INTRODUCTION

OTS requires all savings associations, their affiliates, and subsidiaries to establish and maintain adequate systems of internal control. As financial institutions reposition their portfolios, they must have a process in place to identify, monitor, and control risk. Audits by public accountants and examinations by all the banking agencies have placed a greater emphasis on evaluating the appropriateness of the processes in place, and less reliance on transaction testing.


This section of the Handbook defines internal control, describes objectives and components of internal control, and explains how to consider internal control in planning and performing an examination. In general, when beginning an examination, first review and evaluate the adequacy and effectiveness of the internal control system. If you discover areas where internal controls are inadequate, expand the scope of examination to determine whether there are any safety and soundness concerns.

OBJECTIVES

An effective internal control system better ensures the following important attributes:

- Safe and sound operations.
- The integrity of records and financial statements.
- Compliance with laws and regulations.
- A decreased risk of unexpected losses.
- A decreased risk of damage to the association’s reputation.
- Adherence to internal policies and procedures.
- Efficient operations.

A system of strong internal control is the backbone of an association’s management program. Strong internal control helps an association to meet goals and objectives, and to maintain successful, healthy operations. Conversely, a lack of reliable records and accurate financial information may hamper the long-term viability of an association. An effective internal control system integrated into the organization’s overall risk management strategy serves the best interest of the shareholders, board of directors, management, and regulators.

REGULATORY CONCERNS

Regulators are placing increasing importance on internal control systems in light of recent financial association failures. Some associations failed primarily because they did not detect insider fraud or abuse because they had deficient or nonexistent systems of internal control. The Federal Deposit Insurance Corporation Improvement Act (FDICIA) of 1991 required the banking agencies to establish certain safety and soundness guidelines. Appendix A of 12 CFR Part 570, Interagency Guidelines Establishing Standards for Safety and Soundness, includes a section on operational and managerial standards.

Under these standards, OTS requires management and the board of directors to implement and support effective internal controls appropriate to the size of the association, its nature, and scope of activities.

DIRECTORATE RESPONSIBILITIES

The board of directors has the primary responsibility of establishing and maintaining an adequate and effective system of internal control. An effec-
tive board generally has members who have financial or banking experience, and stature.

The board is responsible to report to the FDIC and the OTS (when it is the primary regulator) on internal control over financial reporting and compliance with certain laws and regulations, as well as filing annual audited statements under Section 112 of FDICIA.

The board is also responsible for approving and periodically reviewing the overall business strategy and significant policies of the association, as well as understanding the major risks the association takes. The board should set acceptable levels for these risks, and ensure that senior management takes the required steps to identify, measure, monitor, and control these risks. To remain effective in the dynamic and ever broadening environment that associations operate in, the board of directors should periodically review and update the internal control system.

To oversee internal control and the external and internal audit function of an association, an audit committee comprised of outside directors (or at least a majority of outside directors) is desirable. Insured depository institutions covered by Section 36 of the Federal Deposit Insurance Act (assets total $500 million or more), as implemented by 12 CFR § 363.1(a) must have an audit committee composed of only outside directors.

An active board or audit committee independent from management sets the association’s control consciousness. The following parameters determine effectiveness:

- The extent of its involvement in and its scrutiny of the association’s activities.
- The ability to take appropriate actions.
- The degree to which the board or audit committee asks difficult questions and pursues the answers with management.

For additional guidance on audit committee responsibilities, see Handbook Section 355, Internal Audit.

**AUDITOR RESPONSIBILITIES**

**Internal Audits**

Both the internal and external auditors play key roles in the monitoring of internal control systems. Each association should have an internal audit function that is appropriate to its size, and the nature and scope of its activities. The internal auditor is typically very involved in the ongoing review and assessment of an association’s internal control. The board of directors should assign responsibility for the internal audit function to a member of management who has no operating responsibilities, and who is accountable for audit plans, programs, and reports. When properly structured and conducted, internal audits provide directors and senior management with vital information about any weaknesses in the system of internal control allowing management to take prompt, remedial action. Through directed reviews of the internal control systems and as part of the regular audit program, the internal auditor can be the first line of defense against a corrupted control system.

**External Audits**

Established policies and practices look to the external auditor to play a significant and vital role in an association’s internal control systems. In this role, the external auditor performs examination procedures to attest to management’s assertion that the internal control over financial reporting is functioning effectively, and that it is in compliance with designated laws and regulations. The external auditor may consider the work done by the internal auditor as part of the auditing procedures.

SAS No. 94, *The Effect of Information Technology on the Auditor’s Consideration of Internal Control*, which amends SAS No. 55, provides guidance to auditors about the effect of information technology on internal control. It also establishes that an auditor should obtain an understanding of internal control sufficient to plan the audit and determine the nature, timing, and extent of tests to perform, including assessment of control risk. While this pronouncement places significant responsibility on the external auditor to look at internal control, the external auditor may
not extensively review controls over all areas of the association, and may use different levels of testing depending on the risk of a specific area.

SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit*, provides guidance to the external auditor in identifying and reporting conditions that relate to an association’s internal controls observed during an audit of financial statements. The reportable conditions discussed in this pronouncement are matters coming to the attention of the auditor that, in the auditor’s judgment, should be communicated to the audit committee because the conditions represent significant deficiencies in the design or operation of internal control. These conditions, in the opinion of the auditor, could adversely affect the association’s ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. In some instances, a reportable condition may be of such magnitude to be a “material weakness.” A material weakness in internal control is a reportable condition in which the design or operation of one or more of the internal control components does not sufficiently reduce the level of risk that material misstatements caused by error or fraud may occur, and employees in the normal course of business would not timely detect the misstatements.

Auditors generally do not search for reportable conditions or material weaknesses. They usually become aware of them through consideration of the components of internal control, application of audit procedures to balances and transactions, or during the course of the audit. The auditor makes a judgment as to which matters are reportable, taking into consideration various factors, such as an entity’s size, complexity and diversity of activities, organizational structure, and ownership characteristics.

When examining the communication of internal control matters noted in an audit, be aware that there is no standard form of communicating reportable conditions or material weaknesses to the audit committee. Once the auditor has chosen to discuss reportable conditions or material weaknesses, the auditor may do so either through a formal presentation to the audit committee, or informally, through conversations. The auditor may also submit written reports. Generally, the auditor will document oral communications by appropriate memoranda or notations in the working papers.

**INTERNAL CONTROL COMPONENTS**

SAS No. 78 provides guidance on the independent auditor’s consideration of an entity’s internal control in an audit of financial statements in accordance with generally accepted accounting standards. SAS No. 78 recognizes the definition and description of internal control contained in the COSO report, and provides an overview of the framework and evaluation tools needed for a strong system of internal control. OTS urges association management and boards of directors to consider SAS No. 78, or other recognized standards in developing and maintaining an effective system of internal control.

SAS No. 78 consists of five interrelated components derived from the way management runs a business, and integrated with the management process. The components are:

- Control environment
- Risk assessment
- Control activities
- Information and communication
- Monitoring.

**The Control Environment**

The effectiveness of internal controls rests with the people of the organization who create, administer, and monitor them. Integrity and ethical values are essential elements of a sound foundation for all other components of internal control. The commitment for effective control environment rests at the top. Reaching a conclusion about a financial institution’s internal control environment involves a degree of subjectivity because of the intangible nature of measuring effectiveness.

**Control Environment Assessment Process**

Draw conclusions as to the quality of risk management and assess the effectiveness of the control environment in the following areas:
Integrity and Ethical Values

Integrity and ethical values are the products of the association’s ethical and behavioral standards. How management communicates and reinforces these values in practice establishes the “tone” for the organization. Management should strive to remove or reduce incentives and temptations that might prompt employees to engage in dishonest, illegal, or unethical acts. Management must also communicate their values and behavioral standards to personnel through policy statements and codes of conduct.

Management Philosophy and Operating Style

Management’s approach to taking business risks and their attitude toward financial reporting (conservative versus aggressive) and information processing weigh heavily in the control environment. Consider the level of commitment by management and the board of directors to establish the necessary foundation on which to build an effective system of internal control. Management must have the will to make policies work or even the best-written policies on internal control lose effectiveness.

Organizational Structure

The association must have an organizational structure that supports its objectives. Management must plan, execute, control, and monitor association objectives. It must establish key areas of authority and responsibility and appropriate lines of reporting.

Assignment of Authority

Assignment of authority includes policies relating to the following areas:

- Appropriate business practices.
- Knowledge and experience of key personnel.
- Resources for carrying out duties.

Human Resource Policies and Practices

Human resource practices send messages to employees regarding expected levels of integrity, ethical behavior, competence, and conflict of interests.

Risk Assessment

All entities, regardless of size, encounter risk in their organizations. The ability to identify and manage these risks will affect an entity’s ability to survive in a competitive market. In order to assess risk, management must first set objectives to quantify the amount of risk they can prudently accept.

Risks relevant to financial reporting include external and internal events, and circumstances that may adversely affect an association’s ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. Such risks can arise or change due to the following circumstances:

- Operating environment changes
- New personnel
- New or revamped information systems
- Rapid growth
- New technology
- New lines, products, or activities
- Corporate restructuring
- Accounting pronouncements.

The Risk Assessment Process

Determine whether management has identified and analyzed the risks, and has methodologies in place to control them. Consider also the following areas in assessing the risk process:

- Prevalence of external and internal factors that could affect whether strategic objectives are achieved.
- Effectiveness of systems used to manage and monitor the risks.
- Capacity of existing processes to react and respond to changing risk conditions.
- Level of competency, knowledge, and skills of personnel responsible for risk assessment.
Control Activities

Control activities are the policies and procedures that help ensure management carries out its directives. Control activities should ensure accountability in the association’s operations, financial reporting, and compliance areas.

The Control Activities Assessment Process

Assessment of control activities relevant to an examination includes the elements discussed below.

Performance Reviews

Management should establish policies and procedures to ensure control activities include reviews of actual performance versus budgets, forecasts, and prior period performance.

Management should conduct independent checks or verifications on function performance and reconciliation of balances.

Information Processing

There are two broad groupings of information systems: General controls and Application controls.

Management should establish policies and procedures to ensure that general controls are commonly in place over the following areas:

- Data center operations.
- System software acquisition and maintenance.
- Security access.
- Application system development and maintenance.

Management should also establish policies and procedures for application controls, which apply to the processing of individual applications. These controls ensure valid, complete, properly authorized, and accurately processed actions.

