1995

Banks and savings institutions audit manual, Volume 1

John C. Compton

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AICPA

Banks and Savings Institutions Audit Manual

INTEGRATED PRACTICE SYSTEM

VOLUME 1

AICPA

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Banks and Savings Institutions Audit Manual

Authors:
John C. Compton, CPA
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INTEGRATED

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This Manual has not been approved, disapproved, or otherwise acted upon by any senior technical committees of the American Institute of Certified Public Accountants or the Financial Accounting Standards Board and has no official or authoritative status.

The Manual is issued as a nonauthoritative kit of practice aids and is not intended as a substitute for professional judgment or for authoritative technical literature.

The documentation in this Manual is not a substitute for development and implementation by a firm of a system of quality control that is appropriately comprehensive and suitably designed in relation to the firm's organizational structure, its policies, and the nature of its practice.

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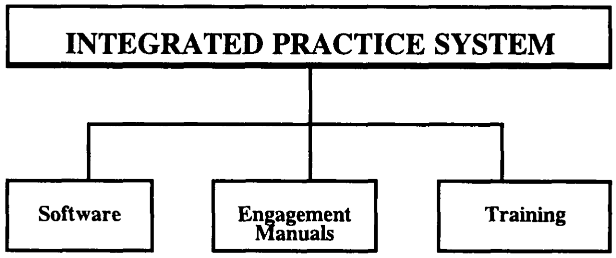
The AICPA Integrated Practice System:
For CPAs Concerned About Quality and Profitability



The Integrated Practice System gives practitioners the tools they need to conduct high-quality and cost-effective engagements. How? By enabling CPAs to anticipate engagement problems and by putting the solutions to these problems — integrated engagement manuals, software products, and training resources — within their grasp.

ONE SYSTEM, ONE SOLUTION

This innovative system is the *first* integrated system that is specifically designed to enhance the quality of your practice. It offers guidance on the day-to-day management of client engagements and provides practical discussions on the applicability of authoritative literature. Each element of the system — manuals, software, and training — was developed by CPAs who recognized the need to provide a comprehensive, hands-on approach to engagement planning and performance. Working alone or as a unified system, Integrated Practice System products provide the solutions needed for a firm to achieve top-quality performance and bottom-line profitability.

INTEGRATED PRACTICE SYSTEM — IN A CLASS BY ITSELF

Significant advantages distinguish these tools from other commercially available products. The Integrated Practice System tools —

- **Represent an integrated, synergistic system** that is state-of-the-art.

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  Engagement Manuals 800-TO-AICPA (800-862-4272)

  Software Products 800-226-5800

  Training 201-938-3060

- **Receive ongoing field-testing and evaluation** from a task force of the AICPA's Private Companies Practice Section (PCPS) — CPAs who confront similar challenges in their practices and who represent the interests of local and regional firms.

- **Include a 60-day "no-questions-asked" return guarantee** that allows you the time to try the Integrated Practice System products and find out for yourself how your firm and staff can benefit from them.

ENGAGEMENT MANUALS: THE SMART KID ON THE BLOCK

Finally, there is a reliable, step-by-step approach for managing and performing your engagements. The Engagement Manuals point you in the right direction with the time-saving tools you need to conduct high-quality engagements with the greatest efficiency. Right from the start, the Engagement Manuals show you a direct route to protecting your bottom line. You can minimize on-site field work and put an end to "over-auditing" because our exclusive "ABC System" helps you evaluate risk in the critical planning stage. You'll find important guidelines to use in evaluating your client, so that you can adjust the level of testing to the internal controls employed by the client.

The Engagement Manuals feature a practical, "how-to" approach that enables you and your staff to cut through the clutter and focus on what's important. By eliminating time-consuming guesswork, they chart the course to the most cost-effective, efficient way of proceeding with your engagement. Plus, the manuals include ready-to-use forms, programs, checklists, and questionnaires — even sample correspondence to speed your work.

Each Engagement Manual includes —

- Guidance based on the most recent relevant authoritative and non-authoritative literature;
- Integrated work programs and checklists;
- Model letters ready for your use;
- Time-saving worksheets that capture important information and also help users identify opportunities for other services that can be provided to existing clients, such as consulting and tax services and the preparation of prospective financial information.
- Diskettes, in WordPerfect format, that include all the sample letters and accountant's/auditor's reports included in the manual.

What's more, the Engagement Manuals ease the process of quality review by helping you develop the documentation you need.

The Engagement Manuals can be easily used as stand-alone practice aids. Or, you can use them in conjunction with the full complement of software products — including the AICPA's very successful Accountant's Trial Balance (ATB) and Audit Program Generator (APG). It's the flexibility you need for a cost-efficient, high-quality engagement.

The AICPA recognizes your need to be up-to-date on issues that affect your clients — that's why subscribers automatically receive annual updates for the engagement manuals. Our goal, pure and simple: to provide the answers to your questions even before you ask them.

Because the AICPA has an ongoing commitment to developing the practice aids you need to serve your clients, it will continue to release new industry-specific manuals. These will contain the same kind of practical tools and how-to guidance that are the hallmarks of the Engagement Manuals.

Comprehensive Engagement Manual

The *Comprehensive Engagement Manual* can help practitioners manage most engagements. Designed to be the accountant's companion to audit, review, and compilation engagements, this manual includes checklists, forms, flowcharts, questionnaires, tables, and all the documentation necessary for any size client.

This four-volume set covers engagement performance, documentation and reporting, and helps you make key decisions, including —

- Assessing risk and establishing materiality limits;
- Selecting the most cost-beneficial audit approach;
- Designing the most economical auditing procedures; and
- Making sampling decisions that maximize efficiency.

The *Comprehensive Engagement Manual* features the unique and highly-popular "ABC System" that enables practitioners to identify the most cost-beneficial mix of tests of controls, substantive tests of balances, and analytical procedures for specific engagements. This manual is ideal for firms that want a system they can apply to the full spectrum of audit engagements — whether they plan to perform tests of controls or a totally substantive audit.

Small Business Audit Manual

The two-volume *Small Business Audit Manual*, an alternative to the *Comprehensive Engagement Manual*, walks you through each step of the audit of a small business client. Designed for firms that use a substantive testing approach on all of their audits, the *Small Business Audit Manual* helps you to:

- Plan a cost-effective and time-efficient engagement;
- Verify all financial statement assertions using substantive tests;
- Understand a client's internal control structure;
- Better understand how to apply authoritative standards to small business audits;
- Evaluate a small business' computer needs.

The *Small Business Audit Manual* also puts at your fingertips sample audit programs, questionnaires, model letters, time sheets, workpapers, and audit reports for a small business audit engagement — organized in the sequence they will be used. If your firm's audits rely totally on substantive testing, this is the manual for you.

Banks and Savings Institutions Audit Manual (formerly the Bank Audit Manual)

The three-volume *Banks and Savings Institutions Audit Manual* can help you cope with the high risk generally associated with bank/savings institution audits and the complexity of their operations. It is designed to enable you to perform high-quality engagements with maximum time savings. Based on the unique "ABC System," this manual allows you to design the most efficient and cost-effective mix of tests of controls and substantive tests of balances, and analytical procedures. It does so by including:

- A framework to help practitioners design the most cost-effective audit strategy;
- Worksheets and forms to help auditors understand a financial institution's internal control structure and assess risk during engagement planning.
- Programs for interim work;
- Sampling documentation and discussions of professional standards that affect the sampling decision;
- Worksheets for various analytical procedures that can help to identify errors and irregularities;
- The AICPA Audit and Accounting Guide, *Audit of Banks*.

Construction Contractors Audit Manual

You'll find this two-volume manual your most valuable practice aid when working on engagements for construction contractors. It contains:

- Two audit approaches—the "System's Walk-through Approach" for substantive audits and the "ABC System" — to help you design the most efficient and effective audit strategy for each engagement;
- Practical, how-to guidance for completing construction contractor audits;
- A chapter dedicated to the surety industry to help you understand what the surety wants and needs;
- All the necessary audit programs, forms, checklists, sample correspondence, and working papers to comply with today's quality control standards;
- A supplemental tax preparation checklist specific for construction contractors;
- The AICPA Audit and Accounting Guide, *Construction Contractors*, which contains discussions on the applicability of specific professional standards to engagements for construction contractors.

Compilation and Review Manual

This two-volume set gives you a step-by-step system to help you conduct high quality compilation and review engagements — profitably and in compliance with all current applicable professional standards. It contains:

- Programs, checklists, and sample correspondence for performing compilation and review engagements;
- Reporting guidance for OCBOA and personal financial statements;
- Guidance on performing and reporting on prospective financial information.

Credit Union Audit Manual

The two-volume set outlines the most efficient way to approach audits of credit unions and contains guidance on conducting them in compliance with current professional standards. This manual uses the "ABC System" and a newly designed audit strategy for small credit unions, which allows you to choose the best mix of tests of controls and substantive tests of balances, and analytical procedures for each engagement. This manual contains:

- Audit programs, forms, checklists, working papers, and illustrations necessary to perform credit union audits and supervisory examinations;
- The AICPA Audit and Accounting Guide, *Audits of Credit Unions*;
- The most recent checklists and illustrative financial statements for credit unions.

Quality Control Manual for CPA Firms

The *Quality Control Manual for CPA Firms*, gives you a step-by-step practical approach to establishing and maintaining your quality control system. Written by CPAs who have extensive peer review experience, it provides all of the guidance and forms you will need, without overburdening you with unnecessary and complex documentation. This manual can be used by firms of all sizes, but its simple approach was designed with the small-to-medium-size firm in mind.

Not-for-Profit Organizations Audit Manual

The two-volume *Not-for-Profit Organizations Audit Manual* contains everything you need to conduct high-quality audits—audit programs, forms, checklists, and sample auditor's reports and financial statements developed especially for not-for-profit organization audits. Also discussed in this manual are two recently-released FASB Statements of Financial Accounting Standards on contributions and not-for-profit organizations' financial statements, as well as FASB's exposure draft on investments, the proposed AICPA Statement of Position on joint activities, and the AICPA's proposed Audit and Accounting Guide for not-for-profit organizations. The manual also helps you efficiently test the compliance requirements of the Yellow Book and OMB Circular A-133.

Auto Dealership Engagement Manual

The *Auto Dealership Engagement Manual* guides you through the twists and turns of an auto dealership audit. Developed to help you conduct effective and efficient engagements in this turbulent industry, it provides guidance that until now has been lacking. This manual includes:

- Two audit approaches — the All Substantive Approach for primarily substantive audits and the unique "ABC System" for audits in which it is efficient to test controls;
- An overview of the industry, including operating characteristics;
- Tailored audit programs and internal controls questionnaire;
- Discussion of auto dealership's unique accounting principles and practices;
- Sample auditor's reports and financial statements; and
- Tax information, including complex LIFO calculations and extended warranty service revenue recognition rules.

SOFTWARE — THE ELECTRONIC EDGE

The AICPA's software products — ATB Write-Up, Accountant's Trial Balance (ATB) and its modules, Audit Program Generator (APG), Engagement Manager (EM) and Depreciation, among others — put the solutions to daily practice problems at your fingertips. Together with the Engagement Manuals, they streamline engagement planning and performance, and enable you to more effectively monitor your staff and your budget. Most importantly, they prevent you from reinventing the wheel each time you plan and conduct an engagement.

It's easy to put these products to work for you. The software requires an IBM PC, XT, AT, PS/2 or IBM-compatible system and DOS version 3.1 or higher. A team of professionals is available to answer any of your questions; simply call the Software Support Hotline at 800-226-5800 or use the Software Express FAX service at 800-226-6868.

ATB Write-Up

ATB Write-Up features powerful options that let you analyze information and generate reports and financial statements quickly and easily. ATB Write-Up takes all of the power and flexibility of ATB, ATB Financial Statements, and ATB Consolidations and adds to it. ATB Write-Up offers:

- Period Reporting — Use up to 13 periods per year. This gives you the flexibility to generate annual, semiannual, quarterly or monthly reports.

- Departmental Reporting — Set up as many departments as you need. ATB Write-Up will print most workpapers and reports by department, in total for all departments, or for a selected range of departments.
- Financial Statements — Up to 16 columns, each custom-definable to include periods, departments, year-to-date, percentages, add columns together, and more.
- Consolidations — Link and combine accounts of related groups into one consolidated company.

Accountant's Trial Balance

ATB, the best-selling, most-used accounting software in the profession today, is an integral part of the IPS family. Designed ***by*** accountants ***for*** accountants and used by approximately 9,000 accounting firms, ATB automates much of the routine work associated with trial balance and financial statement preparation. Specifically, it:

- Generates picture-perfect working papers, including trial balances, journals, lead schedules, user-definable grouping schedules, and analytical review worksheets;
- Enables users to prepare trial balances based on GAAP, federal tax, state tax, or other user-selected accounting bases;
- Keeps up to five years of data on file for any one client, enabling you to generate a variety of comparative reports quickly and simply.

Modules for Use with ATB 3.0

- *ATB Financial Statements* — This powerful report writer enables you to produce final financial statements quickly and easily.
- *ATB Consolidations* — This module enables you to consolidate trial balances from up to nine individual companies into one ATB company trial balance — with ATB automatically keeping track of all activities.
- *ATB Conversion* — With ATB Conversion you can transfer any data electronically from a number of general ledger and working paper packages to ATB and from ATB to leading corporate tax preparation packages.

Audit Program Generator

The Audit Program Generator (APG) enables you to customize an audit program or a checklist to a particular client. Its unique features help you save time and unnecessary expense in conducting audits. Since its introduction in 1987, over 8,000 firms have used APG.

APG Version 2.0 enables you to —

- Create a variety of programs and checklists, including audit programs, disclosure checklists, and compliance checklists;
- Tailor the audit program to the needs of your specific client;
- Customize programs from a wide variety of sample AICPA work programs available in electronic format;
- Quickly link your audit procedures and financial statement assertions;
- Use a full-text editor to customize titles and footers and create appropriate tabular formats.

Engagement Manager

The Engagement Manager (EM) software package can assist you in planning, analyzing, documenting, and correcting engagement management problems — and free up valuable staff time in the process. Most importantly, it handles the details of creating and modifying budgets, recording actual time and expenses, and comparing results so you can devote your energy to other aspects of your business. With EM's help, you can:

- Anticipate potential budget variances and delays through a variety of analytical reports;
- Spot potential problems while there is time to take action;
- Determine the effectiveness of individual staff members by analyzing their efficiency in assigned areas.

Depreciation

Depreciation provides a simple and efficient means of calculating and tracking how assets are depreciated. It calculates depreciation for six separate reporting bases: book, federal, state, AMT, ACE, and "other." What's more, it lets you apply various methods of depreciation to any of these reports and prints out complete worksheets showing changes in various property accounts and the necessary journal entries to record depreciation for the year. Now, with its pull-down menus, Depreciation is easier to use than ever.

Reports generated through AICPA Depreciation include:

- Depreciation schedules by category, G/L account number, system, or convention
- Summarized worksheet information for Forms 4255, 4562, 4626, 4797, 6252, and Schedule D
- AMT preference calculation
- ACE adjustment calculation
- Fully depreciated assets report
- Amortization report
- Section 179 deduction report
- ITC-taken report
- Basis comparison
- Depreciation account reconciliation
- Amortization account reconciliation
- Schedule M-1 information
- Overridden calculations

TRAINING RESOURCES: MAKING THE INTEGRATED PRACTICE SYSTEM WORK FOR YOU

Whether you're a user of one or more of the Integrated Practice System products or you're looking for ways to more effectively manage engagements, Training Resources can benefit you. You'll learn how the Engagement Manuals and Software can help your practice run more smoothly and how the system works to facilitate productivity, efficiency, and quality performance by you and your staff.

The Training Resources come in three formats: self-study or self-administered group study; customized in-house group study; and conferences. Here is what's available in each format:

Self-Study or Self-Administered Group Study

An ***Orientation and Technical Update Seminar*** is a formal group study-program designed to assist firms with initially implementing the Integrated Practice System Engagement Manuals. It also provides a monitored self-study orientation on the manuals for new staff. The seminar materials can help you to better understand and apply common SASs in the most efficient manner. You'll learn how to design tests, auditing procedures and sample sizes to collect the right amount of evidence needed for particular engagements.

Accountant's Trial Balance — CPE Edition is a self-study course that teaches you how to automate your working papers for all types of engagements. You'll earn eight hours of CPE credit as you become familiar with ATB and its most used features for audits, reviews, compilations, and tax working papers.

Accountants Trial Balance With Financial Statement Generator — CPE Edition is a self-study course that enables you to rapidly learn the basics of ATB and the Financial Statement Generator add-on module. The recommended CPE credit for this course is eight hours.

Customized In-House Group Study

Special in-firm training is available to demonstrate how your firm can put the Integrated Practice System products to use. And you'll see immediate results. That's because the training leader will use a current client engagement ***you select*** as the training model. Whether you select a one- or two-day training program, you'll learn how IPS products can help you address real client needs and resolve specific client problems.

AICPA Conferences

Training sessions focusing on the Engagement Manuals are part of many AICPA conferences designed for local and regional practitioners, including the highly rated PCPS Conference and the National Accounting and Auditing Advanced Technical Symposium.

To schedule in-firm training or to obtain more information about the Integrated Practice System Training Resources, including dates and locations of these conferences, call the AICPA Technical Information Division at (201) 938-3060.

AICPA INTEGRATED PRACTICE SYSTEM
BANKS AND SAVINGS INSTITUTIONS AUDIT MANUAL

PREFACE

The AICPA *Banks and Savings Institutions Audit Manual* is a comprehensive tool kit to plan, perform, and report on an audit of the financial statements of a bank or savings institution. The overall approach presented in this Manual is designed to maximize quality and efficiency. This Manual includes all the essentials — checklists, forms, questionnaires, and tables. Our systematic approach provides guidance on engagement performance, documentation, and reporting.

This Manual is designed to comply with all applicable accounting and auditing pronouncements. References are made throughout to the authoritative pronouncements and cited to section numbers in AICPA *Professional Standards* and the FASB *Accounting Standards — Current Text*. Practitioners are encouraged to refer directly to the applicable technical literature.

The Manual's thorough documentation is an integral part of a firm's overall quality control system. All the documentation is explained and illustrated in the Manual.

This three-volume Manual contains all of the documentation necessary to complete a bank/savings institution audit engagement, arranged in the order it normally will be needed in the engagement:

- Client Acceptance and Continuance Form
- Sample engagement Letter
- Planning Memorandum
- Materiality Computation Form
- Preliminary Financial Institution Survey Questionnaire
- Interim Work Assignment Program
- Risk of Potential Misstatements Evaluation Form
- Planning Matrix
- Sampling documentation
- Internal Control Structure Questionnaire and Tests of Controls Programs
- Documentation of the EDP System
- Internal Control Structure Reportable Conditions Form
- Tests of Balances Audit Programs
- Illustrative correspondence and working papers
- Summary of Possible Journal Entries Form
- Audit Reporting and Disclosure Checklist

In addition, the Manual contains quality control and management supervision documents:

- Consultation forms
- Representation letters
- Engagement performance and review checklists
- Financial Statement Control Form
- Budgeting and time control documents

The *Banks and Savings Institutions Audit Manual* maximizes opportunities for additional services. Its checklists and other documentation are sources of meaningful suggestions that can be presented to clients and that ultimately may result in the performance of additional services.

Achieving both engagement quality and profitability requires extensive planning. The *Banks and Savings Institutions Audit Manual's* forms, checklists, and decision matrices are documents that require planning to begin before any field work is done and to continue until engagement completion. The documents included in the Manual allow for timely partner review and involvement in the audit design and execution. Preparing and reviewing documentation helps develop skills of the in-charge and other staff and helps to identify problems early.

The *Banks and Savings Institutions Audit Manual* is designed to permit maximum flexibility in the approach to engagements. All the programs are designed to fit the client circumstances encountered.

ABOUT THE AUTHORS

JOHN C. COMPTON, CPA

John Compton, CPA, currently partner-in-charge of the Greensboro, North Carolina office and Chairman of the Accounting and Auditing Committee of Cherry, Bekaert & Holland, a regional accounting firm with offices throughout the Southeast. In addition, he currently serves as the Chairman of the National Banking School at the University of Virginia and is a member of the AICPA's Accounting Standards Executive Committee and is the immediate past-chair of the AICPA Accounting and Review Services Committee, and a former member of the Technical Issues Committee of the AICPA Private Companies Practice Section, the AICPA Auditing Standards Board, and the AICPA Banking Committee.

Prior to joining Cherry, Bekaert & Holland in 1970, Mr. Compton was associated with Peat Marwick in its Greenville, South Carolina office and served as Treasurer of Henderson Advertising Agency, Inc., one of the 20 largest agencies in the United States, also located in Greenville.

GEORGE L. MARTHINUSS, JR., CPA, CFP

George Marthinuss, CPA, CFP, is president of CPE Institute, Inc. and a former partner in the regional firm of Keller, Zanger, Bissell & Company in Rockville, MD. He has over 25 years of experience in public accounting for national, regional, and local firms.

Mr. Marthinuss holds an MBA from the University of Maryland, where he was also an instructor and the faculty advisor to Beta Alpha Psi. Mr. Marthinuss is past chairman of the AICPA Accounting and Review Services Committee and formerly served on the AICPA CPE Curriculum & Quality Control Subcommittee. He is an active member of the Institute of Certified Financial Planners, the International Association of Financial Planning, the Construction Financial Management Association, and the Suburban Maryland Building Industry Association.

ROBERT DURAK, CPA

Robert Durak is a technical manager with the AICPA's Technical Information Division. He holds a B.S. from Rutgers University and was previously an audit manager with Deloitte & Touche, LLP.

PEER REVIEW OF THE AICPA INTEGRATED PRACTICE SYSTEM

BANKS AND SAVINGS INSTITUTIONS AUDIT MANUAL

In keeping with our commitment to give you reliable practice aids, we engaged the CPA firm, Baird, Kurtz & Dobson, to perform a peer review of the *Banks and Savings Institutions Audit Manual*. Using quality control materials that have been peer reviewed serves two purposes: (1) it provides reasonable assurance that the materials are reliable practice aids; and (2) it helps to minimize the cost of your firm's peer review.

A copy of Baird, Kurtz & Dobson's unqualified peer review report is included on the following page. This report has been accepted by the Private Companies Practice Section and the SEC Practice Section of the AICPA's Division for CPA Firms. Although the report addresses the 1994 edition of this Manual, it is valid for three years.

Baird,
Kurtz &
Dobson

Certified
Public
Accountants

January 24, 1995

The Board of Directors
American Institute of Certified
Public Accountants

We have reviewed the system of quality control for the development and maintenance of the 1994 edition of the *Bank Audit Manual* (materials) of the **AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS (AICPA)** in effect for the year ended December 31, 1994 and the resultant materials in effect at December 31, 1994, in order to determine whether the materials are reliable aids to assist users in conforming with those professional standards the materials purport to encompass. Our review was conducted in accordance with the standards for reviews of quality control materials promulgated by the peer review committees of the Private Companies Practice Section and the SEC Practice Section of the AICPA Division for CPA Firms.

In performing our review, we have given consideration to the following general characteristics of a system of quality control. An organization's system for the development and maintenance of quality control materials encompasses its organizational structure and the policies and procedures established to provide the users of its materials with reasonable assurance that the quality control materials are reliable aids to assist them in conforming with professional standards in conducting their accounting and auditing practices. The extent of an organization's quality control policies and procedures for the development and maintenance of quality control materials and the manner in which they are implemented will depend upon a variety of factors, such as the size and organizational structure of the organization and the nature of the materials provided to users. Variance in individual performance and professional interpretation affects the degree of compliance with prescribed quality control policies and procedures. Therefore, adherence to all policies and procedures in every case may not be possible.

Our review and tests were limited to the system of quality control for the development and maintenance of the aforementioned materials of the AICPA and to the materials themselves and did not extend to the application of these materials by users of the materials nor to the policies and procedures of individual users.

In our opinion, the system of quality control for the development and maintenance of the quality control materials of the AICPA was suitably designed and was being complied with during the year ended December 31, 1994 to provide users of the materials with reasonable assurance that the materials are reliable aids to assist them in conforming with those professional standards the materials purport to encompass. Also, in our opinion, the quality control materials referred to above are reliable aids at December 31, 1994.

Baird, Kurtz & Dobson

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International

SUGGESTED REVISIONS TO MANUALS

Please submit all suggestions to improve the quality of this manual as they arise. We value users' input and will give all comments consideration when revising the manual.

To:
Susan Menelaides, CPA, Director
Technical Information Division
AICPA
Harborside Financial Center
201 Plaza Three
Jersey City, NJ 07311-3881

From:

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(Name)

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Manual: ____________________

Suggested Revisions:

Page No.	Comments

(Please attach additional sheets if necessary)

AUDIT MANUAL ADVISORY TASK FORCE

The manuals in the AICPA Integrated Practice System (IPS) are monitored by a special PCPS Audit Manual Advisory Task Force. Task force members use the manuals in their audit and accounting practices and continuously provide the AICPA staff with recommendations to enhance the manuals from the perspective of the small- and medium-sized firm.

MEMBERS OF THE AICPA PRIVATE COMPANIES PRACTICE SECTION (PCPS)
AUDIT MANUAL ADVISORY TASK FORCE

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AICPA INTEGRATED PRACTICE SYSTEM
BANKS AND SAVINGS INSTITUTIONS AUDIT MANUAL

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CHAPTER 1

INTRODUCTION

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CHAPTER 1

INTRODUCTION

1.000 PURPOSE OF THE MANUAL

1.001 The purpose of this Manual is to provide engagement-oriented documentation for use on bank and savings institution audit engagements. While the documentation and references in this Manual are an integral part of a firm's quality control system, the Manual is not intended to serve as a complete or comprehensive quality control system.

1.002 The documentation in this Manual is designed primarily for audits of nonpublic, historical bank and savings institution financial statements performed in accordance with generally accepted auditing standards (GAAS). Directors' examinations, audits of publicly held banks, agreed-upon procedures engagements, and other special engagements may require additional procedures and documentation. Appendix A to this Manual provides guidance concerning Directors' examinations.

1.003 The information in this Manual is tailored to take into account the unique operating characteristics of financial institutions. Included are useful checklists and questionnaires to incorporate into financial institution audits.

NOTE: The terms "financial institution", "bank", and "savings institution" are used interchangeably throughout this manual; except when a section is explicitly concerned with a particular type of institution.

Organization of the Manual

1.004 This year's edition of the Manual has been reorganized to provide a more efficient and easier-to-follow format. The organization of the Manual is similar to the other industry-specific Manuals in the Integrated Practice System series. This Manual is arranged so that each chapter is the "next step" in the audit process, from planning to completing the audit. In a separate section at the end of each chapter are the applicable forms discussed in the chapter. See Illustration No. 1-1 for a summary of this reorganization. A discussion of the contents of the chapters in this Manual follows.

1.005 Chapter 1 discusses the purpose and use of this Manual on bank audits.

1.006 Chapter 2 explores the banking industry, including the regulatory environment in which banks and savings institutions operate, risk management, and other environmental forces.

1.007 Chapter 3 addresses the auditor's considerations in deciding whether to accept or continue a relationship with a client and audit planning requirements. Included are discussions of client acceptance and continuance, planning documentation, budgeting tools, and risk assessment.

1.008 Chapter 4 describes the unique "ABC System" which provides a framework for obtaining an understanding of the internal control structure, assessing control risk and designing an audit strategy. Emphasis is placed on a flexible method of customizing audit procedures and documentation. This approach is also followed in the AICPA's Integrated Practice System Comprehensive Engagement Manual, and in the other industry-specific manuals in the Integrated Practice System series.

1.009 Chapter 5 discusses the internal control structure of a bank. Included in this chapter are useful tools that assist in documenting and evaluating the control structure and performing tests of controls.

1.010 Chapter 6 includes guidance on substantive testing for banks and savings institutions including specially tailored analytical procedures and test of balances programs.

1.011 Chapter 7 contains information about the final phases of the audit. Included in this chapter are a sample representation letter and checklists documenting the supervision and review of the audit work performed.

1.012 Chapter 8 considers financial statement presentation and disclosure requirements and auditor's reporting requirements. It includes illustrative financial statements, disclosure and auditor's report checklists, and sample auditor's reports.

1.013 **New for the 1995 Edition**. Chapter 9 discusses certain consulting services that auditors can provide to their financial institution clients.

1.014 Chapter 10 is a four credit hour self-study course. The topics of this course are the bank industry in general, the internal control structure of a bank, and the confirmation process in a bank audit. This course will give up to three members of your firm the opportunity to earn these four CPE credits, while enhancing their auditing skills. This CPE course was included in the 1994 edition of the Manual. Any firm members who have already received CPE credit for completion of this course cannot receive additional CPE credit for this course.

1.100 USE OF THIS MANUAL

1.101 This Manual is designed as a nonauthoritative practice aid. It is intended to provide users with practical "how-to" guidance in applying authoritative accounting and auditing literature in their bank and savings institutions audit engagements.

1.102 The sample audit programs, forms, and checklists included in this Manual should be tailored to each engagement's circumstances, and also to the firm's quality control policies and procedures.

1.103 This Manual includes standardized practice guidelines. The documents should be applied in practice only after considering the applicable promulgations of the American Institute of Certified Public Accountants (AICPA), the Financial Accounting Standards Board (FASB), the Securities and Exchange

Commission (SEC), and other state and federal regulatory agencies and laws, including the Office of Thrift Supervision (OTS) (which governs savings & loan institutions and savings banks) and the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA).

1.104 The financial statements of all insured depository institutions must be prepared in accordance with generally accepted accounting principles (GAAP) and the requirements set forth in the OTS regulations. OTS regulations contain extensive requirements applicable to accounting and reporting for federally insured institutions. OTS regulations specify the form and content of financial statements to be filed with OTS.

Updating of the Manual

1.105 This Manual will be updated annually to provide users with the most currenty authoritative guidance. This edition reflects the authoritative guidance issued through September 1995, including:

- Statement on Auditing Standards (SAS) No. 74
- SFAS No. 122
- SOP 95-2
- FASB Intgerpretation No. 41
- FASB Technical Bulletin No. 94-1
- Emerging Issues Task Force (EITF) Consensuses adopted up to and including the July 20-21, 1995 EITF meeting.

1.106 Users should be alert for pronouncements issued subsequent to those listed above that could affect their engagements.

References to Authoritative Literature

1.107 Throughout this Manual, references to publications containing authoritative literature have been included to help users perform research. The explanation of these references follows:

AC: Reference to section numbers in the Financial Accounting Standards Board (FASB) *Accounting Standards - Current Text.*

APB: AICPA Accounting Principles Board Opinion

ARB: Accounting Research Bulletin of the AICPA Accounting Principles Board

AU: Reference to section numbers in the American Institute of Certified Public Accountants (AICPA) *Professional Standards* (Vol. 1).

ET: Reference to the Code of Professional Conduct in the AICPA *Professional Standards* (Vol.2)

PC: Reference to the quality control standards in the AICPA *Professional Standards* (Vol.2)

SFAS: Statement of Financial Accounting Standards

FASBI: Statement of Financial Accounting Standards Interpretation

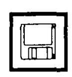
SOP: AICPA Statement of Position

1.200 USE OF FORMS IN ELECTRONIC FORMAT

WordPerfect

1.201 Enclosed with this year's edition of the Manual is a complementary disk that contains the sample engagement letters, representation letters, sample auditor's reports, and other correspondence illustrated in this Manual. The documents in the disk are in WordPerfect format which allow them to be customized as needed.

1.202 The documents contained on the disk are identified in the manual by the following icon:



Audit Program Generator

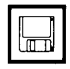
1.203 Many subscribers to the Integrated Practice System (IPS) Engagement Manuals are also users of the AICPA's Audit Program Generator (APG), a specially designed software program that allows you to customize a variety of AICPA work programs and checklists for each client. If you are already an APG user, you may purchase the Library Volume containing the programs and checklists included in this Manual. To order APG and/or the APG Libraries for the IPS Engagement Manuals, call the AICPA's Order Department at 1-800-862-4272, sub-menu #1. The product number for the Library Volume for banks and savings institutions is 016999 and is priced at $46.50. For APG product information, call the AICPA Software Connection at 1-800-226-5800.

1.204 The programs and checklists that are available in the APG Library Volume are identified by the following icon:

Lotus 1-2-3

1.205 Also included on the complementary disk is the Summary of Possible Journal Entries Form in Lotus 1-2-3 (release 3.1 with wysiwyg or release 3.4 and higher). This file provides a spreadsheet for the posting of unrecorded misstatements and contains formulas to calculate totals and percentages. If access to Lotus 1-2-3 is unavailable, the Form included in the section 7.906 of Chapter 7 may be copied for inclusion in the audit workpapers.

1.206 These documents are identified in the manual by the following icon:



1.300 RECENT ISSUANCES OF AUTHORITATIVE PRONOUNCEMENTS

1.301 The remaining sections of this chapter include guidance and descriptions of pronouncements, primarily issued or proposed in the past year, that are relevant to banks and savings institutions. Those pronouncements not deemed to be relevant to a bank or savings institution are not identified herein. Refer to Illustration No. 1-2 (section 1.407) to identify the level of authority the pronouncements have within the GAAP heirarchy.

SFAS No. 107, *Disclosures About Fair Value of Financial Instruments*

1.302 In December 1991, the FASB issued SFAS No. 107, *Disclosures About Fair Value of Financial Instruments*. This Statement requires companies to disclose the fair value of all financial instruments, whether or not recognized in the balance sheet. It defines fair value as the amount at which the instrument could be exchanged in a current transaction between willing parties, other than a forced or liquidation sale. The quoted price for a single trading unit in the most active market is the basis for determining market price and reporting fair value. Therefore, quoted market price multiplied by the number of trading units equals the fair value to be disclosed.

1.303 The Statement is effective for financial statements issued for fiscal years ending after December 15, 1992, or after December 15, 1995, for entities with less than $150 million in total assets in the current balance sheet. The disclosure checklist in chapter 20 includes the required disclosures for this Statement.

SFAS No. 114, *Accounting by Creditors for Impairment of a Loan,* as amended by SFAS No. 118, *Accounting by Creditors for Impairment of a Loan - Income Recognition and Disclosures*

1.304 In May 1993, the FASB issued SFAS No. 114, *Accounting by Creditors for Impairment of a Loan*, which addresses how creditors should account for impairment of certain loans including measurement, income recognition and disclosure requirements. SFAS No. 114 was subsequently amended by the issuance of SFAS No. 118, *Accounting by Creditors for Impairment of a Loan - Income Recognition and Disclosures*, and is effective concurrent with SFAS No. 114, that is for financial statements for fiscal years beginning after December 15, 1994, with earlier application encouraged. SFAS No. 118 does not change how loan impairment should be measured, but it does amend the disclosure requirements and eliminates the income recognition provisions of SFAS No. 114. As amended, SFAS No. 114 no longer specifies how a creditor should recognize, measure, and display interest income on impaired loans.

1.305 A loan is considered impaired when, based on current information and events, it is probable that a creditor will be unable to collect all amounts due according to the loan's contractual terms. An impaired loan should be measured based on the present value of expected future cash flows discounted at the loan's effective interest rate. As a practical matter, a creditor may measure the loan at its observable market price or the fair value of the collateral if repayment of the loan is expected to be provided solely by the underlying collateral.

1.306 If the present value of expected future cash flows (or, alternatively, the observable market price of the loan or the fair value of the collateral) is less than the recorded investment in the loan, the creditor should recognize an impairment by creating a valuation allowance with a corresponding charge to bad-debt expense.

1.307 The following disclosures should be made for loans that meet the definition of an impaired loan in accordance with SFAS No. 114, as amended by SFAS No. 118 (these disclosures supersede those originally required by paragraph 20 of SFAS No. 114):

a. As of the date of each statement of financial position presented, the total recorded investment in the impaired loans at the end of each period and (1) the amount of that recorded investment for which there is a related allowance for credit losses determined in accordance with these Statements and the amount of that allowance and (2) the amount of that recorded investment for which there is no related allowance for credit losses determined in accordance with these Statements.

b. The creditor's policy for recognizing interest income on impaired loans, including how cash receipts are recorded.

c. For each period for which results of operations are presented:

    1. The average recorded investment in the impaired loans during each period, the related amount of interest income recognized during the time within that period that loans were impaired, and, unless not practicable, the amount of interest income recognized using a cash-basis method of accounting during the time within that period that the loans were impaired.

    2. The activity in the total allowance for credit losses related to loans, including the balance in the allowance at the beginning and end of each period, additions charged to operations, direct write-downs charged against the allowance, and recoveries of amounts previously charged off.

1.308 Financial statement presentation and disclosure requirements of SFAS No. 114, as amended by SFAS No. 118 are included in the Financial Statement Disclosure Checklist in Chapter 8, section 8.400.

SFAS No. 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments*

1.309 In an effort to improve the financial reporting of derivatives, the FASB issued SFAS No. 119, which is effective for calendar year 1994 financial statements, except for entities with less than $150 million in total assets, for which it is effective for calendar year 1995 financial statements. SFAS No. 119 expands and amends the requirements of SFAS No. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk* and SFAS No. 107, *Disclosures about Fair Value of Financial Instruments*. First, it expands the disclosure requirements of SFAS No. 105 to include additional types of derivatives, such as options held. It also amends SFAS No. 107 as follows:

- If fair value information is located in more than one note, a summary table of fair value information should be included.
- Fair value and carrying amount should be disclosed together.
- Disclosures should clearly designate whether the derivatives are assets or liabilities.
- Information should clearly relate to balance sheet line items.
- Fair value information should not be combined or netted with non-derivatives (except if netting is permitted under FIN No. 39 or FIN No. 41).

1.310 The Statement requires the following additional disclosures:

For derivatives held or issued for trading purposes (generally applies only to financial institutions that deal in derivatives):

- The average fair value balance of positions during the reporting period and ending fair value, and the net gains or losses resulting from trading activities.
- Identification of the derivative from which the gains or losses arose, and where those amounts are reported in the income statement.

For derivatives held or issued for purposes other than trading:

- The objectives of holding or issuing the derivatives.
- Recognition and measurement policies.
- How they are reported in the financial statements (balance sheet and income statement locations).
- If the derivatives are used to hedge anticipated transactions, a description and time period for the transactions, the classes of the derivatives, deferred gains and losses, and the events that would cause gains and losses to be recognized.

SFAS No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed of*

1.311 In March 1995, the Financial Accounting Standards Board issued SFAS No. 121, which is effective for financial statements for fiscal years beginning after December 15, 1995, with earlier application encouraged. Restatement of previously issued financial statements is prohibited. The Statement establishes accounting standards for the impairment of long-lived assets, certain identifiable intangibles, and goodwill related to those assets for both assets to be held and used and assets to be disposed of. SFAS No. 121 amends several existing pronouncements (see paragraphs 20–33 of the Statement).

1.312 **Assets to Be Held and Used.** According to the Statement, an entity is required to review its long-lived assets, such as buildings and equipment, for impairment whenever events or changes in circumstances relating to the assets ("triggering events") indicate the carrying amount of an asset may not be recoverable. In other words, an event or change in circumstances, such as a significant decrease in the market value of an asset, a significant change in the extent or manner in which an asset is used, or a significant physical change in an asset, may indicate that an asset has been impaired.

1.313 If a triggering event has occurred, the entity then determines if an impairment loss should be recognized by measuring the expected future cash flows[1] (undiscounted and without interest charges) to be generated from the use of the asset and its eventual disposition. If the sum of the expected future cash flows is less than the carrying amount of the asset, then an impairment loss should be recognized.

1.314 The amount of the impairment loss to be recognized is measured by calculating the difference between the carrying amount and the fair value of the asset. The fair value is defined as the amount at which the asset could be bought or sold in a current transaction between willing parties. If quoted market prices in active markets are not available, SFAS No. 121 discusses various methods of determining the fair value of the assets including the use of estimates of expected future cash flows discounted at a rate commensurate with the risks involved.

1.315 Once an impairment is recognized, the reduced carrying amount of the asset is the new cost basis that should be depreciated over the asset's remaining useful life. Restoration of previously recognized impairment losses is prohibited.

1.316 **Assets to Be Disposed Of.** If management has committed to a plan to dispose of long-lived assets (whether by sale or abandonment), has the authority to approve the action, and this action is not considered a disposal of a segment under APB Opinion No. 30, the asset should be reported at the lower of carrying amount or fair value, less costs to sell. Fair value is measured the same as for assets to be held and used. The costs to sell an asset includes incremental direct costs, such as broker commissions, legal and title transfer fees, and closing costs. Assets to be disposed of should not be depreciated while they are held for disposal.

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[1] Future cash flows is defined as the future cash inflows expected to be generated by an asset less the future cash outflows expected to be necessary to obtain those inflows. When estimating expected future cash flows, assets should be grouped at the lowest level for which there are identifiable cash flows that are largely independent of the cash flows of other groups of assets.

1.317 Subsequent revisions to the estimates of fair value should be reported as adjustments to the carrying amount of the assets, not to exceed the carrying amount (original basis less accumulated depreciation) of the assets before an adjustment was made.

1.318 Financial statement presentation and disclosure requirements of SFAS No. 121 are included in the Financial Statement Disclosure Checklist in chapter 8, section 8.400.

SFAS No. 122, *Accounting for Mortgage Servicing Rights*

1.319 SFAS No. 65, *Accounting for Certain Mortgage Banking Activities,* requires separate capitalization of the cost of mortgage loan servicing rights when those rights are acquired through a purchase transaction, but prohibits separate capitalization when those rights are acquired through loan origination activities. In May 1994, the FASB issued SFAS No. 122, *Accounting for Mortgage Servicing Rights*, which amends certain provisions of SFAS No. 65, and is effective for fiscal years beginning after December 15, 1995.

1.320 Specifically, the Statement eliminates the distinction between rights to service mortgage loans that are acquired through loan origination activities and those acquired through purchase transactions, and requires mortgage banking enterprises to assess their capitalized mortgage servicing rights for impairment.

1.321 When mortgage banking enterprises sell or securitize loans but retain the mortgage servicing rights, the enterprise should allocate the total cost of the mortgage loan between the mortgage servicing rights and the loan without the mortgage servicing rights based on their relative fair values if it is practicable to estimate those fair values. If fair value cannot be estimated, the entire cost of acquiring the loans should be allocated to the mortgage loan without the mortgage servicing rights and no cost should be allocated to the mortgage servicing rights. Fair value is defined as the amount at which the asset could be bought or sold in a current transaction between willing parties. If quoted market prices in active markets are not available, SFAS No. 65, as amended, discusses various methods of determining the fair value of the asset, including using estimates of expected future cash flows discounted at a rate commensurate with the risks involved.

1.322 Any costs allocated to the mortgage loan servicing rights should be recognized as a separate asset and amortized in proportion to and over the period of estimated net servicing income and should be evaluated for impairment.

1.323 When evaluating and measuring impairment of capitalized mortgage servicing rights, the mortgage banking enterprise should stratify those rights based on one or more of the predominant risk characteristics of the underlying loans, such as loan type (i.e., adjustable-rate or fixed-rate mortgage loan), note rate, date of origination, term, and geographic location. Once stratified, impairment should be recognized through a valuation allowance for each stratum as the amount by which the capitalized mortgage servicing rights for each stratum exceeds their fair values.

1.324 SFAS No. 122 requires the following additional disclosures to be made:

a. The fair value of capitalized mortgage servicing rights and the methods and significant assumptions used to estimate that fair value.

b. If no cost is allocated to certain mortgage loan servicing rights, a description of those mortgage loan servicing rights and the reasons why it is not practicable to estimate their fair values.

c. The risk characteristics of the underlying loans used to stratify capitalized mortgage servicing rights for purposes of measuring impairment.

d. For each period for which results of operations are presented, the activity in the valuation allowances for capitalized mortgage servicing rights, including the aggregate balance of the allowances at the beginning and end of each period, aggregate additions charged and reductions credited to operations, and aggregate direct write-downs charged against the allowances.

1.325 The provisions of this Statement should be applied prospectively to transactions in which mortgage banking enterprises sell or securitize mortgage loans with servicing rights retained and to impairment evaluations of all amounts capitalized as mortgage servicing rights, including those purchased prior to the adoption of this Statement. Earlier application is encouraged. Retroactive capitalization of mortgage servicing rights retained in transactions in which mortgage banking enterprises originate mortgage loans and sell or securitize those loans before the adoption of this Statement is prohibited.

FASBI No. 41, *Offsetting of Amounts Related to Certain Repurchase and Reverse Repurchase Agreements*

1.326 In December 1994, the FASB issued FASB Interpretation No. 41, *Offsetting of Amounts Related to Certain Repurchase and Reverse Repurchase Agreements*, which applies to financial statements for periods ending after December 15, 1994. This Interpretation modifies FASB Interpretation No. 39 by permitting the offsetting of payables and receivables related to repurchase and reverse repurchase agreements under certain conditions.

1.327 Specifically, the Interpretation allows the offsetting of receivables and payables represented by repurchase and reverse repurchase agreements if: (1) the entity intends to use the same account at the clearing bank or other financial institution at the settlement date for both the cash inflows and outflows resulting from settlement of the repurchase agreement and the offsetting reverse repurchase agreement, and (2) the agreements are:

- executed with the same counterparty,
- have the same explicit settlement date specified at the inception of the agreement,
- are transacted under a master netting arrangement,
- encompass underlying securities that exist in book entry form and can be transferred only by certain means, and
- will be settled on a securities transfer system that meets certain characteristics.

SAS No. 73, *Using the Work of a Specialist*

1.328 In July 1994, the AICPA issued SAS No. 73, *Using the Work of a Specialist*, to provide guidance to an auditor who uses a specialist's work as evidential matter in performing substantive tests to evaluate material financial statement assertions. SAS No. 73, which supersedes SAS No. 11 and its two interpretations, is not expected to dramatically change current practice for auditors who use the work of a specialist. However, the Statement (1) clarifies the applicability of the guidance, (2) provides updated examples of situations that might require using the work of specialists and types of specialists being used today, and (3) provides guidance on using the work of a specialist who is related to the client.

1.329 Auditors may use specialists' work as evidential matter in performing substantive tests to evaluate material financial statement assertions, such as actuaries (to determine employee benefit obligations), appraisers, engineers, and environmental consultants. When using the work of a specialist, the auditor should —

- Evaluate the professional qualifications of the specialist.
- Obtain an understanding of the nature and scope of the work and the assumptions used by the specialist and test, as considered appropriate, the data provided to the specialist, taking into consideration the auditor's assessment of control risk.
- Evaluate the specialist's relationship to the client to ensure that the specialist's objectivity was not impaired. If objectivity may have been impaired, the auditor should perform additional procedures to determine that the findings are not unreasonable.
- Consider whether the specialist's findings support the related assertions in the financial statements. If there is a difference between the findings and the assertions, the auditor should apply additional procedures, which may include obtaining the opinion of another specialist. If the difference still cannot be resolved, the auditor should qualify the opinion or disclaim an opinion because of a scope limitation. If the auditor concludes that the assertions are not in conformity with GAAP, the auditor should issue a qualified or adverse opinion.

1.330 Generally, the auditor's report should not refer to the work of the specialist. However, if the report is modified or an explanatory paragraph is added as a result of the report or findings, the specialist may be referred to and identified.

1.331 The Tests of Balances Program in this Manual includes audit procedures the auditor should perform when using the work of an actuary or another specialist.

1.332 SAS No. 73 is effective for audits of financial statements for periods ending on or after December 15, 1994. Early application is encouraged.

SOP 93-7, *Accounting and Reporting on Advertising Costs*

1.333 The AICPA has issued Statement of Position (SOP) 93-7, *Reporting on Advertising Costs*, to provide guidance on the accounting and reporting for advertising costs in the annual financial statements of all entities. The Statement is effective for financial statement years beginning after June 15, 1994. It does not apply to financial statements of interim periods. The Statement does not require that advertising costs incurred before initial application of this SOP be adjusted or reclassified. However, any unamortized costs reported as assets before application of the SOP would be subject to amortization, write-down, and disclosure.

1.334 The SOP requires the following:

a. The expensing of all advertising costs, except for direct-response advertising (see B below), either as incurred or the first time the advertising takes place. The method selected should be applied consistently to similar kinds of advertising activities.

b. Capitalization of direct-response advertising if both of the following conditions are met:

- The primary purpose for the advertising is to sell to customers who respond specifically to that ad; *and,*
- The advertising is expected to produce future revenues.

Examples of direct-response advertising costs include costs of writing ad copy, idea development, artwork, printing, magazine space, mailing, and direct payroll and payroll-related costs. Administrative costs, such as rent, are not considered direct-response advertising costs.

1.335 Costs indirectly related to a direct-response effort, such as a radio ad that tells people where to get order forms, do not meet the definition of direct-response advertising.

1.336 Capitalized direct-response advertising costs should be amortized over the estimated benefit period, and this period should be reevaluated at each balance-sheet date.

1.337 Tangible advertising assets, such as signs, billboards, and blimps, may be used for several ad campaigns. Their costs should be capitalized and depreciated over their expected useful lives, and depreciation of those assets would be reported as an advertising cost.

1.338 The following should be disclosed in the notes to the financial statements. (These disclosures have been included in the Financial Statement and Notes Checklist included Chapter 8, section 8.400 of this Manual.):

- The accounting policy selected from the two alternatives in section 1.334, part A. above.
- A description of and the accounting policy for any capitalized direct-response advertising, and the amortization period.
- The total advertising cost expensed during the period, with separate disclosure of any write-downs to net realizable value.
- The total amount of advertising reported as assets in each balance sheet presented.

SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties*

1.339 In December 1994, the AICPA issued this SOP in response to a need for improved disclosure of significant risks and uncertainties brought about by a volatile business and economic environment. Many of the disclosure requirements of this SOP supplement or overlap the requirements of other authoritative pronouncements, primarily SFAS No. 5, *Accounting for Contingencies*. The SOP is effective for calendar year 1995 financial statements, and for interim periods in fiscal years subsequent to the year the SOP is first adopted. It applies to financial statements of all nongovernmental entities prepared in accordance with GAAP. This SOP is particularly relevant to financial institutions due to the estimating involved in establishing loan loss allowances, and the uncertainties inherent in those estimates relative to the near term.

1.340 The disclosure requirements of SOP 94-6 fall into four categories:

All entities should report --

(1) Nature of operations

(2) Use of estimates in preparing financial statements

Only entities that meet certain conditions should report --

(3) Certain significant estimates

(4) Current vulnerability due to certain concentrations

Because the disclosure requirements of this SOP overlap with many other disclosure requirements, they may be combined or grouped with other related disclosures.

1.341 Nature of Operations. SOP 94-6 requires that an entity describe its major products or services and principal markets, including the location of those markets. If the entity operates more than one business, it should also disclose the relative importance of each business and the basis for determining the relative importance, such as assets, revenues, or earnings. It is not necessary to quantify the relative importance of different operations; instead, importance can be conveyed by terms such as "predominantly," "about equally," and "major."

1.342 Sample disclosures of nature of operations for a small business follows:

- Retail Franchisor of Sporting Goods

  Sporting Goods Headquarters, Inc. (the Company) was incorporated in Arizona in January 19X1. The Company operates retail sporting goods stores and grants franchises for the operation of retail sporting goods stores under the name of Sports Headquarters. At December 31, 19Y5, the Company had ten franchise locations and three company-owned stores.

- Manufacturing Company

  PipeCo, Inc. located in Houston, Texas, manufactures tubing and related products. The Company sells primarily to manufacturers of oil field equipment and leisure products that are located in the Southwestern Unites States.

1.343 Use of Estimates in the Preparation of Financial Statements. Disclosures should include a statement that financial statements prepared in accordance with GAAP require the use of management's estimates. The following disclosure, found in paragraph A-9 of the SOP, can generally be used verbatim to satisfy this requirement:

> The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

1.344 Certain Significant Estimates. Disclosure of information about estimates is required if two criteria are met: (1) it is reasonably possible that an estimate about a condition existing at the balance-sheet date will change in the near term (one year from the balance-sheet date) and (2) the effect of the change would be material to the financial statements. Examples of estimates that are often sensitive to material change are:

* Inventory and specialized equipment subject to technological obsolescence
* Valuation allowances for deferred tax assets based on future taxable income
* Valuation allowances for commercial and real estate loans
* Environmental cleanup-related liabilities
* Litigation-related obligations
* Contingent liabilities for obligations of other entities
* Amounts reported for pensions and postemployment benefits
* Amounts reported for long-term contracts.

1.345 The disclosures for certain significant estimates supplement those in SFAS No. 5, *Accounting for Contingencies*. However, the SOP applies not just to estimates related to contingencies, but also to other types of estimates, such as those related to the carrying value of assets and liabilities (e.g., loans). Also, the SOP introduces the concept of a "near term" change in the estimate, while SFAS No. 5 makes no distinction between "near term" and long-term changes in estimates.

1.346 As mentioned above, this disclosure need only be made if two criteria are met:

1) *It is at least reasonably possible that an estimate about a condition that existed at the balance-sheet date will change in the near term.* The SOP draws on the SFAS No. 5 definition of reasonably possible, which is "more than remote but less than likely." Therefore, the likelihood that an estimate will change in the near term should be at least "more than remote." In considering whether the estimate is sensitive to change in the near term, the entity should consider only facts and circumstances known to management before the financial statements are issued.

   To illustrate, consider a saving institution's loan loss allowance. Certain of the institution's loans are secured by collateral and the amount of the loan loss allowance is partially based on the realizable value of the collateral. Management is aware at year end that a deterioration in the realizable value of some of the collateral may occur in the next few months. If the likelihood of the deterioration in the near term is more than remote, then this disclosure criterion is met.

2) *The effect of the change would be material to the financial statements.* Determining whether the effect of a change in estimate would be material to the financial statements is a matter of judgment, and presumably involves the same judgment used to determine whether other items are material to the financial statements. Also, note that the SOP refers to materiality in relation to the effect of the change, not to the estimate. For example, consider an entity that has not

recorded a valuation allowance for inventory subject to rapid technological obsolescence. Even though no estimate is recorded, the entity might need to disclose the fact that it is reasonably possible that a material change in the estimate is likely to occur in the near term.

1.347 If an estimate meets the disclosure requirements of SOP 94-6, the following matters should be disclosed:

- The nature of the uncertainty and an indication that it is at least reasonably possible that a change in the estimate will occur in the near term.
- If the estimate involves a loss contingency covered by SFAS No. 5, an estimate of the possible loss or range of loss, or a statement that such an estimate cannot be made. (Note that this requirement overlaps with SFAS No. 5 disclosure requirements for loss contingencies. In fact, for such items, the only disclosure added by SOP 94-6 is the statement that it is at least reasonably possible that a change in the estimate will occur in the near term.) Also, the SOP recommends, but does not require, disclosing the factors that cause the estimate to be sensitive to material change.

1.348 **Current Vulnerability Due to Certain Concentrations.** The SOP requires disclosure of certain concentrations if: (1) the concentration exists at the balance-sheet date, (2) the concentration makes the entity vulnerable to the risk of a near-term severe impact, and (3) it is at least reasonably possible that the events that could cause the severe impact will occur in the near term. (As mentioned earlier near term is defined as a period not to exceed one year from the balance-sheet date.)

1.349 This disclosure is required only if all of the following criteria are met:

1. *The concentration existed at the balance-sheet date.* The SOP specifically identifies the types of concentrations that should be considered for this disclosure:

   - Concentrations in the volume of business transacted with a particular customer, supplier, or lender;
   - Concentrations in revenues from particular products or services;
   - Concentrations in the available sources of supplies of materials, labor or services (paragraph 24 of the SOP requires some specific disclosures for labor subject to collective bargaining agreements), or of licenses or other rights used in the entity's operations; and
   - Concentrations in the market or geographic area in which the entity operates (paragraph 24 of the SOP requires some specific disclosures for foreign operations).

2. *The concentration must make the entity vulnerable to the risk of a near-term severe impact.* The key concept (and probably the most difficult one) in applying this criterion is the concept of "severe impact." Paragraph 7 of the SOP defines severe impact as:

   A significant financially disruptive effect on the normal functioning of the entity. Severe impact is a higher threshold than material. Matters that are important enough to influence a user's decisions are deemed to be material, yet they may not be so significant as to disrupt the normal functioning of the entity...The concept of severe impact, however, includes matters that are less than catastrophic.

As with materiality, determining whether something would constitute a severe impact requires judgment. For example, consider a manufacturer that buys all of its raw materials from one supplier. The loss of this supplier would cause significant production delays and greater than material losses of revenues, yet other suppliers can provide similar raw materials under similar terms. Thus, although losing this supplier could have a significant financially disruptive effect on the normal functioning of the entity, it would not cause bankruptcy because the entity could ultimately turn to other suppliers and resume normal operations.

3. *It is at least reasonably possible that the event that could cause the severe impact will occur in the near term.* As noted above, the SOP uses the SFAS No. 5 definition of reasonably possible of "more than remote but less than likely." Thus, the probability threshold for disclosure of a concentration is the same as that for disclosure of a loss contingency.

   It is important to note that the SOP indicates that two types of concentrations are always considered to meet this "reasonably possible" criterion: (1) concentrations of customers, grantors, or contributors; and (2) concentrations of operations in foreign countries.

   If any concentrations meet these criteria, paragraph 24 of the SOP states that disclosure "should include information that is adequate to inform users of the general nature of the risk associated with the concentration." An example of a disclosure for a concentration related to customers follows:

   At December 31, 19X5, receivables from three customers were about 45% of trade accounts receivable, and sales to these customers comprised 40% of total sales for the year then ended.

   The Financial Statement Disclosure Checklist and Illustrative Financial Statements in Chapter 8, sections 8.400 and 8.300, respectively, have been updated to include the disclosure requirements for SOP 94-6.

1.350 Audit Considerations for SOP 94-6. Since entities must adopt SOP 94-6 for their December 31, 1995 financial statements, auditors of those entities will need to ensure that the client has disclosed the nature of its operations, the use of estimates in preparing financial statements, certain significant estimates, and certain concentrations. The first two disclosures should be fairly straightforward. In fact, many companies already disclose information about the nature of their operations. The more difficult challenge for auditors will be to determine if circumstances that trigger the other two disclosures -- certain significant estimates and current vulnerability due to certain concentrations -- exist and, if they do, whether the disclosures are appropriate.

Generally, much of the information auditors obtain during the normal course of the audit provides a good foundation for determining whether the client has estimates and concentrations that require disclosure. Specific procedures directed towards SOP 94-6 may include:

<u>Certain Significant Estimates:</u>

- Obtain or prepare a listing of any estimates used in determining the carrying values of assets and liabilities and gain and loss contingencies that are sensitive to change. Using information obtained in other audit areas and through inquiries of management, determine that the listing is complete and accurate.

Examples of such estimates include:

* inventory and specialized equipment subject to technological obsolescence
* valuation allowances for deferred tax assets based on future taxable income
* valuation allowances for commercial and real estate loans
* environmental cleanup-related liabilities
* litigation-related obligations
* contingent liabilities for obligations of other entities
* amounts reported for pensions and postemployment benefits
* amounts reported for long-term contracts

- Consider whether it is at least reasonably possible that a material change in the estimate will occur in the near term.
- If such a situation is identified, review support for the calculation of the effect of the change.

Certain Concentrations

- Obtain or prepare a listing of the following types of concentrations, if any, that existed at the balance-sheet date and that make the entity vulnerable to risk of near-term severe impact (severe impact is a higher threshold than materiality, but less than catastrophic). Using information obtained in other audit areas and through inquiries of management, determine that the listing is complete and accurate:

* volume of business transacted with a particular customer, supplier, or lender
* revenues from particular products or services
* available sources of supply of materials, labor or services, or of licenses or other rights used in operations
* market or geographic area in which the entity conducts its operations

- Determine whether it is at least reasonably possible that an event will occur in the near term that would cause the severe impact.

The Tests of Balances Audit Program in Chapter 6, section 6.400 includes steps for considering the completeness and accuracy of the SOP 94-6 disclosures.

Auditing Interpretations

1.351 Auditing Interpretation, ***The Auditor's Consideration of Management's Adoption of Accounting Principles for New Transactions or Events*** **(AU 9411.11-.15)** This interpretation establishes guidance on what the auditor should consider when determining the appropriateness of an accounting principle adopted by management for material new types of transactions or events for which there are no established sources of accounting principles. The Interpretation states that when the auditor is evaluating the principle, he or she should assess the appropriateness of management's basis for selecting the principle by considering whether there are:

- Analogous transactions or events for which there are established accounting principles, or
- Other accounting literature.

1.352 Auditing Interpretation, ***Audits of Financial Statements that had been Previously Audited by a Predecessor Auditor*** **(AU 9315.08-.18)** This Interpretation of SAS No. 7, *Communication Between Predecessor and Successor Auditors*, was issued in April 1995. The Interpretation provides guidance to an auditor who is auditing and reporting on financial statements previously audited and reported on by a predecessor auditor (referred to as "reauditing"). The Interpretation states that:

- The auditor should request the predecessor auditor's workpapers for the year under audit and for the prior year.
- The review of these workpapers and inquiries of the predecessor auditor do not in themselves constitute sufficient competent evidential matter to provide a basis for expressing an opinion on the financial statements.
- The successor auditor should not divide responsibility for the work performed in his or her report.
- The successor may consider the information obtained from inquiries of the predecessor and any review of the predecessor's working papers and report in planning a reaudit.
- The successor auditor must become satisfied with the existence of beginning physical inventories by making or observing physical counts of inventories after the reaudit period and performing "roll back" procedures, test intervening transactions, such as testing prior transactions, reviewing prior count records, and performing analytical procedures. The auditor may not use the predecessor's inventory or other work for these purposes.

1.353 Auditing Interpretations: ***Describing Tests of Operating Effectiveness and the Results of Such Tests*** **(AU 9324.31-.03) and** ***Service Organizations that use the Services of Other Service Organizations (Subservice Organizations)*** **(AU 9324.04-.18)** In April 1995, these Auditing Interpretations of SAS No. 70, *Reports on the Processing of Transactions by Service Organizations* were issued:

a. *Describing Tests of Operating Effectiveness and the Results of Such Tests,* (AU 9324.31-.03) provides guidance to a service auditor as to how much detail and what information should be included in the description of "tests applied" and the "results of the tests."

b. *Service Organizations that Use the Services of Other Service Organizations (Subservice Organizations)* (AU 9324.04-.18) provides guidance for the user auditor and the service auditor when the service organization uses a subservice organization.

1.354 Auditing Interpretation, ***Reporting on a Special-Purpose Financial Statement that Results in an Incomplete Presentation But Is Otherwise in Conformity with Generally Accepted Accounting Principles*** **(AU 9326.80-.87)** This interpretation defines what constitutes a contractual agreement under AU 623, *Special Reports*, and which guidance within the standards should be followed under different "special reporting" situations. This Interpretation also provides guidance when the auditor is to distribute the report to additional parties that were not part of the original contract or agreement.

1.355 Auditing Interpretation, ***Eliminating a Going-Concern Explanatory Paragraph From a Reissued Report*** **(AU 9341.01-.02)** This interpretation addresses the situation where auditors are asked to reissue reports that included a going-concern explanatory paragraph because the situation or condition that gave rise to substantial doubt about the entity's ability to continue as a going-concern has been resolved. This Interpretation provides guidance for auditors who agree to reissue their reports in such instances. It's important to note that the Interpretation does not *require* auditors to reissue their reports, however, if the auditor does agree to reissue his or her report, he or she should:

- Audit the event or transaction that prompted the request for reissuance,

- Perform procedures in paragraph 12 of AU 560, Subsequent Events, at or near the date of reissuance, and
- Consider factors described in paragraphs 6-11 of SAS No. 59, based on the conditions and circumstances at the date of issuance.

Proposed Statements

1.356 Proposed Amendment to SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit.* In February 1995, the AICPA Auditing Standards Board issued this proposed amendment to SAS No. 55 that would incorporate the internal control concepts found in *Internal Control -- Integrated Framework Report* (often referred to as the "COSO report"). Specifically, the amendment would change the current definition of internal control in SAS No. 55 from "control environment, accounting system, and control procedures" to the definition in the COSO report, "control environment, risk assessment, control activities, information and communications, and monitoring." The AICPA Audit Guide, *Consideration of the Internal Control Structure in a Financial Statement Audit*, will also be revised simultaneously. The final documents are expected to be issued in December 1995, and are expected to be effective for audits of entities with fiscal years beginning January 1, 1997. This amendment is not expected to have a significant impact on practical applications of SAS No. 55.

1.357 Proposed Amendment to SAS No. 58, *Reports on Audited Financial Statements*. This proposed amendment was issued in July 1995. It would eliminate the requirement to add an explanatory paragraph to the auditor's report for certain uncertainties. This amendment would not affect the requirement in SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, to add such a paragraph for going-concern uncertainties. If approved, the final SAS is expected to be issued in December 1995, and would be effective for reports issued on or after June 30, 1996.

1.358 Proposed SAS, *Engagements to Apply Agreed-Upon Procedures to Specified Elements, Accounts, or Items of a Financial Statement*. This proposed statement, which will supersede SAS No. 35, provides guidance to auditors on performing and reporting on applying agreed-upon procedures to specified elements, accounts, or items of a financial statement. The proposed statement will be issued in response to the diversity in practice in performing and reporting on these engagements, and the fact existing guidance does not address a number of issues auditors should consider. The proposed statement is expected to be issued in October 1995.

1.359 Proposed SSAE, *Agreed-Upon Procedures Engagements.* Concurrent with the issuance of the proposed SAS referred to in section 1.358, the AICPA's Auditing Standards Board will issue this statement to provide guidance to auditors on performing and reporting on agreed-upon procedures engagements. The guidance in this proposed SSAE is identical to the guidance in the proposed SAS discussed in section 1.358, except that the proposed SSAE requires a written assertion from management.

1.360 Proposed SOP, *Accounting by Participating Mortgage Loan Borrowers*. In situations where a lender participates in increases in the market value of a mortgaged real estate project, the results of its operations, or both, this proposed SOP would establish the borrower's accounting for the related participating mortgage loan.

1.361 The proposed SOP would preclude the borrower from allocating, at origination, any of the proceeds related to a participating mortgage loan to a liability realted to the participation feature. A participation liability would be recorded equal to the amount that would be required to extinguish the participation feature. The participation liability would be reported at the end of every reporting period. The charges or credits associated with adjustments to the participation liability would be booked to debt discount.

1.362 As the market value of the underlying property changes, the participation liabilty should change. As a result, the proposed SOP requires the borrower to recalculate the effective interest rate to reflect changes in expected future payments. The proposed SOP would also require certain financial statement disclosures.

1.363 Implementation of the proposed SOP is to be accomplished and reported in a manner similar tothat of the cumulative effect of a change in accounting principle. The proposed SOP is effective for fiscal years beginning after June 15, 1996. Earlier application is encouraged.

1.364 Proposed SOP, *Environmental Remediation Liabilities*. In June 1995, the AICPA Accounting Standards Executive Committee issued this proposed Statement of Position which provides guidance on the recognition, measurement, display and disclosure of certain environmental remediation liabilities. Among other things, the SOP requires that environmental remediation liabilities be accrued when the criteria of SFAS No. 5 are met, and it includes benchmarks to aid in determining when such liabilities should be recognized in accordance with SFAS No. 5.

