



*LeiningerCPA, Ltd.*  
**INTERNAL AUDITING PROCEDURE STATEMENT**

The purpose of this Internal Auditing Procedure Statement is to provide further guidance in implementing various provisions of the Internal Audit and Control Policy Statement.

**Objectives of the Internal Audit Function**

The overall objective of the internal audit function is described in the Internal Audit and control Policy Statement. To accomplish this overall objective, the principal objectives of the internal audit process include:

1. Determining the adequacy and efficiency of risk management and internal control systems and activities, including bank policies, plans, and other operating procedures,
2. Ascertaining compliance with bank policies, internal controls, and laws and regulations,
3. Reviewing the reliability and integrity of financial and operating information and the means used to identify, measure, classify, and report such information.
4. Reviewing the means of safeguarding assets and verifying the existence of such assets.
5. Reviewing the effectiveness and efficiency of operations and employment of bank resources.

**Role of the Internal Audit Manager**

The role of the Internal Audit Manager will be to assist the directors and senior management in ensuring the following matters are reflected in the bank's internal audit function.

**Management, staffing and audit quality** - The internal audit manager is responsible for control risk assessments, audit plans, audit programs and audit reports, further described as follows:

- A **control risk assessment** documents the understanding of the Bank's significant business activities and their associated risks.
- The **audit plan** is based on the control risk assessment and includes a summary of key internal controls within each significant business activity, the timing and frequency of planned internal audit work, and a resource budget.
- An **audit program** describes the objectives of the audit work and lists the procedures that will be performed during each internal audit review.
- An **audit report** generally presents the purpose, the scope and results of the audit, including findings, conclusions and recommendations. Workpapers should be maintained that adequately document the work performed and support the audit report.

The internal audit manager shall coordinate and oversee the internal audit function and ensure the function is competently supervised and staffed by a combination of internal and external personnel with sufficient expertise and resources to identify the risks inherent in the Bank's operations and assess whether internal controls are effective.

The internal audit manager shall work with the department managers in evaluating the risks in all departments and functions. The department managers should actively participate in determining the risks, or at a minimum, review the risk assessments to determine whether they are reasonable.

The internal audit manager and others shall periodically review the results of internal control processes and analyze financial or operational data for any effect on the risk assessments. Accordingly, the department managers shall keep the auditors current on all major changes in departments or functions, such as the introduction of a new product, implementation of a new system, or changes in organization or staff.

While risk assessment shall remain a dynamic process throughout the year, the internal audit manager shall confirm the risk assessment system's reliability at least annually or whenever significant changes occur within a department.

**Scope** - The frequency and extent of internal audit review and testing should be consistent with the nature, complexity, and risk of the Bank's on- and off-balance sheet activities.

The Board, with the assistance of management, shall evaluate the work of the internal audit function at least annually. The Board shall review and approve the internal audit manager's control risk assessment and the scope of the audit plan, including how much the manager relies on the work of an outsourcing vendor (see below), and periodically review internal audit's adherence to the audit plan.

The Board shall consider requests for expansion of basic internal audit work when significant issues arise or when significant changes occur in the Bank's environment, structure, activities, risk exposures, or systems.

**Communication** - Internal audit shall report internal control deficiencies to the appropriate level of management as soon as they are identified. Significant matters shall be promptly reported directly to the Board and senior management. In periodic meetings with management and the internal audit manager and/or any outsourcing vendor, the Board shall assess whether internal control weaknesses or other exceptions are being resolved expeditiously by management.

The Board should consider giving the internal audit manager and/or any outsourcing vendor the opportunity to discuss his or her findings without management being present.

The Board should also consider establishing procedures for employees of the bank to submit confidentially and anonymously concerns to the Board (preferably an outside director) about questionable accounting, internal control, or auditing matters. They should also establish procedures for the timely investigation of complaints received and the retention for a reasonable time period of documentation concerning the complaint and its subsequent resolution.

**Contingency planning** – As with any other function, the bank should have a contingency plan to mitigate any significant discontinuity in audit coverage, particularly for high-risk areas.

**Internal Audit Independence and Outsourcing**

*[For part-time auditors with other operational responsibilities:]*

**Further considerations for approval of dual reporting relationship of Internal Audit Manager**

It is management's responsibility to carefully consider the level of auditing that will effectively monitor the Bank's internal control system, after taking into account the internal audit function's costs and benefits.

The regulators acknowledge that many banks place the internal audit manager under a dual reporting arrangement: functionally accountable to the Board on issues discovered by the internal audit function, while reporting to another senior manager on administrative matters. The internal auditor may also play a consulting role with the bank on new products and services.

Such an administrative reporting relationship and/or consulting role should be designed so as to not interfere with or hinder internal audit's functional reporting to and ability to directly communicate with the Board.

Stated another way, the board must appropriately balance the need to maintain the independence of the internal audit function, with the need to ensure the audit function is conducted effectively by an employee(s) with sufficient competency and objectivity. As a measure in determining this, any operational responsibilities of the internal audit manager should not impair or unduly influence his or her overall independence.

**Further considerations for Board approval of independence of the external audit process**

The regulators state that when a small non-public institution, such as the bank, decides to hire the same firm to perform internal and external audit work, the Board and the external auditor should pay particular attention to preserving the independence of both the internal and external audit functions. When approving the external audit engagement letter, the Board should document that it has pre-approved the internal audit outsourcing to its external auditor, and has considered the independence issues associated with this arrangement.

In this regard, the Board and external auditor should consider the independence standards described in the Interagency Policy Statement and the standards of the AICPA, and specifically the broad principles that the external auditor should not perform management functions, make management decisions, or act or appear to act in a capacity equivalent to that of a bank employee or serve in an advocacy role for the bank. More specifically, the external auditors should be prohibited from originating or approving entries to the bank's system of accounts, and should not perform any operational activities.

In addition, management and the Board acknowledge that the bank must retain ownership of the accountability for the internal audit function and provide active oversight of the outsourced internal audit relationship.

*[For full-time auditors with no other operational responsibilities:]*

In order to preserve the independence and objectivity of the internal auditor, he/she is generally prohibited from originating or approving entries to the bank's system of accounts. Further, the internal auditor shall generally not be required to perform any on-going operational or control activities that are a material component of the daily operations of the bank. Exceptions to these restrictions include the performance of operating or control procedures (1) necessary to substitute for absent personnel, or (2) performed for internal audit purposes. Other on-going material exceptions to this provision may be appropriate and should be approved by the Board of Directors.

In any event, the internal audit function shall be carried out with the absolute requirement that the auditor not review those areas directly under his or her authority and control. Another individual shall be responsible for performing the internal audit of these areas and communicating the results.