfer may be completed by use of a payments system such as Fedwire or CHIPS. The means of arranging payment orders ranges from manual methods (for example, memos, letters, telephone calls, fax messages, or standing instructions) to electronic methods using telecommunications networks. These networks may include those operated by the private sector, such as SWIFT or Telex, or other networks operated internally by particular financial institutions.

Even though the transfers initiated through systems such as SWIFT and Telex do not result in the immediate transfer of funds from the issuing branch, they do result in the issuing branch having an immediate liability, which is payable to the disbursing institution. Therefore, the operating controls of these systems should be as stringent as the ones implemented for systems such as Fedwire and CHIPS.

### SWIFT

Society for Worldwide Interbank Financial Telecommunications (SWIFT) is a nonprofit cooperative of member banks serving as a worldwide interbank telecommunications network based in Brussels, Belgium. It is the primary system employed by financial institutions worldwide to transmit either domestic or international payment instructions.

## TELEX

Several private telecommunications companies offer worldwide or interconnected services that provide a printed permanent record of each message transmitted. Telex is the primary message system for institutions that do not have access to SWIFT. The Telex systems do not include built-in security features. Telex users exchange security codes, and senders sequentially number messages sent to another institution.

## PAYMENTS SYSTEM RISK (PSR)

Payments system activity gives rise to three forms of risk: *direct credit risk* to the Federal Reserve in the event that an institution may be unable to cover its intraday overdraft arising from a transfer of funds or receipt of book-entry securities; *private direct credit risk* to institutions extending daylight credit through private settlement systems; and *systemic risk*, the possibility that the failure of one participant in a transfer system will cause other participants to fail to meet their obligations.

## SUPERVISORY POLICY OVERVIEW

In 1985, the Board of Governors of the Federal Reserve System adopted a policy to reduce the risks that large-dollar payments systems bring to the Federal Reserve Banks, the banking systems, and other sectors of the economy. An integral component of the Federal Reserve's PSR policy is a program to control the use of intraday Federal Reserve credit.

The PSR policy further established limits, or caps, on the amount of Federal Reserve daylight credit that may be used by a depository institution during a single day and over a two-week period. These limits are sufficiently flexible to reflect the overall financial condition and operational capacity of each institution using Federal Reserve payment services. The policy also permits Reserve Banks to protect themselves from the risk of loss by requiring institutions to post collateral to cover daylight overdrafts in certain circumstances or by restricting the account activity of institutions that incur frequent or excessive overdrafts.

In 1992, the Board of Governors approved a policy that established fee assessments for an institution's use of Federal Reserve daylight credit. Along with the daylight overdraft fee policy, the Federal Reserve adopted a modified method of measuring daylight overdrafts that more closely reflects the timing of actual transactions affecting an institution's intraday Federal Reserve account balance.

The objective of daylight overdraft fees is to provide a financial incentive for institutions to control their use of intraday Federal Reserve credit and to explicitly recognize the risks inherent in the provision of intraday credit. Daylight overdraft fees induce institutions to make business decisions concerning the amount of intraday Federal Reserve credit they are willing to use based on the cost of using that credit. As a result, institutions should establish intraday credit limits for customers that actively use payment services.

Under the Federal Reserve's PSR program, each institution that maintains an account at a Federal Reserve Bank is assigned or may establish a net debit cap, which determines the amount of intraday Federal Reserve credit that the institution may use.

U.S. branches and agencies of foreign banks are typically treated the same as domestic institutions under the Federal Reserve's PSR policy. However, several unique considerations affect the way in which the policy is applied to U.S. branches and agencies of foreign banks.

In general, net debit caps for foreign banks are calculated in the same manner as for domestic banks, that is, by applying cap multiples for one of the six cap categories to a capital measure. However, the determination of an appropriate capital measure, known as the U.S. capital equivalency, is substantially different for foreign banks and depends on whether the bank is based in a country that has signed or adopted the standards of the Basle Capital Accord. In addition, special provisions regarding collateralization of overdrafts, allocation of caps, and capital-reporting requirements also apply to foreign banks.