1.365 Among the costs to be included in the measurement of the liability are:

a. Incremental direct costs of the cleanup effort,

b. Costs of compensation and benefits for employees to the extent they will devote time directly to the cleanup effort, and

c. Certain costs of legal work related to the cleanup effort.

1.366 The proposed SOP would be effective for financial statements beginning after December 15, 1995.

1.367 Proposed Audit and Accounting Guide, *Audits of Banks and Savings Institutions*. At press time, the AICPA was in the final stages of issuing a revised audit and accounting guide covering both commercial banks and savings institutions. The guide will be reviewed by the Financial Accounting Standards Board during late 1995. At the conclusion of the exposure process, there were no substantive changes made to the guide as exposed. At press time, the guide is expected to be issued in late 1995. The most significant feature of the guide will be a requirement for inclusion of audited information concerning the institution's capital adequacy in a note to the financial statements. At the time of publication of this Manual, the indicated effective date for the new guide would be for years ending after June 15, 1996, which would make it effective for savings institutions with years ending on June 30, 1996 and for all commercial banks for calendar year 1996.

1.368 The guide will supersede the AICPA Industry Audit Guide, *Audits of Banks*, and the AICPA Audit and Accounting Guide, *Audits of Savings Institutions*, as well as a number of AICPA SOPs, (to the extent that the SOPs amended previous editions of these two guides), and the AICPA Auditing Procedure Study, *Auditing the Allowance for Credit Losses of Banks*.

1.369 Guidance contained in the revised audit and accounting guide has been incorporated throughout this Manual; particularly Chapter 8, section 8.400, Financial Statement and Auditor's Report Disclosure Checklists.

1.370 To determine the current status of these proposals, call the AICPA's Technical Hotline at 800-862-4272, menu option 2.

1.400 THE GAAP HIERARCHY AND EITF CONSENSUSES

1.401 In January 1992, the AICPA's Auditing Standards Board issued SAS No. 69, *The Meaning of Present Fairly in Confirmity With Generally Accepted Accounting Principles in the Independent Auditor's Report* (AU 411). Statement on Standards for Accounting and Review Services (SSARS) No. 7, *Omnibus Statement on Standards for Accounting and Review Services—1992* (AR 100, footnote 3), clarifies that the hierarchy also applies to compilation and review engagements. SAS NO. 69:

- Created two separate but parallel hierarchies—one for state and local governments and another for nongovernmental entities.
- Established a true GAAP hierarchy—unlike the old SAS, each successive category in the hierarchy is a different level of authority.
- Elevated the authority of Finanical Accounting Standards Board (FASB) Emerging Issues Task Force (EITF) consensuses and AICPA Practice Bulletins from "other literature" to "established accounting principles."

1.402 Paragraph 16 of SAS No. 69 (AU 411.16) summarizes the pronouncements that are included in each of the five categories of GAAP for nongovernmental entities and for state and local governments.

1.403 SAS No. 69 is effective for reports on financial statements for periods ending after March, 15, 1992. Generally, the revised levels of authority apply to pronouncements with effective dates after March 15, 1992. However, EITF consensuses issued before March 16, 1992 also are effective for initial application of an accounting principle after March 15, 1993.

Importance of EITF Consensuses

1.404 The one-year grace period assigned to the old EITF consensuses was designed to give accountants an opportunity to become acquainted with over 150 consensuses that were adopted before March 15, 1992. The consensuses listed in sections 1.405 ("Selected EITF Consensuses Adopted Before March 16, 1992") and 1.406 ("Selected EITF Consensuses Adopted Between March 15, 1992 and July 21, 1995") have the widest applicability and relevance to financial institutions.

1.405 The following are selected EITF Consensuses effective before March 16, 1992, that are applicable to banks and savings institutions.

Issue No.	Title and Issue
84-19	*Mortgage Loan Payment Modification* How should a lender account for a loan agreement that specifies forgiveness of a portion of the principal balance if the borrower increases his or her mortgage payments for a specified period?
84-20	*GNMA Dollar Rolls — consensus applicable to forward commitment dollar rolls only* Should forward commitment dollar rolls, for which the underlying security does not yet exist, be accounted for as separate sales and repurchases? If so, should changes in the value of the underlying security be marked to market?

Issue No.	Title and Issue
85-8	*Amortization of Thrift Intangibles* When banking or thrift institutions are acquired, how should the unidentifiable intangible asset (the excess of the fair value of liabilities assumed over the fair value of assets acquired) be amortized?
85-13	*Sale of Mortgage Service Rights on Mortgages Owned by Others* How should a financial institution account for the gain on the sale of mortgage servicing rights when the sale is for a participation in the future interest income stream of the loans?
85-20	*Recognition of Fees for Guaranteeing a Loan*—partial consensus reached on issue 1 If a financial institution acts as guarantor by lending its creditworthiness to another party for a fee, when should the fees be recognized in income and when should the guarantor recognize a liability?
85-41	*Accounting for Savings and Loan Associations under FSLIC Management Consignment Program* If a financial institution is closed and its net assets transferred to a newly chartered institution, what is the appropriate basis of accounting for the newly chartered institution?
85-42	*Amortization of Goodwill Resulting from Recording Time Savings Deposits at Fair Value* How should goodwill resulting from recording time savings deposits at fair value (at a premium) be amortized?
85-44	*Differences Between Loan Loss Allowances for GAAP and RAP* May a financial institution record different loan loss allowances under Generally Accepted Accounting Principles (GAAP) and regulatory accounting principles (RAP)?
86-8	*Sale of Bad Debt Recovery Rights* How would a financial institution account for the nonrecourse sale of rights to future recoveries on loans that have already been written off?
86-21	*Application of the AICPA Notice to Practitioners Regarding Acquisition, Development and Construction Arrangements to Acquisition of an Operating Property* Does the AICPA Practice Bulletin, *ADC Arrangements*, apply to shared appreciation mortgages and loans on operating real estate?
86-24	*Third-Party Establishment of Collateralized Mortgage Obligations* How does a financial institution account for the sale of mortgage loans to an unrelated third party that uses the mortgages as collateral to issue collateralized mortgage obligations?
86-38	*Implication of Mortgage Prepayments on Amortization of Servicing Rights*—sections A and B only (section C has been superseded by EITF 89-4) Should a financial institution write-down (A) purchased mortgage servicing rights (an intangible asset) or (B) receivables relating to either excess service fees or premiums on loans sold with participation retained, if unanticipated mortgage prepayments occur?

Issue No.	Title and Issue
86-39	*Gains from the Sale of Mortgage Loans with Servicing Rights Retained* Should the gain on the sale of mortgage loans with servicing rights retained be offset against the corresponding capitalized servicing rights before being recognized in income?
86-40	*Investments in Open-End Mutual Funds That Invest in U.S. Government Securities* Should investments in mutual funds that hold debt securities be accounted for at the lower of cost or market or amortized cost?
87-5	*Troubled Debt Restructuring: Interrelationship Between FASB Statement No. 15 and the AICPA Savings and Loan Guide* If a savings institution agrees to a modification of terms in a troubled debt restructuring without incurring a loss, should loan loss allowances, if appropriate, continue to be provided?
87-9	*Profit Recognition on Sales of Real Estate with Insured Mortgages or Surety Bonds* Should the full accrual method of profit recognition be used for sales of real estate when the buyer obtains mortgage insurance or surety bonds on the loan?
87-17	*Spinoffs or Other Distributions of Loans Receivable to Shareholders* What accounting basis should be used when loans receivable are transferred to shareholders via spinoffs or other distributions?
87-19	*Substituting Debtors in a Troubled Debt Restructuring* How should a creditor account for substituted debtors in a troubled debt restructuring when the net investment in the loan exceeds the fair value of the payments to be received from the new debtor?
87-30	*Sale of a Short-Term Loan Made Under a Long-Term Credit Commitment* Should the transfer to a third-party purchaser of a short-term loan under a long-term credit commitment be accounted for as a sale or as a financing?
87-34	*Sale of Mortgage Servicing Rights with a Subservicing Agreement* Should the transfer of mortgage servicing rights and the simultaneous agreement by the transferor to provide subservicing be reported by the transferor as a sale or as a financing?
88-11	*Allocation of Recorded Investment When a Loan or Part of a Loan is Sold* When a financial institution sells only a portion of a loan, how should the recorded investment in the loan be allocated between the portion sold and the portion retained?
88-17	*Accounting for Fees and Costs Associated with Loan Syndications and Loan Participations* How does a financial institution account for fees received and costs incurred on syndications and sales of loan participations?
88-19	*FSLIC-Assisted Acquisitions of Thrifts* How does an acquiror account for the acquisition of a thrift institution under an assistance agreement from the regulator?

Issue No.	Title and Issue
88-20	*Difference Between Initial Investment and Principal Amount of Loans in a Purchased Credit Card Portfolio* Should the premium paid on a cash purchase of a credit card portfolio be allocated between the loans acquired and any identifiable intangible asset acquired?
88-22	*Securization of Credit Card Portfolios* How should a financial institution account for the sale of undivided participation interests in a trust formed from institution's credit card receivables?
88-25	*Ongoing Accounting and Reporting for a Newly Created Liquidating Bank* What accounting and reporting principles apply to a liquidating bank (created for the purpose of liquidating nonperforming loans of the transferring bank and distributing any remaining cash to shareholders)?
89-4	*Accounting for a Purchased Investment ina Collateralized Mortgage Obligation Instrument or in a Mortgage-Backed Interest-Only Certificate* How do accounting principles differ for collateralized mortgage obligations purchased in equity (e.g., stock interests) vs. nonequity from (e.g., participating debt securities)?
89-9	*Accounting for In-Substance Foreclosures* What is the appropriate accounting basis for in-substance foreclosed assets? These conclusions are consistent with AICPA Practice Bulletin No. 7 and AICPA Statement of Position No. 92-3.
90-2	*Exchange of Interest-Only and Principal-Only Securities for a Mortgage Backed Security* Should the exchange of interest-only or principal-only securities for the related mortgage-backed security be recorded at fair value?
90-18	*Effect of a Removal of Accounts Provision on the Accounting for a Credit Card Securization* Should credit card securizations that permit the seller to withdraw certain accounts from the securitized receivables pool be recognized as a sale?
90-21	*Balance Sheet Treatment of a Sale of Mortgage Servicing Rights with a Subservicing Agreement* Should a sale of mortgage servicing rights with a subservicing agreement be recorded as a financing or as a sale with the gain deferred?

1.406 The following are selected EITF Consensuses adopted between March 15, 1992 and July 20-21, 1995, that are applicable to banks and savings institutions.

Issue No.	Title and Issue
92-5	*Amortization Period for Net Deferred Credit Card Origination Costs* May deferred credit card origination costs, as defined, be netted against the related credit card fee, if any, and the net amount amortized on a straight-line basis over the privilege period?

Issue No.	Title and Issue
92-10	*Loan Acquisitions Involving Table Funding Arrangements* Should a mortgage loan that is acquired in a table funding arrangement be accounted for as a loan purchase if the loan is legally structured as an origination by an independent correspondent (i.e., a mortgage broker)?
93-1	*Accounting for Credit Card Acquisitions* If credit card accounts are acquired individually from third parties, should they be accounted for as purchases under APB Opinion No. 17 and EITF Issue No. 88-20 or originations under SFAS No. 91 and EITF Issue No. 92-5?
93-12	*Recognition and Measurement of the Tax Benefit of Excess Tax-Deductible Goodwill Resulting from a Retroactive Change in Tax Law* When an institution elects to retroactively amortize goodwill in accordance with the Omnibus Budget Reconciliation Act of 1993, how is the tax benefit related to tax-deductible goodwill in excess of "book" goodwill determined? How should that benefit be recognized under SFAS No. 109, *Accounting for Income Taxes*?
93-13	*Effect of a Retroactive Change in Enacted Tax Rates That is Included in Income from Continuing Operations* Should the tax effect of a retroactive change in enacted tax rates for the period that includes the enactment date of the change be measured using temporary differences existing at the date of enactment or those existing at the effective date of the tax rate change?
93-18	*Recognition of Impairment for an Investment in a Collateralized Mortgage Obligation Instrument or in a Mortgage-Backed Interest-Only Certificate* What is the effect of SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, on the measurement and recognition of impairment losses on certain mortgage-backed investments?
94-4	*Classification of an Investment in a Mortgage-Backed Interest-Only Certificate as Held-to-Maturity* Can mortgage-backed interest-only certificates be classified as held-to-maturity?
94-8	*Accounting for Conversion of a Loan into a Debt Security in a Debt Restructuring* How should a creditor account for a debt security (issued by the debtor), with a fair value that differs from the creditor's basis in the loan, in a debt restructuring?
94-9	*Determining a Normal Servicing Fee Rate for the Sale of a SBA Loan* How, for the purpose of applying EITF Issue 88-11, should an institution determine a normal servicing fee rate for SBA loans, in the absence of a major secondary market maker?
94-10	*Accounting by a Company for the Income Tax Effects of Transactions among or with Its Shareholders under FASB Statement No. 109, Accounting for Income Taxes* Should tax effects caused by transactions among or with shareholders be included in the income statement or in equity in the separate financial statements of the company affected?

Issue No.	Title and Issue
95-2	*Determination of What Constitutes a Firm Commitment for Foreign Currency Transactions Not Involving a Third Party* What constitutes a significant economic penalty to a consolidated entity that would negate the use of hedge accounting for transactions designed to hedge intercompany foreign currency commitments?
95-4	*Revenue Recognition on Equipment Sold and Subsequently Repurchased Subject to an Operating Lease* Is a manufacturer precluded from recognizing a sale of a product to a dealer if the customer subsequently enters into an operating lease with the manufacturer or its finance affiliate who acquires that product subject to a lease?
95-5	*Determination of What Risks and Rewards, If Any, Can Be Retained and Whether Any Unresolved Contingencies May Exist in a Sale of Mortgage Loan Servicing Rights* Should sales of mortgage loan servicing rights be recognized at the date title passes if the agreement contains any provisions that would result in the seller's retention of specified risks? (Note: This consensus supersedes the consensus reached in EITF Issue No. 89-5.)
95-10	*Accounting for Tax Credits Related to Dividend Payments in Accordance with FASB Statement No. 109, Accounting for Income Taxes* Certain foreign jurisdictions tax corporate income at different rates depending on whether that income is distributed to shareholders. Should a deferred tax asset be recognized (in the financial statements of a company that pays dividends subject to the tax credit to its shareholders) for the tax benefits of future tax credits that will be realized when income previously taxed at the undistributed rate is subsequently distributed?

1.407 Practitioners may obtain the EITF Abstracts by calling the FASB Order Department at (203) 847-0700.

ILLUSTRATION No. 1-1

Reorganization of the Banks and Savings Institutions Audit Manual
(formerly the Bank Audit Manual)

1995 Chapter	1994 Sections/Chapter
1 Introduction	Sections of chapter 1, chapter 2 and chapter 3
2 Banking Industry	1.500-1.590--The Commercial Banking Industry
3 Pre-Engagement Considerations and Audit Planning	1.400-1.405--Official Releases-Ethics Interpretations and Rulings
	2.400-2.407--Relying on the Work of Internal Auditors
	4.201-4.203--Using the Preliminary Bank Survey Questionnaire
	4.300--Preliminary Bank Survey Questionnaire
	5.002-5.205--Purpose and Use of the Interim Surprise Entry Program
	5.300--Interim Surprise Entry Program
	7.101-7.116--Professional Standards
	8.103--Obtaining an Understanding of the Internal Control Structure
	8.107-8.108--Risk of Potential Misstatements
	8.110-8.113--Staff the Engagement and Plan for Supervision
	9.101-9.105--Professional Standards
	9.202--Instructions for Bank Planning Memorandum
	9.300--Bank Planning Memorandum
	10.101-10.106--Making Preliminary Judgments About Materiality Levels
	10.200--Materiality Computation Form

ILLUSTRATION No. 1-1 (Continued)

1995 Chapter	**1994 Sections/Chapter**
3 Pre-Engagement Considerations and Audit Planning (Continued)	18.100-18.300--Budgeting and Time Control Documents
4 Audit Approach	2.000-2.301--Overview of Approach
	2.500-2.505--The Internal Control Structure, Risk Assessment and Program Modification
	7.203--Bank Risk of Potential Misstatement Evaluation Form
	8.300--Bank Planning Matrix
	11.101--Professional Standards
	11.200-11.428--Sampling Documentation
5 Internal Controls	Entire contents of Chapter 6, Internal Controls
	All of Chapter 17, EDP Documentation
6 Substantive Testing	12, Analytical Procedures Program
	13.002-13.004--The ABC System Approach to Substantive Testing and Bank Tests of Balances Audit Program
6A Appendix	All of Chapter 19
7 Completing the Audit	10.300-10.315--Summary of Possible Journal Entries
	10.400--Summary of Possible Journal Entries Form
	14.300--Consultation Form
	15.202--Client Representation Letter-Financial Institutions

ILLUSTRATION No. 1-1 (Continued)

1995 Chapter	1994 Sections/Chapter
7 Completing the Audit (Continued)	16.200-16.204--Tax Accrual/Provision Review and Tax Accrual/Provision Review Checklist
	16.402-16.407--Engagement Performance Review
	16.409--Engagement Performance Review Checklist
	16.500-16.503--The Technical Review
	16.504--Technical Review Checklist
	16.600-16.603--Workpaper and Report Review Checklist-SEC Supplement
	16.700-16.703--Concurring Partner Report Review Checklist
	16.800-16.804--Using the Financial Statement Control Form and the Financial Statement Control Form
8 Illustrative Auditor's Reports and Financial Statements	All of Chapter 20
9 Other Services	New chapter in 1995
10 CPE Course	Same
Appendix A - Directors' Examinations	Same
B - Trust Department Audits	Same
C - AICPA Industry Audit Guide	Same
D - Investment Securities	Same
E - Student Loan Program	New appendix in 1995

Illustration No. 1-2

GAAP HIERARCHY SUMMARY

Established Accounting Principles	1. FASB Statements and Interpretations, APB Opinions, and AICPA Accounting Research Bulletins
	2. FASB Technical Bulletins, AICPA Industry Audit and Accounting Guides, and AICPA Statements of Position
	3. Consensus positions of the FASB Emerging Issues Task force and AICPA Practice Bulletins
	4. AICPA accounting interpretations, "Qs and As" published by the FASB staff, as well as industry practices widely recognized and prevalent
Other Accounting Literature [1]	5. Other accounting literature, including FASB Concepts Statements; APB Statements; AICPA Issues Papers; International Accounting Standards Committee Statements; GASB Statements, Interpretations, and Technical Bulletins; pronouncements of other professional associations or regulatory agencies; AICPA *Technical Practice Aids*; and accounting textbooks, handbooks, and articles

[1] In the absence of established accounting principles, the auditor may consider other accounting literature, depending on its relevance in the circumstances.

Bank and Savings
Institution Industry

CHAPTER 2

THE BANKING INDUSTRY

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THE BANKING INDUSTRY

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CHAPTER 2

2.000 THE BANKING INDUSTRY

2.001 The banking system in the United States is a dual system in which a bank or a savings and loan association ("financial institution") may be chartered as a national bank or association by the federal government or as a state bank or association by any one of the 50 states (or as a District bank by the District of Columbia). This dual system allows each jurisdiction to govern its own system of banks.

2.002 Although small financial institutions outnumber larger ones, the large banks hold the majority of the industry's assets. In fact, the top one percent of commercial banks account for the majority of assets held by all banks.

2.003 Financial institutions are often clustered into segments according to their asset size. These segments are recognized generally in the industry as community banks, medium-sized banks, regional banks, and money center banks. There are very few large savings institutions currently, mostly due to consolidation and the acquisition of such institutions by the large commercial banks. Although these classifications are artificial, they frequently reflect commonality of concerns and interests.

2.004 Financial institutions, perhaps even more than other corporations, vary in their corporate structure and organization. Size, product-mix, customer base, corporate affiliates, and legal restraints all play a part in determining how a bank chooses to organize its operations. In the smallest financial institutions, organization is relatively simple. Individual officers handle multiple functions and frequently deal with all bank customers. As financial institutions grow, they organize their operations into departments or other units, often along functional (e.g., loans, investment, trust) and/or market lines (e.g., consumer/retail, wholesale). In place of assigning departmental responsibility, financial institutions sometimes choose to establish subsidiary corporations to handle certain activities. Separate corporations for loan servicing, data processing services, credit life insurance, and securities brokerage subsidiaries, for instance, are not uncommon.

2.005 Financial institutions themselves may be subsidiaries of larger corporate entities known as bank holding companies. A small number of financial institutions that offer only limited services (i.e., that do not take deposits and also offer commercial loans) are owned by entities other than bank holding companies. The internal organization of such financial institutions may be affected by the structure and organization of affiliate institutions — the parent holding company and other holding company subsidiaries. For instance, in multi-bank holding companies, functions such as investment or credit determinations often are performed centrally to focus expertise and to take advantage of economies of scale. In addition to its bank subsidiaries, the holding company also may own affiliates that are not banking institutions. The activities of a bank holding company's affiliates must, under current law, be closely related to banking, and transactions between bank holding company affiliates are subject to federal regulation.

2.006 Financial institutions' corporate organizations also differ because of state branching laws (applicable by federal law to national banks and federal savings associations) that dictate whether and where banks in the state may locate branch offices. In some states, known as "unit banking states," banks are allowed only a single main office location. In these states, geographic expansion is achieved through chain banking — common ownership of a series of banks. Most states, however, allow intrastate branching on at least a limited basis, and recently many states have begun to allow interstate banking in various forms.

2.007 Banks also vary in the customers they target and in the products and services they offer. Some banks specialize in retail operations — serving the individual consumer. Others focus on wholesale banking activities in which most or all of their customers are businesses. Some banks also offer trust services to commercial and/or private customers. Commercial trust services include, for example, managing pension funds, or acting as a stock transfer agent or as trustee for a corporation's publicly held debt investments. Private trust services might include, for example, acting as an executor for an estate, managing assets for the beneficiaries of a trust, or providing financial planning advice.

2.008 The range of products and services that banks offer is constantly expanding in response to supply and demand. It is also expanding because increased competition from other financial services industry members is forcing banks to identify new opportunities for profit within their markets. Competition not just from other banks, but also from other types of financial institutions, is increasing. Barriers, both historical and legal, that have kept various financial institutions in their own market niches, are being eroded by changes in federal and state regulations and by technological changes that have reduced the costs of computer-based accounting and communications. As a result, both the number and types of institutions offering essentially the same products and services have increased. For example, savings and loan institutions and credit unions, along with commercial banks, provide consumers with interest bearing checking accounts. Even brokerage houses and sponsors of mutual funds offer investment accounts that can be drawn on demand. Many savings and loan associations and credit unions offer loans to small businesses. Corporate borrowers can also forego bank loans and raise short-term funds directly through such instruments as commercial paper or other forms of corporate debt.

2.009 Despite its diversity, the banking industry functions as an integrated network. Every bank has some relationship with other financial institutions, maintaining accounts and check processing arrangements, at a minimum. In addition, correspondent relationships allow even the smallest financial institutions to provide full banking services. In these relationships, larger banks provide smaller financial institutions access to services, such as data processing and foreign currency transactions, that they cannot provide on their own. Compensating correspondent balances — often demand deposit balances on which no interest is paid — may be maintained with the correspondent bank to cover the costs of those services, or the correspondent bank may charge direct service fees.

2.010 Because of its public functions and the insurance of its deposits by the Federal Deposit Insurance Corporation (FDIC), the banking industry is regulated. Individual financial institutions are supervised by various federal and state agencies. These regulatory efforts are aimed at ensuring the safety and soundness of the banking system and fostering the efficient allocation of funds within the economy by promoting competition and limiting opportunities for fraud and self-dealing.

2.011 State bank operating authorities and activities are generally controlled by the states and their bank regulators, but most state financial institutions are subject also to federal regulation for limited purposes. National bank operating authorities and activities are controlled by Congress and federal bank regulators, primarily the Office of the Comptroller of the Currency (OCC). Although the operating authorities of national banks are regulated at the federal level, in some cases the exercise of these authorities may be decided by reference to the operating authorities of state banks within the state in which the national bank is located.

2.012 Banking activities are subject to some restrictions in both systems. For instance, financial institutions are subject to both federal and state laws that restrict their entry into new geographic markets and expanded lines of business. The financial services commercial financial institutions are allowed to offer are also limited. The limitations include restrictions on financial institutions' providing a full range of securities, insurance, and real estate services to the public. Many of these restrictions are being questioned, however, in today's competitive financial services environment.

2.013 To ensure the safety and soundness of the banking system, federal and state authorities require that financial institutions avoid unsafe and unsound banking practices, and also comply with a variety of statutory and regulatory requirements. Bank supervisors monitor bank performance to determine compliance with these laws and regulations and safe and sound banking practices. Enforcement actions may be taken where violations are found.

2.014 Banking regulations require insured banks and savings institutions to file quarterly "call reports" (i.e., the Federal Financial Institutions Examination Council Consolidated Reports of Condition and Income and the OTS Thrift Financial Reports). Regulators use the financial information contained in the call reports as a source of statistical information and as a basis for supervisory action.

The Federal Banking Agencies

2.015 Four separate federal agencies—the OCC, the Board of Governors of the Federal Reserve System, the FDIC, and the OTS—have substantial regulatory and supervisory jurisdiction over banks and savings institutions. The following table outlines their supervisory responsibilities.

Banking Agency	Supervisory Responsibility
OCC	National Banks (Primary)
Board of Governors of the Federal	Bank Holding Companies (Primary)
Reserve System	State Member Banks (Primary) National Banks (Secondary)
FDIC	State Non-Member Insured Banks (Primary) National Banks (Secondary) State Member Banks (Secondary) State Savings Associations (Secondary) Federal Savings Associations (Secondary)
Office of Thrift Supervision	State Savings Associations (Primary) Federal Savings Associations (Primary)

2.016 As the table suggests, these agencies have jurisdictions that overlap in some circumstances. The agencies work together, however, sharing information to reduce the impact of this overlap. Illustration 2-3 at the end of this chapter provides the locations of various regulatory agencies. The following sections discuss the primary functions of these agencies.

The Office of the Comptroller of the Currency

2.017 The OCC is the administrator of the national banking system. It operates a continuous supervisory effort, monitoring the condition of the system's nearly 5,000 banks, requiring appropriate corrective action to preserve bank safety and soundness, and enforcing compliance with applicable laws and regulations.

2.018 The agency is also responsible for regulating the activities of national banks. It charters individual national banks and approves other proposed corporate activities. In particular, the OCC passes on branch applications and on merger applications in which the surviving bank will be a national bank. The agency also promulgates rules and regulations governing the activities of national banks.

The Board of Governors of the Federal Reserve System

2.019 The Board of Governors of the Federal Reserve System (Board) conducts the nation's monetary policy. As part of that effort, the Board exercises some control over financial institutions and other depository institutions. For instance, institutions that offer transaction accounts (checking/NOW accounts) or non-personal time deposits are required to maintain reserves at their district Federal Reserve Bank equal to a percentage of their customers' deposits. These reserves help to control the money supply by dictating what percentage of the bank's deposits may be loaned or invested.

2.020 Besides its responsibilities for monetary policy, the Federal Reserve System performs many other central bank functions. It acts as a fiscal agent for the U.S. Treasury and as a "lender of last resort." It provides services, such as check clearing and collection and wire transfers, which are available to all depository institutions for a fee.

2.021 The Federal Reserve System also has other responsibilities, including responsibility for supervising and regulating bank holding companies. In this capacity, it approves the activities of bank holding companies and examines their operations for safety and soundness. It has some authority over Federal Reserve System member banks (member banks include all national banks and state banks that choose to become members) and serves as the primary federal supervisor of state member banks, reviewing activities and examining their condition for safety and soundness and compliance with federal laws.

The Federal Deposit Insurance Corporation

2.022 The FDIC, generally stated, insures deposit accounts in FDIC-insured financial institutions for up to $100,000 per depositor. National and state banks that are members of the Federal Reserve System are automatically insured and are required by federal law to maintain FDIC deposit insurance, as are federal savings associations. By state law or policy, nearly all other financial institutions also must maintain that coverage. The FDIC acts as receiver when a national bank is closed and when a state requests it to do so for a closed state bank. In addition, it is authorized to make loans to or buy assets from insured financial institutions to facilitate mergers or consolidations under specified circumstances designed to protect the insurance fund or ensure continued banking services in a community.

2.023 Besides its responsibilities for the insurance fund, the FDIC is also the primary federal supervisor of FDIC-insured state banks that are not members of the Federal Reserve System. In this capacity, it supervises and reviews activities and examines the insured non-member banks for safety and soundness and compliance with federal laws.

Office of Thrift Supervision

2.024 With the passage of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA), the Federal Savings and Loan Insurance Corporation (FSLIC) was dissolved and, as noted previously, the FHLBB was succeeded by the Office of Thrift Supervision (OTS), a bureau of the Department of the Treasury. FIRREA also created the Resolution Trust Corporation (RTC) and the RTC Oversight Board. The RTC, under the general oversight of the RTC Oversight Board and the FDIC, manages and resolves all cases involving savings institutions that were insured by the FSLIC; manages assets of the liquidated Federal Asset Disposition Association; and manages, sells, or disposes of assets obtained from the closing of insured institutions. Further, FIRREA made important definitional changes to the Federal Deposit Insurance Act to make it apply to both banks and savings institutions. A new insurance fund, the Savings Associations Insurance Fund (SAIF), was created to replace the insolvent FSLIC fund. The FDIC operates the SAIF and the Bank Insurance Fund (BIF), and has the examination authority for savings institutions. FIRREA also amended the statutory criteria and procedures for applications for deposit insurance, changed the procedures for the termination of deposit insurance, and expanded the FDIC's authority to borrow from the U.S. Treasury. The director of the OTS may appoint the FDIC as conservator or receiver of any insured federal depository institution, contingent upon several factors. These factors include, among others, insolvency, deficient tangible capital, substantial dissipation of assets or earnings, or unsafe and unsound conditions for transacting business. The OTS remains the primary regulator for savings institutions, but the FDIC acts in a secondary regulatory role and may terminate insurance coverage for just cause. The FDIC has the authority to examine any savings institution; the examination may be performed jointly with the OTS or independently.

Federal Home Loan Banks

2.025 The credit function of the district Federal Home Loan Banks (district banks) is administered by the Federal Housing Finance Board (FHFB), an independent agency in the executive branch of the federal government. The primary responsibilities of the district banks include setting standards of community investment for member institutions, providing member institutions with access to long-term advances, and administering the Affordable Housing Reserve Fund (AHRF). The AHRF was established by FIRREA to promote affordable housing by making low-cost funds available to member institutions for loans to low- and moderate-income households. The Federal Home Loan Mortgage Corporation (FHLMC) was established by the Emergency Home Finance Act of 1970. The FHLMC, which is a publicly owned corporation regulated by the Department of Housing and Urban Development (HUD), facilitates the secondary-mortgage market by purchasing mortgages from lenders and selling investment securities backed by those mortgages.

National Bank Supervision

2.026 National banks are supervised by OCC examiners who develop programs of on-site examinations and off-site monitoring, tailored specifically to the requirements of each individual bank. The examiners evaluate the general condition of their assigned banks for safety and soundness, focusing on, among other things, the quality of bank assets and earnings, adequacy of internal control systems, director effectiveness, management competence, and the adequacy of the bank's liquidity and its capital.

2.027 If OCC examiners believe a bank has significant weaknesses, the examiners may identify that bank as one requiring additional or special supervision. Such weaknesses might include an unusual amount of low quality assets; insufficient capital; unwarranted loans to officers, directors, or stockholders; earnings or liquidity problems; or inefficient, or possibly dishonest, management. In such circumstances, the bank is reviewed and monitored more frequently.

2.028 In addition to its responsibility for monitoring the bank's safety and soundness, the OCC is also charged with enforcing compliance with a variety of laws, including some designed to foster the social responsibility of banks or to help broaden legal enforcement efforts. For example, the OCC is required to assist enforcement under the Bank Secrecy Act by ensuring that banks have adequate systems and procedures for complying with that Act's requirement that banks report certain currency transactions. Special on-site examinations are performed to determine compliance with such requirements.

2.029 The OCC also may take action in response to specific notices of possible violations or other relevant matters. It may, for instance, investigate complaints under the Equal Credit Opportunity Act (ECOA). This act makes it illegal for banks to discriminate in the granting of credit based on certain prohibited factors. In determining whether to approve a bank's application to open branches or to merge with another bank, the OCC also may consider information regarding a bank's performance under the Community Reinvestment Act (CRA), which encourages financial institutions to help meet the credit needs of their local communities.

Bank Regulatory Examinations

2.030 Financial institutions are examined regularly at varying dates by the FDIC, the OCC, the Federal Reserve, and state regulatory offices. The primary objective of these examinations is to determine the safety and soundness of the bank's operations and assets. Examinations also help regulators identify problem financial institutions so that corrective action can be taken. Regulatory examinations are geared toward depositors rather than investors. Specifically, they are directed toward determining the bank's solvency, the competence of management, and compliance with the laws under which a bank operates. Examinations are usually scheduled on an 18- to 24-month cycle. More frequent examinations usually occur when a bank has filed a registration statement, changed ownership, or experienced some other special circumstance.

2.031 The part of the examination to which the regulators devote the most time is the evaluation of the credit-worthiness of the bank's loan portfolio. Another important part is the evaluation of the quality of the bank's operations and management. A summary of the bank examination report is presented and discussed with bank's management and board of directors. If the bank's operations are in violation of law, poor operating procedures are detected, or the bank's capital is below regulatory requirement, management of the bank is requested to correct the violation and the bank's progress is closely monitored.

2.032 Federal regulators have adopted a uniform rating system called "CAMEL." Under CAMEL, bank examiners focus on five performance dimensions: capital adequacy, asset quality, management competency, earnings and liquidity. Each of these categories is rated on a scale of one to five.

2.033 An examination by regulatory authorities differs in some respects from an audit in accordance with generally accepted auditing standards (GAAS). Several key distinctions are:

- Regulatory examiners do not address all of the assertions of management embodied in the bank's financial statements. For example, the regulators do not undertake independent confirmation of amounts due to the bank.

- Regulatory examiners direct their efforts to the presentation and disclosure in regulatory reports in accordance with regulatory accounting principles (RAP), as opposed to a set of financial statements fairly presented in accordance with generally accepted accounting principles (GAAP).

- The principal focus of a regulatory examination is the evaluation of the credit-worthiness of the bank's loan portfolio, and the identification of any potential loan losses in the portfolio.

2.034 The findings that result from an examination by regulatory authorities are presented in a document known as a "Report of Examination."

2.035 The Report of Examination as prepared by the FDIC, is a report as of an examination date. When issued in final form, the Report often contains information on events subsequent to the examination date. While the Report is one of the sources of evidence available to the auditor, there are significant limitations on the verification of its contents.

2.036 The auditor has access to the complete examination report given to bank management. However, the auditor has no opportunity to review the regulatory agency's working papers or associated "line cards" (information shared among regulatory examiners). Also, the auditor cannot evaluate the professional credentials of the examiners who performed the examination.

2.037 The Report is subject to a number of levels of review within the FDIC, which often adds many months to the finalization of the Report. The recommended findings of an examination team are subject to change during this process without discussion or notification to interested parties, until the report is issued in final form.

2.038 When the regulatory examination findings are of concern (usually when there is a CAMEL rating of 3 or higher) there are several regulatory vehicles for dealing with the correction of the matters giving rise to the regulatory concerns. An action under Section 8A of the Federal Deposit Insurance Act, results in the FDIC notifying a bank of cancellation of its deposit insurance. Regulatory agencies have other forms of agreements and actions, which are described in sections 2.045 — 2.059. The independent auditor should always be alert for the existence of regulatory agreements and the related commitments they impose on a bank.

2.039 Federal regulatory agencies have several tools available to carry out their supervisory responsibilities, and Congress has given the regulators broad discretion in the use of these tools. Although regulators may sue bank directors in federal court for statutory violations, most often they use administrative actions when dealing with violations or with other breaches of duty and improper practices. The more commonly used actions vary in severity, ranging from the least severe commitment letters to cease and desist orders. The regulatory agencies also have the authority to impose civil monetary penalties and to order the removal of bank officers and directors. Finally, in extreme circumstances, they can take actions to revoke a bank's charter.

2.040 The regulators decide whether to bring an action against a bank or an individual and what the nature of such action should be, giving consideration to the need to correct current violations and prevent future problems. Key factors in its decisions are the seriousness of the safety and soundness concerns and the violations of law, and the bank's history of cooperation with regulators in dealing with problems. Since the regulators and the bank's management and directors have a mutual interest in improving the condition of a bank in which problems have been identified or administrative actions brought, it is in both parties' best interests that corrective action be taken expeditiously. A bank's failure to respond promptly and decisively to cited problems likely will result in a severe regulatory action.

2.041 Generally a bank first becomes aware that its primary regulator is considering an action at the examiner's exit interview, when the examiner in charge meets with management, and often with the board of directors, to discuss the regulator's concerns. Directors should actively participate in this meeting, making sure the examiner is aware of the bank's current strengths and successes and seeking advice in correcting existing or potential problems. The period between the end of an examination and the time the findings are formalized in writing provides a good opportunity for the bank to formulate and begin to carry out a reasonable plan to correct the problems. The regulators encourage financial institutions to submit responses stating the bank's commitment to a corrective plan and specifying the terms of the plan. It also is advisable during this period for the bank to keep in contact, either by telephone or in writing, with the appropriate regulatory personnel to expedite the corrective process and to demonstrate that it is responding promptly and positively to the regulator's concerns. Actions proposed and taken to deal with these concerns should be documented in the board minutes.

2.042 If the primary regulator decides to bring an action, the bank's directors usually will receive a request to meet with the regulators in the district or area office to receive the course of action the regulator has chosen. If the directors disagree with the proposed action and differences cannot be resolved at the meeting, the board will be given a reasonable amount of time to propose changes and to discuss alternatives with the regulator. Good faith discussions between the board and appropriate personnel at the regulatory agency generally are highly useful in bringing about a speedy and mutually acceptable resolution of differences. The emphasis in these proceedings should be on devising a realistic and reasonable method to restore the bank to good condition.

2.043 Remedial actions are actions regulators take to correct specific problems that have been identified at a particular bank. They may take the form of commitment letters, memoranda of understanding, formal agreements, capital directives, cease and desist orders, and removals. Typically, a remedial action specifies several actions the bank or individuals must take to correct identified problems, such as devising a plan to increase capital or to provide for management succession, or disposing of a piece of real property held by the bank in violation of applicable law.

2.044 Such actions may be imposed on a bank or individual either through the bank's directors consenting to comply with the items in the proposed document or, absent consent, through an administrative proceeding. In either case, the directors are ultimately responsible for ensuring that the bank complies with the action. A remedial action is terminated when the regulator determines that the overall condition of the bank is significantly improved, and the bank has substantially complied with the terms of the document.

2.045 Commitment Letter. A commitment letter is the least severe tool used by regulators. In fact, a commitment letter may be submitted by a bank's board of directors that has been advised of a problem, such as a deficiency in the bank's lending policy that needs to be corrected for the bank to avoid serious loan problems in the future. The letter, signed by the board, enumerates the problems that require corrective action and lays out the plan and timetable established by the board to remedy the problems. Commitment letters are often used for financial institutions that have been responsive in the past and that do not have a history of serious problems, and when the problems do not pose an immediate or serious threat to the bank's health.

2.046 Memorandum of Understanding. A memorandum of understanding (MOU) is initiated by the regulator primarily responsible for supervision of the bank and is entered into between a bank's board of directors, or an individual, and the regulator. Unlike the commitment letter, the MOU is a formally drafted document that sets forth the bank's agreement to take certain actions within specified time periods to correct violations of law or unsafe and unsound conditions. Generally, regulators use an MOU only when the problems do not pose an immediate or serious threat to the bank, and when the regulator believes the bank will cooperate in correcting the problems, thereby avoiding legal enforcement. If a bank fails to comply with an MOU, the regulator will consider a stronger action.

2.047 Formal Agreement. Like the MOU and the commitment letter, a formal agreement requires agreement between the regulator and the bank, or individual, as to the remedial action necessary to correct the cited conditions. It is proposed when the problems are not too severe and management is cooperative. The formal agreement differs from an MOU, however, because the regulator may order compliance with a formal agreement through a cease and desist order and may seek judicial enforcement of any failure to respond to the order.

2.048 Cease and Desist Order. Through cease and desist orders (C & Ds), regulators have broad authority to fashion appropriate remedies for abuses. Using a C & D, the regulator may require financial institutions, or persons participating in the bank's affairs, that violate the law or a formal agreement or engage in an unsafe and unsound practice, to stop the proscribed activities and to take affirmative action to remedy the violations or practices. For instance, individuals who received excessive bonuses from a bank have been ordered to return those sums to the bank. Affirmative actions designed to prevent future violations may also be ordered. For example, to prevent future abuses, insiders who have abused their account relationships with a bank have been prohibited from maintaining accounts at the institution.

2.049 Cease and desist orders are issued most often when the regulator is not confident that bank management will take the necessary corrective action or when the problems are so severe that a lesser action cannot be justified. C & Ds are also used to compel compliance with enforcement documents.

2.050 When the regulator determines that a C & D is required, it will bring the problems to the directors' attention and serve the directors an order specifying the corrective actions to be taken. Usually, the order is served at a board meeting. At that time, the regulator will ask the board to sign a formal consent, which requires the signatures of the majority of the board. Once an order becomes effective, all directors are responsible for compliance with it.

2.051 If consent to a C & D is not obtained, the regulator will serve a "notice of charges" identifying the problems and setting out the basis for the action and the parties against whom the action is being brought. Each party charged must file an answer to the notice, after which the matter proceeds to an administrative hearing, which is a formal trial-type proceeding held before an Administrative Law Judge (ALJ). If any violation or practice specified in the notice of charges is established, the regulator may issue a C & D. A bank or other party against whom a C & D has been issued may obtain review of the order in a federal court of appeals.

2.052 If the bank fails to comply with a C & D, the C & D may be enforced in federal district court or by a civil monetary penalty action. The regulator may take the matter to federal district court to seek a mandatory injunction requiring compliance. If the injunction is not obeyed, contempt of court proceedings may be pursued. Regulators may impose civil monetary penalties directly against any bank or individual who violates a C & D. A C & D remains in effect until the regulator terminates it.

2.053 **Temporary Cease and Desist Order.** The regulator may issue a temporary cease and desist order before a cease and desist proceeding is completed when one of the following is likely to occur: bank insolvency; substantial dissipation (shrinkage) of bank assets or earnings; serious and progressive weakening of the bank's condition; or prejudice to the interests of the depositors. The temporary order may require the bank or other party to cease and desist from the violation or practice and/or to take affirmative corrective action. Unless the temporary cease and desist order is set aside by court order, it is effective when served and remains in effect until the administrative proceedings leading to a cease and desist order are complete.

2.054 **Capital Directive.** Because of the critical importance of adequate capital, capital requirements have been established for all insured financial institutions. When necessary or appropriate, the appropriate regulator may issue to an individual bank a capital directive, which requires the bank to and maintain a higher capital requirement. The capital directive is a form of order used by regulators when an insured bank is not maintaining its capital at or above the required level. A directive also may be issued when a bank has failed to submit or is not in compliance with a reasonable plan to achieve required capital levels.

2.055 When a bank is notified that its regulator intends to issue a capital directive, the bank may consent to the directive or notify the regulator in writing of its objection. If the bank objects, the regulator will review the bank's response and determine whether to issue the directive or require the bank to submit an acceptable plan of its own. A capital directive, or any plan submitted pursuant to a directive, may be enforced in the same manner as a cease and desist order.

2.056 Removal and Suspension. Regulators also may initiate action to remove and, if necessary to protect the bank, suspend a bank director or officer for a particularly serious violation of law, unsafe and unsound practice, violation of a cease and desist order, or other breach of duty. A suspension is an interim procedure while removal proceedings are underway to protect the bank and its depositors from an immediate threat. Unless stayed by a court, a suspension is effective upon written notice by the regulator and remains in effect until the removal proceedings are completed or the charges are dismissed.

2.057 To remove an officer or director, the regulator must show that: (1) an improper act was committed; (2) the bank has suffered or probably will suffer substantial financial loss or other damage, (3) the officer or director received financial gain, or the depositors' interests could be seriously prejudiced, and (4) the act involved personal dishonesty or demonstrated willful or continuing disregard for the safety and soundness of the bank.

2.058 A proceeding to remove a person from office begins with a notice of the grounds for the action and the time and place set for a formal administrative hearing on the matter before an Administrative Law Judge (ALJ). If the person does not consent to the removal, the matter proceeds to hearing. Based on the hearing record and the recommendations of the ALJ, a final determination on the removal is made by the Board of Governors of the Federal Reserve System. A removal order may be reviewed in the appropriate federal court of appeals.

2.059 Once in place, a removal or suspension order prohibits the person from participating, in any manner, in the affairs of the bank, in voting for a director of the bank or, without the permission of the regulator, serving or acting as a director, officer, or employee of any other FDIC-insured bank. Removal or suspension of the offending officer or director thus protects the bank from a continuing threat to its safety and soundness. The OCC also may protect the bank by removing or suspending on written notice a bank officer or director charged with or convicted of a felony involving dishonesty or breach of trust if continued service to the bank may threaten the depositors' interests or impair public confidence in the bank. The person may request an informal hearing before the agency to modify or terminate the notice of suspension or order of removal. One year after an adverse ruling, the person may petition for reconsideration of the decision. The removal or suspension remains in effect until terminated or, in the case of a suspension, until the criminal charge is disposed of.

Managing Risk in Audits of Financial Institutions

2.060 The Nature and Forces of Risk Assessment. Designing an audit plan for a financial institution requires a thorough understanding of an audit's objective, the financial institution, and how these two factors interact to create unique and sometimes troublesome challenges.

2.061 Risk Assessment. Statement on Auditing Standards (SAS) No. 47, *Audit Risk and Materiality in Conducting an Audit*, defines audit risk as "the risk that an auditor . . . may unknowingly fail to modify his opinion on financial statements that are materially misstated." Financial statements are considered materially misstated "when they contain errors or irregularities whose effect, individually or in the aggregate, is important enough to cause them not to be presented fairly in conformity with generally accepted accounting principles." While this definition applies to material misstatements in a client's financial statements taken as a whole, in planning an audit, the auditor must assess audit risk and materiality in relation to individual account balances and transaction classes as well. This entails assessments of inherent risk and control risk so that detection risk can be managed at an appropriate level.

2.062 In audits of financial institutions, audit risk should be established at a low level, given the needs and expectations of those who rely on the institutions' audited financial statements. Inherent risk can be affected by such internal factors as management style, an account's susceptibility to theft, and whether it is derived from accounting estimates, and such external factors as operations in a declining industry or market factors giving rise to risk associated with changing interest rates or liquidity needs. As the size of a financial institution increases, the relationship between the assessed level of control risk and audit risk becomes more critical. In smaller financial institutions, it may be practicable to decrease detection risk to a sufficiently low level through the use of substantive tests. For larger financial institutions, control risk is normally assessed at below the maximum level. For most financial institutions, an assessment of control risk at maximum would preclude the issuance of an unqualified opinion, since it would not be possible to perform substantive tests sufficient to provide reasonable assurance that the financial statements were free of material misstatement.

2.063 The volatility of the account balances and classes of transactions in a financial institution must be carefully considered in designing the audit plan. Analytical procedures are useful in developing an effective audit plan for a financial institution. Continued emphasis by regulators on financial ratios and peer comparisons provides a useful approach to evaluating key factors, such as liquidity, capital adequacy, and interest rate sensitivity. Comparative statistics are available from several sources, including rate regulatory agencies. The FDIC's *Uniform Bank Performance Report* provides many comparisons based both on size of the institution and on geographic location. The information included in the Report is based on self-reported data submitted to the regulatory agencies by financial institutions. Thus, evaluation of the institution's control structure, including controls over the preparation of reports to regulatory agencies, is an important consideration in determining how much reliance to place on the data.

2.064 External influences, such as examination and oversight by regulatory agencies, enhance management's awareness of specific regulatory requirements, resulting usually in the establishment of specific internal control policies and procedures. The regulatory oversight and examination process normally results in reports to the institution and, in some cases, certain requirements or agreements for correcting matters noted in the reports. AICPA Statement of Position (SOP) 90-5, *Inquiries of Representatives of Financial Institution Regulatory Agencies*, provides guidance to auditors on the use of these reports and other communications with regulators in planning and conducting an audit of a financial institution. The SOP further assists the auditor in evaluating the effect of these communications on the institution's financial statements and on the auditor's report. Many of the characteristics of failed financial institutions identified in the report of the Comptroller of the Currency discussed below are similar to the general factors discussed in SAS No. 53, *The Auditor's Responsibility to Detect and Report Errors and Irregularities*, as indicators of higher than normal potential for misstatement.

2.065 Given the highly regulated environment in which the financial institutions operate, auditors should be aware of major laws and regulations that could give rise to a material misstatement in a financial institution's financial statements. The auditor should also be aware of uncertainties related to the application of the laws and regulations that might create a need for modified wording in the auditor's report.

2.066 **Identifying High Risk Areas.** In June 1988, the OCC published a study entitled *Bank Failure—An Evaluation of the Factors Contributing to the Failure of National Banks*, which analyzed the performance of 260 banks from 1979 to 1987. Included in the analysis were failed banks (171 banks), rehabilitated banks (51 banks), and healthy banks (38 banks). A failed bank was one that was declared insolvent and resulted in either a purchase and assumption, a deposit transfer, or a payoff of insured depositors.

2.067 The OCC evaluated each bank's performance in eight categories: policy, planning, and management quality; audits, controls, and systems; asset quality; liquidity and funds management; nonfunding expenses; insider abuse; fraud; and economic environment. The findings of the study are a useful guide in managing risk and planning an audit of a financial institution.

2.068 The results of the study indicated that the major cause of decline and eventual failure of problem banks was poor asset quality, which ultimately eroded their capital. To determine the factors leading to poor asset quality, the OCC assessed internal and external conditions in the sample banks. The findings are presented in Illustration No. 2-1. Poor policies, planning, and management were discovered in 90 percent of the failed banks and 88 percent of the rehabilitated banks before recovery. Other internal problems related to insider abuse and audits, controls, and systems also contributed to the poor condition of these banks. The results of these findings are presented in Illustration No. 2-2.

2.069 Seventy-three percent of the failed banks were faced with a depressed economic environment, while another 15 percent of the failed banks operated in marginally depressed conditions. As might be expected, the depressed economic conditions led to problems in loan collectibility in the areas of oil and gas, real estate, and agriculture. Surprisingly, though, the evidence indicated that depressed economic conditions were the primary cause of bank failure for only seven percent of the banks in the study. The OCC concluded that a bank's ability to remain healthy in a depressed economy was a function of how its internal policies and procedures were operating.

2.070 Overall Risk in Financial Institution Audits. In today's environment, an auditor must pay special attention to the material risks facing financial institutions. Internally, material risk involves a combination of management risk associated both with credit decisions and market decisions. The OCC findings reflect that the failed and declining banks in its study seriously lacked systems, policies, and specific controls to limit internal risk. Conversely, healthy and rehabilitated banks exhibited strengths in the following areas: controls over key bank officers and departments, management information systems, systems to ensure compliance with policies and laws, lending policy, and problem loan identification systems.

2.071 The highest risk areas auditors typically face are in the bank's loan portfolio (i.e., the allowance for loan losses) and evolving environmental forces. Planning and performing the audit of loans involves evaluating management's assertions relative to valuation or allocation and presentation and disclosure. The other assertions are important, but, in most instances, simple control systems adequately control the risk associated with existence or occurrence, completeness, and rights and obligations.

ILLUSTRATION NO. 2-1

Conditions Leading to Decline of Banks

Categories	Percent of Banks With Significant Weaknesses: Failed Banks	Percent of Banks With Significant Weaknesses: Rehabilitated Banks (Before Recovery)
Asset quality	98	98
Policies, planning, and management	90	88
Economic environment	35	39
Insider abuse	35	24
Audits, controls, and systems	25	24
Material fraud	11	0
Liquidity and funds management	10	6
Nonfunding expense	9	4

Source: *Bank Failure—An Evaluation of the Factors Contributing to the Failure of National Banks*, (U.S. Government Printing Office, 1988) p. 21.

ILLUSTRATION NO. 2-2

Significant Problem Areas in Failed Banks

- Uninformed or inattentive board of directors or management
- Nonexistent or poorly followed loan policies
- Inadequate systems to ensure compliance with internal policies or banking laws
- Inadequate controls or supervision of key bank officers or departments
- Inadequate problem loan identification systems
- Decisions made by one dominant individual
- Nonexistent or poorly followed asset and liability management policies
- Overly aggressive activity by board or management
- Inappropriate lending policies (liberal repayment terms, collection practices, or credit standards)
- Excessive loan growth in relation to the abilities of management staff, control systems, or funding sources
- Undue reliance on volatile liabilities
- Inadequate liquid assets as a second source of liquidity
- Problems involving the chief executive officer (lack of capability, experience, or integrity)
- Other problems related to oversight or management deficiencies
- Excessive credit exceptions (missing financial statements or poor collateral documentation)
- Overlending
- Collateral-based lending and insufficient cash flow analysis
- Unwarranted concentrations of credit in one industry
- Insider abuse and fraud
- Self-dealing, undue dependence on the bank for income or services by a board member or shareholder, inappropriate transactions with affiliates, or unauthorized transactions by management
- Material fraud

Source: *Bank Failure—An Evaluation of the Factors Contributing to the Failure of National Banks*, (U.S. Government Printing Office, 1988) pp. 5–10.

2.072 Allowance for Loan Losses. In addition to guidance in the AICPA Industry Audit Guide, *Audits of Banks*, (Bank Audit Guide), guidance for evaluating the allowance for loan losses is provided in the AICPA Auditing Procedures Study, *Auditing the Allowance for Credit Losses of Banks*. In 1996, the AICPA will issue a new industry audit and accounting guide, *Audits of Banks and Savings and Loan Associations*, which will incorporate the guidance in the procedures study. The audit objective pertaining to loans and the related allowance for loan losses is to evaluate the reasonableness of the allowance recorded by management. The allowance for loan losses represents the quantification of management's assertion that the loan portfolio is valued at its net realizable value in accordance with GAAP. Guidance for quantifying the allowance is found in Statement of Financial Accounting Standards (SFAS) No. 5, *Accounting for Contingencies*, which provides authoritative guidance on the accounting and reporting of loss contingencies, including addressing the uncertainty about the collectibility of receivables. SFAS No. 5 discusses the likelihood that, when a loss contingency exists, one or more future events will confirm the loss. It requires that an estimated loss from a loss contingency be accrued if both of the following conditions are met:

1. Information available prior to issuance of the financial statements indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements. It is implicit in this condition that it must be probable that one or more future events will occur confirming the fact of the loss.

2. The amount of loss can be reasonably estimated.

2.073 The AICPA's SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties*, expands the disclosure requirements of SFAS No. 5 for disclosure of contingencies and certain estimates. See Chapter 1, section 1.339 for a discussion of SOP 94-6.

2.074 The Bank Audit Guide provides additional guidance on the application of SFAS No. 5 to a bank's loan portfolio. The Guide states that a bank should maintain a reasonable allowance for loan losses applicable to all categories of loans through periodic charges to operating expenses. The amount of the provision (the amount of expense in a particular year) can be considered reasonable when the allowance for loan losses (the amount carried as the accumulated valuation account in the balance sheet) including the current provision, is considered by management to be adequate to cover estimated losses inherent in the loan portfolio. The Bank Audit Guide also indicates that the propriety of the accounting treatment should be judged by considering the adequacy of the allowance, not the provision charged against income. Loans should be charged off as soon as they are deemed uncollectible. It is important to consider the Guide's phrase "estimated losses inherent in the loan portfolio" in connection with SFAS No. 5's requirements. Accordingly, the allowance should be adequate to cover specifically identified loans, as well as loans and pools of loans for which losses are probable but not identifiable on a specific loan-by-loan basis.

2.075 The Bank Audit Guide states that the significant objective of the audit of the allowance for loan losses is to evaluate the reasonableness of the recorded allowance. The Guide describes the allowance as an amount that, in management's judgment, approximates the current amount of loans in the portfolio at the balance-sheet date that will not be collected. All relevant conditions existing at the balance-sheet date should be considered. These considerations should not be limited to previous collection experience but should also incorporate the effect of changing business trends and other environmental conditions. Loan evaluation is a matter of ascertaining loan collectibility — whether the loan will be repaid or the principal otherwise recovered. The outcome may depend, among other factors, on the borrower's financial abilities as indicated in past and projected earnings and cash flow, credit history, net realizable value of the loan collateral, and the financial responsibility of endorsers or guarantors. Most often a combination of these factors determines the soundness of a particular loan.

2.076 The auditor is not responsible for calculating the amount of the allowance but for obtaining reasonable assurance that management has recorded a reasonable allowance, based on available information and all relevant factors bearing on loan collectibility. Since loans are generally a bank's largest single class of assets and generally present the highest potential for loss, the auditor can expect to encounter numerous individuals or groups, in addition to state and federal regulators who have an interest in evaluating the collectibility of the loan portfolio. These include the institution's loan committees, executive committees, internal auditors, and directors' examining committees. The groups' specific responsibilities in loan review may vary, depending on the size of the bank and the directives of the board of directors and management. In planning the approach to an evaluation of the adequacy of the allowance, the auditor should determine the existence and role of the interested parties. Testing the provision for loan losses and related allowance account should maximize the use of information available from these sources, and the auditor may consider their efforts when setting the nature, extent, and timing of tests.

2.077 The principal purpose of the audit procedures for the allowance for loan losses is to identify individual loans or conditions that require further consideration in evaluating the reasonableness of the allowance. Factors include:

- Current trend of delinquencies;
- Loans classified by supervisory agency examiners;
- Excessive loan renewals and extensions;
- Absence of current financial data of borrowers and guarantors;
- Borrowers experiencing such problems as operating losses, marginal working capital, inadequate cash flow, or business interruptions, such as involuntary conversions due to fire loss or condemnation;
- Loans secured by collateral that is not readily marketable or is susceptible to deterioration;
- Loans in industries experiencing economic instability; and
- Inadequately documented loans.

2.078 The auditor is not required to ascertain the collectibility of each individual loan included in a bank's portfolio. Rather, audit procedures should be designed to determine the collectibility of the entire portfolio and should be performed primarily on a test basis. In establishing the scope of the work to be performed, the auditor should consider the composition of the loan portfolio; growth trends in specific loan classifications; previous loss and recovery experience, including timeliness of charge-offs; the existence of appropriate lending policies and procedures; management's procedures for loan review and classification; and subjective factors, such as economic and environmental conditions.

2.079 Although the auditor's primary responsibility when analyzing the allowance for loan losses is to evaluate its adequacy as a whole, practical considerations may dictate that the analysis be directed to the separate categories of loans that constitute the bank's portfolio. Since the risk and other inherent characteristics of loan categories vary, the nature and extent of procedures applied to each category can be expected to vary. Loan categories represented by large volumes of relatively small loans with similar characteristics, such as real estate mortgages, installment loans, and retail credit loans, are generally evaluated on a pool basis. The auditor is generally more concerned with the effectiveness of and adherence to sound procedures related to such loans than with a critical appraisal of individual loans. Testing procedures and reviewing delinquency status reports should permit a conclusion to be drawn about the adequacy of the allowance required for those loan classifications. In evaluating the adequacy of the portion of the allowance attributable to those loans, use of historical average annual charge-off experience should be considered in light of the average remaining lives of loans, consistency of loan policy, and current economic conditions.

2.080 Conversely, evaluating commercial loans normally requires a more detailed review since the amount of individual loans is generally large and the types of borrowers and the purposes of the loans may be dissimilar. The auditor may select and review a certain number of loans in excess of a certain amount, paying particular attention to problem loans previously identified by the bank's internal review procedures, the auditor's prior experience, and loans commented on by regulatory authorities. Loans selected for review may be further stratified by type of loans, such as construction loans, floor plan loans, working capital loans, or loans to a specific class of business, depending on the auditor's assessment of the relative exposure to loss presented by the various categories.

2.081 The total amount, number, and types of loans the auditor should review, cannot be specified with any degree of uniformity. Factors to consider include trends in the level of delinquent loans, local and general business conditions, specific industry conditions, and past loss experience.

2.082 Information about a borrower and any related lending transactions is ordinarily contained in a credit file, a loan documentation file, or both. Loan documentation for new loans or renewals should include information such as a standard loan memorandum, borrower financial statements, appraisals, and forecasts and projections. The documentation required to perfect collateral or to obtain guarantees includes security agreements, collateral receipts, loss payable clauses, assignment of interests in assets, and other similar agreements. Some or all of these documents may be found in separate files, other than credit files. Negotiable collateral should be kept in the bank's vault, and in most cases executed notes are kept in separate secure files.

Environmental Forces

2.083 Communication Obligations. The auditor has important communication obligations that are designed to insure that management, the audit committee, and others are properly informed of conditions observed during the audit. Letters covering reportable conditions, particularly any that might be considered a material weakness in internal control, are of interest to regulators, directors, and others with a fiduciary responsibility for the financial institution.

2.084 Economic Conditions. Financial institutions are also subject to the risk of external influences that may lead to decline or failure. One of the most critical of these risks is the susceptibility of a financial institution to general economic conditions. While many financial institutions have failed due to internally caused risks, a large number have been adversely affected by their operation in certain sectors of the general economy. Among the economic sectors that have led to regulatory action, ranging from forbearance to assistance to closing of the institution, are agriculture in the early 1980's, energy in the mid-1980's and, most recently, real estate development in the late 1980's. For many institutions, loans to foreign countries have also been a problem area.

2.085 Laws and Regulations. The administration of laws and regulations by regulatory agencies present another important area of risk to financial institutions. Passage of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA) and the FDIC Improvement Act of 1991 (FDICIA), combined with the decline in resources of the FDIC, has created a shift in priorities of financial institution regulators. Armed with mandated changes in allowable accounting practices and faced with possible adoption of changes to the U.S. banking system patterned after those in the United Kingdom, regulators are scrutinizing the operations of financial institutions more closely than ever. Faced both with spending restraints and political considerations, regulators must balance the safety and soundness of the U.S. banking system with social cost issues, such as those embodied in the Community Reinvestment Act, Environmental Protection Act, and industry practices that have evolved over six decades. Communication with regulators is now even more critical to the auditor in evaluating the risks associated with a financial institution audit.

2.086 Changing Accounting Standards. Within the last five years, financial institutions have dealt with a number of new accounting rules that have resulted in fundamental changes to their accounting and reporting systems and procedures: accounting for pensions, a new required statement of cash flows and two subsequent amendments to facilitate its preparation by financial institutions, a twice-deferred change in accounting for income taxes, new requirements for disclosure of off-balance sheet risks and concentrations of credit risk, and accounting for certain post-employment benefits. Further uncertainty has been created by the call for "mark-to-market" accounting for investment securities and standardization of valuation methods used to calculate and record foreclosed assets and reserves for losses. The Financial Accounting Standards Board has issued guidance covering market value accounting for all investment securities and valuation of loans. SFAS No. 114, *Accounting by Creditors for Impairment of a Loan*, is effective for calendar year 1995 financial statements. SFAS No. 118, Accounting by Creditors for Impairment of a Loan-Income Recognition and Disclosures, which amends SFAS No. 114, will be effective at that time also. SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, is effective for calendar 1994 and requires that, except for debt and equity securities classified as "held to maturity," investments in debt and equity securities should be reported at fair market value. In an effort to improve the financial reporting of derivatives, the FASB issued SFAS No. 119, which is effective for calendar year 1994 financial statements, except for entities with less than $150 million in total assets, for which it is effective for calendar year 1995 financial statements. SFAS No. 119 expands and amends the requirements of SFAS No. 107, *Disclosures about Fair Value of Financial Instruments* and requires certain additional disclosures (see chapter 1, section 1.309 for further information.)

SFAS No. 122, issued in May 1995, amends SFAS No. 65, *Accounting for Certain Mortgage Banking Activities*. SFAS No. 65 distinguished between loans originated by the services and those that were purchased. This distinction led to different accounting treatments. The new statement eliminates the distinction and requires mortgage services to recognize as separate assets rights to service loans, no matter how the rights were acquired (see chapter 1, section 1.319 for further information).

2.087 Future Directions in Financial Institutions Audits. The FDIC has adopted an aggressive stance in charging auditors with negligence in their work with insured banks and saving institutions that have been assisted or closed. Allegations of damages into the hundreds of millions of dollars have been made against several of the largest accounting firms, along with similar claims against smaller accounting firms. As cases come to trial, an entire new set of case law is being developed. Several of the large CPA firms have reached global settlements with the regulatory agencies, agreeing to pay hundreds of millions of dollars in settlement of claims against them for wrong-doing in financial institution audits. As in the mid-to-late 1980's, the profession will undoubtedly be faced with addressing new issues similar to those that led to the issuance of the "expectation gap" auditing standards in response to the report of the National Commission on Fraudulent Financial Reporting (Treadway Commission).

2.088 In 1990, the AICPA issued SOP 90-6, *Director's Examinations of Banks*. In the future, it might be reasonable to assume that auditors of financial institutions will perform some combination of our traditional "Director's Examination" with the responsibilities of the "Reporting Accountant," as defined in the U.K. Banking Act of 1987. Such an engagement would provide needed services to both the financial institution and regulatory authorities, while returning the auditor's risk to a level consistent with the concept of "reasonable, but not absolute assurance."

2.089 In response to the need for such an approach, and to the requirements of FDICIA, the Auditing Standards Board of the AICPA, during 1993, issued two new attestation standards.

2.090 SSAE No. 2, *Reporting on an Entity's Internal Control Structure Over Financial Reporting*, provides guidance to a practitioner who is engaged to examine and report on management's written assertion about the effectiveness of an entity's internal control structure over financial reporting as of a point in time. The standard is designed to fulfill the requirements of FDICIA relative to management's assertions about the internal control structure over financial reporting. The criteria against which the assertion is evaluated are described in *Internal Control—Integrated Framework*, issued by the Committee of Sponsoring Organizations of the Treadway Commission. SSAE No. 2 provides for either an examination of the assertion or for the application of agreed-upon procedures to the assertion.

2.091 Also issued was SSAE No. 3, *Compliance Attestation*, which provides guidance for engagements related to management's written assertion about either (a) an entity's compliance with requirements of specified laws, regulations, rules, contracts, or grant or (b) the effectiveness of an entity's internal control structure over compliance with specified requirements. Management's assertions may relate to compliance requirements that are either financial or nonfinancial in nature. An attestation engagement conducted in accordance with SSAE No. 3 should comply with the general, fieldwork, and reporting standards SSAE No. 1 and the specific standards set forth in SSAE No. 3. The standard provides guidance for either an examination of compliance or the application of agreed-upon procedures to management's assertion about compliance. A review, which would result in moderate (negative) assurance, is prohibited by the standards.

