



Smart decisions. Lasting value.™

Virginia Bankers Association Internal Audit Seminar

December 1, 2020

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Introductions

A Little About the Class

- Name
- Bank/Company
- Years in Banking/Auditing/Security/Compliance
- Your Objective for Class
- Favorite Food
- Something FUN about YOU



Course Agenda

Course Agenda

- 9:00-10:40: Auditing the Lending Function
- 10:40-10:50: 10 minute break
- 10:50-11:40: Root Cause Analysis
- 11:40-12:40: Lunch
- 12:40-1:30: Remote Delivery of Internal Audit
- 1:30-2:20: Risk Trends at Financial Institutions
- 2:20-2:30: 10 minute break
- 2:30-3:20: Risk Assessments and Value-Add Audits



Auditing the Lending Function

Lending Audit Objectives

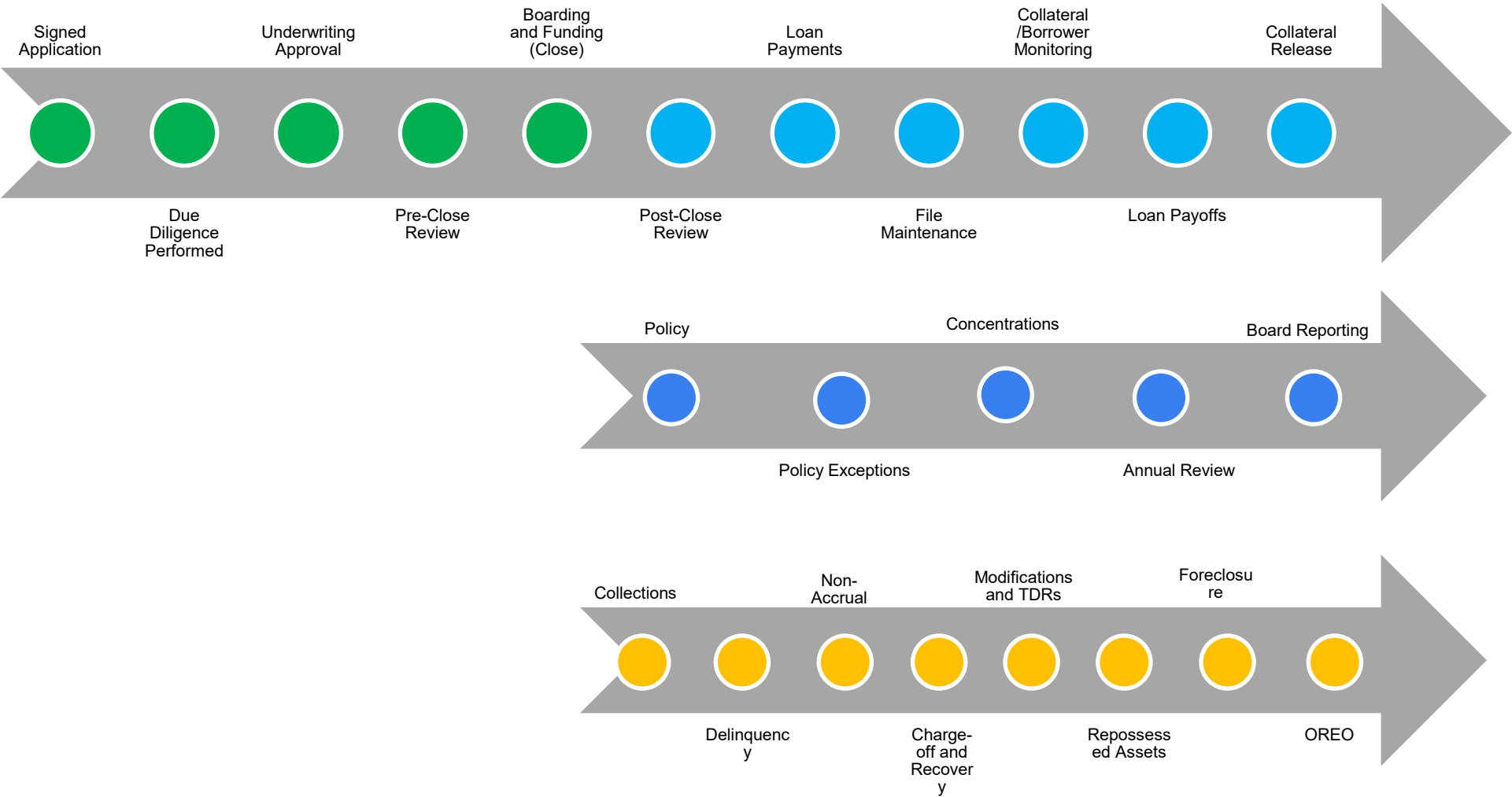
- Understand common exceptions related to the different areas of the lending function
- Determine appropriate controls for collateral and asset security
- Identify risk and controls related to different systems throughout the lending process
- Review and identify the appropriateness of portfolio management controls
- Financial Statement Disclosures

Polling Question #1

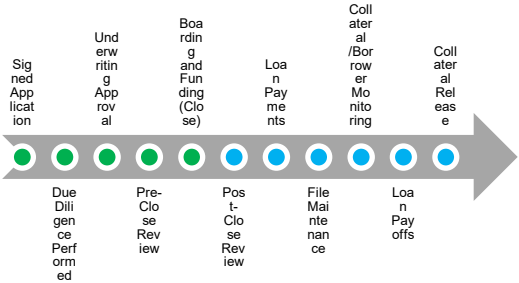
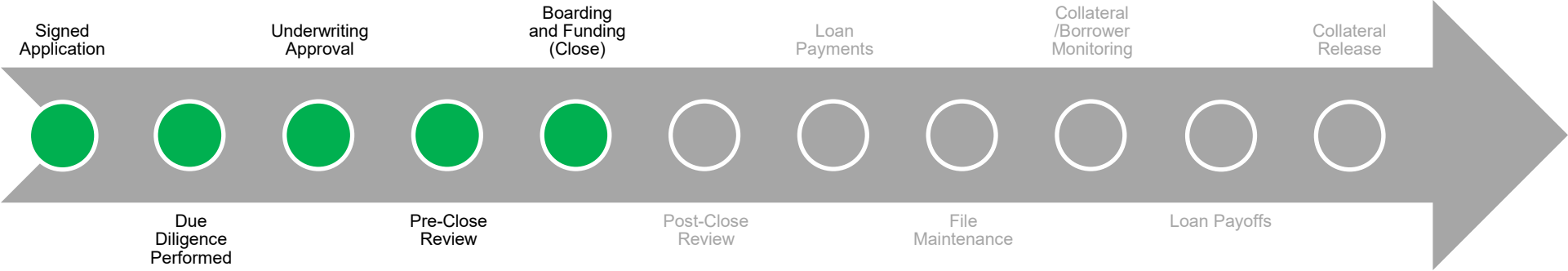
How comfortable are you when it comes to auditing the lending function?

- A. Not at all
- B. Only slightly
- C. Fairly comfortable
- D. Very comfortable

Lending Process



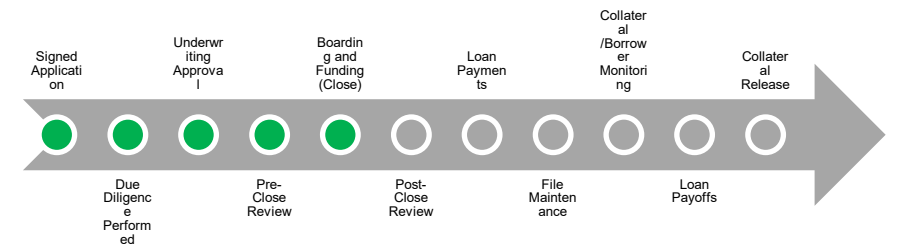
Loan Originations



Loan Originations – Underwriting and Approval

◦ Authorization

- Loan proceeds are disbursed without proper underwriting, complete documentation and/or approval
- Loans may be of lower loan quality and/or documentation may not be adequate to secure the bank's rights to repayment
- Complete loan documentation may not be obtained resulting in no legal rights to collect and/or inadequate collateral support in the event of default
- Loans may be of lower loan quality and/or documentation may not be adequate to secure the bank's rights to repayment



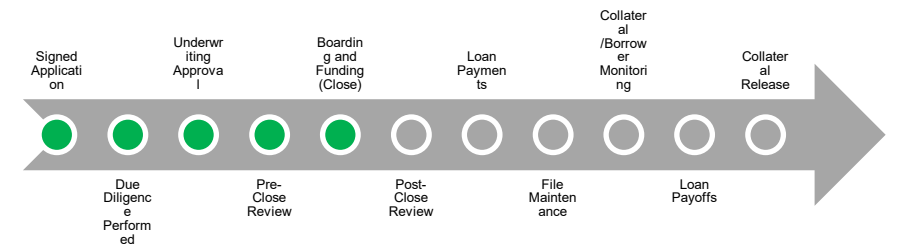
Example Loan Underwriting and Approval Controls

- Lending policy outlines approval procedures
 - Including approval limits
- Underwriting is comprehensive and based on policy guidelines
- Information may be utilized to submit a fictitious loan
- Reasonable loan officer lending limits established
- Underwriters are independent from the loan origination and booking

Loan Originations – Funding

◦ Access to Assets

- Proceeds are disbursed on loans that are not properly documented or are disbursed to fictitious loan customers
- Loan proceeds are disbursed to fictitious borrowers
- Loan proceeds may not agree to the note amount (higher) which could lead to financial loss
- Loan proceeds are disbursed without proper underwriting, complete documentation and/or approval



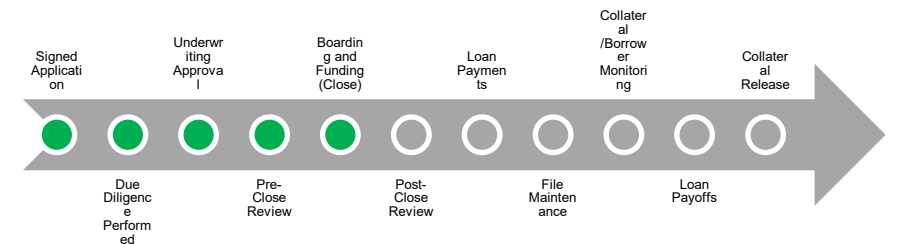
Example Loan Funding Controls

- Loan proceeds disbursed by check or direct deposit
- Disbursements are independent from loan approval and booking
- Limits are established and verified
- Set-up information independently verified for accuracy

Loan Originations – Boarding

- Completeness and Accuracy

- Loan proceeds are disbursed for incorrect amounts or to fictitious customers (funds vs note)
- Complete loan documentation may not be obtained resulting in no legal rights to collect and/or inadequate collateral support in the event of default
- Information in the loan system may not agree to the note leading to errors in billing



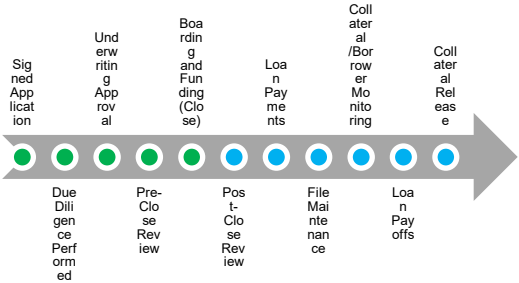
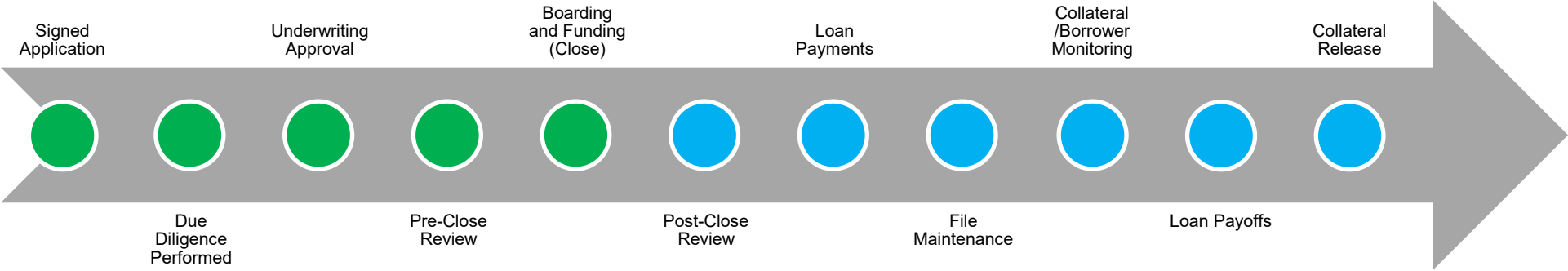
Example Loan Boarding Controls

- Set-up information independently verified for accuracy
- New loan report prepared/reviewed
- New loans reviewed for proper documentation
- Loan input may be automated or input into the loan servicing system through workflows/interface
- Loan files protected and organized
- Loans from general ledger reconciled to subsidiary ledger

Example Loan Origination Testing

- Document controls over set-up of new loans *also part of servicing*
- Test a sample of new loans for proper set-up
- Test adequacy of loan file documentation
- Confirm sample of loans directly with customers
- Test new loan report for completeness
- Test disbursement of proceeds
- Test reconciliation of loan principal account
- Others??

Loan Servicing



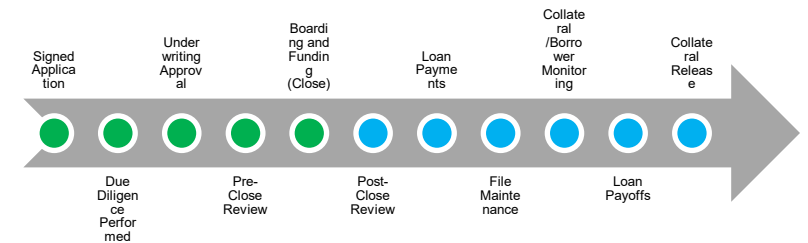
Loan Servicing – Post-Closing

- Authorization

- New account information may be recorded incorrectly or not recorded or a fictitious loan may be set up resulting in misstatement of loan and/or interest balance
- Notes, the bank's legal right to collect, may be misplaced/lost
- Complete loan documentation may not be obtained resulting in no legal rights to collect and/or inadequate collateral support in the event of default

- Completeness and Accuracy

- New account information is recorded incorrectly or not recorded resulting in misstatement of loan and/or interest balance
- Information needed to properly classify and describe loans within the financial statement and monitor loan portfolio risk may be missing



Example Post-Closing Controls

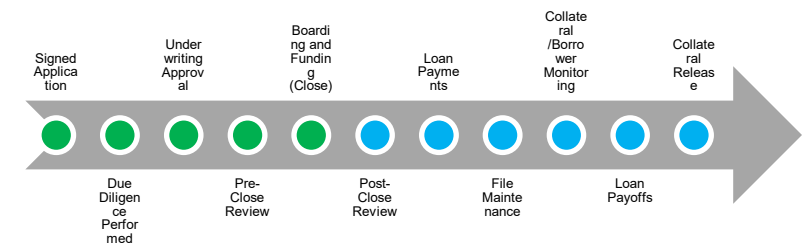
- Checklist(s) used to assure documentation is complete
- Follow-up of incomplete items
- Effective tickler system used for insurance, financing statements and financial statements
- Credit analysis performed and documented in loan files
- Controls over lines of credit which require annual review and pay-out
- Controls to prevent draws in excess of line-of-credit

Example Post-Closing Testing

- Document controls over loan file documentation, tickler system follow up, and lines of credit
- Test sample of loans for proper documentation
- Review loans for current financial information and other critical documentation
- Review lines-of-credit for annual renewal and annual payout
- Test lines-of-credit for advances over approval limit
- Others??

Loan Servicing - Payments

- Authorization
 - Payments are not recorded or are recorded incorrectly resulting in misstatement of loan and/or interest balance
- Completeness and Accuracy
 - Loan balances or accrued interest may be misstated due to errors in recording transactions or due to misappropriation of funds
- Substantiation of Balances
 - Loan balances or accrued interest may be misstated due to errors in recording transactions or due to misappropriation of funds
- Access to Assets
 - Payments are not recorded or are recorded incorrectly resulting in misstatement of loan and/or interest balance



Example Loan Payment Controls

- Receipt of payments restricted
- Payment tickets indicate person processing transaction
- Allocation of payment to principal and interest verified (or automated)
- Special controls for extensions and renewals
- Special payments are reviewed for accuracy



Example Loan Payment Testing

- Document controls over loan payment receipt and posting
- Recalculate principal and interest for a sample of payments
- Verify payment ticket indicates employee who accepted payment
- Test assessment of late charges
- Others??

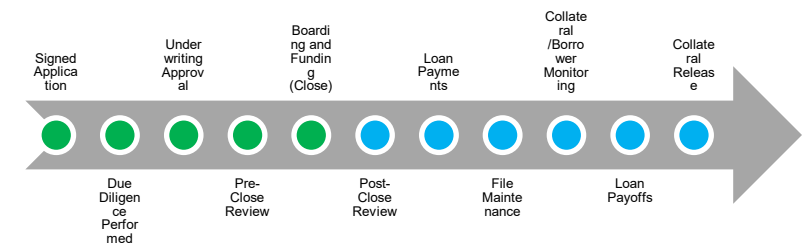
Loan Servicing – Payments (Interest & Fees)

- Completeness and Accuracy

- Loan balances, interest income or accrued interest may be misstated due to capitalization of interest
- Loan income may be intentionally or unintentionally misstated due to errors and omissions
- Loan fees are not amortized in accordance with accounting principals

- Authorization

- Loan income is not properly recognized and recorded
- Interest income or accrued interest may be intentionally or unintentionally misstated due to errors and omissions in processing or defalcations



Example Interest Income Controls

- Rates are input correctly by % and type (fixed or variable) *post-closing*
- Daily accruals calculated automatically and consistently
- General ledger accrued interest is reconciled to the subsidiary ledger daily
- Accrual discontinued based on established delinquency criteria
- System established to change rates in accordance with variable rate agreement

Example Interest Income Testing

- Document controls over calculation of interest
- Recalculate accrued interest receivable
- Calculate general ledger yields and determine reasonableness
- Verify interest discontinued on loans meeting non-accrual criteria
- Verify rate changes on adjustable rate mortgages
- Recalculate deferred loan fees/costs recognized
- Others??