## Self-Assessment Caps

Depository institutions that use intraday Federal Reserve credit in amounts that exceed 40 percent of their risk-based capital on a single day or

on average over a two-week period must establish their daylight overdraft caps through the self-assessment process.

Unlike other institutions participating in the large payment systems, branches and agencies of foreign banks lack a true U.S. corporate entity against which risk can be evaluated. As a result, the self-assessment is necessarily based upon the foreign-based corporate entity to which the branch(es) and/or agency(ies) belong. This analysis looks to the consolidated entity and all branches and agencies of that entity are combined for purposes of developing a single assessment and adhering to cross-system net debit caps.

For foreign banks with access to the large payment systems in more than one Federal Reserve District, a single branch or agency and Reserve Bank will be designated as the primary contact points for administering this program. That branch or agency will maintain the self-assessment file for all branches and agencies of the same foreign bank for the examiner review. The Administrative Reserve Bank will be responsible for monitoring the consolidated position for all branches and agencies of the foreign bank.

Foreign banks usually lack the type of peer data generally available for domestic institutions. Even where it does exist, the data rarely correspond to that of U.S. counterparts because of different accounting standards. Nonetheless, the absence of peer data does not absolve foreign institutions from going through the same type of analysis as their U.S. counterparts. Indeed, the same general expectations on performance relative to peers means including U.S. peers as well as home country peers, if they expect to rate themselves “above average” or “strong.”

Facts regarding a foreign bank’s home country may have significant mitigating considerations particularly where local practices result in substantial “hidden reserves,” involve significant government support of institutions, or result in other distortions of financial data in ways that can be shown to indicate different degrees of risk than, in fact, actually exists. Explanations of such factors should be well documented in the self-assessment file. While such factors can often cause what would otherwise be regarded as an unsatisfactory rating to be upgraded to satisfactory, further upgrading is unlikely to be acceptable unless the extent of the hidden support is quantified.

If a foreign bank has a deposit-taking subsidiary in the United States, that U.S. institution should be evaluated separately, and its data should be backed out of the foreign parent’s data before the self-assessment. Thus, the foreign parent should not “double count” the capital, assets, or liabilities of its U.S. subsidiaries in its self-assessment. For more information, refer to the Guide to the Federal Reserve’s Payments System Risk Policy, which is available from any Reserve Bank.

## ELECTRONIC FUNDS TRANSFER MANAGEMENT (EFT)

Branches should ensure that prudent banking practices are followed in all funds-transfer activities, and establish guidelines for types of allowable transfers. Procedures should be in effect to prevent transfers drawn against uncollected funds. Transfers should not be initiated against simple ledger balances unless preauthorized credit lines have been established for that account.

Errors and omissions or fraudulent alteration of the amount of a transfer or the account number to which funds are to be deposited could result in losses to the branch. Losses may include total loss of the transferred funds, loss of availability of funds, interest charges, and administrative expenses associated with the recovery of the funds or correction of the problem.

Management is responsible for assessing inherent risks in the EFT system, establishing policies and controls to protect the institution against unreasonable exposures, and monitoring the effectiveness of safeguards. Regulatory agencies will ensure that each financial institution has evaluated its own risks realistically and has adequate accounting records and internal controls to keep exposures within reasonable, established limits.

The risk associated with any computerized EFT system can be reduced if management implements the controls that are available on the system. For example, the authority to enter, verify, and send transfers can be segregated. Also the dollar amount of the transactions can be limited.

Effective risk management requires that—

- Reasonable credit limits be established and payments in excess of such limits involving

significant credit risk be properly approved by appropriate lending authorities;

- Banks have adequate recordkeeping to determine the extent of any intraday overdrafts and potential overnight overdrafts before releasing payments, and
- Institutions responsible for settling the position of others should properly monitor respondents' accounts and assign responsibility for this function to an appropriate supervisory level of management.