2.092 In February 1994, the AICPA's Board of Directors authorized a special task force charged with addressing the changing needs of users relative to the assurances given by CPAs. An interim report will be issued by the task force in late 1995. Also in the Spring of 1994, a bill was introduced in Congress entitled the "Private Securities Litigation Reform Act of 1994," which would amend the Securities Exchange Act of 1934 to reform its private action provisions and to provide certain safeguards to ensure that investors' interests are protected. As part of the bill, a self-disciplinary organization called the Public

Auditing Self-Disciplinary Board would be established, with oversight by the SEC. The Board would provide for the timely and effective discipline of public auditors and firms that are guilty of substandard work or professional misconduct.

ILLUSTRATION 2-3

Regulatory Agency Locations

Offices of the Federal Reserve System

The main office of the Federal Reserve System is located at:

Board of Governors of the Federal Reserve System
Federal Reserve Building
20th and C Street, N.W.
Washington, D.C. 20551
(202) 452-3000

The locations of the district offices and the states they administer are as follows:

District Offices	States
District No. 1 Federal Reserve Bank of Boston 600 Atlantic Avenue Boston, MA 02106 (617) 973-3000	ME, MA, NH, RI, VT, CT (except Fairfield County)
District No. 2 Federal Reserve Bank of New York 33 Liberty Street New York, NY 10045-0001 (212) 750-5000	NY, Fairfield County, CT, Twelve counties of northern NJ
District No. 3 Federal Reserve Bank of Philadelphia Ten Independence Mall Philadelphia, PA 19106 (215) 574-6000	DE, nine counties in southern NJ, 48 counties of eastern PA
District No. 4 Federal Reserve Bank of Cleveland 1455 East Sixth Street Cleveland, OH 44114 (216) 579-2000	OH, 56 counties in eastern KY, 19 counties in western PA, six counties in northern WV
District No. 5 Federal Reserve Bank of Richmond 701 East Byrd Street Richmond, VA 23219 (804) 697-8000	MD, VA, NC, SC, 49 counties of WV, Washington, D.C.

ILLUSTRATION 2-3 (Continued)

Regulatory Agency Locations

Offices of the Federal Reserve System (continued)

District Offices	States
District No. 6 Federal Reserve Bank of Atlanta 104 Marietta Street Atlanta, GA 30303 (404) 521-8500	AL, FL, GA, 74 counties in eastern TN, 38 parishes of southern LA, 43 counties of southern MS
District No. 7 Federal Reserve Bank of Chicago 230 S. LaSalle Street Chicago, IL 60604 (312) 322-5322	IA, 68 counties of northern IN, 50 counties of northern IL, 68 counties of southern MI, 46 counties of southern WI
District No. 8 Federal Reserve Bank of St. Louis 411 Locust Street St. Louis, MO 63102 (314) 444-8444	AR, 44 counties of southern IL, 24 counties of southern IN, 64 counties of western KY, 30 counties of northern MS, 71 counties of MO, 21 counties of western TN
District No. 9 Federal Reserve Bank of Minneapolis 250 Marquette Avenue Minneapolis, MN 55401-2171 (612) 340-2345	MN, MT, ND, SD, 15 counties of northern MI, 26 counties of northern WI
District No. 10 Federal Reserve Bank of Kansas City 925 Grand Blvd. Kansas City, MO 64198 (816) 881-2000	CO, KS, NE, OK, WY, 43 counties of western MO, 14 counties of northern NM
District No. 11 Federal Reserve Bank of Dallas 2200 N. Pearl Street Dallas, TX 75201-2272 (214) 922-6000	TX, 26 parishes of northern LA, 18 counties of southern NM
District No. 12 Federal Reserve Bank of San Francisco 101 Market Street San Francisco, CA 94105 (415) 974-2000	AK, AZ, CA, HI, ID, NV, OR, UT, WA

ILLUSTRATION 2-3 (Continued)

Regulatory Agency Locations

Offices of the Comptroller of the Currency (OCC)

The main office of the OCC is located at:

Office of the Comptroller of the Currency
250 East Street, S.W.
Washington, D.C. 20219
(202) 874-4700

The locations of the district offices and the states they administer are as follows:

District Offices	States
Northeast District Office of the Comptroller of the Currency 1114 Avenue of the Americas Suite 3900 New York, NY 10036 (212) 819-9860	CT, Wash, DC, ME, MD, MA, NH, NJ, NY, PA, Puerto Rico, RI, VT, Virgin Islands
Southeast District Office of the Comptroller of the Currency Marquis 1 Tower Number 600 245 Peachtree Street, N.E. Atlanta, GA 30303 (404) 659-8855	AL, FL, GA, MS, NC, SC, TN, VA, WV
Central District Office of the Comptroller of the Currency 440 S. La Salle St./One Financial Place Suite 2700 Chicago, IL 60605 (312) 663-8000	IL, IN, KY, MI, OH, WI
Midwest District Office of the Comptroller of the Currency 2345 Grand Avenue Suite 700 Kansas City, MO 64108 (816) 556-1800	IA, KS, MN, MO, NE, ND, SD
Southwest District Office of the Comptroller of the Currency 500 North Akard Street Number 1600-Lincoln Plaza Dallas, TX 75201-3394 (214) 720-0656	AR, LA, NM, OK, TX
West District Office of the Comptroller of the Currency 50 Fremont Street Suite 3900 San Francisco, CA 94105 (415) 545-5900	AK, AZ, CA, CO, Guam, HI, ID, MT, NV, Northern Marianna Islands, OR, UT, WA, WY

ILLUSTRATION 2-3 (Continued)

Regulatory Agency Locations

Offices of the Office of Thrift Supervision (OTS)

The main office of the OTS is located at:

Office of Thrift Supervision
1700 G Street, N.W.
Washington, D.C. 20552

The locations of the regional offices and the states they administer are as follows:

Regional Offices	States
Northeast Regional Office Northeast Regional Office Office of Thrift Supervision 10 Exchange Place 18th Floor Jersey City, NJ 07302 (201) 413-1000	CT, DE, ME, MA, NH, NJ, NY, PA, RI, VT, WV
Southeast Regional Office Southeast Regional Office Office of Thrift Supervision 1475 Peachtree Street, NE Atlanta, GA 30309 (404) 888-0771	AL, Wash, DC, FL, GA, MD, NC, Puerto Rico, SC, Virgin Islands, VA
Central Regional Office Central Regional Office Office of Thrift Supervision 111 East Wacker Drive Suite 800 Chicago, IL 60601-4360 (312) 540-5900	IL, IN, KY, MI, OH, TN, WI
Midwest Regional Office Midwest Regional Office Office of Thrift Supervision 122 W. John Carpenter Freeway Suite 600 Irving, TX 75039-2010 (214) 281-2000	AR, CO, IA, KS, LA, MN, MS, MO, NE, NM, ND, OK, SD, TX
West Regional Office West Regional Office Office of Thrift Supervision P.O. Box 7165 San Francisco, CA 94128 (415) 616-1500	AK, AZ, CA, Guam, HI, ID, MT, NV, OR, UT, WA, WY

ILLUSTRATION 2-3 (Continued)

Regulatory Agency Locations

Offices of the Federal Deposit Insurance Corporation (FDIC)

The main office of the FDIC is located at:

FDIC
550 17th Street, N.W.
Washington, D.C. 20429

The locations of the regional offices and the states they administer are as follows:

Regional Offices	States
Atlanta Regional Office Federal Deposit Insurance Corporation 1201 W. Peachtree St., N.E. Suite 1800 Atlanta, GA 30309 (404) 817-2500	AL, FL, GA, NC, SC, VA, WV
Boston Regional Office Federal Deposit Insurance Corporation Westwood Executive Center 200 Lowder Brook Drive, Ste. 3100 Westwood, MA 02090 (617) 320-1600	CT, ME, MA, NH, RI, VT
Chicago Regional Office Federal Deposit Insurance Corporation 500 W. Monroe, Ste. 3600 Chicago, IL 60661 (312) 382-7500	IL, IN, WI, MI, OH
Dallas Regional Office Federal Deposit Insurance Corporation 1910 Pacific Avenue Suite 1900 Dallas, TX 75201 (214) 220-3342	CO, NM, OK, TX
Kansas City Regional Office Federal Deposit Insurance Corporation 2345 Grand Avenue Suite 1500 Kansas City, MO 64108 (816) 234-8000	IA, KS, MN, MO, NE, ND, SD

ILLUSTRATION 2-3 (Continued)

Regulatory Agency Locations

Offices of the Federal Deposit Insurance Corporation (FDIC) (continued)

Regional Offices	States
Memphis Regional Office Federal Deposit Insurance Corporation 5100 Poplar Avenue Suite 1900 Memphis, TN 38137 (901) 685-1603	AR, LA, MS, TN, KY
New York Regional Office Federal Deposit Insurance Corporation 452 5th Avenue 19th Floor New York, NY 10018 (212) 704-1200	DE, Wash, DC, MD, NJ, NY, PA, Puerto Rico, Virgin Islands
San Francisco Regional Office Federal Deposit Insurance Corporation 25 Ecker Street Suite 2300 San Francisco, CA 94105 (415) 546-0160	AK, AZ, CA, Guam, HI, ID, MT, NV, OR, UT

Pre-Engagement
Considerations

CHAPTER 3

PRE-ENGAGEMENT CONSIDERATIONS AND AUDIT PLANNING

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CHAPTER 3

PRE-ENGAGEMENT CONSIDERATIONS AND AUDIT PLANNING

3.000 INTRODUCTION

3.001 In recent years, accountants who provide auditing services have become increasingly aware of the importance of evaluating their relationships with prospective and continuing clients and the need to perform adequate planning in their audit engagements. This chapter discusses the requirements to perform client acceptance and continuance procedures and to adequately plan engagements to audit bank financial statements. Also discussed are other pre-engagement considerations.

3.100 CLIENT ACCEPTANCE AND CONTINUANCE

3.101 Although most firms want to expand their client base, this expansion should be carefully monitored to ensure that accepting a prospective client and continuing a relationship with an existing client will not harm the firm's reputation and standing in the community.

3.102 The AICPA Statement on Quality Control Standards (SQCS) No. 1, *System of Quality Control for a CPA Firm*, requires that firms establish policies and procedures for accepting and continuing clients. Specifically, paragraph 7 of SQCS No. 1 (QC 10.07) states:

> Policies and procedures should be established for deciding whether to accept or continue a client in order to minimize the likelihood of association with a client whose management lacks integrity.

3.103 Firms should develop, preferably in writing, quality control policies and procedures for evaluating new and existing client relationships. These policies should specify:

For prospective clients

- The procedures to be followed for evaluating a prospective client, including:
  - — obtaining and reviewing the prospective client's available financial statements or information.
  - — inquiring of third parties, such as the prospective client's attorney, etc., about the organization and its management.
  - — communicating with the predecessor auditor or accountant.
  - — considering circumstances that would require special attention or that present special risks in the engagement.

- evaluating the firm's independence and ability to serve the prospective client.
- determining whether accepting the client would violate any applicable regulatory agency requirements or the ethics codes of the AICPA or state CPA society.

- The individuals responsible for evaluating prospective clients and making acceptance decisions, and for approving such decisions.
- How appropriate firm personnel are informed of the policies and procedures for accepting clients.
- The individuals responsible for administering and monitoring compliance with the firm's policies and procedures.

For continuing clients

- The procedures followed for evaluating relationships with continuing clients, such as:
  - considering whether significant changes have occurred since the last engagement, such as changes in management, the board of directors, legal counsel, financial condition, or scope of the engagement.
  - considering whether any conditions exist that would have caused the firm to reject the client had they been known at the time of initial acceptance.
- The frequency of such evaluations.
- The individuals responsible for evaluating continuing clients, for deciding whether to continue relationships with existing clients, and for approving such decisions.
- How firm personnel are informed of the firm's continuance policies and procedures.
- The individuals responsible for administering and monitoring compliance with the policies and procedures.

Each firm should design quality control policies and procedures that meet its unique organizational and operating characteristics.

3.104 The Client Acceptance and Continuance Form in section 3.701 is designed to help firms evaluate prospective and existing clients. It provides documentation of the evaluation process for new and existing clients, the decision to accept and continue clients, and approval of the decision to accept and continue clients. This Form should be modified as necessary to interface with the firms's quality control policies and procedures for acceptance and continuance of clients.

3.105 For prospective clients, Part I of the Client Acceptance and Continuance Form should be completed by the in-charge and approved by the engagement partner. Part II should be completed by the engagement partner and approved by the partner responsible for approving new clients.

3.106 For existing clients, the in-charge should update and revise the form, as necessary, to evaluate the desirability of continuing the relationship with the client. Multi-year sign-off space is provided to document an annual evaluation and the engagement partner's approval of the continuance (or discontinuance) decision.

3.107 Two critical factors in the acceptance and continuance decision are considering the possibility of going-concern problems and identifying potential independence impairments. These factors are discussed in the following sections.

Potential for Going-Concern Problems

3.108 Financial reporting is based on the asumption that the entity will continue as a going concern, unless there is significant information to the contrary. SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AU 341), requires the auditor to evaluate the client's ability to continue as a going concern for a period not to exceed one year beyond the balance-sheet date. To perform this evaluation, the auditor is not required to design audit procedures to detect going-concern problems; rather, the evaluation should be based on information obtained during the course of the audit about conditions or events that indicate that there is substantial doubt about the entity's ability to continue as a going concern. Examples of such conditions or events are negative cash flows, legal proceedings, and operating difficulties.

3.109 If the auditor concludes that there is substantial doubt about the entity's ability to continue as a going concern, he should:

- Consider management's plan to mitigate the effects of the condition or event; and,
- Assess the likelihood that the plans can be effectively implemented.

3.110 If substantial doubt remains after evaluating management's plans, the auditor should:

- Consider the adequacy of financial statement disclosures about the going concern problem; and,
- Include an explanatory paragraph in the auditor's report to reflect his or her conclusion that there is substantial doubt about the entity's ability to continue as a going concern.[1]

3.111 Whenever the auditor becomes aware of conditions or events that cause him or her to believe that there may be substantial doubt about an entity's ability to continue as a going concern, he or she should document the condition or event, the procedures followed to reach a conclusion about whether substantial doubt exists and, if applicable, the effect on the auditor's report and financial statements. If questions about an entity's ability to continue as a going concern arise in performing pre-engagement and audit planning procedures, they should be documented in the Client Acceptance and Continuance Form and the Planning Memorandum. Questions identified during engagement performance should be documented in a special memorandum that includes a discussion of:

1. The nature of the condition or event that raises a going-concern question.
2. The evaluation of management's plans and other factors, and related audit evidence, that might either mitigate or aggravate the condition or event.

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[1] The AICPA Auditing Standards Board recently issued an Auditing Interpretation, *Eliminating a Going-Concern Explanatory Paragraph From a Reissued Report,* which deals with situations where a previously issued report contains a going-concern explanatory paragraph, and the situation that gave rise to the going-concern has been resolved. Chapter 1, section 1.355 summarizes the guidance in this Interpretation.

3. The assessment of whether substantial doubt exists about the bank's ability to continue as a going concern.
4. The evaluation of the adequacy of financial statement disclosures of the matters giving rise to the information indicating a going-concern problem and management's plans to mitigate the problem.
5. Any modifications to the auditor's report considered necessary for the uncertainty.

3.112 The following are some conditions and events that may raise a question about a financial institution's ability to continue as a going concern:

- Recurring operating losses.
- Restructuring of debt.
- Operation under various regulatory agreements and the ability to comply with the provisions of the agreement (e.g., commitment letters, memoranda of understanding, cease and desist orders, and capital directives).
- A sudden decline in the value of investment securities as a result of interest rate increases or decline in credit quality of the investment portfolio, raising questions as to the institution's ability to meet liquidity needs.
- Concentrations of credit risk associated with segments of the economy, where economic conditions may raise questions about the ability of customers to repay loans.

3.113 As mentioned above, if the auditor becomes aware of any of these conditions during the course of the audit, he or she should inquire about management's plans to mitigate the effect of the conditions or events, and should assess the likelihood that such plans can be effectively implemented.

Independence

3.114 A critical factor in deciding to accept a new client or continue a relationship with an existing client is whether the firm is independent of the client. The following sections briefly summarize the AICPA's key independence requirements for auditors, including special independence interpretations and rulings that apply to auditors of banks and savings institutions.

3.115 Auditors must be independent of a client in order to be able to express an opinion on the financial statements. SQCS No. 1 contains a requirement that firms establish quality control policies and procedures that ensure compliance with the professional requirements concerning independence. Specifically, paragraph 7 of this Statement states:

> Policies and procedures should be established to provide the firm with reasonable assurance that persons at all organizational levels maintain independence to the extent required by the rules of conduct of the AICPA. Rule 101 of the rules of conduct (ET section 101) contains examples of instances wherein a firm's independence will be impaired.

3.116 Also the AICPA's *Code of Professional Conduct* "Objectivity and Independence" (ET section 55), states:

> A member in public practice should be independent in fact and appearance when providing auditing and other attestation services.

3.117 In addition to these general requirements to maintain independence, there are independence interpretations and rulings that address specific situations encountered by accountants. The following are two interpretations of Rule 101 of the rules of conduct and eight independence rulings that have special applicability to financial institutions. However, auditors should be familiar with all of the independence rules, interpretations, and rulings.

- **Interpretation of 101-1.A.4: Interpretation of Rule 101.** Independence shall be considered to be impaired if, for example, a member had any of the following transactions, interests, or relationships:

  A. During the period of professional engagement, or at the time of expressing an opinion, a member or a member firm...

     4. Had any loan to or from the enterprise, or any officer, director, or principal stockholder of the enterprise except as specifically permitted in Interpretation 101-5.

- **Interpretation of 101-5: Loans from Financial Institution Clients and Related Terminology.** Interpretation 101-1.A.4 provides that, except as permitted in this interpretation, a member's independence shall be considered to be impaired if the member has any loan to or from the enterprise or any officer, director, or principal stockholder of the enterprise. This interpretation does not consider independence to be impaired for certain grandfathered loans and other permitted loans from financial institution clients for whom services are performed requiring independence as set forth below under "Grandfathered Loans" and "Other Permitted Loans," respectively.

  Grandfathered Loans. This interpretation grandfathers the following types of loans obtained from a financial institution under that institution's normal lending procedures, terms, and requirements, and that meet the other specified conditions stated herein, and that (a) existed as of January 1, 1992; (b) were obtained from a financial institution prior to it becoming a client requiring independence; (c) were obtained from a financial institution for which independence was not required and that were later sold to a client for which independence is required; or (d) were obtained from a firm's financial institution client requiring independence by a borrower prior to his or her becoming a member[2] with respect to such client. *However, independence will be considered to be impaired if, after January 1, 1992, a member obtains a loan of the type described in this paragraph from an entity that, at the time of obtaining the loan, is a client requiring independence.* Grandfathered loans must, at all times, be current as to all terms and such terms shall not be renegotiated after the latest of the dates in (a) through (d) above.

[2] For the definition of "member" see ET Section 101.11 for Interpretation 101.9 — "The meaning of certain independence terminology and the effect of certain family relationships on independence."

1. Home mortgages
2. Other secured loans. The collateral on such loans must equal or exceed the remaining balance of the loan at January 1, 1992 and all times thereafter
3. Loans not material to the member's net worth

Other Permitted Loans. This interpretation permits the following types of personal loans obtained from a financial institution client for which independence is required under that institution's normal lending procedures, terms, and requirements. Such loans must, at all times, be kept current as to all terms.

1. Automobile loans and leases collateralized by the automobile
2. Loans of the surrender value under terms of an insurance policy
3. Borrowings fully collateralized by cash deposits at the same financial institution (e.g., "passbook loans")
4. Credit cards and cash advances on checking accounts with an aggregate balance not paid currently of $5,000 or less

Terminology. For purposes of Interpretation 101-1.A.4 and 101-5, the following terms are defined:

Loan — A loan is considered to be a financial transaction, the characteristics of which generally include, but are not limited to, an agreement that provides for repayment terms and a rate of interest. A loan includes a guarantee of a loan, a letter of credit, and a line of credit. A loan to a limited partnership in which members have a combined investment exceeding 50 percent of the total limited partnership interest is considered a loan to those members.

Financial Institution — A financial institution is considered to be an entity that, as part of its normal business operations, makes loans to the general public.

Normal Lending Procedures, Terms, and Requirements — "Normal lending procedures, terms, and requirements" relating to a member's loan from a financial institution are defined as lending procedures, terms, and requirements that are reasonably comparable with those relating to loans of a similar character committed to other borrowers during the period in which the loan to the member is committed. Accordingly, in making such comparison and in evaluating whether a loan was made under "normal lending procedures, terms, and requirements," the member should consider all the circumstances under which the loan was granted, including:

1. The amount of the loan in relation to the value of the collateral pledged as security and the credit standing of the member or the member's firm
2. Repayment terms
3. Interest rate, including "points"

4. Closing costs
5. General availability of such loans to the public.

Related prohibitions that may be more restrictive are prescribed by certain state and federal agencies having regulatory authority over such financial institutions. Broker-dealers, for example, are subject to regulation by the Securities and Exchange Commission.

Independence Rulings

3.118 Presented below are eight independence rulings, found in ET Section 191, that may apply to banks.

- Ethics Ruling 191.13, "Member as Bank Stockholder" (ET 191.025-.026), indicates that to the extent that such an indirect financial interest is not material, independence of the member's firm would not be considered to be impaired.
- Ethics Ruling 191.38, "Member as Co-Fiduciary With Client Bank" (ET 191.075-.076), indicates that the independence of a member would not be considered to be impaired provided the assets in the estate or trust were not material in relation to the total assets of the bank and/or trust department.
- Ethics Ruling 191.67, "Servicing of Loan" (ET 191.134-.135), indicates that the servicing of a member's loan by a client financial institution would not impair the member's independence with respect to that client as long as there was no risk of material loss to the client with respect to the loan being serviced.
- Ethics Ruling 191.70, "Member's Depository Relationship With Client Financial Institution" (ET 191.140-.141), indicates that the member's and his or her firm's independence would not be considered to be impaired with respect to the financial institution provided that the checking accounts, savings accounts, certificates of deposit or money market accounts were fully insured by the appropriate state or federal government deposit insurance agencies. Checking accounts, savings accounts, certificates of deposit and money market accounts not fully insured by state or federal government deposit insurance agencies would not impair independence provided that the uninsured amounts are not material to the member or the member's firm.
- Ethics Ruling 191.85, " Bank Director" (ET 191.170-.171), indicates that before accepting a bank directorship, the member should carefully consider the implications of such service if the member has clients that are customers of the bank.
- Ethics Ruling 191.86, "Partially Secured Loans" (ET 191.172-.173), indicates that a loan is "grandfathered" if, at all times after the member is required to be independent with respect to the client, the portion of the loan that exceeds the value of the collateral is not material to the member's net worth.
- Ethics Ruling 191.87, "Loan Commitment or Line of Credit" (ET 191.174-.175), indicates that if a loan commitment or line of credit were renegotiated (including renewals that are not solely at the option of the borrower) subsequent to the time the member was required to be independent, independence would be impaired.
- Ethics Ruling 191.88, "Loans to Partnership in Which Members are Limited Partners" (ET 191.88-.89), indicates that independence is impaired if a limited partnership in which members have a combined interest of more than 50% obtain a loan from a financial institution client.

- Ethics Ruling 191.89, "Loan to Partnership in Which Members are General Partners (ET 191.178-.179), indicates that a loan to a partnership in which a member is general partner would be considered a loan to the member if the member, as general partner, can control the partnership.
- Ethics Ruling 191.90 "Credit Card Balances and Cash Advances" (ET 191.180-.181), indicates that independence would not be considered to be impaired if the aggregate outstanding balance were reduced to $5,000 or less on a current basis.
- Ethics Ruling 191.97, "Performance of Certain Extended Audit Services" (ET 191.194-.195), addresses independence issues that may arise if a member has been engaged to perform internal audit activities for a client. The Ruling states that the member's independence would be impaired if the auditor is engaged to review loan originations or similar activities as part of the client's approval process or internal control system. However, the member's independence would not be impaired if the member is engaged to review the client's loan origination and other processes for their functioning, efficiency, and effectiveness, provided the member does not make management decisions or perform management functions. The ruling also indicates that the member's independence would not be impaired if the member is engaged to analyze fluctuations in income and expense.
- Ethics Ruling 191.98, "Member's Loan From a Nonclient Subsidiary or Parent of an Attest Client" (ET 191.196-.197), states that a loan from a nonclient subsidiary or parent of an attest client would generally impair the member's independence.

3.119 These independence requirements apply not only to AICPA members, but to their spouses and dependents as well. Independence of a member or a member's firm is generally not impaired solely because the member's spouse, or a dependent is employed by the client, as long as the employment is in a position that does not allow significant influence over the bank's operating, financial, or accounting policies. However, if the employment is in a position in which the person's activities are audit-sensitive (normally an element of or subject to significant internal accounting controls, such as cashier, internal auditor, or accounting supervisor), the auditor's independence would be impaired.

3.120 In addition to establishing policies and procedures to ensure that firms have adequate procedures to determine that their personnel are independent with respect to their clients, the authors believe it is advisable to also ensure that potential independence impairments have been identified and resolved before each engagement begins. As a result, the Client Acceptance and Continuance Form in section 3.701 requires that this determination be made on each engagement before deciding to accept a new client or continue a relationship with an existing client.

Practice Tip:

All practitioners, and the members of their professional staffs, must be thoroughly familiar with the Code of Professional Conduct, the interpretations of ET section 55 that appear in ET section 101, and the related individual rulings that appear at ET section 191 ("Ethics Rulings on Independence, Integrity, and Objectivity").

3.200 ENGAGEMENT LETTERS

3.201 Adequate engagement planning includes establishing an understanding with the client regarding the nature of the firm's services, timing of field work, report deadlines, responsibilities of the client and methods of fee determination and payment. The engagement partner should annually confirm an understanding of the nature of the engagement and the extent of the reporting responsibilities before beginning field work. Such understanding will normally include an appropriate engagement letter and a pre-engagement client conference. If an engagement letter is not used, the understanding should be documented in the workpapers.

3.202 Currently there are no authoritative pronouncements requiring a written engagement letter for an audit, although most firms regard their completion as good business practice. An engagement letter helps to prevent misunderstandings between the client and the auditor regarding the services to be provided, including the limitations. The engagement letter also sets forth the responsibilities of the client, and in most states it becomes a legally binding contract on both parties. There are other good reasons to obtain an engagement letter, including the following:

- *Reduce the risk of litigation.* Misunderstandings with clients regarding the nature and limitations of the services provided can result in litigation.
- *Avoid misunderstandings by the staff.* The staff performing the work can review the engagement letter to obtain a clear understanding of the services to be provided and the required timing of issuance of the report.

> **Practice Tip:**
>
> Often, entities that have never been audited resist signing a client representation letter. To avoid client resistance at the end of the audit, many firms notify the client in the engagement letter that they will be asked to sign a client representation letter.

3.203 The letter should be prepared by the in-charge before any significant work takes place on the engagement. The partner should personally present the letter to the client to ensure that a complete understanding has been achieved. The signed copy should be filed with the current engagement's working papers.

> **Practice Tip:**
>
> Be careful when using a proposal or preliminary engagement letter for a client. If the letter describes additional services that are not finally agreed upon, it may be used in litigation as an indication of inadequate performance by you on the engagement. You should always make sure that a final engagement letter is issued in such circumstances.

3.204 Should the nature of an engagement change during its progress, or should the firm be engaged for additional services during the year, a new engagement letter should be prepared. A step-down to a compilation or review engagement, or a special engagement for preparing a forecast, are examples of changes that would require a new engagement letter. Such changes should be made by the engagement partner after careful consideration of the reasons justifying the change. For example, the reasons justifying a step-down from an audit to a compilation or review may prevent the firm from reporting on the lower level of service.

3.205 The content of the engagement letter should include the following:

- Addressee

  The letter should be addressed to the board of directors or shareholders. The client should be requested to return a copy of the letter indicating approval by the appropriate person.

- Nature of the engagement

  A description of the primary service and illustrative report wording should be included for all standard and modified reports. Circumstances causing modification of the standard report, subsequent to signing the engagement letter, should be discussed with the client by the partner.

- Additional services

  All additional services such as income tax return preparation or consulting services should be described in the letter.

- Unexpected circumstances

  Client notification, in the event of unforeseen circumstances, should be mentioned.

- Client's responsibilities

  Client assistance such as schedules, financial statements and tax return preparation, and other clerical assistance should be included. It often is detailed in a separate attachment to the engagement letter.

- Fraud, irregularities, and illegal acts

  A statement that although the audit is designed to provide reasonable assurance of detecting errors and irregularities that are material to the financial statements, it is not designed and cannot be relied upon to disclose all fraud, defalcations or other irregularities. However, the auditors will inform the client of any material errors, and all irregularities or illegal acts, unless they are clearly inconsequential, that come to their attention.

- Fee determination and billing methods

  The anticipated fee or fee range may be included. Estimates of fees should be based on conservative, carefully prepared estimates. The expected billing methods and payment periods should be described.

- Signatures

  The engagement partner should sign the letter on behalf of the firm. The client representative responsible for the engagement should sign the letter indicating agreement with the contract.

- Regulator's access to working papers.

  As discussed in Chapter 7, section 7.718, auditors may be required by federal and state laws and regulations to provide regulators access to their audit workpapers. In such instances, a notice to that effect may be included in the engagement letter.

3.206 Two illustrative engagement letters (one for a bank and the other for a savings bank) is shown in section 3.702. They should be modified to fit the specific engagement circumstances.

3.300 AUDIT PLANNING

3.301 Professional standards include many general and specific planning requirements. The two basic requirements to plan engagements are—

(1) The third General Standard of Rule 201 of the AICPA *Code of Professional Conduct* (ET 201.01) states that a member shall "adequately plan and supervise the performance of professional services."

(2) The first standard of generally accepted auditing standards (Statement on Auditing Standards (SAS) No. 1, section 150, AU 150.02) requires that "the work is to be adequately planned and assistants, if any, are to be properly supervised."

3.302 SAS No. 22, *Planning and Supervision* (AU 311), provides specific guidance to the independent auditor performing an audit in accordance with GAAS, including developing an audit program and obtaining an understanding of the client's operations. Many other SASs also require consideration during planning of matters such as potential misstatements, continued existence of the entity, accounting estimates, obtaining an understanding of the internal control structure, and preliminary materiality.

3.303 Audit planning for banks is also affected by the following AICPA auditing standards:

SAS No. 31, *Evidential Matter*
SAS No. 39, *Audit Sampling*
SAS No. 41, *Working Papers*
SAS No. 47, *Audit Risk and Materiality in Conducting an Audit*
SAS No. 48, *The Effects of Computer Processing on the Examination of Financial Statements*
SAS No. 53, *The Auditor's Responsibility to Detect and Report Errors and Irregularities*
SAS No. 54, *Illegal Acts by Clients*
SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit*
SAS No. 56, *Analytical Procedures*
SAS No. 57, *Auditing Accounting Estimates*
SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*
SAS No. 65, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*
SAS No. 67, *The Confirmation Process*
SAS No. 70, *Reports on the Processing of Transactions by Service Organizations*
SAS No. 73, *Using the Work of a Specialist*

3.304 The in-charge should be familiar with the requirements of these pronouncements before completing the planning memorandum. In addition, the in-charge should be familiar with the auditing guidance in the AICPA Industry Audit Guide, *Audits of Banks* and the AICPA Industry Audit Guide, *Audits of Savings Institutions*. A revised industry guide (combining the Bank and Savings Institutions guides together) is in the process of being prepared and issued. See Chapter 1, section 1.367 for further information.

3.305 Achieving both engagement quality and profitability requires extensive planning. Engagement planning should begin well before field work begins and continue until the completion of the engagement. The engagement partner should be involved at strategic times during the planning, performance, and completion of an engagement. Early and frequent partner involvement in program design and in related judgment decisions will help develop the in-charge and other staff, will help identify problems early, and will result in a high-quality, profitable engagement.

3.306 Complying with all applicable professional standards and achieving maximum audit profitability can only be accomplished through effective planning. Effective planning for audits of banks and savings institutions must include, among other things, the following basic audit planning activities:

1. Obtain an understanding of the client's internal control structure.
2. Determine the level of overall engagement risk, the risks of potential misstatements, the risk of direct-effect illegal acts, the potential for going-concern problems, and the overall materiality limit.
3. Make judgments about the staffing of the engagement and the extent of supervision.
4. Decide on the most cost-beneficial audit approach and the planned reliance on types of tests, based on the risk assessment.
5. Perform analytical procedures sufficient to plan the nature, timing, and extent of auditing procedures.
6. Consider placing reliance upon the work of internal auditors.

Obtain an Understanding of the Internal Control Structure

3.307 SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit,* requires that auditors obtain an understanding of the client's internal control structure sufficient to plan the audit. Paragraph 16 of SAS No. 55 (AU 319.16) says:

> The auditor should obtain a sufficient understanding of the three elements of the entity's internal control structure [the control environment, accounting system, and control procedures] to plan the audit of the financial statements. The understanding should include knowledge about the design of relevant policies, procedures, and records and whether they have been placed in operation by the entity. In planning the audit, such knowledge should be used to:
>
> - Identify types of potential misstatements.
> - Consider factors that affect the risk of material misstatements.
> - Design substantive tests.

3.308 As discussed in Chapter 1, section 1.356, the AICPA's Auditing Standards Board has released a proposed amendment to SAS No. 55 that would incorporate the definition and description of internal control found in the Committee on Sponsoring Organizations report, *Internal Control - Integrated Framework*, (the "COSO" report) into SAS No. 55. It is not expected to result in a significant change in practice.

3.309 Completion of the Internal Control Structure Questionnaire in Chapter 5, section 5.200, provides a basis for obtaining an understanding of the client's internal control structure sufficient to plan the audit.

Assess Risk

3.310 **Overall Engagement Risk.** Engagement risk for a client has the following primary components:

- Integrity of management
- Use of financial statements
- Auditability of the entity
- Business environment

3.311 Overall engagement risk will subjectively affect the desired level of assurance in the financial statements taken as a whole. Specifically, it will affect the acceptable levels of risk of incorrect acceptance and risk of assessing control too low in the substantive tests of balances and tests of controls sample size determination.

3.312 Evaluating overall engagement risk as high or low will result from considering each of these four components. The rationale behind the evaluation should be documented in the Planning Memorandum (section 3.706).

3.313 High overall engagement risk on bank and savings institution audits should be controlled primarily by using more reliable procedures and by examining more individually significant items and larger samples. Such high risk, however, does not preclude performing procedures at an interim date when the bank's internal control structure qualifies as a System A or B for the applicable financial statement items and related assertions.

3.314 **Integrity of Management.** SAS No. 58, *Reports on Audited Financial Statements* (AU 508), states, "The financial statements are the responsibility of management." SAS No. 53, *The Auditor's Responsibility to Detect and Report Errors and Irregularities* (AU 316), states, "The auditor neither assumes that management is dishonest nor assumes unquestioned honesty." SAS No. 53 also states, "Management integrity is important because management can direct subordinates to record transactions or conceal information that can materially misstate financial statements."

3.315 The integrity of management should be evaluated as part of the client acceptance or continuance decision and noted on the Client Acceptance and Continuance Form (section 3.701). Approval of the Client Acceptance and Continuance Form by designated partners is an indication that the integrity of management is considered adequate and that no circumstances have come to their attention that would require special auditing procedures to detect and report errors, irregularities, and illegal acts.

3.316 Any significant matters related to management's integrity, that arise during the planning and performance of the audit, should be documented in a special memorandum containing a description of:

- The matters designated for further consideration.
- The risk of material misstatement to the financial statements.
- The additional or changed auditing procedures considered necessary to mitigate such risks.
- The results of performing such procedures and their effects on the audit report.

3.317 **Use of Financial Statements.** The risk associated with the use of financial statements is usually high since auditors cannot control their ultimate distribution or the purposes for which users rely on them. The risk is even higher in circumstances such as the following:

- Statements used in legal proceedings.
- Statements used by regulators.
- Statements used for public offerings.

3.318 The expected use of the financial statements should be documented annually on the Client Acceptance and Continuance Form.

3.319 **Auditability of the Entity.** A firm should consider the auditability of the entity prior to deciding whether to accept or retain a client. Although a potential client may request an audit and users of the financial statements may require an audit, certain factors may preclude an auditor from being able to express an opinion on the financial statements.

3.320 If a client's accounting system does not provide sufficient evidence to support the recorded transactions, or if the client's accounting records have been destroyed or lost, the entity may be unauditable.

3.321 For a new client, auditability can usually be determined through discussions with management and the predecessor auditor. The auditor should inquire as to the accounting system and how management determines that the policies and procedures for processing financial information are followed. For a continuing client, auditability is determined by discussions with management as well as through prior experience.

3.322 **Business Environment.** The auditor should also consider the business environment in which the client operates. Is the nature of the client's business one which the firm does not have the requisite expertise? Is the client in a financial position where bankruptcy, takeover or merger, or sudden collapse could occur? All of these concerns should be addressed when an auditor decides to accept or retain a client. Financial institutions that are significantly involved in real estate lending could be affected by changes in the economic environment, and institutions that are significantly involved in investment securities could be affected by fluctuations in interest rates.

3.323 **Risk of Potential Misstatements.** The risk that potential misstatements will occur results primarily from weaknesses in the internal control structure, inherent risks in certain transactions or account balances, material and unusual account balances, and the client's history of misstatements. SAS No. 47, *Audit Risk and Materiality in Conducting an Audit,* refers to these risks as inherent and control risks. SAS No. 53, *The Auditor's Responsibility to Detect and Report Errors and Irregularities,* refers to errors and irregularities as unintentional and intentional misstatements of financial statements, respectively. These risks are evaluated and documented on the following forms, which are included in Chapters 4 and 5 of this Manual:

- Internal Control Structure Questionnaire
- Risk of Potential Misstatements Evaluation Form
- Planning Matrix
- Tests of Controls Program

3.324 The level of risk of potential misstatements will directly affect the desired level of assurance in the affected transaction or balance. High risk requires a higher level of assurance which requires more evidence. Low risk means less evidence is necessary.

3.325 Errors and Irregularities. SAS No. 53 (AU 316), *The Auditor's Responsibility to Detect and Report Errors and Irregularities*, requires auditors to assess the risk that errors and irregularities that have a material effect on the financial statements could occur, and to design and perform the audit to obtain reasonable assurance that such errors and irregularities will be detected during the audit. It also discusses the impact of errors and irregularities on the auditor's report, and the auditor's requirement to communicate errors and irregularities to the audit committee or its equivalent.

3.326 Paragraph 2 of SAS No. 53 (AU 316.02) defines errors as "unintentional misstatements or omissions of amounts or disclosures in financial statements." In paragraph 3 (AU 316.03), irregularities are defined as "*intentional* misstatements or omissions of amounts or disclosures in financial statements." Because irregularities are intentional (and, as a result, may involve forgery or collusion), they are usually more difficult to detect than errors.

3.327 Because the auditor's opinion is based on the concept of reasonable assurance, auditors cannot guarantee that financial statements are free from material misstatements due to errors and irregularities. However, they must exercise due care in planning, performing, and evaluating the results of the audit and must apply the appropriate level of professional skepticism to achieve reasonable assurance that the material errors and irregularities will be detected.

3.328 As part of audit planning, auditors should assess the risk that errors and irregularities may cause the financial statements to be materially misstated. The auditor's concern about the risk of material misstatement is either heightened or mitigated by the auditor's understanding of the internal control structure. Based on this assessment, the auditor should design the audit to provide reasonable assurance of detecting errors and irregularities that could have a material effect on the financial statements.

3.329 SAS No. 53 (AU 316.10) and a 1988 OCC report (see Chapter 2, section 2.066) cite a number of management, operating and industry, and engagement characteristics that might cause the auditor to believe that there is an increased risk that material errors and irregularities could occur. Several of these characteristics are listed below:

- Management's operating and financing decisions are dominated by a single person.
- Management places undue emphasis on meeting earnings projections.

- The entity's profitability relative to its industry is inadequate.
- Many contentious or difficult accounting issues are present.
- Significant and unusual related-party transactions or balances are present.
- Nonexistent or poorly followed loan policies.
- Uninformed or inattentive board of directors or management.

3.330 Completing the Risk of Potential Misstatement Evaluation Form at Chapter 4, section 4.501 provides a basis for assessing the risk that material errors and irregularities could occur.

3.331 Design of the Audit. Based on this assessment, the auditor should design the audit to provide reasonable assurance of detecting errors and irregularities that could have a material effect on the financial statements. In high-risk situations, this strategy might involve placing more experienced staff on the engagement, increasing supervision and review of assistants' work, testing more items, performing procedures at year end rather than at interim, and modifying the nature of auditing procedures to obtain more reliable evidential matter.

3.332 Evaluating the Audit Test Results. Auditors are accustomed to evaluating the financial statement impact of differences between the client's accounting records and the auditor's findings. This evaluation is emphasized in SAS No. 53 because irregularities have implications beyond their direct monetary effects.

3.333 SAS No. 53 requires that when the auditor concludes that a potential audit adjustment is related to an irregularity, but is not material to the financial statements, he should refer the matter to at least one level of management above those involved in the irregularity, and should be satisfied that the irregularity has no implications on other aspects of the audit. An example of an irregularity that would generally not be material to the financial statements is a misappropriation of petty cash.

3.334 If the auditor believes that the irregularity is or could be material to the financial statements, he or she should:

a. Consider the implications for other aspects of the audit.

b. Discuss the matter and the approach of further investigation with an appropriate level of management at least one level above those involved.

c. Attempt to obtain sufficient competent evidential matter to determine whether, in fact, material irregularities exist and, if so, their effect.

d. If appropriate, suggest that the client consult with legal counsel on matters concerning questions of law.

3.335 Effect of Irregularities on the Auditor's Report. If financial statements affected by a material irregularity are not revised, the auditor should express either a qualified or adverse opinion, explaining all substantive reasons for the opinion. If the auditor is unable to perform necessary auditing procedures related to the irregularity, or if the auditor is unable to reach a conclusion about the financial statement effect of the irregularity, he or she should issue a disclaimer of opinion or a qualified opinion due to a scope limitation. If the client refuses to accept a modified auditor's opinion due to an irregularity, the auditor should withdraw from the audit. In any event, the auditor should ensure that matters involving errors and irregularities are communicated to the audit committee or its equivalent. In addition, the auditor may have a responsibility to communicate the irregularities to a regulatory agency. The auditor should consider whether an understanding as to disclosure of any errors or irregularities discovered should be addressed in the engagement letter.

3.336 **Illegal Acts.** SAS No. 54, *Illegal Acts by Clients* (AU 317), prescribes the nature and extent of consideration an auditor should give to the possibility that the client has committed illegal acts, and also provides guidance on the auditor's responsibilities when a possible illegal act is detected.

3.337 Paragraph 2 of SAS No. 54 (AU 317.02) defines illegal acts as "violations of laws or governmental regulations. Illegal acts by clients are acts attributable to the entity whose financial statements are under audit or acts by management or employees acting on behalf of the entity." Determining whether an act is illegal is normally beyond the auditor's professional competence, and would generally be based on the advice or on the findings of a court of law.

3.338 Of key importance to applying SAS No. 54 is an understanding of the difference between direct and indirect effects of laws and regulations. Direct-effect laws and regulations are those that affect financial statement line items. For example, federal tax laws directly affect the amounts of income tax expense and accruals reported in the financial statements. Some examples of laws and regulations that have a direct effect on banks are the Bank Holding Company Act of 1956, Bank Service Corporation Act, FDIC Improvement Act of 1992 and the Bank Secrecy Act. Indirect-effect laws and regulations are those that relate more to the entity's operations than to its financial statements, such as occupational safety and health, food and drug administration, equal employment, and anti-trust laws and regulations. While violations of these laws do not directly affect financial statement line items, they can result in monetary fines, penalties and damages that could require adjustment to or disclosure in the financial statements. Understanding these two concepts is important because the auditor's responsibilities to detect and report direct-effect laws and regulations are different from the responsibilities to detect indirect-effect laws and regulations. Specifically, the auditor's responsibility to detect misstatements from illegal acts that have a direct and material effect on the financial statements is governed by SAS No. 53 (discussed in sections 3.332–3.334). SAS No. 54 therefore applies to illegal acts related to indirect-effect laws and regulations (hereinafter called simply "illegal acts"). The following are examples of indirect-effect laws that might be violated by banks:

- A bank might extend credit that is collaterized by the stock of its parent company. Since banks are prohibited from owning their own stock, the extension may be an indirect violation of state banking laws.
- An investor might obtain a loan from a bank to purchase units of a real estate limited partnership that would benefit the bank. Such a transaction would be in violation of the Securities Act of 1934.

3.339 SAS No. 54 does not require the auditor to design tests to detect illegal acts; however, the auditor must be aware that illegal acts may have occurred and must perform certain audit procedures to confirm the existence of illegal acts if such specific evidence is discovered. The Statement indicates that the auditor should obtain an understanding of the nature of the act, the circumstances in which it occurred, and sufficient other information to evaluate the effect on the financial statements. If information provided by management is insufficient to determine whether an illegal act has occurred, the auditor should:

- Consult with the client's attorneys or other specialists about the application of relevant laws and regulations to the circumstances, and the possible effects on the financial statements.
- Apply additional procedures, if necessary, to obtain further understanding of the nature of the act.

3.340 If the auditor concludes that an illegal act has occurred, he or she must consider the implications (both qualitative and quantitative) of the illegal act on the auditor's report and the financial statements. Improper accounting or inadequate disclosure of a material illegal act could result in a qualified or adverse opinion, disclosing all substantive reasons for the opinion. If the auditor is unable to obtain sufficient competent evidential matter about a possible illegal act, the auditor would generally disclaim an opinion on the financial statements. If the client refuses to accept a modified auditor's report in these situations, the auditor should consider withdrawing from the engagement, and should communicate the reasons for withdrawal to the audit committee or its equivalent, or to the board of directors or owners.

Make Preliminary Judgment About Materiality Levels

3.341 Overall Materiality. Under SAS No. 22, auditors are required to plan their audits to provide reasonable assurance that material misstatements will be detected. In meeting this requirement, auditors should establish a preliminary materiality threshold for the purpose of planning the appropriate auditing procedures to detect material misstatements in the financial statements.

3.342 Materiality Table. Obviously, quantifying the materiality level is a matter of professional judgment. Most auditors of financial institutions base the preliminary materiality level on a percentage of some component of the client's financial statements, generally the greater of total assets or the sum of total revenues. The following is a suggested scale that may be used in making a preliminary judgment about materiality.

Materiality Base — Greater of Total Assets or Total Revenues		Percentage of the Base
Over	**But Not Over**	
$ 0	$ 30,000	6.00%
30,000	100,000	$ 1,800 + 5.00% in excess of $ 30,000
100,000	300,000	$ 5,300 + 3.00% in excess of $ 100,000
300,000	1,000,000	$ 11,300 + 2.00% in excess of $ 300,000
1,000,000	3,000,000	$ 25,300 + 1.50% in excess of $ 1,000,000
3,000,000	10,000,000	$ 55,300 + 1.00% in excess of $ 3,000,000
10,000,000	30,000,000	$ 125,300 + 0.50% in excess of $ 10,000,000
30,000,000	100,000,000	$ 225,300 + 0.25% in excess of $ 30,000,000
100,000,000	300,000,000	$ 400,300 + 0.20% in excess of $ 100,000,000
300,000,000	—	$ 800,300 + 0.15% in excess of $ 300,000,000

3.343 As an illustration of the application of the table, assume that a financial institution has total assets of $80,000,000 and total revenues of $150,000,000. Using the larger materiality base, materiality for planning purposes would be calculated as follows:

400,300 + [(150,000,000 - 100,000,000) x .002] = 500,300

3.344 Because many audits are begun prior to year end, it is often necessary to estimate the financial statement bases (total assets and total revenue) for use in calculating planning materiality. Usually these estimates are made based on the entity's year-to-date results, and considering any audit adjustments that are likely to be made. Audit adjustments from the prior period are often good predictors of adjustments that will be necessary in the current year.

3.345 **Using the Materiality Computation Form.** A Materiality Computation Form is in section 3.707. This schedule should be used to compute the overall materiality limit, the basic allowance for unknown misstatements to be used in substantive tests of balances sampling, and the lower limit for individually significant items. The lower limit for individually significant items can be used to determine immaterial sampling populations and account balances for which no auditing procedures are necessary.

3.346 The overall materiality limit represents the allowance for both known and unknown misstatements. Known and unknown misstatements are considered to comprise 100% of the overall materiality limit; known misstatements being 1/3 and unknown misstatements being 2/3. The rationale used to establish engagement materiality limits should be documented on the Materiality Computation Form (section 3.707) and in the Planning Memorandum (section 3.706).

NOTE:

The materiality guidelines shown above are primarily designed for commercial entities. Given the nature of a typical bank's/savings institution's revenues in relation to their total assets, materiality would virtually always be based on total assets, and the calculation would result in a materiality level that seems high in relation to income statement amounts. Consequently, auditors of financial institutions should consider reducing the planning materiality calculated in the above table, particularly if the bank's/savings institution's revenues and net income as a percentage of total assets are below industry averages. Also, auditors may consider adjusting the assets base used in the calculation for items such as traveler's checks on consignment recorded as assets and securities used as instruments in a repurchase or reverse repurchase transaction that are not netted in the balance sheet. Other situations that may warrant reducing planning materiality include:

- The institution is operating under a letter of understanding and agreement.
- The institution has a low CAMEL rating.
- Net income and capital levels are below the institution's peer group levels.

Staff the Engagement and Plan for Supervision

3.347 As part of the planning process, auditors should determine the staffing needs of the engagement to insure that persons who work on a financial institution audit possess the appropriate technical training and proficiency. SQCS No. 1 states the basic quality control requirement for assigning personnel to engagements:

> Policies and procedures for assigning personnel to engagements should be established to provide the firm with reasonable assurance that work will be performed by persons having the degree of technical training and proficiency required in the circumstances. In making assignments, the nature and extent of supervision to be provided should be taken into account. Generally, the more able and experienced the personnel assigned to a particular engagement, the less is the need for direct supervision.

3.348 The following should be considered in making assignments of individuals to bank and savings institution engagements:

- Staffing and timing requirements of the specific engagement.
- Evaluation of qualifications of personnel regarding experience, position, background, and special expertise.
- The planned supervision and involvement by supervisory personnel.
- Projected time availability of individuals to be assigned.
- Situations where independence problems and conflicts of interest may exist or may appear to exist, such as loans to staff personnel and assignment of personnel to engagements for clients who are former employers or are employers of certain kin.
- Continuity of personnel to provide an efficient audit, balanced against rotation of staff to provide other personnel with different experience.

3.349 Supervising personnel on an engagement is an ongoing process. However, at the initial planning stage of the engagement, supervision of personnel requires developing realistic estimates of the time that will be needed to perform and review the staff's work. Use of budgeting and time control documents facilitate effective engagement supervision and management. Although not required by professional standards, budget and time control analyses can help improve engagement profitability by identifying problems and inefficiencies early. Staff time should be recorded weekly on the Time Accumulation Sheet (section 3.703), with total engagement time summarized on the Time Summary Form (section 3.704) and compared to budget. These documents have been designed for use in all audit engagements of financial institutions in excess of 40 hours. Used consistently, they will make staff more conscious of the efficient use of time, cause staff to become more creative in performing engagements, create opportunities for communicating problems to engagement partners, and contribute to increased engagement and firm profitability.

3.350 For budgets to benefit the firm and engagement personnel, they must first be realistically prepared. Budgets must be based on engagement circumstances, not on fees. All time spent on engagements must be charged to the client and entered on the Time Accumulation Sheet in section 3.703. At the completion of the engagement, the Time Accumulation Sheet should be reconciled to the Time Summary Form in section 3.704 and to the firm's billing records. If the staff becomes aware of ways to reduce audit time in the future, the suggestions should be noted on the Summary of Time Savings for Next Year Form found in section 3.705.

Perform Analytical Procedures

3.351 SAS No. 56, *Analytical Procedures* (AU 329), provides for analytical procedures to be used for the following three purposes:

- In the planning stage, to plan the nature, timing, and extent of other auditing procedures.
- As a substantive test to obtain evidential matter about financial statement assertions.
- In the final review stage, as an overall review of the financial information.

3.352 The purpose of analytical procedures performed during the planning stage of an audit is to identify unusual transactions or events and any areas that represent specific risks, so that the auditor can plan an appropriate audit strategy, i.e., the appropriate nature, timing, and extent of tests.

3.353 Analytical procedures performed during planning are often very simple. For example, they may consist of a review of fluctuations in account balances using the current and prior year's trial balances. Larger, more sophisticated financial institutions may warrant a review in greater detail, using quarterly or monthly financial information or information for each location or program.

3.354 The auditor should document the procedures and results of the planning analytical procedures performed in the Planning Memorandum in section 3.706, and communicate his observations to the audit team. Further audit testing should be modified based on the results of the analytical procedures performed. The auditor should also document the modification of audit testing as a result of planning analytical procedures. Analytical procedures performed as a substantive test and at the final review stage are discussed in Chapters 6 and 7, respectively.

Relying on the Work of Internal Auditors

3.355 Depending on the competency, objectivity, and relevance of the activities performed by internal auditors of bank clients, a substantial amount of time may be saved by relying on their work or having them provide direct assistance during the audit. SAS No. 65, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements* (AU 322), provides authoritative guidance for relying on the work of internal auditors. This Statement requires the auditor to (1) obtain an understanding of the internal audit function, (2) assess the internal auditors' competency and objectivity, (3) consider the effect of their work on the audit, and (4) evaluate and test their work, if the auditor plans to rely on the internal auditors' work.

3.356 Obtaining an Understanding of the Internal Audit Function. Before deciding to use the work of the internal auditors, the auditor should obtain an understanding of the internal audit function. This can be accomplished by inquiring of management and internal audit personnel about the internal auditors' organizational status within the entity, whether they apply professional internal auditing standards, their audit plan, their access to records and whether there are limitations imposed on the scope of their work. If the auditor plans to rely on work they have performed during the year, he should also determine that the work is relevant to the audit.

3.357 Assessing the Competence and Objectivity of Internal Auditors. SAS No. 65 cites the following factors that should be considered in assessing the competency of internal auditors:

- Educational level and professional experience of internal auditors
- Professional certification and continuing education
- Audit policies, programs, and procedures
- Practices regarding assignment of internal auditors
- Supervision and review of internal auditors' activities
- Quality of working paper documentation, reports, and recommendations
- Evaluation of internal auditors' performance

3.358 To evaluate the internal auditors' objectivity, the auditor should first consider information about their position within the organizational structure. Specifically, (1) who the internal auditors report to, (2) whether they have access to the board of directors, audit committee or management, and (3) who makes employment decisions for the internal audit department. Also, the auditor should evaluate the internal auditors' own policies for ensuring that they maintain objectivity in the areas they audit.

3.359 Effect of the Internal Auditors' Work on the Audit. Once it is concluded that the internal auditors are competent and objective, the auditor should then consider how to use them to reduce audit work. That is, how their work will affect the nature, timing, and extent of auditing procedures, including:

1. **Obtaining an understanding of the control structure.** If the internal auditors have gathered information about the bank's internal control structure policies and procedures, the auditor may be able to use that information in obtaining and documenting his understanding of the control structure.
2. **Assessment of the risk that material misstatements in the financial statements could occur.** The internal auditors' work may influence the assessment of the risk that material misstatements could occur, both on an overall basis and at the balance-sheet account and class-of-transaction levels.
3. **Substantive procedures.** If the internal auditors have applied substantive procedures to specific account balances or transactions, such as confirming loan balances, the auditor may be able to reduce the extent of substantive tests or perform them at an interim date.

3.360 Evaluating and Testing the Internal Auditors' Work. Because the auditor takes full responsibility for any of the internal auditors' work relied upon, SAS No. 65 requires that the auditor evaluate and test such work. The auditor should determine that the scope of their work was sufficient, their audit programs were adequate, their work was properly documented, their conclusions were appropriate in the circumstances, and their reports were consistent with the work performed. The auditor should also test their work by examining some of the same, or similar, tests of controls or substantive tests, and comparing the results of his tests with their work. The degree to which the auditor tests the internal auditors' work should be based on factors such as the materiality of the accounts or transactions involved, the sensitivity of the items tested, and the degree of judgment required to perform the work.

3.361 Internal auditors can also assist directly during the audit. Just as the auditor must supervise and review the work of his or her own staff, he or she must also carefully supervise and review the work of the internal auditors and, as discussed in section 3.360, test and evaluate their work to ensure that it meets the audit objectives.

3.400 DOCUMENTING AUDIT PLANNING DECISIONS

3.401 The Planning Memorandum in section 3.706 is the culmination of the planning process and should be prepared for all bank and savings institution audit engagements. It is critical to achieving both engagement quality and profitability. The Memorandum should be prepared by the in-charge and appproved by the engagement partner before engagement personnel begin field work. It can be prepared using the form in section 3.706 or in a handwritten or typed narrative. Subsequent revision to the planning activities should be documented in the working papers.

3.402 The Planning Memorandum is comprised of Section I - Engagement Administration, and Section II - Technical Audit Planning Decisions. These detailed instructions will facilitate completing the memorandum:

I.A. Presentation of Engagement Letter

The engagement letter is a primary tool for obtaining client understanding of the firm's and client's responsibilities. A good understanding before the engagement begins can prevent misunderstandings later. To gain a good understanding, the engagement partner should deliver the letter and discuss its contents with the client's audit committee or persons of equivalent authority, such as the board of directors, or with management.

I.B. Use of Client Assistance or Paraprofessionals

The schedule attached to the Client Acceptance and Continuance Form (section 3.701) lists possible areas of client assistance. The auditor should use client assistance to the maximum extent possible on every engagement. When client personnel are unavailable, the auditor should use firm paraprofessionals to perform any necessary accounting services and clerical work in connection with the engagement.

I.C. Planning for Proper Workspace and Equipment

The engagement in-charge has responsibility for arranging adequate workspace before the field work begins. Poor lighting, lack of adequate heat or air conditioning, desks or tables that are too small, or work locations that are not near client accounting personnel are examples of situations that hinder the efficient completion of an engagement and that should be avoided.

I.D. Assignment of Staff

A basic element of a good quality control system is assigning personnel to engagements and tasks that are commensurate with their capabilities. Assigning the right people to engagements also helps complete the engagements in the minimum amount of time.

Whenever possible, the prior year's engagement personnel should be reassigned and rotated to new positions on the engagement each year. When reassignment is not possible, the auditor should attempt to assign new staff with experience in financial institutions. When inexperienced personnel, or personnel unfamiliar with the client's business or industry, are assigned to an engagement, the in-charge or partner is responsible for providing appropriate training and supervision.

I.E. Target Dates

Setting target dates during planning is the first step to achieving timely engagement completion. These target dates should also become the input to the firm's staff scheduling system.

I.F. Use of Specialists

The auditor should consider using outside specialists whenever he performs any auditing procedures in areas outside the firm's expertise. Such areas may include actuarial computations for pension funds, legal or regulatory questions, appraisals of real estate, audits designed using clients' EDP systems, and complex accounting and auditing situations.

I.G. Use of Audit Software

Audit software should be used to the maximum extent practical on all engagements. This section should list the specific, planned applications.

I.H. Audit Budget

The budget should be based on circumstances, not on fees. The budget documents should be summarized in this section for discussion with the engagement partner.

I.I. Other Special Considerations

This section is provided to document any significant engagement administration circumstances or problems not covered above.

II.A.- II.F. Technical Audit Planning Decisions

Each section should present the results of the decisions, as well as the rationale, or judgments behind them. Detailed computations or explanations should be either included or incorporated by reference to other working papers or forms. Section II.B must include documentation of the basis for conclusions about the assessed level of control risk, if the assessed level of control risk is below the maximum.

II.G. Planning Analytical Procedures

Analytical procedures used in planning the audit should focus on enhancing the auditor's understanding of the client's operations, transactions, and events that have occurred since the last audit, and on identifying areas that may present significant audit risks. Such procedures range from reviewing changes from the prior year to the current year's working trial balances, to more extensive analyses using quarterly financial information. Documentation should include a description of the types of analytical procedures used, a summary of the results obtained and the impact these procedures have on the nature, timing and extent of audit procedures to be performed.

Sources of information for analytical procedures for financial institutions include:

(1) The FDIC's "Uniform Bank Performance Report," which compares a financial institution with its local and national peer groups. (There is a nominal charge.)

(2) Industry information sources, such as Sheshunoff Information Services, Inc., P.O. Box 13203, Capital Station, Austin, Texas 78711. Sheshunoff publishes quarterly summarizations of key information from bank call reports for every bank filing with the FDIC. The annual service costs about $500.

(3) Bank rating services that review information on banks and award ratings used by insurance companies for risk management purposes. The best known of ratings services is Veribanc.

(4) IHS Regulatory Products' CD-Rom which contains all of the materials published by the regulatory agencies. (It costs about $1,800.) Also, the various regulators publish loose-leaf versions of their materials for about $225–$300 per year.

II.H. Other Special Considerations

Special risks of misstatements, irregularities, or illegal acts, or any other accounting or auditing problems discovered during planning should be discussed in this section. The situation, its possible impact on financial statements, and the planned modification of auditing procedures should be detailed for consideration and approval by the partner. Extra attention must be given to interest rate risk, credit risk, economic risk, and liquidity risk. Recent pronouncements should be reviewed to ascertain if they are applicable to the engagement. The possible impact of such pronouncements on the financial statements and modification of auditing procedures should be described for consideration and approval by the engagement partner. Also, the most recent AICPA Audit Risk Alert should be reviewed. If any special engagements have been conducted (Management Advisory Services or Tax) since the prior audit, discuss any possible implications on this year's audit. If an SEC engagement, determine that the engagement partner has not been responsible for the audit engagement for seven consecutive years, or if rotated off, was not responsible for a two-year period.

3.500 PRELIMINARY FINANCIAL INSTITUTION SURVEY QUESTIONNAIRE

3.501 SAS No. 22, *Planning and Supervision* (AU 311), requires the auditor to obtain an understanding of the client's business and its industry as the foundation to effectively plan an audit. The Preliminary Financial Institution Survey Questionnaire (section 3.708) assists the auditor in gathering and assembling information to facilitate the planning of interim and year-end auditing procedures. It should ordinarily be accompanied by a schedule or floor plan describing the locations of negotiable items such as cash and cash items, securities, unissued savings bonds and travelers checks, unissued official treasurer's and officer's checks and other official items, and any other negotiable items.

Using the Preliminary Financial Institution Survey Questionnaire

3.502 The information in this Questionnaire will aid the in-charge in planning the engagement. It should be modified as considered necessary to fit the circumstances of each bank and savings institution client.

3.503 Financial and operations information should be the most recent at that time. The Questionnaire should be completed by bank personnel and reviewed by the in-charge and the engagement partner.

3.600 INTERIM WORK

3.601 Because the overall engagement risk on bank and savings institution audits is normally high, and because the complexity of bank operations increases the risks of potential misstatement and irregularities, the Internal Control Structure Questionnaire (section 5.200) the Risk of Potential Misstatements Evaluation Form (section 4.501) and the Planning Matrix (section 4.502) should be completed on all financial institution audit engagements before any field work is started. These forms enable the auditor to relate the bank's internal control structure and the risk of potential misstatements evaluation to the substantive testing procedures. This process incorporates the six basic audit planning activities mentioned in section 3.306 and results is an audit designed to collect the optimum evidence in the minimum time.

3.602 Procedures are generally performed as tests of specific internal control procedures. Interim work for banks may serve dual purposes. First, it provides limited tests of controls evidence about the operation of the internal control structure and, at the same time, provides tests of balances evidence from certain procedures performed at an interim date.

3.603 Under the ABC System approach, test of controls procedures such as inquiry, inspection, and observation may be performed as part of interim work when the auditor decides to rely on the work of the internal audit department or when the internal control procedures are strong, as in a System A. Tests of controls should be performed as a part of interim work when the accounting systems and safeguarding procedures are good (System B). When the accounting systems and safeguarding procedures are weak, as in a System C, work otherwise performed at an interim date should be completed near the balance-sheet date.

3.604 Interim work procedures have been generally outlined in the Interim Work Assignment Program (section 3.709). Performing tests at interim dates can be performed for banks with or without controls testing. Reductions in related tests of balances will depend on the extent and results of the interim work and tests of controls, if any.

3.605 Tests of Controls Programs are included in Chapter 5; section 5.400. It is the in-charge's responsibility to modify the standard program procedures as considered necessary to accommodate the peculiarities of a client's operating system and for matters revealed in the preliminary evaluation of the internal control structure. Tests of controls consist of inspections and observations of evidence of internal control procedures, such as the initials of an officer approving an entry to the general ledger. They also consist of reperformance of accounting procedures such as recalculating extensions on invoices or comparing entries in general ledger accounts to supporting documents. Tests of Balances Programs should be modified to reflect the results of tests of controls and analytical procedures.

3.606 Auditing banks requires, in certain circumstances, that control of certain key areas be obtained at the beginning of the audit. The Interim Work Assignment Program (section 3.709) is designed to coordinate procedures that may be performed as of an interim date or at year end. The interim work procedures may simultaneously serve to test the bank's internal control structure and to provide substantive tests of balances evidence.

3.607 This Program will aid the in-charge in planning and performing comtrol procedures. Such procedures are normally omitted when control risk is assessed at below the maximum and when they are not required by state law.

3.608 Areas that require immediate control include cash on hand, investment and trading securities, the trust vault, passbooks, negotiable collateral held for loans, and subsidiary ledgers of loan and deposit accounts. Part I of the Program contains a listing of the work areas that generally require immediate control, and provides spaces for indication of the staff persons who will be responsible for that area on the control day. Part II contains the procedures to be performed.

3.609 The procedures in this Program can be performed for financial statement areas with an internal control structure that qualifies as a System A or System B. For a System C evaluation, procedures should be performed at or near the balance-sheet date. A System A evaluation will permit the design and performance of control testing procedures, such as observing or inspecting work done by the client's internal audit department personnel or other personnel. System B interim work, and System C year-end work, will consist primarily of auditor reperformance of client procedures.

3.610 If interim work is performed, the procedures required by SAS No. 45, *Substantive Tests Prior to the Balance-Sheet Date* (AU 313), should be performed. Such procedures, among others, include inspecting significant transactions from the date of the interim work to the balance-sheet date, comparing the details of account balances at the balance-sheet date to the interim work date, and applying selected auditing procedures to major transactions and balances.

3.611 SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit* (AU 319), provides guidance for assessing control risk and testing a client's internal control structure policies and procedures. When control risk is assessed at below the maximum, evidence obtained from tests of controls can be relied upon to reduce related substantive tests.

3.612 Control risk is assessed at less than maximum when the bank's internal control structure for a financial statement area evaluates as either a System A or B. A System A evaluation indicates the internal control procedures are good, and/or the internal audit function is effective, and that tests of controls may be performed at an interim date where appropriate. A System B evaluation indicates the accounting and safeguarding procedures are good and that tests of controls procedures may be performed at an interim date.