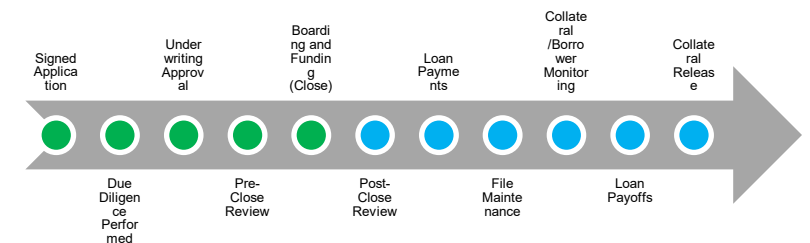
Loan Servicing – File Maintenance

- Authorization

- Account information may be recorded incorrectly or not recorded or a fictitious loan may be set up resulting in misstatement of loan and/or interest balance

- Completeness and Accuracy

- Account information is recorded incorrectly or not recorded resulting in misstatement of loan and/or interest balance
- Account information may be altered or a fictitious loan may be set up resulting in misstatement of loan and/or interest balance
- Information needed to properly classify and describe loans within the financial statement and monitor loan portfolio risk may be inaccurate



Example of File Maintenance Controls and Testing

- Controls

- Segregation of duties
- Accuracy of changes

- Testing

- Review sample
 - Walkthrough process
 - Documentation of segregation
 - Documented support for changes

Loan Servicing – Collateral Monitoring

- Valuation and Security

- Authorization

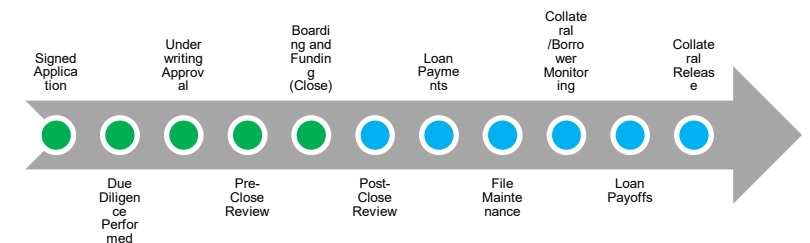
- Collateral securing loans may be inadequate, overvalued or inadequately secured resulting in inability to rely on collateral as a source of repayment in the event of default
 - Collateral may be released or misappropriated before the loan balance is fully paid off, resulting in lack of security for remaining balance

- Access to Assets

- Collateral securing loans may be lost or misappropriated, resulting in inability to rely on collateral as a source of repayment in the event of default

- Evaluation of Balances

- Collateral securing loans may be overvalued resulting in inability to rely on collateral as a source of repayment in the event of default



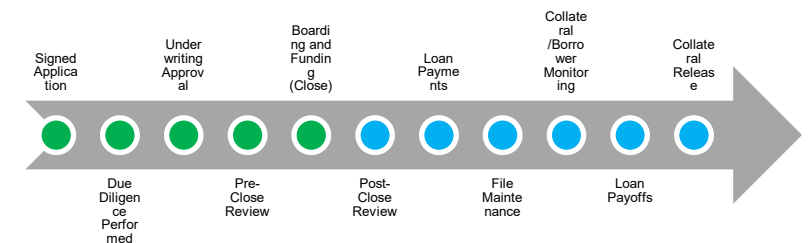
Loan Servicing - Reconciliations

- Authorization

- Loan balances or accrued interest may be intentionally or unintentionally misstated due to errors and omissions in processing or defalcations

- Substantiation of Balances

- Loan accounts are not properly or timely reconciled allowing intentional or unintentional misstatements to go undetected
- Loan commitments and guarantees may be made but not properly reported in the financial statements or properly monitored for credit or interest rate risk



Other – Financial Statement Disclosures

- Financial Statement Disclosures
 - Completeness and Accuracy
 - Financial statement disclosures are inaccurate or incomplete
 - Individuals gathering financial disclosure data do not understand the data requirements or intentionally misrepresent the data causing the information gathered to be inaccurate or incomplete
 - Data gathered is inaccurate or incomplete due to errors during the data gathering process



Other – Example Construction Loan Controls

- Controls are established to ensure draws do not exceed approved limits
- Disbursements are only made to authorized individuals
- Disbursements are only paid upon review of inspection reports, verbal title policy updates, and partial lien waivers from contractors or suppliers to substantiate collateral values and clear title
- Agreement terms as to refinancing and interest payments are followed
- Policies exist to ensure the exposure to "spec house" construction loans is limited



Example Construction Loan Testing

- Review a sample of construction loans and verify that balance on subsidiary does not exceed approved loan amount
- Confirm a sample of construction loans with borrowers, both disbursed and undisbursed balances
- Review a sample of construction loan files:
 - Vouch fund disbursements to properly signed and endorsed checks
 - Ascertain that prior to disbursements the loan officer obtained:
 - Inspection reports
 - Verbal title policy update
 - Partial lien waivers from contractors or suppliers.
 - Verify that principal and interest payments are being made in accordance with the agreement
 - Ensure for "spec house" construction loans that no more than a set number of "spec houses" will be financed for one builder

Other - Example Credit Card Controls

- All credit card loans are analyzed and underwritten in accordance with bank policies by authorized individuals
- Over line credit card balances are identified and monitored
- Credit card disputes are investigated by an individual independent of the credit card process and are resolved in a timely manner
- Appropriate due diligence is performed before accepting credit card merchant processing accounts



Example Credit Card Testing

- Assess the adequacy and completeness of the credit card department's procedures
- Review the credit card "over line" for any accounts in excess of bank policy
- Select a sample of <X> recent credit card disputes and verify the adequacy and completeness of resolution procedures
- Select a sample of <X> new merchant accounts and perform a review to determine whether the accounts were underwritten in accordance with policy and procedures and whether they were properly approved within the approver's authority

Other - Example Letters of Credit Controls and Testing

- Controls
 - Proper Approval
 - Collateral Perfection
 - Expiration Monitoring
- Testing
 - Review sample and test for -
 - Approval within officer limits
 - Collateral documentation in file or on suspense
 - Proper fee assessment and collection
 - Expiration monitoring



Other - Example Indirect Lending Controls

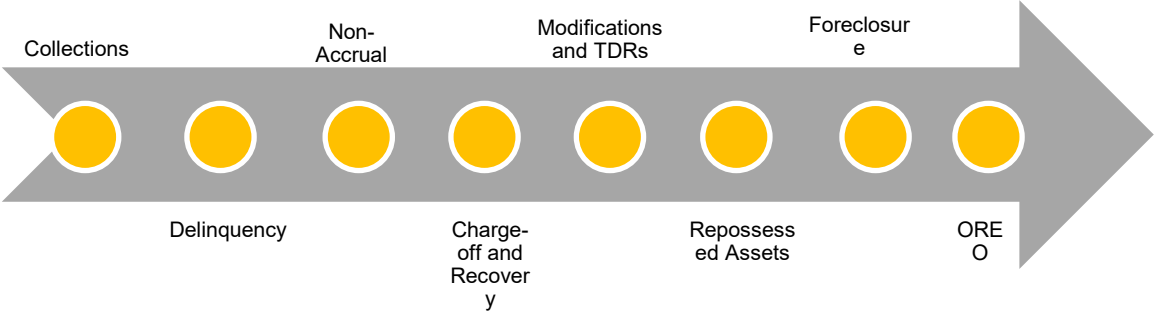
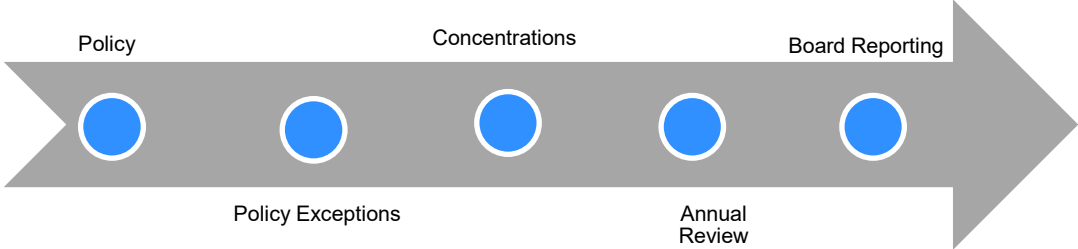
- Dealers are accepted into the indirect lending program according to Bank policies and procedures
- Dealer reserve transactions are executed and approved in accordance with Bank policy and procedures
- Dealer reserve account balances are monitored for sufficiency



Example Indirect Lending Testing

- Select a sample of <X> new Dealers and verify the Dealer Agreement has been properly signed and approved (including signed dealer reserve agreement); and, the Dealer has been appropriately approved by Senior Management and/or the BOD
- Review the process of establishing and monitoring dealer reserve balances
- Test <X> dealer reserve balances to ensure the balances maintained are per the agreement

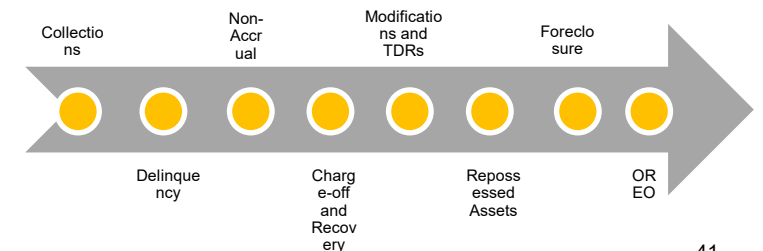
Credit Administration



Credit Administration – Troubled Credit Cycle

- Process from the time a loan moves from current pay status to delinquent through the collection process to sale of asset
- Includes:
 - Delinquency
 - Collections
 - Non-Accrual
 - Charge-off and Recovery
 - Modifications and TDRs
 - Foreclosed and Repossessed Assets

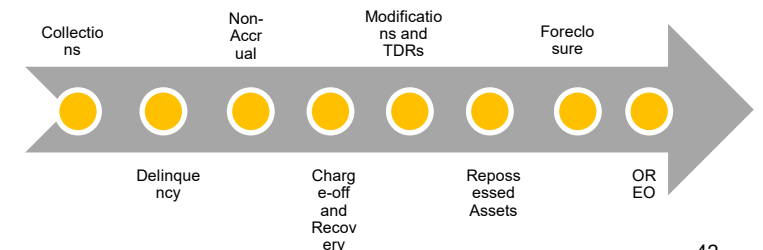
Allowance for Loan Losses



Credit Administration – Delinquencies

◦ Authorization

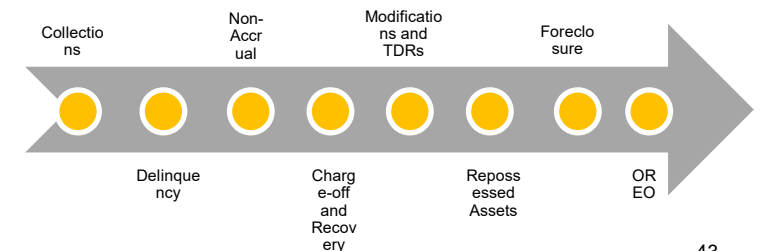
- Problem loans are not properly monitored and recorded, increasing the potential for loss and misstatement of the loan and income related accounts
- The established methodology for estimating the allowance for loan losses is flawed, not in accordance with accounting principles
- Accounting principles and significant assumptions in applying principles are not accurate or in accordance with management objectives
- Past-due account information is not provided, reducing potential for complete and timely repayment
- Problem loans or fictitious loans exist without timely detection, increasing the potential for loss



Credit Administration – Collections

◦ Authorization

- Collection efforts are not performed in accordance with management objectives, reducing potential for complete and timely repayments
- Collections on highly regulated loan types (i.e. mortgages) are not performed in accordance with government regulations
- Inadequate collection procedures reduce the potential for partial/complete recovery
- Loan accounts are not properly or timely reconciled allowing intentional or unintentional misstatements to go undetected



Example Delinquent Loan and Collection Controls

- Delinquent loan report reviewed
- Delinquent report independently generated
- Established and consistent criteria for reporting loan as delinquent
- Past due notices mailed independently
- Collection efforts on individual loans reviewed
- Status of collections are periodically reviewed by management and Board

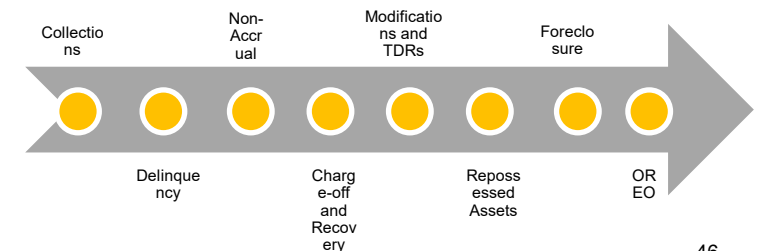
Example Delinquent Loan and Collections Testing

- Document controls over delinquent loans, including collections, past due notices, etc.
- Test delinquent loan report for accuracy and completeness
- Test loans that were 30+ days past due that were brought current before month-end (looking for loan interest capitalization)
- Test for extensions/renewals of delinquent loans (number of extensions, “evergreen loans”)
- Review collection process for independence
- Others??

Credit Administration – Non-Accrual

◦ Completeness and Accuracy

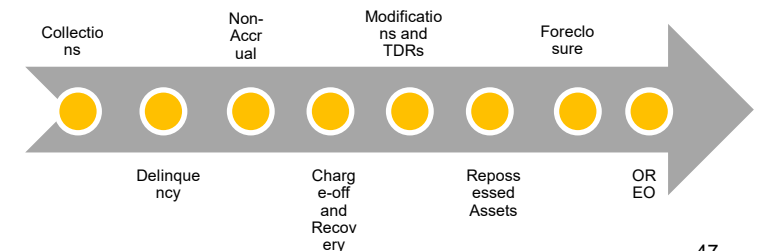
- Loan balances or accrued interest may be intentionally or unintentionally misstated due to errors and omissions in processing or defalcation
- Problem loans are not recorded properly resulting in misstatement of the loan and income related accounts
- Income is recognized improperly resulting in misstatement of AIP and income
- Records are not maintained of the actual principal balance owed by the borrower, reducing the potential for partial/complete collection



Credit Administration – Charge Off and Recoveries

◦ Authorization

- An incorrect amount is charged-off or fictitious account is charged-off
- The established methodology for estimating the allowance for loan losses is flawed, not in accordance with accounting principles
- Accounting principles and significant assumptions in applying principles are not accurate or in accordance with management objectives



Example Non-accrual, Charge-off, and Recovery Controls

- Loans are periodically (and timely) placed on nonaccrual status
- The loan policy establishes criteria for when delinquent loans should be charged off (i.e., number of days delinquent)
- Appropriate individuals are assigned the authority and responsibility for determining which loans should be placed on non-accrual status or returned to accrual status, and approving charge-offs of uncollectible loans
- Charged off loan subsidiary ledgers are posted and balanced by an individual independent of approval, disbursement functions and the collection of loan payments or recoveries
- Charged off loan subsidiary records are reconciled to the general ledger allowance for loan losses account to ensure that subsidiary records have been updated
- Periodic progress reports are prepared and reviewed by an appropriate individual and the Board of Directors on all loans charged off on which collection efforts are continuing

Example Non-accrual, Charge-off, Recovery Testing

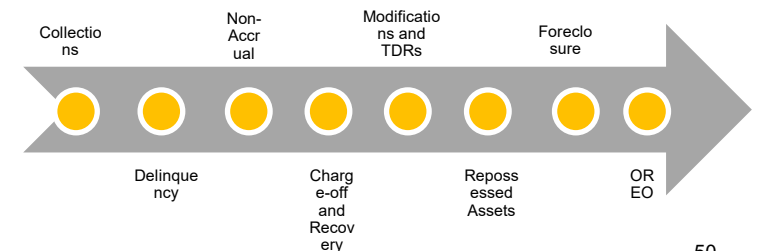
- Review loan policy to ensure charge off requirements (i.e., number of days delinquent)
- Review a sample of past due loans to ensure appropriate individuals authorized non-accrual status or return to accrual status
- Review a sample of charge-offs of uncollectible loans to ensure appropriate approval
- Review reports to the Board and management of loans in collection status. Ensure:
 - Accuracy and completeness of the report
 - That status of collections are periodically reviewed by management and Board
- Review the charged off loan subsidiary ledgers for:
 - Accurate posting and balancing by an individual independent of approval, disbursement functions and the collection of loan payments or recoveries
 - Reconciliation to the general ledger allowance for loan losses account to ensure that subsidiary records have been updated

Credit Administration – Modifications and TDRs

◦ Authorization

- Problem loans are not properly monitored and recorded, increasing the potential for loss and misstatement of the loan and income related accounts
- Loans are extended without re-assessment of the credit quality
- Inaccurate financial reporting – *specifically related to TDRs*

Critical during times of uncertainty



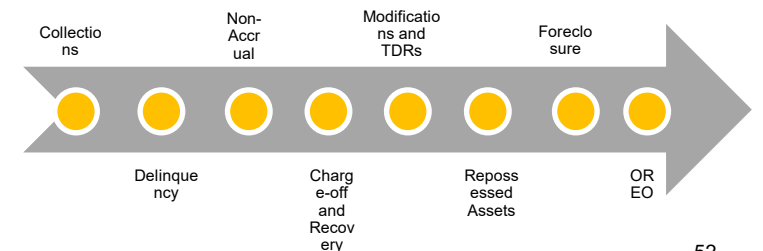
Example Modifications and TDR Controls

- Renewals and extensions are adequately reported
- Policy over renewals and extensions includes limits and processes for approval
- Delinquent loans are adequately reported to management and the Board
- Bank has a watch or problem loan list that is updated periodically
- Modifications and extensions are tracked

Credit Administration – Foreclosure and OREO

- Authorization

- Foreclosures are initiated prior to the allowed period/timeline
- Properties are acquired without validation of current value leading to inaccurate assets being booked in the balance sheet
- Expenses related to OREO properties may not be appropriately tracked
- Efforts to sale the properties may not be monitored which could lead to additional losses in the portfolio



Example Foreclosure and OREO Asset Controls

- Periodically analyzed to determine value of property
- Periodic appraisals/evaluations performed on all real estate owned
- Assets removed from loan trial balance when foreclosed/ repossessed
- Foreclosed/repossessed assets subsidiary is reconciled to general ledger at least monthly
- Subsequent sale - gain/loss is recorded appropriately
- Receipt of sales proceeds or rental income is adequately controlled - ensure return is maximized

Example Foreclosure and OREO Tests

- Document controls over foreclosed/reposessed assets
- Test values of foreclosed/reposessed assets to independent valuation
- Reconcile foreclosed/reposessed assets to subsidiary ledger
- Review assets to determine all deficient loan balances have been charged-off
- Vouch sales to supporting documents
- Review income from revenue-generating properties
- Others??