## AUTHENTICATION OR VERIFICATION METHODS

The same due care that financial institutions use when executing EFT transactions must also be used when accepting EFT requests from customers. Management must implement security procedures for ensuring that the transfer requests are authentic. As stated in the Uniform Commercial Code (UCC) section 4A-201, security procedures may require the use of algorithms, or other codes, identifying works or numbers, encryption, call-back procedures, or similar security devices. Authorized and verified payment orders are detailed in the UCC section 4A-202.

### Signature Verification

One method to verify the authenticity of a customer's EFT request is to verify the customer's signature; however, this procedure cannot be performed when the customer requests the transaction by telephone. Some financial institutions have implemented policies whereby the customer completes and signs a transfer request, and then faxes the request to the bank. This is not, however, a safe EFT procedure because, although the branch can verify the signature on the faxed request, it cannot be certain that the transfer request is legitimate. Any document that is transmitted electronically can be altered (for example, by changing the amount or account number); the alteration can occur before the document is digitized or after. In most instances, these alterations cannot be detected by the receiving entity. If there is any question about a document's authenticity, the transaction should be reconfirmed through other sources.

### Personal Identification Numbers

One way for financial institutions to authenticate transfers initiated over the telephone is through the use of personal identification numbers (PIN) issued to each customer. When a customer requests a transfer, the customer's identity is verified by comparing the PIN that is supplied with the customer PIN request form that is on file. At a minimum, the following safeguards for these types of transfers should be implemented:

- All customers should be requested to sign an agreement whereby the branch is held harmless in the event of an unauthorized transfer if the branch follows routine authentication procedures. The customer is responsible for informing the branch about changes relating to individuals authorized to execute EFTs. These procedures should minimize the risk to the branch in the event someone is able to execute a fraudulent transaction. These procedures are described in detail in the UCC section 4A-202, *Authorized and Verified Payment Orders*.
- All transactions over a specific dollar amount should be re-verified by a callback routine. The branch should require that the person being called for re-verification is someone other than the person who initially requested the transaction.
- Whenever new PINs are issued, they should be mailed in sealed, confidential envelopes (preferably computer-generated) by someone who does not have the ability to execute wire transfers.
- The number of branch employees with access to the PINs should be very limited.

### Tape Recording

Tape recording EFT requests made over the telephone is another internal control practice. Likewise, when possible, verifying and recording the incoming telephone number (caller-I.D.). The laws addressing telephone recording vary by state. Some states require that the caller be informed that the conversation is being recorded; other states do not have this requirement. Regardless of the state's law, the branch should inform callers that, for their protection, conversations are being recorded. Moreover, branches should have in place a policy for

archiving the taped telephone records and should retain them for a specified period of time.

## Statements of Activity

Some larger branches have implemented a procedure whereby customers are electronically sent a summary statement at the end of each day that lists the transfers executed and received on their behalf. The statement can be sent through a fax machine, personal computer, or remote printer. This procedure can help towards quickly identifying any unauthorized transfers.

## Test Keys

EFT requests can also be authenticated by using test keys. A test key is a calculated number that is derived from a series of codes that are contained in a test-key book. The codes in a test-key book represent such variables as the current date, hour of the day, receiving institution, receiving the account number, and amount of the transfer. The value derived from these variables equals the test key. The financial institution or corporate customer initiating the transfer will give its EFT information, along with the test-key value. The receiving institution will recalculate the test key and, if the two test keys equal the same amount, the EFT request is considered authenticated. Test-key code books should be properly secured to prevent unauthorized access or fraudulent use. The use of test keys has declined in recent years as more and more institutions implement personal computer-based EFT systems.

## INTERNAL CONTROL

### Supervisory Evaluation

Branch management is responsible for assessing the inherent risks in the EFT systems it uses, establishing policies and controls to protect the institution against unreasonable exposures, and monitoring the effectiveness of such safeguards.

Bank examiners are responsible for ensuring that financial institutions have evaluated their own risks realistically and have provided internal controls that are adequate to keep the exposures within acceptable limits.

Examiners should consider the following internal control guidelines when reviewing policies and procedures covering funds-transfer activities.