Using the Interim Work Assignment Program

3.613 Part I of the Interim Work Assignment Program should be used to assign and control work areas and should be completed by the in-charge before the control day. Part II includes the general procedures that should be performed as of an interim date (System A or B) or at or near the balance-sheet date (System C).

3.614 Letters of introduction, which appear in Chapter 6, Appendix 6A, should be prepared and given to audit personnel.

3.615 The interim work procedures primarily are reperformance or recalculation procedures. For financial statement areas evaluated as a System A, certain interim procedures can be performed, e.g., procedures performed by internal audit department personnel or accounting personnel may be reviewed in lieu of the auditor's reperformance of such procedures. The in-charge should modify the program for opportunities to perform such tests of controls.

3.616 This Program should be modified by the in-charge during planning and reviewed by the engagement partner before any interim work is performed. Any unacceptable results of interim work procedures, and resulting modifications of year-end tests, should be described in a special memorandum. This Program should be completed by the in-charge and reviewed by the engagement partner.

3.700 DOCUMENTATION ASSISTANCE

3.701

Client Acceptance and Continuance Form— Banks and Savings Institutions	Part I
Client: ______	
Financial Statement Date: ______	

INSTRUCTIONS:

Part I: Part I of this form should be completed or updated for all existing and prospective clients for which audit, or other attestation services are to be performed. The data on the form should be completed by the in-charge and approved by the engagement partner as a basis for initially accepting the client. Part I should then be updated and reviewed annually as a basis for deciding to retain the client.

Part II: Part II of this form should be completed by the engagement partner and concurring partner to document the firm's decision to either accept or reject the client.

CLIENT'S LEGAL NAME:	
ADDRESS:	
PHONE:	
FEDERAL I.D. NO.:	STATE I.D. NO.:

1. Describe the nature of the client's business (and locations, if other than above address):

Client Acceptance and Continuance Form — Part I
(Continued)

2. Identify the type of entity (e.g., national bank, Federal Reserve Member bank, state nonmember bank, bank holding company, savings bank, etc.):

3. List significant shareholders (>25%), officers, and directors of the client:

Name	Percent Owned	Position	Date Initially Owned/Hired

4. Identify any related businesses of individuals listed above (use additional sheets as necessary):

Name of business	Nature of Relationship

5. Identify the client's predecessor accountants:

Name:
Address:
Contact Person & Phone:

Client Acceptance and Continuance Form — Part I
(Continued)

6. Indicate the results of our inquiries of the predecessor accountants regarding the following:

 a. Reasons for change of accountants: ______

 b. Integrity of management: ______

 c. Disagreements on accounting principles and auditing, or other procedures: ______

 d. Fee Disputes: ______

7. Describe the client's relationships with other financial institutions: ______

Institution	Type of A/C's or Services	Account Executive & Phone

 Results of Inquiries: ______

8. Describe the services to be provided by us: ______

Client Acceptance and Continuance Form — Part I
(Continued)

Service	How Often? Monthly	Quarterly	Annually	Report Deadlines

Other Services:

Consulting services: ______________________
Federal tax returns: ______________________
State tax returns: ______________________
Payroll tax returns: ______________________
Tax returns for principal owners: ______________________

9. Describe the use of the financial statements and reports, expecially for any high-risk purposes, such as reports to regulatory agencies, to obtain significant amounts of new credit, to obtain bonding, or for sale of the business:

10. Read the latest financial statements and tax returns and indicate any unusual items:

Client Acceptance and Continuance Form — Part I
(Continued)

11. Describe any potential going-concern problems:

12. Describe the client's major sources of financing and/or funding:

13. State name(s) of third parties contacted concerning management's and owners' reputation, attitude, ability, and integrity (consider Lexis search or D&B inquiry):

14. Describe any significant engagement performance, accounting, or tax problems with which we should be concerned:

15. Identify the client's legal counsel:

Name:
Address:
Contact Person:

Client Acceptance and Continuance Form — Part I
(Continued)

16. Describe any pending litigation against the client or its principals:

17. Describe the billing arrangements:

18. Describe any potential independence problems with respect to the client including any loans to members of the firm:

19. Describe any major changes in the above information since our last evaluation. Also describe any other matters that have come to our attention that would have caused us to reject the client had we been aware of them at the time of our initial acceptance of this client.

Client Acceptance and Continuance Form — Part I
(Continued)

	19____	19____	19____	19____	19____
Prepared or updated by: (In-Charge)	______	______	______	______	______
Reviewed by: (Engagement Partner)	______	______	______	______	______

Client Acceptance and Continuance Form— Banks and Savings Institutions — Part II

Client: ______________________________

Financial Statement Date: ______________________________

	Yes	No
1. Is there any reason to doubt the integrity of management or the board of directors?	☐	☐
2. Are we aware of any significant disagreements between management or the board of directors and the predecessor accountant?	☐	☐
3. Does there appear to be any potential fee collection problems?	☐	☐
4. Are the client's needs beyond our capabilities or staffing abilities?	☐	☐
5. Are we aware of any independence problems that may affect our ability to meet the client's needs?	☐	☐
6. Are there high-risk factors related to the engagement that may affect our decision to accept the client?	☐	☐
7. Is there a potential problem with management or the board of directors not fully understanding the limitations of the services to be provided.	☐	☐

For any "Yes" answers, explain how we plan to mitigate the problem (for example, by assigning more experienced personnel to the engagement, obtaining outside consultants, obtaining a retainer from the client, etc.):

Acceptance Decision:

Yes ______ No ______

Engagement Partner: ______________________________ Date: ____________

Concurring Partner: ______________________________ Date: ____________

3.702 ENGAGEMENT LETTER— AUDIT OF BANK FINANCIAL STATEMENTS

[Date]

____
____
____

This will confirm our understanding of the arrangements for our audit of the financial statements of _____ ________________________ [bank name] for the year ending ________ [balance-sheet date].

We will audit the Bank's balance sheet at ________ [date], and the related statements of income, retained earnings, and cash flows for the year then ended, for the purpose of expressing an opinion on them. The financial statements are the responsibility of the Bank's management. Our responsibility is to express an opinion on the financial statements based on our audit.

We will conduct our audit in accordance with generally accepted auditing standards (GAAS). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit will provide a reasonable basis for our opinion.

Our procedures will include tests of documentary evidence supporting the transactions recorded in the accounts, and direct confirmation of receivables and certain other assets and liabilities by correspondence with selected customers, creditors, legal counsel, and banks. At the conclusion of our audit, we will request certain written representations from you about the financial statements and matters related thereto.

Although the audit is designed to provide reasonable assurance of detecting errors and irregularities that are material to the financial statements, it is not designed and cannot be relied upon to disclose all fraud, defalcations or other irregularities. However, we will inform you of any material errors, and all irregularities or illegal acts, unless they are clearly inconsequential, that come to our attention.

If you intend to publish or otherwise reproduce the financial statements and make reference to our firm, you agree to provide us with printers' proofs or masters for our review and approval before printing. You also agree to provide us with a copy of the final reproduced material for our approval before it is distributed.

We will review the Bank's federal and state ___________ [identify states] income tax returns for the fiscal year ended ________ [date]. These returns, we understand, will be prepared by the controller.

Further, we will be available during the year to consult with you on the tax effects of any proposed transactions or contemplated changes in business policies.

Assistance is to be supplied by your personnel, including the preparation of schedules and the analysis of accounts, as described on a separate attachment.

Our fee for these services will be at our regular per diem rates, plus travel and other out-of-pocket costs. Invoices will be rendered every two weeks and are payable on presentation.

The working papers for this engagement are the property of ____________________ [name of auditor] and constitute confidential information. However, we may be requested to make certain working papers available to ____________________ [name of regulator] pursuant to authority given to it by law or regulation. If requested, access to such working papers will be provided under the supervision of ____________________ [name of auditor] personnel. Furthermore, upon request, we may provide photocopies of selected working papers to ____________________ [name of regulator]. The ____________________ [name of regulator] may intend, or decide, to distribute the photocopies or information contained therein to others, including governmental agencies.

We are pleased to have this opportunity to serve you.

If this letter correctly expresses your understanding, please sign the enclosed copy where indicated and return it to us.

Very truly yours,

____

[Partner]

____

[Firm Name]

Accepted:

____

[Representative's Name]

____

[Title]

____

[Date]

3.702 ENGAGEMENT LETTER— AUDIT OF SAVINGS BANK FINANCIAL STATEMENTS

[Date]

____
____
____

This will confirm our understanding of the arrangements for our audit of the financial statements of _____ ______________________ [savings bank name] for the year ending ________ [balance-sheet date].

We will audit the Savings Bank's balance sheet at ________ [date], and the related statements of income, retained earnings, and cash flows for the year then ended, for the purpose of expressing an opinion on them. The financial statements are the responsibility of the Savings Bank's management. Our responsibility is to express an opinion on the financial statements based on our audit.

We will conduct our audit in accordance with generally accepted auditing standards (GAAS). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit will provide a reasonable basis for our opinion.

The scope of our audit will encompass the requirements set forth under Bulletin PA-7 issued by the Federal Home Loan Bank Board.

Our procedures will include tests of documentary evidence supporting the transactions recorded in the accounts, and direct confirmation of receivables and certain other assets and liabilities by correspondence with selected customers, creditors, legal counsel, and banks. At the conclusion of our audit, we will request certain written representations from you about the financial statements and matters related thereto.

Although the audit is designed to provide reasonable assurance of detecting errors and irregularities that are material to the financial statements, it is not designed and cannot be relied upon to disclose all fraud, defalcations or other irregularities. However, we will inform you of any material errors, and all irregularities or illegal acts, unless they are clearly inconsequential, that come to our attention.

The working papers for this engagement are the property of ______________________ [name of auditor] and constitute confidential information. However, we may be requested to make certain working papers available to ____________________ [name of regulator] pursuant to authority given to it by law or regulation. If requested, access to such working papers will be provided under the supervision of ____________________ [name of auditor] personnel. Furthermore, upon request, we may provide photocopies of selected working papers to ______________________________ [name of regulator]. The ____________________ [name of regulator] may intend, or decide, to distribute the photocopies or information contained therein to others, including governmental agencies.

We agree to perform specific auditing procedures instructed by the District Director — Examinations. These procedures may be in addition to those ordinarily performed in connection with the rendering of our audit report.

If you intend to publish or otherwise reproduce the financial statements and make reference to our firm, you agree to provide us with printers' proofs or masters for our review and approval before printing. You also agree to provide us with a copy of the final reproduced material for our approval before it is distributed.

We will review the Savings Bank's federal and state __________ [identify states] income tax returns for the fiscal year ended ________ [date]. These returns, we understand, will be prepared by the controller.

As set forth in Bulletin PA-7, we agree to meet (within 30 days after the date of delivery of our audit report) with the board of directors or a duly elected or appointed audit committee of the board of directors for the purpose of discussing our audit or any related matter.

Further, we will be available during the year to consult with you on the tax effects of any proposed transactions or contemplated changes in business policies.

Assistance is to be supplied by your personnel, including the preparation of schedules and the analysis of accounts, as described on a separate attachment.

Our fee for these services will be at our regular per diem rates, plus travel and other out-of-pocket costs. Invoices will be rendered every two weeks and are payable on presentation.

We are pleased to have this opportunity to serve you.

If this letter correctly expresses your understanding, please sign the enclosed copy where indicated and return it to us.

Very truly yours,

____
[Partner]

____
[Firm Name]

Accepted:

____
[Representative's Name]

____
[Title]

____
[Date]

ENGAGEMENT LETTER— AUDIT OF SAVINGS BANK FINANCIAL STATEMENTS
(Continued)

CLIENT ASSISTANCE

1. Daily statement as of ______________ when available.
2. List of federal funds sold at ________________.
3. List of public fund deposits.
4. Return cash letter items (Monday, Tuesday, Wednesday).
5. Amount of ________________ cash letter.
6. List of participation loans sold or purchased.
7. List of real estate foreclosures and bankruptcies.
8. Overdraft listing that supports ________________ balance.
9. List of Director, Officer, Employee loans and salaries.
10. Loans for shareholder(s) whose holdings are/or exceed 10% of outstanding stock.
11. Regulatory reports since ___________________.
12. Minute book.
13. Commercial/mortgage loan commitments at ________________.
14. List of nonaccrual loans.
15. List of outstanding letters of credit.
16. List of matured CDs not redeemed.
17. List of CDs amounting to $100,000 or greater.
18. Confirmation preparation — person to assist ________________.
19. Bank stationery.
20. List of specific reconciliations either/or interim and year end.

3.703

TIME ACCUMULATION SHEET - BANKS AND SAVINGS INSTITUTIONS

Client: ______________________________

Financial Statement Date: ______________________________

		ACTUAL HOURS AND DATE																	
WORK AREAS	Budget						Sub-total						Sub-total						Total
Planning:																			
Preliminary survey																			
Internal control evaluation																			
Audit program																			
Client schedules																			
Budgets, time summaries, etc.																			
Other																			
Trial balance																			
Cash and cash items:																			
Cash count																			
Cash items																			
Other procedures																			
Clearings and exchanges																			
Due from banks:																			
Confirmations																			
Other procedures																			
Real estate mortgage loans:																			
Confirmations																			
Other procedures																			
Time and demand loans:																			
Confirmations																			
Other procedures																			
Installment loans:																			
Confirmations																			
Other procedures																			
Credit card loans:																			
Confirmations																			
Other procedures																			

TIME ACCUMULATION SHEET - BANKS AND SAVINGS INSTITUTIONS (Continued) **Page 2 of 3**

		ACTUAL HOURS AND DATE																	
WORK AREAS	Budget						Sub-total						Sub-total						Total
Other loans and discounts (Federal funds sold, commercial paper, etc.):																			
Confirmations																			
Other procedures																			
Prepaid expenses																			
Investment securities:																			
Securities count																			
Confirmations																			
Other procedures																			
Investments in and advances to affiliates																			
Bank premises, equipment, and other real estate																			
Other assets:																			
Interest—real estate mortgage loans																			
Interest—time and demand loans																			
Interest—installment loans																			
Interest—investment securities																			
Other																			
Demand deposit liabilities:																			
Confirmations																			
Other procedures																			
Certificates of deposit:																			
Confirmations																			
Other procedures																			
Other time deposit liabilities:																			
Confirmations																			
Other procedures																			
Capital notes, term debt, and other borrowed funds																			
Other liabilities:																			
Interest—CDs																			
Interest—other time deposits																			
Unearned discount																			
Other																			

TIME ACCUMULATION SHEET - BANKS AND SAVINGS INSTITUTIONS (Continued)

		ACTUAL HOURS AND DATE																	
WORK AREAS	Budget						Sub-total						Sub-total						Total
Reserve for loan losses																			
Contingencies, commitments, and subsequent events																			
U.S. savings bonds, traveler's checks, letters of credit, etc.																			
Collection department																			
Safekeeping																			
Safe deposit																			
Trust department																			
Capital stock																			
Surplus																			
Undivided profits:																			
Income accounts																			
Expense accounts																			
Other procedures																			
Financial statements:																			
Consolidation																			
Report writing																			
SEC schedules																			
Tax returns:																			
Preparation																			
Review																			
Management letter																			
Permanent file																			
Other—Describe:																			
TOTAL																			

Prepared by: ______________________ Date: ______________
(In-Charge)

Reviewed by: ______________________ Date: ______________
(Partner)

TIME SUMMARY FORM - BANKS AND SAVINGS INSTITUTIONS

Client: ______________________________

Financial Statement Date: ______________________________

	Budgeted Hours					Actual Hours					Actual Over (Under)*
	Asst.	I/C	Mngr.	Ptnr.	Tot.	Assist.	I/C	Mngr.	Ptnr.	Tot.	
Planning:											
Preliminary survey											
Internal control evaluation											
Audit program											
Client schedules											
Budgets, time summaries, etc.											
Other											
Trial balance											
Cash and cash items:											
Cash count											
Cash items											
Other procedures											
Clearings and exchanges											
Due from banks:											
Confirmations											
Other procedures											
Real estate mortgage loans:											
Confirmations											
Other procedures											
Time and demand loans:											
Confirmations											
Other procedures											
Installment loans:											
Confirmations											
Other procedures											
Credit card loans:											
Confirmations											
Other procedures											

*Attach memorandum explaining significant variances.

TIME SUMMARY FORM - BANKS AND SAVINGS INSTITUTIONS (Continued)

	Budgeted Hours					Actual Hours					Actual Over
	Asst.	I/C	Mngr.	Ptnr.	Tot.	Assist.	I/C	Mngr.	Ptnr.	Tot.	(Under)*
Other loans and discounts (federal funds sold, commercial paper, etc.):											
Confirmations											
Other procedures											
Prepaid expenses											
Investment securities:											
Securities count											
Confirmations											
Other procedures											
Investments in and advances to affiliates											
Bank premises, equipment, and other real estate											
Other assets:											
Interest—real estate mortgage loans											
Interest—time and demand loans											
Interest—installment loans											
Interest—investment securities											
Other											
Demand deposit liabilities:											
Confirmations											
Other procedures											
Certificates of deposit:											
Confirmations											
Other procedures											
Other time deposit liabilities:											
Confirmations											
Other procedures											
Capital notes, term debt, and other borrowed funds											
Other liabilities:											
Interest—CDs											
Interest—other time deposits											
Unearned discount											
Other											

*Attach memorandum explaining significant variances.

TIME SUMMARY FORM - BANKS AND SAVINGS INSTITUTIONS (Continued)

	Budgeted Hours					Actual Hours					Actual Over
	Asst.	I/C	Mngr.	Ptnr.	Tot.	Assist.	I/C	Mngr.	Ptnr.	Tot.	(Under)*
Reserve for loan losses											
Contingencies, commitments, and subsequent events											
U.S. savings bonds, traveler's checks, letters of credit, etc.											
Collection department											
Safekeeping											
Safe deposit											
Trust department											
Capital stock											
Surplus											
Undivided profits:											
Income accounts											
Expense accounts											
Other procedures											
Financial statements:											
Consolidation											
Report writing											
SEC schedules											
Tax returns:											
Preparation											
Review											
Management letter											
Permanent file											
Other—Describe:											
TOTAL											

Prepared by: ______________________ Date: ______________
(In-Charge)

Reviewed by: ______________________ Date: ______________
(Partner)

*Attach memorandum explaining significant variances.

3.705

SUMMARY OF TIME SAVINGS FOR NEXT YEAR

Client: ______________________

Financial Statement Date: ______________________

SAVINGS SUGGESTIONS

3.706

PLANNING MEMORANDUM

Client: ______________________________

Financial Statement Date: ______________________________

INSTRUCTIONS:

This memorandum should be completed for all audit engagements by the in-charge and reviewed by the engagement partner, before engagement personnel begin field work.

I. ENGAGEMENT ADMINISTRATION

A. Presentation of Engagement Letter

B. Use of Client Assistance or Paraprofessionals

C. Planning for Proper Workspace and Equipment

D. Assignment of Staff

E. Target Dates

Audit report ____________________
Management letter ____________________
Tax returns ____________________
Start of interim field work ____________________
Start of year-end field work ____________________
Other ____________________

F. Use of Specialists

G. Use of Audit Software

H. Audit Budget

I. Other Special Considerations

II. TECHNICAL AUDIT PLANNING DECISIONS

A. Overall Engagement Risk

B. Understanding of Internal Control Structure

C. Overall Materiality Limit

D. Sampling

E. Audit Approach

F. Key Engagement Areas

G. Planning Analytical Procedures

H. Other Special Considerations

____

____

____

____

Prepared by: ________________________ Date: ________________
(In-charge)

Reviewed by: ________________________ Date: ________________
(Partner)

3.707

Materiality Computation Form

Client: ______________________________

Financial Statement Date: ______________________________

INSTRUCTIONS:

This form should be completed by the in-charge during planning and approved by the partner before field work is started.

I. Overall Materiality Limit Computation:

Approximate balances at or near financial statement date:

A. Total Assets $________ × ________% + ________ = $________

B. Total Revenue $________ × ________% + ________ = $________

Overall Materiality Limit $________

Materiality Base — Greater of Total Assets or Total Revenues | **Percentage of the Base**

Over		But Not Over		Percentage of the Base
$	0	$	30,000	6.00%
	30,000		100,000	$ 1,800 + 5.00% in excess of $ 30,000
	100,000		300,000	$ 5,300 + 3.00% in excess of $ 100,000
	300,000		1,000,000	$ 11,300 + 2.00% in excess of $ 300,000
	1,000,000		3,000,000	$ 25,300 + 1.50% in excess of $ 1,000,000
	3,000,000		10,000,000	$ 55,300 + 1.00% in excess of $ 3,000,000
	10,000,000		30,000,000	$ 125,300 + 0.50% in excess of $ 10,000,000
	30,000,000		100,000,000	$ 225,300 + 0.25% in excess of $ 30,000,000
	100,000,000		300,000,000	$ 400,300 + 0.20% in excess of $ 100,000,000
	300,000,000		—	$ 800,300 + 0.15% in excess of $ 300,000,000

Rationale for overall materiality limit (if other than the larger of above computations):

____

____

____

____

____

II. Basic Allowance for Unknown Misstatement Computation:

For nonstatistical sampling applications, the basic allowance can be used in place of tolerable misstatement amount. If used in the table approach or model approach, it should also be considered when comparing total actual, projected and estimated misstatement to the final financial statement amounts.

Overall materiality limit from above	$ ____________
Less estimated known misstatement from sampling and nonsampling tests (e.g., 1/3 of overall materiality)	$ ____________
Basic allowance for unknown misstatement	$ ____________

III. Individually Significant Items — Computation of Lower Limit:

The lower limit for individually significant items will usually be set at 1/3 of the basic allowance. Individually significant items may also be determined judgmentally for each sampling application. The rationale for such judgmentally determined limits should be explained at the bottom of the page.

Lower limit for individually significant items	$ ____________

Rationale for lower limit:

This uniform lower limit will normally be used for determining individually significant items to derive sampling populations and for determining sampling populations and account balances that are not material which can be excluded from testing.

If different lower limits are used for certain accounts, or for such procedures as search for unrecorded liabilities, the reasons for their use should be documented below:

3.708

Preliminary Financial Institution Survey Questionnaire

Client: ______________________________

Financial Statement Date: ______________________________

INSTRUCTIONS:

The Preliminary Financial Institution Survey Questionnaire data for planning the engagement should be obtained from discussion with the member of management responsible for operations. Identify all areas in the bank or savings institution where negotiable items are located and prepare a schedule or floor plan describing the locations and attach to this Questionnaire. Such negotiable items would include cash and cash items, securities, unissued savings bonds and traveler's checks, unissued official checks, and any other negotiable items.

Personnel List

MAIN OFFICE

Main Office Personnel (Officers):

Name: **Title:**

1. ______________________________
2. ______________________________
3. ______________________________
4. ______________________________
5. ______________________________
6. ______________________________

Operations Department Personnel

1. ______________________________
2. ______________________________
3. ______________________________
4. ______________________________

Trust Department Personnel

1. ______________________

Tellers

1. ______________________
2. ______________________
3. ______________________
4. ______________________
5. ______________________
6. ______________________

Night Depository

Locations ______________________

Automatic Teller Machines

Locations ______________________

BRANCH A

Location ______________________

Officer

1. ______________________

Tellers

1. ______________________
2. ______________________
3. ______________________

BRANCH B

Location ______________________

Officer

1. ______________________

Tellers

1. ______________________
2. ______________________

BRANCH C

Location ______________________

Officer

1. ______________________

Tellers

1. ______________________
2. ______________________

GENERAL

1. Where is the corporate stock register maintained? ____________________

2. Where may the last call report be found? ____________________

3. Where is the blanket fidelity bond policy kept? ____________________

4. Where is the insurance register and the related policies? ____________________

5. What time is incoming mail received? ____________________

6. Who receives and where is incoming mail delivered? ____________________

7. What are the hours of operation? ____________________

8. What holidays are observed? ____________________

9. When was last examination by a regulatory authority? ____________________

10. May we inspect last examiners' reports at this time? ____________________

11. Which officer is to review clearings? ____________________

12. Are there central information and credit files on all "due from" banks? If so, where located? ____________________

13. Does the financial institution use fax or bank wire? ____________________

14. How is the night depository handled? ____________________

15. How is Electronic Funds Transfer handled? ____________________

16. What department or functions have not been discussed? ____________________

17. For any given week, indicate in descending order the days having the highest overall volume of activity to the day having the lowest activity. ____________________

CASH

1. How much is the total average cash on hand? (Show the distribution among the tellers and/or branches.) ______________________

2. Is there a marked variance as to cash on hand on certain days of the week? If so, describe. ______________________

3. Do tellers clear all cash items and checks at the end of the day? ______________________

4. Who ordinarily balances total cash on hand with the Proof Department and/or general ledger? ______________________

5. Who is the head teller? ______________________

6. Who is in charge of vault cash? ______________________

7. Is automated counting equipment or a scale used to verify currency? Describe. ______________________

8. Is a scale used to verify bagged coin? Describe. ______________________

AVERAGE CASH ON HAND

TELLER NUMBER	LOCATION AND TYPE OF TELLER	AVERAGE CASH ON HAND

SUBTOTAL ______________________

VAULT RESERVE ______________________

TOTAL AVERAGE CASH ON HAND ______________________

PROOF AND TRANSIT

Cash Collections

1. Who handles and how are "Cash Collection Items" sent out, charged, etc.? ____________________

2. Who handles and where are "Cash Collection Items" remittances received? ____________________

3. Are all "Cash Collection Items" microfilmed? ____________________

Transit

4. Number of daily cash *letters* sent. Obtain list of those ordinarily sent. ____________________

5. Number of daily transit *items* sent. ____________________

6. Are all transit items microfilmed? ____________________

7. Latest time transit items may go out to meet courier schedules. ____________________

8. Who is in charge of transit? ____________________

Clearings

9. What is the method of clearing? ____________________

10. Obtain list of financial institutions with whom clearings are effected. ____________________

11. What is the time of clearing? ____________________

12. Are outgoing clearing items microfilmed? ____________________

13. Who is in charge of outgoing clearings? ____________________

CASH ITEMS

1. Who holds cash items? ____________________

2. Is a cash items register maintained? ____________________

3. Average number of items? ____________________

CASH ITEMS
(continued)

4. What do they include? __________

5. Are cash items under a separate control on the general ledger? __________

DUE FROM BANKS

1. Approximate number of correspondent banks? __________

2. How often are statements received? __________

3. Who reconciles? __________

4. Where are records kept? __________

5. Name of supervisor? __________

RECORD KEEPING AND ACCOUNT INFORMATION

ACCOUNTS

TYPE OF ACCOUNTS	INDICATE NUMBER --------------- ACCOUNTS/BOOKS/CONTROLS	TYPE OF POSTING

PERIODIC STATEMENTS FOR CHECKING ACCOUNTS

FREQUENCY PREPARED	CYCLED? (Note A)	INDICATE PERCENTAGE ------------ PREPARED/MAILED/HELD	PERCENT OF ADDRESSOGRAPH PLATES OR LABELS

Note A: If cycled, attach schedule.

1. Who is in charge of this department? __________

2. Indicate approximate time:
   Bookkeepers arrive __________
   Start posting __________
   Complete posting __________
   Leave __________

3. Are they on (a) immediate, (b) fully deferred, or (c) partially deferred posting? __________

4. Explain how inactive and/or dormant accounts are handled. __________

5. How are overdrafts handled? __________

6. Does the financial institution confirm? If so, explain. __________

SAVINGS

TYPE OF OF ACCOUNT	INDICATE NUMBER ------------ ACCOUNTS	INTEREST POSTING DATE	ADDRESS LOCATION?	COMMENTS

1. Who is in charge of this department? __________
2. Where and how are the Certificate of Deposit records maintained? __________
3. Does the financial institution confirm? If so, explain. __________

SAVINGS BONDS

1. Who is in charge of this department? __________
2. Are savings bonds sold? Into what account do the proceeds of these sales go? __________
3. Where are the supplies of savings bonds maintained? __________
4. Is a perpetual inventory maintained on unissued savings bonds? __________
5. Who will prepare the Federal Reserve confirmation form? __________

COMMERCIAL LOANS

CLASSIFICATION	INDICATE NUMBER OF LOANS	INDICATE NUMBER OF NOTES	INDICATE LOCATION OF COLLATERAL	INDICATE LOCATION OF CREDIT FILES

1. If the above are not in a central location, could it be conveniently rearranged to expedite our checking? If so, how? __________
2. Is there a collateral register? __________
3. Are the collateral and related registers controlled? Explain how. __________
4. Are the collateral and related registers in exact agreement? __________
5. Where is the negotiable collateral kept and who is in charge? __________
6. Where are the records of participation loans (purchased or sold) located? __________
7. Does the bank discount notes of others? __________
8. For whom are notes of others discounted? Secure a list. __________
9. If notes of others are discounted, are the makers placed on notice in all cases? If not, explain in detail. __________
10. Are any payments on these notes received from the endorser discounted? If so, secure a list. __________
11. Explain how nonaccrual loans are handled and where they are located. __________

COMMERICAL LOANS (continued)

12. Is there a "pending file" or follow-up on items or documents outstanding and not yet received? Where is it located? ______

13. Does the bank confirm? If so, explain. ______

14. Explain the bank's interest recognition policies. ______

REAL ESTATE MORTGAGE LOANS

	INDICATE NUMBER OF		INDICATE LOCATION OF	
CLASSIFICATION	LOANS	NOTES	COLLATERAL	CREDIT FILES

1. Are the above items filed in a central location? ______

2. Is there a "pending file" or follow-up on documents outstanding and not yet received? Where is it located? ______

3. Who checks files for completeness? ______

4. Where are FHA and other real estate account insurance and/or escrow accounts maintained? How may we reconcile? ______

5. Explain how nonaccrual loans are handled. ______

6. Does the financial institution confirm? If so, explain. ______

7. Explain the financial institution's interest recognition policies. ______

8. Are loans serviced for others? ______

9. Does the financial institution package loans and sell to third parties? ______

INSTALLMENT LOANS

CLASSIFICATION	INDICATE NUMBER OF LOANS	INDICATE NUMBER OF NOTES	INDICATE LOCATION OF COLLATERAL	INDICATE LOCATION OF CREDIT FILES

1. Does the financial institution discount paper originated by dealers? __________
2. Where is the dealer liability record? __________
3. Where is the dealer reserve record? __________
4. From what dealers is paper discounted? Obtain a list. __________
5. If dealer paper is discounted, are the makers placed on notice in *all* cases? __________
6. Are any payments on these notes received from the originating dealer? __________
7. Does the financial institution "commodity check" paper purchased from dealers? __________
8. Is there a collateral register? __________
9. Are the collateral and related registers controlled? __________
10. Are the collateral and related registers in exact agreement? __________
11. Where is the collateral kept and who is in charge? __________
12. Does the financial institution always "commodity check" wholesale floor plans? __________
13. Does the financial institution make accounts receivable or inventory loans? __________

INSTALLMENT LOANS (continued)

14. How are past-due notes handled and where are they located? ______
15. Does the financial institution confirm? If so, explain. ______
16. Explain financial institution's interest recognition policy. ______
17. Does financial institution periodically observe dealer floor plan inventory? ______
18. Are vehicle identification numbers checked for validity? ______

EXCHANGE

1. Where are the operating and backup inventories of the following?
   a. Official checks and drafts ______
   b. Traveler's checks ______
   c. Letters of credit ______
2. Is a register or voucher system maintained on official checks and drafts? ______
3. Where may the register or outstanding vouchers be found? ______
4. Is a perpetual inventory maintained on unissued traveler's checks? ______
5. What type of traveler's checks are used? ______
6. What type of letter of credit is used? ______
7. Who is in charge of this department? ______

COLLECTION

1. How many notes are held for collection? ______
2. Is there a memorandum control account of the balance outstanding? ______

COLLECTION LOANS (continued)

3. Does the financial institution confirm? ______
4. How many incoming collections daily? ______
5. May we send tracers? ______
6. How many outgoing collections daily? ______
7. May we send tracers? ______
8. Who is in charge of this department? ______

BANK/SAVINGS INSTITUTION-OWNED SECURITIES

1. Where are financial institution-owned securities retained and are they registered in the bank's name? ______
2. Under whose control are these securities? ______
3. Where is the securities register? ______
4. Is a list of securities owned readily available? ______
5. Who may be asked to prepare the list of securities owned? ______
6. Does the securities register indicate those pledged, reason pledged and where held in safekeeping? ______
7. How often is a market valuation made of all securities? ______
8. Indicate date of last valuation of municipals, etc. ______
9. Can a copy be obtained of the last market valuation of securities other than government bonds, notes, certificates and bills? ______
10. What is the volume of security transactions? ______
11. Can prices be obtained from broker or other sources? ______
12. Does the financial institution have a formal method for designating held to maturity, held for sale, and held for trading securities? ______

COLLECTION LOANS (continued)

13. Who are the securities dealers with whom the financial institution executes transactions? ____________

SECURITIES DEPARTMENT
(Purchases for customers)

1. Who is in charge of this service? ____________
2. Where are undelivered securities held? ____________
3. Does the bank operate a retail securities department? ____________

SAFEKEEPING

1. Where are safekeeping items held? ____________
2. What is the volume of safekeeping items? ____________
3. Where is the safekeeping register? ____________
4. Who is in charge of safekeeping? ____________

ESCROW

1. Where are escrow accounts handled? ____________
2. How many escrow accounts? ____________
3. To what account may these be reconciled? ____________
4. Who is in charge of this operation? ____________

TRUST

1. How many trust accounts are there (type of account)? ____________
2. Where are trust securities held? ____________
3. Who is in charge of this department? ____________
4. How many employees are in the Trust Department? ____________
5. Is there a trust committee? If so, are trust committee minutes maintained? ____________

TRUST (continued)

6. What type of trust records are maintained? ______

7. Are trust statements prepared monthly? ______

8. Is there a petty cash fund for teller's window in the trust area? ______

9. What are the total resources in dollars of the Trust Department statement of condition? ______

10. Does the trust department use collective trust funds for customer investments? ______

	19____	19____	19____	19____	19____
Prepared/updated by:					
Client	______	______	______	______	______
In-charge	______	______	______	______	______
Reviewed by:					
Engagement Partner	______	______	______	______	______

3.709

Interim Work Assignment Program

Client: ____________________

Financial Statement Date: ____________________

Work Performed Date: ____________________

INSTRUCTIONS:

This Program may be completed for bank and savings institution audit engagements as of an interim date for Systems A and B, and at or near year end for System C. It contains the work areas (Part I) and procedures (Part II) related to audit areas that require immediate control.

In Part I, the in-charge should indicate in the "Auditor" column the initials of the staff person responsible for the work area. Indicate "N/A" if the work area is not applicable to this bank. The Part II procedures should be initialed and dated by the appropriate staff persons upon completion of the procedures.

PART I—WORK AREAS:

Control	Auditor	Control (continued)	Auditor
Teller's cash	______	Checking accounts—active	______
Bank/savings institution securities	______	Checking accounts—inactive	______
Vault cash	______	Real estate loan ledgers	______
Collateral	______	Real estate loan notes	______
Letters of credit	______	Secured loan ledgers	______
Traveler's checks	______	Secured loan notes	______
Savings bonds—unissued	______	Unsecured loan ledgers	______
Savings bonds—redeemed	______	Unsecured loan notes	______
Cash items	______	Installment loan deposit ledgers	______
Official checks	______	Installment loan notes	______
Money orders	______	Certificates of deposit	______
Certified checks	______	Collateral register	______
Loose securities	______	Transit items	______
Other negotiable assets	______	Return items	______
Collection items	______	Noncash collections	______
Bank securities ledger	______	Local clearings	______
Savings ledgers—active	______	Inquire if bank has	
Savings ledgers—inactive	______	safekeeping securities	______

Foot	Auditor	Foot (continued)	Auditor
Savings ledgers—active	______	Unsecured loan ledgers	______
Savings ledgers—inactive	______	Unsecured loan notes†	______
Checking accounts—active	______	Installment loan deposit ledgers	______
Checking accounts—inactive	______	Installment loan notes†	______
Real estate loan notes†	______	Bank/Savings Institution securities	
Real estate loan ledger	______	ledger	______
Secured loan ledgers	______	Certificates of deposit	______
Secured loan notes†	______	Unearned interest income	______

List & Examine	Auditor	List & Examine (continued)	Auditor
Cash—vault & tellers	______	Certified checks—unissued	______
Cash items—arrange to clear		Money orders—unissued	______
listing daily	______	Local clearings	______
Letters of credit—unissued	______	Collection items—arrange	
Traveler's checks—unissued	______	to clear daily	______
Savings bonds—unissued	______	Transit items	______
Savings bonds—redeemed	______	Loose securities	______
Official checks—unissued	______		

List	Auditor
Outstanding:	
Letter of credit	______
Official checks	______
Certified checks	______
Money orders	______
Inquire about accommodations collections, prepare explanation and list (if not too many)	______

List (continued)	Auditor
Request all returned items be held each day for five days	______
Public funds	______
Overdrafts	______
Accompany local clearings to clearing house	______
Prepare working papers for afternoon review	______

Confirm	Auditor
Savings accounts	______
Checking accounts	______
Real estate loans	______
Secured loans	______
Bank/Savings Institution securities	______
Traveler's checks	______
Letters of credit	______

Confirm (continued)	Auditor
Due from banks	______
Unsecured loans	______
Installment loans	______
Certificates of deposit	______
Savings bonds	______
Due to banks	______
Public funds	______

Examine	Auditor
Loan files (examine files for accounts confirmed and indicate comments on control copy of confirmation)	______
Explain and assign due from banks reconciliations	______
Collateral[‡]	______
Bank/Savings Institution securites	______

Examine (continued)	Auditor
Federal Reserve stock	______
Explain and assign bank securities schedule	______
Prepare trial balance	______
Foot capital stock register and test transactions. Also unissued certificates (if within scope of work)	______

Prepared by: ______________________________ Date: ______________

Reviewed by: ______________________________ Date: ______________

† Foot only if payments are posted to note.

‡ Trace 100% to collateral and control records and to loan file examination work.

PART II — INTERM WORK PROCEDURES:

	Done By	Date	W/P Ref.
A. Immediately upon arrival at the financial institution (before the bank/savings institution opens), seal or otherwise control the following:			
1. Cash (including "unverified" cash in transit and cash prepared for shipment), cash in ATM's and night depository	______	______	______
2. Cash items	______	______	______
3. Securities	______	______	______
4. U.S. savings bonds (including unissued bonds, spoiled or voided bonds and stubs from sale of bonds)	______	______	______
5. Traveler's checks	______	______	______
6. Official checks (cashiers' checks, expense checks, treasurers' checks, officers' checks, etc.)	______	______	______
7. Acceptances and confirmed letters of credit	______	______	______
8. Notes, and a copy of the loan trial balance	______	______	______
9. Collateral loans and collateral records	______	______	______
10. All safekeeping items on hand together with the safekeeping records	______	______	______
11. Open incoming collection items and related control records	______	______	______
12. Outgoing collection register	______	______	______
13. Assets and asset records of the trust department	______	______	______
14. Any other vaults, compartments, safe deposit boxes (in bank's name) and overnight safes that may contain any of the above (including items that may be temporarily in the custody of loan officers, secretaries, or others)	______	______	______

	Done By	Date	W/P Ref.

B. To facilitate obtaining the necessary confirmations in a timely, efficient and reliable manner, prepare to have confirmation requests sent out upon beginning of the audit as follows:

1. Request from Federal Reserve Bank:

Note: A preliminary request prior to mailing this confirmation may be made to the Federal Reserve Bank (FRB) by an officer of the bank by telephone or wire to expedite this procedure. Such requests are well understood by FRB personnel and are often referred to as a "Full Tassle."

a. Bank statements and canceled vouchers ______ ______ ______

b. Statement of reserve account ______ ______ ______

c. Statement of deferred credit account ______ ______ ______

d. Statement of U.S. Treasury tax and loan account ______ ______ ______

e. Advances from FRB ______ ______ ______

f. Itemized list of securities, acceptances, and/or commercial paper held in safekeeping, indicating the purpose for which held ______ ______ ______

2. In a separate letter to the FRB request confirmation of U.S. savings bonds on consignment ______ ______ ______

Note: This procedure can best be accomplished by enclosing a copy of the bank's latest report submitted to the FRB or by requesting the bank to prepare a report as of the balance sheet date to be enclosed with the confirmation request.

3. Correspondent "Due From" banks:

a. Standard bank confirmation form ______ ______ ______

b. Cash letters, clearings, and exchanges forwarded on the audit date. (This confirmation request should be enclosed with the items unless they have been forwarded before beginning the audit and should also request itemization of items being returned in excess of $ _______) ______ ______ ______

	Done By	Date	W/P Ref.
c. Federal funds sold (amount and interest rate)	______	______	______
d. Securities held in safekeeping	______	______	______
e. FRB stock held in safekeeping	______	______	______
4. Correspondent "Due To" banks:	______	______	______
a. Request confirmation of balance and a copy of reconciliation. (Have bank prepare a special cutoff statement of the "Due To" bank's accounts to enclose with the confirmation request)	______	______	______
b. Federal funds purchased	______	______	______
5. Public funds depositors:			
a. Request confirmation of public funds on deposit (demand and time) with the bank: (1) as of the audit date (enclose special cutoff statement if necessary for demand deposits), (2) as of the depositors last regular statement date, or (3) as of the next regular statement date	______	______	______
6. Holders of letters of credit:			
a. Request confirmation of amount of letters of credit outstanding	______	______	______
7. Holders of any trust department assets not on hand:			
a. Request confirmation of securities held by others and uninvested cash held by other depositories as necessary	______	______	______
8. Holder (e.g., the drawee bank) of items sent out for collection:			
a. Request confirmation of all items sent out for collection that are outstanding and unpaid as of the audit date	______	______	______

Note: Depending on the internal control in the collection department and the bank's or savings institution's internal auditing procedures and the volume of the items, it may be more practical to select a

	Done By	Date	W/P Ref.

representative sample of the items or to limit confirmation requests only for those items that are still outstanding several days after the balance sheet date.

C. The following procedures, involving physical inspection, counting, and preparation of the necessary working paper documentation should be performed upon beginning the audit as considered necessary. Consider the use of cross counts between tellers and the use of internal audit personnel and bank or savings institution's management not related to the teller functon.

1. Cash and cash items:

a. Assign an auditor to tellers and other cash locations and assume control of cash and cash items whether in tellers' cages or in vault ______ ______ ______

b. Count cash on hand wherever located and record the count on a cash count sheet. The contents of night depository boxes, representing items deposited by customers during the night, are not to be counted. However, control must be exercised to assure that these items are not mixed with tellers' cash that is to be counted.

c. List all cash items and obtain explanation of any questionable items such as "late" checks cashed, return items, items held for a long period, and items of an unusually large amount. Indicate those items for which subsequent disposition is to be determined ______ ______ ______

d. Schedule "holdover" deposits and other holdover credits such as installment loan payments, general ledger entries for official checks issued after settlement date, etc. ______ ______ ______

2. Clearings and exchanges:

a. Refer to confirmation procedures in Step B.3.b ______ ______ ______

b. Arrange to intercept and inspect (on a test basis if numerous) all return items for ____business days following the start of the audit ______ ______ ______

	Done By	Date	W/P Ref.
c. Obtain or prepare a list of the clearings and exchanges by drawee bank and reconcile the total with the general ledger account balance	______	______	______
3. Due from banks:			
a. Refer to confirmation procedures in Step B.3.a	______	______	______
Note: If the internal control structure is adequate (a System A or B) it may not be necessary to confirm cash letters forwarded on the balance-sheet date.			
b. Prepare or arrange to obtain reconciliations of the accounts and adequately describe the reconciling items and indicate their date of origin	______	______	______
c. If applicable, scan the checks accompanying cash letters that have not been forwarded upon beginning of the audit for "on us" checks and bank drafts	______	______	______
d. Determine the last issued serial numbers of drafts by inspecting the supply and trace such numbers to the applicable outstanding lists of drafts	______	______	______
4. Investment securities:			
a. Obtain a listing or prepare a detailed schedule of investment securities and summarize by the various classifications	______	______	______
b. Maintain control of the securities until all securities have been accounted for by inspection or otherwise	______	______	______
c. Count securities on hand and trace to the detail schedule	______	______	______
d. Reconcile the total of securities on hand plus those held in safekeeping by others to the general ledger to determine that all investment securities have either been counted or confirmation has been requested	______	______	______

	Done By	Date	W/P Ref.
5. Loans and collateral:			
a. Determine that postings to loan records and ledgers have been made to the date interim work begins	____	____	____
b. Maintain control of the notes, collateral records and receipts until they have been inspected and checked with the loan records on a test basis and any missing items have been subsequently accounted for	____	____	____
c. Maintain control of notes until trial balances have been obtained and tested, reconciled to the general ledger, collateral evaluated, and confirmation requests have been typed and checked. If computerized records are used, arrange in advance to obtain records and confirmations from EDP department or outside service bureau	____	____	____
d. If during the time the notes and collateral are under control, anyone in the bank or savings institution needs to remove a note or items of collateral, list the item removed indicating to whom released and have the recipient sign or initial the list	____	____	____
e. Confirm all participation and/or service agreements	____	____	____
6. Demand deposits:			
a. Determine that postings to the demand deposit records have been made to the date interim work begins	____	____	____
b. Prepare, obtain, and test trial balances of all accounts and reconcile to the general ledger	____	____	____
c. Select ____ accounts for confirmation requests as directed in the Tests of Balances Program or planning working papers. (Including treasury tax and loan accounts)	____	____	____
7. Official checks and demand certificates of deposit:			
a. Inspect the stock of unissued official checks and obtain serial numbers of the last issued checks and trace to list of those outstanding	____	____	____

	Done By	Date	W/P Ref.
b. Obtain or prepare a list of the outstanding official checks and reconcile the totals to the general ledger	______	______	______
c. Arrange to have official checks and demand certificates of deposit paid during the first ____ business days of the audit presented to us daily for our inspection. Compare all pertinent details to listings of outstanding items.	______	______	______
d. Obtain or prepare a list of the outstanding demand certificates of deposit and reconcile the total to the general ledger. Select items for confirmation	______	______	______
8. Time deposits:			
a. Determine that postings to the deposit ledgers have been made to the date interim work begins	______	______	______
b. Prepare or test trial balances of all accounts and reconcile to the general ledger	______	______	______
c. Select accounts for confirmation requests as directed in the Tests of Balances Program or planning working papers. (Include any accounts representing public funds)	______	______	______
9. U.S. savings bonds, traveler's checks, letters of credit, etc.:			
a. Count and summarize the total face value of unissued and spoiled savings bonds on hand and check to bank's records. Also count the face value of stubs on hand (sold bonds that the bank has not remitted for), calculate proceeds received, and agree total to the liability account in the general ledger	______	______	______
b. Determine if any bonds are held by subagents and prepare confirmation requests	______	______	______
c. Count and summarize, by denomination and serial numbers, unissued traveler's checks, letters of credit, etc., and prove the total with the financial institution's records	______	______	______

	Done By	Date	W/P Ref.
10. Safekeeping:			
a. Obtain or prepare a trial balance of all safekeeping items on hand and prove the total to the memorandum control account	______	______	______
b. Select safekeeping accounts for confirmation requests as considered necessary by the engagement partner.	______	______	______
11. Trust department (as considered necessary by the engagement partner.):			
a. Count any cash in the trust department	______	______	______
b. Select _____ trust accounts (or all trust accounts if practical) and maintain control over the related files containing the trust assets. Inspect and count stocks, bonds, mortgages, real estate deeds, etc. for the accounts selected and prove the counts to the detail of the trust records	______	______	______
12. Make inquiries of management about related parties and inquire about recorded or unrecorded transactions during the period. (See Chapter 6, section 6.400 of Tests of Balances Audit Programs)	______	______	______

Prepared by: ______________________ Date: ______________

Reviewed by: ______________________ Date: ______________

Audit Approach

CHAPTER 4

THE AUDIT APPROACH

Table of Contents

CHAPTER 4

THE AUDIT APPROACH

Table of Contents (Continued)

CHAPTER 4

THE AUDIT APPROACH

4.000 INTRODUCTION

4.001 This Manual presents practical assistance to all auditors of banks, whether the auditors develop their own forms, questionnaires, programs and workpapers, or whether they use those provided throughout this Manual.

4.002 This chapter, however, presents a unique approach (the ABC System) to audit planning and performance - an approach designed specifically to minimize substantive testing and thereby maximize engagement profits. This Manual contains all the forms, questionnaires, programs, and workpapers needed to meet all planning and documentation requirements, as well as to determine the most cost effective way to conduct the engagement.

4.003 Also included in this chapter is sampling guidance for performing tests of controls and tests of balances.

4.100 OVERVIEW OF AUDIT APPROACH

Overview of ABC System

4.101 The ABC System is a unique approach to planning and performing the audit, in that it is designed to allow the auditor to assess the control risk for each of the major audit areas of the bank, and to provide the auditor with the tests of controls, tests of balances, and analytical procedures most likely to be relevant to each major audit area.

4.102 The ABC System is based on the assumption that the auditor will desire to place as much reliance on the client's internal control structure as possible in order to minimize substantive testing while maintaining high audit quality and complying fully with generally accepted auditing standards.

4.103 The ABC System's Internal Control Structure Questionnaire (section 5.200) is organized into three levels of priorities (for each major audit area):

- those controls necessary to provide the client with an effective basic accounting system (level C),
- those controls necessary to provide the client with both an effective accounting system and good primary controls (levels B and C acting together), and
- those controls necessary to provide the client with good secondary controls, as well as good primary controls and an effective accounting system (levels A, B, and C acting together).

4.104 By completing the entire Internal Control Structure Questionnaire for an audit engagement, the auditor can assess the controls for each major audit area. The auditor can then exercise judgment to determine that:

- A major audit area for which all (or substantially all) controls in the A, B, and C levels are present would qualify as an "A System," for which the auditor could assess control risk as low or moderate (which would justify minimizing substantive tests once the controls themselves are tested),

- A major audit area for which all (or substantially all) controls in the B and C (but not the A) levels are present would qualify as a "B System," for which the auditor could assess control risk as moderate to slightly below the maximum (which would justify reducing some substantive tests once the controls are tested), or

- A major audit area for which all (or substantially all) controls in the C level (but not the A and B levels) are present would qualify as a "C System," for which the auditor could assess control risk as maximum to slightly below maximum (which would cause the auditor to perform primarily substantive tests in most cases, even after the controls are tested).

4.105 Illustration No. 4-1 portrays the interrelationship of control risk and degree of reliance on controls for systems classified as A, B, or C.

4.106 The Manual's programs for tests of controls (section 5.200) and tests of balances (section 6.400) are organized according to whether controls over a major audit area are determined to constitute an A System, a B System, or a C System. Each major audit area must be assessed and classified independently from other major audit areas; thus, the payroll cycle may be classified as an A System, the deposits and payments cycle may be classified as a B System, and the income recognition cycle may be a C System. Of course, an auditor must use his understanding of the client and the client's industry to customize the precise audit program for an engagement, but the ABC System gives the auditor assistance with determining appropriate and justifiable levels of substantive testing without "overauditing" or "underauditing."

4.107 The ABC System incorporates analytical procedures to the maximum extent possible, whether a system is rated as A, B, or C, in order to obtain the optimal mix of audit evidence for quality and efficiency. The ABC System is discussed further in section 4.300.

ILLUSTRATION NO. 4-1

RELIANCE MATRIX

Reliance on Types of Tests Based on Control Risk Assessment

Audit Approach	Control Risk	Test of Controls	Analytical Procedures	Tests of Balances
ABC Approach:				
SYSTEM A: Good Internal Control Procedures	Low to Moderate	High Reliance	Maximum Extent Possible	Low Reliance
SYSTEM B: Good Accounting System and Primary Controls	Moderate to Slightly below the Maximum	Moderate Reliance	Maximum Extent Possible	Medium Reliance
SYSTEM C: Good Accounting System or More Efficient Test of Balances Approach	Slightly below the Maximum to Maximum	Low or No Reliance	Maximum Extent Possible	Slightly less than High to High Reliance

4.200 TYPES OF TESTS

4.201 In developing an audit strategy, the auditor must consider, among other things, the relative efficiency and effectiveness of the three types of audit procedures—tests of controls, tests of balances, and analytical procedures. To help in this determination (which influences the auditor's selection in the ABC System), the following sections briefly describe these three types of tests.

Tests of Controls

4.202 When the auditor assesses control risk below the maximum (such as in a System A or B approach), he or she must perform tests of controls to support the lower assessed level of control risk. Appendix B of AICPA Statement on Auditing Standards (SAS) No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit* (AU 319.67), defines tests of controls as:

> Tests directed toward the design or operation of an internal control structure policy or procedure to assess its effectiveness in preventing or detecting material misstatements in a financial statement assertion.

Examples of tests of controls include inquiries of client personnel, inspection of documents and reports, and reperformance and observation of the application of a control policy or procedure. Performing tests of controls to support a lower assessed level of control risk allows the auditor to reduce substantive tests. As a result, before performing tests of controls, the auditor should weigh the relative effort needed to perform the tests of controls against the effort saved by reducing substantive tests. Tests of Controls Programs are included in section 5.200.

Substantive Tests

4.203 Paragraph 4.11 of the AICPA's Audit Guide, *Consideration of the Internal Control Structure in a Financial Statement Audit*, states:

> The auditor makes judgments about the nature of substantive tests based on an assessment of the effectiveness and efficiency of the available alternative procedures in detecting material misstatements. The procedures may include substantive analytical procedures, substantive tests of balances, or a combination of both. Judgments about the nature, timing, and extent of audit procedures are influenced by the following:
>
> - Assessment of the inherent risk of material misstatement.
> - Materiality of transactions and balances.
> - Assessed level of control risk.
> - Amount, volume, and variability of transactions and balances.
> - The effectiveness of other available audit procedures.

4.204 As a result, the assurance an auditor needs from substantive tests (which is based on the assessed level of control risk and tests of controls) is obtained by performing substantive tests of balances procedures, substantive analytical procedures, or a combination of both.

4.205 Depending on the nature and extent of the analytical procedures, it may be possible to *substantially* reduce the related tests of balances. For example, a reasonableness test of depreciation expense may eliminate detail tests of a client's depreciation schedule. As another example, computation of the effective interest rates by category and comparing them with interest rates in effect during the year may eliminate the need for further analysis of the interest expense account. In both of these cases, a simple analytical procedure can be used to adequately verify all the financial statement assertions for a general ledger account balance. Further tests of those balances may not be necessary.

4.206 **Substantive Tests of Balances (Detailed Tests).** Whenever control risk is assessed at the maximum level (a substantive audit approach), the auditor will place high reliance on substantive testing. Characteristics of highly reliable substantive tests are that they are performed at year end rather than at interim dates, the evidence provided by the tests is highly reliable (such as examining supporting documents prepared by a third party rather than internally-prepared documents), and maximum sample sizes are selected.

4.207 When the auditor assesses control risk at a moderate or low level and therefore performs tests of controls, the nature, timing, and extent of substantive tests may be changed. The Evidence Matrix in Illustration No. 4-2 shows the impact of the auditor's control risk assessment on the substantive tests of balances evidence.

4.208 The Tests of Balances Audit Programs for banks and savings institutions are included in section 6.400.

4.209 **Substantive Analytical Procedures.** In most cases, analytical procedures should be performed to the maximum extent possible, because they are often more efficient to perform than detailed testing.

4.210 SAS No. 56, Analytical Procedures (AU 329), describes analytical procedures as follows:

> Analytical procedures involve comparisons of recorded amounts, or ratios developed from recorded amounts, to expectations developed by the auditor. The auditor develops such expectations by identifying and using plausible relationships that are reasonably expected to exist based on the auditor's understanding of the client and of the industry in which the client operates. Following are examples of sources of information for developing expectations:
>
> a. Financial information for comparable prior period(s) giving consideration to known changes.
>
> b. Anticipated results — for example, budgets or forecasts including extrapolations from interim or annual data.
>
> c. Relationships among elements of financial information within the period.
>
> d. Information regarding the industry in which the client operates — for example, gross margin information.
>
> e. Relationships of the financial information with relevant nonfinancial information.

4.211 Whenever analytical procedures are applied as substantive tests, the auditor must apply the following procedures:

1. Consider whether the relationship is plausible and predictable.

2. Consider whether the data used for the comparison is reliable.

3. Consider whether the account balance tested is consistent with the auditor's expectations. If it is not consistent, obtain the client's explanation for the variance and get evidence to corroborate the client's explanation.

ILLUSTRATION NO. 4-2

EVIDENCE MATRIX

Audit Approach	Control Risk for Most Financial Statement Assertions	Substantive Tests of Balances Evidence: Amount	Nature	Extent	Timing
ABC Approach					
System A: Good Internal Control Procedures	Low	Small Amounts	Least Reliable	Small Samples	Most Precede Year End
System B: Good Accounting System and Primary Controls	Moderate	Medium Amounts	More Reliable	Medium Samples	Some Precede Year End
System C: Good Accounting System	Slightly Below the Maximum to Maximum	Large Amounts	Most Reliable	Large Samples	Most at Year End

Change in 1995 Edition of the Tests of Balances Programs and the Analytical Procedures Program

Based on feedback we have received from users of this Manual, we have revised the 1995 edition of the Tests of Balances Programs. Each Tests of Balances Program now includes the related substantive analytical procedures (previously included in the Analytical Procedures Program), which is designed to allow the user to more easily choose the right mix of tests of details and substantive analytical procedures for each major audit area, based on the results of completing the Internal Control Structure Questionnaire, the Risk of Potential Misstatements Form, and the Tests of Controls Program, and considering which types of tests are the most efficient and effective for the audit area. Because of this change, the separate Analytical Procedures Program is no longer included in this Manual.

4.300 THE ABC SYSTEM

4.301 As mentioned in section 4.102, the ABC System should be used for engagements in which the auditor plans to assess control risk at a moderate or low level in order to minimize substantive tests. The following are the basic steps involved in designing an audit approach using the ABC System, and the forms and documents contained in this Manual related to those steps:

Procedure	Documentation
1. Understand the organization's operations and industry.	1. Client Acceptance and Continuance Form
2. Perform audit planning procedures.	2. Planning Memorandum
3. Perform analytical procedures sufficient to plan the audit.	3. Planning Memorandum
4. Obtain an understanding of the organization's internal control structure.	4. Internal Control Structure Questionnaire and Computer Controls Questionnaires
5. Assess the risk that misstatements in the financial statements could occur.	5. Risk of Potential Misstatements Evaluation Form
6. Assess control risk for each financial statement assertion and determine the tests of controls and the level of substantive tests to be performed.	6. Internal Control Structure Questionnaire and Planning Matrix

4.302 Procedures 1, 2, and 3 are discussed in Chapter 3 of this Manual. The following sections discuss procedures 4, 5, and 6 and the related documentation.

Using the AICPA Audit and Accounting Guides

4.303 The AICPA's Audit and Accounting Guides, *Audits of Banks* and *Audits of Savings Institutions*, include information about accounting and auditing that is unique to these industries. They discuss the components of the internal control structure, audit objectives, and the nature of the financial institutions' operations and financial statement classifications. All engagement personnel should read and understand the appropriate guide before modifying and using the documentation in this Manual. There is a project underway to combine both guides into one. The tentative issuance date of the new combined guide is late 1995. See Chapter 1, section 1.367 for further information.

Internal Control Structure, Risk Assessment, and Program Modification

4.304 Because the overall engagement risk on bank audits and savings institutions is normally high, and the complexity of their operations increases the risks of potential misstatements and irregularities, the Internal Control Structure Questionnaire, the Risk of Potential Misstatements Form, and the Planning Matrix should be completed on all audit engagements before any field work is started.

The Nature, Purpose, and Performance of Interim Work

4.305 Interim work for banks and savings institutions, often called control-day procedures, may serve two purposes. First, it provides limited tests of controls evidence about the operation of the internal control structure and, at the same time, provides substantive tests of balances evidence from certain procedures performed at the interim date.

4.306 In this Manual, testing of controls may be performed as part of interim work, when the auditor decides to rely on the work of the client's internal audit department or when the internal control procedures are strong (i.e., System A). Other tests of controls should be performed as part of interim work when the accounting systems and safeguarding procedures are good (System B). When the accounting systems and safeguarding procedures are weak, as in a System C, work otherwise performed at an interim date should be completed at or near the balance-sheet date.

4.307 Interim work procedures have been generally outlined in the Interim Work Assignment Schedule. Interim work, performing tests of balances procedures at a date other than the balance-sheet date, can be performed with controls testing. Reductions in related tests of balances will depend on the extent and results of the interim work and tests of controls, if any.

4.308 Tests of Controls Programs are included in this Manual. It is the in-charge's responsibility to modify standard program procedures as considered necessary to accommodate the peculiarities of a client's operating system and for matters revealed in obtaining an understanding of the internal control structure. Tests of controls consist of inspections and observations of evidence of bank internal control procedures, such as the initials of a bank officer approving a debit or credit ticket entry to the general ledger. Other procedures consist of reperformance of accounting systems procedures, such as recalculating extensions on invoices or comparing entries in general ledger accounts to supporting documents. Tests of Balances Programs should be modified to reflect the results of performing tests of controls.

Internal Control Structure

4.309 SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit* (AU 319), requires the auditor to obtain a sufficient understanding of an entity's control structure (control environment, control policies and procedures, and accounting system) to adequately plan the audit and to determine the nature, timing, and extent of audit procedures. As discussed in Chapter 1, the Auditing Standards Board of the AICPA is revising SAS No. 55 to reconcile that document with the Committee of Sponsoring Organizations (COSO) of the Treadway Commission's Report, Internal Control — Integrated Framework (see section 1.356). The description of the three elements of the control structure contained in SAS No. 55 is shown in Illustration No. 4-3.

ILLUSTRATION NO. 4-3

ELEMENTS OF THE INTERNAL CONTROL STRUCTURE

For a financial statement audit, an entity's internal control structure comprises the following:

Control Environment: The collective effect of various factors on establishing, enhancing, or mitigating the effectiveness of specific policies or procedures. The control environment includes such factors as—

- Management's philosophy and operating style.
- The entity's organizational structure.
- The functioning of the board of directors and its committees, particularly the audit committee.
- 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 an entity's operations and practices, such as examinations by bank regulatory agencies.

The control environment reflects the overall attitude, awareness, and action of the board of directors, management, owners, and others concerning the importance of control and its emphasis in the entity.

Accounting System: The methods and records established to identify, assemble, analyze, classify, record, and report an entity's transactions and to maintain accountability for the related assets and liabilities. An effective accounting system will give 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.
- Present properly the transactions and related disclosures in the financial statements.

ILLUSTRATION NO. 4-3 (Continued)

ELEMENTS OF THE INTERNAL CONTROL STRUCTURE

Control Procedures: Those policies and procedures, in addition to the control environment and the accounting system, that management has established to provide reasonable assurance that specific entity objectives will be achieved. Control procedures pertain to—

- Proper authorization of transactions and activities.
- Segregation of duties to reduce the opportunities to allow any person to be in a position to both perpetrate and conceal errors or irregularities in the normal course of his duties— assigning different people the responsibilities of authorizing transactions, recording transactions, and maintaining custody of assets.
- Design and use of adequate documents and records to help ensure proper recording of transactions and events, such as monitoring the use of prenumbered shipping documents.
- Adequate safeguards over access to and use of assets and records, such as secured facilities and authorization for access to computer programs and data files.
- Independent checks on performance and proper valuation of recorded amounts, such as clerical checks, reconciliations, comparisons of assets with recorded accountability, computer-programmed controls, management review of reports that summarize the detail of account balances (for example, an aged trial balance of accounts receivable), and user review of computer-generated reports.

4.310 Completion of the Internal Control Structure Questionnaire (Chapter 5) satisfies the SAS No. 55 requirement to obtain and document the understanding of the three elements of the control structure. Additional narratives and flowcharts may be useful on larger, more complex engagements, however, they should supplement rather than replace the Internal Control Structure Questionnaire.

4.311 The Questionnaire contains the following 13 sections, representing 13 major audit areas for banks:

I. General
II. Internal Audit
III. Cash, Cash Items, Proof and Transit, and Due from Banks
IV. Investments
V. Loans and Other Finance Receivables
VI. Allowance for Loan Losses
VII. Property and Equipment
VIII. Other Real Estate Owned
IX. Cash Disbursements
X. Deposits
XI. Payroll
XII. Consigned Items
XIII. Other

4.312 The Internal Control Structure Questionnaire, Tests of Controls Programs, and Tests of Balances Programs are designed by audit areas and are based on transaction cycles. Strengths and weaknesses in the internal control structure for each transaction cycle must, therefore, be reflected in the auditor's planned assessed level of control risk.

4.313 Within each of the 13 sections of the Internal Control Structure Questionnaire listed in section 4.311 are three categories of controls: accounting system controls, primary controls, and secondary controls. As described below, the "yes" and "no" responses within the three categories will help the auditor select the proper system for that section. System C is the weakest system and is characterized by good accounting system controls, but weak primary and secondary controls; System A is the strongest and is characterized by a good accounting system and good primary and secondary controls. Even if the auditor anticipates that some major audit areas will be C Systems, all questions should be answered so that the auditor's requirement to understand the control structure is met. The following describes how to select the appropriate system (A, B, or C) after completing the Internal Control Structure Questionnaire.

1. Within each of the 13 sections of the Questionnaire, identify the most advanced system classification, A, B, or C, with a majority of "yes" answers within that section. Because tests of controls often require less time than tests of balances, the objective should be to perform tests of controls to the maximum extent practical.

2. Consult with the engagement partner to determine if tests of controls for the system classification selected are practical in light of past experience with the client. Prior years' unacceptable results from tests of controls, and the resulting high reliance on tests of balances, may cause the selection of a lower system classification, i.e., B or C, and minimize controls testing.

3. For all "no" answers, i.e., potential weaknesses, up to and including the system selected in each section, complete the following process:

   a. Determine if the "no" answer is, in fact, a weakness.

   b. For the potential weakness, review any "yes" answers to other controls for possible offsetting strengths. Such strengths could be included within the system classification selected or in a more advanced system. For example, a weakness in a System B (a "no" answer) could be offset by another control within System B (a "yes" answer) or by a control in System A.

   c. The Tests of Controls Programs have been designed to test the controls that exist in each system, as evidenced by the Internal Control Structure Questionnaire. For example, the control in a System A that may offset a weakness in System B would not be tested when the System B Tests of Controls program is used. To rely on the offsetting System A control, a modifying test of that control must be added to the System B program.

   d. Select the Tests of Controls Programs for each section of the Questionnaire that corresponds with the selected system classification, A, B, or C.

4.314 The in-charge's selection of the type of internal control system should be recorded on the Planning Matrix, section 4.502, and reviewed by the engagement partner before the in-charge selects the corresponding Tests of Controls Programs. The complete Internal Control Structure Questionnaire is included in Chapter 5, section 5.200.

4.315 **EDP Controls.** SAS No. 48, *The Effects of Computer Processing on the Examination of Financial Statements,* amended SAS No. 22, *Planning and Supervision,* by adding to the list of required planning considerations the methods used to process significant accounting information (e.g., computer processing) because such methods influence the design of the accounting system and the nature of the internal control procedures. SAS No. 48 also added a new paragraph summarizing the aspects of computer processing that may have an effect on planning an audit of financial statements. The auditor should complete the Microcomputer Questionnaire or the General Computer Controls Questionnaire along with the Application Computer Controls Questionnaire, depending on the sophistication of the client's system. These forms are included in Chapter 5, sections 5.315 to 5.317.