Other - Allowance Audit Approach

- Identify and document controls and procedures in place
- Design tests of the loan review system and the allowance system
- Consider trends, ratio analysis, peer comparison, concentrations, economic factors etc.



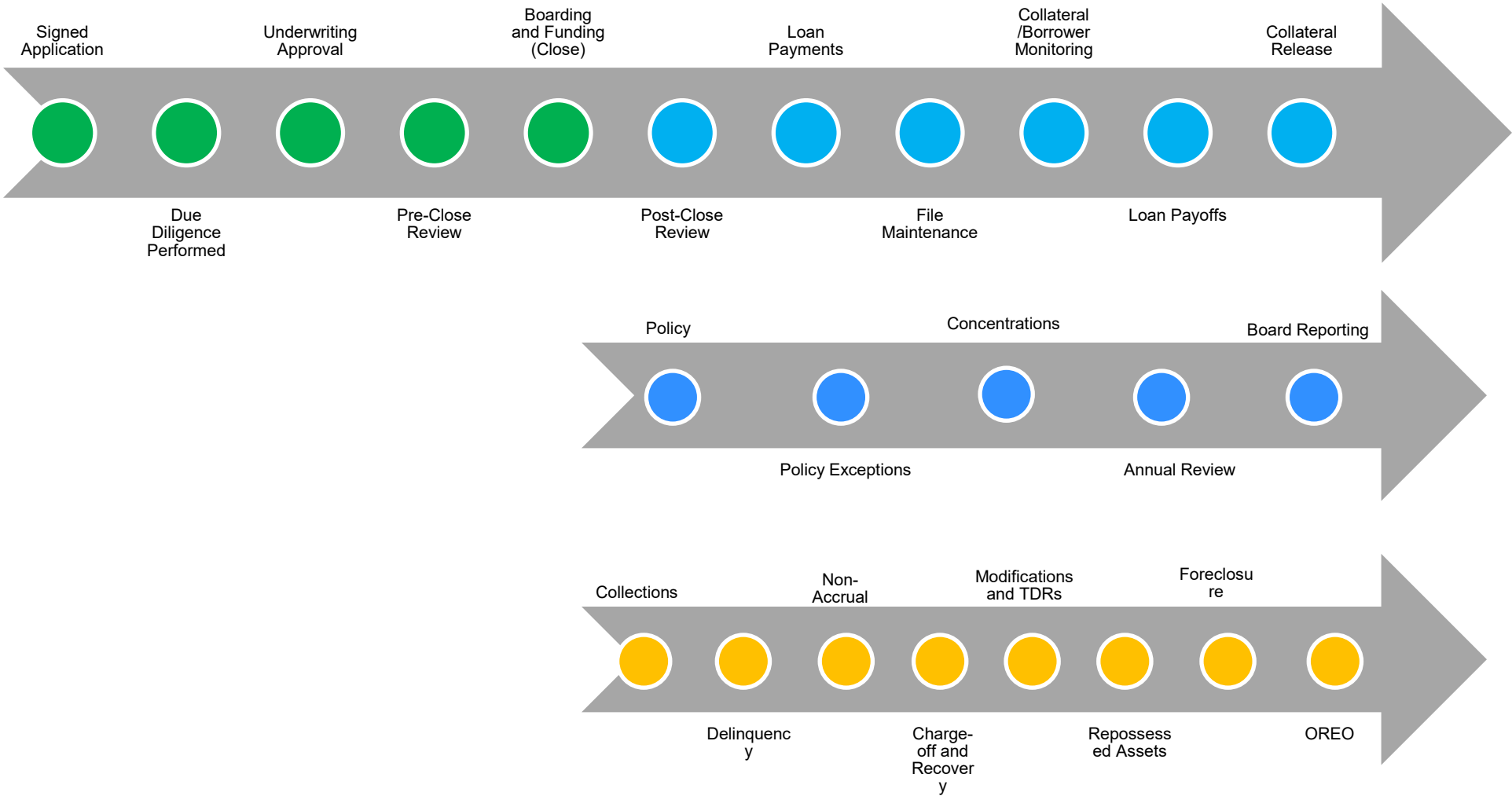
Example Controls for Allowance for Loan Losses

- Management has formal written procedures to determine the adequacy of the allowance
- Procedures are updated to reflect current economic trends
- Analysis is prepared by all loan officers, senior management or a loan review officer
- Analysis includes a review of problem loans for potential loss exposure
- Analysis includes allocations for loans not specifically evaluated
- Analysis takes into consideration potential losses on unused loan commitments, standby letters of credit, overdrafts and accrued interest

Example Allowance for Loan Losses Testing

- Document the process of completing the allowance calculation
- Test inclusion of potential problem loans in management's analysis
 - Classified loan report
 - Delinquent loan and nonaccrual loan report
 - Watch list, inquiry of management, etc.
- Test accuracy of delinquent loan report used in the preparation of the ALLL
- Review a sample of delinquent loans to determine if they should be charged off or, if still accruing, be placed on nonaccrual status and accrued interest reversed
- Review supporting schedules for ALLL calculations
- Determine whether methodology changed to reflect changing conditions

Lending Process





Mortgage Banking Function

Polling Question #2

How comfortable are you when it comes to auditing mortgage banking functions?

A. Not at all

B. Only slightly

C. Fairly comfortable

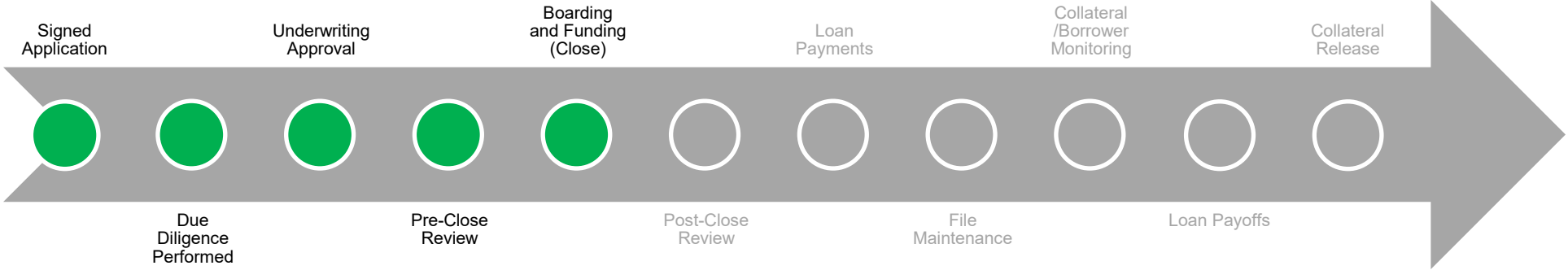
D. Very comfortable

Mortgage Origination

The creation of a new mortgage. Mortgage origination involves the necessary legal papers, the marketing of the mortgage to consumers, the qualifying of the buyer, the processing of the mortgage and the placement of the mortgage.

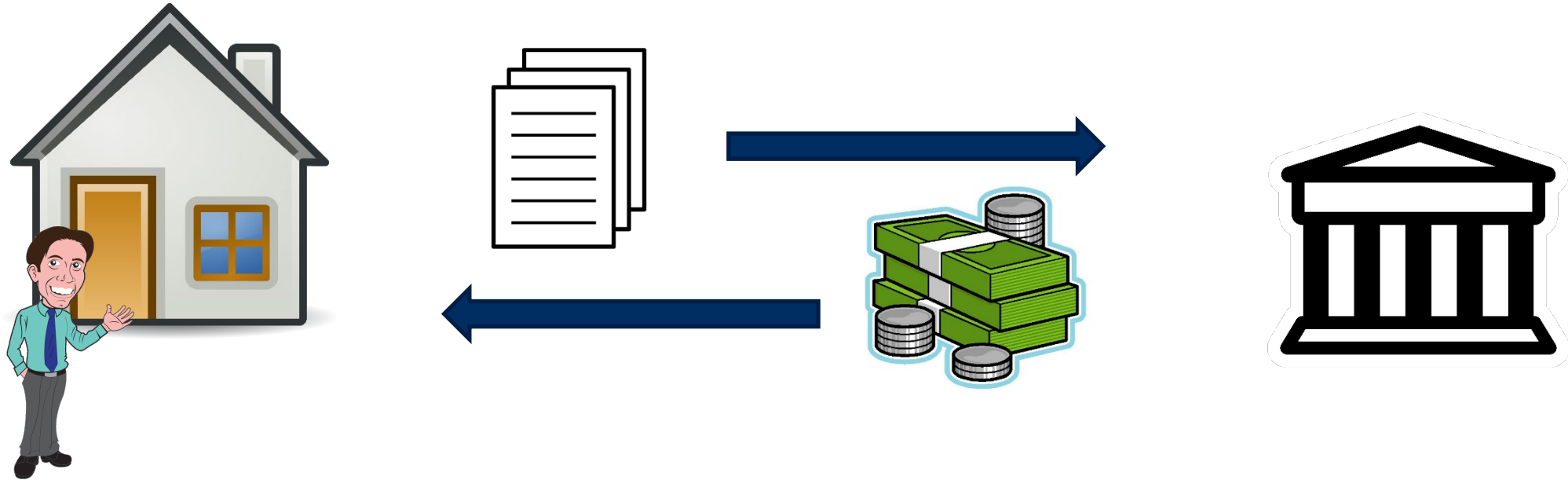


Loan Originations



Mortgage Origination – Business Objectives

- Banks or Lenders originate mortgage loans to create a profit from the interest charge and/or origination fees.



Mortgage Origination – Quality Control



RISKS

Systemic quality issues with mortgage loans originated are not identified in a timely or complete manner.



CONTROL POINTS

An independent quality control review is performed to verify for compliance with investor requirements. A report of the results is distributed to management; management response is required and corrective action plans are formed.

Mortgage Origination – Quality Control

DESIGN ASSESSMENT

- Through discussion of the control with management and review of the quality control review process, assess whether the control meets the following requirements:
 - a. Management independently (or through a third-party) performs a quality control review on at least a monthly basis
 - b. The quality control sampling methodology consists of both a random and discretionary sample
 - c. The results of the quality control reviews are discussed at senior management and/or Board of Directors meetings
 - d. The quality control reports highlight unusual items and trends
 - e. Management has a process in place to take any corrective action necessary as recommended by the quality control reports
- Document the client's control details with respect to the items listed above. Attach all relevant documentation used to support the control design.
- Perform a walkthrough to better substantiate your understanding of the control design.

Mortgage Origination – Quality Control

OPERATING EFFECTIVENESS ASSESSMENT

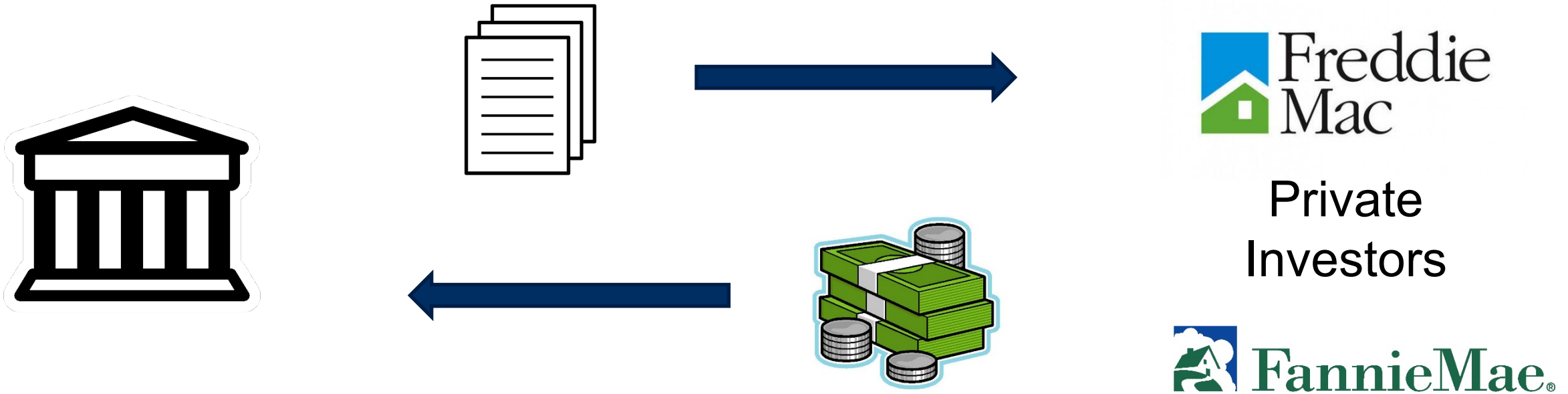
- Analyze the most recent quality control reviews performed as of the audit date to verify it meets the following criteria:
 - a. The quality control review highlights any unusual items or trends
 - b. If any exceptions were noted/corrected action recommended, management has since taken the necessary action
 - c. The results of the quality control reviews are discussed at senior management and/or Board of Directors meetings

Secondary Marketing

Buying and selling existing mortgage loans, which are often pooled and traded as mortgage-backed securities.

Secondary Marketing – Business Objectives

- Banks or Lenders sell mortgages to capture a profit and to release funds in order to lend further.



- The profit is created via the interest rate difference between the originated loan



Secondary Marketing- Investor Management



RISKS

Institution lacks the appropriate outlets to sell originated mortgage loans resulting in losses; this is due to the lack of investors or appropriate investors for the business originated.



CONTROL POINTS

The Board of Director's and Management has established policies and procedures to ensure that the appropriate number and type of investors are utilized to support originations and strategic direction.

Secondary Marketing- Investor Management

DESIGN ASSESSMENT

- Through discussion of the control with management and review of the product offering investor agreement approval, assess whether the control meets the following requirements:
 - a. Management maintains a formalized policy that contains a list of approved investors
 - b. Management maintains a formalized policy that establishes guidelines and authority to approve new investors
 - c. Management has a formalized, annual review process for any policy revisions or to review that the current policy is correct, accurate, and acceptable
- Document the client's control details with respect to the items listed above. Attach all relevant documentation used to support the control design.
- Perform a walkthrough to better substantiate your understanding of the control design.

Secondary Marketing- Investor Management

OPERATING EFFECTIVENESS ASSESSMENT

- Analyze the institution's Secondary Marketing Policy and verify that it meets the following criteria:
 - a. List of approved investors
 - b. Guidelines for the approval of new investors
- Using the policy approval documentation, verify that the policy was approved by the Board of Directors or Board-appointed committee within the last calendar year. The meeting minutes should clearly indicate a unanimous vote to approve the policy.

Secondary Marketing- Investor Management



RISKS

Institution fails to understand and comply with all investors requirements and/or the contractual obligation is outside the risk tolerance desired. Legal fees and related losses may also be incurred in the event of a dispute.



CONTROL POINTS

Management maintains all investor agreements which outline roles, responsibilities, and investor requirements.

Secondary Marketing- Investor Management

DESIGN ASSESSMENT

- Through discussion of the control with management and review of the investor agreement process, assess whether the control meets the following requirements:
 - a. Management has a formalized process to execute investor agreements
 - b. Management review investor agreements to verify they outline roles, responsibilities, and investor requirements.
- Document the client's control details with respect to the items listed above. Attach all relevant documentation used to support the control design.
- Perform a walkthrough to better substantiate your understanding of the control design.

Secondary Marketing- Investor Management

OPERATING EFFECTIVENESS ASSESSMENT

- Test a sample of new investors added during the audit cycle verify that they meet the following criteria:
 - a. Evidence that they have been approved by an individual with appropriate authority as is outlined by the institution's policies and procedures
 - b. The agreement has been executed by an individual with appropriate authority as is outlined by the institution's policies and procedures
 - c. The agreement outlines roles, responsibilities, and investor requirements
 - d. The agreement has been executed by both a member of the institution and a member from the investor

Secondary Marketing- Investor Management



RISKS

Institution fails to understand and comply with all investors requirements and/or the contractual obligation is outside the risk tolerance desired. Legal fees and related losses may also be incurred in the event of a dispute.



CONTROL POINTS

Underwriters review to ensure loans are sold and underwritten to approved investors and in accordance with their established guidelines.

Secondary Marketing- Investor Management

DESIGN ASSESSMENT

- Through discussion of the control with management and review of the investor agreement process, assess whether the control meets the following requirements:
 - a. Underwriters are trained on how to underwrite loans to be sold to new investors
 - b. Underwriters review to verify loans meet the requirements outlined in investor agreements
- Document the client's control details with respect to the items listed above. Attach all relevant documentation used to support the control design.
- Perform a walkthrough to better substantiate your understanding of the control design.

Secondary Marketing- Investor Management

OPERATING EFFECTIVENESS ASSESSMENT

- Test a sample of mortgage loans originated during the audit cycle and verify that they meet the following attributes:
 - a. The loan was reviewed by an underwriter qualified for the investor and loan type.
 - b. The underwriter documented that the loan met the conditions set forth in the investor agreement and/or guidelines.

Secondary Marketing- Pricing and Profitability Management



RISKS

Interest margins and fee income are not sufficient to profitability.



CONTROL POINTS

Management monitors profitability to ensure appropriate interest margins (between note rate and investor paid rates) and fee income. The profitability review also serves to ensure that a 'best pricing' approach is utilized in the placing of loans with investors.

Secondary Marketing- Pricing and Profitability Management

DESIGN ASSESSMENT

- Through discussion of the control with management and review of the profitability analysis process, assess whether the control meets the following requirements:
 - a. Management performs a review of profitability analysis on a monthly basis
 - b. The report is compiled and reviewed by individuals independent of the secondary marketing function
 - c. Management reviews for unusual items/trends which are researched and explained
 - d. Management reports the analysis to senior management and/or the Board of Directors
- Document the client's control details with respect to the items listed above. Attach all relevant documentation used to support the control design.
- Perform a walkthrough to better substantiate your understanding of the control design.