- Job descriptions for personnel responsible for a branch's EFT activities should be well defined, and provide for the logical flow of work and adequate segregation of duties.
- No single person in an EFT operation should be responsible for all phases of the transaction.
- All funds transfers should be reconciled at the end of each business day. The daily balancing process should include a reconciliation of both the number and dollar amount of messages transmitted.
- All adjustments required in the processing of a transfer request should be approved by a branch's supervisory personnel, with the reasons for the adjustment documented, particularly in the case of requests as of a past or future date.
- Only authorized persons should have access to EFT equipment.

Considerable documentation is necessary to maintain adequate accounting records and auditing control. Many branches maintain transfer-request logs, assign sequence numbers to incoming and outgoing messages, and keep an unbroken electronic copy of all EFT messages. At the end of each business day, employees who are independent of the transfer function should ensure that all EFT documents are accounted for by comparing request forms to the actual transfers.

Examiners should review the funds-transfer operations to determine that there are accurate and reliable recordkeeping systems, prompt and efficient handling of all transactions, appropriate separation of duties, adequate audit coverage, and recognition by management of the risks associated with those activities.

# Payments System Risk and Electronic Funds Transfer Activities Examination Objectives

Effective date July 1997

## Section 4060.2

---

1. To determine if electronic funds transfer objectives, policies, practices, procedures, and internal controls are adequate.
2. To determine if branch officers and other funds transfer personnel are operating in conformance with established guidelines.
3. To determine the scope and adequacy of the audit function as it relates to funds transfer activities.
4. To determine that senior management is informed of the current status of and any exposure relative to funds transfer operations.
5. To determine compliance with applicable laws and regulations.
6. To obtain initiation of corrective action when objectives, policies, procedures or internal controls are deficient or when violations of laws or regulations have been noted.

# Payments System Risk and Electronic Funds Transfer Activities Examination Procedures

Effective date July 1997

## Section 4060.3

---

1. If selected for implementation, complete or update the Internal Control Questionnaire for this area.
2. Based upon an evaluation of internal controls and work performed by internal/external auditors, determine the scope of the examination.
3. Test for compliance with policies, practices, procedures, and internal controls in conjunction with performing the remaining examination procedures. Also, obtain a listing of any deficiencies noted in the most current internal audit report and determine if appropriate corrections have been made.
4. Review the bank's policies with respect to electronic funds transfers and determine their reasonableness.
5. For institutions incurring daylight overdrafts, determine that senior management has reviewed and approved the institution assessment and sender net debit cap in conformance with the Federal Reserve Board's policy statement on risk reduction on large-dollar payment systems.

# Payments System Risk and Electronic Funds Transfer Activities Internal Control Questionnaire

Effective date July 1997

## Section 4060.4

Review the branch's internal controls, policies, practices and procedures regarding wire transfer activities. The branch's system should be documented in a complete, concise manner and should include, where appropriate, narrative descriptions, flowcharts, copies of forms used and other pertinent information.

### SIGNATURE CARD CONSIDERATIONS

1. Does management maintain a current list of branch personnel authorized to initiate transfer requests?
2. Does the branch limit the number of authorized employees?
3. Are authorized employee signature cards kept under dual control?
4. Does the branch maintain a current list or card file of authorized signers for customers who use the branch's funds transfer services?
5. Does the branch limit the number of authorized signers for branch customers?
6. Are customer signature cards maintained under dual control or otherwise protected?
7. Do customer signature cards limit the amount of funds that an individual is authorized to transfer?
8. Does the branch advise its customers to maintain their lists of authorized signers under dual control?
9. Do branch personnel compare the signature on an original mail request with the authorized signature on file?

### TEST KEY CONSIDERATIONS

10. Are the files containing test key formulas maintained under dual control or otherwise protected?
11. Are only authorized personnel permitted in the test key area or allowed access to computers, teletapes or terminals?
12. Does the branch maintain an up-to-date test key file?
13. Does management maintain a list of those persons who have access to test key files?