Physical Controls

Management should establish safeguards and physical controls over the following activities:

- The physical security of assets, such as secured facilities.
- Access to books, and sensitive records and systems.
- Authorization for access to computer programs and data files.

Segregation of Duties

Management should reduce the opportunities to perpetrate and conceal errors, irregularities, or any wrongdoing. Management must assign different people the responsibility of authorizing transactions, recording transactions, and maintaining custody of assets. For these safeguards, management should ensure that vacation requirements or periodic rotation of duties for personnel in sensitive positions occurs.

Information and Communication Systems

Management must identify, capture, and communicate information to enable people to carry out their responsibilities. Internally generated data, along with external events, activities, and conditions is necessary for a business to make informed decisions.

To be effective, management must communicate information to the people who need it to carry out their responsibilities. Management must design ways to downstream messages from the top, as well as upstream significant information.

An information system should provide sufficient detail to properly classify the transaction for financial reporting, and measure the value of the transactions in a manner that permits recording the proper monetary value in the financial statements in accordance with GAAP.
Information and Communication Systems Assessment Process

Communication involves an understanding of individual roles and responsibilities pertaining to internal control over financial reporting. Determine whether policy manuals, accounting and financial reporting manuals, and other memoranda effectively communicate internal control responsibilities.

Determine if management established systems to capture and impart pertinent and timely information in a form that enables staff to carry out their responsibilities. Also, determine whether the following safeguards exist:

- Accounting systems identify and record all valid transactions in the proper accounting period, ensure accountability for related assets and liabilities, and present transactions and related disclosures in the financial statements.
- Management information systems identify and capture relevant internal and external information in a timely manner.
- Contingency plans exist for information systems.

Monitoring

Monitoring is a process that assesses the quality of the internal control performance over time. Management must build ongoing monitoring activities into the normal recurring activities of their association, and monitor the internal control system on an ongoing basis to ensure that the system continues to be relevant and addresses new risks. In many cases, the internal auditor is responsible for monitoring the entity’s activities and regularly provides information about the functioning of internal control, including the design and operation.

The Monitoring Assessment Process

Determine who oversees and assesses the monitoring process. Review the type of periodic evaluation of internal control that occurs. For example, is it by self-assessment or by independent audit? Check whether systems ensure timely and accurate reporting of deficiencies and whether there are processes to ensure timely modification of policies and procedures, as needed.

ASSESSING CONTROL RISK

Under SAS No. 78, control risk is the risk that the entity’s internal control system will not prevent or detect on a timely basis a material misstatement. Assessing control risk is the process of evaluating the design and operating effectiveness of an entity’s internal control. Although you do not ordinarily consider the individual components of internal control, you should consider the combined aspects of the five SAS No. 78 components.

You can assess control risk in quantitative terms, such as percentages, or in nonquantitative terms that range from maximum to minimum.

Assessing Control Risk at the Maximum

You should assess control risk at the maximum when there is risk that internal control will not prevent or detect material misstatements on a timely basis. In addition, you should review control risk at the maximum if management’s representations conflict with controls or reduce the effectiveness, or you have concern that you cannot obtain sufficient competent evidential matter to evaluate the effectiveness of internal controls.

Assessing Control Risk at Less Than Maximum

Assessing control risk below the maximum involves performing tests to evaluate the effectiveness of such internal control. Tests of controls should determine whether the control is suitably designed to prevent or detect material misstatements. These tests ordinarily include evidence obtained from the following actions:

- Conducting management inquiries.
- Inspecting documents and reports to review how staff performs controls.
- Observing directly how management applies the controls.
- Retesting how management applies the controls.
• Evaluating if management designs an effective internal control system to monitor and correct noncompliance.

After examining the components and their risk, draw an overall conclusion as to the adequacy of the association’s system of internal control and include the assessment in the report of examination. A system deemed inadequate is potentially in noncompliance with Appendix A of 12 CFR Part 570, Interagency Guidelines Establishing Standards for Safety and Soundness. OTS may notify an association with an inadequate assessment of the need to file a plan of compliance as provided for under the regulations. The plan would establish the manner in which the association will rectify its internal control deficiencies.

Overall Assessment

The overall risk assessment should determine whether management takes the following actions:

• Supports fully the concept of effective internal control.
• Encourages their employees to comply with the controls.

LIMITATIONS OF INTERNAL CONTROL

When operating under the best of conditions, internal control provides only reasonable assurance to management and the board of directors that the association is achieving its objectives. Reasonable assurances do not imply that the internal control systems will never fail. Many factors, individually and collectively, serve to provide strength to the concept of reasonable assurance. However, because of inherent limitations, management has no guarantee that, for example, an uncontrollable event, a mistake, or improper reporting incident could never occur. Thus, it is possible for the best internal control system to fail. The limitations inherent to internal control are:

• Judgment
• Breakdowns
• Management override
• Collusion
• Fraud
• Cost versus benefits.

We discuss each of these limitations below.

Judgment

Human judgment can limit the effectiveness of internal controls. Management makes business decisions based on the information at hand and under time constraints. With hindsight, these decisions may produce less than desirable results.

Breakdowns

The best internal control system can experience any of the following breakdowns:

• Misunderstood instructions
• Careless employees
• Inadequate training
• Time limitations.