4.316 If the organization uses a service organization to process a significant application (e.g., payroll), the auditor may be required to obtain an understanding of the controls at the service organization in accordance with SAS No. 70, *Reports on the Processing of Transactions by Service Organizations*. Refer to Chapter 5, section 5.327 for further details. Also, the auditor may wish to complete the Service Organization Application Controls Questionnaire Form or the Service Auditor Report Evaluation Form in Chapter 5, sections 5.338 to 5.339.

4.317 The Questionnaires should be used primarily to identify major weaknesses and strengths that could affect the auditor's planned tests of controls and tests of balances procedures. Weaknesses that represent reportable conditions (see Chapter 7, section 7.600) must be communicated to the client. The auditor may also wish to communicate less significant weaknesses to management along with recommendations for improvement.

Risk of Potential Misstatements Evaluation

4.318 As discussed in sections 3.323-3.340 of Chapter 3, an important consideration in designing an audit strategy is considering the risk that errors, irregularities, and illegal acts that have a material effect on the financial statements could occur. The assessment of this risk, combined with information obtained in completing the Client Acceptance and Continuance Form, the Planning Memorandum, and the Internal Control Structure Questionnaire affects the nature, timing, and extent of tests required to reduce that risk to an acceptable level. For example, if the auditor determines that there is a high risk that a material error could occur in a particular area (such as an asset subject to misappropriation or an account that involves very complex accounting methods), he or she would increase the amount of evidence required from tests of controls, analytical procedures, and/or tests of balances for that area. The purpose of the risk evaluation is to direct the auditor's efforts toward the audit areas that are most likely to contain misstatements. Most importantly, this assessment occurs before the evidence collection process begins.

4.319 This early assessment allows the auditor to modify the design of tests before the engagement is completed and overauditing has occurred. For example, the auditor may have planned to test a client's investments by relying heavily on tests of controls, in order to reduce year-end investments count observations, valuation, and clerical tests. A review of the client's prior year's error history, however, revealed that significant errors had occurred, resulting in a significant extension of the year-end tests. In this case, both extensive tests of controls and tests of balances were required. Had the prior year's errors been identified at the beginning of the engagement, the auditor would have planned to rely primarily on substantive tests, rather than waste time and effort on tests of controls that produced unsatisfactory results.

4.320 The Risk of Potential Misstatements Evaluation Form in section 4.501 is designed to help the auditor assess the likelihood that material misstatements in the financial statements could occur, and if so, to develop an appropriate audit strategy. It should be completed during the pre-engagement audit planning by the in-charge and reviewed by the partner.

4.321 The Form is comprised of two parts. Part I, "Special Considerations," is a series of questions about the client and the audit engagement circumstances that could indicate a high risk of potential misstatements. "Yes" answers to the questions in Part I should be explained. Part II, "Potential Misstatements Matrix," involves assessing the risk of misstatements for each audit area. This assessment is made by considering: (1) the responses to Part I, "Special Considerations," (2) whether the accounts are unusual and material or high risk due to the client's industry and operations, and (3) information from prior years' engagements about high exposure areas and any significant adjustments, made or passed. After considering these three risk categories, the auditor arrives at a conclusion, based on his or her professional judgment, as to whether risk is high or low for each area. This conclusion is transferred to the Planning Matrix, section 4.502, where it will be considered in developing an audit strategy. Any situations that indicate a high risk of potential misstatement should be described, along with the planned modification to the tests of controls and substantive tests.

The Planning Matrix

4.322 Completion of the Client Acceptance and Continuance Form, the Planning Memorandum, the Internal Control Structure Questionnaire, and the Risk of Potential Misstatements Evaluation Form provides the auditor with the information needed to plan the nature, timing, and extent of tests. The Planning Matrix in section 4.502 is designed to bring this information into one form. The Planning Matrix contains the following audit areas:

- Cash, Cash Items, Proof and Transit, Due from Banks
- Loans/Allowance for Loan Losses
- Investments
- Deposits
- Other Real Estate Owned

4.323 These are the areas most likely to be tested under a System A or B in a bank or savings institution. In other words, they are areas in which tests of controls is an efficient and effective means of reducing substantive tests. The Matrix should be modified on each engagement to include any other accounts or audit areas for which System A or B would be more efficient and effective.

4.324 Completion of the Planning Matrix involves the following steps for each audit area:

1. Indicate the preliminary system classification (A, B, or C) from the Internal Control Structure Questionnaire.

2. Based on the system classification in step 1, select the planned assessed level of control risk. Because a System C lacks good primary and secondary controls, control risk should be assessed at the maximum or slightly below the maximum for these classifications. Control risk for System B classifications can be assessed at a moderate level; and for System A at a low level. Also, the auditor may elect to use the System C even though the system is evaluated as an A or B, if he or she believes it will be more efficient and effective to test those assertions under System C (a primarily substantive approach).

3. From the Risk of Potential Misstatements Matrix, indicate whether the risk of potential misstatements is high or low.

4. Determine whether analytical procedures can be relied on to detect material misstatements and indicate whether the risk that they will **not** detect a material misstatement is maximum, moderate, or low.

5. Indicate briefly, the planned reliance on tests of balances, including the nature, timing, and extent of these tests.

4.400 SAMPLING DECISIONS

Audit Procedure Study and Changes to "Sampling Decisions"

4.401 As this Manual goes to print, the Auditing Standards Division of the AICPA is developing an Audit Procedure Study (APS) to replace the AICPA Audit and Accounting Guide, *Audit Sampling*. The APS is expected to be issued in late 1995.[1]

4.402 The guidance contained in this section is consistent with the guidance in the Audit and Accounting Guide, except that the "assurance factors" used in the Model Approach (see section 4.436) conform with those in the draft APS. The authors believe that these factors better reflect current practice.

4.403 This section has been revised to make it easier to comply with the requirements of SAS No. 39, *Audit Sampling*. To simplify our coverage of audit sampling for substantive tests, the Table Approach to nonstatistical sampling has been removed from this edition of the Manual because the approach is in substance equivalent to the Model Approach. Practitioners who wish to use the Table Approach should refer to the AICPA Audit Sampling Guide. In this regard, the following forms have been deleted:

[1] When the APS is issued, it may be obtained by calling the AICPA's Order Department at 1-800-862-4272.

- Sampling Decision Working Paper
- Sample Size Selection and Evaluation Form
- Attributes Sampling Summary Form
- Nonstatistical Sample Size Selection Matrix — Tests of Controls

4.404 The requirements for audit sampling are included in SAS No. 39, *Audit Sampling* (AU 350), and the AICPA Audit and Accounting Guide, *Audit Sampling* (AAG-SAM). According to SAS No. 39, *Audit Sampling* (AU 350), sampling occurs when the auditor tests less than 100% of a population to make some conclusion about the population. SAS No. 39 applies to tests of controls when such tests are performed and to tests of balances when sampling populations are material. The extent to which sampling is used in an audit depends on the size of the client and the nature of the client's internal control structure. If the sampling populations are small, it is usually more efficient to audit individually significant items and obtain audit assurance about the remaining balance through analytical procedures than to perform audit sampling. As the size and sophistication of the client's internal control structure increases, the auditor is more likely to use audit sampling to perform tests of controls and tests of balances.

Audit Sampling for Tests of Controls

4.405 SAS No. 39 indicates that an auditor may use nonstatistical or statistical sampling in performing tests of controls. This Manual provides guidance for both approaches. Regardless of whether nonstatistical or statistical sampling is being used, audit sampling for tests of controls involves the following steps:

1. **Determine the objective of the test** — The objective of a test of control is to determine whether a particular internal control policy or procedure is being applied as prescribed. Audit sampling for tests of controls is generally appropriate when application of the internal control policy procedure leaves documentary evidence of performance. Normally, audit sampling for tests of controls will involve selecting a sample of documents and examining them for evidence that the relevant internal control policy or procedure was applied. Tests of controls involving observation of performance of procedures or inquiries of the client are not normally subject to audit sampling.

2. **Define the deviation conditions** — A deviation condition is a situation that indicates that the policy or procedure was not performed. For example, if the auditor is examining purchase invoices for evidence of approval of an expenditure (e.g., the initials of the approving individual), a deviation condition would be an invoice that is not initialed by the appropriate individual. Adequate performance of a policy or procedure consists of all the steps the auditor believes are necessary to support the assessed level of control risk. For example, assume that a prescribed procedure requires that support for every disbursement should include an invoice, a voucher, a receiving report, and a purchase order, all stamped "Paid." The auditor believes that the existence of an invoice and a receiving report, both stamped "Paid," is necessary to indicate adequate performance of the procedure for purposes of supporting the assessed level of control risk. Therefore, a deviation may be defined as " a disbursement not supported by an invoice and a receiving report that have been stamped 'Paid.'"

3. **Define the population** — The population selected must be appropriate for the objective being tested. For example, if the auditor is testing the operating effectiveness of an internal control procedure designed to determine if items accepted from customers for safekeeping are being properly held at the bank, the auditor would not detect deviations by sampling from the physically stored items. An appropriate population for detecting such deviations usually includes the inventory records of items placed in safekeeping.

   For samples to be representative of the period under audit, the population generally should include all transactions processed during the period. However, sometimes the results of tests performed at an interim date may be sufficient to generalize about the population for the entire period. In determining whether interim tests are sufficient, the auditor should consider the results of the tests, responses to inquiries concerning the remaining period, the length of the remaining period, the nature and amounts of the transactions or balances involved, and related evidence obtained from the tests of balances. If a control policy or procedure has been changed during the year, the auditor will often decide that it is efficient to only test the new policy or procedure.

   For sample results to be reliable, the sample must be selected from the complete population. Completeness of the population can be determined by either physical or numerical control. Normally, the auditor can establish the completeness of the population by inspecting the documents to see that it appears that they have all been accounted for.

4. **Determine the method of selecting the sample** — Any sample that is selected should be representative of the population and all items should have an opportunity to be selected. Random-number selection should generally be used when statistical sampling is being applied. When nonstatistical sampling is applied, random-number sampling, systematic sampling, and haphazard sampling are methods that might be used to obtain a representative sample. Methods of selecting samples are discussed beginning at section 4.440.

5. **Determine the sample size** — Sample sizes for tests of controls are affected by (1) the risk of assessing control risk too low, (2) the tolerable deviation rate, (3) the expected population deviation rate, and (4) any effects of small population sizes.

   Guidance for determining sample size when performing nonstatistical sampling begins with section 4.406. A description of statistical sampling begins with section 4.409.

6. **Perform the sampling plan** — Once the sample has been selected, the auditor should examine each item for evidence of performance of the internal control policy or procedure. If the auditor selects an item that is unused (e.g., a voided document), the auditor should select another item, at random. However, the auditor should make sure that the item really represents an unused item. If the document is valid, but cannot be found, the item should be treated as a deviation in evaluating the sample results.

7. **Evaluate the sample results** — Guidance for evaluating nonstatistical sampling results begins with section 4.407 and guidance for evaluating statistical sampling results begins with section 4.410.

8. **Document the sampling procedure** — The audit working papers should document the following matters:

- The objectives of the test.
- A description of the deviation conditions.
- The acceptable risk of assessing control risk too low.
- The tolerable deviation rate.
- The expected deviation rate.
- The sample results, including the disposition of any deviations found.
- The effect of the results on the auditors assessed level of control risk.

4.406 Factors Affecting Sample Sizes for Tests of Controls. Sample sizes for tests of controls are affected by the following factors:

1. *Acceptable risk of assessing control risk too low.* The risk of assessing control risk too low is the risk that the sample supports a lower level of control risk than is in fact the case. Decreasing the risk of assessing control risk too low will increase the sample size.

2. *Expected population deviation rate.* The expected population deviation rate represents the rate of deviations the auditor expects to find in the population. As the expected population deviation rate increases, the sample size will increase.

3. *Tolerable deviation rate.* Tolerable deviation rate is the maximum rate (%) of deviations from a control procedure that the auditor is willing to accept without increasing the assessed level of control risk. Higher tolerable deviation rates will permit smaller sample sizes.

4. *Population size.* Populations over 500 items have little or no effect on sample size. For populations under 500 in size, the auditor may slightly reduce the size of the sample.

4.407 The effects of these factors may be summarized as follows:

Factor	Effect on Sample Size
Acceptable risk of assessing control risk too low — increase (decrease)	Smaller (larger)
Tolerable deviation rate — increase (decrease)	Smaller (larger)
Expected population deviation rate — increase (decrease)	Larger (smaller)
Population size	Populations less than 500 items should be adjusted to slightly smaller sample sizes

4.408 Sample Sizes Using Nonstatistical Sampling. Nonstatistical sample sizes for tests of controls may be determined using the sample size selection tables in section 4.409, or they may be selected on a purely judgmental basis. Sample sizes should be entered directly on the appropriate Tests of Controls Program. For each method of selection, the auditor should document consideration of the relevant factors. For example, the rationale for selecting tests of controls sample sizes of 30 from the first table in section 4.409 for an internal control system that is classified as a System B may be:

1. Control risk will be assessed at a moderate level, and
2. The expected population deviation rate is at or near zero.

4.409 The following tables should be used for a nonstatistical approach to determine sample sizes for tests of controls:

CONTROLS TESTING NONSTATISTICAL SAMPLE SIZE SELECTION TABLE

Assessed Level of Control Risk	Sample Size
Maximum	0
Slightly below the maximum	15
Moderate	30
Low	40

The numbers in the table were determined using a risk of assessing control risk too low of 10% and an expected population deviation rate of 0%. When deviations are expected or found in a sample, the following table may be used to determine the sample size or evaluate the sample results:

Deviations (Expected or Actual)	Assessment of Control Risk		
	Slightly Below Maximum	Moderate	Low
0	15	30	40
1	25	50	65
2	34	67	90
3	43	85	115

4.410 In evaluating the results of the sample, the auditor should consider the number of deviations found and the nature of the deviations. If the auditor uses the first table in section 4.409 to determine sample size, the discovery of one or more deviations will require the auditor to reassess the planned level of control risk. In these cases, the second table in section 4.407 may be used to evaluate the assessed level of control risk that is supported by the sample results. When looking at the nature of the deviations, the auditor is concerned with the following questions:

- Was the cause of the deviation an error or does it indicate an intentional violation of the control?

- Are there implications for other audit areas?

4.411 **Sample Sizes Using Statistical Sampling.** The appropriate statistical method for tests of controls is attributes sampling, which is a technique designed to estimate qualitative characteristics of a population. Attributes sampling results may be used to estimate the frequency of deviations from performance of an internal control policy or procedure.

4.412 Applying attributes sampling involves performing the following steps:

1. **Decide on the attributes to test.** The Tests of Controls Program may include the testing of one or more attributes. Proper evaluation of the results may require testing and evaluating each attribute separately.

2. **Define the population from which the sample items should be selected.** The auditor should make sure that the population is appropriate for the audit objective as described in 4.403.

3. **Specify the following factors:**

   - *Acceptable risk of assessing control risk too low.* The risk of assessing control risk too low is the risk the sample supports a lower level of control risk than is the case. Since sample evidence represents the only evidence typically obtained about the operating effectiveness of a particular control, the risk of assessing control risk too low is usually set at 5% or 10%.

   - *Tolerable deviation risk.* Tolerable deviation rate is the maximum rate (%) of deviations from a control procedure the auditor is willing to accept without increasing the assessed level of control risk. Higher assessments of control risk will permit higher tolerable deviation rates as shown in the following table:

Planned Assessed Level of Control Risk	Tolerable Rate
Low	2% - 7%
Moderate	6% - 12%
Slightly below the maximum	11% - 20%
Maximum	Omit test

   - *Expected population deviation rate.* The expected population deviation rate represents the rate of deviations the auditor expects to find in the population. The auditor's expectations may be based on prior years' experience with the client, or experience with similar clients. Sample sizes will increase significantly as the expected population deviation rate increases from zero. If the deviation rate in the sample turns out to be higher than the rate specified by the auditor in determining the sample size, the sample results will not support the auditor's planned assessed level of control risk.

4. **Determine the appropriate sample size.** Sample sizes are found in the tables in sections 4.413 through 4.414. The table in section 4.413 is designed for a risk of assessing control risk too low of 5%, and the table in section 4.414 is designed for a 10% risk of assessing control risk too low. With the tolerable deviation rate and the expected deviation rate, the auditor may find the sample size from the table. The numbers in parentheses are the number of deviations that may be found in the sample and still support the auditor's planned assessed level of control risk.

5. **Randomly select the sample from the population.** The section beginning at 4.442 describes the methods that may be used to select a random sample.

6. **Perform the audit procedures to identify deviations in the samples.**

7. **Calculate the statistical results.** Using the tables in sections 4.415–4.416 for the appropriate risk of assessing control risk too low, determine the actual tolerable deviation rate from the sample size and the actual number of deviations found in the sample.

8. **Reassess the level of control risk.** If the actual deviation rate in the sample is higher than that specified in determining the sample, the sample results will not support the auditor's planned assessed level of control risk. In these situations, the auditor should increase the assessed level of control risk. The auditor should also consider the causes of the deviations found, and whether they have implications for other audit areas.

9. **Document the Sampling Procedures.** The audit working papers should document the matters set forth in 4.403 (Item 8).

4.413

Statistical Sample Sizes for Testing Controls
Five Percent Risk of Assessing Control Risk Too Low
(with number of expected deviations in parentheses)

Expected Population Deviation Rate	Tolerable Rate 2%	3%	4%	5%	6%	7%	8%	9%	10%	15%	20%
0.00%	149(0)	99(0)	74(0)	59(0)	49(0)	42(0)	36(0)	32(0)	29(0)	19(0)	14(0)
.25	236(1)	157(1)	117(1)	93(1)	78(1)	66(1)	58(1)	51(1)	46(1)	30(1)	22(1)
.50	*	157(1)	117(1)	93(1)	78(1)	66(1)	58(1)	51(1)	46(1)	30(1)	22(1)
.75	*	208(2)	117(1)	93(1)	78(1)	66(1)	58(1)	51(1)	46(1)	30(1)	22(1)
1.00	*	*	156(2)	93(1)	78(1)	66(1)	58(1)	51(1)	46(1)	30(1)	22(1)
1.25	*	*	156(2)	124(2)	78(1)	66(1)	58(1)	51(1)	46(1)	30(1)	22(1)
1.50	*	*	192(3)	124(2)	103(2)	66(1)	58(1)	51(1)	46(1)	30(1)	22(1)
1.75	*	*	227(4)	153(3)	103(2)	88(2)	77(2)	51(1)	46(1)	30(1)	22(1)
2.00	*	*	*	181(4)	127(3)	88(2)	77(2)	68(2)	46(1)	30(1)	22(1)
2.25	*	*	*	208(5)	127(3)	88(2)	77(2)	68(2)	61(2)	30(1)	22(1)
2.50	*	*	*	*	150(4)	109(3)	77(2)	68(2)	61(2)	30(1)	22(1)
2.75	*	*	*	*	173(5)	109(3)	95(3)	68(2)	61(2)	30(1)	22(1)
3.00	*	*	*	*	195(6)	129(4)	95(3)	84(3)	61(2)	30(1)	22(1)
3.25	*	*	*	*	*	148(5)	112(4)	84(3)	61(2)	30(1)	22(1)
3.50	*	*	*	*	*	167(6)	112(4)	84(3)	76(3)	40(2)	22(1)
3.75	*	*	*	*	*	185(7)	129(5)	100(4)	76(3)	40(2)	22(1)
4.00	*	*	*	*	*	*	146(6)	100(4)	89(4)	40(2)	22(1)
5.00	*	*	*	*	*	*	*	158(8)	116(6)	40(2)	30(2)
6.00	*	*	*	*	*	*	*	*	179(11)	50(3)	30(2)
7.00	*	*	*	*	*	*	*	*	*	68(5)	37(3)

* Sample Size is too large to be cost effective for most audit applications.
Derived from AICPA Audit and Accounting Guide, *Audit Sampling*.
NOTE: This table assumes a large population.

4.414

Statistical Sample Sizes for Testing Controls
Ten Percent Risk of Assessing Control Risk Too Low
(with number of expected deviations in parentheses)

Expected Population Deviation Rate	Tolerable Rate										
	2%	3%	4%	5%	6%	7%	8%	9%	10%	15%	20%
0.00%	144(0)	76(0)	57(0)	45(0)	38(0)	32(0)	28(0)	25(0)	22(0)	15(0)	11(0)
.25	194(1)	129(1)	96(1)	77(1)	64(1)	55(1)	48(1)	42(1)	38(1)	25(1)	18(1)
.50	194(1)	129(1)	96(1)	77(1)	64(1)	55(1)	48(1)	42(1)	38(1)	25(1)	18(1)
.75	265(2)	129(1)	96(1)	77(1)	64(1)	55(1)	48(1)	42(1)	38(1)	25(1)	18(1)
1.00	*	176(2)	96(1)	77(1)	64(1)	55(1)	48(1)	42(1)	38(1)	25(1)	18(1)
1.25	*	221(3)	132(2)	77(1)	64(1)	55(1)	48(1)	42(1)	38(1)	25(1)	18(1)
1.50	*	*	132(2)	105(2)	64(1)	55(1)	48(1)	42(1)	38(1)	25(1)	18(1)
1.75	*	*	166(3)	105(2)	88(2)	55(1)	48(1)	42(1)	38(1)	25(1)	18(1)
2.00	*	*	198(4)	132(3)	88(2)	75(2)	48(1)	42(1)	38(1)	25(1)	18(1)
2.25	*	*	*	132(3)	88(2)	75(2)	65(2)	42(1)	38(1)	25(1)	18(1)
2.50	*	*	*	158(4)	110(3)	75(2)	65(2)	58(2)	38(1)	25(1)	18(1)
2.75	*	*	*	209(6)	132(4)	94(3)	65(2)	58(2)	52(2)	25(1)	18(1)
3.00	*	*	*	*	132(4)	94(3)	65(2)	58(2)	52(2)	25(1)	18(1)
3.25	*	*	*	*	153(5)	113(4)	82(3)	58(2)	52(2)	25(1)	18(1)
3.50	*	*	*	*	194(7)	113(4)	82(3)	73(3)	52(2)	25(1)	18(1)
3.75	*	*	*	*	*	131(5)	98(4)	73(3)	52(2)	25(1)	18(1)
4.00	*	*	*	*	*	149(6)	98(4)	73(3)	65(3)	25(1)	18(1)
5.00	*	*	*	*	*	*	160(8)	115(6)	78(4)	34(2)	18(1)
6.00	*	*	*	*	*	*	*	182(11)	116(7)	43(3)	25(2)
7.00	*	*	*	*	*	*	*	*	199(14)	52(4)	25(2)

* Sample Size is too large to be cost effective for most audit applications.

Derived from AICPA Audit and Accounting Guide, *Audit Sampling*.

NOTE: This table assumes a large population.

4.415

Statistical Sample Results Evaluation
Table for Tests of Controls
Tolerable Deviation Rate at Five Percent Risk of Assessing Control Risk Too Low

	Actual Number of Deviations Found										
Sample Size	0	1	2	3	4	5	6	7	8	9	10
25	11.3	17.6	*	*	*	*	*	*	*	*	*
30	9.5	14.9	19.6	*	*	*	*	*	*	*	*
35	8.3	12.9	17.0	*	*	*	*	*	*	*	*
40	7.3	11.4	15.0	18.8	*	*	*	*	*	*	*
45	6.5	10.2	5.4	16.4	19.2	*	*	*	*	*	*
50	5.9	9.2	12.1	14.8	17.4	19.9	*	*	*	*	*
55	5.4	8.4	11.1	5.5	15.9	18.2	*	*	*	*	*
60	4.9	7.7	10.2	12.5	14.7	16.8	18.8	*	*	*	*
65	4.6	7.1	9.4	11.5	5.6	15.5	17.4	19.3	*	*	*
70	4.2	6.6	8.8	10.8	12.6	14.5	16.3	18.0	19.7	*	*
75	4.0	6.2	8.2	10.1	11.8	5.6	15.2	16.9	18.5	20.0	*
80	3.7	5.8	7.7	9.5	11.1	12.7	14.3	15.9	17.4	18.9	*
90	3.3	5.2	6.9	8.4	9.9	11.4	12.8	14.2	15.5	16.8	18.2
100	3.0	4.7	6.2	7.6	9.0	10.3	11.5	12.8	14.0	15.2	16.4
125	2.4	3.8	5.0	6.1	7.2	8.3	9.3	10.3	11.3	12.3	5.2
150	2.0	3.2	4.2	5.1	6.0	6.9	7.8	8.6	9.5	10.3	11.1
200	1.5	2.4	3.2	3.9	4.6	5.2	5.9	6.5	7.2	7.8	8.4

* Over 20 percent.

Derived from AICPA Audit and Accounting Guide, *Audit Sampling*.

NOTE: This table presents upper limits as percentages. This table assumes a large population.

4.416

Statistical Sample Results Evaluation
Table for Tests of Controls
Tolerable Deviation Rate at Ten Percent Risk of Assessing Control Risk Too Low

Actual Number of Deviations Found

Sample Size	0	1	2	3	4	5	6	7	8	9	10
20	10.9	18.1	*	*	*	*	*	*	*	*	*
25	8.8	14.7	19.9	*	*	*	*	*	*	*	*
30	7.4	12.4	16.8	*	*	*	*	*	*	*	*
35	6.4	10.7	14.5	18.1	*	*	*	*	*	*	*
40	5.6	9.4	12.8	16.0	19.0	*	*	*	*	*	*
45	5.0	8.4	11.4	14.3	17.0	19.7	*	*	*	*	*
50	4.6	7.6	10.3	12.9	15.4	17.8	*	*	*	*	*
55	4.1	6.9	9.4	11.8	14.1	16.3	18.4	*	*	*	*
60	3.8	6.4	8.7	10.8	12.9	15.0	16.9	18.9	*	*	*
70	3.3	5.5	7.5	9.3	11.1	12.9	14.6	16.3	17.9	19.6	*
80	2.9	4.8	6.6	8.2	9.8	11.3	12.8	14.3	15.8	17.2	18.6
90	2.6	4.3	5.9	7.3	8.7	10.1	11.5	12.8	14.1	15.4	16.6
100	2.3	3.9	5.3	6.6	7.9	9.1	10.3	11.5	12.7	5.9	15.0
120	2.0	3.3	4.4	5.5	6.6	7.6	8.7	9.7	10.7	11.6	12.6
160	1.5	2.5	3.3	4.2	5.0	5.8	6.5	7.3	8.0	8.8	9.5
200	1.2	2.0	2.7	3.4	4.0	4.6	5.3	5.9	6.5	7.1	7.6

* Over 20 percent.

Derived from AICPA Audit and Accounting Guide, *Audit Sampling*.

NOTE: This table presents upper limits as percentages. This table assumes a large population.

Audit Sampling for Tests of Balances

4.417 In planning tests of balances, the auditor should decide on the most efficient approach to performing the tests. For some recorded populations, instead of sampling, it may be more efficient to examine individually significant items comprising a majority, or near majority, of the recorded population. Audit assurance about the remaining balance may then be obtained by (1) performing analytical procedures, or (2) concluding that the risk of material misstatement of the remaining balance is low. For example, confirmation of 50% to 80% of the dollar amount of loans receivable may be necessary when risk is high; 40% to 60% may be sufficient when risk is low.

4.418 Obviously, when the remaining balance, after auditing the individually significantly items, is immaterial, no testing of the remaining balance is necessary.

4.419 The decision to sample, or not to sample, should be documented in the Planning Memorandum (Chapter 3, section 3.706).

4.420 Selecting all individually significant items is not considered a sampling application. Items such as large receivables are usually examined individually. Procedures used for examining such items should ordinarily be the most reliable under the circumstances, such as positive confirmation requests.

4.421 When planning a sampling application for tests of balances, the in-charge should consider the financial statement assertions and audit objectives and their relationship to populations selected. For example, understatements cannot be detected by sampling recorded amounts; instead, units from populations of all existing transactions must be selected. The populations, and the appropriate sampling units, are described in the Tests of Balances Programs—Banks and Savings Institutions (Chapter 6, section 6.400).

4.422 The following is an approach to nonstatistical sampling for tests of balances.

1. Determine the sampling population by identifying and deducting the individually significant items.
2. Determine the sample size by considering the following factors:
   - The amount of tolerable misstatement.
   - The assessed level of inherent and control risk for the assertions being tested.
   - The risk that other substantive procedures (e.g., analytical procedures) will fail to detect a material misstatement.
   - Variations within the population.
3. Select the sample.
4. Perform the test procedure.

5. Evaluate the results.

   - Project the misstatement.
   - Consider sampling risk.
   - Consider qualitative aspects of the test results.

6. Document the sample procedure when using the Model Approach described in sections 4.430–4.441, the Model Approach Working Paper — Tests of Balances Sampling (see section 4.503) and the Audit Sampling Evaluation Form — Tests of Balances Sampling (see section 4.504) may be used for this purpose.

4.423 Sample selection methods should produce representative samples and may include random selection, systematic selection, or haphazard selection methods. Care should be taken to avoid bias, however, when a haphazard selection method is used. Section 4.440 describes these sample selection methods.

4.424 Determine the Sample Size for Tests of Balances. Sample sizes for tests of balances are affected by the following factors:

- *Tolerable misstatement.* As the amount of tolerable misstatement increases, the sample size decreases. Conversely, larger sample sizes are required to compensate for a smaller amount of tolerable misstatement. The tolerable misstatement for a sampling application may be taken from the Materiality Computation Form in Chapter 3, section 3.707.
- *Assessed level of inherent and control risk.* As the combined level of inherent and control risk increases, the sample size increases. Assessments of inherent and control risk may be obtained by reviewing the Planning Matrix (see section 4.502).
- *The risk that other substantive procedures will fail to detect a material misstatement.* As the risk that other substantive procedures will fail to detect a material misstatement increases, the sample size increases. This risk is determined by considering the effectiveness of these procedures.
- *Variations within the population.* Sample sizes are smaller when the sampling population is stratified into homogeneous groups. Larger sample sizes are usually required to obtain a representative sample from sampling populations with high variations.

4.425 Illustration No. 4-4 summarizes the impact of the factors above on sample size planning.

ILLUSTRATION NO. 4-4

FACTORS INFLUENCING SAMPLE SIZES FOR SUBSTANTIVE TESTS OF BALANCES

Factor	Conditions Leading to: Smaller Sample Size	Larger Sample Size
a. Tolerable misstatement.	Larger amount	Smaller amount.
b. Assessed level of inherent and control risk.	Lower.	Higher.
c. Risk that other procedures will fail to detect a material misstatement.	Lower.	Higher.
d. Variation within the population.	Less variation.	More variation.

4.426 Nonstatistical Sampling Approaches. At the direction of the engagement partner, either of the following nonstatistical approaches can be used for selecting tests of balances sample sizes:

1. Judgmental method.
2. Model approach.

4.427 Judgmental Method. Sample sizes can be selected judgmentally after considering the influence of the factors described above. The in-charge should describe, in the Audit Planning Memorandum, the factors that influence the sample sizes selected for substantive tests of balances. The engagement partner should approve the planned sample sizes before the substantive tests of balances work is begun. See Chapter 3, section 3.706 for an illustrative Planning Memorandum.

4.428 Judgmentally selected samples are considered in terms of audit coverage of a total population. Large dollar coverage generally includes individually significant items, and units from the sampling population that cover more than 50% of the dollar amount of the total population.

4.429 The coverage of the total population will also be affected by the nature of the population and the degree of the engagement risks. For example, a large coverage of loans receivable for confirmation in high-risk circumstances may be from 50% to 80% of the total dollar population. A large coverage for a cost test of fixed asset additions in the same circumstances may only be 30% to 40% of total fixed asset additions because the risk of fixed asset cost misstatement is generally less. In low-risk circumstances, a large coverage of loans receivable may be 40% to 60%, a large fixed asset addition coverage may be 20% to 30%. These percentages are not presented as specific guidelines for decision making, but as illustrations of the factors influencing nonsampling decisions. Since the auditor's opinion is expressed on the financial statements taken as a whole, evidence should be designed to include tests of a majority of the dollars in the financial statements, but should also be, overall, the most efficient in the circumstances.

4.430 The Model Approach. The model approach is a nonstatistical sampling method that is based on Probability-Proportional-To-Size (PPS) Sampling. Because the approach is based on PPS theory, the overall materiality limit does not have to be allocated to each account to determine tolerable misstatements. Instead, the basic allowance for unknown misstatement, i.e., overall materiality limit minus estimates for unadjusted misstatement from nonsampling tests, expected projected misstatement from sampling tests and related allowances for imprecision, may be used in place of tolerable misstatement for each sampling application. An acceptable approach would be to use $66\frac{2}{3}\%$, or a smaller percentage, of the overall materiality limit for the basic allowance. (See the Materiality Computation Form in Chapter 3, section 3.707). Under PPS theory, the overall materiality limit does not have to be allocated to accounts because the financial statements may be viewed as one population and the basic allowance for unknown error applies to the financial statements taken as a whole. The basic allowance must also be considered, however, when measuring misstatements on the Summary of Possible Journal Entries Form.

4.431 It is important to recognize that when sample sizes are selected nonstatistically based on some statistical theory such as PPS, it is assumed that the population will be stratified. A simple method of stratification is as follows:

- Determine the mean of the population to be sampled.
- Select 2/3 of the sample items from those items equal to or greater than the mean.
- Select 1/3 of the sample items from those items less than the mean.

4.432 If it is not practical to stratify the sampling population, the sample size should be increased by a factor of 20%, or multiplied by 1.2.

4.433 A more time consuming, yet more accurate method would, of course, be a PPS statistical selection method. For the sake of time, however, this statistical method ordinarily is not used. When populations are unusually large and engagement risks are high, however, a PPS statistical method may be appropriate. Guidance for PPS statistical sampling may be found in the Audit Sampling Guide.

4.434 Developed from the model in the AICPA Audit Sampling Guide (paragraphs 4.57 to 4.60), the Model Approach follows:

Sampling Population Tolerable Misstatement	×	Assurance Factor	=	Preliminary Sample Size (units)
Preliminary Sample Size (Units)	×	Marginal Risk Factors (1.2 to 1.5)	=	Adjusted Sample Size (units)

4.435 The assurance factors, also based on PPS statistical theory, are as follows:

Assessment of inherent and control risk	Risk that other substantive procedures (e.g. analytical procedures) will fail to detect a material misstatement		
	Maximum	Moderate	Low
Maximum	3.0	2.3	1.9
Slightly below maximum	2.7	2.0	1.6
Moderate	2.3	1.6	1.2
Low	1.9	1.2	1.0

4.436 The steps to be taken in determining the sample size using the Model Approach Working Paper — Tests of Balances Sampling Form (see section 4.503) are as follows:

A. Assess the combination of inherent and control risk:

1. Maximum — Control and inherent risk are assessed at the maximum for the particular assertions. No tests of controls are required to support this assessment.

2. Slightly below the maximum — Control and inherent risk are assessed at slightly below the maximum for the particular assertions. Minimal tests of controls are required for this assessment.

3. Moderate — Control and inherent risk are assessed at a moderate level for this particular assertion. Moderately effective tests of controls are required for this assessment.

4. Low — Control and inherent risk are assessed at a low level for the particular assertions. Very effective tests of controls are required for this assessment.

B. Determine the basic allowance for unknown misstatements (tolerable misstatement). This is related to preliminary estimates of materiality for the engagement.

C. Assess the risk that other substantive procedures (such as analytical procedures) designed to test the same assertions will fail to detect a material misstatement in a particular assertion as follows:

1. Maximum — No other substantive procedures are performed that are designed to test the same assertions.

2. Moderate — Other substantive procedures to test the assertions are expected to be moderately effective in detecting material misstatements.

3. Low — Other substantive procedures to test the assertions are expected to be highly effective in detecting material misstatements.

D. Determine the population's recorded amount after deducting any items that will be audited 100% (all items that are more than 1/3 of tolerable misstatement).

E. Use the appropriate assurance factor and the formula to determine the initial sample size.

4.437 Depending on the amount of the basic allowance for unknown misstatements, sample sizes computed with this model may approximate those sizes selected judgmentally. Because the model is based on a highly stratified approach, and this approach usually will include minimal or no stratification, the sample should be somewhat larger than the preliminary size if there are significant variations in the population. If stratification is necessary and is not practical, an acceptable approach would be to multiply the preliminary sample size by a marginal risk factor of 1.2 to compensate for the sampling risk associated with not stratifying. The marginal risk factor should *not* be used when the population is stratified or when stratification is not necessary.

4.438 Evaluating the Sample Results. The misstatement in the sample must be projected to the population. One method of projecting the amount of misstatement found in a sample is to divide the amount of misstatement by the fraction of total dollars in the population to total dollars included in the sample. For example, if a $1,000 misstatement is found in a sample of 10 percent of the population, the projected misstatement would be $10,000 ($1,000/.10).

4.439 A second method for projecting the misstatement uses the average difference between the audited and the recorded amounts of each item included in the sample. For example, if $200 of misstatement is found in a sample of 100 items, the average difference between audited and recorded amounts for items in the sample is $2 ($200/100). An estimate of the amount of misstatement in the population may be calculated by multiplying the total number of items in the population (in this case 25,000 items) by the average difference of $2 for each sample item. The estimate of misstatement in the population is $50,000 (25,000 × $2).

4.440 If the projected misstatement is less than tolerable misstatement for the account balance, consideration must be given to the risk that actual misstatement exceeds the amount of tolerable misstatement. If the projected misstatement is less than 1/3 of tolerable misstatement, it is generally safe to conclude that sampling risk is sufficiently low. If it is greater than 1/3, consideration should be given to performing additional tests of the account.

4.441 The Audit Sample Evaluation Form — Tests of Balances (section 4.504) is designed to project the misstatement in the sample to the population, and to evaluate sampling risk. The form should be completed by the in-charge and reviewed by the engagement partner. Remember that any projected misstatement should be posted to the Summary of Possible Journal Entries Form.

Selecting Samples

4.442 SAS No. 39 permits random number selection, systematic selection with or without random starts and haphazard selection methods for nonstatistical sampling. Block sampling is not acceptable. A random number selection method should be used for statistical sampling.

4.443 Random-based selection methods can be applied using random number tables or computer or calculator programs. The Random Selection With a Random Table Form (see section 4.505) may be used to document sample size selections using a random number table.

4.444 To use a random number table:

1. Assign each element in the population a unique address that corresponds to the random number table.
2. Decide how to read the table, i.e., the number of digits and location, and if top to bottom, left to right.
3. Place a pencil on a page to determine a random starting point.
4. Modify the population numbers to the smallest possible number of digits to reduce discards.

4.445 The procedure for using a program or calculator to generate random numbers varies with the programs. However, these techniques generally require the auditor to provide the smallest and largest item numbers, and the number of sample items needed.

4.446 Systematic sampling requires the calculation of an interval. An interval is determined by dividing the population size by the number of sample units desired. For example:

$$N = \text{Sample Size} = 4{,}000$$
$$n = \text{Desired Units} = 50$$
$$I = \text{Interval}$$

$$I = \frac{N}{n} = \frac{4{,}000}{50} = 80$$

4.447 After selecting a random number within the interval as a starting point, each 80th unit would be selected. A Random Selection With a Systematic Sample Form in section 5.709 may be used to document systematic selection methods with random starts.

4.448 Haphazard sampling involves selecting items on a purely judgmental basis, without any bias towards the selection of particular items.

Section		Page
4.500	DOCUMENTATION ASSISTANCE	

4.501

Risk of Potential Misstatements Evaluation Form–Banks and Savings Institutions

Client: ______________________________

Financial Statement Date: ______________________________

INSTRUCTIONS:

This form should be used on bank and savings institution audit engagements to evaluate and document the risk of potential misstatements. Answers should be based on inquiries of client personnel, the understanding of the client's business and industry, experience from prior years' engagements, the current year's control risk assessment and other special considerations. The summary of the risk of potential misstatements should be transferred to the Planning Matrix.

	Yes	No
I. **SPECIAL CONSIDERATIONS**: ("Yes" answers, i.e, high risk, should be checked on accompanying Potential Misstatements Matrix.)		
1. Are there client-imposed limitations on the scope of our engagement? (Describe below)	____	____
2. Is this an initial engagement?	____	____
3. Do discussions with prior engagement personnel or predecessor auditors indicate a high risk of potential errors? (Describe below)	____	____
4. Are the client's accounting policies, methods, or estimates unusual or difficult to apply, or have they been changed recently? (Describe below)	____	____
5. Are there significant related-party or other unusual transactions? (Describe below)	____	____
6. Is overall engagement risk high? (Normally high for financial institutions)	____	____

Describe the circumstances surrounding "yes" answers and record effects on Potential Misstatements Matrix.

II. POTENTIAL MISSTATEMENTS MATRIX:

Complete the accompanying Potential Misstatements Matrix and transfer the summary of risk by audit area to the Planning Matrix. The Matrix assumes low risk unless circumstances indicate otherwise. In addition to classifying the risk of potential misstatements from special considerations above by engagement area, the Potential Misstatements Matrix includes columns for:

1. High Risk/Unusual and Material Account Balances:

   The nature of the client's industry and business may typically cause certain account balances, and the relative risk of misstatements, to be high. Loans and the allowance for losses are typically considered high-risk accounts. A high risk of potential misstatements would be considered in this column only if a material account balance is also high risk or unusual in the client's circumstances and environment. Material account balances, in other words, must also be high risk and/or unusual.

2. Internal Control Structure Reportable Conditions:

   Reportable conditions are identified in completing the current Internal Control Structure Questionnaire and Tests of Controls Programs. The effects of those reportable conditions on major engagement areas should be noted on the Potential Misstatements Matrix.

3. Significant Prior-year Adjustments and Exposure Areas:

   Significant prior-year adjustments, made or passed, and exposure areas that may recur and affect the current period should also be noted on the Bank Potential Misstatements Matrix.

   ____
   ____
   ____
   ____
   ____
   ____

Prepared by: ______________________ Date: ______________________
(In-Charge)

Reviewed by: ______________________ Date: ______________________
(Engagement Partner)

SUMMARY

Explanation of High Risk of Potential Errors

INSTRUCTIONS:

This form should be used to summarize the information disclosed from the Potential Misstatements Matrix.

The risk categories on the Potential Misstatements Matrix for each engagement area should contain a check mark (✓) where the risk of potential misstatements is high. Absent any check marks, low risk should be assumed. After considering the number and significance of potential misstatements in each engagement area, the in-charge should use professional judgment to summarize the risk of potential misstatements as low or high. The risk summary should be transferred to the Planning Matrix. Describe below the modifications to the Tests of Balances Audit Program that will be made to compensate for the high risks of potential misstatements (low risks require no modification).

Engagement Area	Explanation

POTENTIAL MISSTATEMENTS MATRIX—BANKS AND SAVINGS INSTITUTIONS

Engagement Area	Special Consideration	High Risk/Unusual and Material Account Balances	Internal Control Structure Reportable Conditions	Prior Year Adjustments or Exposure Areas	Risk Summary (Low or High)
Cash, etc.					
Due from banks					
Loans					
— Commercial					
— Real Estate and Const.					
— Installment					
Investments					
Property and equipment					
Deposit Accounts					
— Demand					
— Savings					
— CDs					
Official checks					
Consigned items					
Accounts payable					
Investment Income					
Payroll					
Occupancy expenses					
Other operating expenses					

4.502

Planning Matrix—
Banks and Savings Institutions

Client: ______________________________

Financial Statement Date: ______________________________

INSTRUCTIONS:

The Planning Matrix should be prepared by the in-charge for all audit engagements. The Matrix coordinates the evaluation of the risk of potential misstatements and the internal control structure to guide the selection of tests of controls, interim work, and tests of balances, analytical procedures and sample sizes. The Matrix should be completed after the following documents have been finalized:

1. Client Acceptance and Continuance Form
2. Planning Memorandum
3. Internal Control Structure Questionnaire and any supplementary flowcharts and narratives
4. Risk of Potential Misstatements Evaluation Form

The Planning Matrix and related documentation should be reviewed by the engagement partner before any tests of controls are performed.

Prepared by: ______________________________ Date: ______________________________
(In-Charge)

Reviewed by: ______________________________ Date: ______________________________
(Partner)

Planning Matrix Legend

(1) The systems classification is obtained from the Internal Control Structure Questionnaire. It may vary by financial statement assertion.

(2) Assessing control risk at less than the maximum will decrease the amount of evidence required from substantive tests. Control risk may be assessed at the Maximum (M), Slightly below the Maximum (S), Moderate (Md), or Low (L). Tests of controls must be performed in situations where control risk is assessed at slightly below the maximum or at a moderate or low level.

(3) From the Risk of Potential Misstatements Evaluation Form, the risk of potential misstatements (low or high) may vary for different financial statement assertions. These risk factors may increase or decrease the needed evidence from substantive tests. The risks may be assessed as high or low.

(4) Evidence from analytical procedures can reduce the extent of the evidence required from other substantive tests (i.e., detailed tests of balances). The Planning Matrix rates this evidence in terms of the risk that the analytical procedures will fail to detect a material misstatement in the account or the assertions about the account. For example, maximum risk means no evidence is obtained from analytical procedures.

(5) The required evidence from detailed tests of balances (TOBs) is a product of the assessed level of control risk, the risk of potential misstatements, and the evidence obtained from analytical procedures. The examples below illustrate this relationship.

System Classi-fication	Control Risk	Risk of Potential Misstatements	Risk That Analytical Procedures Will Not Detect a Material Misstatement	Resulting Required Evidence from Detailed Tests of Balances
A	M S Md L	Low	M Md L	None
A	M S Md L	High	M Md L	Low
A	M S Md L	Low	M Md L	Low
A	M S Md L	Low	M Md L	Moderate
B	M S Md L	Low	M Md L	None
B	M S Md L	High	M Md L	Moderate
B	M S Md L	Low	M Md L	Moderate
C	M S Md L	Low	M Md L	Low
C	M S Md L	High	M Md L	Moderate
C	M S Md L	Low	M Md L	Slightly Below High
C	M S Md L	Low	M Md L	Moderate
C	M S Md L	Low	M Md L	High

The Planning Matrix contains only those accounts where control risk is often assessed at a moderate or low level. Assertions about other accounts not contained on the Matrix may be added if control risk for those assertions is assessed at below the maximum. For assertions about accounts not included or added to the Planning Matrix, control risk is assessed at the maximum and maximum reliance is placed on analytical procedures and detailed tests of balances.

These guidelines presume account balances are material. If balances are immaterial, so state in the Resulting Evidence Required from Detailed Tests of Balances column. No evidence is required for immaterial account balances.

A high degree of evidence from detailed tests of balances will require procedures with high reliability, e.g., large sample sizes with tests performed primarily at the balance-sheet date. A low degree of evidence from detailed tests of balances will allow less reliable tests, e.g., small sample sizes and performing tests at an interim date.

The ABC approach presumes high reliance on analytical procedures for all engagements to the maximum extent practical.

Final modification of the Tests of Balances Audit Program will be made based on the results of performing the tests of controls on the internal control structure policies and procedures.

(6) Nonstatistical sample size ranges for tests of controls may be determined using the following table unless otherwise directed by the engagement partner. Sample sizes so selected should be entered directly on the appropriate Tests of Controls Program. The in-charge should document in the Planning Memorandum consideration of the factors that affect the sample sizes selected. The partner should approve the Planning Memorandum *before* the tests of controls are begun.

Tests of Controls
Sample Size Selection Table

Assessed Level of Control Risk	Sample Size *
Maximum	0
Slightly below the maximum	15
Moderate	30
Low	40

Tests of controls consisting of observation of performance and inquiries are not normally subject to audit sampling.

For a statistical evaluation of results, minimum sample sizes should be obtained from the graphs in the Audit and Accounting Guide, *Audit Sampling*.

* The numbers in the table were determined using a risk of assessing control risk too low of 10% and an expected population deviation rate of 0%. If one or more deviations are found in the sample, the sample size should be increased or the assessed level of control risk should be increased.

(7) When deviations are expected or found in a sample the following table may be used to determine the sample size or evaluate the sample results:

Deviations (Expected or Actual)	Assessment of Control Risk	
	Slightly Below Maximum	Moderate
0	15	30
2	25	50
3	34	67
4	43	85

Tests of controls consisting of observation of performance and inquiries are not normally subject to audit sampling.

PLANNING MATRIX—BANKS AND SAVINGS INSTITUTIONS

Audit Area	Internal Control Structure Questionnaire Section	(1) Systems Classification (Circle One)	(2) Assessed Level of Control Risk (Circle One)	(3) Risk of Potential Misstatement High or Low	(4) Risk that Analytical Procedures Will Not Detect Material Misstatements* (Circle One)	(5) Resulting Evidence From Detailed TOBs	TOBs Program Section
1. Cash, cash items, and proof and transit	III	A B C	M S Md L	____	M Md L	____	II
2. Due from banks	III	A B C	M S Md L	____	M Md L	____	II
3. Loans							
— Commercial	V	A B C	M S Md L	____	M Md L	____	IV
— Real estate and construction	V	A B C	M S Md L	____	M Md L	____	IV
— Installment	V	A B C	M S Md L	____	M Md L	____	IV
4. Allowance for loan losses	VI	A B C	M S Md L	____	M Md L	____	V
5. Other Real Estate Owned	VIII	A B C	M S Md L	____	M Md L	____	VIII
6. Deposit accounts							
— Demand	X	A B C	M S Md L	____	M Md L	____	IX
— Savings	X	A B C	M S Md L	____	M Md L	____	X
— CDs	X	A B C	M S Md L	____	M Md L	____	X
7. Investments	IV	A B C	M S Md L	____	M Md L	____	III

NOTE: The accounts contained on this Form are those for which control risk is often assessd at a moderate or low level. It is assumed that control risk is assessed at the maximum for accounts not listed above. Any items not listed for which control risk will be assessed at a moderate or low level should be added to this Form.

Prepared by: ____________________ Approved By: ____________________

Date: ____________________ Date: ____________________

(A) See related asset or liability program section.

* M - Maximum
S - Slightly below the maximum
Md - Moderate
L - Low

4.503

Model Approach Working Paper — Tests of Balances Sampling

Client: ____________________
Financial Statement: ____________________

1. Check the financial statement assertion(s) being tested:

   a. Existence and occurrence ______   c. Completeness ______
   b. Rights and obligations ______   d. Valuation or allocation ______

2. Description of sampling application: ____________________

   ____

   ____

3. Total recorded population for ____________________ $______

   Less amount of individually significant items (Usually all items equal to or greater than 1/3 of tolerable misstatement) (______)

   Sample population $______

4. Describe what will be considered to be a misstatement for testing purposes:

   ____

   ____

   ____

   ____

Assessment of inherent and control risk	Risk that other substantive procedures (e.g. analytical procedures) will fail to detect a material misstatement		
	Maximum	Moderate	Low
Maximum	3.0	2.3	1.9
Slightly below maximum	2.7	2.0	1.6
Moderate	2.3	1.6	1.2
Low	1.9	1.2	1.0

5. Calculate the initial sample size with the following formula:

Sampling Population		Basic Allowance (Tolerable Misstatement)		Assurance Factor		Initial Sample Size
$ ________	÷	$ ________	×	________	=	________

6. Allocate the sample items:

	Population Items	Population Dollars	Sample Items	Sample Dollars
a. Stratum 1—Items above the mean of the sampling population (select 2/3 of the sample items from this subpopulation)	____	$____	____	$____
b. Stratum 2—Items less than the mean of the sampling population (select 1/3 of the sample items from this subpopulation)	____	$____	____	$____
c. Total	____	$____	____	$____

4.504

Audit Sample Evaluation Form — Tests of Balances Sampling

Client: ______________________________

Financial Statement Date: ______________________________

1. Project the misstatement (use only one column if the sample population was not stratified):

	Stratum 1	Stratum 2
a. Misstatement in the sample	$______	$______
b. Dollar value of the sample	$______	$______
c. Dollar value of the strata	$______	$______
d. Projected misstatement in the sample stratum (c. ÷ b. × a.)	$______	$______
e. Total projected misstatement in the sample population (d.1 + d.2)	$ ______	

2. Evaluate sample risk:

a. Misstatements found in the group audited 100%	$______
b. Projected misstatement in the sample population (1.e.)	$______
c. Total projected and known misstatement (2.a. + 2.b.)	$______
d. Amount of above misstatement corrected	$______
e. Remaining known and projected misstatement (2.c.–2.d.)	$______*
f. Tolerable misstatement for the account (From the Model Approach Working Paper—Tests of Balances)	$______
g. Is the remaining known and projected misstatement (e.) less than 1/3 of the amount of tolerable misstatement (f.)?	Yes ___ No ___

If the answer to g is "No" sampling risk may be unacceptably high and additional testing should be considered.

* This amount should be posted to the Summary of Possible Journal Entries Form (Chapter 7, section 7.906).

4.505

Random Selection With a Random Table Form

Client: ______________________________

Financial Statement Date: ______________________________

INSTRUCTIONS:

To use the random selection method with a random number table:

- Assign each element of the population a unique address that corresponds to the random number table.
- Decide how to read the table, i.e., the number of digits and location, and if top to bottom, left to right.
- Place a pencil on a page to determine a random starting point.
- Modify the population numbers to the smallest possible number of digits to reduce discards.
- Pure random sampling should be applied to the entire population; stratified random sampling would separate the population according to some characteristic such as size of elements or features of the underlying transaction. This form should be used to document random selection with a random table or calculator. If a computer is used, a copy of the computer printout should be retained as documentation.

POPULATION DESCRIPTION

1. Type of document designated as the sampling unit. ______________________
   a. Largest document number plus 1 ______________________
   b. Smallest document number ______________________
   c. Population size ______________________
2. Nature of the sampling unit if not a document. ______________________

3. Description of the population if No. 2. is applicable (including population size and numbering of population). ______________________

RANDOM NUMBER TABLE

Name of table. ______________________

Page(s) used. ______________________

Correspondence between the table and sampling units (normally document number). ______________________

Number of digits used. ______________________

Starting point in table. ______________________

First usable sample number. ______________________

Last usable sample number. ______________________

Stopping point in table. ______________________

Number of sample items selected. ______________________

Modifications to reduce discards. ______________________

Prepared by: ______________________ Date: ______________________

(In-Charge)

Reviewed by: ______________________ Date: ______________________

(Engagement Partner)

4.506

Random Selection With a Systematic Sample Form

Client: ______________________________

Financial Statement Date: ______________________________

INSTRUCTIONS:

This form is used to document systematic selection methods with random starts.

POPULATION DESCRIPTION

1. Type of document designated as the sampling unit. ______________
   a. Largest document number plus 1 ______________
   b. Smallest document number ______________
   c. Population size ______________
2. Nature of the sampling unit if not a document. ______________
3. Description of the population if No. 2. is applicable (including population size and numbering of population). ______________

$$\frac{\text{Population Size}}{\text{Sample Size}} = \text{initial interval}$$

Initial interval × number of desired starts =

adjusted interval

Rounded interval.

Random number(s) from the table.

First sample item(s).

Last sample item(s).

Prepared by: ______________________ Date: ______________
(In-Charge)

Reviewed by: ______________________ Date: ______________
(Engagement Partner)

Internal Controls

CHAPTER 5

BANKS AND SAVINGS INSTITUTIONS INTERNAL CONTROLS

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CHAPTER 5

BANKS AND SAVINGS INSTITUTIONS INTERNAL CONTROLS

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CHAPTER 5

INTERNAL CONTROLS

5.000 CONSIDERATION OF INTERNAL CONTROLS IN BANK AND SAVINGS INSTITUTION AUDITS

Introduction

5.001 This Chapter covers the auditor's consideration of the internal control structure in audits of financial institutions' financial statements in accordance with generally accepted auditing standards (GAAS). As discussed in Chapter 3, the auditor's consideration of the internal control structure plays a vital role in determining the nature, timing, and extent of the audit procedure to be performed. This Chapter provides guidance on obtaining an understanding of documenting, and testing internal control procedures used by banks and savings institutions.

5.002 Statement on Auditing Standards (SAS) No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit* (AU 319), indicates that an entity's internal control structure consists of the following three elements:

- the control environment,
- the accounting system, and
- control procedures.

5.003 As discussed in Chapter 1, section 1.356, the AICPA's Auditing Standards Board has released a proposed amendment to SAS No. 55 that would incorporate the definition and description of internal control found in the Committee on Sponsoring Organizations report, *Internal Control—Integrated Framework*, (the "COSO report") into SAS No. 55. It is not expected to result in a significant change in practice.

5.004 Control Environment. Most auditors think of internal controls in terms of policies and procedures over the recording, processing, and reporting of financial data. While these specific internal control policies and procedures are certainly the backbone of good internal controls, SAS No. 55 emphasizes the need to consider other factors (referred to as the "control environment") that can greatly impact, both positively and negatively, an entity's internal controls. The following are examples of factors that should be considered in obtaining an understanding of an entity's control environment, as listed in paragraph 9 of SAS No. 55 (AU 319.09):

- Management or board of directors' philosophy and operating style.

- The organizational structure.
- The functioning of the board and its committees, particularly the audit committee.
- Methods of assigning authority and responsibility.
- Management or board of directors' control methods for monitoring and following up on performance.
- Personnel policies and practices.
- External influences that affect the bank's operations and practices.

5.005 As mentioned above, these factors can positively or negatively impact a bank's or savings institution's internal controls. For example, if the bank has established strong internal controls but management's attitude toward maintaining the controls is lax, then internal controls could easily be bypassed or overridden. Conversely, if internal controls are weak due to a lack of segregation of duties, active oversight by top management of the accounting and financial reporting process can mitigate the weakness. In most cases, considering the above factors gives the auditor a sufficient understanding of the control environment to understand top management's and the board's attitude, awareness, and actions towards the control environment.

5.006 **Accounting System**. The accounting system consists primarily of the financial institution's methods to identify, assemble, analyze, and record financial information. These methods are crucial to providing accountability of the bank's assets and liabilities. Effective accounting systems will:

- Identify and record all valid transactions.
- Classify financial transactions on a timely basis.
- Value these financial transactions in an appropriate manner.
- Identify the time period in which these financial transactions occurred.
- Adequately disclose these transactions in the financial statements.

5.007 **Control Procedures**. Control procedures are those policies and procedures, in addition to the control environment and accounting system, that have been established to provide reasonable assurance that specific organizational objectives will be achieved. Control procedures include:

- Proper authorization of transactions.
- Adequate segregation of duties.
- Providing a documented audit trail.
- Safeguarding of assets.
- Independent review of other procedures performed.

5.008 The auditor must understand the procedures an entity utilizes to attain the objectives outlined above in order to adequately plan and perform an audit.

Documentation of Internal Control Structure

5.009 In all audits, the auditor is required to obtain and document his understanding of the three elements of the control structure in order to plan the engagement. The Internal Control Structure Questionnaire, (section 5.200) the Microcomputer Questionnaire (section 5.315) and the General Computer Controls Questionnaire (section 5.316) can assist the auditor in accomplishing these objectives for an engagement in which the ABC System is selected.

5.010 As discussed in section 4.103, completing the Internal Control Structure Questionnaire helps the auditor select the appropriate system (A, B, or C) for each major audit area. The system selected should be noted on the Planning Matrix in section 4.502 for use in determining the nature, timing, and extent of tests.

5.011 The following describes the process for selecting a system:

1. Within each of the thirteen sections of the Internal Control Structure Questionnaire, identify the most advanced system classification, A, B, or C, with a majority of "yes" answers. Because tests of controls often require less time than tests of balances, the objective should be to perform tests of controls to the maximum extent practical.

2. Consult with the engagement partner to determine if tests of controls for the system classification selected are practical in light of past experience with the client. Prior years' unacceptable results from tests of controls, and the resulting high reliance on tests of balances, may cause the in-charge to select a lower system classification, i.e., B or C, and minimize controls testing. In other words, this decision may prevent inefficient auditing.

3. For all "no" answers, i.e. potential weaknesses, up to and including the system selected in each section, perform the following:

    a. Determine if the "no" answer is, in fact, a weakness.

    b. For the potential weakness, review any "yes" answers to other controls for possible offsetting strengths. Such strengths could be included within the system classification selected or in a more advanced system. For example, a weakness in a System B (a "no" answer) could be offset by another control within System B (a "yes" answer) or by a control in System A.

5.012 The Internal Control Structure Questionnaire may be completed by the client's employees or by engagement personnel. If the client's employees are used, their work should be reviewed by the in-charge to ensure that questions are answered correctly.

5.013 Rather than complete a new Questionnaire every year, many firms merely update the prior year's questionnaire and any supplementary narratives and flowcharts. As mentioned above, client personnel should be used whenever possible to perform the updates.

Testing the Internal Control Structure

5.014 An inverse relationship exists between the amount of tests of controls and the substantive testing performed in an audit. Based upon the system evaluation, the auditor will perform tests of controls.

5.015 Similar to the Internal Control Structure Questionnaire, the Tests of Controls Programs contain the three levels of controls: System C (accounting system), System B (primary controls), and System A (secondary controls). As a result, the auditor should complete the Tests of Controls Programs that correspond to the systems selected in the Internal Control Structure Questionnaire.

5.016 Because the Tests of Controls procedures within a system correspond directly to that system's control procedures in the Internal Control Structure Questionnaire, the auditor may need to modify the Tests of Controls Programs for any compensating controls considered in the Internal Control Structure Questionnaire. For example, if a control in a System A offsets a weakness in System B, that control would not otherwise be tested under the System B Tests of Controls Program. To rely on the offsetting System A control, a modifying test of that control must be added to the System B program.

5.017 Standard Tests of Controls Programs, section 5.200, have been coordinated with the Internal Control Structure Questionnaire with particular attention paid to the special needs of banks and savings institutions. Completing and evaluating the results of these tests may reduce substantive procedures.

Documenting Internal Control Structure Weaknesses

5.018 In completing the Internal Control Structure Questionnaire and the Computer Questionnaires and in performing the tests of controls, the auditor may become aware of deficiencies in the design or operation of the control that could adversely affect the bank's ability to properly record, summarize, and process financial data. SAS No. 60, *Communication of Internal Control Structure Related Matters Noted in an Audit* (AU 325), defines such matters as "reportable conditions" and requires that they be communicated to the bank's audit committee or board of directors. As the auditor becomes aware of reportable conditions during the course of the audit, he should record them on the Internal Control Structure Reportable Conditions Form in section 5.400 for inclusion in the communication to the audit committee or board of directors.

5.100 CONTROL ENVIRONMENT AND ACCOUNTING SYSTEM QUESTIONNAIRE

Use of Questionnaire

The Control Environment and Accounting System Questionnaire is designed to assist the auditor in obtaining an understanding of the control environment and the accounting system that the client follows.

Section I — Control Environment addresses the overall attitude, awareness, and actions of the board of directors, management, owners, and others concerning the importance of control and its emphasis in the entity. Section II — Accounting System addresses the flow of information through the accounting system. Section III — Work Program addresses documenting the understanding of the flow of information through the accounting system. The Computer Questionnaires should be reviewed in conjunction with this checklist to obtain an overall assessment of risk in the accounting system.

Control Environment and Accounting System Questionnaire—Banks and Savings Institutions

Client: ______________________________

Financial Statement Date: ______________________________

INSTRUCTIONS:

It is recommended that this Questionnaire be brought forward each year; a copy should be made and placed in the prior year's workpapers. If significant changes have taken place, a new form should be prepared. This workpaper is required for all engagements.

I. CONTROL ENVIRONMENT

Consider the following environmental factors. "Yes" answers generally indicate a control environment which tends to reduce control risks. "No" answers generally do not reduce control risks. Supplements may be necessary for some special industries.

	Yes	No	Comments
A. Management Philosophy and Operating Style			
1. Is management conservative in taking risks to achieve their objectives?	___	___	______
2. Are management attitudes and actions toward financial reporting conservative?	___	___	______
3. Is the emphasis on achieving budget, profit, and other financial and nonfinancial goals moderate or less?	___	___	______
4. Does management have good work ethics?	___	___	______
5. Is management not dominated by one or a few individuals?	___	___	______
B. Organizational Structure			
1. Is authority and responsibility within the Institution assigned in an appropriate manner?	___	___	______
2. Is data processing organized as a separate functional branch within the Institution?	___	___	______

Control Environment and Accounting System Questionnaire
(continued)

	Yes	No	Comments
3. Is management's reporting system adequate for the needs of the Institution?	___	___	________
4. Does the Institution's organizational structure provide an adequate overall framework for planning, directing and controlling operations?	___	___	________
Additional explanations ________________________________			
________________________________	___	___	________
C. Audit Committee (if an audit committee does not exist, these matters should be addressed by the Board of Directors)			
1. Is the audit committee active in overseeing the Institution's accounting and financial reporting practices?	___	___	________
2. Does the audit committee maintain a direct line of communication with external and internal auditors?	___	___	________
Additional explanations ________________________________			
________________________________	___	___	________
D. Methods to Communicate the Assignment of Authority and Responsibility			
1. Is the delegation of authority adequate in relation to the responsibility assigned?	___	___	________
2. Are employee job descriptions adequate in delineating responsibilities?	___	___	________
3. Have effective policies been established regarding acceptable business practices, conflicts of interest, codes of conduct, etc.?	___	___	________

Control Environment and Accounting System Questionnaire
(continued)

	Yes	No	Comments
Additional explanations ______	___	___	______
E. Management Control Methods			
1. Is there adequate use of planning and reporting systems (such as budgeting and responsibility accounting)?	___	___	______
2. Are the methods for measuring performance and communicating them to the appropriate level of management adequate?	___	___	______
3. Has the Institution established procedures for investigating variances from expected performance?	___	___	______
4. Has the Institution established policies for the development and modification of the accounting system and control procedures (including EDP procedures)?	___	___	______
5. Is there an internal audit function?	___	___	______
6. Are there sufficient qualified personnel and adequate authority in the internal audit function?	___	___	______
Additional explanations ______	___	___	______
F. Personnel Management Methods			
1. Has the Institution established effective policies and procedures for:			
a. Hiring?	___	___	______
b. Training?	___	___	______
c. Evaluating?	___	___	______
d. Promoting?	___	___	______
e. Compensating?	___	___	______

Control Environment and Accounting System Questionnaire
(continued)

	Yes	No	Comments
2. Is the Institution willing and able to provide employees the resources necessary to perform their duties?	___	___	________
Additional explanations ________________________________			
________________________________	___	___	________

G. External Control Considerations

	Yes	No	Comments
1. Is the Institution subject to monitoring and compliance requirements imposed by legislative or regulatory bodies?	___	___	________
2. Is there careful review and follow-up by parties outside the Institution concerning its actions?	___	___	________
Additional explanations ________________________________			
________________________________	___	___	________

H. Engagement Characteristics

	Yes	No	Comments
1. Is there a minimum number of difficult accounting issues present?	___	___	________
2. Is there a minimum number of difficult-to-audit transactions or balances present?	___	___	________
3. Is there a minimum number of unusual related-party transactions not in the ordinary course of business?	___	___	________
4. Have the audits of prior periods' financial statements not disclosed material errors and misstatements?	___	___	________
Additional explanations ________________________________			
________________________________	___	___	________

Control Environment and Accounting System Questionnaire
(continued)

II. ACCOUNTING SYSTEM

To properly plan and conduct the audit, the auditor is required to gain an understanding of the flow of information through the accounting system for each significant account or transaction class. The following factors should be considered in determining which accounts or transaction classes should be deemed to be significant:

1. Relative significance of the account or related transactions to the overall financial statements.
2. Volume of transactions flowing through the account during the period.
3. The susceptibility of related assets to theft or similar loss.
4. Accounts or transaction classes that have traditionally required significant adjustments.
5. Accounts with a high level of inherent risk.