14. Are all messages and transfer requests that require testing authenticated by the use of a test key?
15. Are test codes verified by someone other than the person receiving the initial transfer request?
16. Are call-back or other authentication procedures performed on all transfers that do not have a test key or signature card on file?
17. Do mail transfer requests include a test word as an authentication procedure?
18. Does the branch's test key formula incorporate a sequence number resulting from an agreement between the branch and the customer?
19. Does the branch have procedures in operation for the issuance and cancellation of test keys?
20. Is the responsibility for issuing and cancelling test keys assigned to someone who is not responsible for testing the authenticity of transfer requests?

### TELEPHONE TRANSFER REQUESTS

21. Has the branch established guidelines for what information should be obtained from a person making funds transfer request by telephone?
22. Does that information include a test word authentication code?
23. Does the branch use a call-back procedure that includes a test code authentication to verify telephone transfer requests?
24. Does the branch limit call-back to transactions over a certain dollar amount?
25. Does the branch maintain a current list of persons authorized to initiate telephonic funds transfers and messages?
26. Does the branch have procedures in effect to prohibit persons who receive telephone transfer requests from transmitting those requests?
27. Does the branch use devices that record all incoming and outgoing transfer requests?
28. Does the branch advise its customers in written contracts, by audible bleeping signals, or by informing the caller that telephone calls are being recorded?

29. Are pre-numbered or sequentially numbered (at a central location after initiation) transfer request forms used?
30. Are transfer requests recorded in a log or another branch record at origination?
31. Is the log or record of transfer requests reviewed daily by supervisory personnel?
32. Do the records of transfer requests contain:
  - A sequence number?
  - An amount transferred?
  - The person, firm or institution making request (also specific transferror)?
  - The date?
  - The test code authentication?
  - Paying instructions?
  - Authorizing signatures for certain types and dollar amount transfers?
33. Are all pre-numbered forms, including cancellations, accounted for in the daily reconciliation?
34. Is the daily reconciliation of funds transfer and message request activity reviewed by supervisory personnel?
35. Is the balancing of the daily activity separate from the receiving, processing and sending functions?
36. Does the wire transfer department verify that work sent to other branch departments agrees with its totals?
37. Is someone responsible for reviewing all transfer requests to determine that they have been properly processed?
38. Are all rejects and/or exceptions reviewed by someone not involved in the receipt, preparation or transmittal of funds?
39. If the institution accepts transfer requests after the close of business or transfer requests with a future value date, are they properly controlled and processed?
40. Are Federal Reserve Bank statements reviewed daily to determine if there are "open" funds transfer items and the reasons for the outstanding items?
41. Are corrections, overrides, open items, reversals and other adjustments reviewed and approved by an officer?
42. Does the wire transfer department or another area of the branch have procedures in effect to prohibit transfers of funds against accounts that do not have preauthorized credit availability and have uncollected balances?
43. Does the branch maintain adequate records as required by the Currency and Foreign Transactions Reporting Act of 1970 (also known as the Bank Secrecy Act)?
44. Have managing officers adopted written procedures or flowcharting to serve as a training tool?
45. Does management and/or the audit department undertake a periodic review to ensure that work is being performed in accordance with established policy?
46. Is the audit department promptly informed when a change is made in systems or method of operation?
47. Are all general ledger tickets, automated transaction cards or other supporting documents initialed?

## WIRE TRANSFER REQUESTS

33. Does the branch have teletype or computer terminal equipment capable of receiving and transmitting messages and funds transfer information?
34. Are the functions of receipt, testing and transmission of funds transfer requests performed by different employees?
35. Are incoming and outgoing messages time stamped or sequentially numbered for control?
36. Do incoming and outgoing messages include a test word or code as a means of message authentication?
37. Is an unbroken copy of all messages kept throughout the business day?
38. Is that copy reviewed and controlled by someone not connected with operations in the wire transfer area?