Management Override

Management override means management overrules prescribed policies or procedures for illegitimate purposes with the intent of personal gain or to enhance the presentation of financial statements. Override practices include deliberate misrepresentations to regulators, lawyers, accountants, and vendors.

Do not confuse management override with management intervention. Management intervention represents management’s actions that depart from prescribed policies for legitimate purposes. At times, management intervention is necessary to deal with nonrecurring and nonstandard transactions or events, that otherwise might be handled inappropriately by the control system.
Collusion

When two or more individuals act in concert to perpetrate and conceal an action from detection, they can circumvent any system of internal control.

Fraud

Fraud is a broad legal concept, and involves intentional illegal acts that generally cause misstatement in the financial statements. Management bears the primary responsibility for detecting fraud. Internal control systems implementation is part of management’s fiduciary responsibilities to prevent fraud and abuse by insiders. While the primary objective of an examination is the qualitative analysis of the association, fraud detection is certainly a goal when reviewing an association’s internal control system. Recent problems concerning insiders at some associations have some commonalities. Potential red flags that could signal fraud include the following situations:

- Management that is hostile or uncooperative towards examiners.
- Significant insider transactions that the association improperly approves or fails to fully document.
- Basic internal control deficiencies, such as failure to separate functions or rotate duties.
- Poor or incomplete documentation.
- Financial accounting systems and reports are unreliable, underlying controls are deficient, or the reconciliation process is lacking.
- Repeated and significant Thrift Financial Report reporting errors.
- Continuing unsafe and unsound conditions.

You should be aware of the potential warning signs of fraud and the examination and audit procedures that you should employ when warranted. If you encounter any red flags, you should bring the situation to the attention of the Regional Accountant. For more information, see Thrift Activities Handbook Section 360, Fraud and Insider Abuse.

Costs versus Benefits

The challenge is to find the right balance between the proper controls and the costs to design and implement internal controls. Excessive control is costly and counterproductive. Too few controls present undue risks.

EXAMINATION APPLICATIONS

Internal Control and Funds Transfer Questionnaires

The objective of examining the internal control of an association is to assess the extent to which management has established internal control procedures and programs to identify and mitigate the association’s internal control risks. In planning the examination, be aware of the following situations that may suggest that there is a breach in the control system that warrants attention:

- Management does not implement effective procedures to correct internal deficiencies noted in audit reports.
- Management scales back or suspends the internal audit function.
- The internal auditor has an operational role in addition to audit responsibilities. For example, the internal auditor reports through operating management and not directly to the board of directors or a committee. Ideally, the internal audit function should be under the board of directors or the audit committee, and the internal auditor should report directly to them. The extent to which the internal auditor reports to management may warrant attention to ensure that such reporting does not impair the independence of the internal auditor.
- The association’s external audit firm lacks savings association or bank audit experience, or the auditors assigned have limited experience.
- The association enters new areas of activity without first implementing proper controls, or engages in new activities without experienced staff and appropriate controls in place.
- The association fails to provide adequate reports to the board of directors.
The association does not have proper controls in high-risk areas.

The association often deviates from board-approved policies with exception documentation.

The association fails to effectively segregate duties and responsibilities among employees.

In both the Internal Control and Funds Transfer Questionnaires, there are certain “flagged” questions that are the minimum verifications you should perform.

Level I Procedures

Review the list of objectives in the Internal Control Program, included in the Appendix of this Handbook section, and follow the Level I Procedures to design the examination. These procedures are generally sufficient when an association has an effective internal audit function.

Although the five components of internal control provide a useful framework for you to review the effect of an entity’s internal control in an examination, they do not reflect how the association considers and implements internal control. Therefore, you should consider the five SAS No. 78 components in the context of the following criteria:

- Size of the association.
- Organization and ownership characteristics.
- Nature of the association’s business.
- Diversity and complexity of the association’s business.
- Methods of transmitting, processing, maintaining, and accessing information.
- Legal and regulatory requirements.

Management’s Responses

OTS sends questionnaires to the association as part of the PERK. Association management answers the Internal Control Questionnaire and the Funds Transfer Questionnaire, which contain questions regarding the overall internal control system of the thrift. You should verify answers provided by management to ensure that the answers accurately reflect the association’s activities.

Internal Audit Work Papers

Examine samples of work papers from internal audits, and include samples from outsourced functions or director’s examinations. The samples should be sufficient to provide a basis to validate the scope and quality of the association’s internal control system, and determine the amount of reliance, if any, you can place on the system.

Review also, whether the external auditor communicated any reportable conditions, either orally or in writing, to management. If you determine that external audit work papers are necessary for your review, contact the Regional Accountant before requesting external audit work papers, or other pertinent documents related to the external auditor’s judgment about the association’s internal control. See Handbook Section 350 for requesting external audit work papers, Appendices D and E.

Make requests for work papers specific to the areas of greatest interest. The request may include related planning documents and other pertinent information related to the internal control areas in question. If management or the internal auditor refuses to provide access to the work papers, contact the Regional Accountant.

If the internal audit work papers review or the external auditor’s communications with management on reportable conditions raises concerns about audit effectiveness, discuss the issues with management, the board of directors, and the audit committee. If issues remain unresolved regarding external audit work, consult the Regional Accountant.