Using this guidance, indicate below which transaction classes should be considered significant. The amount of the account or transaction class alone does not indicate that the account is significant for these purposes. For example, if the auditor computes and records or does a 100% audit of income taxes, the accounting system for income taxes would not be significant for these purposes.

Audit Area	Significant? Yes/No	Reason for Significance
Cash		
Investments		
Loans		
Allowance for Losses		
Property and Equipment		
Other Real Estate Owned		
Cash Disbursements		
Deposits		
Payroll		
Consigned Items		
Other		

Control Environment and Accounting System Questionnaire
(continued)

III. WORK PROGRAM

For the audit areas considered to be significant as indicated in Section II of this form, the auditor is required to gain an understanding of information flow through the accounting system and to document the understanding.

	Done By			
	19__	19__	19__	19__
This understanding can be gained by completing the Internal Control Structure Questionnaire (section 5.200), and by completing narratives and/or flowcharts. The narratives and/or flowcharts should include the following for each audit area:				
a. How and by whom transactions are initiated and authorized.	____	____	____	____
b. Descriptions of the accounting processing steps (including how the computer is used to process data) from initiation to inclusion in the general ledger.	____	____	____	____
c. Description of supporting documents.	____	____	____	____
d. Subsidiary ledgers, if any.	____	____	____	____
When EDP is involved in processing, the procedures are to include:				
1. Completion of the Microcomputer Questionnaire (section 5.315).	____	____	____	____
2. Completion of the General Computer Controls Questionnaire (section 5.316).	____	____	____	____
3. Completion of the Application Computer Controls Questionnaire (section 5.317).	____	____	____	____
4. A memo documenting management's control environment and the involvement of top ranking officials in computer systems matters.	____	____	____	____

Control Environment and Accounting System Questionnaire
(continued)

	Done By			
	19__	19__	19__	19__
When a service center is used, and it is necessary to obtain an understanding of the controls at the service center, the procedures should include:				
1. Completion of the Service Organization Application Controls Questionnaire (section 5.338).	____	____	____	____
2. Completion of the Service Auditor Report Evaluation Form (section 5.339).	____	____	____	____

5.200 INTERNAL CONTROL STRUCTURE QUESTIONNAIRE—BANKS AND SAVINGS INSTITUTIONS AND TESTS OF CONTROLS PROGRAMS

Use of Questionnaire

This Questionnaire is divided into the following audit areas:

Section I — General
Section II — Internal Audit Department
Section III — Cash, Cash Items, Proof and Transit, and Due from Banks
Section IV — Investments
Section V — Loans and Other Finance Receivables
Section VI — Allowance For Loan Losses
Section VII — Property and Equipment
Section VIII — Other Real Estate Owned
Section IX — Cash Disbursements
Section X — Deposits
Section XI — Payroll
Section XII — Consigned Items
Section XIII — Other

Sections I and II provide the auditor with a general overview of the entity. Sections II–XII are further divided into three levels: Accounting System (System C); Primary Controls (System B); and Secondary Controls (System A).

System C will result in control risk being assessed at the maximum or slightly below the maximum for most financial statement assertions. The absence of significant aspects of an effective accounting system may mean the client's system is not auditable or that significant reconstruction of records must take place before the audit begins.

System B includes an adequate accounting system and significant primary control procedures, which allows control risk to be assessed at a moderate level for some financial statement assertions.

System A has a well-designed control environment, accounting system, and primary and secondary control policies and procedures. This system allows control risk to be assessed at a moderate or low level.

Instructions:

When appropriate, client personnel should complete the Questionnaire for review by the in-charge. This questionnaire should be used to select the standard system classification and the related Tests of Controls Programs for each major audit area.

In the "Personnel" column insert the name and title of the individual that performs the control procedure. If more than one individual is listed because the question relates to segregation of duties, briefly describe the procedure performed by each. "No" answers represent potential weaknesses. Material weaknesses and reportable conditions should be posted to the Internal Control Structure Reportable Conditions Form.

The client's systems may contain board of director or manager controls. The term "manager", as used in this questionnaire, describes a person performing internal verification functions. That person may be a board member, general manager, controller, bookkeeper, foreman, or other employee.

The systems selected in this questionnaire should be transferred to the Planning Matrix.

Use of Tests of Controls Program

Tests of controls will ordinarily be performed only when reductions in related substantive tests for affected accounts can be achieved. An evaluation of the internal controls structure in a transaction cycle as a System A or B may permit such reductions. Tests of Controls Programs for System A or B should be completed when such tests will result in overall time savings. The Tests of Controls Program for a System C is designed to enhance the auditor's understanding of the internal control structure and flow of transactions through the accounting system. Evidence to verify financial statement assertions for related account balances should primarily be obtained through analytical procedures and tests of balances for a System C.

Internal Control Structure Questionnaire—Banks and Savings Institutions

Section I

Client: ____________________

Financial Statement Date: ____________________

	Personnel	Yes	No
General			
1. Does the institution have an organization chart? Obtain a copy.	______	___	___
2. Does the institution have a proof department that is independent from other operating and accounting departments?	______	___	___
3. Does the institution maintain a general ledger that is posted daily in sufficient detail?	______	___	___
4. Is there a chart of general ledger accounts?	______	___	___
5. a. Are there operations manuals in use? Obtain copies.	______	___	___
List the departments: ____________________ ____________________	______	___	___
b. Are the manuals updated periodically?	______	___	___
6. Is there a formal plan for rotating employees' duties?	______	___	___
7. Are all officers and employees required to take annual vacations of at least two continuous weeks?	______	___	___
8. Does the institution take satisfactory precautions when hiring all new officers and employees?	______	___	___
9. Is an executive officer or other designated officer responsible for handling employee complaints and personal problems?	______	___	___
10. Are permanent records maintained of all incoming and outgoing registered mail?	______	___	___
11. Is incoming mail opened in the presence of at least two people?	______	___	___

INTERNAL CONTROL STRUCTURE QUESTIONNAIRE— BANKS AND SAVINGS INSTITUTIONS SECTION I (Continued)

	Personnel	Yes	No
12. Are all officers and employees covered by an insurance bond and are the amounts of coverage adequate? Provide listing of all types of insurance coverages.	_____	___	___
13. Is there a policy concerning property and casualty insurance that is approved by the board of directors?	_____	___	___
14. Does this policy call for periodic, formal analysis and consideration of all insurable risks and types of coverage?	_____	___	___
15. Are insurance records properly maintained, including tickler files to ensure prompt payment of premiums?	_____	___	___
16. Is the main vault under dual control?	_____	___	___
17. Is the timer to the main vault set at the close of business each day by one person and checked by another?	_____	___	___

18. Describe security procedures followed for the opening of the bank.

____

____

____

____

____

	19___	19___	19___	19___	19___
Prepared or updated by: In-charge	_____	_____	_____	_____	_____
Reviewed by: Engagement Partner	_____	_____	_____	_____	_____

Internal Control Structure Questionnaire— Banks and Savings Institutions

Section II

Client: ______________________

Financial Statement Date: ______________________

Internal Audit Department

	Personnel	Yes	No

Client personnel from whom answers were obtained:

Name	Title

1. To whom does the internal auditor report?

____

2. Does the internal auditor provide written reports on the results of examinations? ______ ___ ___

3. Are all significant and/or unresolved exceptions noted during examinations required to be included in the report? ______ ___ ___

4. Are reports of audit findings distributed to the operating officer of the area audited? ______ ___ ___

5. Are formal responses required from an officer of the area audited? ______ ___ ___

6. Describe the system of follow-up to determine the degree of consideration and implementation given internal audit findings and recommendations.

____

____

____

____

INTERNAL CONTROL STRUCTURE QUESTIONNAIRE— BANKS AND SAVINGS INSTITUTIONS SECTION II (Continued)

	Personnel	Yes	No
7. Describe any other duties of the internal auditors, if any. ______ ______ ______ ______			
8. Is there a scope and frequency schedule for the audit of each activity or function in the bank?	______	___	___
• If yes, provide a copy. If no, describe the activities of the internal auditor during the current year. ______ ______ ______ ______	______	___	___
9. Are formal audit programs used?	______	___	___
10. Are internal control questionnaires used?	______	___	___

	19___	19___	19___	19___	19___
Prepared or updated by: In-charge	______	______	______	______	______
Reviewed by: Engagement Partner	______	______	______	______	______

Internal Control Structure Questionnaire— Banks and Savings Institutions

Section III

Client: ______________________

Financial Statement Date: ______________________

MAJOR AUDIT AREAS:

1. Cash and Cash Items
2. Proof and Transit
3. Due from Banks

ACCOUNTING SYSTEMS (SYSTEM C)	Personnel	Yes	No
Cash			
1. Is a teller cash settlement prepared each day and reconciled to cash totals prepared by the proof department?	______	___	___
2. Are tellers required to clear all checks and cash items from their cash funds daily?	______	___	___
3. Are teller overages and shortages cleared daily?	______	___	___
4. Do tellers provide receipts to customers for all credit transactions?	______	___	___
Cash Items			
1. Are tellers prohibited from holding cash items (checks, drafts, etc.) as part of their cash fund balance?	______	___	___
Proof and Transit			
1. Is the source of all input to the proof department clearly identified?	______	___	___
2. Do all input sources maintain control totals of work forwarded to the proof department?	______	___	___
3. Are out-of-balance situations corrected as they occur?	______	___	___
4. Are proof operators prohibited from altering input documents?	______	___	___

INTERNAL CONTROL STRUCTURE QUESTIONNAIRE— BANKS AND SAVINGS INSTITUTIONS SECTION III (Continued)

	Personnel	Yes	No
Collection Items			
1. Are items for collection accepted only by authorized individuals?	______	___	___
2. Are collection items received recorded on prenumbered, multicopy forms providing a copy for the customer?	______	___	___
3. Are negotiable collection items sent by certified or insured mail?	______	___	___
4. Is the collection clerk required to credit proceeds to the customer the same day they are received?	______	___	___
5. Are notes held for collection clearly segregated from the bank's portfolio of notes?	______	___	___
Interoffice Transactions			
1. Are interoffice suspense accounts reconciled daily?	______	___	___
Due From Banks			
1. Are only designated individuals allowed to sign checks drawn on due from bank accounts?	______	___	___
2. Are all due from bank accounts reconciled regularly (at least monthly)?	______	___	___
3. Do reconciliations clearly describe reconciling items and indicate the date of each item?	______	___	___
4. Is a separate general ledger account used for each due from bank account?	______	___	___
5. Has the bank established a formal policy concerning opening maintaining due from bank accounts?	______	___	___
6. Does the bank periodically evaluate the safety and soundness of correspondents?	______	___	___

INTERNAL CONTROL STRUCTURE QUESTIONNAIRE— BANKS AND SAVINGS INSTITUTIONS SECTION III (Continued)

	Personnel	Yes	No
Automated Teller Machine (ATM)			
1. Are correspondent accounts used for ATM transactions reconciled on a daily basis?	______	___	___
Wire Transfers			
1. Is access to wire transfer activities adequately restricted?	______	___	___
2. Are the duties of origination, testing, processing, and balancing wire transfer requests segregated?	______	___	___
3. Is proper authorization obtained for wire disbursements exceeding the available balance in share accounts or other deposits?	______	___	___
4. Are there written agreements maintained for all depositors making funds or securities transfer requests (including phone requests and other means that do not provide for signed authorization) that clearly set forth the scope of the liability of the institution?	______	___	___
5. Are the written instructions concerning the wire transfer function complete and current?	______	___	___
6. Are authorized caller codes used and changed periodically?	______	___	___
7. Are authorized caller codes changed each time there is a change in the employee assigned that duty?	______	___	___
8. Is the list of personnel authorized to initiate wire transfers current?	______	___	___
9. Is access to the wire equipment area physically restricted?	______	___	___
10. Are holds placed on customer accounts by wire operations personnel when instructions are received directly from the authorized customer to confirm that available funds are in the customer's account or that the transfer of funds is within authorized limits before the transfer is made?	______	___	___

INTERNAL CONTROL STRUCTURE QUESTIONNAIRE— BANKS AND SAVINGS INSTITUTIONS SECTION III (Continued)

	Personnel	Yes	No
11. Are card files or authorization letters on file for customers who request telephone transfers directly from the wire function?	________	___	___
General Ledger			
1. Is each of the functions of recording cash receipts and disbursements, posting to subsidiary and general ledgers and reconciliation performed by a different employee?	________	___	___
2. Are confirmation requests received from depository banks, supervisory examiners, and other parties processed by an employee other than the one reconciling the account?	________	___	___
Other			
1. Does management evaluate the financial strength of institutions in which the institution has deposits in excess of insured limits?	________	___	___
2. Does management review currency transaction reporting to the Department of the Treasury?	________	___	___
3. Are funds for "on us" checks available the next day?	________	___	___
PRIMARY CONTROLS (SYSTEM B)			
Cash			
1. Are all currency and coins locked in a vault or safe during nonbanking hours?	________	___	___
2. Is the vault protected by an adequate alarm system?	________	___	___
3. Is the opening of the vault regulated by a time-lock mechanism?	________	___	___
4. Is the vault opened at the latest and closed at the earliest practical time each business day?	________	___	___
5. Does each teller have his or her own cash fund for which he or she is solely responsible?	________	___	___

INTERNAL CONTROL STRUCTURE QUESTIONNAIRE— BANKS AND SAVINGS INSTITUTIONS SECTION III (Continued)

	Personnel	Yes	No
6. Is each teller's work space provided with a lock to guard their cash supply should they leave their window?	______	___	___
7. Is each teller's window equipped with adequate robbery alarms?	______	___	___
8. Is each teller's cash supply sight verified at the end of each day by the head teller or an officer?	______	___	___
9. Are cash limits set for each teller fund?	______	___	___
10. Are interteller transfers made by tickets cleared through proof or by blotter entries that are verified by both tellers?	______	___	___
11. Are combinations and keys to the ATM controlled by separate individuals?	______	___	___
12. Is access to the night depository under control of two employees, both of whom must be present when the safe contents are removed, listed, and processed?	______	___	___
13. Are electronic funds transfers in excess of $______ approved by an officer?	______	___	___
Cash Items			
1. Are cash items held by one individual until they are collected?	______	___	___
2. Is a complete listing of all cash items maintained and periodically prepared and reviewed by an officer?	______	___	___
3. Are overdraft items excluded from the cash item account?	______	___	___
4. Is there a formal policy for charging-off uncollectible cash items?	______	___	___
Proof and Transit			
1. When input is received in the proof department, is it recorded, receipted for, and scheduled for processing?	______	___	___

INTERNAL CONTROL STRUCTURE QUESTIONNAIRE— BANKS AND SAVINGS INSTITUTIONS SECTION III (Continued)

	Personnel	Yes	No
2. Are all correcting entries made by a separate entry and approved by a supervisor?	______	___	___
3. Are item counts and transaction totals used to ensure complete and accurate processing?	______	___	___
4. Are cash letters prepared and sent daily?	______	___	___
5. Are items reported missing from cash letters promptly traced?	______	___	___
6. Are all entries to the general ledger originated or proved by the proof department?	______	___	___
7. Is a daily summary prepared summarizing all transactions processed through the proof department and entries made to the general ledger?	______	___	___
8. Are transactions processed through individual proof machines and the overall proof department balanced daily?	______	___	___
Collection Items			
1. Is each item, on which immediate credit is granted, recorded on the general ledger and in a subsidiary ledger?	______	___	___
2. Are serial numbers from the collection form recorded on each collection item and all related papers?	______	___	___
3. Do paid collection item forms clearly indicate the final disposition of the proceeds from that collection item?	______	___	___
4. Are tracer notices sent on collection items outstanding for an unreasonable length of time?	______	___	___
5. Are collection items returned unpaid promptly returned to the customer?	______	___	___
6. Are installment collections accepted only after special approval and then only subject to a collection agreement?	______	___	___

INTERNAL CONTROL STRUCTURE QUESTIONNAIRE— BANKS AND SAVINGS INSTITUTIONS SECTION III (Continued)

	Personnel	Yes	No
7. Are separate subsidiary records maintained for notes held for collection?	______	___	___

Interoffice Transactions

1. Are transactions recorded using two-part forms that identify the sending and receiving parties?	______	___	___

Due From Banks

1. Are all due from checks prenumbered?	______	___	___
2. Are reconcilements of due from accounts periodically reviewed and approved by an officer?	______	___	___
3. Are guidelines established for the charge-off of old reconciling items?	______	___	___

SECONDARY CONTROLS (SYSTEM A)

Cash

1. Is vault or reserve cash maintained under effective dual control?	______	___	___
2. Does each teller have his or her own cash bus or vault in which to store the cash?	______	___	___
3. Is each teller's cash audited periodically?	______	___	___
4. Are individual and cumulative over and short records maintained and reviewed periodically for all persons handling cash?	______	___	___
5. Do tellers place identification on all transactions and currency straps?	______	___	___
6. Are teller duties periodically rotated?	______	___	___
7. Is the ATM opened and balanced under dual control?	______	___	___

INTERNAL CONTROL STRUCTURE QUESTIONNAIRE— BANKS AND SAVINGS INSTITUTIONS SECTION III (Continued)

	Personnel	Yes	No
8. When maintenance is performed on the ATM, is an institution representative required to be present?	________	___	___
9. Are customer personal identification numbers mailed separately from the customer's access card?	________	___	___
10. Are personnel who have custody of customer access cards prohibited from having access to customer personal identification numbers?	________	___	___
11. Are procedures in place to trigger reporting procedures for large cash amounts?	________	___	___
Cash Items			
1. Are cash items handled by someone other than the teller who originated the transaction?	________	___	___
Proof and Transit			
1. Are pickups of work from input sources made according to a predetermined schedule?	________	___	___
2. Are proof department employees prohibited from working in other departments?	________	___	___
3. Are job responsibilities periodically rotated?	________	___	___
4. Are cash letters microfilmed before they are sent?	________	___	___
5. Are returned items handled by employees not responsible for preparation of cash letters?	________	___	___
6. Are holdover items properly identified on the general ledger and processed by an independent group?	________	___	___
Collection Items			
1. Is there a policy concerning the types of items on which customers will be granted immediate credit?	________	___	___

INTERNAL CONTROL STRUCTURE QUESTIONNAIRE—
BANKS AND SAVINGS INSTITUTIONS
SECTION III (Continued)

	Personnel	Yes	No
2. Are duties for sending items for collection and receiving and distributing proceeds segregated?	______	___	___
3. Are job duties periodically rotated?	______	___	___
4. Is the status of open collection items periodically reviewed by a supervisor?	______	___	___
Interoffice Transactions			
1. Are uncleared items promptly investigated?	______	___	___
2. Is the account reconciled by a person or group that does not originate interoffice transactions?	______	___	___
3. Is the reconcilement reviewed periodically by someone other than the preparer?	______	___	___
Due From Accounts			
1. Are balances kept at a minimum?	______	___	___
2. Are paid checks and advices sent to an independent reconciling unit in the bank?	______	___	___
3. Are persons responsible for reconciling due from bank accounts prohibited from signing checks?	______	___	___
4. Are reconciling items followed up on a timely basis by individuals other than those responsible for originating the transaction?	______	___	___
5. Are checks outstanding over six months subject to special controls?	______	___	___
6. Are guidelines established for average balances to be maintained in each account?	______	___	___

INTERNAL CONTROL STRUCTURE QUESTIONNAIRE— BANKS AND SAVINGS INSTITUTIONS SECTION III (Continued)

Other comments:

____

____

____

____

____

System selection (circle one):

System A[1] System B[2] System C[3]

Modification of standard tests:

____

____

____

____

____

	19____	19____	19____	19____	19____
Prepared or updated by: In-charge	____	____	____	____	____
Reviewed by: Engagement Partner	____	____	____	____	____

[1] Represents a decision to assess control risk at a moderate or low level for most financial statement assertions.

[2] Represents a decision to assess control risk at moderate level for some of the financial statement assertions.

[3] Represents a decision to assess control risk at the maximum or slightly below the maximum for most financial statement assertions.

Tests of Controls Programs— Banks and Savings Institutions

Section III: System A

Client: ____________________

Financial Statement Date: ____________________

MAJOR AUDIT AREAS:
1. Cash, cash items, proof and transit, and due from banks.

TRANSACTION CYCLES:
1. Processing deposits and payments (tellers and new business).
2. Clearings and exchanges.
3. Daily balancing.

Procedure	Done By	Date	W/P Ref.
Processing deposits and payments			
1. Determine by inquiry, observation, or inspection that daily cash fund balancing procedures are reviewed by an officer.	______	______	______
2. Determine by inquiry, observation, or inspection that periodic test counts of vault and teller cash funds are being made by an appropriate officer or internal auditor.	______	______	______
3. Determine by inquiry, observation, or inspection that vault cash and the night depository are under dual control and that tellers maintain sole control over their cash funds at all times.	______	______	______
4. Determine by observation that pre-encoded input forms are used.	______	______	______
5. Determine by inspection that individual teller over and short records are maintained and periodically reviewed by an appropriate officer.	______	______	______
6. Inspect evidence that automated teller machines are opened and balanced under dual control.	______	______	______
7. Determine by inquiry, inspection, or observation that the status of open collection items are periodically reviewed by an appropriate officer.	______	______	______

TESTS OF CONTROLS PROGRAMS—
BANKS AND SAVINGS INSTITUTIONS
SECTION III: SYSTEM A (Continued)

Procedure	Done By	Date	W/P Ref.
8. Select a sample of ____ days' teller balancing verifications performed by an officer and:	_____	_____	_____
a. Verify that sequence numbers on wire transfers sent and received are unique and consecutive.	_____	_____	_____
b. Determine by observation that confirmations are returned for all outgoing messages.	_____	_____	_____
c. For __ days verify that the total number and dollar amount of funds and securities transfer messages sent and received are compared and reconciled with summaries received from the Federal Reserve.	_____	_____	_____
d. Verify that differences on daily reserve or clearing account statements are reconciled, any discrepancies investigated and disposed of in a timely fashion.	_____	_____	_____
e. Foot the verification working paper.	_____	_____	_____
f. Agree the teller balance to the general ledger balance.	_____	_____	_____
g. Discuss any unusual items with an officer.	_____	_____	_____
9. Select a sample of __ dormant accounts that had activity during the year and verify that the activity was proper. (If the results of Step 1 of processing deposits and payments are positive, this step may be eliminated.)	_____	_____	_____
10. Inspect __ days' over and short records and discuss large or unusual amounts with an appropriate officer.	_____	_____	_____
11. Inspect ___ days' documentation of balancing automated teller machines. Discuss unusual matters with an appropriate officer.	_____	_____	_____
12. Inspect __ days' open collection items records. Discuss unusual open items with an appropriate officer.	_____	_____	_____

TESTS OF CONTROLS PROGRAMS— BANKS AND SAVINGS INSTITUTIONS SECTION III: SYSTEM A (Continued)

Procedure	Done By	Date	W/P Ref.
13. Other procedures: ____________________ ____________________ ____________________ ____________________ ____________________	______	______	______
Clearings and exchanges			
1. Determine by observation or inspection that MCIR encoding and proof work is formally assigned to operators and accounted for upon completion.	______	______	______
2. Determine by inquiry, observation, or inspection that proof operators are not allowed to operate as tellers or to approve work for processing.	______	______	______
3. Determine by observation or inspection that controls are in place to assure that all cash letter items have been accounted for properly.	______	______	______
4. Determine by inquiry, observation, or inspection that reinput of differences is reviewed and approved by supervisory personnel.	______	______	______
5. Select a sample of __ days and verify that all work processed by the proof and transit department is balanced to the incoming and outgoing cash letters and reviewed by an appropriate officer. (If the results of Clearings and Exchanges Steps 1, 2, and 3 are positive, this step may be eliminated.)	______	______	______
6. Review the composition of "suspense accounts," especially noting recurring use of such accounts and the failure or inability to reconcile the cash account.	______	______	______
7. If the tests disclose large cash transactions, test the amounts to required reports filed with the Department of the Treasury.	______	______	______

TESTS OF CONTROLS PROGRAMS—
BANKS AND SAVINGS INSTITUTIONS
SECTION III: SYSTEM A (Continued)

Procedure	Done By	Date	W/P Ref.
8. Other procedures:			
______________________________			
______________________________			
______________________________			
______________________________			
______________________________	______	______	______
Daily balancing			
1. Determine by inquiry, observation, or inspection that general ledger entries are approved by supervisory personnel who did not actively participate in the preparation of the entry.	______	______	______
2. Determine by inquiry, observation, or inspection that recording cash receipts and disbursements posting to subsidiary and general ledgers and reconciliations are performed by different employees who do not have access to cash or cash items.	______	______	______
3. Determine by inquiry, observation, or inspection that requests received from depositing institution's supervisory examiners or other parties are processed by an employee other than the one reconciling the account.	______	______	______
4. Determine by observation or inspection that controls are in place to:			
a. Prevent unauthorized personnel from processing general ledger entries.	______	______	______
b. Reduce the possibility of entries being posted to wrong accounts.	______	______	______
c. Eliminate the possibility of using the incorrect computer files when processing.	______	______	______
d. Limit access to the processing area.	______	______	______

TESTS OF CONTROLS PROGRAMS—
BANKS AND SAVINGS INSTITUTIONS
SECTION III: SYSTEM A (Continued)

Procedure	Done By	Date	W/P Ref.
5. Determine by observation or inspection that controls are in place over daily proof work to:			
a. Verify that general ledger entries are in agreement with proof totals.	______	______	______
b. Determine that general ledger entries are properly approved.	______	______	______
6. Determine by observation or inspection that due from/to account reconciliations are prepared on a timely basis and are reviewed by an appropriate officer.	______	______	______
7. Determine by inquiry, observation, or inspection that computer program changes are adequately controlled and approved.	______	______	______
8. Select a sample of ___ general ledger entries, including any automatic entries generated by a computer system, and determine that the entry had adequate support, was proper, was posted to the proper account and was approved by an appropriate officer. (If the results of Daily Balancing Steps 1 and 2 are positive, sample size may be reduced.)	______	______	______
9. Select a sample of proof work for ___ days and:			
a. Verify that general ledger entries are in agreement with proof totals.	______	______	______
b. Trace the general ledger entries to postings in the general ledger.	______	______	______
c. Trace cash letter to posting in due from/to depository institution's accounts.	______	______	______
d. Determine that the entries were approved.	______	______	______
10. Select a sample of ___ days due from/to account reconciliations and:			
a. Trace balances per correspondent institution to statement.	______	______	______

**TESTS OF CONTROLS PROGRAMS—
BANKS AND SAVINGS INSTITUTIONS
SECTION III: SYSTEM A (Continued)**

Procedure	Done By	Date	W/P Ref.
b. Trace general ledger balance to general ledger.	______	______	______
c. Trace clearance of reconciling items and offsets to any general ledger entries that clear reconciling items.	______	______	______
11. Other procedures: ________________________	______	______	______

Modification of analytical procedures and tests of balances, cross-reference to related tests of controls step above, and reasons therefor.

____

Prepared by: ____________________ Date: ____________
(In-charge)

Reviewed by: ____________________ Date: ____________
(Engagement Partner)

Tests of Controls Programs— Banks and Savings Institutions

Section III: System B

Client: ______________________

Financial Statement Date: ______________________

MAJOR AUDIT AREAS:

1. Cash, cash items, proof and transit, and due from banks.

TRANSACTION CYCLES:

1. Processing deposits and payments (tellers and new business).
2. Clearings and exchanges.
3. Daily balancing.

Procedure	Done By	Date	W/P Ref.
Processing deposits and payments			
1. Select a sample of ___ days' teller balancing verifications and determine that cash funds are balanced daily and are being reviewed by management. (Sample size may be reduced to one day per month in institutions where the daily teller balancing is centralized.)	______	______	______
a. Foot the verification working paper.	______	______	______
b. Agree the teller balance to the general ledger balance.	______	______	______
c. Discuss any unusual items with an officer.	______	______	______
2. Select a sample of ___ deposit accounts from active ledgers, that have been inactive, and determine if they meet the institution's criteria of a dormant account. Discuss any potentially dormant accounts with an officer to determine why not segregated.	______	______	______
3. Select a sample of ___ dormant deposit accounts that had activity during the year and verify that the activity was reviewed by an appropriate officer.	______	______	______
4. Determine by inquiry, observation, or inspection that spare keys or combinations to teller funds are maintained under appropriate control.	______	______	______

TESTS OF CONTROLS PROGRAMS— BANKS AND SAVINGS INSTITUTIONS SECTION III: SYSTEM B (Continued)

Procedure	Done By	Date	W/P Ref.
5. Determine by inquiry, observation or inspection that mail is maintained under the control of two employees, both of whom must be present when the mail is opened and cash received is listed and processed.	______	______	______
6. Determine by inspection that change funds are maintained in amounts authorized by the Board of Directors.	______	______	______
7. Inspect ___ days' over and short records and discuss large or unusual amounts with an appropriate officer.	______	______	______
8. Inspect ___ days' documentation of balancing automated teller machines. Discuss unusual matters with an appropriate officer.	______	______	______
9. Inspect ___ days' open collection items records. Discuss unusual open items with an appropriate officer.	______	______	______
10. Other procedures: ______ ______ ______ ______ ______	______	______	______
Wire transfers			
1. Verify that sequence numbers on wire transfers sent and received are unique and consecutive.	______	______	______
2. Determine by observation that confirmations are returned for all outgoing messages.	______	______	______
3. For ___ days verify that the total number and dollar amount of funds and securities transfer messages sent and received are compared and reconciled with summaries received from the Federal Reserve.	______	______	______
4. Verify that differences on daily reserve or clearing account statements are reconciled, any discrepancies investigated and disposed of in a timely fashion.	______	______	______

TESTS OF CONTROLS PROGRAMS—
BANKS AND SAVINGS INSTITUTIONS
SECTION III: SYSTEM B (Continued)

Procedure	Done By	Date	W/P Ref.
5. Other procedures: ____________________	______	______	______
Clearings and exchanges			
1. Select a sample of __ days and verify that all work processed by the proof and transit department is balanced to the incoming and outgoing cash letters.	______	______	______
2. Other procedures: ____________________	______	______	______
Daily balancing			
1. Select a sample of __ general ledger entries and determine that the entry has adequate support, was posted to the proper account, and was proper.	______	______	______
2. Select a sample of __ days and inspect the reconciliation of all loan and deposit accounts, including any "in process accounts" (this reconciliation process should include a "rollforward" from the prior day), to the general ledger and:			
a. Foot the reconciliation.	______	______	______
b. Trace the general ledger balance on the reconciliation to the general ledger.	______	______	______
c. Examine support for the detail trial balance amount shown on the reconciliation.	______	______	______
d. Verify reconciling items.	______	______	______

TESTS OF CONTROLS PROGRAMS— BANKS AND SAVINGS INSTITUTIONS SECTION III: SYSTEM B (Continued)

Procedure	Done By	Date	W/P Ref.
3. Select a sample of proof work for ___ days and:			
a. Verify that general ledger entries are in agreement with proof totals.	______	______	______
b. Trace the general ledger entries to postings in the general ledger.	______	______	______
c. Trace cash letter totals to posting in due from/to depository institutions accounts.	______	______	______
4. Select a sample of ___ due from/to account reconciliations and:			
a. Trace balance per correspondent institution to statement.	______	______	______
b. Trace general ledger balance to general ledger.	______	______	______
c. Trace clearance of reconciling items and offsets to any general ledger entries that clear reconciling items.	______	______	______
5. Other procedures:			
______________________________			
______________________________			
______________________________			
______________________________	______	______	______

Modification of analytical procedures and tests of balances, cross-reference to related tests of controls step above, and reasons therefor.

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Prepared by: ______________________________ Date: ______________________
(In-charge)

Reviewed by: ______________________________ Date: ______________________
(Engagement Partner)

Tests of Controls Programs— Banks and Savings Institutions

Section III: System C

Client: ______________________________

Financial Statement Date: ______________________________

MAJOR AUDIT AREAS:
1. Cash, cash items, proof and transit, and due from banks.

TRANSACTION CYCLES:
1. Processing deposits and payments (tellers and new business).
2. Clearings and exchanges.
3. Daily balancing.

Procedure	Done By	Date	W/P Ref.
Processing deposits and payments			
1. Select a sample of ___ days and determine that cash funds are being balanced daily.	______	______	______
2. Select a sample of ___ deposit accounts from active ledgers, which have been inactive, and determine if they meet the institutions' criteria for a dormant account. Discuss any potentially dormant accounts with an officer to determine why not segregated.	______	______	______
3. Determine by inspection that bait money is included in:	______	______	______
a. Each teller's drawer	______	______	______
b. Vault cash	______	______	______
4. Inspect evidence that automated teller machines (ATM's) are opened and balanced under dual control.	______	______	______
5. Other procedures: ______________________________ ______________________________ ______________________________ ______________________________ ______________________________	______	______	______

TESTS OF CONTROLS PROGRAMS—
BANKS AND SAVINGS INSTITUTIONS
SECTION III: SYSTEM C (Continued)

Procedure	Done By	Date	W/P Ref.
Wire transfers			
1. Verify that sequence numbers on wire transfers sent and received are unique and consecutive.	______	______	______
2. Determine by observation that confirmations are returned for all outgoing messages.	______	______	______
3. For ___ days verify that the total number and dollar amount of funds and securities transfer messages sent and received are compared and reconciled with summaries received from the Federal Reserve.	______	______	______
4. Verify that differences on daily reserve or clearing account statements are reconciled, any discrepancies investigated and disposed of in a timely fashion.	______	______	______
Clearings and exchanges			
1. Select a sample of ___ days and verify that all work processed by the proof and transit department is balanced to the incoming and outgoing cash letters.	______	______	______
2. Other procedures: ____________ ____________ ____________ ____________	______	______	______
Daily balancing			
1. Select a sample of ___ general ledger entries and determine that the entry has adequate support, was posted to the proper account, and was proper.	______	______	______
2. Select a sample of ___ days and inspect the reconciliation of all loan and deposit accounts to the general ledger and:			
a. Foot the reconciliation.	______	______	______

TESTS OF CONTROLS PROGRAMS—
BANKS AND SAVINGS INSTITUTIONS
SECTION III: SYSTEM C (Continued)

Procedure	Done By	Date	W/P Ref.
b. Trace the general ledger balance on the reconciliation to the general ledger.	______	______	______
c. Examine support for the detail trial balance amount shown on the reconciliation.	______	______	______
d. Verify reconciling items.	______	______	______
3. Select a sample of proof work for __ days and:			
a. Verify that general ledger entries are in agreement with proof totals.	______	______	______
b. Trace the general ledger entries to postings in the general ledger.	______	______	______
c. Trace cash letter totals to posting in due from/to depository institution's accounts.	______	______	______
4. Other procedures:			
______________________________			
______________________________			
______________________________			
______________________________	______	______	______

Modification of analytical procedures and tests of balances, cross-reference to related tests of controls step above, and reasons therefor.

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Prepared by: ______________________________ Date: ____________________
(In-charge)

Reviewed by: ______________________________ Date: ____________________
(Engagement Partner)

Internal Control Structure Questionnaire— Banks and Savings Institutions

Section IV

Client: ______________________

Financial Statement Date: ______________________

MAJOR AUDIT AREAS: Investments

ACCOUNTING SYSTEMS (SYSTEM C)	Personnel	Yes	No
1. Is there a written investment policy detailing investment guidelines, objectives and limitations that conform to regulatory guidelines, and are monitored by the board of directors?	______	___	___
The policies and procedures shall include but not be limited to:			
a. Investment objectives, including use of "held for sale" and trading activities	______	___	___
b. Permissible types of investments	______	___	___
c. Diversification guidelines to prevent undue concentration	______	___	___
d. Maturity schedules	______	___	___
e. Limitation on quality ratings	______	___	___
f. Hedging activities and other uses of futures, forwards, options, and other financial instruments	______	___	___
g. Handling exceptions to standard policies	______	___	___
h. Valuation procedures and frequency	______	___	___
i. Limitations on the investment authority of officers	______	___	___
j. Frequency of periodic reports to the board of directors on securities holdings	______	___	___
2. Are detailed records maintained of investments and are they periodically reconciled to the general ledger?	______	___	___

INTERNAL CONTROL STRUCTURE QUESTIONNAIRE— BANKS AND SAVINGS INSTITUTIONS SECTION IV (Continued)

	Personnel	Yes	No
3. Are investment transactions adequately supported by documentation from independent sources (e.g., brokers' confirmations, bank advices)?	______	___	___
4. Are safekeeping receipts obtained for investment securities held in safekeeping outside the institution?	______	___	___
5. Are securities gains and losses computed and recorded as realized?	______	___	___
6. Are unrealized gains and losses substantiated by reconciliation of market values with carrying amounts?	______	___	___
7. Do responsible management personnel understand and have the appropriate technical competence to understand complex off-balance sheet financial instruments?	______	___	___

PRIMARY CONTROLS (SYSTEM B)

	Personnel	Yes	No
1. Are the purchases, sales, and exchanges of securities approved by the board of directors or its designated committee in accordance with federal and state regulations?	______	___	___
2. Are employees who are authorized to initiate investment transactions approved by the board of directors?	______	___	___
3. Are reviews and approvals of investment transactions recorded in the minutes?	______	___	___
4. Are two authorized signatures required to release securities held in safekeeping?	______	___	___
5. Are securities held at the institution maintained in a vault under dual control?	______	___	___
6. Are securities owned by the institution segregated from securities held for others?	______	___	___
7. Are write-downs or write-offs of investments approved by the board of directors?	______	___	___

INTERNAL CONTROL STRUCTURE QUESTIONNAIRE— BANKS AND SAVINGS INSTITUTIONS SECTION IV (Continued)

	Personnel	Yes	No
8. Are securities and other evidence of ownership in the name of the institution or its nominee?	______	___	___
9. Are accounting entries supporting security transactions periodically reviewed by supervisory personnel to ensure that classification of investments is in accordance with the institution's investment policy?	______	___	___
10. Are recorded amounts of investments periodically compared with safekeeping ledgers, custodial confirmations, and with current market values on a timely basis; any differences found are investigated and resolved; and appropriate supervisory personnel review and approve completed reconciliations on a timely basis?	______	___	___
11. Does an authorized list of signatures and brokers exist and is it adhered to, reviewed, and updated periodically?	______	___	___
12. Are buy and sell orders to brokers compared to brokers' advices periodically by management?	______	___	___
13. Are investments classified as held-to-maturity, trading securities or available-for-sale monitored for valuation at amortized cost or fair value, respectively?	______	___	___
14. Are investments for which there is no active market monitored for valuation at cost and written down to market value when required?	______	___	___
15. Are unrealized gains and losses substantiated by reconciliation of market values with carrying amounts?	______	___	___
16. Is interest and dividend income reviewed for accuracy by reference to supporting documentation?	______	___	___
17. Are mortgage-backed securities classified as available-for-sale monitored for valuation at fair value?	______	___	___
18. Are valuations periodically obtained from outside brokers?	______	___	___
19. Are valuations, for reporting purposes, reviewed for conformity with published value?	______	___	___

INTERNAL CONTROL STRUCTURE QUESTIONNAIRE— BANKS AND SAVINGS INSTITUTIONS SECTION IV (Continued)

	Personnel	Yes	No
20. Are mortgage derivatives monitored on an ongoing basis and factors affecting income recognition and the carrying amount of the investment analyzed periodically to determine whether adjustments are necessary?	________	___	___
21. Is the internal control structure related to off-balance sheet financial instruments designed to meet the objectives described above and determine that the institution has complied with relevant laws and regulations?	________	___	___
22. For hedging instruments, do the internal control policies and procedures address —			
a. Transaction limits	________	___	___
b. Accreditation of brokers	________	___	___
c. Segregation of duties	________	___	___
d. Reconciliations?	________	___	___
SECONDARY CONTROLS (SYSTEM A)			
1. Are brokers used approved by the board of directors?	________	___	___
2. Is the investment portfolio reviewed periodically for quality ratings and market value?	________	___	___
3. Are reconciliations prepared by employees who do not authorize or record investment transactions?	________	___	___
4. Are responsibilities for recording investment transactions segregated from responsibilities for executing transactions?	________	___	___
5. Are documents supporting investment transactions reviewed by an employee who does not originate transactions?	________	___	___
6. When possible, are securities registered in the institution's name?	________	___	___
7. Is income on investments collected and recorded by employees who do not have authorization or record-keeping duties?	________	___	___

INTERNAL CONTROL STRUCTURE QUESTIONNAIRE
BANKS AND SAVINGS INSTITUTIONS
SECTION IV (Continued)

Other comments:

____
____
____
____
____

System selection (circle one):

System A[1]   System B[2]   System C[3]

Modification of standard tests:

____
____
____
____
____

	19__	19__	19__	19__	19__
Prepared or updated by: In-charge	____	____	____	____	____
Reviewed by: Engagement Partner	____	____	____	____	____

1 Represents a decision to assess control risk at a moderate or low level for most financial statement assertions.

2 Represents a decision to assess control risk at a moderate level for some of the financial statement assertions.

3 Represents a decision to assess control risk at the maximum or slightly below the maximum for most financial statement assertions.

Tests of Controls Programs— Banks and Savings Institutions

Section IV: System A

Client: ______________________________

Financial Statement Date: ______________________________

MAJOR AUDIT AREAS:
1. Investments.
2. Trading account.

TRANSACTION CYCLES:
1. Purchasing and selling.
2. Income recognition.

Procedure	Done By	Date	W/P Ref.
Purchasing and selling			
1. Examine institution's investment policy to determine that it is being reviewed and updated (at least annually) to conform with the institution's liquidity and asset/liability management requirements and that it complies with federal and state regulations.	______	______	______
2. Review the transactions in the investment accounts for unusually high volume and frequency of activity. This could indicate investments should be classified as trading securities.	______	______	______
3. Determine by observation or inspection that purchase and sale transactions are properly approved and executed.	______	______	______
4. Determine by observation or inspection that dual control is in effect over investment securities held by the institution.	______	______	______
5. Determine by observation or inspection that the monthly valuation of the trading account is rechecked by an individual external to the trading area.	______	______	______
6. If the institution uses an outside custodian to maintain its investment securities, review the third-party report on internal controls in effect in the custodian's operations.	______	______	______

TESTS OF CONTROLS PROGRAMS
BANKS AND SAVINGS INSTITUTIONS
SECTION IV: SYSTEM A (Continued)

Procedure	Done By	Date	W/P Ref.
7. Examine the documentation to support an officer's physical inspection/confirmation of investment securities.	______	______	______
8. Determine that securities are registered in the institution's name.	______	______	______
9. For transactions accounted for as hedges, review the degree of correlation between financial instruments and the items they are hedging to determine whether the correlation requirement for hedge accounting has been met.	______	______	______
10. Select a sample of ____ investment purchase and sale transactions (exclude maturities) and:			
a. Examine broker's advice and compare the broker's name to the approved list of brokers.	______	______	______
b. Determine that the transaction is in accordance with the investment policy and was approved by the board of directors (or committee thereof).	______	______	______
c. Examine custodian's safekeeping receipt.	______	______	______
d. Verify computation and posting of all aspects of the transaction (accrued interest, discount accretion, etc.).	______	______	______
e. Determine that all purchases are classified as held-to-maturity, trading securities, or available-for-sale securities.	______	______	______
11. Select a sample of ____ securities from the three classifications and determine that the valuation of the securities are correct.	______	______	______
12. Review transfers between the three classifications and determine that they are recorded at the proper value (especially the amortization of unrealized gains or losses as an adjustment of yield when securities are transferred from available-for-sale to held-to-maturity).	______	______	______

TESTS OF CONTROL PROGRAMS— BANKS AND SAVINGS INSTITUTIONS SECTION IV: SYSTEM A (Continued)

Procedure	Done By	Date	W/P Ref.
13. Review minutes of the board of directors, investment committee, or asset/liability management committee meetings for evidence of monthly review of investment activity (or of person with investment authority).	______	______	______
14. Other procedures: ______ ______ ______ ______ ______	______	______	______
Income recognition			
1. Determine by inquiry, observation, or inspection that an officer monitors the receipt of investment income. (If the results of income recognition test is positive, sample size may be reduced.)	______	______	______
2. Select a sample of ____ income receipts from a list of assets held during the year. Verify that the correct amount was received and recorded.	______	______	______
3. Select a sample of _____ securities from the accrued interest receivable trial balance and verify the computation of the accrued interest and any accumulated amortization of premium or accretion of discount.	______	______	______
4. Other procedures: ______ ______ ______ ______ ______	______	______	______

TESTS OF CONTROL PROGRAMS— BANKS AND SAVINGS INSTITUTIONS SECTION IV: SYSTEM A (Continued)

Modification of analytical procedures and tests of balances, cross-reference to related tests of controls step above, and reasons therefor.

Prepared by: ______________________ Date: ______________
(In-charge)

Reviewed by: ______________________ Date: ______________
(Engagement Partner)

Tests of Controls Programs— Banks and Savings Institutions

Section IV: System B

Client: ____________________

Financial Statement Date: ____________________

MAJOR AUDIT AREAS:
1. Investments.
2. Trading account.

TRANSACTION CYCLES:
1. Purchasing and selling.
2. Income recognition.

Procedure	Done By	Date	W/P Ref.
Purchasing and selling			
1. Select a sample of ____ investment purchase and sale transactions (exclude maturities) and:			
a. Examine broker's advice and compare the broker's name to the approved list of brokers.	____	____	____
b. Determine that the transaction was approved and is in accordance with the investment policy.	____	____	____
c. Examine custodian's safekeeping receipt.	____	____	____
d. Verify computation and posting of all aspects of the transaction (accrued interest, discount accretion, etc.).	____	____	____
e. Determine that all purchases are classified as held-to-maturity, trading securities or available-for-sale securities.	____	____	____
2. Select a sample of ____ securities from the three classifications and determine that the valuation of the securities are correct.	____	____	____
3. Review transfers between the three classifications and determine that they are recorded at the proper value.	____	____	____

TESTS OF CONTROLS PROGRAMS
BANKS AND SAVINGS INSTITUTIONS
SECTION IV: SYSTEM B (Continued)

Procedure	Done By	Date	W/P Ref.
4. Review the transactions in the investment accounts for unusually high volume and frequency of activity. This could indicate investments should be classified as trading securities.	______	______	______
5. Determine that securities are registered in the institution's name.	______	______	______
6. Review minutes of the Board of Directors' meetings for evidence of periodic review of investment activity.	______	______	______
7. Other procedures: ______________________ ______________________ ______________________ ______________________ ______________________	______	______	______

Income recognition:

Procedure	Done By	Date	W/P Ref.
1. Select a sample of ____ income receipts from a list of assets held during the year. Verify that the correct amount was received and recorded.	______	______	______
2. Select a sample of ____ securities from the accrued interest receivable trial balance and verify the computation of the accrued interest and any accumulated amortization of premium or accretion of discount.	______	______	______
3. Other procedures: ______________________ ______________________ ______________________ ______________________ ______________________	______	______	______

TESTS OF CONTROLS PROGRAMS
BANKS AND SAVINGS INSTITUTIONS
SECTION IV: SYSTEM B (Continued)

Modification of analytical procedures and tests of balances, (cross-reference related tests of controls step above), and reasons therefor:

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Prepared by: ____________________ Date: ____________
(In-charge)

Reviewed by: ____________________ Date: ____________
(Engagement Partner)

Tests of Controls Programs— Banks and Savings Institutions

Section IV: System C

Client: ______

Financial Statement Date: ______

MAJOR AUDIT AREAS:
1. Investments.
2. Trading account.

TRANSACTION CYCLES:
1. Purchasing and selling.
2. Income recognition.

Procedure	Done By	Date	W/P Ref.
Purchasing and selling			
1. Select a sample of ____ investment purchase and sale transactions (exclude maturities) and:			
a. Examine broker's advice and compare the broker's name to the approved list of brokers.	______	______	______
b. Examine custodian's safekeeping receipt.	______	______	______
c. Verify computation and posting of all aspects of the transaction (accrued interest, discount accretion, etc.).	______	______	______
d. Ascertain that all purchases are classified as held-to-maturity, trading securities, or available-for-sale securities.	______	______	______
2. Select a sample of ____ securities from the three classifications and determine that the valuation of the security is proper.	______	______	______
3. Review transfers between the three classifications and determine that they are recorded at the proper value.	______	______	______
4. Review the transactions in the investment accounts for unusually high volume and frequency of activity. This could indicate that the investments should be classified as trading securities.	______	______	______

TESTS OF CONTROLS PROGRAMS
BANKS AND SAVINGS INSTITUTIONS
SECTION IV: SYSTEM C (Continued)

Procedure	Done By	Date	W/P Ref.
5. Determine that securities are registered in the institution's name.	______	______	______
6. Review minutes of the Board of Directors ' meetings for evidence of periodic review of investment activity.	______	______	______
7. Other procedures: ______ ______ ______ ______ ______	______	______	______
Income recognition			
1. Select a sample of ____ income receipts from a list of assets held during the year. Verify that the correct amount was received and recorded.	______	______	______
2. Select a sample of ____ securities from the accrued interest receivable trial balance and verify the computation of the accrued interest and any accumulated amortization of premium or accretion of discount.	______	______	______
3. Other procedures: ______ ______ ______ ______ ______	______	______	______

TESTS OF CONTROLS PROGRAMS— BANKS AND SAVINGS INSTITUTIONS SECTION IV: SYSTEM C (Continued)

Modification of analytical procedures and tests of balances, cross-reference to related tests of controls step above, and reasons therefor:

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Prepared by: ____________________________________ Date: ________________________
(In-charge)

Reviewed by: ____________________________________ Date: ________________________
(Engagement Partner)

Internal Control Structure Questionnaire— Banks and Savings Institutions

Section V

Client: ______________________________

Financial Statement Date: ______________________________

MAJOR AUDIT AREAS:
Commercial Loans
Real Estate and Construction Loans
Installment Loans
Mortgage Banking Activities

Commercial Loans

ACCOUNTING SYSTEMS (SYSTEM C)	Personnel	Yes	No
1. Is there a formal loan policy, approved by the board of directors?	______	___	___
2. Does the loan policy set limits for loan officers?	______	___	___
3. Are there limits and controls over the type of loans made, collateral, geographic location, maturity, and interest rates charged?	______	___	___
4. Are deviations from the loan policy approved by the board of directors or designated loan committee?	______	___	___
5. Are all notes serially numbered or identified by customer number?	______	___	___
6. Are loan documents protected during business hours and locked in a fireproof vault overnight?	______	___	___
7. Is a completed and signed loan application obtained for each loan?	______	___	___
8. Are loan proceeds distributed only by official check or by direct deposit to the customer's account?	______	___	___
9. Are credit files maintained from each borrower?	______	___	___
10. Are collateral receipts given to the customer?	______	___	___

INTERNAL CONTROL STRUCTURE QUESTIONNAIRE— BANKS AND SAVINGS INSTITUTIONS SECTION V (Continued)

	Personnel	Yes	No
11. Have procedures been established to ensure that the proper security interest has been perfected in all collateral?	________	___	___
12. Are there policies and procedures to limit involvement in loans to debtors with environmental problems?	________	___	___
PRIMARY CONTROLS (SYSTEM B)			
1. Is there an independent loan review function?	________	___	___
2. Are all notes signed or initialed by the approving officer?	________	___	___
3. Is the pertinent loan information such as loan amount, interest rate, maturity, amortization, terms, and collateral independently tested to ensure accuracy entered into the data processing system?	________	___	___
4. Are procedures set to ensure that credit file information is complete and current?	________	___	___
5. Are detail loan records posted and reconciled to the general ledger on a daily basis by employees who do not approve loans or control notes and collateral or receive payments?	________	___	___
6. Are paid notes and related documents marked paid or cancelled and returned promptly to the customer?	________	___	___
7. Is all loan collateral receipted for on multicopy, prenumbered forms?	________	___	___
8. Is negotiable collateral held under dual control in a fireproof vault?	________	___	___
9. Is negotiable collateral periodically revalued and the value compared to the customer's outstanding loan balance?	________	___	___
10. Are past due loans periodically reported to the board of directors or their designated loan committee?	________	___	___
SECONDARY CONTROLS (SYSTEM A)			
1. Are commercial loan policies reviewed annually?	________	___	___

INTERNAL CONTROL STRUCTURE QUESTIONNAIRE— BANKS AND SAVINGS INSTITUTIONS SECTION V (Continued)

	Personnel	Yes	No
2. Are employees prohibited from holding notes signed in blank by customers?	______	___	___
3. Are reconcilements prepared by employees not responsible for initiating or recording loan transactions?	______	___	___
4. Are loan balance inquiries or discrepancies handled by an employee not responsible for initiating or recording loan transactions?	______	___	___
5. Are documents supporting credit adjustments reviewed and approved by someone other than the person originating the transaction?	______	___	___
6. Is a report of totals of transactions (new loans, payments) entered to the subsidiary records prepared daily and reconciled to entries posted to the general ledger?	______	___	___
7. Are past-due notices prepared and mailed by employees not responsible for originating loans or handling payments?	______	___	___
8. Are payments due for principle or interest monitored as to their eventual receipt, aging of delinquencies, and follow-up with late payers?	______	___	___

<u>Real Estate and Construction Loans</u>

ACCOUNTING SYSTEMS (SYSTEM C)

	Personnel	Yes	No
1. Does the construction loan agreement:			
a. Include a project completion date?	______	___	___
b. Forbid the commencement of work without bank approval?	______	___	___
c. Provide for site inspections and progress disbursements?	______	___	___
d. Permit the lender to assume control of the project in the event of default?	______	___	___
2. Are loan disbursements made only after reviewing written inspection and progress reports?	______	___	___

INTERNAL CONTROL STRUCTURE QUESTIONNAIRE—
BANKS AND SAVINGS INSTITUTIONS
SECTION V (Continued)

	Personnel	Yes	No
PRIMARY CONTROLS (SYSTEM B)			
1. Is a checklist used to determine that all documents (e.g., appraisals, recorded mortgages) have been reviewed and are on file?	______	___	___
2. Have procedures been established to follow up missing documents?	______	___	___
3. For construction loans, does the institution require a breakdown of estimated costs for each stage of construction?	______	___	___
4. Does the institution obtain documentary evidence of the property owners' payment of real estate taxes and hazard insurance premiums?	______	___	___
SECONDARY CONTROLS (SYSTEM A)			
1. Has an employee or department been given the responsibility of reviewing loan files prior to closing to determine that all documents have been properly drawn, recorded, and included in the institution's files?	______	___	___
2. Have procedures been established to check new mortgage loans for flood insurance requirements?	______	___	___
3. Are construction loan agreements reviewed and approved by the institution's attorney?	______	___	___
4. Does the institution require change orders to be approved by the institution, permanent lender, supervising engineer, and prime tenants?	______	___	___
5. Does the institution's legal counsel review take-out commitments for acceptability?	______	___	___
Installment Loans			
ACCOUNTING SYSTEMS (SYSTEM C)			
1. Is there a formal installment loan policy, approved by the board of directors?	______	___	___
2. Does the installment loan policy set loan limits for loan officers?	______	___	___

INTERNAL CONTROL STRUCTURE QUESTIONNAIRE— BANKS AND SAVINGS INSTITUTIONS SECTION V (Continued)

	Personnel	Yes	No
3. Are deviations from the installment loan policy approved by the board of directors or designated loan committee?	______	___	___
4. Are all installment notes serially numbered or identified by customer number?	______	___	___
5. Are installment loan documents protected during business hours and locked in a fireproof vault overnight?	______	___	___
6. Is a completed and signed loan application obtained for each loan?	______	___	___
7. Are installment loan proceeds distributed only by official check or by direct deposit to the customer's account?	______	___	___
8. Are credit files maintained for each borrower?	______	___	___
9. Are collateral receipts given to the customer?	______	___	___
10. Have procedures been established to ensure that the proper security interest has been perfected in all collateral?	______	___	___
11. Do all insurance policies indicate the institution as loss payee?	______	___	___
12. Are payments on dealer loans made directly to the institution?	______	___	___
13. Is a separate general ledger account maintained for repossessions?	______	___	___
14. Are items sold by dealers required to be paid off immediately?	______	___	___
15. Are all floor plan loans made under an approved line?	______	___	___
16. Are dealers required to submit periodic financial statements?	______	___	___
PRIMARY CONTROLS (SYSTEM B)			
1. Is there an independent loan review function?	______	___	___
2. Are all installment notes signed or initialed by the approving officer?	______	___	___
3. Are procedures set to ensure that credit file information is complete and current?	______	___	___

INTERNAL CONTROL STRUCTURE QUESTIONNAIRE— BANKS AND SAVINGS INSTITUTIONS SECTION V (Continued)

	Personnel	Yes	No
4. Are detailed installment loan records posted and reconciled to the general ledger on a daily basis?			
5. Are paid notes and related documents marked "paid" or "cancelled" and returned promptly to the customer?			
6. Is all installment loan collateral receipted for on multicopy, prenumbered forms?			
7. Is negotiable collateral held under dual control in a fireproof vault?			
8. Is negotiable collateral periodically revalued and the value compared to the customer's outstanding loan balance?			
9. Are past-due loans periodically reported to the board of directors or their designated loan committee?			
10. Have procedures been established to ensure that descriptions of motor vehicles appearing on title certificates and insurance policies are checked to security agreement and financing statement?			
11. Is an insurance maturity file maintained to ensure adequate insurance is carried on collateral?			
12. Have procedures been established to obtain single interest insurance coverage if regular insurance expires or is cancelled?			
13. Are separate controls maintained for dealer loans?			
14. Are credit checks on borrowers performed independently of dealers?			
15. Does the institution take prompt action on repossessions to take advantage of dealer repurchase agreements?			
16. Are floor plan checks performed periodically on a surprise basis?			
17. Are dealer loan limits strictly observed and are large loans usually investigated?			

INTERNAL CONTROL STRUCTURE QUESTIONNAIRE— BANKS AND SAVINGS INSTITUTIONS SECTION V (Continued)

	Personnel	Yes	No
SECONDARY CONTROLS (SYSTEM A)			
1. Are installment loan policies reviewed annually?	______	___	___
2. Are employees prohibited from holding notes signed in blank by customers?	______	___	___
3. Are reconcilements prepared by employees not responsible for initiating or recording loan transactions?	______	___	___
4. Are installment loan balance inquiries or discrepancies handled by an employee not responsible for initiating or recording loan transactions?	______	___	___
5. Are documents supporting credit adjustments reviewed and approved by someone other than the person originating the transaction?	______	___	___
6. Is a report of totals of transactions (new loans, payments) entered to the installment loan subsidiary records prepared daily and reconciled to entries posted to the general ledger?	______	___	___
7. Are past-due notices prepared and mailed by employees not responsible for originating loans or handling payments?	______	___	___
8. Are dealers required to make periodic loan curtailment payments?	______	___	___
<u>Mortgage Banking Activities</u>			
ACCOUNTING SYSTEMS (SYSTEM C)			
1. Is there a formal written policy on mortgage banking activities, approved by the board of directors?	______	___	___
2. For loans purchased, does the institution have a program for review of the underlying documentation prior to the purchase of the loans?	______	___	___
3. Are there limits and controls over the types of loans purchased?	______	___	___
4. Does the policy set limits on the authority of officers to purchase and sell loans?	______	___	___

INTERNAL CONTROL STRUCTURE QUESTIONNAIRE— BANKS AND SAVINGS INSTITUTIONS SECTION V (Continued)

	Personnel	Yes	No
5. Are deviations from the policy approved by the board of directors or designated committee?	______	___	___
6. Have procedures been established to ensure that the security interest has been perfected in all loans purchased?	______	___	___
7. Have procedures been established to ensure that mortgage loans and mortgage-backed securities held for sale are reported at the lower of cost or market value?	______	___	___
PRIMARY CONTROLS (SYSTEM B)			
1. Is there a quality control or internal audit function to monitor underwriting and documentation practices?	______	___	___
2. Does management review open and pending commitments and strategies to minimize exposure to changing interest rates?	______	___	___
3. Is there periodic reconciliation of cash receipts and payments applied to the servicing (investor and escrow) system?	______	___	___
4. Is there periodic reconciliation of custodial accounts by employees who do not control notes and collateral or receive or disburse payments?	______	___	___
5. Is there periodic reconciliation of servicing fees received to servicing fee income recorded in the general ledger?	______	___	___
6. Is there periodic evaluation of the recoverability of deferred loan sale premium, purchased servicing values and their capitalized costs?	______	___	___
SECONDARY CONTROLS (SYSTEM A)			
1. Is the mortgage banking policy reviewed annually?	______	___	___
2. Are all reconciliations prepared by employees not responsible for initiating or recording mortgage banking activities?	______	___	___
3. Are mortgage banking inquiries or discrepancies handled by an employee not responsible for initiating or recording mortgage banking transactions?	______	___	___

INTERNAL CONTROL STRUCTURE QUESTIONNAIRE— BANKS AND SAVINGS INSTITUTIONS SECTION V (Continued)

	Personnel	Yes	No
4. Are documents supporting adjustments to mortgage banking accounts reviewed and approved by someone other than the person originating the transaction?	____	__	__
5. Are past-due notices prepared and mailed by employees not responsible for originating mortgage banking transactions or handling payments?	____	__	__
6. Are payments due on mortgages purchased monitored as to their eventual receipt?	____	__	__
7. Are delinquencies and prepayments monitored by a responsible officer?	____	__	__

Other comments:

System selection (circle one):

System A[1] System B[2] System C[3]

[1] Represents a decision to assess control risk at a moderate or low level for most financial statement assertions.

[2] Represents a decision to assess control risk at a moderate level for some of the financial statement assertions.

[3] Represents a decision to assess control risk at the maximum or slightly below the maximum for most financial statement assertions.

INTERNAL CONTROL STRUCTURE QUESTIONNAIRE— BANKS AND SAVINGS INSTITUTIONS SECTION V (Continued)

Modification of standard tests:

	19___	19___	19___	19___	19___
Prepared or updated by:					
In-charge					
Reviewed by:					
Engagement Partner					

Tests of Controls Programs— Banks and Savings Institutions

Section V: System A

Client: ______________________

Financial Statement Date: ______________________

MAJOR AUDIT AREAS:
1. Loans and other finance receivables:*
   Commercial
   Real estate and construction
   Installment
   Mortgage Banking Activities

TRANSACTION CYCLES:
1. Lending.
2. Income recognition.

Procedure	Done By	Date	W/P Ref.
Lending			
1. Examine evidence of officer's review of loan trial balances.	______	______	______
2. Examine the loan policy manual to determine that it is updated when significant changes are being made in loan policy.	______	______	______
3. Determine by inquiry, observation, or inspection that loan documents, collateral, etc. are properly safeguarded.	______	______	______
4. Determine by observation and inspection that credit files are properly maintained and contain information necessary for the monitoring of the credit worthiness of borrowers.	______	______	______
5. Determine that the daily new loan journal is being reviewed and reconciled to the related general ledger activity.	______	______	______

* Sampling decisions should normally be made based on the separate populations of all loans and finance receivables classifications. When the aggregate number of loans in all classifications is less than 500, sampling decisions may be based on the aggregate population. In this case, sample units selected must be representative of all loan categories.