Secondary Marketing- Pricing and Profitability Management

OPERATING EFFECTIVENESS ASSESSMENT

- Analyze the institution's most recent profitability analysis report as of the audit verify that it meets the following criteria:
 - a. Any unusual items/trends are explained
 - b. The report was compiled by an individual independent of the secondary market function
 - c. The analysis and findings have been reported to senior management and/or the Board of Directors

Secondary Marketing- Hedging Activities



RISKS

Pipeline is not properly hedged leaving the institution exposed to greater than desired interest rate risk.



CONTROL POINTS

If management relies upon an automated system for hedging, all inputs and assumptions are periodically reviewed. The hedging reports are also reviewed by management to ensure proper oversight of the model and/or vendor. If a vendor, a SSAE-16 or other report is utilized to ensure proper user end controls have been implemented.

Secondary Marketing - Hedging Activities

RISKS

- Pipeline is not properly hedged leaving the institution exposed to greater than desired interest rate risk.

CONTROL POINTS

- If management relies upon an automated system for hedging, all inputs and assumptions are periodically reviewed. The hedging reports are also reviewed by management to ensure proper oversight of the model and/or vendor. If a vendor, a SSAE-16 or other report is utilized to ensure proper user end controls have been implemented.

Secondary Marketing - Hedging Activities

DESIGN ASSESSMENT

- Through discussion of the control with management and review of the hedge management process, assess whether the control meets the following requirements:
 - a. Management performs a review of model inputs and assumptions on at least a quarterly basis
 - b. Management obtains and reviews an SSAE 16 on an annual basis for the hedge management system to verify that proper user end controls are established
- Document the client's control details with respect to the items listed above. Attach all relevant documentation used to support the control design.
- Perform a walkthrough to better substantiate your understanding of the control design.

Secondary Marketing - Hedging Activities

OPERATING EFFECTIVENESS ASSESSMENT

- Analyze the institution's hedge management system and verify that it meets the following criteria:
 - a. Management has reviewed the model input and assumptions for hedging and pipeline management within the quarter
 - b. Management has obtained an SSAE 16 for the system within the past year and reviewed for user-end controls

Secondary Marketing- Hedging Activities



RISKS

Pipeline is not properly hedged leaving the institution exposed to greater than desired interest rate risk.



CONTROL POINTS

Management manually reviews the pipeline and hedging reports to calculate and determine proper hedging amounts and strategies. Risk limits are established within respect to the hedging of the portfolio. These are monitored daily by qualified individuals but also reported to senior management to ensure proper oversight and accountability within respect to the established limits

Secondary Marketing- Hedging Activities

DESIGN ASSESSMENT

- Through discussion of the control with management and review of the pipeline and hedge management process, assess whether the control meets the following requirements:
 - a. Management performs a review of pipeline and hedging reports on a frequent basis to calculate proper hedging amounts and strategies
 - b. Management monitors the pipeline and hedging reports on a daily basis to verify that hedging strategy is within established limits set forth in policy.
 - c. Management reports hedging strategy to senior management and/or the Board of Directors on a monthly basis
- Document the client's control details with respect to the items listed above. Attach all relevant documentation used to support the control design.
- Perform a walkthrough to better substantiate your understanding of the control design.

Secondary Marketing- Hedging Activities

OPERATING EFFECTIVENESS ASSESSMENT

- Analyze the institution's hedge management system and verify that it meets the following criteria:
 - a. Management has reviewed the model input and assumptions for proper hedging amounts and strategy within the last month
 - b. Management has monitored the pipeline and hedging reports on a daily basis to verify that hedging strategy is within established limits set forth in policy
 - c. Current hedging strategy is within established limits set forth in policy
 - d. Management has reported hedging strategy to senior management and/or the Board of Directors within the last month

Secondary Marketing- Loan Delivery



RISKS

Loans are not delivered in the investor required timeframe resulting in buy-backs and purchase delays



CONTROL POINTS

Management tracks and monitors to ensure timely delivery of loan file documentation to an investor. Loans over 30 days outstanding are elevated and an action plan is formulated.

Secondary Marketing- Loan Delivery

DESIGN ASSESSMENT

- Through discussion of the control with management and review of the loan delivery process, assess whether the control meets the following requirements:
 - a. Management adequately reviews, monitors, and tracks the outstanding loan documentation reports to verify timely delivery
 - b. Management verifies the completeness and accuracy of the loan delivery reports
 - c. If any items are outstanding greater than 30 days or miss their delivery date, they are escalated to management and action plans are formed.
- Document the client's control details with respect to the items listed above. Attach all relevant documentation used to support the control design.
- Perform a walkthrough to better substantiate your understanding of the control design.

Secondary Marketing- Loan Delivery

OPERATING EFFECTIVENESS ASSESSMENT

- Analyze the loan delivery tracking reports as of the audit date and verify that they contain the following information:
 - a. The name of the borrower
 - b. Individual missing documents
 - c. The deadline for delivery;
 - d. The number of days since loan closing; and
 - e. The status of the delivery.
- Analyze the same report and verify the following:
 - a. No documents haven't missed their delivery deadline date
 - b. If there have been documents that missed their delivery deadline date, verify the exceptions have been reported to management
 - c. If there have been documents that missed their delivery deadline date, verify the institution has not incurred any hold-backs from the investor as a result of non-delivery.
- Additionally, review a sample of documents outstanding greater than 30 days to verify that they have been reported to management and that an action plan has been formed
- Auditor Note: This test can be performed in conjunction with RESMOR-C16-TS01 and RESMOR-C17-TS01

Secondary Marketing- Pipeline Management



RISKS

Hedging activities and other volume based metrics cannot be properly managed due to poor or nonexistent tracking of mortgage fallout activity; this results in financial losses.



CONTROL POINTS

Management has defined an acceptable fallout (pull-through) ratio within Policy. Management formally monitors and tracks fallout ratios by product type and/or branch on a periodic basis.

Secondary Marketing- Pipeline Management

OPERATING EFFECTIVENESS ASSESSMENT

- Analyze the institution's Secondary Marketing Policy and verify that it meets the following criteria:
 - a. Acceptable pull-through (fallout) ratio; or
 - b. Documentation of a hedging strategy if not solely based on pull-through ratio.
- Review the most recent senior management and/or Board Meeting minutes to determine that pull-through (fallout) ratio is both discussed and meets policy guidelines. If any differences exist, investigate that they were discussed by management
- Using the policy approval documentation, verify that the policy was approved by the Board of Directors or Board-appointed committee within the last calendar year. The meeting minutes should clearly indicate a unanimous vote to approve the policy.

Secondary Marketing- Warehouse Management



RISKS

Improper warehouse management results in the inability to access liquidity to fund origination activities.



CONTROL POINTS

Management monitors warehouse inventory reports on a frequent basis for turnover and aging. Warehouse loans exceeding 30 days are elevated to management and an action plan is formulated.

Secondary Marketing- Warehouse Management

DESIGN ASSESSMENT

- Through discussion of the control with management and review of the warehouse inventory monitoring process, assess whether the control meets the following requirements:
 - a. Management adequately reviews, monitors, and tracks the applicable warehouse inventory reports for aging
 - b. All loans held greater than 30 days are escalated to management and an action plan is developed
 - c. Management verifies that no loans are held greater than 90 days without supporting and valid rationale.
- Document the client's control details with respect to the items listed above. Attach all relevant documentation used to support the control design.
- Perform a walkthrough to better substantiate your understanding of the control design.

Secondary Marketing- Warehouse Management

OPERATING EFFECTIVENESS ASSESSMENT

- Test a sample of warehouse inventory reports as of the audit date and verify that they meet the following criteria:
 - a. Evidence that they have been monitored and reviewed by management
 - b. Loans held greater than 30 days have been escalated to management and an action plan has been formed
 - c. No loans have been held for greater than 90 days
 - d. If any loans have been held greater than 90 days, management maintains valid documentation and rationale to support the maintaining of the loan for the extended period of time as held-for-sale

Secondary Marketing- Warehouse Management



RISKS

Warehouse Investor and/or Mortgages Held for Sale GL data is inaccurate leading to inaccuracies in the financial statements and the environment in which fraud can occur and not be detected.



CONTROL POINTS

A reconciliation is periodically performed to verify warehouse inventory data versus the mortgage held for sale general ledger accounts to ensure accuracy and completeness.

Secondary Marketing- Warehouse Management

DESIGN ASSESSMENT

- Through discussion of the control with management and review of warehouse inventory and mortgage held-for-sale general ledger account reconciliations, assess whether the control meets the following requirements:
 - a. Reconciliations are prepared by individuals independent from the transaction authorization or recording functions
 - b. Reconciliations are reviewed by individuals independent from the transaction authorization or recording functions
 - c. Reconciliations are prepared timely (7 days daily, 30 days monthly)
 - d. Reconciliations are reviewed timely (7 days daily, 30 days monthly)
 - e. Reconciling items are researched and cleared in a timely manner (30 days daily, 90 days monthly)
 - f. Management has an established process to escalate any issues such as unknown reconciling items
 - g. Management has an established process to charge-off reconciling items
- Document the client's control details with respect to the items listed above. Attach all relevant documentation used to support the control design.
- Perform a walkthrough to better substantiate your understanding of the control design.

Secondary Marketing- Warehouse Management

OPERATING EFFECTIVENESS ASSESSMENT

- Test a sample of reconciliations as of the audit date and verify that they meet the following criteria:
 - a. The reconciliation was prepared by an individual independent from the transaction authorization or recording function
 - b. The reconciliation was reviewed by an individual independent from the transaction authorization or recording function
 - c. The reconciliation was prepared timely (7 days daily, 30 days monthly)
 - d. The reconciliation was reviewed timely (7 days daily, 30 days monthly)
 - e. No stale items are present (30 days daily, 90 days monthly)
 - f. No unknown items (not dated or explained) are present
 - g. No items unrelated to the purpose/nature of the account are present
 - h. The general ledger balance per the reconciliation traces to the supporting statement/subsidiary ledger
 - i. The reconciliation was footed for accuracy
- Additionally, select a sample of reconciling item and verify that they meet the following criteria:
 - a. Documentation exists that supports the origination of the item
 - b. Documentation exists that supports the final disposition of the item
 - c. If the item has not cleared, support exists as to the rationale why the item has not cleared or been charged-off

Secondary Marketing- Warehouse Management



RISKS

Financial statements are not accurate as loans are not recorded as at a value that is in accordance with accounting standards.



CONTROL POINTS

Mortgage loans held for sale are held at cost or at fair market value. The calculation of the value or cost amount is reviewed for accuracy and completeness by someone who did not prepare the calculation. Based upon these adjustments, the general ledger is adjusted to the balance per the calculations. An independent person reviews these recorded entries back to source documentation.

Secondary Marketing- Warehouse Management

DESIGN ASSESSMENT

- Through discussion of the control with management and review of the fair market value calculation and recording process, assess whether the control meets the following requirements:
 - a. An individual independent from the calculation process reviews that the calculation was appropriately supported.
 - b. An individual independent from the recording process reviews that the general ledger entries were appropriately recorded.
- Document the client's control details with respect to the items listed above. Attach all relevant documentation used to support the control design.
- Perform a walkthrough to better substantiate your understanding of the control design.

Secondary Marketing- Warehouse Management

OPERATING EFFECTIVENESS ASSESSMENT

- Test a sample of valuation calculations and associated general ledger entries recorded during the audit cycle and verify they meet the following criteria:
 - a. The calculation was reviewed by an independent person; the reviewer evaluated that the valuation was properly supported.
 - b. The fee recorded through the general ledger entry traces to source documentation (i.e. valuation).
 - c. The individual who recorded the general ledger entry is independent of the valuation process.

Secondary Marketing- Settlement



RISKS

Accounting for loans sold to investors may be inaccurate or result in loss of due funds if settled loans are not properly recorded.



CONTROL POINTS

An individual independent of the loan sale process verifies that trade executions are properly recorded. If operating in a mandatory sales environment, this include placement of forward commitments to sell loans and execution of hedging activities.

Secondary Marketing- Settlement

DESIGN ASSESSMENT

- Through discussion of the control with management and review of the loan sale process, assess whether the control meets the following requirements:
 - a. An individual independent from the loan sale process verifies that trade executions are properly recorded by tracing to supporting documentation, including verifying the loan was sold to a Board-approved investor
- Document the client's control details with respect to the items listed above. Attach all relevant documentation used to support the control design.
- Perform a walkthrough to better substantiate your understanding of the control design.

Secondary Marketing- Settlement

OPERATING EFFECTIVENESS ASSESSMENT

- Test a sample of loan sales during the audit cycle and verify they meet the following criteria:
 - a. The sale was executed by an individual with BOD-approved trading authority.
 - b. The sale was reviewed/approved by a second individual with BOD-approved trading authority.
 - c. The confirmation is received and verified against the trade log by someone independent of the trade execution.
 - d. The data on the trade ticket agrees with the data on the trade log (entered to the system correctly).
 - e. The sale was executed with a BOD-approved investor.

Secondary Marketing- Settlement



RISKS

Fees for pair-off activity are not properly management;
resulting in losses related to the activity that impact
overall profitability.



CONTROL POINTS

Management formally monitors and tracks pair-off
activity; the pair-off fees are tracked to ensure sustained
profitability within the mandatory commitment
environment.

Secondary Marketing- Settlement

DESIGN ASSESSMENT

- Through discussion of the control with management and review of the pair-off fee reporting process, assess whether the control meets the following requirements:
 - a. Management maintains a formalized process to monitor, track, and report all pair-off fees.
- Document the client's control details with respect to the items listed above. Attach all relevant documentation used to support the control design.
- Perform a walkthrough to better substantiate your understanding of the control design.

Secondary Marketing- Settlement

OPERATING EFFECTIVENESS ASSESSMENT

- Test for evidence that an independent individual has periodically prepared reports of pair-fees associated with mortgages sold and those reports are monitored by management.

Secondary Marketing- Settlement



RISKS

The gains or losses on the sale of mortgage loans are not booked accurately; resulting in financial misstatements.



CONTROL POINTS

To review for proper booking on the gains or losses from the sale of mortgage loans; a report from the loan origination system (or other system utilized to originate and sell loans) is reconciled to the general ledger account utilized to fund the closing of mortgage loans. Discrepancies are identified and researched with Mortgage. Due to the nature of mandatory and bulk sales; management may implement a tolerance level in discrepancies rather than absolute agreement.

Secondary Marketing- Settlement

DESIGN ASSESSMENT

- Through discussion of the control with management and review of the gain/loss on sale recording process, assess whether the control meets the following requirements:
 - a. An individual independent from the recording process, reviews that gains/losses associated with mortgages sold are accurately recorded
 - b. The reviewer verifies that income is realized in accordance with accounting standards
- Document the client's control details with respect to the items listed above. Attach all relevant documentation used to support the control design.
- Perform a walkthrough to better substantiate your understanding of the control design.

Secondary Marketing- Settlement

OPERATING EFFECTIVENESS ASSESSMENT

- Test for a sample during the audit cycle and verify the following criteria:
 - a. An independent person (one segregated from recording) reviewed for proper recording of gain/loss on sale entries.
 - b. Evidence that entries were reviewed to source documentation
- Test a sample of gain/loss entries recorded during the audit cycle and verify they meet the following criteria:
 - a. The fee recorded through the general ledger entry traces to source documentation.

Mortgage Servicing

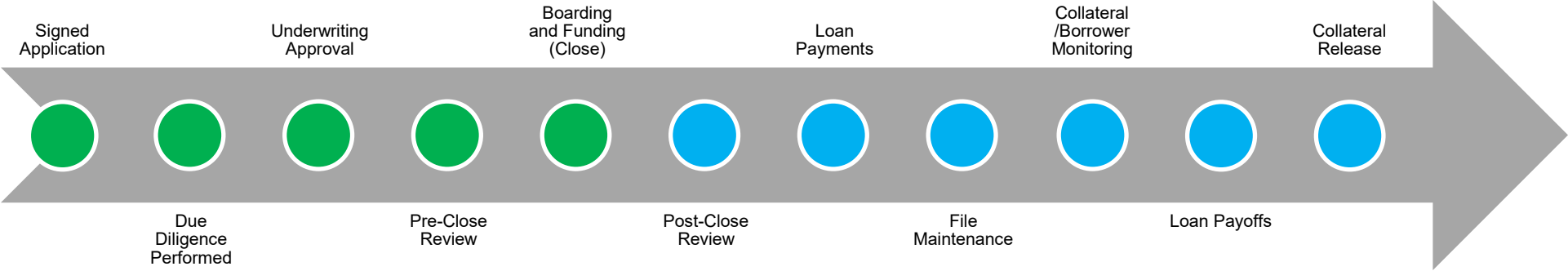
Administering a mortgage. Includes calculating principal and interest, collecting payments from the mortgagor, acting as an escrow agent, and foreclosing in the event of a default.

Mortgage Servicing – Business Objectives

- Mortgage servicing is the process which an entity collects interest, principal, and escrow payments from a borrower.
- The payments collected by the mortgage servicer are remitted to various parties; distributions typically include paying taxes and insurance from escrowed funds, remitting principal and interest payments to investors, and remitting fees to mortgage guarantors, trustees, and other third parties providing services.
- The profit is created via contractually specified servicing fees.



Loan Servicing



Mortgage Loan Servicing- Escrow and Documentation Monitoring



RISKS

Escrow accounts are not accounted for accurately and completely, resulting in decreased customer satisfaction and inaccurate reporting. Regulatory scrutiny may also occur if issues are systemic.



CONTROL POINTS

Management monitors escrow accounts for proper preparation of escrow analysis (both initial and annual); escrow account shortages and notifications; and escrow overages and refunds.

Mortgage Loan Servicing- Escrow and Documentation Monitoring

DESIGN ASSESSMENT

- Through discussion of the control with management and review of the escrow process, assess whether the control meets the following requirements:
 - a. Management monitors that an initial and annual escrow analysis is prepared.
 - b. Management monitors for escrow overages and has a formalized process to verify that overages are refunded.
 - c. Management monitors for escrow shortages and has a formalized process to verify that overages are collected.
- Document the client's control details with respect to the items listed above. Attach all relevant documentation used to support the control design.
- Perform a walkthrough to better substantiate your understanding of the control design.