Level II Procedures

Based on management’s responses to questionnaires, or when an association does not have an effective system of internal audit, or when warranted based on examination findings, consider expanding the scope of the examination to include Level II procedures provided in the Internal Con-
control Program. Also perform appropriate Level II procedures if the association outsources any significant activities and Level I procedures are insufficient to determine how the association controls the outsourced activity.

Issues that would require expanded procedures under Level II include:

- Concern about the competency or independence of internal auditors.
- No internal audit program is in place.
- Unexplained or unexpected changes occurring in the internal or external auditors, or significant changes occurring in the audit program.
- Inadequate controls in key risk areas.
- Deficient audit work papers in key risk areas, or work papers that do not support audit conclusions.
- High growth areas exist without adequate audit or internal control.
- Inappropriate actions by insiders to influence the findings and scope of audits.

If significant concerns remain about the adequacy of internal control, the next step, after completion of Level II procedures, should be to consider expanding the scope of the review to include procedures under Level III of the Internal Control Program. The following situations may warrant Level III procedures:

- Account records are significantly out of balance.
- Management is uncooperative or poorly manages the thrift.
- Management restricts access to records.
- Significant accounting, audit, or internal control deficiencies remain uncorrected from previous examinations or from one audit to the next.
- Internal auditors are unaware of, or unable to sufficiently explain, significant deficiencies.
- Management engages in activities that raise questions about its integrity.
- Repeated violations of law affect audit, internal control, or regulatory reports.
- Other situations that you believe warrant further investigation.

Consult with the Regional Accountant to determine which procedures you should perform.

OUTSOURCING RISKS

Associations rely increasingly on services provided by third parties to support a wide range of activities. Outsourcing, both to affiliated companies or third parties, may help manage costs, improve and expand services offered, and obtain expertise not internally available. At the same time, reduced operational control over outsourced activities may expose an association to additional risks.

Outsourcing involves some of the same operational risks that arise when an association performs a function internally. Such risks include the following:

- Threats to the availability of systems used to support customer transactions.
- The integrity or security of customer account information.
- The integrity of risk management information systems.

Under outsourcing arrangements, however, the risk management measures commonly used to address these risks, such as internal controls, are generally under the direct control of the service provider, rather than the association that bears the risk of financial loss, damage to its reputation, or other adverse consequences.

OTS expects associations to ensure that controls over outsourced activities are equivalent to those that the association would implement if they conducted the activity internally. The association’s board of directors and senior management should understand the key risks associated with the use of service providers. They should ensure that an appropriate oversight program is in place to monitor each service provider’s controls, condition, and
performance. See discussion of outsourcing in Handbook Section 355, Internal Audit.

REFERENCES

United States Code (12 USC)

*Federal Deposit Insurance Act*

| § 1831 | Contracts Between Depository Institutions and Persons Providing Goods, Products, or Services |
| § 1831p-1 | Standards for Safety and Soundness |

Code of Federal Regulations (12 CFR)

| Part 363 | Requirements For External Audits And Audit Committees |
| Part 570 | Appendix A, Interagency Guidelines Establishing Standards for Safety and Soundness |

OTS References

Directors’ Guide to Management Reports
http://www.ots.treas.gov/docs/48091.pdf

AICPA Professional Standards

Statement of Auditing Standards (U.S. Auditing Standards (AU))

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Internal Control Program

Examination Objectives

Determine whether existing controls reasonably ensure all of the following:

- Accurate and reliable accounts and records.
- Properly authorized transactions.
- Adequately safeguarded assets.
- Compliance with applicable laws and regulations.
- Identification of weaknesses that require further examination (testing) and correction.

Examination Procedures

Perform the procedures that summarize the internal controls review. The procedures require the input of other regulators on the team.

Level I

Level I procedures are typically sufficient when an association has an effective internal audit function in place and no findings develop that would cause an expansion of scope.

1. In consultation with the examiner in charge (EIC), review and evaluate the responses to the Management Questionnaire (PERK 002), the Internal Control Questionnaire (PERK 004), and the Funds Transfer Questionnaire (PERK 018). Follow up by reviewing appropriate internal audit work papers and by interviewing the internal auditors and operations staff to determine possible areas of internal control weaknesses. Perform this review as early in the examination as possible. Immediately notify the examiner assigned any area where there are possible weaknesses so the examiner can make any necessary scope changes.

2. Review management reports on internal controls and related attestations by independent accountants required by the Federal Deposit Insurance Corporation Improvement Act (FDICIA). Review the external audit internal control work papers or other communications regarding reportable conditions.

Exam Date: ____________________________
Prepared By: __________________________
Reviewed By: __________________________
Docket #: _____________________________
3. Check for material weaknesses in internal controls by noting any deficiencies reported in the following:
   - Recent internal and external audit reports.
   - Related management letters.
   - Management and the board of directors’ responses.
   - The most recent examination reports of all types.

Determine if management has corrected the deficiencies. Determine the reasons if management has not taken effective corrective action. If management has not taken effective corrective action or if new deficiencies developed, follow appropriate procedures for reporting.

4. Determine whether management modified its program of internal control through policy or procedural changes since previous examinations of all types. If so, evaluate the reasons for, and the validity of, such changes.

5. Determine whether management established an effective system of internal control and enforces the controls for subordinate organizations and other subsidiaries.