TESTS OF CONTROLS PROGRAMS— BANKS AND SAVINGS INSTITUTIONS SECTION V: SYSTEM A (Continued)

Procedure	Done By	Date	W/P Ref.
6. Examine evidence that loan numbers are assigned to all loans.	______	______	______
7. Determine by observation or inspection that all types of loan trial balances are being reconciled to the general ledger and that such reconciliations are being reviewed by an appropriate officer.	______	______	______
8. Test the footing in the general ledger loan accounts and investigate any debit entries not posted from the new loan journal. (Note: This step may be omitted if results of lending tests 1 and 5 are acceptable.)	______	______	______
9. Select a sample of ____ new loans made during the year and inspect files for approved applications, credit reports, loan agreements, borrowers' financial information, etc., determine the presence of file enclosures listed in the Loan section of the Tests of Balances Program, and examine for:			
a. Evidence of approval within stated lending limits.	______	______	______
b. Proper completion of loan documents.	______	______	______
c. Existence of collateral, if any is required.	______	______	______
d. Verification that credit investigation was made in accordance with institution policy.	______	______	______
e. Verification for disbursement of loan proceeds by examining paid check, credit to deposit account, etc.	______	______	______
10. Select ____ numerical series of ____ loan numbers, account for the numerical sequence, compare to loan documents and entries in the new loan journal for name, date, and amount.	______	______	______
11. For ____ periods, test the accuracy of past due reports for all categories of loans.	______	______	______

TESTS OF CONTROLS PROGRAMS— BANKS AND SAVINGS INSTITUTIONS SECTION V: SYSTEM A (Continued)

Procedure	Done By	Date	W/P Ref.
12. Select a sample of ____ days and inspect the reconciliation of all loan accounts, including any "in process accounts," (this reconciliation process should include a "rollforward" from the prior day) to the general ledger and:			
a. Foot the reconciliation.	____	____	____
b. Trace the general ledger balance on the reconciliation to the general ledger.	____	____	____
c. Examine support for the detail trial balance shown on the reconciliation.	____	____	____
d. Verify reconciling items.	____	____	____
e. Examine for evidence of review by an appropriate officer.	____	____	____
(If the results of daily balancing tests 2 and 3, Section III, are positive, sample size may be reduced.)			
13. Obtain the listing and test the amount of loans on a nonaccrual status, including loans accruing at a reduced rate.	____	____	____
14. Obtain a list of related-party loans and perform the procedures as indicated in tests 8 through 13.	____	____	____
15. Obtain a list of all transactions in financial instruments with off-balance-sheet risk (loans sold with recourse — with or without floating interest rate provisions — loan commitments, financial guarantees, and letters of credit):			
a. Examine evidence of the transactions and proper approvals.	____	____	____
b. Obtain confirmations of significant outstanding transactions as of the balance-sheet date.	____	____	____
c. Review subsequent transactions to determine completeness of the list.	____	____	____

TESTS OF CONTROLS PROGRAMS— BANKS AND SAVINGS INSTITUTIONS SECTION V: SYSTEM A (Continued)

Procedure	Done By	Date	W/P Ref.
16. Other procedures: ______ ______ ______ ______	______	______	______
Income recognition			
1. Determine by inquiry, observation, and inspection that interest accruals and unearned income computations are approved/verified by an officer periodically.	______	______	______
2. Determine by observation and inspection that interest computations are tested periodically by someone independent of the lending function.	______	______	______
3. Examine evidence that loan portfolio yields are monitored by an officer.	______	______	______
4. Test the footings in the general ledger accrued income on loans receivable and unearned interest accounts. (Note — this step may be omitted if results of income recognition tests 1, 2, and 3 are positive.)	______	______	______
5. Agree or reconcile the detailed accrued income on loans receivable and unearned interest trial balances to the general ledger balances and test foot the detailed trial balances.	______	______	______
6. Select a sample of ____ loans listed in the accrued income on loans receivable and unearned interest trial balances and perform the following:			
a. Recompute the accrued income on loans or unearned interest balance.	______	______	______

TESTS OF CONTROLS PROGRAMS—
BANKS AND SAVINGS INSTITUTIONS
SECTION V: SYSTEM A (Continued)

Procedure	Done By	Date	W/P Ref.
b. Verify that the correct interest rate is being used (for loans, the original unearned interest may have to be verified).	______	______	______
(If results of income recognition tests 1, 2, and 3 are positive, sample size may be reduced.)			
7. Scan the accrued income on loans receivable and unearned interest trial balances and investigate any unusual items.	______	______	______
8. Verify that loans selected under lending test 9 are included in the detailed trial balances tested under income recognition test 5.	______	______	______
9. Select a sample of ____ debit entries in the accrued income on loans receivable and unearned interest accounts and			
a. Verify the computation of the amount.	______	______	______
b. Trace the offset to the related income account (determine propriety of any offset not made to an income account).	______	______	______
10. Determine the policy for deferral of nonrefundable loan fees charged to borrowers in connection with originating, refinancing, or restructuring of a loan (points, placement fees, application fees, etc.) and the deferral of the related costs is in accordance with GAAP.	______	______	______
a. Test the footings in the general ledger accounts for deferred fees and deferred costs and investigate any entries not posted from the new loan journal.	______	______	______
b. Obtain an analysis for each significant classification of deferred fees and costs and agree or reconcile to the general ledger balances and test foot. Trace opening balance to audit working papers for the preceding year. The propriety of any significant reconciling items should be determined.	______	______	______

TESTS OF CONTROLS PROGRAMS—
BANKS AND SAVINGS INSTITUTIONS
SECTION V: SYSTEM A (Continued)

Procedure	Done By	Date	W/P Ref.
c. Select a sample of _______ new, refinanced, or restructured loans made during the period and perform the following:			
i. Trace the deferred fees to supporting loan file documentation.	______	______	_____
ii. Review and test the basis of loan origination costs being deferred.	______	______	_____
iii. Verify that the correct amortization or accretion is being recognized over the life of the loan using the interest method.	______	______	_____
iv. Trace the amounts of net amortized fees or costs to the related general ledger accounts.	______	______	_____
d. Select a sample of __________ loans prepaid in full, refinanced, or restructured and determine that any unamortized net fees or costs have been recognized as an adjustment of interest income when the loan is paid or when the new loan is granted. (If a refinancing and the terms of the loan are as favorable to the lender as the terms for comparable loans with similar collection risks.)	______	______	_____
e. For purchased loans, determine and trace to original documentation that the initial investment includes the amount paid to the seller, plus any fees paid less any fees received. Test the amortization of any premiums or discounts on purchased loans and trace to general ledger accounts.	______	______	_____
f. Determine that any loans held for sale are recorded at the lower of cost or market.	______	______	_____
g. Determine that interest income is not being recorded on loans classified as nonaccrual.	______	______	_____

TESTS OF CONTROLS PROGRAMS—
BANKS AND SAVINGS INSTITUTIONS
SECTION V: SYSTEM A (Continued)

Procedure	Done By	Date	W/P Ref.
11. Other procedures: ______ ______ ______ ______ ______	______	______	______

Mortgage Banking Activities (Systems A, B, and C)

Lending

Procedure	Done By	Date	W/P Ref.
1. Examine the loan policy manual to determine that it is updated when significant changes are made in mortgage banking activities.	______	______	______
2. Determine by inquiry, observation, or inspection that loan documents, collateral, etc. for serviced loans are properly safeguarded.	______	______	______
3. Determine by observation or inspection that periodic reconciliations of cash receipts and payments applied to the mortgage servicing (investor and escrow) system and trial balance are being reviewed by an appropriate officer and reconciled to the related general ledger activity.	______	______	______
4. Review custodial account reconciliations and supporting documentation to ensure all activity is processed and cleared currently.	______	______	______
5. Test the footings in the general ledger mortgage servicing activity accounts and investigate any unusual entries.	______	______	______
6. Select a sample of _____ borrowers remittances and test the allocation of the payment to income, principal, escrow, and service fee accounts.	______	______	______

**TESTS OF CONTROLS PROGRAMS—
BANKS AND SAVINGS INSTITUTIONS
SECTION V: SYSTEM A (Continued)**

Procedure	Done By	Date	W/P Ref.
7. Select a sample of ____ delinquent loans serviced and consider whether collection and follow-up procedures are being performed on a timely basis and are in accordance with investor requirements or contractual arrangements.	______	______	______
8. Test _____ documentations supporting custodial/escrow and investor account reconciliations. (Note: custodial accounts may be off-balance-sheet accounts and may have to be selected from records independent of the general ledger.)	______	______	______
a. Foot the reconciliation.	______	______	______
b. Trace the balances on the reconciliations to the general ledger.	______	______	______
c. Examine support for the detail amounts shown.	______	______	______
d. Verify the propriety of any significant reconciling items.	______	______	______
e. Examine evidence of review by an appropriate officer.	______	______	______
9. Select a sample of loan sales made during the year and review investor contracts to test whether excess and normal servicing fees, weighted average interest rate calculations, sale versus financing treatment have been treated properly. Recalculate a sample transaction.	______	______	______
10. Other procedures: ____ ____ ____ ____ ____	______	______	______
Income recognition			
1. Determine that deferred loan servicing amortization computations are approved/verified by an officer periodically.	______	______	______

TESTS OF CONTROLS PROGRAMS— BANKS AND SAVINGS INSTITUTIONS SECTION V: SYSTEM A (Continued)

Procedure	Done By	Date	W/P Ref.
2. Determine that servicing income computations are tested periodically by someone independent of the lending function.	______	______	______
3. Determine that purchased loan portfolio yields are monitored by an officer.	______	______	______
4. Determine that prepayment data used by management to calculate deferred loan sale premiums at sale date and the systems used to update prepayment data over time is based on actual prepayments experience.	______	______	______
5. Select ______ loan pools sold in prior periods, and compare actual current loan balance with prepayment estimates.	______	______	______
6. Determine that the allowance for loan losses on mortgage banking activities includes amounts relating to recourse provisions or loans sold.	______	______	______
7. For mortgage servicing rights, acquired either through a purchase transaction or through loan origination activities, determine recoverability and that the assumptions used in the valuation process are currently reasonable.	______	______	______
8. Other procedures: ______________________ ______________________ ______________________ ______________________ ______________________	______	______	______

TESTS OF CONTROLS PROGRAMS— BANKS AND SAVINGS INSTITUTIONS SECTION V: SYSTEM A (Continued)

Modification of analytical procedures and tests of balances, cross-reference to related tests of controls step above, and reasons therefor.

____
____
____
____
____
____
____

Prepared by: ______________________ Date: ______________
(In-charge)

Reviewed by: ______________________ Date: ______________
(Engagement Partner)

Tests of Controls Programs— Banks and Savings Institutions

Section V: System B

Client: ______________________________

Financial Statement Date: ______________________________

MAJOR AUDIT AREAS: 1. Loans and other finance receivables:*
- Commercial
- Real estate and construction
- Installment

TRANSACTION CYCLES: 1. Lending.
2. Income recognition.

Procedure	Done By	Date	W/P Ref.
Lending			
1. Test the footings in the general ledger loan accounts and investigate any debit entries not posted from the new loan journal.	______	______	______
2. Foot and crossfoot the new loan journal for _____ days and trace the totals to postings in the general ledger and, if available, control totals for postings to the details loan subledger. If no control totals are available, consider alternate procedures.	______	______	______
3. Select ____ numerical series of ____ loan numbers, account for the numerical sequence, compare to loan documents and entries in the new loan journal for name, date, and amount.	______	______	______

* Sampling decisions should normally be made based on the separate populations of all loans and finance receivables classifications. When the aggregate number of loans in all classifications is less than 500, sampling decisions may be based on the aggregate population. In this case, sample units selected must be representative of all loan categories.

TESTS OF CONTROLS PROGRAMS— BANKS AND SAVINGS INSTITUTIONS SECTION V: SYSTEM B (Continued)

Procedure	Done By	Date	W/P Ref.
4. Select a sample of _______ entries in the new loan journal, inspect bank files for approved applications, credit reports, loan agreements, borrowers' financial information, etc., determine the presence of file enclosures listed in the Loan section of the Tests of Balances Program and perform the following:			
a. Trace to loan file and compare similarity of name, date, and amount.	______	______	______
b. Verify that the interest rate stated in the loan documents is correct (consider type of loan, collateral, repayment terms, and date loan was made).	______	______	______
c. Check for lending officer approval within authorized limits.	______	______	______
d. Trace postings to detailed loan subledger and compare name, date, and amount.	______	______	______
e. Verify disbursement of loan proceeds by examining paid check, credit to deposit account, etc.	______	______	______
f. Check that credit report is current.	______	______	______
g. Ascertain that any loan collateral:			
i. Is properly safeguarded.	______	______	______
ii. Is properly insured.	______	______	______
iii. Is properly recorded in the collateral register.	______	______	______
5. For ____ periods, test the accuracy of past due reports for all categories of loans.	______	______	______
6. Select a sample of ____ days and inspect the reconciliation of all loan accounts, including any "in process accounts" (this reconciliation process should include a "rollforward" from the prior day), to the general ledger and:			

TESTS OF CONTROLS PROGRAMS—
BANKS AND SAVINGS INSTITUTIONS
SECTION V: SYSTEM B (Continued)

Procedure	Done By	Date	W/P Ref.
a. Foot the reconciliation.			
b. Trace the general ledger balance on the reconciliation to the general ledger.			
c. Examine support for the detailed trial balance amount shown on the reconciliation.			
d. Verify reconciling items.			
e. Examine for evidence of review by an appropriate officer.			
(If the results of daily balancing tests 2 and 3, Section III, are positive, sample size may be reduced.)			
7. Obtain the listing and test the amount of loans on a nonaccrual status, including loans accruing at a reduced rate.			
a. For disclosure purposes determine the effect of nonaccrual loans on the income statement.			
b. For disclosure purposes determine and test for completeness the dollar amount of outstanding commitments, undisbursed lines of credit, unused credit card lines, and loans in process.			
8. Obtain a list of all transactions in financial instruments with off-balance-sheet risk (loans sold with recourse— with or without floating interest rate provisions, loan commitments, financial guarantees, and letters of credit):			
a. Examine evidence of the transactions and proper approvals.			
b. Obtain confirmations of significant outstanding transactions as of the balance-sheet date.			
c. Review subsequent transactions to determine completeness of the list.			

TESTS OF CONTROLS PROGRAMS—
BANKS AND SAVINGS INSTITUTIONS
SECTION V: SYSTEM B (Continued)

Procedure	Done By	Date	W/P Ref.
9. Other procedures: ______ ______ ______ ______ ______	______	______	______
Income recognition			
1. Test the footings in the general ledger accrued interest and unearned income accounts.	______	______	______
2. Agree or reconcile the detailed accrued interest and unearned income trial balances to the general ledger balances and test foot the detailed trial balances.	______	______	______
3. Select a sample of _____ loans listed in the accrued interest receivable and unearned income trial balances and perform the following:			
a. Recompute the accrued interest on unearned income balance.	______	______	______
b. Verify that the correct interest rate is being used.	______	______	______
4. Scan the accrued interest on loans receivable and unearned interest trial balances and investigate any unusual items.	______	______	______
5. Verify that loans selected under lending test 4 are included in the trial balance tested under income recognition test 2.	______	______	______
6. Select a sample of ____ debit entries in the accrued interest on loans receivable and unearned income accounts and:			
a. Verify the computation of the amount.	______	______	______
b. Trace the offset to the related income account (determine propriety of any offset not made to an income account).	______	______	______

TESTS OF CONTROLS PROGRAMS— BANKS AND SAVINGS INSTITUTIONS SECTION V: SYSTEM B (Continued)

Procedure	Done By	Date	W/P Ref.
7. Determine the policy for deferral of nonrefundable loan fees charged to borrowers in connection with originating, refinancing, or restructuring of a loan (points, placement fees, application fees, etc.) and the deferral of the related costs is in accordance with GAAP.	______	______	______
a. Test the footings in the general ledger accounts for deferred fees and deferred costs and investigate any entries not posted from the new loan journal.	______	______	______
b. Obtain an analysis for each significant classification of deferred fees and costs and agree or reconcile to the general ledger balances and test foot. Trace opening balance to audit working papers for the preceding year. Investigate reconciling items.	______	______	______
c. Select a sample of _______ new, refinanced, or restructured loans made during the period and perform the following:			
i. Trace the deferred fees to supporting loan file documentation.	______	______	______
ii. Review and test the basis of loan origination costs being deferred.	______	______	______
iii. Verify that the correct amortization or accretion is being recognized over the life of the loan using the interest method.	______	______	______
iv. Trace the amounts of net amortized fees or costs to the related general ledger accounts.	______	______	______
d. Select a sample of ____ loans prepaid in full, refinanced, or restructured and determine that any unamortized net fees or costs have been recognized as an adjustment of interest income when the loan is paid or when the new loan is granted. (If a refinancing and the terms of the loan are as favorable to the lender as the terms for comparable loans with similar collection risks).	______	______	______

TESTS OF CONTROLS PROGRAMS—
BANKS AND SAVINGS INSTITUTIONS
SECTION V: SYSTEM B (Continued)

Procedure	Done By	Date	W/P Ref.
8. For purchased loans, determine and trace to original documentation that the initial investment includes the amount paid to the seller, plus any fees paid less any fees received. Test the amortization of any premiums or discounts on purchased loans and trace to general ledger accounts.	______	______	_____
9. For loans held for sale, determine that they are recorded at the lower of cost or market.	______	______	_____
10. Determine that interest income is not being recorded on loans classified as nonaccrual.	______	______	_____
11. Other procedures: ____________________	______	______	_____

Modification of analytical procedures and tests of balances, cross-reference to related tests of controls step above, and reasons therefor.

____

____

____

Prepared by: ________________________ Date: ________________
(In-charge)

Reviewed by: ________________________ Date: ________________
(Engagement Partner)

Tests of Controls Programs— Banks and Savings Institutions

Section V: System C

Client: ______________________________

Financial Statement Date: ______________________________

MAJOR AUDIT AREAS: 1. Loans and other finance receivables:*
Commercial
Real estate and construction
Installment

TRANSACTION CYCLES: 1. Lending.
2. Income recognition.

Procedure	Done By	Date	W/P Ref.
Lending			
1. Test the footings in the general ledger loan accounts and investigate any debit entries not posted from the new loan journal.	______	______	______
2. Foot and crossfoot the new loan journal for _____ days and trace totals to postings in the general ledger.	______	______	______
3. Select _____ numerical series of _____ loan numbers, account for the numerical sequence, compare to loan documents and entries in the new loan journal for name, date, and amount.	______	______	______
4. Select a sample of ____ entries in the new loan journal, inspect bank files for approved applications, credit reports, loan agreements, borrowers' financial information, etc., determine the presence of file enclosures listed in the Loan section of the Tests of Balances Program and perform the following:			
a. Trace to loan file and compare similarity of name, date, and amount.	______	______	______

* Sampling decisions should normally be based on the separate populations of all loans and finance receivables classifications. When the aggregate number of loans in all classifications is less than 500, sampling decisions may be based on the aggregate population. In this case, sample units selected must be representative of all loan categories.

TESTS OF CONTROLS PROGRAMS— BANKS AND SAVINGS INSTITUTIONS SECTION V: SYSTEM C (Continued)

Procedure	Done By	Date	W/P Ref.
b. Verify that the interest rate stated in the loan documents is correct (consider type of loan, collateral, repayment terms, and date loan was made).	_____	_____	_____
c. Verify that corrections on the notes are initialed by concerned parties.	_____	_____	_____
d. Check for lending officer approval within authorized limits.	_____	_____	_____
e. Verify disbursement of loan proceeds by examining paid check, credit to deposit account, etc.	_____	_____	_____
f. Ascertain that any loan collateral is properly safeguarded and insured with the bank/savings institution as loss payee.	_____	_____	_____
5. Select a sample of ____ days and inspect the reconciliation of all loan accounts, including any "in process accounts" (this reconciliation process should include a "roll-forward" from the prior day), to the general ledger and:			
a. Foot the reconciliation.	_____	_____	_____
b. Trace the general ledger balance on the reconciliation to the general ledger.	_____	_____	_____
c. Examine support for the detail trial balance amount shown on the reconciliation.	_____	_____	_____
d. Verify reconciling items.	_____	_____	_____
e. Examine for evidence of review by an appropriate officer.	_____	_____	_____
(If the results of daily balancing tests 2 and 3, Section III, are positive, sample size may be reduced.)			
6. Test the listing of loans on a nonaccrual status, including loans accruing at a reduced rate for proper approval.	_____	_____	_____

TESTS OF CONTROLS PROGRAMS— BANKS AND SAVINGS INSTITUTIONS SECTION V: SYSTEM C (Continued)

Procedure	Done By	Date	W/P Ref.
7. Obtain a list of all transactions in financial instruments with off- balance-sheet risk (loans sold with recourse—with or without floating interest rate provisions—loan commitments, financial guarantees, and letters of credit).	______	______	______
a. Examine evidence supporting the transactions and determine that proper approvals were obtained.	______	______	______
b. Obtain confirmations of significant outstanding transactions as of the balance-sheet date.	______	______	______
c. Review subsequent transactions to determine completeness of the list.	______	______	______
8. Determine by inquiry, observation, or inspection that loan proceeds are disbursed by a person other than the loan officer who approved the loan.	______	______	______
9. Other procedures: ______________________ ______________________ ______________________ ______________________ ______________________	______	______	______
Income recognition			
1. Test the footings in the general ledger accrued interest and unearned income accounts.	______	______	______
2. Agree or reconcile the detail accrued income on loans and unearned interest trial balances to the general ledger balances and test foot the detail trial balances.	______	______	______

TESTS OF CONTROLS PROGRAMS— BANKS AND SAVINGS INSTITUTIONS SECTION V: SYSTEM C (Continued)

Procedure	Done By	Date	W/P Ref.
3. Select a sample of ____ loans listed in the accrued interest on loans receivable and unearned interest trial balances and perform the following:			
a. Recompute the accrued interest or unearned interest balance.	______	______	______
b. Verify that the correct interest rate is being used.	______	______	______
4. Scan the accrued interest on loans receivable and unearned interest trial balances and investigate any unusual items.	______	______	______
5. Verify that loans selected under lending test 4 are included in the trial balance and investigate any unusual items.	______	______	______
6. Select a sample of ____ debit entries in the accrued interest receivable and unearned interest accounts and:			
a. Verify the computation of the amount.	______	______	______
b. Trace the offset to the related income account (determine propriety of any offset not made to an income account).	______	______	______
7. Determine the policy for deferral of nonrefundable loan fees charged to borrowers in connection with originating, refinancing, or restructuring of a loan (points, placement fees, application fees, etc.) and the deferral of the related costs is in accordance with GAAP.			
a. Test the footings in the general ledger accounts for deferred fees and deferred costs and investigate any entries not posted from the new loan journal.	______	______	______
b. Obtain the detail listing for each significant classification of deferred fees and costs and agree or reconcile to the general ledger balances and test foot. Trace opening balance to audit working papers for the preceding year. Investigate reconciling items.	______	______	______

TESTS OF CONTROLS PROGRAMS—
BANKS AND SAVINGS INSTITUTIONS
SECTION V: SYSTEM C (Continued)

Procedure	Done By	Date	W/P Ref.
c. Select a sample of ____ new, refinanced, or restructured loans made during the period and perform the following:			
i. Trace the deferred fees to supporting loan file documentation.	______	______	______
ii. Review and test the basis of loan origination costs being deferred.	______	______	______
iii. Verify that the correct amortization or accretion is being recognized over the life of the loan using the interest method.	______	______	______
iv. Trace the amounts of net amortized fees or costs to the related general ledger accounts.	______	______	______
d. Select a sample of ____ loans prepaid in full, refinanced, or restructured and determine that any unamortized net fees or costs have been recognized as an adjustment of interest income when the loan is paid or when the new loan is granted. (If a refinancing and the terms of the loan are as favorable to the lender as the terms for comparable loans with similar collection risks.)	______	______	______
8. For purchased loans, determine and trace to original documentation that the initial investment includes the amount paid to the seller, plus any fees paid less any fees received. Test the amortization of any premiums or discounts on purchased loans and trace to general ledger accounts.	______	______	______
9. For loans held for sale determine that they are recorded at the lower of cost or market.	______	______	______
10. Determine that interest income is not being recorded on loans classified as nonaccrual.	______	______	______

TESTS OF CONTROLS PROGRAMS—
BANKS AND SAVINGS INSTITUTIONS
SECTION V: SYSTEM C (Continued)

Procedure	Done By	Date	W/P Ref.
11. Other procedures: ______________________________ ______________________________ ______________________________ ______________________________ ______________________________	________	________	______

Modification of analytical procedures and tests of balances, cross-reference to related tests of controls step above, and reasons therefor.

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Prepared by: ______________________________ Date: ____________________
(In-charge)

Reviewed by: ______________________________ Date: ____________________
(Engagement Partner)

Internal Control Structure Questionnaire— Banks and Savings Institutions

Section VI

Client: ______________________________

Financial Statement Date: ______________________________

MAJOR AUDIT AREAS: Allowance for Loan Losses

ACCOUNTING SYSTEMS (SYSTEM C)	Personnel	Yes	No
1. Has the board of directors, consistent with its duties and responsibilities:			
a. Established a comprehensive and well documented process for maintaining an adequate allowance?	______	___	___
b. Established an effective loan review system that will identify, monitor, and address asset quality problems in an accurate and timely manner?	______	___	___
c. Established procedures for the timely charge-off of loans that are confirmed to be uncollectible?	______	___	___
d. Defined collection efforts to be undertaken after a loan is charged-off?	______	___	___
2. Has the institution adopted a formal policy on how to recognize impairment of loans and for recognizing interest income on impaired loans including how cash receipts are recorded?	______	___	___
PRIMARY CONTROLS (SYSTEM B)			
1. Is the preparation and posting of any subsidiary records of loans charged-off performed or reviewed by persons who do not also:			
a. Issue official checks and drafts singly?	______	___	___
b. Handle cash?	______	___	___
2. Are all loans charged-off reviewed and approved by the board of directors as evidenced by the minutes of board meetings?	______	___	___

INTERNAL CONTROL STRUCTURE QUESTIONNAIRE— BANKS AND SAVINGS INSTITUTIONS SECTION VI (Continued)

	Personnel	Yes	No
3. Are notes for loans charged-off maintained under dual custody?	______	___	___
4. Are collection efforts continued for loans charged-off until the potential for recovery is exhausted?	______	___	___
5. Are periodic progress reports prepared and reviewed by appropriate management personnel for all loans charged-off for which collection efforts are continuing?	______	___	___
6. Does the institution have a written description of the process and methodology used by management to determine the adequacy of the allowance?	______	___	___
7. Does management review the adequacy of the allowance and make necessary adjustments at least quarterly and report the findings to the board of directors before preparing the Reports of Condition and Income?	______	___	___
8. Does management retain documentation of its review of the adequacy of the allowance?	______	___	___
SECONDARY CONTROLS (SYSTEM A)			
1. Does the institution have a loan review section or the equivalent?	______	___	___
2. Is the loan review section independent of the lending function?	______	___	___
3. Are the initial results of the loan review process submitted to a person or committee which is also independent of the lending function?	______	___	___
4. Are all loans exceeding a certain dollar amount selected for review?	______	___	___
5. Do lending officers recommend loans for review?	______	___	___
6. Is a method, other than those detailed in steps 3 or 4, used to select loans for review (if so, provide details)?	______	___	___
7. Are internal reviews conducted at least annually for all lending areas?	______	___	___

INTERNAL CONTROL STRUCTURE QUESTIONNAIRE— BANKS AND SAVINGS INSTITUTIONS SECTION VI (Continued)

	Personnel	Yes	No
8. In an officer identification system, are guidelines in effect which define the consequences of an officer withholding a loan from the review process?	________	___	___
9. Is the institution's problem loan list periodically updated by the lending officers?	________	___	___
10. Does the institution maintain a list of loans reviewed, indicating the date of the review and the credit rating?	________	___	___
11. Does the loan review section prepare summations to substantiate credit ratings, including pass loans?	________	___	___
12. Are loan review summations maintained in a central location or in appropriate credit files?	________	___	___
13. Are follow-up procedures in effect for internally classified loans, including an update memorandum to the appropriate credit file?	________	___	___
14. Is a record of charged-off loans maintained by a person other than the one who has custody of the notes or receives payment? Is this record checked against the loans at least annually?	________	___	___
15. Are adequate procedures in effect with respect to recoveries?	________	___	___

Other comments:

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INTERNAL CONTROL STRUCTURE QUESTIONNAIRE—
BANKS AND SAVINGS INSTITUTIONS
SECTION VI (Continued)

System selection (circle one):

System A[1] System B[2] System C[3]

Modification of standard tests:

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	19____	19____	19____	19____	19____
Prepared or updated by:					
In-charge	____	____	____	____	____
Reviewed by:					
Engagement Partner	____	____	____	____	____

[1] Represents a decision to assess control risk at a moderate or low level for most financial statement assertions.

[2] Represents a decision to assess control risk at a moderate level for some of the financial statement assertions.

[3] Represents a decision to assess control risk at the maximum or slightly below the maximum for most financial statement assertions.

Tests of Controls Programs— Banks and Savings Institutions

Section VI: System A

Client: ______________________________

Financial Statement Date: ______________________________

MAJOR AUDIT AREAS: 1. Allowance for loan losses.

Procedure	Done By	Date	W/P Ref.
1. Agree the total of charged-off loans since the last date as recorded in the charged-off loan ledger to the total of debit entries to the allowance for loan and lease losses for the same period.	______	______	______
2. Select ___ charged-off loans and:			
a. Examine supporting documentation.	______	______	______
b. Trace to approval by the directors, as evidenced in the minutes of board meetings.	______	______	______
c. Determine whether any charged-off loans are extended to foreign government officials or other persons or organizations covered by the Foreign Corrupt Practices or the Federal Election Campaign Acts.	______	______	______
3. Select ___ recovery entries in the charged-off ledger since the last audit and compare to credit entries in the allowance account.	______	______	______
4. Through discussion with appropriate personnel and the possible use of flowcharts, organizational charts, observation, investigation, etc., analyze the operation of the overall internal loan review process. Determine:			
a. Method of loan selection.	______	______	______
b. Manner in which the loan is analyzed.	______	______	______
c. Type of report generated.	______	______	______
d. Use of results by appropriate institution personnel.	______	______	______

TESTS OF CONTROLS PROGRAMS—
BANKS AND SAVINGS INSTITUTIONS
SECTION VI: SYSTEM A (Continued)

Procedure	Done By	Date	W/P Ref.
e. That procedures are in effect to monitor compliance with loan terms and/or loan agreements.	______	______	______
f. Any possible internal restrictions placed on the review function personnel.			
g. Which internal grade classification qualifies as a credit for the problem loan list.	______	______	______
h. Procedures required to remove a loan from criticized and/or problem loan list.	______	______	______
5. Obtain listing of loans rated other than "Pass". Compare listing with listing at prior year end and at most recent regulatory examination. Inquire about differences.			
6. Obtain a list, including credit rating, of all loans reviewed since the last examination and, if available, analytical summations supporting that rating.	______	______	______
7. Using a numerical sampling technique, test the population of loans analyzed by the institution since the last examination to determine if problem loans are being identified. Accomplish that by reviewing internal comments on both passed and criticized loans to determine if appropriate criteria have been considered.	______	______	______

Modification of analytical procedures and tests of balances, cross-reference to related tests of controls step above, and reasons therefor.

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Prepared by: ______________________________ Date: ____________________
(In-charge)

Reviewed by: ______________________________ Date: ____________________
(Engagement Partner)

Tests of Controls Programs— Banks and Savings Institutions

Section VI: System B

Client: ____________________

Financial Statement Date: ____________________

MAJOR AUDIT AREAS: 1. Allowance for loan losses

Procedure	Done By	Date	W/P Ref.
1. Agree the total of charged-off loans since the last year end date as recorded in the charged-off loan ledger to the total of debit entries to the allowance for loan losses for the same period.	______	______	______
2. Select ____ charged-off loans and:			
a. Examine supporting documentation.	______	______	______
b. Trace to approval by the directors, as evidenced in the minutes of board meetings.	______	______	______
c. Determine whether any charged-off loans are extended to foreign government officials or other persons or organizations covered by the Foreign Corrupt Practices or the Federal Election Campaign Acts.	______	______	______
3. Select ____ recovery entries in the charged-off ledger since the last audit and compare to credit entries in the allowance account.	______	______	______
4. Through discussion with appropriate personnel and the possible use of flowcharts, organizational charts, observation, investigation, etc., analyze the operation of the overall internal loan review process. Determine:			
a. Method of loan selection.	______	______	______
b. Manner in which the loan is analyzed.	______	______	______
c. Type of report generated.	______	______	______

TESTS OF CONTROLS PROGRAMS— BANKS AND SAVINGS INSTITUTIONS SECTION VI: SYSTEM B (Continued)

Procedure	Done By	Date	W/P Ref.
d. Use of results by institution personnel.	_____	_____	_____
e. That procedures are in effect to monitor compliance with loan terms and/or loan agreements.	_____	_____	_____
f. Any possible internal restrictions placed on the review function personnel.	_____	_____	_____
g. Which internal grade classification qualifies as a credit for the problem loan list.	_____	_____	_____
h. Procedures required to remove a loan from criticized and/or problem loan list.	_____	_____	_____
5. Obtain listing of loans rated other than "Pass". Compare listing with listing at prior year end and at most recent regulatory examination. Inquire about differences.	_____	_____	_____

Modification of analytical procedures and tests of balances, cross-reference to related tests of controls step above, and reasons therefor.

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Prepared by: ____________________ Date: ______________
(In-charge)

Reviewed by: ____________________ Date: ______________
(Engagement Partner)

Tests of Controls Programs— Banks and Savings Institutions

Section VI: System C

Client: ______

Financial Statement Date: ______

MAJOR AUDIT AREAS: 1. Allowance for loan losses

Procedure	Done By	Date	W/P Ref.
1. Agree the total charged-off loans since the year end as recorded in the charged-off ledger to the total debit entries in the allowance for loan and lease losses for the same period.	______	______	______
2. Select ____ charged-off loans and:			
a. Examine supporting documentation.	______	______	______
b. Trace approval by the directors, as evidenced in the minutes of board meetings.			
c. Consider sending positive confirmation requests to the borrower. (There should be no indication to the borrower that the accounts have been charged-off.)	______	______	______
d. Determine whether any charged-off loans are extended to foreign government officials or other persons or organizations covered by the Foreign Corrupt Practices Act or the Federal Election Law.	______	______	______
3. Select ____ recovery entries in the charged-off ledger since the last examination and compare to credit entries in the allowance account.	______	______	______

TESTS OF CONTROLS PROGRAMS— BANKS AND SAVINGS INSTITUTIONS SECTION VI: SYSTEM C (Continued)

Modification of analytical procedures and tests of balances, cross-reference to related tests of controls step above, and reasons therefor.

Prepared by: ______________________ Date: ______________
(In-charge)

Reviewed by: ______________________ Date: ______________
(Engagement Partner)

Internal Control Structure Questionnaire— Banks and Savings Institutions

Section VII

Client: ______________________________

Financial Statement Date: ______________________________

MAJOR AUDIT AREAS: Property and Equipment

ACCOUNTING SYSTEMS (SYSTEM C)	Personnel	Yes	No
1. Are detailed records of all capital assets and property maintained?			
2. Are the detailed asset records reconciled to the general ledger on a periodic basis?			
PRIMARY CONTROLS (SYSTEM B)			
1. Has a policy been adopted establishing authority for acquiring property and equipment and setting limits for capitalizing or expending purchases?			
2. Do the asset records contain accumulated depreciation amounts and net book values?			
SECONDARY CONTROLS (SYSTEM A)			
1. Is a physical inventory taken of property and equipment at least annually?			
2. Are the responsibilities for the purchase and sale of property and equipment segregated from those for bill paying?			
3. Are there procedures for identifying unused or surplus property and equipment and for evaluating any required write-down of its carrying value?			

Other comments:

INTERNAL CONTROL STRUCTURE QUESTIONNAIRE— BANKS AND SAVINGS INSTITUTIONS SECTION VII (Continued)

System selection (circle one):

System A[1] System B[2] System C[3]

Modification of standard tests:

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	19____	19____	19____	19____	19____
Prepared or updated by: In-charge	______	______	______	______	______
Reviewed by: Engagement Partner	______	______	______	______	______

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[1] Represents a decision to assess control risk at a moderate or low level for most financial statement assertions.

[2] Represents a decision to assess control risk at a moderate level for some of the financial statement assertions.

[3] Represents a decision to assess control risk at the maximum or slightly below the maximum for most financial statement assertions.

Tests of Controls Programs—Banks and Savings Institutions

Section VII: System A
Section IX: System A

Client: ______________________

Financial Statement Date: ______________________

MAJOR AUDIT AREAS:
1. Vouching disbursements and inspecting fixed assets.
2. Search for unrecorded liabilities.
3. Expense account analysis and vouching.

TRANSACTION CYCLES: Payments and Acquisitions.
Cash disbursements.

Procedure	Done By	Date	W/P Ref.
Payments			
1. Examine evidence to determine that supporting documents are being approved and cancelled at time of check signing.	______	______	______
2. Examine evidence or observe that the numerical sequence of checks is accounted for by someone independent of the preparation function.	______	______	______
3. Inquire or observe that checks are mailed by an officer or someone under his/her supervision after signing.	______	______	______
4. Examine evidence of the monthly balancing of the accounts payable subledger to the general ledger.	______	______	______
5. Examine evidence, inquire, or observe that the bank reconciliation is prepared by an officer or a person independent of the check signing function or that the reconciliation is reviewed by the officer.	______	______	______
6. Determine by inquiry, observation, or inspection that the check preparation function is independent of the source journal, general ledger, and accounts payable subledger posting functions.	______	______	______

TESTS OF CONTROLS PROGRAMS— BANKS AND SAVINGS INSTITUTIONS SECTION VII AND IX: SYSTEM A (Continued)

Procedure	Done By	Date	W/P Ref.
7. Determine by inquiry, observation, or inspection that account items returned are received and opened by an officer.	______	______	______
8. Determine by observation or inspection that a check protector is in use.	______	______	______
9. Foot and review the general ledger account and investigate any credit entries not posted from the disbursements journal. (This step may be omitted if results of payments test 6 are positive.	______	______	______
10. Foot and crossfoot the disbursements journal for __ months and trace totals to postings in the general ledger and, if available, control totals for postings to accounts payable subledger. If no control totals are available, consider agreeing to adding machine tape of disbursements postings to individual vendor cards.	______	______	______
11. Select a sample of ___ entries in the disbursements journal and perform the following procedures:			
a. Obtain paid check and:			
i. Examine signature and endorsement.*	______	______	______
ii. Compare to entry for payee, date, and amount.*	______	______	______
b. Obtain supporting documents and:			
i. Determine that documents agree with disbursement and that vendor and nature of purchase are proper.*	______	______	______
ii. Examine for officer approval for payment.*	______	______	______
iii. Compare vendor name and amount to entry.*	______	______	______
iv. Determine if discount was taken where appropriate.*	______	______	______
v. Examine approval of disbursement account coding.*	______	______	______

* If results of payments tests Nos. 1, 3 and 6 are positive, sample size may be reduced.

TESTS OF CONTROLS PROGRAMS— BANKS AND SAVINGS INSTITUTIONS SECTION VII AND IX: SYSTEM A (Continued)

Procedure	Done By	Date	W/P Ref.
vi. Determine if supporting documents are cancelled to prevent duplicate payment.* (Note: a System A normally includes a purchases journal. Additional supporting documents will be examined in the test of balances.)	______	______	______
c. Trace postings to the accounts payable subledger. (Note — if results of payments test No. 4 are positive, sample size may be reduced.)	______	______	______
12. Select ___ series of ___ duplicate check copies and account for the numerical sequence. Compare to the disbursements journal for name, date, and amount. (Note: if results of payments test No. 2 are positive, reduce sample size.)	______	______	______
13. Scan the disbursements journal for — months and investigate any unusual entries.	______	______	______
14. Other procedures: ________________ ________________ ________________ ________________ ________________	______	______	______
Acquisitions			
1. Determine by inquiry, observation, or inspection that the persons posting the source journal and general ledger are independent of the accounts payable subledger posting function and/or an officer or other independent person reconciles or reviews the reconciliation of the subledger to the general ledger.	______	______	______
2. Determine by inquiry, observation, or examining evidence that all supporting documents are matched by a person independent of the ordering function, or by an officer, before entry in the source journal.	______	______	______

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*If results of payments tests Nos. 1, 3 and 6 are positive, sample size may be reduced.

TESTS OF CONTROLS PROGRAMS—
BANKS AND SAVINGS INSTITUTIONS
SECTION VII AND IX: SYSTEM A (Continued)

Procedure	Done By	Date	W/P Ref.
3. Examine evidence of the monthly balancing of the accounts payable subledger to the general ledger.	______	______	______
4. Examine evidence of an independent review of expense account codings.	______	______	______
5. Examine evidence or observe that approved vendors' price lists are being used.	______	______	______
6. Examine evidence or observe that the numerical sequence of any receiving reports is being accounted for.	______	______	______
7. Examine evidence or observe that the numerical sequence of any purchase orders and/or purchase requisitions is being accounted for.	______	______	______
8. Examine evidence or observe that accounts payable subledger balances are periodically reconciled to vendors' statements by a person independent of the ordering and payments function.	______	______	______
9. Examine evidence or observe that an independent person inspects the quantity and quality of materials when receiving reports are prepared.	______	______	______
10. Select a sample of ___ receiving reports issued during the year and trace to vendor invoices and entries in the purchases journal.* Compare:			
a. Type of merchandise.	______	______	______
b. Name of vendor.	______	______	______
c. Dates received.	______	______	______
d. Quantities.	______	______	______
e. Amounts.	______	______	______

*If results of payments tests Nos. 1, 3 and 6 are positive, sample size may be reduced.

TESTS OF CONTROLS PROGRAMS— BANKS AND SAVINGS INSTITUTIONS SECTION VII AND IX: SYSTEM A (Continued)

Procedure	Done By	Date	W/P Ref.
11. Select __ series of __ receiving reports issued during the year and account for the numerical sequence.	______	______	______
12. Select __ series of __ purchase orders and __ purchase requisitions issued during the year and account for the numerical sequence.	______	______	______
13. Select a sample of __ entries in the purchases journal and perform the following:			
a. If paid, trace check number to entry in disbursements journal. If unpaid, investigate reasons.	______	______	______
b. Obtain vendor invoice, receiving report, purchase order and/or purchase requisition and perform the following:	______	______	______
i. Compare name, dates, and amounts.	______	______	______
ii. Review invoice for approval of purchase by officer.	______	______	______
iii. Review receiving report for proper approval.	______	______	______
iv. Review purchase order and/or purchase requisition for proper approval.	______	______	______
v. Verify prices and recalculate footings and extensions on invoices.	______	______	______
vi. Compare quantities and descriptions.	______	______	______
vii. Check propriety of account codings.	______	______	______
viii. Determine that supporting documents are canceled to prevent reuse.	______	______	______
14. For __ months, foot and crossfoot the purchases journal and trace postings to the general ledger.	______	______	______

TESTS OF CONTROLS PROGRAMS— BANKS AND SAVINGS INSTITUTIONS SECTION VII AND IX: SYSTEM A (Continued)

Procedure	Done By	Date	W/P Ref.
15. If available, control totals for postings to the accounts payable subledger should be compared with purchases journal totals. If no control totals are available, consider agreeing purchase journal totals to an adding machine tape of purchases postings to individual vendor cards.	______	______	______
16. Scan the purchases journal for a period of ____ months and investigate large or unusual entries.	______	______	______
17. Other procedures: ______ ______ ______ ______	______	______	______

Modification of analytical procedures and tests of balances, cross-reference to related tests of controls step above, and reasons therefor.

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Prepared by: ______________________ Date: ______________
(In-charge)

Reviewed by: ______________________ Date: ______________
(Engagement Partner)

Tests of Controls Programs— Banks and Savings Institutions

Section VII: System B
Section IX: System B

Client: ______________________________

Financial Statement Date: ______________________________

MAJOR AUDIT AREAS:
1. Vouching disbursements and inspecting fixed assets.
2. Search for unrecorded liabilities.
3. Expense account analysis and vouching.

TRANSACTION CYCLES: Payments and Acquisitions.
Cash disbursements.

Procedure	Done By	Date	W/P Ref.
Payments			
1. Foot and review the general ledger cash account and investigate any credit entries not posted from the disbursements journal.	______	______	______
2. Foot and crossfoot the disbursements journal for ___months and trace totals to postings in the general ledger.	______	______	______
3. Select a sample of ____ entries in the disbursements journal for ___ months and trace totals to postings in the general ledger.	______	______	______
a. Obtain paid check and:			
i. Examine officer's signature and propriety of endorsement.	______	______	______
ii. Compare to entry for payee, date, and amount.	______	______	______
iii. Compare to amount of entry on bank statement.	______	______	______
b. Obtain supporting documents and:			
i. Determine propriety of vendor and nature of purchase.	______	______	______
ii. Compare vendor name and invoice amount to entry.	______	______	______

TESTS OF CONTROLS PROGRAMS— BANKS AND SAVINGS INSTITUTIONS SECTION VII AND IX: SYSTEM B (Continued)

Procedure	Done By	Date	W/P Ref.
iii. Determine if discount was taken where appropriate.	______	______	______
iv. Check propriety of disbursement account coding.	______	______	______
v. Note dates of supporting documents as a possible clue to duplication of previous disbursement. (Note: a System B normally does not contain a purchases journal. Additional supporting documents should be examined in the acquisitions transactions tests section, if available. System B may not include invoice cancellation at time of check signing. Sample size, therefore, may be larger than if invoices are cancelled.)	______	______	______
4. Select __ series of __ duplicate check copies and account for the numerical sequence. Compare to disbursements journal for name, date, and amount.	______	______	______
5. Scan the disbursements journal for a period of __ months and investigate any unusual entries.	______	______	______
6. Other procedures: ______________________ ______________________ ______________________ ______________________ ______________________	______	______	______
Acquisitions			
1. Select a sample of __ entries in the purchases journal (or use the journal entry in section above if no purchases journal) and perform the following:			
a. If paid, trace check number to entry in disbursements journal. If unpaid, investigate reasons.	______	______	______
b. Obtain supporting vendor invoice:			
i. Compare name, dates, and amounts.	______	______	______

TESTS OF CONTROLS PROGRAMS—
BANKS AND SAVINGS INSTITUTIONS
SECTION VII AND IX: SYSTEM B (Continued)

Procedure	Done By	Date	W/P Ref.
ii. Review invoice for approval of purchase by officer.	______	______	______
iii. Verify prices and recalculate footings and extensions on invoices.	______	______	______
iv. Check propriety of account codings.	______	______	______
v. Determine if discount was taken, where applicable.	______	______	______
2. If receiving reports are in use, select a sample of ___ issued during the year and trace to vendor invoices and entries in the purchases journal. Compare:			
a. Type of merchandise.	______	______	______
b. Name of vendor.	______	______	______
c. Dates received.	______	______	______
d. Quantities.	______	______	______
e. Amounts.	______	______	______
3. For ___ months, foot and crossfoot the purchases journal and trace postings to the general ledger.	______	______	______
4. Scan the purchases journal for a period of __ months and investigate large or unusual purchases.	______	______	______
5. Other procedures: ______________________________ ______________________________ ______________________________ ______________________________ ______________________________	______	______	______

(Note: System B may not include invoice cancellation at time of check signing. Sample sizes in such cases may be larger than if invoices are cancelled.)

TESTS OF CONTROLS PROGRAMS— BANKS AND SAVINGS INSTITUTIONS SECTION VII AND IX: SYSTEM B (Continued)

Modification of analytical procedures and tests of balances, cross-reference to related tests of controls step above, and reasons therefor.

Prepared by: ______________________ Date: ______________
(In-charge)

Reviewed by: ______________________ Date: ______________
(Engagement Partner)

Tests of Controls Programs— Banks and Savings Institutions

Section VII: System C
Section IX: System C

Client: ______________________________

Financial Statement Date: ______________________________

MAJOR AUDIT AREAS:
1. Vouching disbursements and inspecting fixed assets.
2. Search for unrecorded liabilities.
3. Expense account analysis and vouching.

TRANSACTION CYCLES: Payments and Acquisitions.
Cash disbursements.

Procedure	Done By	Date	W/P Ref.
Payments			
1. Foot and review the general ledger cash account and investigate any credit entries not posted from the disbursements journal.	______	______	______
2. Foot and crossfoot the disbursements journal for __ months and trace totals to postings in the general ledger.	______	______	______
3. Account for the numerical sequence of __ series of __ prenumbered checks. Compare to the disbursements journal for name, date and amount.	______	______	______
4. Account for unnumbered checks or prenumbered checks written out of sequence for ____ months by tracing bank statement enclosures to the disbursements journal. Enclosures must be totaled on an adding machine tape and agreed to bank statement totals.	______	______	______
5. Select a sample of ____ entries in the disbursements journal and perform the following procedures:	______	______	______
a. Obtain paid check and:			
i. Examine for an authorized signature and endorsement.	______	______	______
ii. Compare to entry for payee, date, and amount.	______	______	______

TESTS OF CONTROLS PROGRAMS—
BANKS AND SAVINGS INSTITUTIONS
SECTION VII AND IX: SYSTEM C (Continued)

Procedure	Done By	Date	W/P Ref.
iii. Compare to amount of entry on bank statement.	______	______	______
b. Obtain supporting documents and:			
i. Compare vendor name and invoice amount to entry and determine that vendor and nature of purchase are proper.	______	______	______
ii. Determine if discount was taken where applicable.	______	______	______
iii. Check propriety of account coding.	______	______	______
iv. Verify prices and recalculate vendors' invoices.	______	______	______
v. Note dates of supporting documents as a possible clue to duplication of previous disbursement.	______	______	______
(Note: a System C normally does not contain a purchases journal. Consequently, all tests of controls support will be concentrated in this step. The sample size, therefore, may be larger than normal. An extensive search for unrecorded liabilities will also be performed at balance-sheet date.)			
6. Scan the cash disbursements journal for the year and investigate any unusual entries.	______	______	______
7. Other procedures:			
______________________________			
______________________________			
______________________________			
______________________________			
______________________________			
______________________________			
______________________________	______	______	______

TESTS OF CONTROLS PROGRAMS—
BANKS AND SAVINGS INSTITUTIONS
SECTION VII AND IX: SYSTEM C (Continued)

Modification of analytical procedures and tests of balances, cross-reference to related tests of controls step above, and reasons therefore.

Prepared by: ______________________ Date: ______________
(In-charge)

Reviewed by: ______________________ Date: ______________
(Engagement Partner)

Internal Control Structure Questionnaire— Banks and Savings Institutions

Section VIII

Client: ______________________

Financial Statement Date: ______________________

MAJOR AUDIT AREAS: Other Real Estate Owned

ACCOUNTING SYSTEM (SYSTEMS A, B, AND C)	Personnel	Yes	No
1. Is the preparation, addition, and posting of subsidiary other real estate owned records performed and/or tested by persons who do not have direct, physical or accounting, control of those assets?	______	___	___
2. Are the subsidiary other real estate owned records balanced, at least annually, to the appropriate general ledger accounts by persons who do not have direct, physical or accounting control of those assets?	______	___	___
3. Is the posting to the general ledger other real estate owned accounts approved, prior to posting, by persons who do not have direct, physical or accounting, control of those assets?	______	___	___
4. Are supporting documents maintained for all entries to other real estate owned accounts?	______	___	___
5. Are acquisitions and disposals of other real estate owned reported to the board of directors or its designated committee?	______	___	___
6. Does the institution maintain insurance coverage on other real estate owned including liability coverage where necessary?	______	___	___
7. Are all parcels of other real estate owned reviewed at least annually for:			
a. Current appraisal or certification?	______	___	___
b. Documented inquiries and offers?	______	___	___
c. Documented sales efforts?	______	___	___
d. Evidence of the prudence of additional advances?	______	___	___
e. Anticipated methods for disposal of the property?	______	___	___

INTERNAL CONTROL STRUCTURE QUESTIONNAIRE— BANKS AND SAVINGS INSTITUTIONS SECTION VIII (Continued)

	Personnel	Yes	No
f. Changes in tax status, zoning restrictions, other liens, etc.?	______	___	___
8. Are the institution's policies and procedures relating to other real estate owned in writing?	______	___	___

Other comments:

____
____
____
____
____

System selection (circle one):

System A[1] System B[2] System C[3]

Modification of standard tests:

____
____
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____
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	19___	19___	19___	19___	19___
Prepared or updated by: In-charge	______	______	______	______	______
Reviewed by: Engagement Partner	______	______	______	______	______

[1] Represents a decision to assess control risk at a moderate or low level for most financial statement assertions.

[2] Represents a decision to assess control risk at a moderate level for some of the financial statement assertions.

[3] Represents a decision to assess control risk at the maximum or slightly below the maximum for most financial statement assertions.

Tests of Controls Programs— Banks and Savings Institutions

Section VIII: Systems A, B, and C

Client: ____________________

Financial Statement Date: ____________________

MAJOR AUDIT AREAS: Other real estate owned.

TRANSACTION CYCLES: Other real estate.

Procedure	Done By	Date	W/P Ref.
Other Real Estate Owned			
1. Test the additions of the subsidiary ledgers, and reconcile total to the general ledger. Include in substance foreclosures and property sold in "covered transactions."	______	______	______
2. Using appropriate sampling techniques, select specific properties and determine that:			
a. Legal title to the property is obtained when the asset is recorded as other real estate owned.	______	______	______
b. Legal fees and direct costs of acquiring title, including payment of existing liens, taxes, and recording fees, are expensed when incurred and not capitalized.	______	______	______
c. Insurance, including liability coverage, is adequate, and the bank is named as loss payee.	______	______	______
3. Using appropriate sampling techniques, select specific properties, and for expenses incurred in maintaining the properties or capitalized costs of improvement and development:			
a. Trace the transaction to any succeeding summary records and to postings in the general ledger.	______	______	______
b. Examine documentation supporting the transaction, and prove any computations reflected on the supporting document.	______	______	______

Internal Control Structure Questionnaire— Banks and Savings Institutions

Section IX

Client: ______________________

Financial Statement Date: ______________________

MAJOR AUDIT AREAS: Cash disbursements

ACCOUNTING SYSTEMS (SYSTEM C)	Personnel	Yes	No
Payments			
1. Is a disbursements journal prepared and balanced?	______	___	___
2. Are disbursements made by check?	______	___	___
3. Are disbursements supported by vendors' invoices or other external documents?	______	___	___
4. Are reconciliations prepared for all internal use institution accounts?	______	___	___
Acquisitions			
1. Do vendor invoices, or receiving reports, contain the date goods were received?	______	___	___
2. Are unpaid vendor invoices filed separately from paid invoices?	______	___	___
PRIMARY CONTROLS (SYSTEM B)			
Payments			
1. Are all checks signed by an officer?	______	___	___
2. Does the check signer compare data on supporting documents to checks?	______	___	___
3. Are checks recorded in the journal or other record as prepared?	______	___	___
4. Are checks prenumbered and accounted for?	______	___	___
5. Are all invoices approved for payment by an officer?	______	___	___

INTERNAL CONTROL STRUCTURE QUESTIONNAIRE— BANKS AND SAVINGS INSTITUTIONS SECTION IX (Continued)

	Personnel	Yes	No
6. Are checks prepared by an officer or persons independent of vendor invoice approval?	________	___	___
7. Are checks signed based on approved invoices (not signed in advance)?	________	___	___

Acquisitions

	Personnel	Yes	No
1. Are vendors' invoices or documents included as support for all purchases?	________	___	___
2. Are vendors' invoices recalculated prior to payments?	________	___	___
3. Are all purchases approved by an officer?	________	___	___

SECONDARY CONTROLS (SYSTEM A)

Payments

	Personnel	Yes	No
1. Are all supporting documents cancelled after check signing by the check signer or independent person to prevent duplicate payment?	________	___	___
2. Is the numerical sequence of checks issued accounted for by someone independent of the preparation function?	________	___	___
3. Are checks mailed by an officer or a person under his/her supervision after signing? (Consider other responsibilities of person mailing checks.)	________	___	___
4. Are disbursements posted to an accounts payable subledger?	________	___	___
5. Is the accounts payable subledger posted, balanced, and reconciled to the general ledger monthly?	________	___	___
6. Is the reconciliation prepared by an officer or a person independent of the check-signing function?	________	___	___
7. Are reconciliations reviewed by an officer?	________	___	___
8. Is the check-preparation function independent of general ledger and accounts payable subledger-posting functions?	________	___	___

INTERNAL CONTROL STRUCTURE QUESTIONNAIRE—BANKS AND SAVINGS INSTITUTIONS SECTION IX (Continued)

	Personnel	Yes	No
9. Are account codings reviewed by someone other than the preparer?	________	___	___
10. Is a check protector used?	________	___	___
11. Is access to blank checks limited to persons authorized to prepare checks?	________	___	___

Acquisitions

	Personnel	Yes	No
1. Are all supporting documents marked in a way to prevent re-entry in purchases journal?	________	___	___
2. Are purchases posted to an accounts payable subledger?	________	___	___
3. Is the accounts payable subledger posted and reconciled to the general ledger monthly?	________	___	___
4. Are all supporting documents matched by a person independent of the ordering function, or an officer, before entry in the purchases journal?	________	___	___
5. Are account codings reviewed by someone other than the preparer?	________	___	___
6. Are prenumbered purchase requisitions and/or purchase orders prepared as authorization for purchases?	________	___	___
7. Are approved price lists in use?	________	___	___
8. Is the numerical sequence of purchase requisitions and purchase orders accounted for by a person independent of the preparation function?	________	___	___
9. Are accounts payable subledger balances periodically reconciled to vendors' statements by a person independent of the ordering and payments functions?	________	___	___
10. Is voucher system with prenumbered vouchers approved by an officer in use?	________	___	___

INTERNAL CONTROL STRUCTURE QUESTIONNAIRE— BANKS AND SAVINGS INSTITUTIONS SECTION IX (Continued)

Other comments:

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System selection (circle one):

System A[1] System B[2] System C[3]

Modification of standard tests:

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	19___	19___	19___	19___	19___
Prepared or updated by: In-charge	____	____	____	____	____
Reviewed by: Engagement Partner	____	____	____	____	____

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1 Represents a decision to assess control risk at a moderate or low level for most financial statement assertions.

2 Represents a decision to assess control risk at a moderate level for some of the financial statement assertions.

3 Represents a decision to assess control risk at the maximum or slightly below the maximum for most financial statement assertions.

Internal Control Structure Questionnaire— Banks and Savings Institutions

Section X

Client: ______________________________

Financial Statement Date: ______________________________

MAJOR AUDIT AREAS: Demand Deposits
Savings Deposits
Certificates of Deposit
Official Checks

Demand Deposits

ACCOUNTING SYSTEMS (SYSTEM C)	Personnel	Yes	No
1. Is there a formal written policy on the acceptance of deposits, approved by the board of directors?	______	___	___
2. Are controls in place to ensure adequate protection of files, drafts, deposit tickets, and signature cards?	______	___	___
3. Are completed signature cards obtained and filed when the account is opened?	______	___	___
4. Are account numbers assigned in such a manner to eliminate the possibility of duplicate account numbers?	______	___	___
5. Are all checks overdrawing the collected balance in an account reviewed and approved for payment daily by an officer?	______	___	___
6. Are there adequate procedures for attaching holds on accounts to which stop payment or other legal restrictions are applied?	______	___	___
7. Does the demand deposit system match items presented against the stop payment order file?	______	___	___
8. Are statements rendered on every account at least monthly?	______	___	___

INTERNAL CONTROL STRUCTURE QUESTIONNAIRE— BANKS AND SAVINGS INSTITUTIONS SECTION X (Continued)

	Personnel	Yes	No
PRIMARY CONTROLS (SYSTEM B)			
1. Are demand deposit accounts opened only by employees who are not tellers, proof operators, or who are responsible for processing demand deposits?	______	___	___
2. Is all demand deposit activity posted daily and independently reconciled to proof and general ledger totals?	______	___	___
3. Are rejects, missorts, holdovers, unpostables, overdrafts, and other reconciling items clearly identified by type and date on the reconcilement?	______	___	___
4. Are reconciling items required to be cleared daily?	______	___	___
5. Is a trial balance listing of checking accounts prepared daily?	______	___	___
6. Are all paid checks properly cancelled, microfilmed, and filed daily?	______	___	___
7. Have procedures been established regarding review of paid checks for proper signatures and endorsements?	______	___	___
8. Are all reversing or adjusting entries posted to customer accounts approved by an officer?	______	___	___
9. Is a report prepared and reviewed daily by an officer of accounts with an overdrawn balance?	______	___	___
10. Are dishonored items returned within one business day following dishonor?	______	___	___
11. Is a designated person or department responsible for handling return items?	______	___	___
12. Are unidentified deposit slips kept under joint custody and their disposition approved by an officer?	______	___	___
13. Are oral stop payment orders required to be confirmed in writing within 14 days?	______	___	___

INTERNAL CONTROL STRUCTURE QUESTIONNAIRE— BANKS AND SAVINGS INSTITUTIONS SECTION X (Continued)

	Personnel	Yes	No
14. Are checking account statements prepared, processed, and delivered by individuals independent of operational activities involving checking accounts?	______	___	___
15. Are returned statements properly controlled and adequately followed up?	______	___	___
16. Have procedures been established for identifying and designating accounts as "dormant"?	______	___	___
17. Is activity in dormant accounts reviewed and approved by an officer?	______	___	___
18. Are closed accounts reported daily to management?	______	___	___
19. Are signature cards for closed accounts removed from the active files?	______	___	___
20. Has a policy for service charging demand deposit accounts been established and approved by management?	______	___	___
21. Are listings of service charges collected by type, prepared, and reconciled to entries posted to the general ledger?	______	___	___
22. Are waivers or refunds of service charges approved by an officer?	______	___	___
23. Is an appropriate officer assigned to review activity in employee accounts for unusual or unauthorized transactions?	______	___	___
24. Is the organization of and access to the mailing address file controlled?	______	___	___
25. Are mail receipts opened under dual control?	______	___	___
SECONDARY CONTROLS (SYSTEM A)			
1. Does the DDA record system maintain a complete overdraft history for each account?	______	___	___
2. Are deposit and check filing responsibilities segregated from statement preparation?	______	___	___

INTERNAL CONTROL STRUCTURE QUESTIONNAIRE— BANKS AND SAVINGS INSTITUTIONS SECTION X (Continued)

	Personnel	Yes	No
3. When statements must be remade to replace spoiled statements, are they prepared under dual control?	______	___	___
4. Are statements held for customer pickup delivered to persons independent of teller or other DDA duties?	______	___	___
5. Are customers required to sign for statements picked up?	______	___	___
6. Are checking accounts for which employees have disbursement authority identified and monitored?	______	___	___
7. Are signature cards for dormant accounts removed from the file of active accounts and placed under joint custody?	______	___	___
8. Are service charges collected compared to budgeted amounts and significant variances investigated?	______	___	___

Other comments:

____

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____

System selection (circle one):

System A[4] System B[5] System C[6]

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[4] Represents a decision to assess control risk at a moderate or low level for most financial statement assertions.

[5] Represents a decision to assess control risk at a moderate level for some of the financial statement assertions.

[6] Represents a decision to assess control risk at the maximum or slightly below the maximum for most financial statement assertions.

INTERNAL CONTROL STRUCTURE QUESTIONNAIRE— BANKS AND SAVINGS INSTITUTIONS SECTION X (Continued)

Modification of standard tests:

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	19____	19____	19____	19____	19____
Prepared or updated by:					
In-charge	____	____	____	____	____
Reviewed by:					
Engagement Partner	____	____	____	____	____

INTERNAL CONTROL STRUCTURE QUESTIONNAIRE— BANKS AND SAVINGS INSTITUTIONS SECTION X (Continued)

	Personnel	Yes	No
Savings Deposits			
ACCOUNTING SYSTEMS (SYSTEM C)			
1. Is there a formal written policy on acceptance of deposits, approved by the board of directors?	______	___	___
2. Are controls in place to ensure adequate protection of files, ledger cards, cancelled drafts, deposit tickets, and signature cards?	______	___	___
3. Are complete signature cards obtained when the account is opened?	______	___	___
4. Are account numbers assigned in a controlled fashion?	______	___	___
5. Do tellers, or automated tellers, issue receipts for all savings deposits?	______	___	___
6. Are tellers prohibited from holding over savings transactions from one business day to another?	______	___	___
7. Are savings account statements mailed on all accounts at least quarterly?	______	___	___
8. Are dormant accounts escheated to the state in accordance with state law?	______	___	___
PRIMARY CONTROLS (SYSTEM B)			
1. Are new accounts opened only by employees who do not perform teller or savings record-keeping functions?	______	___	___
2. Are resolutions obtained designating authorized signatures for organization accounts?	______	___	___
3. Is the teller or machine identification number placed on all customer transactions?	______	___	___
4. Is the preparation and posting of subsidiary time deposit records performed by someone who is not a teller?	______	___	___
5. Are totals of savings transactions processed by the subsidiary system reconciled to the totals posted to the general ledger daily?	______	___	___

INTERNAL CONTROL STRUCTURE QUESTIONNAIRE—
BANKS AND SAVINGS INSTITUTIONS
SECTION X (Continued)

	Personnel	Yes	No
6. Are trial balances prepared and reconciled to the general ledger daily?			
7. Are all reconciling items (unpostable transactions, edit rejects) clearly identified and promptly followed up and cleared?			
8. Are savings statements printed, processed, and delivered by individuals independent of operational activities related to savings accounts?			
9. Does the savings system allow the placing of holds on accounts?			
10. Are signature cards for closed accounts removed from the active file?			
11. Are policies set for determining the dormant status of accounts?			
12. Is savings interest expense accrued and are variances between accrued and actual expense analyzed?			
SECONDARY CONTROLS (SYSTEM A)			
1. Are reconcilements duties periodically rotated?			
2. Are reconcilements periodically reviewed and approved by a supervisor?			
3. Are savings customer inquiries handled by someone who does not process savings transactions?			
4. Are duplicate statements prepared under dual control?			
5. Are undeliverable statements returned to a P.O. box controlled by an independent person?			
6. Are hold overrides approved by a supervisor?			
7. Are signature cards for dormant accounts removed from the active file and placed under dual control?			
8. Are transactions in dormant accounts reviewed and approved by an employee who does not process savings transactions?			

INTERNAL CONTROL STRUCTURE QUESTIONNAIRE—
BANKS AND SAVINGS INSTITUTIONS
SECTION X (Continued)

	Personnel	Yes	No
9. Are interest expense amounts and charges for excessive activity detailed in system reports and are these amounts checked to postings to general ledger by an employee independent of the process?	______	___	___

Certificates of Deposit (CD)

ACCOUNTING SYSTEMS (SYSTEM C)

	Personnel	Yes	No
1. Is there a formal policy for the issuance and payment of interest on certificates of deposit?	______	___	___
2. Is each depositor required to sign a deposit agreement in which penalties for early redemption are disclosed?	______	___	___
3. Are certificates cancelled when they are redeemed?	______	___	___
4. Are totals of CD transactions posted to the subsidiary records reconciled to amounts posted to the general ledger?	______	___	___
5. Are interest payments made by official check or direct credit only?	______	___	___

PRIMARY CONTROLS (SYSTEM B)

	Personnel	Yes	No
1. Are supplies of blank CDs periodically inventoried?	______	___	___
2. Are all CDs signed by two employees of the bank?	______	___	___
3. Are trial balances of outstanding CDs prepared and reconciled to the general ledger periodically?	______	___	___
4. Are customers with nonrenewable certificates contacted prior to the CD's maturity?	______	___	___
5. Are variances between accrued and actual interest expense analyzed?	______	___	___

SECONDARY CONTROLS (SYSTEM A)

	Personnel	Yes	No
1. Are supplies of blank certificates held in a vault under dual control?	______	___	___
2. Are the reconcilements reviewed and approved by an officer?	______	___	___

INTERNAL CONTROL STRUCTURE QUESTIONNAIRE— BANKS AND SAVINGS INSTITUTIONS SECTION X (Continued)

	Personnel	Yes	No
3. Are matured CDs transferred to a noninterest-bearing demand deposit classification at maturity?	______	___	___
4. Are checks distributed by persons not responsible for processing CD transactions?	______	___	___

Other comments:

____

____

____

____

____

System selection (circle one):

System A[1] System B[2] System C[3]

[1] Represents a decision to assess control risk at a moderate or low level for most financial statement assertions.

[2] Represents a decision to assess control risk at a moderate level for some of the financial statement assertions.

[3] Represents a decision to assess control risk at the maximum or slightly below the maximum for most financial statement assertions.

INTERNAL CONTROL STRUCTURE QUESTIONNAIRE— BANKS AND SAVINGS INSTITUTIONS SECTION X (Continued)

Modification of standard tests:

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	19____	19____	19____	19____	19____
Prepared or updated by:					
In-charge	______	______	______	______	______
Reviewed by:					
Engagement Partner	______	______	______	______	______

INTERNAL CONTROL STRUCTURE QUESTIONNAIRE—BANKS AND SAVINGS INSTITUTIONS
SECTION X (Continued)

	Personnel	Yes	No
Official Checks			
ACCOUNTING SYSTEMS (SYSTEM C)			
1. Are separate general ledger accounts maintained for each type of official check?			
2. Is an itemized register of outstanding official checks maintained and updated periodically?			
3. Are all official checks prenumbered on multicopy forms?			
4. Are certified checks stamped when certified?			
5. Has the list of official check signers been approved by the board of directors? Are there limitations on the amount of the check for signers based on level of authority?			
6. Are checks cancelled when they are paid?			
PRIMARY CONTROLS (SYSTEM B)			
1. Is the list of official check signers updated annually?			
2. Are working supplies assigned by sequence number and receipted for by the person responsible for issuing them?			
3. Is a check protector used to protect amounts from alteration?			
4. If facsimile signatures are used, are signature plates appropriately safeguarded during and after business hours?			
5. Are checks retained in accordance with the institution's retention schedule?			
6. Are special controls exercised over the payment of dormant official checks?			