Mortgage Loan Servicing- Escrow and Documentation Monitoring

OPERATING EFFECTIVENESS ASSESSMENT

- Analyze the audit period for evidence that management has performed the following:
 - a. Management monitored that an initial and annual escrow analysis was prepared.
 - b. Management monitored for escrow overages and had a formalized process to document that overages were refunded.
 - c. Management monitored for escrow shortages and had a formalized process to document that overages were collected.
- Document the client's control details with respect to the items listed above. Attach all relevant documentation used to support the control design.
- Perform a walkthrough to better substantiate your understanding of the control design.

Mortgage Loan Servicing- Escrow and Documentation Monitoring



RISKS

Escrow disbursements are not paid accurately and timely, resulting in decreased customer satisfaction and inaccurate reporting. Regulatory scrutiny may also occur if issues are systemic.



CONTROL POINTS

Management monitors a report of all upcoming insurance and tax payments due; then monitors to verify proper payment of those items. An independent person reviews escrow payments by tracing back to system generated reports to verify accurate and complete payments. An independent person also review for escrow payments not remitted within the established timeframe.

Mortgage Loan Servicing- Escrow and Documentation Monitoring

DESIGN ASSESSMENT

- Through discussion of the control with management and review of the escrow process, assess whether the control meets the following requirements:
 - a. Management actively monitors upcoming payments due for insurance and taxes
 - b. An independent person reviews escrow payments processed by tracing back to system generated reports.
 - c. An independent person reviews a system generated report of escrow payments not remitted within established timeframes.
- Document the client's control details with respect to the items listed above. Attach all relevant documentation used to support the control design.
- Perform a walkthrough to better substantiate your understanding of the control design.

Mortgage Loan Servicing- Escrow and Documentation Monitoring

OPERATING EFFECTIVENESS ASSESSMENT

- Test a sample of weeks during the audit period for the following:
 - a. Management monitored for upcoming payments due for insurance and taxes
 - b. An independent person reviewed escrow payments processed by tracing back to system generated reports.
 - c. An independent person reviewed a system generated report of escrow payments not remitted within established timeframes.

Mortgage Loan Servicing- Mortgage Servicing Rights



RISKS

Mortgage Servicing Assets are not accurately valued.



CONTROL POINTS

Valuation of Mortgage Servicing Assets is periodically conducted. The valuation is well-supported and reviewed for accuracy and completeness by an independent person. General ledger entries are recorded and reviewed by an independent person.

Mortgage Loan Servicing- Mortgage Servicing Rights

DESIGN ASSESSMENT

- Through discussion of the control with management and review of the mortgage servicing rights valuation process, assess whether the control meets the following requirements:
 - a. Management periodically re-values mortgage servicing rights
 - b. Management retains supporting documentation to validate their calculation
 - c. An independent, individual reviews the calculation
 - d. An independent, individual will make the necessary general ledger entry
- Document the client's control details with respect to the items listed above. Attach all relevant documentation used to support the control design.
- Perform a walkthrough to better substantiate your understanding of the control design.

Mortgage Loan Servicing- Mortgage Servicing Rights

OPERATING EFFECTIVENESS ASSESSMENT

- Analyze the most recent mortgage servicing rights valuation as of the audit date to verify it meets the following criteria:
 - a. Supporting documentation is retained to validate management's calculation
 - b. The valuation results tie to the general ledger entry made
 - c. The valuation calculation and general ledger entry are independently reviewed

Investor Accounting - Investor Remittances



RISKS

Funds may leave the company without adequate support or monitoring due to poor record keeping and accounting, resulting in financial loss.



CONTROL POINTS

Investor remittances are prepared and submitted by an individual independent from the investor custodial account reconciliation process. Remittances are reviewed to system generated reports prior to disbursement by someone an individual of preparation.

Investor Accounting - Investor Remittances

DESIGN ASSESSMENT

- Through discussion of the control with management and review of the investor remittance process, assess whether the control meets the following requirements:
 - a. The investor remittance process is performed by individuals independent from the reconciliation process
 - b. Management calculates the remittances in accordance with investor requirements
 - c. Management has a formalized process to verify that remittances are calculated and submitted in a timely manner
 - d. A review process is established to verify that investor remittances are calculated accurately
- Document the client's control details with respect to the items listed above. Attach all relevant documentation used to support the control design.
- Perform a walkthrough to better substantiate your understanding of the control design.

Investor Accounting - Investor Remittances

OPERATING EFFECTIVENESS ASSESSMENT

- Test a sample of investor remittances as of the audit date and verify that they meet the following criteria:
 - a. The remittance calculation and submission were performed and in a timely manner
 - b. The remittance was calculated in accordance with investor requirements (i.e. amount agrees to investor reports)
 - c. The remittance was prepared and submitted by an individual who does not reconcile the investor custodial account
 - d. The remittance was independently reviewed prior to submission and the review is documented
 - e. The remittance is supported by relevant documentation
 - f. Trace the remittance amount from the calculation to the custodial account posting, to the remittance documentation (i.e. ACH advice), and to the investor report.

Investor Accounting - Investor Remittances



RISKS

Funds may leave the company without adequate support or monitoring due to poor record keeping and accounting, resulting in financial loss.



CONTROL POINTS

Disbursements from investor custodial accounts are reviewed and approved prior to disbursement by an individual independent of posting payments or reconciling the custodial accounts. The disbursement by one individual is physically or electronically prevented through proper segregation of duties.

Investor Accounting - Investor Remittances

DESIGN ASSESSMENT

- Through discussion of the control with management and review of the investor custodial account disbursement process, assess whether the control meets the following requirements:
 - a. Disbursements from investor custodial accounts are reviewed and approved prior to disbursement
 - b. Disbursements are made by an individual independent of posting payments or the reconciliation process
 - c. A segregation of duties prevents one individual from disbursement funds on their own
- Document the client's control details with respect to the items listed above. Attach all relevant documentation used to support the control design.
- Perform a walkthrough to better substantiate your understanding of the control design.

Investor Accounting - Investor Remittances

OPERATING EFFECTIVENESS ASSESSMENT

- Test a sample of investor custodial account disbursements during the audit cycle and verify that they meet the following criteria:
 - a. The disbursement was approved by management prior to the date of disbursement
 - b. The disbursement was made by an individual independent of posting payments or the reconciliation process

Investor Accounting – Custodial Account Reconciliation



RISKS

Assets held for others may be misstated or misplaced; resulting in reputational and financial losses



CONTROL POINTS

Custodial Account Reconciliations are prepared and reviewed on a timely basis by individuals independent from the transaction authorization or recording functions. Reconciling items are identified, dated, and followed through to clearing.

Investor Accounting – Custodial Account Reconciliation

DESIGN ASSESSMENT

- Through discussion of the control with management and review of servicing/custodial account reconciliations, assess whether the control meets the following requirements:
 - a. Reconciliations are prepared by individuals independent from the transaction authorization or recording functions
 - b. Reconciliations are reviewed by individuals independent from the transaction authorization or recording functions
 - c. Reconciliations are prepared timely (7 days daily, 30 days monthly)
 - d. Reconciliations are reviewed timely (7 days daily, 30 days monthly)
 - e. Reconciling items are researched and cleared in a timely manner (30 days daily, 90 days monthly)
 - f. Management has an established process to escalate any issues such as unknown reconciling items
 - g. Management has an established process to charge-off reconciling items
- Document the client's control details with respect to the items listed above. Attach all relevant documentation used to support the control design.
- Perform a walkthrough to better substantiate your understanding of the control design.

Investor Accounting – Custodial Account Reconciliation

OPERATING EFFECTIVENESS ASSESSMENT

- Test a sample of servicing/custodial account reconciliations prepared by management as of the audit date and verify that they meet minimum requirements
- Additionally, select a sample of reconciling item and verify that they meet the following criteria:
 - a. Documentation exists that supports the origination of the item
 - b. Documentation exists that supports the final disposition of the item
 - c. If the item has not cleared, support exists as to the rationale why the item has not cleared or been charged-off

Investor Accounting – Reconciliation of Investor Records



RISKS

Accounting for loans serviced may be inaccurate; resulting in reputational and financial losses



CONTROL POINTS

The institution's records for loans serviced for others are reconciled to investor reports on a periodic basis by an individual independent from the authorization or recording functions. Differences are identified, dated, and researched.

Investor Accounting – Reconciliation of Investor Records

DESIGN ASSESSMENT

- Through discussion of the control with management and review of investor account reconciliations, assess whether the control meets the following requirements:
 - a. Reconciliations are prepared by individuals independent from the transaction authorization or recording functions
 - b. Reconciliations are reviewed by individuals independent from the transaction authorization or recording functions
 - c. Reconciliations are prepared timely (7 days daily, 30 days monthly)
 - d. Reconciliations are reviewed timely (7 days daily, 30 days monthly)
 - e. Reconciling items are researched and cleared in a timely manner (30 days daily, 90 days monthly)
 - f. Management has an established process to escalate any issues such as unknown reconciling items
 - g. Management has an established process to charge-off reconciling items
- Document the client's control details with respect to the items listed above. Attach all relevant documentation used to support the control design.
- Perform a walkthrough to better substantiate your understanding of the control design.

Investor Accounting – Reconciliation of Investor Records

OPERATING EFFECTIVENESS ASSESSMENT

- Test a sample of investor account reconciliations prepared by management as of the audit date and verify that they meet minimum requirements
- Additionally, select a sample of reconciling item and verify that they meet the following criteria:
 - a. Documentation exists that supports the origination of the item
 - b. Documentation exists that supports the final disposition of the item
 - c. If the item has not cleared, support exists as to the rationale why the item has not cleared or been charged-off



10 minute break



Root Cause Analysis

Agenda

- Background and Context
- Writing Internal Audit Findings
- Identifying the Root Cause of the Finding
- Effective Writing Techniques

Polling Question #4

How comfortable are you when it comes to identifying the root cause of audit findings?

- A. Not at all
- B. Only slightly
- C. Fairly comfortable
- D. Very comfortable

Audit Committee Feedback

- *“The report tells us what we already know.”*
- *“The report makes it sound worse than it is.”*
- *“There is no recognition of good work in the report; only negative by exception commentary.”*
- *“The report is too long and too wordy.”*



Audit Report Basics – An Overview

- **Audit Report**

- The final deliverable where work is summarized to communicate the results of detailed work that was performed
- Often issued following the completion of fieldwork
- Can take many forms

- **Audit reports typically communicate the following:**

- Summary of audit objectives
- Review of scope and procedures performed
- Key findings and recommendations
- Views of auditee or their action plans (i.e., management responses)



Importance of Effective Reporting

- This is often the **key deliverable**
 - What Internal Audit leaves behind
- Reflective on the quality of the work overall
 - Can leave a lasting impression
 - People remember the written word
 - High-quality audit reports must be supported by high-quality fieldwork, BUT high-quality fieldwork can be NULLIFIED by poorly written or ineffective reports



Consider the Audience

- More often this phase involves members of senior management, including key executives:
 - Board Members, such as Audit Committee
 - Executive Level: CFO, CAO, CAE, COO, etc.
 - Senior Management: VPs, Controllers, etc.

Consider the Audience

- The Board or Audit Committee members need to know:
 - Is everything OK?
 - What should I be concerned about?
 - What needs to be done?

Writing Internal Audit Findings



Writing Internal Audit Findings

- Audit Finding
 - A conclusion concerning a matter related to an examination of an organization's program, activity, or function, which identifies problems and their causes, and provides recommendations for corrective action in order to prevent their future recurrence
- Audit Findings make up the majority of the Traditional Internal Audit Report format





Writing Internal Audit Findings

- Validating findings with process owners to:
 - Confirm understanding
 - Focus on the facts!
 - Review Audit Findings details
 - Ensure the details support conclusion
 - Determine impact and significance
 - Identify underlying root cause of the condition
 - Assist with recommendations and remediation
 - What can be done to fix the condition?
 - Maintain credibility and respect with process owners
 - Gain buy-in with process owners / management (for findings and fixes)



Writing Internal Audit Findings

Five Components of an Effective Audit Finding (“the 5 C’s”):

1. Criteria: What should be
2. Condition: The current state
3. Cause: The reason for the difference
4. Consequence: Effect or implication
5. Corrective Action: Summarizes the key steps that must be implemented to fix the current condition and prevent it from occurring again

Source: Writing High-Impact Reports

Polling Question #5

Which of the following is not one of the five components of an effective audit finding?

A. Criteria

B. Consideration

C. Cause

D. Corrective Action

Writing Internal Audit Findings

Criteria

- Should clearly state to the reader what is expected or how something is being measured
 - Helps the reader determine what and why something is important
- Example:
 - “Finance policy required continuous monitoring by the project manager and officer approval of capital expenditures over \$1 million.”

Writing Internal Audit Findings

Condition

- Specific evidence should exist to support the finding
- Where applicable, quantification is important
 - How many, how much, etc.
- Conciseness is critical for understanding
 - Should be limited to one sentence whenever possible
- Example:
 - “Capital expenditures of \$5.8 million for the renovation project were not monitored, and time and budget overruns were not monitored, or approved.”



Writing Internal Audit Findings

Cause

- All findings should be traced to their root cause (*to be discussed later*)
- May help to identify problems in other areas
- Often requires discussion with the process owner and/or management
- Needs to be as specific as possible
 - Helps management address the source of the problem and implement a corresponding action plan
- Example:
 - “A project owner had not been appointed to manage the renovation project.”

Writing Internal Audit Findings

Consequence

- Must indicate the impact of the audit finding (i.e., significance) to the organization
 - Helps persuade the reader; gains buy-in
 - Helps management with prioritization should multiple audit findings exist
- Example:
 - “The renovation project was over budget by 25 percent and \$3.7 million, and the contractors paid no penalties.”

Writing Internal Audit Findings

Corrective Action

- Should be as specific as possible
- Should address the cause
- There is usually more than one solution
 - Consideration of cost-benefit is important
 - Consideration of organization's culture
- Include who should be involved in the solution and when the solution needs to occur
- Include management in identifying solutions
- Example:
 - “The Controller should require written VP approval of all capital expenditure project plans, monthly status reports, and cost overruns. In addition, a project leader should be appointed for all future capital projects.”

Writing Internal Audit Findings

- Recommended order of Audit Finding components:
 1. Criteria
 2. Condition
 3. Cause
 4. Consequence
 5. Corrective Action
- Management Response section should always directly follow the Findings and Recommendations when using a Traditional Internal Audit Report format

Writing Internal Audit Findings

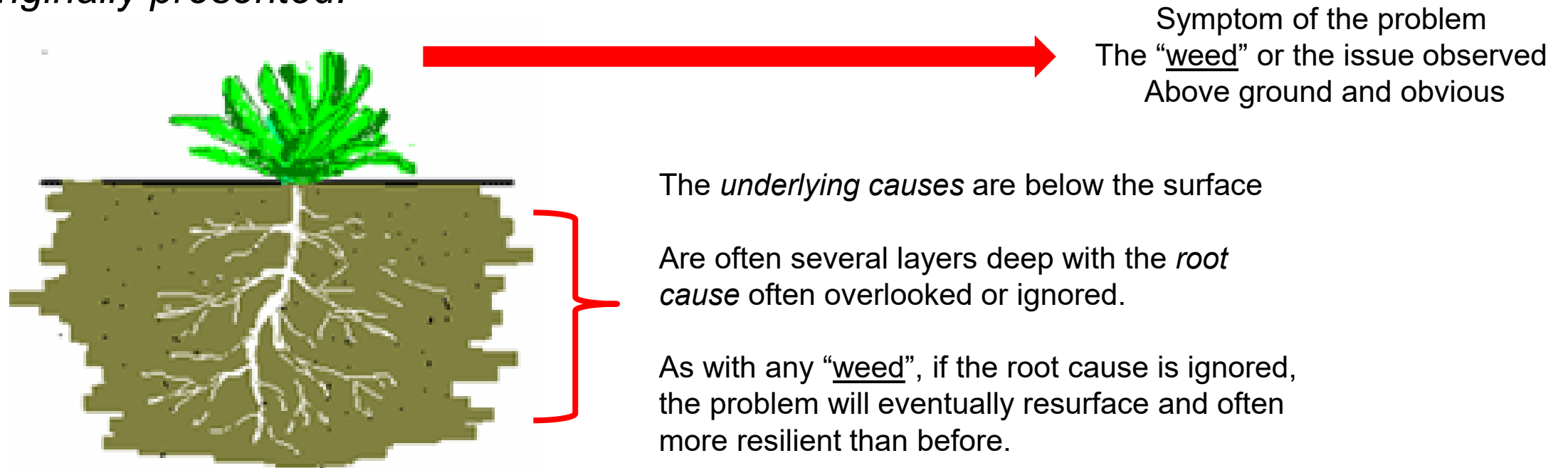
Management Responses

- Should be as specific as possible
- Should address the root cause of the audit finding
- Should include a specific implementation date
- Should be provided in a timely nature
- Should only be edited by the internal audit engagement team to ensure the flow of the report is consistent. If changes are recommended, this must be confirmed and agreed to with the auditee.