6. Verify that management enforces all critical policies.

7. Review the general questionnaires as other examiners complete them during the examination to identify all critical internal control weaknesses noted. Discuss these weaknesses with appropriate management personnel, either personally or by the examiner responsible for the review of these areas.
8. Verify that appropriate staff performs reconciliation of general ledger accounts with subsidiary ledgers, supporting documentation, or external confirmations often. Check whether the association promptly clears or resolves reconciling items. (You may do these verifications piecemeal as part of several other examination programs.)

9. Determine whether the association outsources any significant activities to third-party vendors. Review internal and external audit reports for identified problems or concerns regarding outsourced activity. Perform Level II procedures as appropriate.

10. If the association uses its external auditors to conduct the internal audit, determine that the association maintains the integrity and quality of internal control.

11. Determine the presence and effectiveness of internal control activities in all major business lines.

Level II

You should perform Level II procedures when an association does not have an effective system of internal audit or when warranted based on examination findings. You should also perform appropriate Level II procedures if the association outsources any significant activities and Level I procedures are insufficient to determine how the association handles and controls the outsourced activity.

12. Determine whether the external auditor appropriately evaluated internal control by reviewing the engagement letter and management letter on internal controls. Review audit work papers only after consulting with the EIC and/or the FM.
13. Determine whether internal audit or alternate control reviews are sufficiently independent. Pay particular attention to independence issues when the association uses the external auditors to conduct the internal audit.

14. Determine the frequency of testing and reporting for compliance with laws and regulations. Determine whether the association gives appropriate attention and follow-up to violations of laws and regulations.

15. Assess the adequacy of information and communication systems.

16. Determine whether management gives appropriate and timely attention to material control weaknesses once identified.

17. Review outsourcing contracts with third-party vendors to determine their existence and that they are sufficiently detailed commensurate with the scope and nature of the outsourced activity. (See the discussion of Outsourcing in Handbook Section 355.)

18. Determine that the third-party vendor has implemented internal control policies and procedures comparable to those that the association would utilize if the association conducted the activity internally.

19. Determine that the association properly documents and approves all insider and affiliated party transactions.
20. Review director’s, officer’s, and employee’s deposit accounts for any unusual activity.

21. Ensure that your review meets the Objectives of this Handbook Section. State your findings and conclusions as well as appropriate recommendations for any necessary corrective measures, on the appropriate work papers and report pages.

Level III

After consultation with the field manager you should perform agreed upon Level III procedures based on findings from Level I and Level II procedures. You should also consider Level III procedures when:

- Level I and II procedures are insufficient to draw sound conclusions.
- The association is not audited by an independent party.
- The association does not have an internal audit program in place.

22. Verify cash on hand. Review cash items or any other assets or liabilities held in suspense accounts to determine proper and timely disposition.

23. When control concerns exist in a given area or activity, prove subsidiary records for targeted area to the general ledger such as loans, investments, or deposits.

24. Verify the safekeeping of securities on hand or held by others.

25. Review accrued interest accounts and test the computation and disposition of interest income.
26. Verify the loan balances for loans charged-off since the previous examination and the debit entries to the allowance account.

27. Check supporting documentation for loans charged-off.

28. Review loan recoveries and check the credit entries in the allowance account.

29. Review closed deposit accounts to determine that they were properly closed. Review dormant account activity for propriety.

30. Review deposit overdraft activity to determine legitimacy and adherence to policies.

31. Review the timeliness and adequacy of all bank account reconciliations.

32. Review all suspense accounts and ascertain explanations for large or unusual items. Determine that no one is using a suspense account to divert deposits, conceal impaired or worthless assets, or hide shortages.

33. With the written concurrence of the field manager, conduct a direct verification of appropriate loan or deposit accounts.
34. Review the timeliness of wire transfer verifications and reconciliations and verify that independent parties were involved in the process.

35. Determine that association management properly supports and approves entries to the books and records and that they review unusual entries.

36. Request documentation for significant or unusual transactions. Review the tax return for disclosures.

Examiner's Summary, Recommendations, and Comments
QUESTIONNAIRES

This discussion briefly addresses subjects in the Internal Control Questionnaire and Funds Transfer Questionnaire. The association completes these Questionnaires as part of the PERK. You should follow up with an interview and indicate on the form any answers that you verified. The association must explain negative responses and you should review through interview and observation any problems needing supervisory attention. Many of these topics are somewhat self-evident and the Handbook covers others in more detail in other sections.

Internal Control Questionnaire

Internal Audit

Associations should have an internal auditing program that is appropriate to its size and the nature and scope of its activities. Associations should follow specific procedures to test accounting information and internal routine and controls. Preferably, the internal auditor should report findings to the board of directors or an audit committee consisting of outside directors. Internal audit reports should include suggested corrective actions to noted problems. The board or audit committee should ascertain whether management made adequate corrections when recommended. A full-time internal auditor should preferably serve the board or audit committee. If this is impractical, at least the board or audit committee should review the auditor’s performance. It should set the salary to keep the auditor independent of the audit subjects, especially top management. Refer to Thrift Activities Regulatory Handbook Section 355, Internal Audit.

General Items

The records and systems should enable others to trace any given item as it passes through the association’s books. Exception or large item reports list all transactions over a specific dollar amount, regardless of whether they involve cash, check, etc. The association should have a person not involved in the transaction review the report for unusual items. You may suggest to management that they create such reports if the association does not currently prepare them.

