



Federal Reserve Bank of Atlanta

Overview of the Components of an Effective Audit Function

The purpose of this pamphlet is to give directors and managers who are responsible for the oversight of bank internal audit programs a general overview of the components of an effective audit function. This overview includes the supervisory expectations to consider when developing an institution's internal audit policy and audit committee charter. This document is intended for informational purposes only and therefore cannot substitute for formal supervisory guidance.

INTRODUCTION

To ensure the safe and sound operation of a financial institution, the board of directors and senior management must have in place an effective system of internal controls, including internal audit. On March 17, 2003, the Federal Reserve reaffirmed this expectation with the issuance of Supervision and Regulation (SR) Letter 03-05, "Interagency Policy Statement on the Internal Audit Function and Its Outsourcing," which provided audit-related guidance to all bank holding companies, state member banks, and the U.S. operations of foreign banking operations. When the internal audit function is properly structured and conducted, it gives directors and senior management vital information about the condition of the system of internal controls and identifies weaknesses so that management can take prompt, remedial action.

In addition, under the "Interagency Guidelines Establishing Standards for Safety and Soundness," pursuant to section 39 of the Federal Deposit Insurance Act (FDI Act) (12 USC 1831p-1), each institution must have an internal audit function appropriate to its size and the nature and scope of its activities.

AUDIT FUNCTION/GOVERNANCE

Generally, insured banks with consolidated assets of more than \$500 million are required to establish an audit committee. However, the board of directors may fulfill the responsibilities of the audit committee if the institution is not required by law to establish one. To establish an effective internal audit function, the board of directors (or its audit committee) should establish an audit policy that outlines the framework and standards for which the audit function is expected to operate. The policy and audit committee charter should take into consideration the size and complexity of the bank, with consideration given to the development of the following documents: Audit Committee Charter, Internal Audit Charter, Internal Audit Policy, and Internal Audit Procedures.

SR Letter 03-05 also suggests that directors consider whether an institution's internal audit activities are conducted in accordance with internal audit professional standards, such as the Institute of Internal Auditor's (IIA) Standards for the Professional Practice of Internal Auditing (Standards). The IIA Standards acknowledge that no single policy will meet the needs of every audit committee or audit function. For example, larger institutions have more formal policies and procedures, while smaller ones may have fewer, less complex policies that articulate the basic needs of the organization. More important than the number of documents is the existence of written, board-approved documentation to support the purpose of the audit function.

Some of the following audit policy components are incorporated within IIA Standards, while others represent industry best practices.

COMPONENTS OF AN AUDIT COMMITTEE CHARTER

Note: In the absence of an audit committee, these responsibilities should be outlined in official board-approved documentation.

Purpose: The charter should identify the purpose of the audit committee. Components of the purpose statement may include, but should not be limited to, assisting the board of directors, fulfilling oversight responsibilities for financial reporting and internal controls, overseeing the audit process, and monitoring compliance with laws and regulations.

Authority: The charter should define the audit committee's authority. The paragraph may include the committee's authority regarding external auditors, disagreements between management and auditors, approving audit services, retaining experts (such as legal or accounting), and meeting with officers, auditors, or outside counsel.

Composition: The charter should articulate the composition of the audit committee, including the number of members, how the members are selected or elected, qualifications of the members, and independence.

Meetings: The charter should clearly communicate the number of mandated meetings, the authority to call special meetings, attendance requirements for the committee members, the members' ability to invite bank management to attend, the authority to man-

date executive sessions with both internal and external auditors without management present. Also, consistent with IIA Practice Advisory standards, the chief audit executive should draft the audit committee's meeting agenda for the chairman's review, facilitate the distribution of meeting materials to audit committee members, and write-up the minutes of audit committee meetings.

Responsibilities: One of the most important components of the charter is to articulate the committee's responsibilities, which may include:

- Review and approve audit's risk assessment methodology and the resulting risk assessment.
- Review and approve the annual audit plan and changes to the plan.
- Review and approve internal audit policy(ies).
- Review financial statements.
- Monitor compliance with applicable regulations.
- Monitor progress and outcome of special investigations.
- Review audit reports.
- Monitor remediation of audit and regulatory examination issues.
- Ensure internal auditors have unrestricted access to all areas of the bank.
- Provide final approval of the selection of qualified external auditors and the scope of audit work.
- Meet with internal and external auditors on a regular basis.
- Review independence of internal and external auditors.
- Establish and maintain procedures for employees to confidentially submit concerns related to questionable accounting, internal control, or auditing matter.
- Investigate complaints in a timely manner and maintain documentation of findings and resolution.
- Review and assess the adequacy of the audit committee charter annually.
- Coordinate reporting to the full board.
- Perform other activities as requested by the board.

