



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

Effective internal control is a foundation for safe and sound operations. Management and the Board of Directors are committed to providing sufficient personnel and other resources for maintaining an overall environment conducive to a sound system of internal control procedures and activities, commonly known as a system of “checks and balances.”

***Objectives of the Internal Control Process***

Internal control is a process, effected by the Board of Directors, management and to some extent all personnel, designed to provide reasonable, but not absolute, assurance regarding the achievement of objectives in the following categories:

1. ***Risk management systems are effective*** – including the capability to promptly detect and correct unintentional mistakes and errors, as well as intentional noncompliance, fraud or irregularities.
2. ***Compliance with applicable laws and regulations*** – including compliance with bank policies and procedures, and sound fiduciary principles.
3. ***Reliability of financial / management reporting*** – which will permit preparation of reliable financial statements and reports and enable management, the board and all other stakeholders to make sound judgments.
4. ***Recorded transactions are accurate*** – including the accuracy and reliability of accounting data and other financial information.
5. ***Effectiveness and efficiency of operations*** – including *safeguarding of bank resources*, and achievement of performance and profitability goals. The cost of providing controls must be balanced with the risks associated with the transaction or activity.

Stated another way, in discharging their responsibilities, management and the directors should have reasonable assurance that the internal control system prevents or detects inaccurate, incomplete or unauthorized transactions; deficiencies in the safeguarding of assets; unreliable financial and regulatory reporting; and deviations from laws, regulations, and Bank policies.

The internal control system consists of: 1) general policies approved by the Board, 2) management policies and procedures, 3) department operating procedures and standard control documentation, and 4) specific internal control and audit procedures.

The specific internal control and audit procedures are comprised of three levels: 1) performer of the control procedure itself, 2) supervisory reviewer/manager of the control procedure, and 3) audit of the control procedure for overall effectiveness.

- The performer, reviewer and manager comprise the internal control layer, providing the “first line of defense” responsible for detecting and correcting errors or irregularities on a timely basis. The audit layer is responsible for determining the internal control activities are operating effectively.

Procedures at each of these levels for each business function form the basis for documentation and evaluation of the system of internal control.

### ***Internal Control Elements***

The formality of any control system will depend largely on the organization’s size and the complexity of its operations. Although a smaller organization’s operations are likely to be less formal and less structured, its internal control system should be as effective as those at more complex and larger organizations.

The Committee of Sponsoring Organizations of the Treadway Commission (COSO) outline five essential components of any internal control system. The five components are:

1. **Control Environment** – While each component is important, the first – control environment – is the foundation for all the others. The control environment reflects the overall attitude, awareness, and actions of the board and management concerning the importance of control activities. Overall, the control environment provides discipline and structure for the organization’s entire operations.
2. **Risk Assessment** – Risk assessment is the process the board and management use to identify and analyze risks that could keep the organization from achieving planned objectives. The assessment should help determine what the risks are, how they should be managed, and what controls are needed. Risks can arise or change because of various circumstances.
3. **Control Activities** – Control activities include the policies, procedures, and practices established to help ensure that personnel carry out board and management directives. These activities help ensure that the board and management manage and control risks that could affect operating performance or cause financial loss. Policies governing control activities should ensure that officers who perform internal control functions in addition to their operational duties do not evaluate their own work.

Control activities are applied at various organizational and functional levels and include:

- **Operational performance reviews** – These control activities include risk assessments and reviews of actual financial performance versus budgets, forecasts, and prior-period performance.
- **Information processing** – general and application controls.
- Physical controls.
- Segregation of duties.

4. **Accounting, Information, and Communication Systems.**

5. **Self-Assessment or Monitoring.**

The bank’s internal control activities are comprised of five general control elements or responsibilities that apply to all areas of the bank and all types of transactions and accounts, including interaction with bank customers or other third parties. These control elements are defined as follows:

1. **Authorization.** Transactions are to be initiated, authorized and/or executed in accordance with management's general authorization by establishing policies which are approved by the board of directors. This includes ensuring the identity and authorization of customer and other third party personnel to authorize transactions on their behalf.
2. **Recording.** All authorized transactions are to be recorded and input into manual or computerized subsidiary ledgers, in the correct amounts, in the appropriate accounting period, and in the appropriate account. No fictitious transactions are to be recorded.
3. **Reconciliation.** Records are to be compared periodically with physical assets, documents, or control accounts. The nature and amount of any differences, and appropriate adjustments, are to be explained and recorded. Reconciliation helps provide assurance that other control objectives have been achieved.
4. **Safeguarding.** Direct or indirect access to bank or customer assets and other resources, including electronic access to computer data files or electronic funds, is to be limited to those who are properly authorized. Safeguarding includes physical precautions and security measures, such as dual control of sensitive physical assets or items, and limiting bank and customer electronic access through the use of on-line security.
5. **Valuation.** Recorded amounts are to be reviewed for impairment in value; and direct write-down, allowance or other adjustment is to be recorded as appropriate to conform with generally accepted accounting principles.