INTERNAL CONTROL STRUCTURE QUESTIONNAIRE— BANKS AND SAVINGS INSTITUTIONS SECTION X (Continued)

	Personnel	Yes	No
SECONDARY CONTROLS (SYSTEM A)			
1. Are the responsibilities for issuing, paying, and accounting for official checks segregated?	______	___	___
2. Is the reserve supply of official checks kept in a vault under dual control?	______	___	___

Other comments:

____

____

____

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____

System selection (circle one):

System A[1]   System B[2]   System C[3]

[1] Represents a decision to assess control risk at a moderate or low level for most financial statement assertions.

[2] Represents a decision to assess control risk at a moderate level for some of the financial statement assertions.

[3] Represents a decision to assess control risk at the maximum or slightly below the maximum for most financial statement assertions.

INTERNAL CONTROL STRUCTURE QUESTIONNAIRE— BANKS AND SAVINGS INSTITUTIONS SECTION X (Continued)

Modification of standard tests:

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____

____

____

	19____	19____	19____	19____	19____
Prepared or updated by:					
In-charge	____	____	____	____	____
Reviewed by:					
Engagement Partner	____	____	____	____	____

Tests of Controls Programs — Banks and Savings Institutions

Section X: System A

Client: ______________________

Financial Statement Date: ______________________

MAJOR AUDIT AREAS:
1. Deposits — demand, savings and certificates of deposit.
2. Official checks.

TRANSACTION CYCLES:
1. Acceptance and maintenance of deposits.
2. Income and expense recognition.

Procedure	Done By	Date	W/P Ref.
Acceptance and maintenance of deposits			
1. Inquire or observe that the unissued supply of official checks are properly safeguarded.	______	______	______
2. Examine evidence that all official check account reconciliations are properly completed and reviewed by an officer.	______	______	______
3. Determine that a list of authorized official check signers is maintained.	______	______	______
4. Inquire or observe that the numerical sequence of all official checking accounts and unused passbooks, certificates, etc., is accounted for properly.	______	______	______
5. Determine by observation or inspection that all types of deposit trial balances are being reconciled to the general ledger and that such reconciliations are being reviewed by an appropriate officer.	______	______	______
6. Determine by inquiry, observation, or inspection that deposit account statements are mailed to all customers periodically unless a written "no mail" authorization is on file.	______	______	______
7. Determine by inquiry, observation, or inspection that dormant accounts are segregated and that activity in these accounts is reviewed by an appropriate officer.	______	______	______

TESTS OF CONTROLS PROGRAMS — BANKS AND SAVINGS INSTITUTIONS SECTION X: SYSTEM A (Continued)

Procedure	Done By	Date	W/P Ref.
8. Determine by inquiry, observation, or inspection that undeliverable statements are returned to a controlled P.O. Box.			
9. Test the footings of or perform suppression tests of the general ledger deposit accounts.	______	______	______
10. Examine working papers that support test counts of vault and teller cash made by an officer, test foot the working papers and trace the general ledger balance to the general ledger.	______	______	______
11. Examine working papers that support the reconciliation of official check accounts made by an officer, test foot the reconciliations, and trace the reconciliation balance to the control accounts.	______	______	______
12. Select a sample of __ paid official checks and verify that the check signer was properly authorized.	______	______	______
13. Select a sample of __ new deposit accounts/certificates opened during the year and examine for:			
a. Evidence of approval within the guidelines of the institution's stated policy.	______	______	______
b. Proper completion of deposit account/certificate documents.	______	______	______
14. Select a sample of __ days and inspect the reconciliation of all deposit accounts, including any "in process accounts," (this reconciliation process should include a "rollforward" from the prior day), to the general ledger and:			
a. Foot the reconciliation.	______	______	______
b. Trace the general ledger balance on the reconciliation to the general ledger.	______	______	______
c. Examine support for the detail trial balance amount shown on the reconciliation.	______	______	______

TESTS OF CONTROLS PROGRAMS — BANKS AND SAVINGS INSTITUTIONS SECTION X: SYSTEM A (Continued)

Procedure	Done By	Date	W/P Ref.
d. Verify reconciling items.	______	______	______
e. Examine for evidence of review by an appropriate officer.	______	______	______
(If the results of Daily Balancing Tests Nos. 1 and 4 are positive, sample size may be reduced.)			
15. Other procedures: ______ ______ ______ ______ ______	______	______	______
Income and expense recognition			
1. Determine by observation or inspection that interest expense, accrued interest payable, and service charge income are tested periodically by an officer.	______	______	______
2. Determine by observation or inspection that changes in interest rates paid on deposit accounts is adequately controlled.	______	______	______
3. Inquire or observe that interest costs and service charge income accounts are analytically reviewed by an officer.	______	______	______
4. Select a sample of __ deposit accounts from the detail trial balances and verify that the rate of interest being paid and service charge code agrees with the customer's deposit account contract. (If the results of Income and Expense Recognition Tests Nos. 1, 2, and 3 are positive, sample size may be reduced.)	______	______	______
5. Scan daily deposit activity reports (file maintenance reports) for changes in interest rates or service charges made to individual accounts or certificates. Select a sample of ___ changes and ascertain that the change was proper and approved. (If the results of Income and Expense Recognition Tests Nos. 1, 2, and 3 are positive and Section III is evaluated as a System A, sample size may be reduced.)	______	______	______

TESTS OF CONTROLS PROGRAMS — BANKS AND SAVINGS INSTITUTIONS SECTION X: SYSTEM A (Continued)

Procedure	Done By	Date	W/P Ref.
6. Agree or reconcile the detail accrued interest payable trial balances to the general ledger balances and test foot the detail trial balances.	______	______	______
7. Select a sample of ___ deposit accounts listed in the accrued interest payable trial balances and perform the following:			
a. Recompute the accrued interest balance.	______	______	______
b. Verify that the correct interest rate is being used. (If the results of Income and Expense Recognition Tests Nos. 1, 2, and 3 are positive, sample size may be reduced.)	______	______	______
8. Scan the accrued interest payable trial balances and investigate any unusual items.	______	______	______
9. Verify that deposit accounts selected under Income and Expense Recognition Test No. 4 are included in the detail trial balances tested under Income and Expense Recognition Test No. 6.	______	______	______
10. Select a sample of ___ credit entries in the accrued interest payable accounts and:			
a. Verify the computation of the amount.	______	______	______
b. Trace the offset to the related expense account (ascertain propriety of any offset not made to an expense account). (If the results of Income and Expense Recognition Tests Nos. 1, 2, and 3 are positive, sample size may be reduced.)	______	______	______
11. Other procedures: ______________________ ______________________ ______________________ ______________________ ______________________	______	______	______

TESTS OF CONTROLS PROGRAMS—
BANKS AND SAVINGS INSTITUTIONS
SECTION X: SYSTEM A (Continued)

Procedure	Done By	Date	W/P Ref.

Modification of analytical procedures and tests of balances, cross-reference to related tests of controls step above, and reasons therefor.

Prepared by: ____________________ Date: ____________
(In-charge)

Reviewed by: ____________________ Date: ____________
(Engagement Partner)

Tests of Controls Programs—Banks and Savings Institutions

Section X: System B

Client: ____________________

Financial Statement Date: ____________________

MAJOR AUDIT AREAS:	1. Deposits—demand, savings and certificates of deposit. 2. Official checks.
TRANSACTION CYCLES:	1. Acceptance and maintenance of deposits. 2. Income and expense recognition.

Procedure	Done By	Date	W/P Ref.
Acceptance and maintenance of deposits			
1. Test the footings of or perform suppression tests of the general ledger deposit accounts.	____	____	____
2. Select a sample of ___ official check reconciliations made during the year, test foot the reconciliations, trace the reconciliation balance to the control account balance, and verify that the reconciliation was approved.	____	____	____
3. Select a sample of __ paid official checks and verify that the check signer was properly authorized.	____	____	____
4. Select a sample of _____ deposits and examine for teller or machine identification number.			
5. Other procedures: ____________________ ____________________ ____________________ ____________________ ____________________	____	____	____

TESTS OF CONTROLS PROGRAMS — BANKS AND SAVINGS INSTITUTIONS SECTION X: SYSTEM B (Continued)

Procedure	Done By	Date	W/P Ref.
Income and expense recognition			
1. Select a sample of ____ deposit accounts from the detail trial balances and verify that the rate of interest being paid and service charge code agrees with the customer's deposit account contract.	______	______	______
2. Scan daily deposit activity reports (file maintenance reports) for changes in interest rates or service charges made to individual accounts or certificates. Select a sample of ___ changes and ascertain that the change was proper and approved.	______	______	______
3. Agree or reconcile the detail accrued interest payable trial balances to the general ledger balances and test foot the detail trial balances.	______	______	______
4. Select a sample of ___ deposit accounts listed in the accrued interest payable trial balances and perform the following:			
a. Recompute the accrued interest balance.	______	______	______
b. Verify that the correct interest rate is being used.	______	______	______
5. Scan the accrued interest payable trial balances and investigate any unusual items.			
6. Verify that deposit accounts selected under Income and Expense Recognition Test No. 1 are included in the trial balance tested under Income and Expense Recognition Test No. 3.	______	______	______
7. Select a sample of ___ credit entries in the accrued interest payable accounts and:			
a. Verify the computation of the amount.	______	______	______
b. Trace the offset to the related expense accounts (determine propriety of any offset not made to an expense account).	______	______	______

TESTS OF CONTROLS PROGRAMS — BANKS AND SAVINGS INSTITUTIONS SECTION X: SYSTEM B (Continued)

Procedure	Done By	Date	W/P Ref.
8. Other procedures: ______________________________			
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______________________________			
______________________________	________	________	________

Modification of analytical procedures and tests of balances, cross-reference to related tests of controls step above, and reasons therefor.

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Prepared by: ______________________________ Date: ______________
(In-charge)

Reviewed by: ______________________________ Date: ______________
(Engagement Partner)

Tests of Controls Programs— Banks and Savings Institutions

Section X: System C

Client: ______________________________

Financial Statement Date: ______________________________

MAJOR AUDIT AREAS:
1. Deposits—demand, savings and certificates of deposit.
2. Official checks.

TRANSACTION CYCLES:
1. Acceptance and maintenance of deposits.
2. Income and expense recognition.

Procedure	Done By	Date	W/P Ref.
Acceptance and maintenance of deposits			
1. Test the footings of or perform suppression tests of the general ledger deposit accounts.	______	______	______
2. Select a sample of ___ official check reconciliations made during the year, test foot the reconciliations, trace the reconciliation balance to the control account balance.	______	______	______
3. Other procedures: ______________________________ ______________________________ ______________________________ ______________________________ ______________________________	______	______	______
Income and expense recognition			
1. Select a sample of __ deposit accounts from the detail trial balances and verify that the rate of interest being paid and service charge code agrees with the customer's deposit account contract.	______	______	______

TESTS OF CONTROLS PROGRAMS — BANKS AND SAVINGS INSTITUTIONS SECTION X: SYSTEM C (Continued)

Procedure	Done By	Date	W/P Ref.
2. Scan daily deposit activity reports (file maintenance reports) for changes in interest rates or service charges made to individual accounts or certificates. Select a sample of ____changes and ascertain that the change was proper.	______	______	______
3. Agree or reconcile the detail accrued interest payable trial balances to the general ledger balances and test foot the detail trial balances.	______	______	______
4. Select a sample of ___ deposit accounts listed in the accrued interest payable trial balances and perform the following:			
a. Recompute the accrued interest balance.	______	______	______
b. Verify that the correct interest rate is being used.	______	______	______
5. Scan the accrued interest payable trial balances and investigate any unusual items.	______	______	______
6. Verify that deposit accounts selected under Income and Expense Recognition Test No. 1 are included in the trial balance tested under Income and Expense Recognition Test No. 3.	______	______	______
7. Select a sample of ___ credit entries in the accrued interest payable accounts and:			
a. Verify the computation of the amount.	______	______	______
b. Trace the offset to the related expense account (determine propriety of any offset not made to an expense account).	______	______	______
8. Other procedures:			
____			
____			
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____	______	______	______

TESTS OF CONTROLS PROGRAMS — BANKS AND SAVINGS INSTITUTIONS SECTION X: SYSTEM C (Continued)

Procedure	Done By	Date	W/P Ref.

Modification of analytical procedures and tests of balances, cross-reference to related tests of controls step above, and reasons therefor.

Prepared by: ______________________ Date: ______________
(In-charge)

Reviewed by: ______________________ Date: ______________
(Engagement Partner)

Internal Control Structure Questionnaire— Banks and Savings Institutions

Section XI

Client: ______________________________

Financial Statement Date: ______________________________

MAJOR AUDIT AREAS: Payroll

ACCOUNTING SYSTEMS (SYSTEM C)

1. Is a payroll journal prepared and balanced? ________ ___ ___
2. Are payroll disbursements made by check? ________ ___ ___
3. Are salaries and wages classified by category or department? ________ ___ ___
4. Are employees' time records maintained? ________ ___ ___
5. Are W-4 forms maintained? ________ ___ ___
6. Are employees' earnings records maintained? ________ ___ ___
7. Is a payroll bank account reconciliation prepared? ________ ___ ___
8. Are wage rates authorized by an officer (at least verbally)? ________ ___ ___

PRIMARY CONTROLS (SYSTEM B)

1. Are time cards prepared by employees? ________ ___ ___
2. Does an officer approve:
   a. Rates of pay? ________ ___ ___
   b. Withholdings? ________ ___ ___
   c. Changes in above? ________ ___ ___
3. Is the payroll bank account reconciliation prepared by someone independent of payroll preparation and check signing or by an officer? ________ ___ ___

INTERNAL CONTROL STRUCTURE QUESTIONNAIRE— BANKS AND SAVINGS INSTITUTIONS SECTION XI (Continued)

	Personnel	Yes	No
4. Are payroll checks prenumbered and accounted for?	______	___	___
5. Are checks recorded in the payroll journal as prepared?	______	___	___
6. Are payroll journals posted at least monthly to employees' earnings records?	______	___	___
7. Are payroll checks signed by an officer?	______	___	___
8. Are time cards approved by an officer?	______	___	___
9. Is the payroll bank account reconciliation approved by an officer?	______	___	___
SECONDARY CONTROLS (SYSTEM A)			
1. Is a time clock used to record time or is time logged by someone independent of payroll preparation, check signing, or distribution functions?	______	___	___
2. Is an imprest payroll bank account used?	______	___	___
3. Are payroll calculations checked by an independent person?	______	___	___
4. Are employees' earnings records periodically reconciled to the general ledger by persons independent of payroll preparation and distribution?	______	___	___
5. Are account codings reviewed by someone other than preparer?	______	___	___
6. Are adequate personnel files maintained?	______	___	___
7. Are payroll checks accounted for by a person independent of the preparation function?	______	___	___
8. Is payroll prepared by persons independent of time card approval, check signing, and check distribution?	______	___	___
9. Is payroll bank account reconciliation reviewed by an officer?	______	___	___
10. Are unclaimed payroll checks followed up on by an officer?	______	___	___

INTERNAL CONTROL STRUCTURE QUESTIONNAIRE— BANKS AND SAVINGS INSTITUTIONS SECTION XI (Continued)

Other comments:

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System selection (circle one):

System A[1]   System B[2]   System C[3]

Modification of standard tests:

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	19____	19____	19____	19____	19____
Prepared or updated by: In-charge	______	______	______	______	______
Reviewed by: Engagement Partner	______	______	______	______	______

[1] Represents a decision to assess control risk at a moderate or low level for most financial statement assertions.

[2] Represents a decision to assess control risk at a moderate level for some of the financial statement assertions.

[3] Represents a decision to assess control risk at the maximum or slightly below the maximum for most financial statement assertions.

Tests of Controls Programs— Banks and Savings Institutions

Section XI: System A

Client: ______________________

Financial Statement Date: ______________________

MAJOR AUDIT AREAS: Payroll tests.

TRANSACTION CYCLES: Payroll and personnel.

Procedure	Done By	Date	W/P Ref.
1. Observe that a time clock is used to record time or that time is logged by persons independent of payroll preparation, check signing, or distribution functions.	______	______	______
2. Examine evidence of double-checking payroll rates and calculations by an independent person.	______	______	______
3. Examine evidence of periodic reconciliation of employees' earnings records to general ledger by persons independent of payroll preparation and distribution.	______	______	______
4. Select __ payroll labor distributions and examine evidence that account codings are reviewed by someone other than preparer.	______	______	______
5. Select __ personnel files and examine written evidence of the following:			
a. Wage rate authorization.	______	______	______
b. W-4 form signed by the employee.	______	______	______
c. Withholdings authorizations signed by employee and approved by officer.	______	______	______
6. Examine evidence or observe that payroll checks are accounted for by a person independent of the preparation function.	______	______	______

TESTS OF CONTROLS PROGRAMS— BANKS AND SAVINGS INSTITUTIONS SECTION XI: SYSTEM A (Continued)

Procedure	Done By	Date	W/P Ref.
7. Examine evidence that the payroll bank account reconciliation is performed by a person independent of the preparation and distribution functions and is reviewed by an officer.	______	______	______
8. Select a sample of ___ series of ___ duplicate payroll checks and:			
a. Account for the numerical sequence.	______	______	______
b. Trace to payroll journal entries for name, date, and amounts.	______	______	______
9. Select a sample of ___ entries in the payroll journal, obtain cancelled checks, time cards (hours), and personnel files (rate and withholding information) and:			
a. Recompute gross pay. Scan withholdings and other deductions for reasonableness.	______	______	______
b. Examine time cards for approval by officer.	______	______	______
c. Examine check for signature of officer.	______	______	______
d. Examine or obtain officer approval of rates of pay and withholdings.	______	______	______
e. Compare signature on W-4 form to check endorsement.	______	______	______
f. Trace postings to employees' earnings records.	______	______	______
g. Check account classification.	______	______	______
10. Obtain ___ unissued payroll checks and control distribution to employees. Check the following:			
a. Proper identification.	______	______	______
b. Employee satisfaction with net pay computations.	______	______	______

TESTS OF CONTROLS PROGRAMS—
BANKS AND SAVINGS INSTITUTIONS
SECTION XI: SYSTEM A (Continued)

Procedure	Done By	Date	W/P Ref.
11. Other procedures: ____________________	______	______	______

Modification of analytical procedures and tests of balances, cross-reference to related tests of controls step above, and reasons therefor.

Prepared by: ______________________ Date: ______________
(In-charge)

Reviewed by: ______________________ Date: ______________
(Engagement Partner)

Tests of Controls Programs— Banks and Savings Institutions

Section XI: System B

Client: ______________________________

Financial Statement Date: ______________________________

MAJOR AUDIT AREAS: Payroll tests.

TRANSACTION CYCLES: Payroll and personnel.

Procedure	Done By	Date	W/P Ref.
1. Test by observation and inquiry that time cards are prepared by employees.	______	______	______
2. Test by observation and inquiry that time cards are approved by a supervisor or manager.	______	______	______
3. Test by observation, inquiry, and inspection that the manager approves rates of pay and withholding and changes thereto.	______	______	______
4. Examine evidence that the payroll bank account is reconciled by someone independent of payroll preparation, approvals, and check signing.	______	______	______
5. Examine evidence that payroll checks are prenumbered and accounted for.	______	______	______
6. Other procedures: ______________________________ ______________________________ ______________________________ ______________________________ ______________________________	______	______	______

TESTS OF CONTROLS PROGRAMS—
BANKS AND SAVINGS INSTITUTIONS
SECTION XI: SYSTEM B (Continued)

Modification of analytical procedures and tests of balances, cross-reference to related tests of controls step above, and reasons therefor.

Prepared by: ______________________ Date: ______________
(In-charge)

Reviewed by: ______________________ Date: ______________
(Engagement Partner)

Tests of Controls Programs— Banks and Savings Institutions

Section XI: System C

Client: ____________________

Financial Statement Date: ____________________

MAJOR AUDIT AREAS: Payroll tests.

TRANSACTION CYCLES: Payroll and personnel.

Procedure	Done By	Date	W/P Ref.
1. Review selected payroll journals and personnel records.	______	______	______
2. Other procedures:			
____________________			
____________________			
____________________			
____________________			
____________________	______	______	______

Modification of analytical procedures and tests of balances, cross-reference to related tests of controls step above, and reasons therefor.

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Prepared by: ____________________ Date: ____________________
(In-charge)

Reviewed by: ____________________ Date: ____________________
(Engagement Partner)

Internal Control Structure Questionnaire— Banks and Savings Institutions

Section XII

Client: ______________________

Financial Statement Date: ______________________

MAJOR AUDIT AREAS: Consigned Items

ACCOUNTING SYSTEMS (SYSTEM C)	Personnel	Yes	No
1. Are records maintained of serial numbers of consigned items held in the reserve supply and assigned to tellers as a working supply?	______	___	___
PRIMARY CONTROLS (SYSTEM B)			
1. Are shipments of consigned items opened and counted under dual control when received?	______	___	___
2. Are tellers' working supplies of consigned items stored in the vault during nonbusiness hours?	______	___	___
3. Are proceeds of sales credited to the issuing company daily?	______	___	___
4. Is the commission on sales of consigned items credited to income daily?	______	___	___
5. Are remittances sent regularly for all consigned items sold?	______	___	___
SECONDARY CONTROLS (SYSTEM A)			
1. Are reserve supplies of consigned items stored in a vault under dual control?	______	___	___
2. Are periodic inventories taken (by a supervisory employee) of consigned items on hand and compared to records maintained by the issuing company?	______	___	___

INTERNAL CONTROL STRUCTURE QUESTIONNAIRE— BANKS AND SAVINGS INSTITUTIONS SECTION XII (Continued)

Other comments:

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System selection (circle one):

System A[1] System B[2] System C[3]

Modification of standard tests:

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	19____	19____	19____	19____	19____
Prepared or updated by: In-charge	______	______	______	______	______
Reviewed by: Engagement Partner	______	______	______	______	______

[1] Represents a decision to assess control risk at a moderate or low level for most financial statement assertions.

[2] Represents a decision to assess control risk at a moderate level for some of the financial statement assertions.

[3] Represents a decision to assess control risk at the maximum or slightly below the maximum for most financial statement assertions.

Tests of Controls Programs — Banks and Savings Institutions

Section XII: Systems A, B, and C

Client: ____________________

Financial Statement Date: ____________________

MAJOR AUDIT AREAS: Consigned items.

TRANSACTION CYCLES: Consigned items.

Procedure	Done By	Date	W/P Ref.
1. Select a sample of __ consigned items and account for numerical sequence.	______	______	______
2. Select a sample of __ remittances for all consigned items sold and:			
a. Check that proceeds of the sale are credited to issuing company.	______	______	______
b. Check that commission on sales is credited on income.	______	______	______
3. Compare summary of periodic inventories taken of consigned items on hand to records maintained by the issuing company.	______	______	______
4. Other procedures:			
____________________			
____________________			
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____________________	______	______	______

TESTS OF CONTROLS PROGRAMS—
BANKS AND SAVINGS INSTITUTIONS
SECTION XII: SYSTEMS A, B, AND C (Continued)

Modification of analytical procedures and tests of balances, cross-reference to related tests of controls step above, and reasons therefor.

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Prepared by: ______________________ Date: ______________
(In-charge)

Reviewed by: ______________________ Date: ______________
(Engagement Partner)

Internal Control Structure Questionnaire— Banks and Savings Institutions

Section XIII

Client: ______________________________

Financial Statement Date: ______________________________

MAJOR AUDIT AREAS:
- Other Assets
- Capital Accounts
- Safe Deposit
- Night Depository
- Customer Safekeeping
- Trust Department
- Security and Record Preservation
- Currency Transactions and Bank Secrecy Act (BSA)
- File Maintenance

	Personnel	Yes	No
Other Assets			
1. Are detail records maintained that itemize the composition of each account?	______	___	___
2. Are these detail records balanced periodically to the general ledger control account?	______	___	___
3. Are supporting documents maintained for all entries to these accounts?	______	___	___
Capital Accounts			
1. Are stock certificates prenumbered consecutively?	______	___	___
2. Are unissued stock certificates held in a vault under dual control?	______	___	___
3. Are records maintained of issued stock certificates?	______	___	___
4. Are stockholder records periodically reconciled to the general ledger?	______	___	___
5. Are surrendered stock certificates promptly cancelled?	______	___	___

INTERNAL CONTROL STRUCTURE QUESTIONNAIRE— BANKS AND SAVINGS INSTITUTIONS SECTION XIII (Continued)

	Personnel	Yes	No
6. Is a stock transfer journal maintained indicating names, dates, and amounts of transactions?			
7. Are duties for preparing, signing, and distributing dividend checks segregated?			
8. Are blank dividend checks held in a vault under dual control?			
9. Are dividend checks reconciled in detail prior to mailing?			
Safe Deposit			
1. Is a lease on file for each safe deposit box in use, signed by the customer?			
2. Does the customer sign a receipt for the box keys received?			
3. Is the customer required to sign indicating termination of the box lease, receipt of all property, and release of liability?			
4. Are locks changed following all lease terminations, losses of keys, and deletions of authorized signers?			
5. Is each customer required to sign an access slip before entering their box?			
6. Does an employee witness the signing of all access slips and compare the signature to the lease agreements?			
7. Does an employee sign the access ticket indicating they observed the withdrawal and return of the box?			
8. Are employees prohibited from acting as deputies or accepting box keys for safekeeping?			
9. Are employees prohibited from assisting customers in examining the contents of their box?			
10. Are safe deposit booths inspected after each customer use?			
11. Are guard keys maintained under adequate control?			

INTERNAL CONTROL STRUCTURE QUESTIONNAIRE— BANKS AND SAVINGS INSTITUTIONS SECTION XIII (Continued)

	Personnel	Yes	No
12. Are flags attached to signature cards and boxes to indicate special circumstances (i.e., joint access, past due rent, court orders)?	________	___	___
13. Are forced openings of boxes witnessed by at least two employees?	________	___	___
14. Are contents of boxes forcibly opened immediately inventoried and the inventory listing signed by witnesses?	________	___	___
15. Are contents of boxes forcibly opened held under dual control?	________	___	___
16. Are keys to unrented boxes maintained under dual control?	________	___	___
17. Does the institution carry adequate safe deposit liability insurance?	________	___	___
Night Depository			
1. Are signed contracts on file for each night deposit bag issued by the institution?	________	___	___
2. Is the night deposit vault equipped with a dual locking mechanism (e.g., key and combination lock)?	________	___	___
3. Is the night deposit vault opened under dual control?	________	___	___
4. Are the contents of the vault listed and initialed by both parties of the dual control team?	________	___	___
5. Are all night deposit bags and envelopes opened and processed under dual control?	________	___	___
6. Are customers promptly notified of any differences?	________	___	___
7. Are customers required to sign for bags when they are picked up?	________	___	___
Customer Safekeeping			
1. Are signed agreements on file for all customer items held for safekeeping?	________	___	___
2. Are items held for safekeeping segregated from institution owned assets and held under dual control?	________	___	___

INTERNAL CONTROL STRUCTURE QUESTIONNAIRE— BANKS AND SAVINGS INSTITUTIONS SECTION XIII (Continued)

	Personnel	Yes	No
3. Are customers given receipts for items held in safekeeping?	______	___	___
4. Are safekeeping receipts prenumbered?	______	___	___
5. Is a record maintained of all entries to the safekeeping vault?	______	___	___
6. Are customers required to receipt for all safekeeping items returned to them?	______	___	___

Trust Department

	Personnel	Yes	No
1. Are invoices, distribution authorizations, and other supporting documents presented to officials for inspection simultaneously with the checks for signature?	______	___	___
2. Are supporting documents handled so as to prevent the likelihood of improper or duplicate payment?	______	___	___
3. Is the person who receives securities prevented from:			
a. Making cash disbursements?	______	___	___
b. Handling cash receipts?	______	___	___
c. Posting to the general ledger?	______	___	___
4. Does an officer authorize security purchases and sale orders with brokers?	______	___	___
5. Are securities and other trust assets under dual control of two or more persons?	______	___	___
6. a. Is a record of trust assets deposited or withdrawn from the vault prepared and signed by those depositing or withdrawing same?	______	___	___
b. Are such deposit and withdrawal tickets prenumbered and are all numbers accounted for?	______	___	___
7. Is one copy of each vault deposit and withdrawal ticket retained by a person other than the one receiving or delivering securities in the department?	______	___	___

INTERNAL CONTROL STRUCTURE QUESTIONNAIRE— BANKS AND SAVINGS INSTITUTIONS SECTION XIII (Continued)

	Personnel	Yes	No
8. Is so, are deposit or withdrawal tickets independently checked to:			
a. Record of proceeds of securities sold, beneficiaries' receipts, etc. with respect to withdrawals?	______	___	___
b. Cash disbursements, estate inventories, etc. with respect to deposits?	______	___	___
9. Is an independent record of securities in the vault maintained, by means of open vault deposit tickets, by the vault custodian or Auditing department?	______	___	___
10. Are copies of inventories of new trusts furnished to:			
a. Bookkeepers and the Auditing department by the trust officer receiving the trust?	______	___	___
b. The person handling the securities in the department?	______	___	___
11. a. Is an income tickler maintained?	______	___	___
b. Is an independent comparison made of income actually received with the income shown by the income tickler?	______	___	___
c. Are differences traced to conclusion?	______	___	___
12. Are all trusts reviewed by the trust committee yearly?	______	___	___

Security and Record Preservation

	Personnel	Yes	No
1. Has a security officer been designated by the Board of Directors?	______	___	___
2. Are security devices adequate to meet the needs of the institution?	______	___	___
3. Have the employees of the institution been instructed how to conduct themselves during and after a robbery?	______	___	___
4. Are vital records stored in fire-resistant containers?	______	___	___
5. Does the institution hold any customers' securities in safekeeping?	______	___	___

INTERNAL CONTROL STRUCTURE QUESTIONNAIRE— BANKS AND SAVINGS INSTITUTIONS SECTION XIII (Continued)

	Personnel	Yes	No
6. Does the institution have a program for record retention?	________	___	___
7. Obtain and review a copy of the record retention program.	________	___	___
8. Does the institution have a formal, documented disaster recovery plan for emergency operations?	________	___	___
9. Obtain and review a copy of the disaster recovery plan.	________	___	___
10. Was the computer backup tested within the last year?	________	___	___
Currency Transactions and Bank Secrecy Act (BSA)			
1. Obtain a copy of the Board approved BSA policy.	________	___	___
2. Who is the employee designated to administer the BSA?	________	___	___
3. Does the institution have regular training sessions with all effected employees?	________	___	___
4. Are new employees familiarized with the BSA?	________	___	___
5. Are periodic random checks of teller transactions performed to ensure compliance with reporting and recordkeeping regulations?	________	___	___
6. Does the institution report all currency transactions of more than $10,000 and near cash transactions (travelers checks, money orders, etc.) of more than $3,000 on Form 4789, Currency Transactions Report?	________	___	___
7. Are multiple currency transactions monitored and reported as if a single transaction?	________	___	___
8. Does the institution have any exempt depositors?	________	___	___
a. If yes, does the institution have an exemption form (application) prepared by the customer detailing the nature of the business, name, address, taxpayer IDN and the dollar limit of the exemption?	________	___	___

INTERNAL CONTROL STRUCTURE QUESTIONNAIRE— BANKS AND SAVINGS INSTITUTIONS SECTION XIII (Continued)

	Personnel	Yes	No
9. Are exempt accounts monitored to ensure exempt amounts are not being exceeded?	______	___	___
10. Does the institution report all reportable currency or monetary instrument transactions of more than $10,000 into or out of the United States on Form 4790, Report of International Transportation of Currency or Monetary Instrument?	______	___	___
11. Is the identity and address of individuals making reportable transactions verified by a drivers license or credit card?	______	___	___
12. Are Forms 4789 and 4790 filed within 15 days of the transaction with the IRS?	______	___	___
13. Do the institution's record retention policies comply with the minimum provisions of the BSA (Generally retain records five years)?	______	___	___

File Maintenance

	Personnel	Yes	No
1. Are employees restricted as to type of file maintenance they can perform?	______	___	___
2. Is a file maintenance report generated daily?	______	___	___
3. Is the report reviewed daily?	______	___	___
4. Is the review documented by the reviewer's signature and date?	______	___	___

Other comments:

____
____
____
____
____

INTERNAL CONTROL STRUCTURE QUESTIONNAIRE—
BANKS AND SAVINGS INSTITUTIONS
SECTION XIII (Continued)

System selection (circle one):

System A[1] System B[2] System C[3]

Modification of standard tests:

____

____

____

____

____

	19____	19____	19____	19____	19____
Prepared or updated by: In-charge	______	______	______	______	______
Reviewed by: Engagement Partner	______	______	______	______	______

---

1 Represents a decision to assess control risk at a moderate or low level for most financial statement assertions.

2 Represents a decision to assess control risk at a moderate level for some of the financial statement assertions.

3 Represents a decision to assess control risk at the maximum or slightly below the maximum for most financial statement assertions.

Tests of Controls Programs— Banks and Savings Institutions

Section XIII: Systems A, B, and C

Client: ______________________

Financial Statement Date: ______________________

MAJOR AUDIT AREAS: Other assets.
Capital accounts.
Safe deposit.
Night depository.
Customer safekeeping.
Trust department.

TRANSACTION CYCLES: Other assets.
Capital accounts.
Escrow.

Procedure	Done By	Date	W/P Ref.
1. Select a sample of ___ detailed records maintained that itemize the composition of each account and:			
a. Trace detailed records to general ledger control account.	______	______	______
b. Trace supporting documents for entries to these accounts.	______	______	______
2. Scan each account for ___ months and investigate large or unusual entries.	______	______	______
3. Select a sample of ___ stock certificates and:			
a. Account for numerical sequence.	______	______	______
b. Trace to stock transfer journal.	______	______	______
4. Examine surrendered stock certificates for cancellation.	______	______	______
5. Reconcile stockholder records to the general ledger.	______	______	______

TESTS OF CONTROLS PROGRAMS—
BANKS AND SAVINGS INSTITUTIONS
SECTION XIII: SYSTEMS A, B, AND C (Continued)

Procedure	Done By	Date	W/P Ref.
6. Select a sample of ___ dividend checks and:			
a. Examine checks for signature of officer.	______	______	______
b. Reconcile dividend checks to detail.	______	______	______
7. Select a sample of ___ leases and examine customer signature.	______	______	______
8. Select a sample of ___ box key receipts and examine customer signature.	______	______	______
9. Select a sample of ___ terminated leases and examine customer signature.	______	______	______
10. Select a sample of ___ access slips and:			
a. Examine customer signature and trace to lease agreement.	______	______	______
b. Examine employee signature indicating they observed withdrawal and return of the box.	______	______	______
11. Select a sample of ___ contracts for night deposit bags and examine customer signature.	______	______	______
12. Select a sample of ___ vault contents lists and examine initials of both parties of the dual control team.	______	______	______
13. Select a sample of ___ agreements on file and examine customer signature.	______	______	______
14. Select a sample of ____ customer receipts and account for numerical sequence.	______	______	______
15. Select a sample of ___ security purchases and sales orders and examine for authorized signature.	______	______	______
16. Select a sample of ___ vault deposit and withdrawal tickets and:			
a. Account for numerical sequence.	______	______	______

TESTS OF CONTROLS PROGRAMS—
BANKS AND SAVINGS INSTITUTIONS
SECTION XIII: SYSTEMS A, B, AND C (Continued)

Procedure	Done By	Date	W/P Ref.
b. Examine for customer signature.	______	______	______
c. Trace contents to record of proceeds of securities sold, beneficiaries' receipts, etc. with respect to withdrawals.	______	______	______
d. Trace contents to cash disbursements, estate inventories, etc. with respect to deposit.	______	______	______
17. Select a sample of ___ inventories of new trusts and:			
a. Trace to copies in the Bookkeeping and the Auditing Departments.	______	______	______
b. Trace to Trust Department copy.	______	______	______
18. Select a sample of ___ entries from the income tickler file and:			
a. Compare amount of income actually received with the income shown by the income tickler.	______	______	______
b. Investigate differences.	______	______	______
19. Other procedures:			
______________________________			
______________________________			
______________________________			
______________________________			
______________________________			
______________________________	______	______	______

TESTS OF CONTROLS PROGRAMS—
BANKS AND SAVINGS INSTITUTIONS
SECTION XIII: SYSTEMS A, B, AND C (Continued)

Modification of analytical procedures and tests of balances, cross-reference to related tests of controls step above, and reasons therefor.

Prepared by: ______________________ Date: ______________
(In-charge)

Reviewed by: ______________________ Date: ______________
(Engagement Partner)

5.300 INTERNAL CONTROLS OVER COMPUTER PROCESSING

5.301 SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit,* requires the auditor to obtain an understanding of an entity's internal control structure, including the controls over computer processing. This understanding of computer processing controls enables the auditor to design effective substantive tests. This section describes how the auditor can obtain this required understanding, and how it may be documented in the working papers. It also describes typical tests of computer processing controls.

As discussed in Chapter 1, section 1.356, the AICPA's Auditing Standards Board has released a proposed amendment to SAS No. 55 that would incorporate the definition and description of internal control found in the Committee on Sponsoring Organizations report, *Internal Control—Integrated Framework,* (the "COSO report") into SAS No. 55. It is not expected to result in a significant change in practice.

5.302 Today's computer environment is very diverse. Many entities use microcomputer systems to maintain all of their accounting records. Larger institutions use mainframe computers that are often linked to microcomputer work stations. This section may be used to evaluate the computer controls for clients that have a sophisticated computer system, as well as those that use microcomputers and purchased software products.

5.303 Paragraphs 5.304 through 5.306 explain the various types of computer controls that may be established by a client. Tests of computer controls are addressed in paragraphs 5.318 through 5.326. Paragraphs 5.327 through 5.337 describe the auditor's consideration of computer controls when a client has a significant accounting application that is processed by a service organization (e.g., a data processing service center, mortgage servicer, or benefit plan servicer). The following elements of documentation assistance are included in this section:

- The Microcomputer Questionnaire (section 5.315) — is designed to document the required understanding of computer processing controls in audit engagements in which the client's computer system is comprised of only microcomputers and purchased software products. If the computer system has some of the controls included in the Questionnaire, the procedures used to obtain an understanding of the computer processing controls will usually provide evidence that will support a lower assessed level of control risk.
- The General Computer Controls Questionnaire and the Application Computer Controls Questionnaire (sections 5.316 and 5.317) — designed to document the auditor's understanding of computer systems that are more sophisticated (e.g., when the client develops its own software).
- Service Organization Application Controls Questionnaire (section 5.338) — designed to document the auditor's understanding of the controls at a service organization when it is necessary to obtain and understand those controls and a service auditor's report is not available.
- The Service Auditor Report Evaluation Form (section 5.339) — designed to document the auditor's evaluation of the report of a service auditor when it is necessary to obtain an understanding of the controls applied at a service organization.

Computer System Controls

5.304 To evaluate a client's internal control structure, the auditor should have a general understanding of the different computer system controls. In this section the two major types of computer controls — general controls and application controls — are briefly described.

5.305 General controls affect all applications and include:

a. Adequate segregation of computer-related duties, e.g., computer operation, programming, and data input,

b. Controls over the development and testing of programs and systems,

c. Procedures to prevent unauthorized changes to existing programs and systems,

d. Controls over access to programs and data, and

e. Controls over computer operations.

5.306 Application computer controls are those that relate only to a specific accounting application, such as payroll. Application controls include those that relate to input, processing, and output of specific information. For example, application controls for payroll would include:

- Controls to ensure the accuracy of the input of hours and wage rates.
- Controls over the accuracy of payroll checks and reports, such as reconciliation of control totals, or supervisory review of checks and reports.

Practice Tip:

General controls affect all computer applications. If a client has weak general controls, the auditor generally cannot place any reliance on application controls.

Obtaining an Understanding of Computer System Controls

5.307 As a part of planning the audit, the auditor should identify those account balances, transaction classes, and disclosure components of the financial statements that involve significant computer processing. This will define the scope of the auditor's review of computer system controls. If the systems are very complex, it may be useful to prepare flowcharts documenting significant computer applications. The information in these flowcharts may be obtained from prior knowledge of the client's business, discussions with client personnel, and reference to prior year's workpapers.

Practice Tip:

Flowcharts generally should be prepared only when the computer system is very complex and the auditor is planning to assess control risk at a moderate or low level.

5.308 Procedures to Obtain Understanding. The auditor obtains an understanding of computer-related controls through procedures such as inquiry, observation, and inspection of documents. For example, to obtain an understanding of the design of the computer system used to generate the general ledger, the auditor may make inquiries of appropriate personnel about input, processing, and output control procedures, and inspect application software documentation. The auditor may inquire about data security and database backup procedures, and inspect any control reports or logs. The auditor also may observe users of the system in actual performance of their duties and review the resultant documents and records.

5.309 The nature and extent of the auditor's understanding will vary from client to client, and is influenced by the size and complexity of the client's computer system and procedures. The auditor's prior experience with the client and assessments of inherent risk and materiality of the various account balances and transaction classes may also effect the nature and extent of the audit procedures performed to obtain an understanding of the computer controls.

5.310 Documenting Computer System Controls. The Microcomputer Questionnaire (section 5.315) may be used to document the client's controls when the computer system consists of microcomputers and purchased software products. This is the only computer questionnaire that should be completed for such clients.

5.311 For clients with more sophisticated computer systems, the auditor may complete:

- The General Computer Controls Questionnaire (section 5.316)
- The Application Computer Controls Questionnaire (section 5.317)

5.312 The General Computer Controls Questionnaire documents controls over the client's computer system environment. The areas addressed include data processing management issues, systems development practices, and policies regarding end-user developed systems. If the client does not develop any application software internally, many of the questions in this questionnaire will not apply.

5.313 The Application Computer Controls Questionnaire is used to document the nature of each major computer application. The information prepared to document the understanding of the internal control structure elements will vary depending on the size and complexity of the client and its computer systems.

5.314 In some cases, the auditor may find it necessary to prepare additional materials to adequately document complex applications. Block diagrams, flowcharts, database structure listings, video display layouts (screen shots), and narratives are sometimes used to document the flow of transactions through a complex system. Copies of key input forms, computer prepared documents, and reports also may help to describe the nature of the computer processing. For very complex computer systems, the auditor should consider getting a computer specialist to participate in the review.

5.315

Microcomputer Questionnaire

Client: ______________________________

Financial Statement Date: ______________________________

INSTRUCTIONS:

This questionnaire should be used to document controls when a client uses microcomputers and one or more purchased, standard, UNMODIFIED accounting packages to process accounting information.

1. Names and models of computers: ______________________________

2. Name of operating system: ______________________________

3. Name and version of software:

   Package 1 ______________________________
   Package 2 ______________________________
   Package 3 ______________________________
   Package 4 ______________________________

4. Major reports generated from software:

   Package 1 ______________________________
   Package 2 ______________________________
   Package 3 ______________________________
   Package 4 ______________________________

5. Key operators and their responsibilities:

Key Operator	Responsibilities

MICROCOMPUTER QUESTIONNAIRE (Continued)

Are any of their duties incompatible?_____ Explain. ____

____

____

6. Describe any controls, such as user ID numbers, passwords and locking on/off switches that are used to prevent unauthorized access to programs and accounting data. ______________________________

____

____

____

7. Describe controls that insure that all transactions are processed and that the same data is not processed twice.

____

____

____

____

____

____

8. Are users adequately trained and provided with adequate instructions on how to use the computer system? Yes _________ No _________

9. Who is responsible for reviewing the reports generated from the microcomputer?

Report	Reviewer
______________________________	______________
______________________________	______________
______________________________	______________
______________________________	______________

10. Have procedures been developed for periodic back-up of files? ______________________________

____

11. Are backup files stored in a secure location? ______________________________________

____

12. Has management considered developing a disaster plan, including arrangements for emergency equipment, facilities, insurance, etc.? Yes ____ No ____

MICROCOMPUTER QUESTIONNAIRE (Continued)

13. Tests of Controls

> **Note:**
>
> The inquiry, observation, and inspection procedures used to obtain an understanding of the computer system are usually sufficient to support an assessment of control risk at less than the maximum.
>
> Additional tests should be performed only if the auditor wishes to further reduce the level of control risk.

Describe any *additional* tests of microcomputer controls performed (e.g., inspection of evidence of review of computer output):

____

____

____

____

____

14. Summary of Findings

Describe the major control strengths noted:

____

____

____

____

Describe the major control weaknesses noted:

____

____

____

____

15. The auditor's understanding of computer controls, and the results of the tests of controls should be considered in the auditor's assessment of control risk for all financial statement assertions that are affected by computer processing.

> **Note:**
>
> Computer processing controls usually have an impact on the existence, completeness, and dollar value of related transactions and balances. For example, if the client has good internal controls over processing of loans and cash receipts, the auditor may reduce the extent of the tests of existence, completeness and gross dollar value of loans receivable (e.g., the number of confirmations mailed may be reduced).

MICROCOMPUTER QUESTIONNAIRE (Continued)

	19____	19____	19____	19____	19____
Prepared or updated by:					
Client	________	________	________	________	________
In-Charge	________	________	________	________	________
Reviewed by:					
Engagement Partner	________	________	________	________	________

5.316

General Computer Controls Questionnaire

Client: ____________________

Financial Statement Date: ____________________

INSTRUCTIONS:

This questionnaire should be completed and updated annually to document controls that are global to the client's computer system environment. For each item, place a "✓" in the "Yes" or "No" column to indicate whether the procedure is performed or in the "N/A" column if the procedure is not applicable to the client's control system. When you've completed the questionnaire, review your "Yes" and "No" responses and determine how they impact your assessment of control risk. The effects of any "No" answers should be considered and documented in the space provided. Also, "No" answers should be considered for required communication of internal control structure related matters as material weaknesses and reportable conditions. (See Chapter 7 section 7.606.) **(If the client's computer system uses only unmodified software products and the system is not complex, this questionnaire should not be completed. See section 5.315 for the Microcomputer Questionnaire.)**

Organizational Controls

	Yes	No	N/A
1. If available, attach a copy of the management information systems (MIS) department organization chart.	___	___	___
2. Does the MIS department have adequate organizational status to be independent of the other organizational groups that it serves?	___	___	___
3. Have written job descriptions been prepared for all key positions in the MIS department?	___	___	___
4. Have procedures been established to ensure that MIS department employee qualifications are matched to the specific requirements for each employee's position?	___	___	___
5. Are system operations, input, database control functions, and system development activities performed by separate individuals?	___	___	___
6. Are operations personnel periodically rotated between jobs or applications?	___	___	___

GENERAL COMPUTER CONTROLS QUESTIONNAIRE (Continued)

	Yes	No	N/A
7. Are operations personnel required to take vacations?	____	____	____
8. Are operations personnel prohibited from initiating transactions or making master file (table) changes?	____	____	____
9. Are departments (groups) that initiate changes to database master information provided a report showing changes actually made?	____	____	____
Application Development Controls (includes standard spreadsheets, databases used for computer applications, Lotus programs, etc.)			
10. Have formal documentation standards and procedures been established?	____	____	____
11. Have standards for systems development and programming been developed?	____	____	____
12. Have formal operator and user instructions been developed?	____	____	____
13. Have formal program testing procedures been established for new applications and revisions to existing applications?	____	____	____
14. Are programs tested by persons independent of the programmer(s) who developed the software?	____	____	____
15. Are the data used for testing and the results of testing maintained for supervisory review and historical purposes?	____	____	____
16. Are personnel that test programs prohibited from testing new or revised programs on live data files?	____	____	____
17. Have procedures been developed for the documentation of requests for program changes?	____	____	____
18. Are program change requests approved in writing by a supervisory level person?	____	____	____

GENERAL COMPUTER CONTROLS QUESTIONNAIRE (Continued)

	Yes	No	N/A
Operations Controls			
19. Have procedures been established to monitor operator/user adherence to prescribed instructions?	______	______	______
20. Are adequate computer operation logs maintained for batch processing of transactions?	______	______	______
21. Are adequate computer controls (transaction logging, etc.) established over interactive processing of transactions?	______	______	______
22. Is a schedule prepared of applications to be processed, and reports and documents to be produced?	______	______	______
23. Are control procedures over report distribution adequate?	______	______	______
24. Have procedures been established to prohibit computer operators or users from having access to system or program logic documentation?	______	______	______
Data, Program and Facilities Backup Controls			
25. Have procedures been established for the periodic backup of critical data and programs from all centralized computers and file servers?	______	______	______
26. Is the backup media (diskettes, tapes, tape cartridges, etc.) stored at a secure location?	______	______	______
27. Have procedures been established for the restoring of backed up data and programs in the event of a system failure?	______	______	______
28. Has the client's ability to restore critical data and programs been tested?	______	______	______
29. Has a written disaster recovery plan been developed and have arrangements for emergency equipment and facilities been made?	______	______	______
30. If necessary, are virus tests performed on a regular basis?	______	______	______

GENERAL COMPUTER CONTROLS QUESTIONNAIRE (Continued)

31. Tests of Controls:

> **Note:**
>
> Inquiry observation, and inspection procedures are typically the only procedures that are used to test general controls. Therefore, the procedures used to obtain an understanding of the general controls are usually sufficient to support an assessment of control risk at less than the maximum.
>
> Additional tests should be performed only if the auditor wishes to further reduce the level of control risk.

Describe any additional procedures designed to test general computer controls:

____

____

____

____

____

32. Summary of Findings:

Describe the major control strengths in the general controls:

____

____

____

____

____

Describe the major control weaknesses in the general controls:

____

____

____

____

____

GENERAL COMPUTER CONTROLS QUESTIONNAIRE (Continued)

33. This evaluation of general computer controls and the evaluations of application computer controls should be considered in the assessment of control risk for the financial statement assertions that are affected by computer processing.

	19____	19____	19____	19____	19____
Prepared or updated by:					
In-Charge	________	________	________	________	________
Reviewed by:					
Engagement Partner	________	________	________	________	________

5.317

Application Computer Controls Questionnaire

Client: ______________________________

Financial Statement Date: ______________________________

INSTRUCTIONS:

This form should be completed and updated annually for each significant accounting application by the in-charge or a computer specialist, and reviewed by the engagement partner. Additional documentation obtained from the client, vendors, and others should be included in the workpapers with this form. **(If the client's computer system uses only unmodified software products and the system is not complex, this form should not be completed. See section 5.315 for the Microcomputer Questionnaire.)**

Attach copies of any computer input screens, input documents, and reports that are considered necessary to document the internal controls.

Application Name: ______________________________
System Name: ______________________________

Application Narrative: (describe in non-technical terms what the application does)

____
____
____
____

Describe how critical this application is to the mission of the client. Discuss the impact on the client of not having this application operational.

____
____
____
____

APPLICATION COMPUTER CONTROLS QUESTIONNAIRE (Continued)

Section 1 — Technology Employed by the Application

Computer Hardware

Mainframe (centralized) Computer: ______

File server(s): ______

Stand Alone Workstations: ______

Other Significant Hardware Devices (e.g. point of sale terminals, bar code readers, image scanners, etc.): ______

Systems Software

Mainframe (centralized) computer: ______

File server(s): ______

Stand Alone Workstations: ______

Application and Utility Software

Name (including version #): ______
Vendor: ______

Name (including version #: ______
Vendor: ______

APPLICATION COMPUTER CONTROLS QUESTIONNAIRE (Continued)

Name (including version #): ____________________
Vendor: ____________________

Name (including version #: ____________________
Vendor: ____________________

Section 2 — Application Database/File Structure

List the major master files/tables in the application and a brief description of their contents: ________

List the key transaction files/tables in the application and a brief description of their contents: ________

ATTACH COPIES OF EACH FILE OR TABLE STRUCTURE LISTING

Section 3 — Master File/Table and Transaction Entry

Describe the nature of the transaction including:

Significant Source Documents and Contents

Input Screens

Retention Policy

APPLICATION COMPUTER CONTROLS QUESTIONNAIRE (Continued)

Who is responsible for reviewing the completeness and accuracy of the input?

____
____
____
____

Describe forms, logs, reconciliation's, etc. used to control input.

Form	Description
____________	______________________________
____________	______________________________
____________	______________________________
____________	______________________________

Describe the controls established to insure that all transactions are processed and that the same data is not processed more than once.

____
____
____
____

Section 4 — Report, Query and Other Output

Describe the nature of computer output including:

Printed Documents

____
____
____
____

Listings, journals, subsidiary ledgers, ledgers, summaries, etc.

____
____
____
____

Control reports and listings

____
____
____
____

APPLICATION COMPUTER CONTROLS QUESTIONNAIRE (Continued)

Describe the tests made by accounting or user personnel to verify the accuracy of the information processed.

Describe the procedures for error correction and reprocessing.

Describe the retention policy.

Section 5 — Personnel

Identify all persons performing any computer or accounting function related to the application.

Name and Job Title	Related Duties

Do any of the above persons have other duties that are incompatible?

Is segregation of duties adequate for the application?

APPLICATION COMPUTER CONTROLS QUESTIONNAIRE (Continued)

Is cross-training of personnel adequate to provide for vacations, emergency leaves and unplanned terminations?

Section 6 — Custody of Assets and Authorization of Transactions

Do computer operations, programming or other computer systems personnel have access to client assets or the ability to authorize transactions?

Section 7 — Security

Describe how the following security features of the operating system and/or network operating system are implemented for this application.

Software:

User numbers and password protection

File and subdirectory user and group rights assignment

Hardware/Operating System:

Disk mirroring, duplexing, transaction tracking and other data protection and error recovery features.

APPLICATION COMPUTER CONTROLS QUESTIONNAIRE (Continued)

Describe any other security features

___

___

___

Section 8 — Tests of Controls:

> **Note:**
>
> The inquiry, observation, and inspection procedures used to obtain an understanding of the computer system are usually sufficient to support an assessment of control risk at less than the maximum.
>
> Additional tests should be performed only if the auditor wishes to further reduce the level of control risk.

Describe any additional procedures designed to test application computer controls:

___

___

___

___

___

___

Section 9 — Summary of Findings

The application computer controls analyzed in this questionnaire (in conjunction with your evaluation of general computer controls) should be considered in determining the assessed level of control risk for the related financial statement assertions.

Describe the effect of your understanding and the tests of controls performed on your assessment of control risk for the related financial statement assertions:

___

___

___

___

	19____	19____	19____	19____	19____
Prepared or updated by:					
Client	______	______	______	______	______
In-Charge	______	______	______	______	______
Reviewed by:					
Engagement Partner	______	______	______	______	______

Tests of Controls

5.318 In addition to obtaining an understanding of the internal control structure, the auditor may perform tests of controls. These tests provide evidential matter to support an assessed level of control risk below the maximum. Tests of controls may be directed toward the effectiveness of the design of internal control structure policies and procedures, or they may be directed toward the effectiveness of operation of the policies and procedures during the period under audit.

5.319 **Microcomputer Systems.** Tests of controls in a microcomputer environment are not significantly different from those in a manual accounting environment. Control over a microcomputer can be achieved in one of two ways:

- Adequate segregation of duties exists, and access to the computer system is controlled to prevent changes in programs and data by unauthorized employees, or
- Adequate segregation of duties does not exist or access to the computer system is not adequately controlled, but these weaknesses are mitigated by the fact that appropriate personnel perform a detailed review of the computer reports.

5.320 These controls can generally be tested with observation, inquiry, and inspection of computer reports. The Microcomputer Questionnaire (section 5.315) may be used to document the auditor's tests of controls in a microcomputer environment.

5.321 **Sophisticated Computer Systems.** In more sophisticated computer systems, the auditor will generally begin by testing general controls. If these controls are weak, no reliance can be placed on application controls.

5.322 General controls over computer systems are generally tested by observation, inquiry, and inspection of documents and control logs. Controls that are most significant include:

- Segregation of duties within the MIS department, so that individuals with knowledge of programs and programming language cannot make unauthorized changes in programs or data,
- Procedures for developing and testing, and implementing new programs, and
- Security controls to prevent unauthorized changes to data by users, e.g., passwords and control logs.

5.323 The procedures used to obtain an understanding of the general controls generally are sufficient to obtain evidence about their operating effectiveness.

5.324 Applications controls are designed to assure the accuracy and completeness of specific data. The controls that are most significant to the auditor include:

- Controls that prevent unauthorized changes to data, such as passwords, user numbers, and control reports,
- Controls that insure the accuracy of data input, such as validity tests of data as it is entered into the system, review of edit reports that summarize changes to data, and control totals,

- Procedures for correcting and reprocessing data that was entered incorrectly, such as follow-up procedures on computer error reports,
- Training of user personnel about how to input data, and
- Adequate user instructions (i.e., in user manuals).

5.325 Application controls in sophisticated computer systems can be tested in a number of ways. The most common approach to testing application controls is described below:

- Observation and inquiry about the use of passwords and the application of validity tests as actual data is entered,
- Inspection of computer output, including error reports and related follow-up,
- Inspection of documents that evidence the review of computer output by appropriate personnel, and
- Inquiry about the training of user personnel and inspection of user instructions.

5.326 The procedures performed in obtaining an understanding of application controls generally are sufficient to allow control risk to be assessed at a level below the maximum. If the client's general and application controls are very effective, these procedures may be sufficient to justify a moderate level of control risk for the related assertions. If the auditor wishes to further reduce the level of control risk, he or she may add tests of controls to the General Applications Computer Controls Questionnaires.

Processing of Transactions by Service Organizations

5.327 SAS No. 70, *Reports on the Processing of Transactions by Service Organizations,* provides guidance to the auditor when his or her client uses a service organization to process a significant application. The Statement also provides guidance for auditors who issue reports on the processing of transactions by service organizations for use by other auditors, but for purposes of this discussion, we will focus on the guidance for auditors whose clients use the service organization. In April 1995 an auditing interpretation of SAS No. 70 was issued which provides guidance for the user auditor when the service organization uses a subservice organization. See Chapter 1, section 1.353.

5.328 When auditing a client that uses a service organization, the auditor should consider the significance that the service organization's policies, procedures, and records have on the client's financial statements. Factors the auditor considers include:

- The financial statement assertions affected by the service organization's processing,
- The nature of the services provided by the service organization,
- The client's internal control policies and procedures that are applied to the transactions processed by the service organization and the availability of auditable data in the client's possession,
- The terms of the contract between the client and the service organization, and
- The service organization's capabilities, including its—

- Record of performance
- Insurance coverage
- Financial stability.

5.329 In many situations the client will have adequate controls over the data processed by the service organization. In these circumstances, there is no need to obtain an understanding of the controls at the service organization. As an example, a client that uses a service bureau to process payroll will usually have adequate controls to provide reasonable assurance that the service bureau is processing the payroll transactions accurately. These controls might consist of a review and testing of the payroll records that are received from the bureau.

5.330 An understanding of the controls at the service organization is generally needed only when the service organization both authorizes and processes transactions. An example of this organization would be a trust (e.g., a pension trust), in which the servicing financial institution makes investment decisions and maintains records of the transactions.

5.331 When the auditor decides that an understanding of the service organization's controls is necessary, this understanding may be obtained by:

- Reviewing manual or system documentation held by the client that describes the service organization's controls over the client's transactions, or
- Obtaining a report from a service auditor who performed procedures at the service organization for the benefit of multiple users.

5.332 In rare circumstances, the auditor may decide that it is necessary to perform procedures at the service organization to gain the required understanding of internal control.

5.333 If the auditor decides that an understanding of the controls at the service organization is necessary and a report by the service auditor is not available, he or she may complete the Service Organization Application Controls Documentation Form, shown in section 5.338.

5.334 If a service auditor report is available, it will be of one of the following two types:

- a report on policies and procedures placed in operation, or
- a report on policies and procedures placed in operation and tests of operating effectiveness.

5.335 **Report on Policies and Procedures Placed in Operation.** This report addresses the policies and procedures that the service organization has put into effect in the processing of the client's transactions. More specifically, it addresses (1) whether the policies and procedures were suitably designed to achieve specified control objectives, and (2) whether they have been placed in operation as of a specified date. This type of report is useful for obtaining an understanding of the controls at the service organization, but it does not provide evidence to reduce the assessed level of control risk.

5.336 **Report on Policies and Procedures Placed in Operation and Tests of Operating Effectiveness.** In addition to describing the service organization's controls over the client's transactions, this report addresses the effectiveness of the related controls during the period specified. Therefore, this type of report provides evidence that may allow the user auditor to reduce the assessed level of control risk.

5.337 **Evaluating the Service Auditor Report.** The Service Auditor Evaluation Form, shown in section 5.339, may be used to evaluate a service auditor report.

5.338

Service Organization Application Controls Questionnaire

Client: ______________________________

Financial Statement Date: ______________________________

INSTRUCTIONS:

This form should be used when (1) the service organization both authorizes and maintains records of significant transactions, and (2) there is no service auditor's report available. The information should be used to evaluate the need to visit the service center to perform a detailed evaluation of the center's internal controls, to document information obtained during the visit and to identify any material weaknesses for follow-up.

This form should be completed by the in-charge, or computer specialist and reviewed by the engagement partner.

Any weaknesses or strengths noted should be evaluated by the auditor in assessing control risk.

Section 1 — General Information

Name of service center: ______________________________

____

Address: ______________________________

____

Name of individual(s) in client's organization responsible for service center application:

____

____

____

____

Is there a formal agreement? _____ If so, obtain copy.

Is there insurance protection for the following:

1. Program or software destruction? _____

SERVICE ORGANIZATION APPLICATION CONTROLS QUESTIONNAIRE (Continued)

2. Loss of data? _____

3. Business interruption? ______

4. Errors and omissions? _____

Application Narrative: (describe in non-technical terms what the application does) ________________

Describe how critical this application is to the client. Discuss the impact on the client of not having this application operational. ________________

Section 2 — Technology Employed by the Application

Computer Hardware

Provide a general description of the service organization's hardware that is used to process client transactions: ________________

Systems and Application Software

Provide a general description of the service organization's systems and application software that is used to process client transactions: ________________

SERVICE ORGANIZATION APPLICATION CONTROLS QUESTIONNAIRE (Continued)

Section 3 — Transaction Entry

Describe the nature of the transaction including:

Significant Source Documents and Contents

Input Screens

Retention Policy

Who is responsible for reviewing the completeness and accuracy of the input?

SERVICE ORGANIZATION APPLICATION CONTROLS QUESTIONNAIRE (Continued)

Describe any forms, logs, reconciliations, etc. used to control input.

Form	Description

Describe the controls established to insure that all transactions are processed and that the same data is not processed more than once.

Describe how information is submitted to the service organization.

Section 4 — Report, Query, and Other Output Received From the Service Organization

Describe the nature of computer output including:

Printed Documents

SERVICE ORGANIZATION APPLICATION CONTROLS QUESTIONNAIRE (Continued)

Listings, journals, subsidiary ledgers, ledgers, summaries, etc.

Describe any tests made by service organization personnel to verify the completeness and the accuracy of the information processed.

Describe any tests made by user accounting or other user personnel to verify the completeness and the accuracy of the information processed.

Describe the procedures for error correction and reprocessing.

SERVICE ORGANIZATION APPLICATION CONTROLS QUESTIONNAIRE (Continued)

Section 5 — Information Retained by the Service Organization

Describe significant documents, transaction files, master tables/files, etc. retained by the service organization and the security and retention procedures employed.

Section 6 — Custody of Assets and Authorization of Transactions by the Service Organization

Describe the nature of service organization personnel's access to client assets and ability to authorize transactions.

Section 7 — Security

Describe the segregation of duties related to the processing of the client's transactions.

SERVICE ORGANIZATION APPLICATION CONTROLS QUESTIONNAIRE (Continued)

Describe how the following security features of the operating system and/or network operating system are implemented for this application.

User numbers and password protection

Describe any other security features.

Section 8 — Summary of Findings

Describe the major control strengths noted.

SERVICE ORGANIZATION APPLICATION CONTROLS QUESTIONNAIRE (Continued)

Describe the major control weaknesses noted.

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Note:

Additional tests should be performed only if the auditor plans to rely on the controls of the service organization in assessing control risk for the client.

Describe the effect of your understanding and the tests of controls performed on your assessment of control risk for the related financial statement assertions.

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	19____	19____	19____	19____	19____
Prepared or updated by: In-Charge	________	________	________	________	________
Reviewed by: Engagement Partner	________	________	________	________	________

5.339

Service Auditor Report Evaluation Form

Client: ______________________________

Financial Statement Date: ______________________________

INSTRUCTIONS:

This form should be used when (1) the service organization both authorizes and maintains records of significant transactions, and (2) there is a service auditor's report available.

This form should be completed by the in-charge or computer specialist and reviewed by the engagement partner.

Include a copy of the service auditor's report in the workpapers.

Section 1 — General Information

Name of service center: ______________________________

____

Address: ______________________________

____

Name of individual(s) in client's organization responsible for service center application:

____

____

____

____

____

Is there a formal agreement? _____ If so, obtain copy.

Is there insurance protection for the following:

1. Program or software destruction? _____
2. Loss of data? _____

SERVICE AUDITOR REPORT EVALUATION FORM (Continued)

3. Business interruption? ______

4. Errors and omissions? _____

Application Narrative: (describe in non-technical terms what the application does) ________________

Describe how critical this application is to the client. Discuss the impact on the client of not having this application operational: ________________

Section 2 — Service Auditor

Name of the service auditor: ________________

Does the Service Auditor have a good reputation? _______

Section 3 — The Service Auditor's Report

A. Describe the type of report issued by the service auditor. ________________

B. Describe the major control strengths in the service organization's processing.

C. Describe the major control weaknesses in the service organization's processing.

SERVICE AUDITOR REPORT EVALUATION FORM (Continued)

> **Note:**
>
> Section 3, item D, and Section 5 should be completed only if the auditor plans to rely on the controls of the service organization in assessing control risk for the client.

D. If the service auditor performed tests of the operating effectiveness of controls, identify those tests that will be relied upon in assessing control risk for the client.

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Section 4 — Client Involvement

Describe any control procedures performed by client personnel to test the accuracy of service organization processing.

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Section 5 — Summary of Findings:

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____

____

Describe the effect of your understanding and the tests of controls performed on your assessment of control risk for the related financial statement assertions:

	19____	19____	19____	19____	19____
Prepared or updated by: In-Charge	________	________	________	________	________
Reviewed by: Engagement Partner	________	________	________	________	________

5.400

Internal Control Structure Reportable Conditions Form–Banks and Savings Institutions

Client: ______________________________

Financial Statement Date: ______________________________

INSTRUCTIONS:

This form should be completed by the in-charge, or supervised staff, and reviewed by the engagement partner for all audit engagements. The information should be used to complete the required communication of internal control structure related matters and other matters.

The Internal Control Structure Questionnaire—Banks and Savings Institutions, any internal control flowcharts or narratives, and the results of tests of controls are the primary sources for identifying reportable conditions. Reportable conditions are significant deficiencies in the design or operation of the internal control structure, including the accounting system and primary and secondary controls, that could adversely affect the institution's ability to record, process, and summarize financial data consistent with management's assertions in the financial statements. Weaknesses should be classified as material or immaterial. Other operational or administrative suggestions may also be included on this form.

The form is designed to include the documentation source of the conditions, the audit areas affected by the conditions, and a format for writing comments.

Prepared by: ______________________________ Date: ____________________
(In-charge)

Reviewed by: ______________________________ Date: ____________________
(Engagement Partner)

REPORTABLE CONDITIONS

Documentation Source	Audit Areas Affected by Condition	Situation	Problem	Recommendation	Discussed With	Disposition

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References are to section numbers.

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