Cash and Cash Items

Cash items are “near cash” checks received as deposits from customers. In the normal course of business, the association sends these items to a correspondent that collects them from the drawee institution. The association receives immediate credit for them. The correspondent will return some items as cash items in which the association will have to resend for collection again. The association may also return them to the depositor.

Checks drawn on uncollected funds in an association are a form of loans to depositors. Management should use software controls and a daily drawing on uncollected funds report to monitor these checks. You can identify these checks by deposit accounts with deposit totals for the past three days being greater than the balance for the day. Checks drawn on uncollected funds must be limited to prevent abuse by depositors unworthy of credit. Some associations reject all checks drawn on uncollected funds. If an association permits drawings on uncollected funds, then management should allow such drawings only after they make a credit decision on the creditworthiness of the depositor. You should determine how management controls or prevents checks drawn on uncollected funds.

Overdrafts are loans made by paying checks that draw a deposit account into a negative (debit) balance. Management should permit overdrafts only after it makes a credit decision on the customer (borrower). An officer should review overdraft activity every day for old, overly large, or inappropriate overdrafts.

Return items are checks deposited in an association, but drawn elsewhere and returned for some reason, usually non-sufficient funds (NSF). The normal procedure for handling return items is to call the depositor and ask if the depositor knows if the item will be good if sent for collection on that day, or if it should be bought back by the depositor. The appropriate staff person should
record return items as return item assets if not debited to a customer’s deposit account. The association should not hold return items for days pending a decision. They may result in losses, if not paid soon. Management should maintain over and short accounts for each person with a cash drawer. If activity is minimal, then each entry should identify the person with the cash difference. Larger operations may have over and short accruals to compare actual performance with projections.

Management must ensure that accounting controls over all liquid assets prevent personal use by employees. Management’s policies should not permit “IOUs” in cash or cash item totals. An appropriate staff person should record all cash and cash item transactions and review them daily to limit abuse.

**Association (Official) Checks**

Many associations use checks drawn on themselves (known variously as “on-us checks” or “official checks”) for payment of expenses, interest, dividends, and loan proceeds. They may also sell them to customers as cashier’s checks or money orders. The association must honor its own checks or risk its reputation. The association cannot reject its checks unless there is fraud. For these reasons, management must have policies in effect to control official checks.

One common control is to require two authorized signatures. If management does not require two signatures, someone without signature authority should control the unsigned blank checks. This person should fill out the check amount and payee based on an approved voucher. The approving officer should compare the voucher to the check before signing it. Ideally, the appropriate staff person should verify unused check supplies to a shipping invoice to ascertain that the supply has not been lost and subject to misuse. After checks are paid, someone should review the checks for authorized signatures and compare them with vouchers for alteration. Someone should reconcile copies of outstanding checks to vouchers and the respective liability accounts.

**Due From Banks**

Due from banks describes assets that consist of demand and time deposits maintained in other financial institutions to facilitate the transfer of funds. Also called correspondent bank balances, these accounts enable the transfer of funds between financial institutions, resulting from the collection of cash items and cash letters, the transfer and settlement of securities transactions, the transfer of participating loan funds, the purchase or sale of federal funds, and from many other causes. Shortcomings in procedures and controls, as they relate to due from bank accounts, can lead to manipulation and shortages. The association must check incoming statements from banks to record copies in each instance to protect against fraud and errors.

**Investments and Securities**

Transactions in investment securities are typically large and involve liquid movable assets, thus making controls in this area very important. To ensure accurate records as well as discourage fraud, appropriate staff should implement the following controls:

- Document transactions and maintain them separately from the initiating officers and the executing traders (if the association has its own trading operation).
- Record all transactions and all holdings in a securities ledger system.
- Reconcile the transactions and the securities ledger to confirmations and broker statements daily.
- Reconcile transactions and the securities ledger to the general ledger at least monthly.
- Maintain accrual accounts to ensure income is collected.
- Review broker statements and confirmations and reconcile them to the books before they go to the investment officers (this action limits the chance of abuse by unauthorized officers in concert with brokers).
Management should enforce policies that limit, by dollar amount, board-granted investment authorities. They should require dual approval for unusually large transactions. Management should make this policy clear to brokers doing business with the association. Brokers should never have the authority to manipulate association assets without prior approval for every transaction. Investment advisors should advise the association, not the broker.

Brokers frequently engage in borrowing of customers’ assets through repurchase agreements or use of customers’ assets as collateral for their own trading. Management should only permit this for the most creditworthy dealers, who are typically the primary dealers in treasury issues subject to daily monitoring by the Federal Reserve.

To discourage unauthorized and unrecorded transactions (personal trading with association assets), the authorizing officer should initiate book entries for transactions by memo to the paying officer who books the transaction. Both parties perform their part of the transactions simultaneously on the clearing day. Therefore, all securities transactions should be delivery versus payment.

Most associations hold securities in safekeeping under delivery versus payment procedures. Management should permit free deliveries; those not requiring payment (such as a transfer from one safekeeping agent to another), only under contract specified dual approval to deter theft of the portfolio. When the association holds negotiable securities on premises, the securities should be under strict dual control at all times. Refer to Handbook Section 540, Investment Securities.