POLICY COMPOSITION

Whether the bank's internal audit activities are outsourced or conducted in-house, management should consider the following components when developing an internal audit charter and/or policy:

Policy objective/Purpose: The policy should address the objectives of the internal audit function. Phrases to describe the purpose of the function often include “conduct independent audit and objective assurance,” “provide advisory services,” “add value,” “improve the institution’s operations,” “help the institution accomplish objectives,” and “improve risk management, control, and governance processes.”

Scope of work: Although some banks address the scope of work within the purpose statement, some choose to make it a separate, more detailed section. The scope of work should address the review and approval of the audit universe, audit risk assessment, audit plan, and work performed.

Authority: The policy should mandate the auditor’s authority, including unrestricted access to all business units, documents, and employees.

Independence/Institutional structure: Careful thought should be made with regard to the placement of the audit function within the institution’s management structure. The board should evaluate the auditor’s independence and document mitigating controls.

Auditing standards: The bank’s audit policy (or charter) should identify how the audit function provides reasonable assurance as to the effectiveness of the system of internal controls. Regulatory guidance suggests that directors consider whether the institution’s internal audit activities are conducted in accordance with professional standards, such as the IIA’s Standards for the Professional Practice of Internal Auditing. These standards address independence, professional proficiency, scope of work, performance of audit work, management of internal audit, and quality assurance reviews. It is the responsibility of the board of directors (or audit committee) to determine the extent of auditing that will effectively monitor the institution’s system of internal controls.

Outsourcing/Third parties: Although many community banks use an outsourcing arrangement to execute internal audit activities, the ultimate responsibility for ensuring an effective system of internal controls rests with the board of directors and senior management. It is therefore incumbent on the board to establish a policy that governs the vendor management aspect of the outsourced relationship. Policy considerations would

include the contract provisions, assessments of vendor competence, communication between the vendor and the institution, requirement that work products will be owned by the institution and subject to regulatory review, and contingency planning.

External auditor restrictions: In January 2013, the Federal Reserve issued SR Letter 13-1, “Supplemental Policy Statement on the Internal Audit Function and Its Outsourcing,” which applies to institutions with consolidated assets of greater than \$10 billion. However, SR Letter 13-1 provides for one important exception in that the external auditor of an institution with consolidated assets of greater than \$500 million is precluded from also performing internal audit services. This restriction is consistent with the 2009 amendments to Section 36 of the FDI Act. Though not required, institutions that fall below the \$500 million threshold are also encouraged to preclude their external auditors from performing internal audit services.

Procedures: (Based on the size and complexity of the institution, these items may be detailed in the policy or detailed in an audit procedures manual.) At a minimum, procedures should include the following:

- Risk assessments: Identification of the risk assessment methodology, including responsibility for preparation, risk rating definitions, frequency of updates, approval, and change control processes. An audit procedures manual may include methodology and details.
- Audit plan: Identification of the audit universe, corresponding risk rating (determined during the risk assessment process), audit cycle/frequency requirements, person responsible for change control, and mandates for audit committee annual review and ongoing reporting of status and changes.
- Reporting: Identification of management reporting distribution requirements, report content requirements, timeliness of report preparation, definitions of report and/or issue ratings, management response requirements (correction action plan, management responsibility for corrective action, and targeted remediation date), and reporting to the audit committee.
- Issue tracking and follow-up: Identification of requirements related to monitoring remediation of issues noted, validation of corrective actions, and board (audit committee) updates.

Reporting: The policy should include various types of reporting, frequency, and distribution.

Other: The policy should also include items related to record retention requirements for work papers, policy and procedural processes for sharing work papers with regulators, and the approval process for auditors to complete tasks outside of those defined as internal audit responsibilities.

REFERENCE SOURCES

- Institute of Internal Auditors' Standards for the Professional Practice of Internal Auditing and associated Practice Advisory guidance
- American Institute of Certified Public Accountants
- Supervisory Letter 03-05, "Interagency Policy Statement on the Internal Audit Function and its Outsourcing"
- Supervisory Letter 13-1, "Supplemental Policy Statement on the Internal Audit Function and its Outsourcing"
- Board of Governors of the Federal Reserve System Commercial Bank Examination Manual, Section 1010-Internal Control and Audit Function, Oversight, and Outsourcing
- Section 36 of the FDI Act (as implemented by FDIC regulation 12 CFR 363)
- The Sarbanes-Oxley Act of 2002 (Pub. L. No. 107-204)

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