Identify the Root Cause of the Finding

Identifying the Root Cause

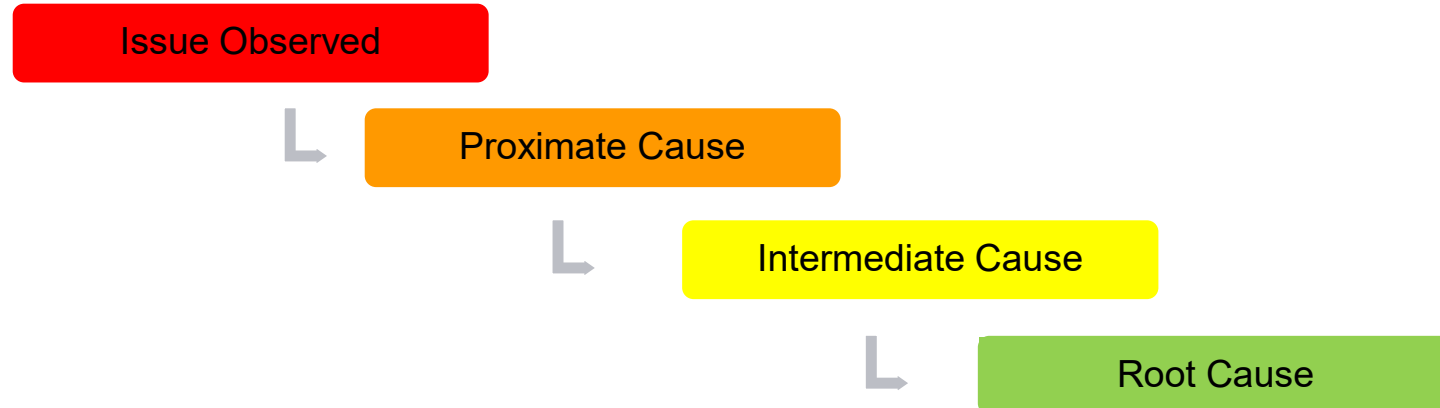
- What caused the issue to occur?
 - The root cause describes why (or reasons) the issue occurred
 - To understand the root cause, we need to determine all actions (or lack thereof) that resulted in the issues being observed. *This is often several layers below the cause originally presented.*



Root Cause Analysis

- Root Cause Analysis - Breaking Down the Cause

- A process to breakdown the cause of an issue by asking and answering a series of questions to determine the chain of events leading to the observed result
- By asking and understanding the answer to each question, you will drive closer to the root cause of the issue
 - Proximate Cause – an event or action which is closest to, or immediately responsible for causing, some observed result (our audit finding)
 - Intermediate Cause – an event or series of events that led up to the observed result (our audit finding)
 - Root Cause – the initiating event is a series of events that led up to the observed result (our audit finding)

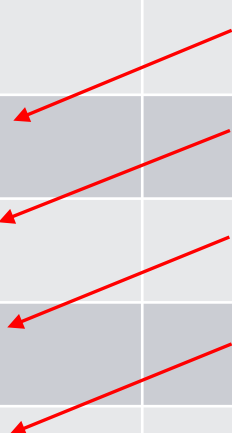


Root Cause Analysis

- Breaking Down the Cause – The “WHY’s” Exercise:

- Drills down and through the proximate and intermediate causes to the root cause by asking a series of “Why?” questions
- Includes any number of “Why?” questions; though will typically be 4-6 questions down the ladder, if asked effectively

Issue Observed	Reasons	Cause Level
What was observed?	Why did that happen?	Proximate
Reason #1	Why did reason #1 happen?	Intermediate
Reason #2	Why did reason #2 happen?	Intermediate
Reason #3	Why did reason #3 happen?	Intermediate
Reason #4	Why did reason #4 happen?	Intermediate
Reason #5	Why did reason #5 happen?	Root



Root Cause Analysis - Example

Breaking Down the Cause – The “WHY’s” Exercise:

Example:

Issue Observed	Reasons	Cause Level
I was late to work	Why was I late to work?	Proximate
My car wouldn't start	Why wouldn't my car start?	Intermediate
My battery was dead.	Why was my battery dead?	Intermediate
The dome light was left on all night.	Why was the light left on all night?	Intermediate
I turned on the light to look for the keys I dropped between the seats.	No further questions needed. The root was uncovered	Root

Internal Audit Findings – 5 Components

- **Breaking Down the Cause – The “WHY’s” Exercise:**

- Know when you have reached the root cause
 - It is the fundamental reason for the issue at hand
 - Addressing the root cause will prevent recurrence
 - It is the last cause in the chain of events

- **How to tell when you have reached the root cause:**

- The cause is actionable. If you take action, the issue is resolved and will not reappear.
- The solution seems to jump off of the page
- Probing any deeper starts to make no sense
 - Example – In the prior example, the next question in the series would be:
 - “Why did I drop my keys?” with a response of “I am clumsy” or “I had too many things in my hand”
 - With each additional question following the root, the solutions are less actionable and harder to pin down

Polling Question #6

The Root Cause describes which of the following elements of an audit finding?

A. Why the issue occurred

B. The issue itself

C. What is expected

D. The associated risk

Effective Writing Techniques



Basic Principles and Best Practices

- Reports should convey a message that will efficiently and effectively address the readers questions
- Reports should clearly communicate the findings in a language that can be easily understood by the reader
- Reports should be suitable to the amount of risk related to the area under review
- Timely documentation of the finding is critical
- Confront objections upfront with management

Report Style – Top 10 Tips and Techniques

1. **Keep reports short and always include an Executive Summary, where applicable**
2. Be consistent with terminology
3. Use headings and subheadings to make documents more accessible
4. Spell out acronyms when first used in the document
5. Spell out numbers one through nine
6. **Make subjects like “auditors” plural to avoid gender exclusiveness**
7. **Avoid using complex words when natural, direct words are available**
8. Follow standard rules of punctuation
9. Follow standard rules of grammar
10. **Use tables and graphs to communicate complex data sets**

Polling Question #7

Following this session, do you have a better understanding of how to analyze and identify root causes?

A. Yes

B. Somewhat

C. Not really

Q&A



Lunch Break



Remote Delivery of Internal Audit

Agenda

- 1) Objectives
- 2) An Auditors Approach to a Virtual Internal Audit
- 3) The Impact of Digital Workers on Internal Audit
- 4) Q&A

Objectives

Upon completing this webinar, attendees should be able to:

- Identify opportunities to enable easy collaboration amongst your internal audit team
- Properly communicate and address risks with Audit Committees while working remote
- Apply new techniques to preparing, executing, and reporting high caliber results while still maintaining audit quality
- Identify opportunities for the use of RPA as part of your internal audit plan
- Define the impact and role of bots on the existing control environment, including new risks, and control automation

An Auditor's Approach to a Virtual Internal Audit

What Does Today Look Like?

- Virtual Workforce
- Travel Limitations
- Economic Uncertainty
- Enhanced Regulatory Scrutiny over Liquidity and Credit Quality

What Else Does Today Look Like?

- Home Schooling
- Grocery deliveries during calls
- Internet bandwidth
- Barking dogs
- Juggling schedules

Polling Question #8

What percentage of your audits have been delayed to later in the year due to the current environment?

A. 0-10%

B. 10-30%

C. 30-50%

D. 50-80%

E. 80-100%

Polling Question #9

What percentage of your audits have been postponed to a different year due to the current environment?

A. 0-10%

B. 10-30%

C. 30-50%

D. 50-80%

E. 80-100%

Key Elements for a Successful Remote Audit



Plan



Plan

The most critical part of every audit is planning and it is even more important when performing virtual audits.

Challenges	Opportunities
<ul style="list-style-type: none">• Limited time and resources• Control Changes	<ul style="list-style-type: none">• Reassess risks and the institution's priorities• Revisit availability of Auditees
<ul style="list-style-type: none">• Restrictions on data accessibility – remote vs onsite	<ul style="list-style-type: none">• Be flexible when necessary• Identify audit timelines that can be adjusted – increase prep time

Value Add – with new risks come new opportunities to assist your audit clients.

Execute



Use technology to enable the efficient execution of audit procedures.

Challenges	Opportunities
<ul style="list-style-type: none">• Training new employees	<ul style="list-style-type: none">• Daily working sessions• Online walkthroughs
<ul style="list-style-type: none">• Lack of personal contact with auditees	<ul style="list-style-type: none">• Optimal use of technology• Anticipate technical issues• Document Sharing – technology that allows for easy monitoring• Video Conferencing• Use alternative tools such as whiteboards
<ul style="list-style-type: none">• Difficulty to coordinate schedules and answer questions	<ul style="list-style-type: none">• Daily open item/questions list

While working remotely, it is key to keep in close contact with the auditee to remain aligned.

Results



Reporting protocols might be different as we go through virtual auditing.

Challenges	Opportunities
<ul style="list-style-type: none">• Requests from stakeholders for information	<ul style="list-style-type: none">• Revisit reporting timelines/schedules• Provide updated schedule of communication to supervisory Committees
<ul style="list-style-type: none">• Uncertainty experienced by auditees from lack of human interaction	<ul style="list-style-type: none">• More frequent updates• Focus on key risks - do not overload auditees with low risk findings• Validation through multiple channels can help reduce miscommunication

Overall, increase Communication!

Polling Question #10

Have you changed your monitoring approach or moved to a more data driven monitoring to supplement the flexibility which audit plans and auditees are requiring during this time?

A. Yes

B. No

Risk Analysis



Risk Analysis

Key is to understand how risk is changing and how effectively it is being managed in the various areas of the organization

- Analyzing results for thematic issues
- Adopting data driven monitoring to reassess risk and reduce time required with audit clients
- Communicating trends on risk changes throughout the organization to the Audit Committee

Polling Question #11

Are you using BOTS as part of your internal audit team?

A. Yes

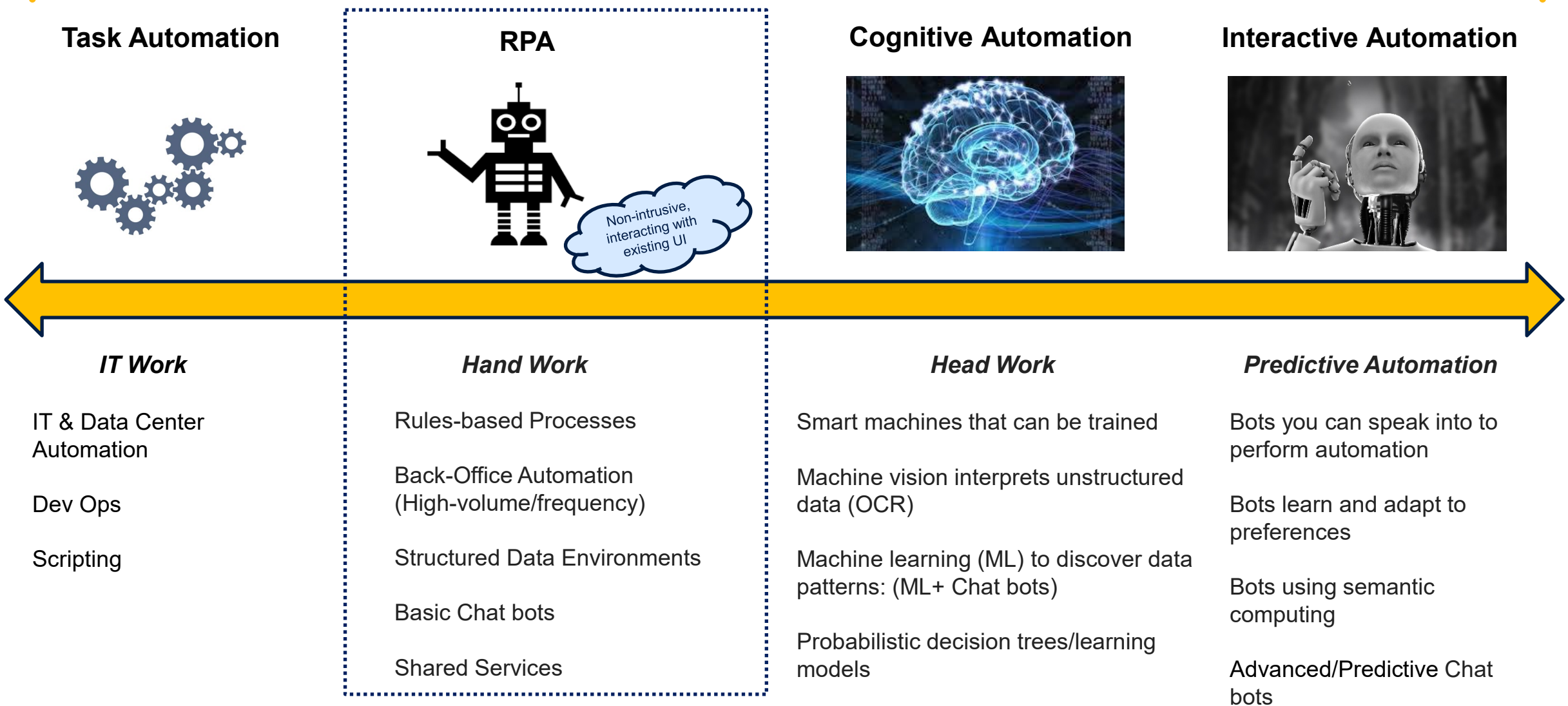
B. No

The Impact of Digital Workers on Internal Audit

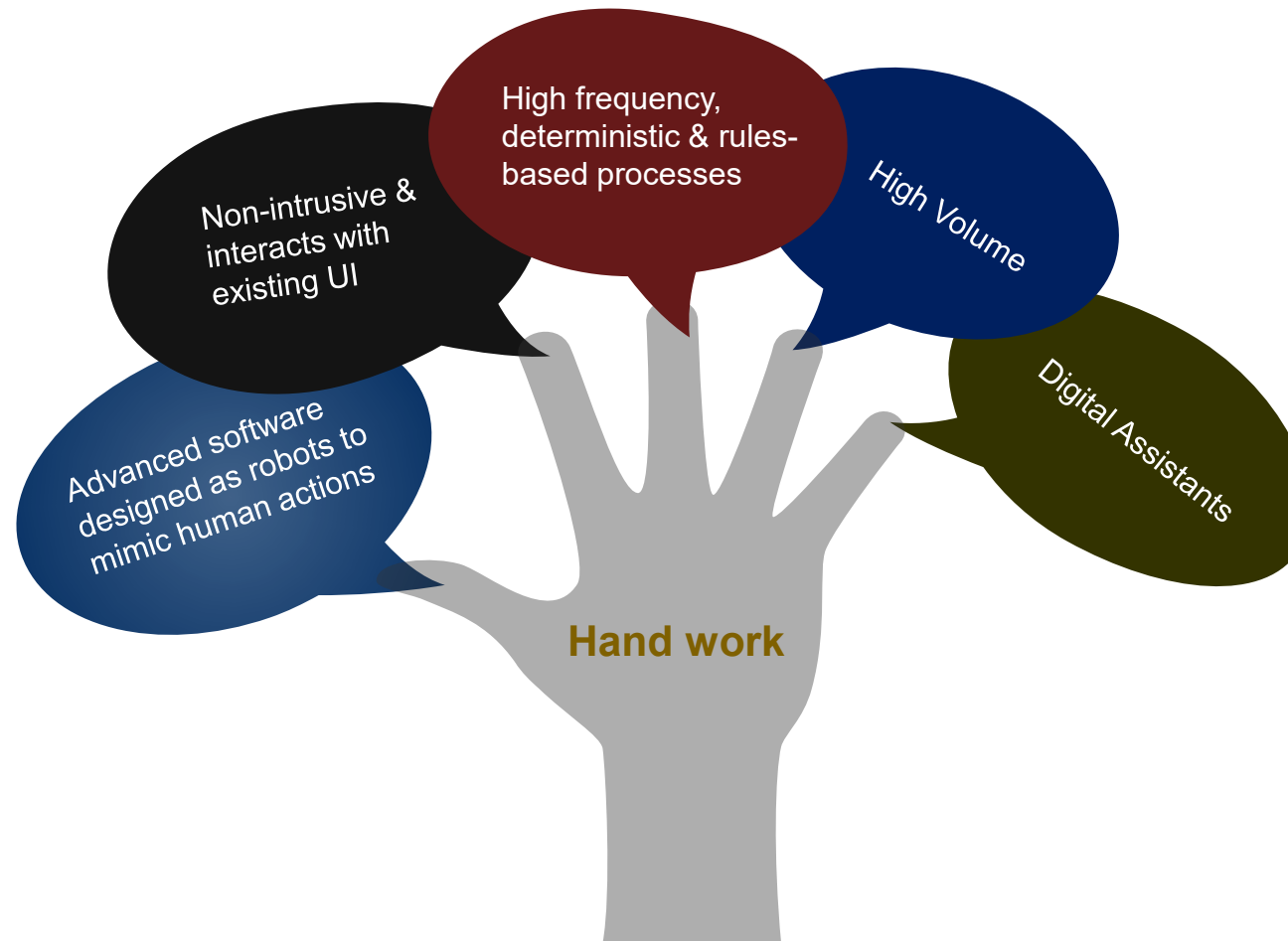
Topics of Interest

- Spectrum of Automation
- What is RPA and where is it applicable?
- How are RPA applied and what impacts for IA?
- Demo & Case Studies
- Open Discussion

Automation – The Spectrum



What is Robotic Process Automation (RPA) and Where is it Applicable?

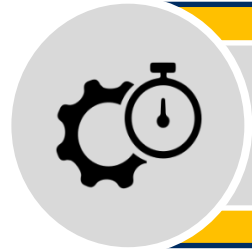


How Can RPA Be Applied to Internal Control?



1st Line of Defense

- Control Operator
- Control Owner



2nd Line of Defense

- Internal Control Tester
- Periodic Management Testing of Control Effectiveness



3rd Line of Defense

- Internal Audit Tester
- Independent Testing

What Are the Impacts to Internal Audit?