#### ***Segregation and Rotation of Responsibilities***

To provide appropriate segregation of duties, no one person should be responsible for performing all of the above mentioned responsibilities with respect to a transaction. Involving at least two people somewhere in the transaction processing stream helps to detect inadvertent mistakes, including both human and system error, while lessening the risk of or opportunity for fraudulent or inappropriate activities. At a minimum, a thorough and knowledgeable supervisory review of the transaction activity should be performed by someone independent of the processing stream.

Consideration should be given to periodically rotating responsibility for performance of operating and control procedures among appropriate bank personnel, especially where it is more difficult to fully provide segregation of duties. Rotation of duties not only assists the bank in providing cross-training for personnel, but also provides for an effective "peer audit" of operating and control procedures.

Considerations for determining appropriate personnel to be involved in the control process include balancing: 1) their independence from the processing stream, 2) their objectivity and authority to take action when any errors or irregularities are detected, and 3) their knowledge and bank experience. These factors should be weighed to determine the ability of the person to determine the completeness, accuracy and reasonableness of transaction activity recorded.

### ***Written Description of Internal Control and Operating Procedures***

In order to facilitate the establishment and performance of effective internal control activities, the bank shall provide a written description of all important internal control responsibilities. Management also endeavors to provide detailed written descriptions of how to perform the underlying operating and control procedures, to the extent necessary and cost-beneficial.

To assist in pro-actively documenting and supervising internal control activities, the bank has developed a written Internal Control Chart, a copy of which is attached.

The objective of the Internal Control Chart is to provide a comprehensive listing of control procedures for all major points of operational risk, and to clearly communicate to all affected personnel and facilitate monitoring of the bank's expectations for performance of the procedures.

The Chart provides a brief description and the frequency and personnel responsible for performing and reviewing important operational and control procedures. The Chart also identifies back-up personnel, and provides a cross-reference to any written operating procedures.

See the separate written instructions for a more complete discussion of how to utilize the Internal Control Chart.

### ***Evaluating the Performance of Internal Control Procedures***

Determine that each control procedure is:

- *Performed effectively*, in accordance with policy, in a timely manner, by the proper person, and subject to supervisory review.
- *Properly documented*, including dates and descriptions of reconciling items and initials of the preparer and reviewer, and including retention of appropriate documents, providing an audit trail for future reference. Consideration must be given to maintaining an appropriate audit trail where evidence of performance of control procedures is stored in an electronic format.

Exception and reconciling items are *properly resolved* in a timely manner, with a description of how resolved where appropriate.

### ***Other Considerations for Designing Internal Control Procedures***

When designing internal control procedures, consider the following objectives:

- ***Scope of coverage*** – comprehensive in covering all bank transactions and activities, including such considerations as whether they flow through or flow outside of the general ledger and/or computer system, and whether they exist in paper or electronic form.
- ***Adequacy of design*** – a comparison of “what should be,” to “what is.” Ask the question: If properly performed, will the control be effective in reducing risk to an acceptable level?
- ***Effectiveness and efficiency*** – helping ensure an appropriate degree of bank and individual compliance, while maintaining the cost-benefit relationship. Not under or over controlling. Ask the question: what are the risks associated with this transaction or activity, balanced against the cost of providing control activities to minimize the risk to an acceptable level?

When designing control procedures, vary the nature (type), timing (frequency) and extent (depth) of each procedure in order to reduce to an acceptable level the risk that errors or irregularities occur and go undetected by the bank's control activities.

- For example, reconciliations of the bank's primary correspondent bank are performed daily, because of the size and volume of activity, and management's desire for significant errors to remain undetected for no more than a very short period of time. In addition, the ability to identify and research the cause and resolution of reconciling items is far more efficient when performed frequently.
- On the other hand, reconciliations of the bank's minor correspondent bank accounts with minimal activity are usually performed monthly.

Similarly, the nature, timing and extent of the supervisory review required for each procedure should vary according to the various factors affecting the risk inherent in the account or activity, while maintaining a proper cost-benefit relationship.

It is usually both more effective and efficient to maintain a control environment and design internal control procedures that help prevent errors or irregularities from ever occurring, rather than to hoping to rely on procedures to detect and correct them once they have occurred. Policies and procedures represent directive controls that help to ensure safe and sound operations.