## ACCOUNTING, PROCESSING, AND SYSTEMS

39. Does the wire transfer department of the branch prepare a daily reconciliation of funds transfer activity by dollar amount and number of messages?
40. Is a daily reconciliation of funds transfer activities performed in another area of the branch, i.e., correspondent banks, accounting,

## PERSONNEL

56. Has the branch taken steps to ensure that screening procedures are applied to personnel hired for sensitive positions in the wire transfer department?
57. Does the branch prohibit new employees from working in sensitive areas of the wire transfer operation?
58. Are temporary employees excluded from working in sensitive areas? If not, is the number of such employees limited?
59. Are statements of indebtedness required of employees in sensitive positions of the wire transfer function?
60. Are employees subject to unannounced rotation of responsibilities regardless of the size of the institution?
61. Are relatives of employees in the wire transfer function precluded from working in the same institution's bookkeeping or data processing departments?
62. Does the branch's policy require that employees take a minimum number of consecutive days as part of their annual vacation? Is this policy being enforced?
63. Does management reassign employees who have given notice of resignation or been given termination notices, from sensitive areas of the wire transfer function?
70. Are terminals and other hardware in the wire transfer area shut down after normal working hours? Are they regulated by automatic time-out controls or time-of-day controls?
71. Are passwords suppressed when entered in terminals?
72. Are operator passwords frequently changed? If so, how often?
73. Is supervisory approval required for terminal access made at other than authorized times?
74. Are passwords restricted to different levels of access such as data files and transactions that can be initiated?
75. Is terminal operator training conducted in a manner that will not jeopardize the integrity of live data or memo files?
76. Are employees prohibited from taking keys for sensitive equipment out of the wire transfer area?
77. Does the branch maintain back-up communications systems?
78. Are back-up systems periodically tested by branch personnel?
79. Does the use of back-up equipment require approval by supervisory personnel?

## PHYSICAL SECURITY

64. Is access to the wire transfer area restricted to authorized personnel?
65. Are visitors to the wire transfer area identified, required to sign in and be accompanied at all times?
66. Is written authorization given to those employees who remain in the wire transfer area after normal working hours? Who gives such authority? Are security guards informed?
67. Are branch terminal operators or others in wire transfer operations denied access to computer areas or programs?
68. Do procedures prohibit computer personnel from gaining access to branch terminals or test key information?
69. Does wire transfer equipment have physical and/or software locks to prohibit access by unauthorized personnel at all times?

## CONTINGENCY PLANS

80. Have written contingency plans been developed for partial or complete failure of the systems and/or communication lines between the branch and the New York Clearing House, Federal Reserve Bank, data centers and/or servicer companies?
81. Are these contingency plans reviewed regularly and tested periodically?
82. Has management distributed these plans to all wire transfer personnel?
83. Are sensitive information and equipment adequately secured before evacuation in an emergency and is further access to the affected areas denied by security personnel?

## CREDIT EVALUATION AND APPROVAL

84. Have customer limits been established for Fedwire, CHIPS, and Cash Wire exposure which include consideration of intraday and overnight overdrafts?

- a. Are groups of affiliated customers included in such limits?
  - b. How often are the limits reviewed and updated?
  - c. Are the customer limits reviewed by senior management? How frequently?
85. Does the branch make payments in anticipation of the receipt of covering funds? If so, are such payments approved by officers with appropriate credit authority?
86. Are intraday exposures limited to amounts expected to be received the same day?
87. Are intraday overdraft limits established in consideration of other types of credit facilities for the same customer?
88. Is an intraday posting record kept for each customer showing opening collected and uncollected balances, transfers in, transfers out, and the collected balances at the time payments are released?
89. If payments exceed the established limits, are steps taken in a timely manner to obtain covering funds?
90. When an overnight overdraft occurs, is a determination made as to whether a fail caused the overdraft? If so, is this properly documented? Is adequate follow-up made to obtain the covering funds in a timely manner?

## CONCLUSION

91. Is the information covered by this ICQ adequate for evaluating internal controls in this area? If not, indicate any additional examination procedures deemed necessary.
92. Based on the information gathered, evaluate the internal controls in this area (i.e. strong, satisfactory, fair, marginal, unsatisfactory).