- 1 Need to understand the technology
- 2 Opportunity to influence control design & governance
- 3 Potential to increase audit efficiency
- 4 Free up capacity to focus on higher priorities
- 5 Need to develop new testing approaches
- 6 Consider need for changes to IA staffing model

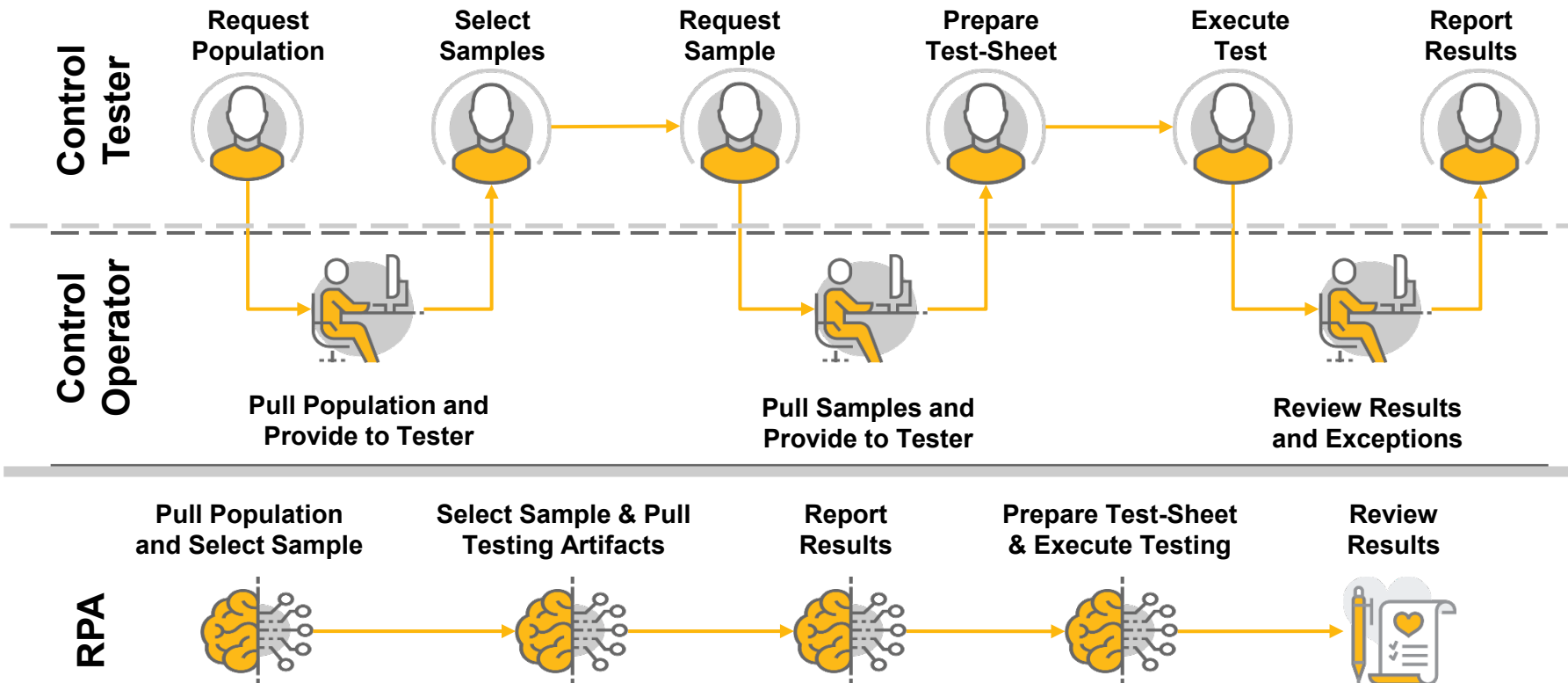
Sample Use Case for Internal Audit

Sample RPA Use Cases

- Internal Control/Repetitive Operational Audits
 - Request lists
 - Sample selection
 - Status trackers
 - Deficiency logs
 - Exit Meeting Agenda
- Areas Digital Assistant can support Testing:
 - Logical Access/Change Management/Computer Operations
 - Repetitive areas in Business Controls, including but not limited to
 - Account Reconciliation
 - Three-way matching
 - Re-calculation
- Corporate Governance (framework, process and policy review)
- Continuous Monitoring (transaction monitoring/breach of privileges)
- Information Technology/Application Controls (SOD/Least Privileged Access)

How Does the User Access Review (UAR) “BOT” Work?

A High-level View of How a “BOT” Typically Operates





Q&A



Recent Trends at Financial Institutions Fraud

Spotting Unethical Behaviors

RED FLAGS OF UNETHICAL BEHAVIOR

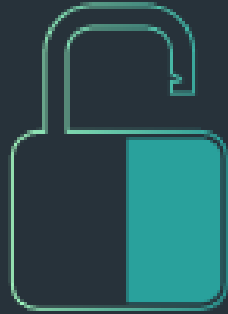
Numerous factors may lead someone to behave unethically in the workplace. Here are just a few, and some associated indicators.

REASONS FOR UNETHICAL BEHAVIOR*	RED FLAGS	POSSIBLE OUTCOME
Unquestioning obedience to authority – Facilitates justifying bad behavior: “I was just doing what I was told.”	<ul style="list-style-type: none"> » The boss supports an environment in which he or she is always right. » Employees parrot the philosophy that “what the boss says, goes.” 	The boss coerces the accountant to make fraudulent journal entries to cover the boss’s theft or to improve organizational performance.
Tunnel vision – A single-minded focus on achieving goals to the exclusion of ethical concerns that may interfere with that achievement.	<ul style="list-style-type: none"> » Employees express feeling excessively pressured to achieve goals. » Human resources has established compensation policies that are tied to completing projects, regardless of their usefulness or profitability. 	The company may set a goal of being the top producer in its industry and encourage doing “whatever it takes” to reach it.
Power of names – The use of nicknames for questionable practices to make them seem more acceptable.	<ul style="list-style-type: none"> » High-pressure, questionable campaigns are given clever, but nondescriptive, names to obfuscate their goals or means of achieving the goal. Generic placeholder names are used for criminal activities. 	Employees become inured to fraud because it is described in terms like <i>greasing the wheels</i> instead of <i>bribery</i> or <i>financial engineering</i> instead of <i>accounting fraud</i> . Other red-flag terms include <i>smoothing earnings</i> and <i>deseasonalizing the data</i> .
Broken window – Physical and social disorder that is taken as a sign that everything is permitted and authority is absent. A single transgression encourages further transgressions.	<ul style="list-style-type: none"> » Employees demonstrate a follow-the-leader mentality that considers “everyone is doing it” as a viable excuse for poor behavior. 	A single fraudulent act spirals into several others, committed by a wider group of people, because the first one was not caught or was not treated as criminal.
The Galatea effect – Employees who see themselves as controlled by their environment or having their choices made for them are more likely to bend the rules.	<ul style="list-style-type: none"> » Executives demonstrate a “victim mentality,” conveying that seeking revenge on anyone (or any organization) perceived to have wronged them is appropriate. » Employees display a low level of engagement in the business. 	Employees commit fraud because they think the company has treated them badly.

Building an Anti-Fraud Framework

Did You Know...

INTERNAL CONTROL WEAKNESSES
WERE RESPONSIBLE FOR NEARLY
HALF OF FRAUDS



MEDIAN LOSSES ARE FAR GREATER
WHEN FRAUDSTERS COLLUDE



***Source: 2018 Global Study on Occupational Fraud and Abuse**

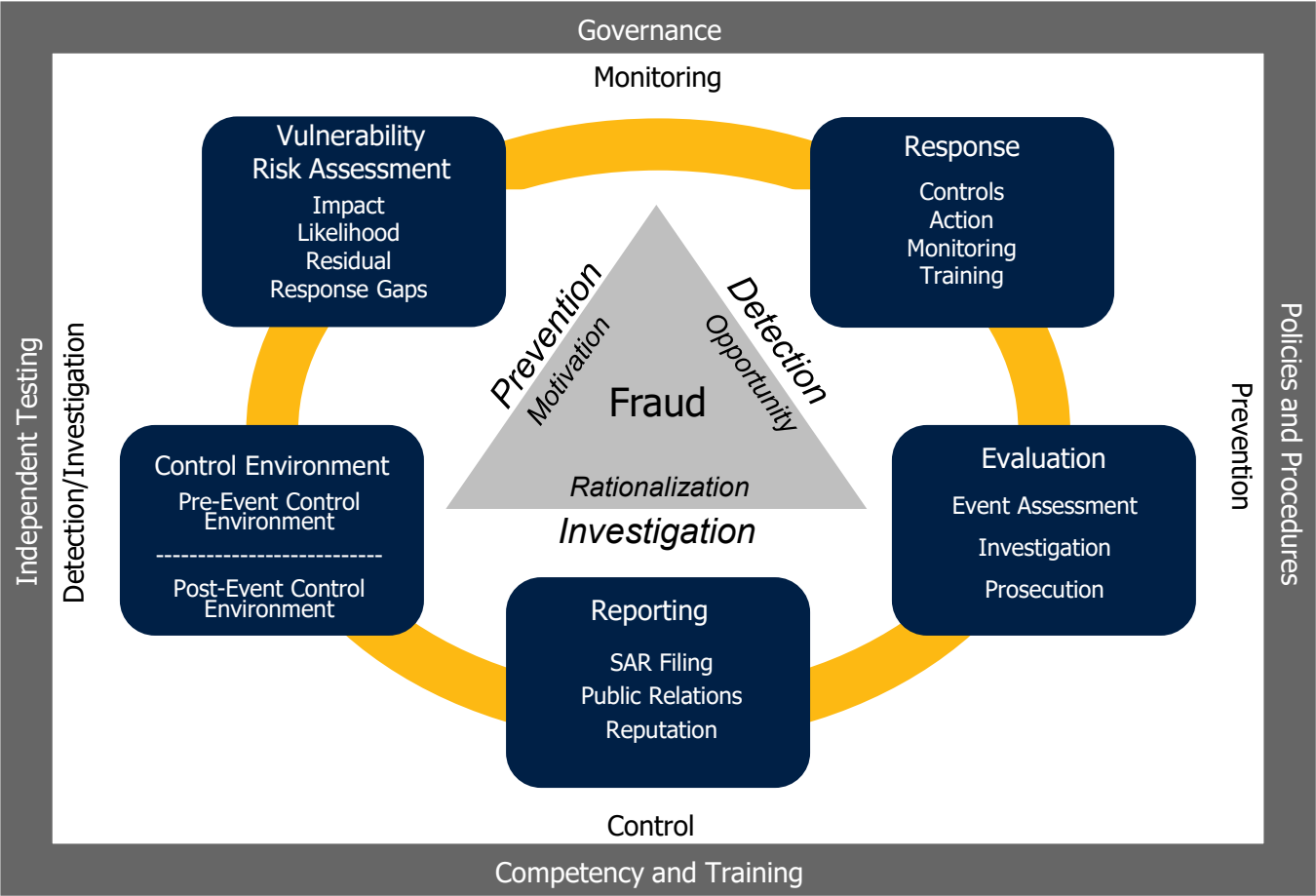
Why Develop an Anti-fraud Framework

- Per the ACFE's 2018 Report to the Nations, an estimated 5% of any one organization's revenue is lost to fraud each year. Investing in fraud prevention programs today will save your company revenues lost to fraud in the future
- External auditors and industry regulators are evaluating your programs
- Protect your company, your Board of directors, your employees and your shareholders
- Reduce fraud losses. Good fraud programs help deter and discourage fraud.

Benefits of an Anti-fraud Framework

- Minimize long-term impact of costs of fraud to your company
- Stave off regulatory investigations
- Protect shareholder value
- Maintain high investor confidence
- Keep a positive profile in the press
- Protect yourself and employees
- Protect employee retirement and pensions
- Keep audit fees down

Anti-fraud Framework



Four Cornerstones of an Anti-fraud Framework

- Governance – The effective top down oversight and direction establishing the proper “tone at the top”
- Policies and Procedures – The Board approved policies related to fraud prevention and detection
- Competency/Training – Fraud awareness training throughout the organization
- Independent Testing/Validation – Periodic testing and validation of fraud systems and capabilities

Governance

- Strong corporate culture and ethics based on integrity
- Code of Conduct/Ethics
- Conflict of Interest
- Fraud Policy
- Board and audit committee oversight
- Effective and educated board and audit committee

Governance

- No deviations from legal or ethical standards accepted
- Good leadership
- Participative top management
- Open lines of communication
- Audit reporting to highest level
- Environment in which employees believe that dishonest acts will be detected, are not tolerated, and are punished

Policies and Procedures

- Requirement to comply with all laws and regulations
- Explicit guidance regarding making payments to obtain contracts, holding pricing discussions with competitors
- Environmental discharges
- Relationships with vendors
- Maintenance of accurate books and records

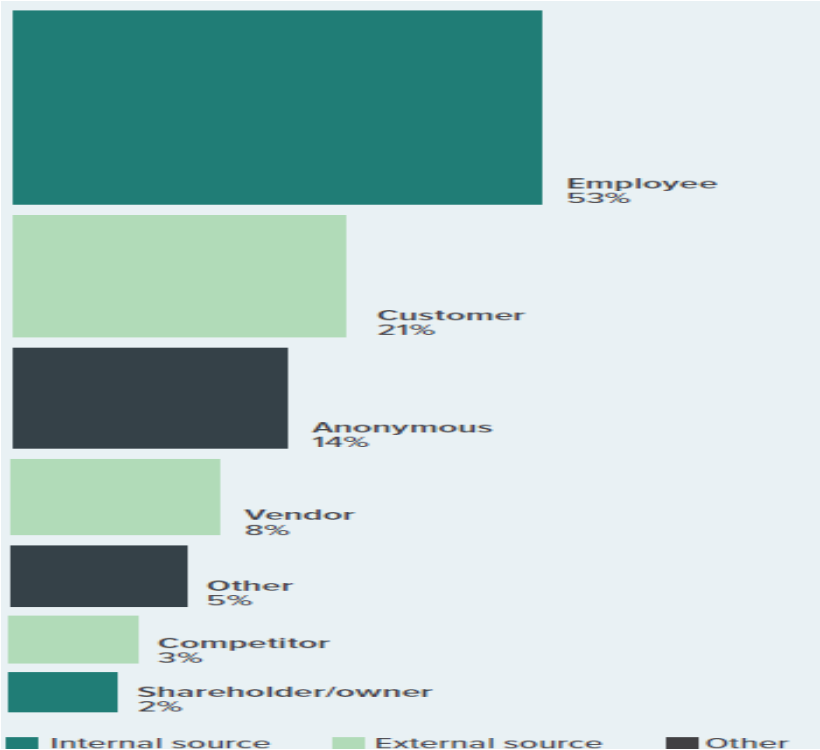
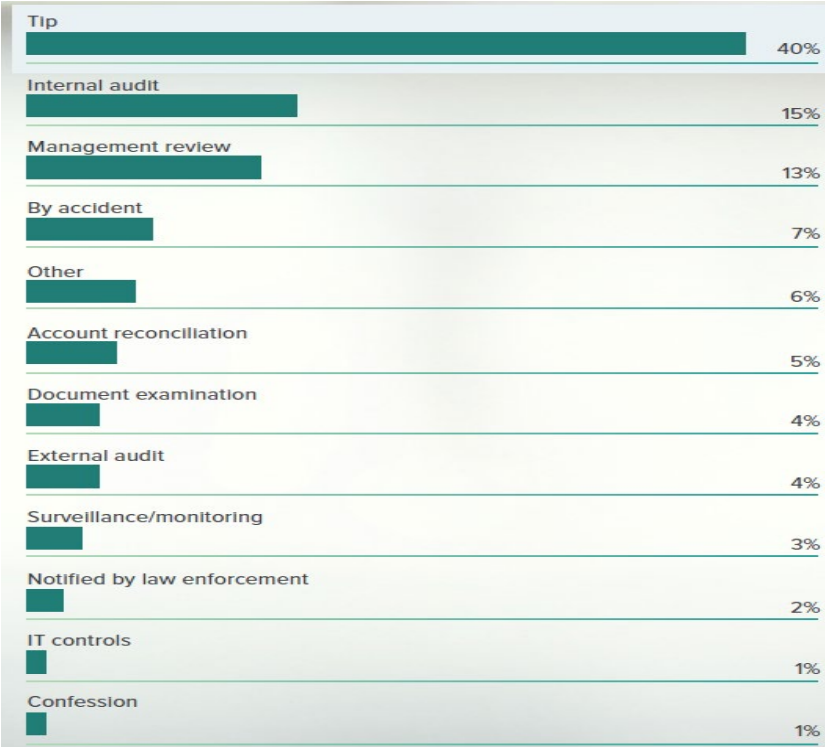
Policies and Procedures

- Specific measures implemented to deter fraud
- Establish and maintain procedures to detect fraud
- Encourage employees to report any suspicion of fraud
- Investigate all suspected fraud
- Report all suspected fraud to appropriate authorities
- Assist authorities in the prosecution of fraudsters
- Recover all assets illegally obtained

Competency/Training

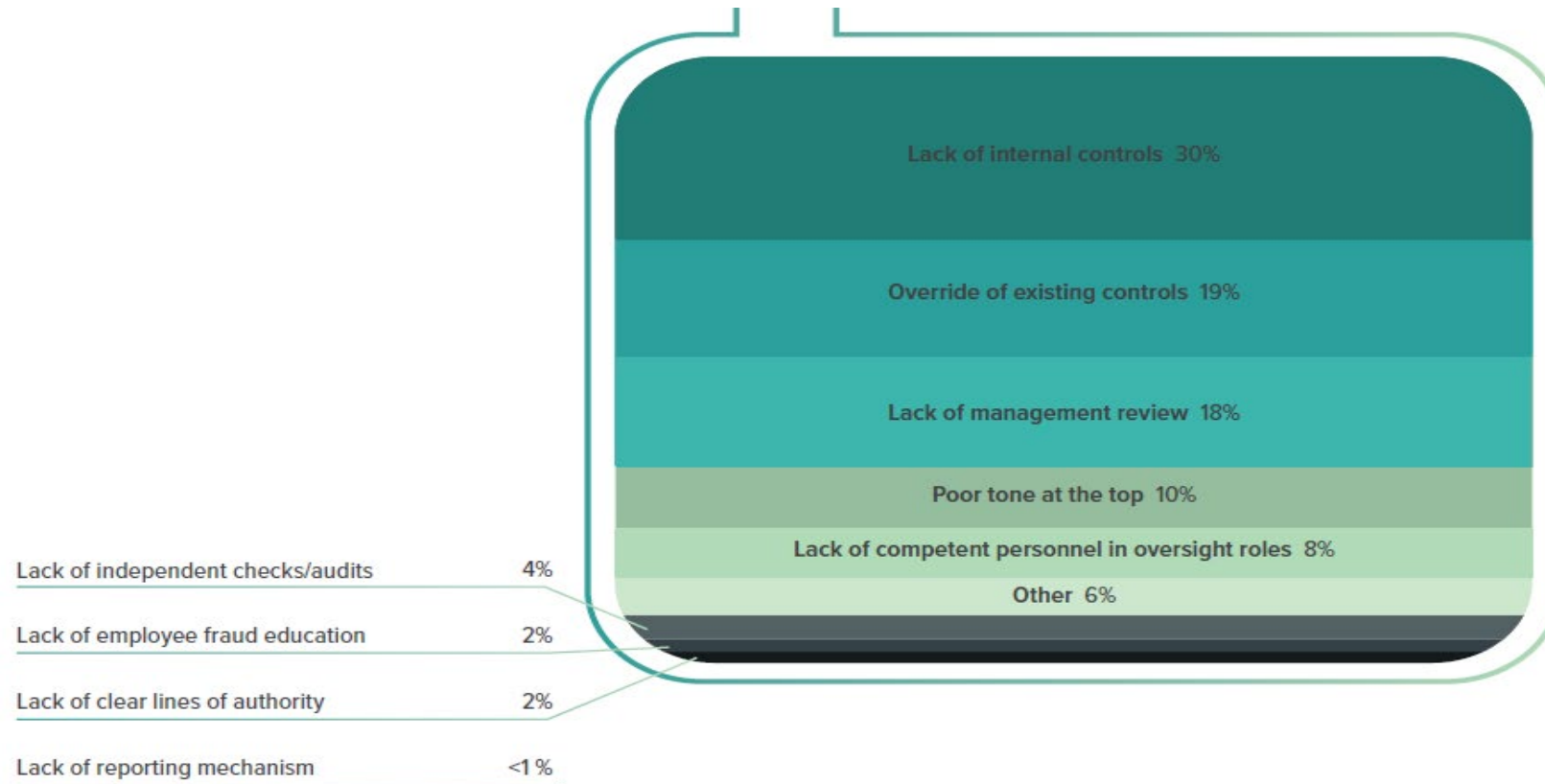
- New employees trained at hiring on institution's values and code of conduct
- Fraud red flags – specific to employees' daily responsibilities
- Duty to communicate certain matters and types of matters to be communicated, including actual or suspected fraud, with examples
- Information on how to communicate those matters – hotline, independent third party, etc.
- Specific to an employee's level with the institution, geographic location, and assigned responsibilities

Training - Initial Detection of Frauds



Source: ACFE 2018 Report to the Nation

Training - Causes Related to How Frauds Occurred



Source: ACFE 2018 Report to the Nations

Independent Testing/Validation

- Complete a Fraud Risk Assessment
 - Identify all applicable areas
 - Determine likelihood and impact of fraud losses
 - Identify “gaps” in fraud responses
- Determine appropriate fraud responses (ex. internal controls) have been implemented in areas identified as posing a higher risk of fraudulent activity
- Determine appropriate controls (automated or manual) exist over computer generated information

Independent Testing/Validation

- Determine appropriate internal controls over the financial reporting process have been established
 - Fraudulent financial reporting by upper level management usually involves override of internal controls
 - Higher-level review of financial reporting by lower levels of management and employees
 - Evaluate the financial results reported by individual departments or subsidiaries
 - Unusual fluctuations in results of departments, or lack of expected fluctuations, may indicate potential manipulation
- Implement fraud specific tests/reviews in both the operating units and within the internal audit function

Fraud Vulnerability Assessment



Overall Entity Assessment

- The Overall Entity Assessment is a global view of how the organization is structured/managed to combat fraud
- This assessment takes into consideration a number of elements including the “Tone at the Top”, company-wide policies/procedures, internal factors and external factors.

Fraud Awareness Training

- In preventing and detecting fraud, there is a direct correlation between an organization's effectiveness and the overall awareness of its employees/managers
- Simply put, the more employees and managers know about fraud and fraud schemes, the better equipped they will be to prevent and detect a fraudulent situation
- Fraud training can take on a more global approach and/or be directed specifically to a business unit

Business Unit/Process Assessment

- Similar to the Overall Entity Assessment, the Business Unit/Process Assessment is designed to give a specific view of how the business unit/process is structured/managed to combat fraud
- The assessment would include many of the topics in the Overall Entity Assessment, but only as they apply to a particular business unit/process
- The selection of which Business Units/Processes to review might be identified through the Overall Entity Assessment or through actual fraud loss experience

Integrated Fraud Detection & Prevention Techniques

- Related to both the Overall Entity Assessment and the Business Unit/Process Assessment, the integration of specific fraud prevention and detection techniques will need to be deployed at the global and business unit/process level
- Implementing these techniques might include the establishment of policies/procedures, business re-engineering and software solutions
- The company should establish the right mix of controls and techniques to mitigate the risk of fraud within the organization

Control Environment

- Organizational structure of institution
- Management's philosophy and operating style
- Integrity, ethics, and competence of personnel
- External influences that affect operations and risk management practices
- Attention and direction provided by the Board of directors and its Committees

Fraud Hotlines

- The ACFE 2018 Report to the Nation on Occupational Fraud and Abuse found that anonymous hotlines reduced the impact of fraud losses by 50%
- In fact, researchers noted that organizations without anonymous reporting mechanisms suffered median losses that were more than twice as high as organizations where such mechanisms had been established

Fraud Hotlines

- Determine your institution's needs
- The set up of the hotline is very important for maximum effectiveness
- Service 24 hours days, 365 days a year
- Announcing the hotline
- Initial communication from CEO to provide proper emphasis and importance
- Available to employees, customers, and vendors
- Handling tips completely and anonymously
- Develop a reporting structure with built in checks and balances

Hiring and Promoting Employees

- Conduct background investigations on individuals being considered for employment or for promotion to a position of trust
- Thoroughly checking a candidate's education, employment history, and personal references
- Periodic training of all employees about the institutions values and code of conduct

Hiring and Promoting Employees

- Incorporating into regular performance reviews an evaluation of how the individual has contributed to creating an appropriate workplace environment in line with the institutions values and code of conduct
- Continuous objective evaluation of compliance with the entity's values and code of conduct, with violations being addressed immediately

Evaluation - Fraud Risk Assessment

- Identify business units/processes, including entity level or a global view, to assess
- Identify possible fraud risks/scenarios within each assessed area. Be sure to include internal and external fraud situations
- Identify fraud responses (internal controls, physical protections, detection tools, etc.)

Evaluation - Fraud Risk Assessment

- Identify any “gaps” where a fraud scenario does not have an adequate fraud response
- Measure the individual fraud scenarios based on impact and likelihood
- Value the individual fraud scenarios as a group to arrive at the assessed area’s overall fraud susceptibility

Evaluation - Fraud Red Flags

Organizational

- Weak Corporate Culture and Ethics
 - No Code of Ethics or Code not enforced
 - No policy on Conflict of Interest
- Lack of Board Oversight
- Ineffective and/or uneducated Board or Audit Committee
- Absence of clearly defined authority
- Weak leadership
- Dominant top management
- Crisis management

Evaluation - Fraud Red Flags

- Employees
 - Rapid turnover
 - No rotation of duties/employees (only person who can perform duties)
 - Insufficient staffing
 - Lack of accountability
 - Unusual activity
 - Defensive attitude
 - Living beyond means

Evaluation - Fraud Red Flags

- Employees
 - Lack of vacations/leave
 - Unusual work hours
 - “Holding” work during vacation
 - High debts
 - Never out of balance – balancing perfectly all the time
 - Secretive, territorial

Evaluation - Investigation

- Validate assertions
- Be prepared to face obstacles and risks
- Bring the issue to the attention of the appropriate supervisor, if applicable
- Don't always confront after one finding - many times, there's more

Evaluation - Investigation

Anticipate management's reaction to fraud

- Denial, anger, rationalization, depression, acceptance

Assemble team to investigate – Should have collective knowledge

- Internal Audit
- External Audit
- Legal Counsel
- Human Resources
- Security

Communicate on a “Need to Know” basis

- Discreetly
- With sensitivity
- Keep workpapers secure

Response

Establish effective internal controls

- Segregation of duties
- Mandatory vacations
- Performance reviews
- Prohibition of insider transactions
- Conflict of interest policy – require full disclosure
- Employee expense account reviews
- Surprise audits/inventories/inspections
- Selective hiring practices through background investigations and reference checks
- Effective employee assistance programs

Response

- Appropriate and consistent actions should be taken against violators
- Relevant internal controls should be assessed and improved
- Communication and training should occur to reinforce the entity's values, code of conduct, policies, and expectations

Reporting

- Clearly distinguish between conclusions (fact based) and opinions (supposition)
- Avoid any opinions relating to guilt or innocence
- Ensure evidence follows all legal requirements
- If providing originals, always maintain copies
- Safeguard all evidential matter

Reporting

Presentation of Information

- Chronological
- By Transaction
- Use Exhibits effectively
- Clearly establish chain of custody of all evidential matter

Q&A



10 Minute Break



Risk Assessments and Value-Add Audits

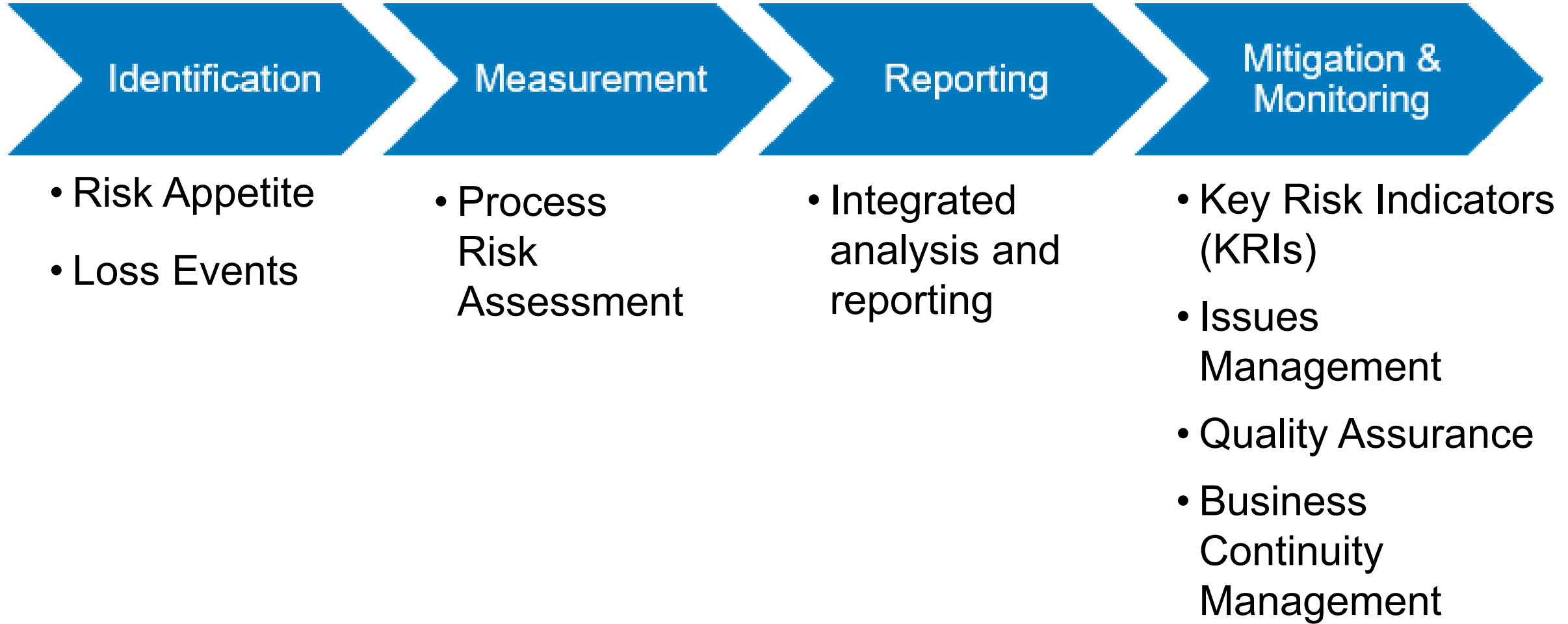
Agenda

- Risk Management Framework
- Risk and Control Relationship
- Conducting the Risk Assessment
- How the Risk Assessment Adds Value



Risk Management Framework

Risk Management Framework



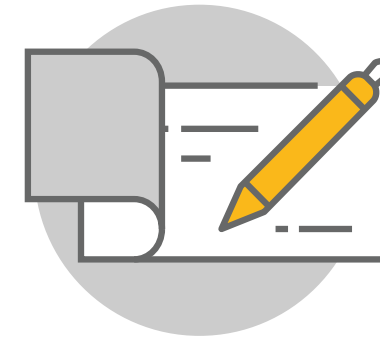
Risk and Control Relationship

Risk and Control Relationship

- Materiality of risks should inform the control design
- Controls are designed to mitigate inherent risks but do not eliminate risk completely
- Inherent Risk is driven by
 - Impact (financial/ non-financial, recovery time, pervasiveness)
 - Likelihood
- Control design and operating effectiveness inform Residual Risk

Key Characteristics of a Good Control

- Purpose and Alignment
- Definition and Measure
- Maturity
- Efficiency
- Ownership and Transparency
- Capability
- Level of automation
- Complexity
- Velocity of detection



Purpose and Alignment

- Is the control used to manage a risk?
 - Mitigate an existing risk
 - Detect a potential risk
- Is there alignment with organization mission, vision, values, and business objectives?
- What is the value proposition and are controls consistent with this?
- Is the control aligned to an existing process?
 - Material processes (volume, value, complexity)
 - Aggregation of non-material processes
 - End-to-end view



Definition and Measure

- Is the control well-defined?
- Is the control well-documented?
 - Policy, guidelines, operating procedure
- Is the control measurable?
 - Reasonableness vs. precision
- Is the control **operating** at a level to detect variances?
 - Dollar thresholds
 - Are all applicable attributes included in the control (existence, completeness, accuracy, etc.)



Maturity

- How long has the control been in place?
- Is it a new control or a change to an existing control?
- How long has the control owner executed or been responsible for the control activity including the reviewer?
- Is the control relevant?
- Is the control maturity in synch with the process maturity?



Efficiency

- How efficiently does the control operate?
- Inputs and outputs – what resources are used to gather/use the inputs
 - Resources – effort, time, and level, (non-) automated potential alternatives for all factors during the analysis
- Outputs – what output is created?
 - Can the output be enhanced/improved? If so and in what way? What impact would it have on the inputs (cost, time, effort)

Ownership and Transparency

- Who is the control owner?
- How many people are involved with the exercise of the control?
- If the control breaks down, what's the escalation process, within and outside control area?
- Is the control activity included in the documented procedures?



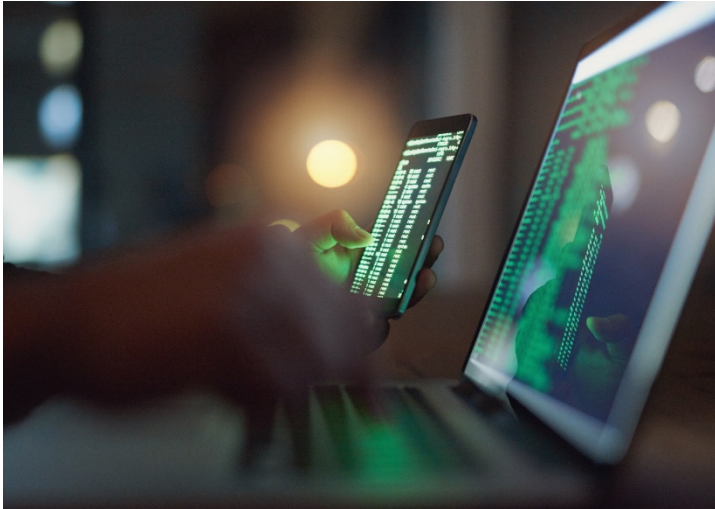
Capability and Velocity of Control Design

- Does the execution of the control require specialized knowledge or skill – by all individuals that are part of the control (preparer and reviewer)?
- Does the output/report generated as part of the control require specialized knowledge to review and understand?
- When the control fails, how long will it take to be detected and by whom?
- If the control is not being executed, who will detect it and how?
- How often does the risk change, who will detect this change and how?

Level of Automation and Complexity

- **Level of Automation**

- Fully manual
- System utilized for some automation
- Control is IT dependent for system sign off
- Control is IT dependent for reports or monitoring
- Control is fully automated



- **Complexity**

- Number of inputs
- Number of hand-offs
- Volume of documentation
- Interdependencies
- Number of steps
- Number of regulatory requirements related to the control
- Level of subjective criteria used
- Number of assumptions used

Conducting the Risk Assessment



Polling Question #12:

How comfortable are you when it comes to conducting risk assessments?

- A. Not at all
- B. Only slightly
- C. Fairly comfortable
- D. Very comfortable



Conducting the Risk Assessment

- **Beginning the Process**

- Leveraging existing knowledge and documentation
- Reviewing prior internal audit and/or compliance findings
- Reviewing and understanding changes in the business which may include key strategic initiatives
- Reviewing external auditor findings
- SEC comment letters and other regulatory findings including enforcement actions



Conducting the Risk Assessment

- **Beginning the Process (cont.)**

- Methods for executing the Process-Level Risk Assessment include the following see:
 - Individual Interviews
 - Facilitated workshops
 - Electronic surveys
- Depending on the auditor's knowledge of the organization and complexity of the process, it may be useful to complete the Risk Assessment via desktop procedures and then review results with key stakeholders.



Conducting the Risk Assessment

- **Individual Interviews**

- time-efficient for the client person being interviewed
- May result in some bias in views obtained about risk
- May stretch the process of information gathering out over time due to scheduling issues, availability of right people, etc.

- **Facilitated sessions:**

- Can be simple or complex
- Can have great value by themselves because of the opportunity for key stakeholders to exchange and compare views on business risks – a rich dialog that can create new insight, perspectives in addition to guiding internal audit plans and activities
- Take a significant investment by audit team to plan and conduct effectively

- **Electronic Surveys**

- Have the ability to gather a large amount of input from varied sources very cost-effectively, and
- Permit anonymous (and therefore candid) input about risk from people
- May take additional time to sort key risks from non-key risks
- May require follow-up conversations with respondents to understand the survey responses



Conducting the Risk Assessment

- **Evaluating Inherent Risk**

- Inherent risk factors should be evaluated for all Auditable Entities.
- Inherent Risk Factors include the following:
 - Significance of Business Risk
 - Changes in System, Processes, Personnel or Budgets
 - Organizational Impact
 - Degree of Automation
 - Complexity of Processes, Systems, or Applications
 - Significance of Regulation/Compliance
 - Size and Volume of Transactions





Conducting the Risk Assessment

- **Evaluating Residual Risk**
- Residual risk is the risk remaining after the consideration of controls.
- Factors to Consider in the evaluation:
 - Past Issues specific to the process/activity, i.e. audit findings, control breakdowns and process failures
 - Existence and quality of policies and procedures
 - Existence and quality of performance monitoring and key performance indicators
 - Is the process operating efficiently and effectively?
 - Are there process-level performance metrics that would help evaluate this?

How the Risk Assessment Adds Value

Adding Value – Internal Audit C.A.R.E.S.!

- Customized Internal Audit Approach
- Approach that accounts for the business environment
- Risk Driven Focus to the Organization
- Event Identification to Enhance the Control Environment
- Specialized Scopes





Polling Question #13:

Following this session, do you have a better understanding of how to perform risk assessments?

- A. Yes
- B. Somewhat
- C. Not Really

Q&A



Questions? Thank You!

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