**General Lending**

To control the income from loan originations, management should provide a written schedule of fees and interest rates for originators to follow. Loan administration personnel should test loan originations to assure compliance with policy. Associations must establish a lending limit in accordance with 12 CFR § 560.93, Lending limits, to prevent over-lending to any one borrower. Loan administration should enforce the limit by ensuring that it does not fund loans in excess of the association’s legal lending limit. The internal auditor should report any excess loans to the board of directors.

Management should base the allowance for loan and lease losses (ALLL) on an internal asset review (IAR). They should then periodically review the credit quality and collectability of the association’s loans and leases. Staff members that review and grade assets as part of the IAR should not be responsible for originating or servicing activities.

Loan originators may request loan disbursements. Until loan administration verifies that the disbursement is in agreement with the contract and the loan complies with policies, management must not authorize the disbursement. Loan administration staff should obtain and verify credit information. They should not be involved in the loan origination. These are essential segregation of duties preventing loan officers from misapplying funds.

Internal lending limits are an extremely important control. The board of directors should implement all of the following safeguards:

- Set low individual lending limits for all officers.
- Require two or more officers to co-approve larger loans.
- Require advisory committees to co-approve especially complex or very large loans.

All loans not meeting strict board approved limits and policies should require prior board approval before commitment or funding.

A central loan (or liability) ledger should tie together all direct and indirect credits and commitments for each borrower. Otherwise, the association runs a risk of lending too much to one borrower in violation of internal policies or regulations.

**Construction Lending**

Construction lending involves many disbursements to cover construction costs as construction progresses. The association must have a construction inspector on site to verify that requests for
funds (draws) are legitimate. The inspector should check to make sure material is on site and that the contractor follows construction plans. It is also prudent to occasionally alternate inspectors at each site. Their supervisor should occasionally perform a review inspection to ascertain that inspections are reliable. Before disbursement of funds, loan administration should match inspection reports to draws. They should compare them with construction plans to ensure that work is progressing accordingly. Loan administration should never authorize cash disbursements.

Staff should not make payments to third parties directly. To prove that a borrower received funds, the appropriate staff should make the payments to the borrower’s account for payment of specific draws. Checks, however, may be payable jointly to the borrower and a supplier or subcontractor. When a contractor provides paid bills and materials’ lien wavers, staff should compare them with draws to be certain that the loan funds will pay for actual expenses. Loan administration should compare progress from draws with construction plans to ensure that they are not funding cost overruns without due consideration. Refer to Thrift Activities Regulatory Handbook Section 213, Construction Lending.

**Loan Servicing and Recordkeeping Functions**

After loan approval, staff should take the following steps:

- Maintain records under careful control to ensure that collection will be possible if legal action is necessary.
- Keep all collateral secure, so it cannot be lost, stolen, or released to the borrower early.
- Place large dollar collateral under dual control so that employees do not release it in error or through collusion with a borrower.
- Maintain complete collateral documents to ensure perfected collectible liens.
- Control advance payments on loans with appropriate accounting procedures.

- Whenever possible, cross-collateralize loans with the same obligor, that is, all collateral should cover all loans of the obligor.

Loan administration must be careful to adjust interest rates according to contracts. Collection efforts should follow official procedures to avoid legal complications. Collectors should keep a log of all contacts with delinquent borrowers, detailing any promised action. Management should use insurance ticklers to ensure that borrowers pay insurance premiums on time.

**Accrued Interest Receivable**

To prevent diversion of interest earned by the association and to ensure that interest calculations are correct, the appropriate staff should perform audit tests on interest calculations.

**Advance Payments by Borrowers for Taxes and Insurance**

Borrowers often make regular payments to an association for real estate taxes and insurance on collateral real estate. The association credits these funds to escrow or impound accounts. Staff should analyze these accounts annually to make sure the association is receiving adequate funds to cover the next expense payments. As a further control practice, the association should send the borrower an annual statement of escrow account activity. It should involve the audit department in any customer disputes. Refer to the Mortgage Banking sections of this Handbook.

**Loans in Process**

The association typically places funds allocated for construction loans in a “loans-in-process” (LIP) account and pays draws from this account. Management should review, approve, and audit draws from LIP to ensure proper application of funds. Refer to Thrift Activities Regulatory Handbook Section 213, Construction Lending.

**Commercial Lending**

The variety and risks of commercial lending require administrative controls on both information and collateral. Management should put a tickler
system into operation to ensure timely requests for financial statements from borrowers and guarantors, and to track exceptions. Qualified persons should evaluate collateral and appraise it for adequacy. Management should control collateral release to prevent loss from untimely release. Refer to Thrift Activities Regulatory Handbook Section 214, Other Commercial Lending.

Other Loans (unsecured, mobile homes, etc.)

Loan administration must control the entire process of lending and collecting. When a government agency is involved in a loan, the association must strictly meet the requirements for the guarantee or participation or the agency is generally relieved of duty to honor the guarantee. The association should verify the amount of Federal Housing Administration reserve accounts annually with the Department of Housing and Urban Development.

Dealer paper refers to loans originated by a retail seller of merchandise that the association funds or purchases. In funding such loans, management must maintain strict segregation of duties to avoid loss, because the association has no control over the dealer’s employees. The association must record collateral liens according to state law before another creditor records a lien. Management should inform the board of directors of charge-offs and recoveries to ensure that diversion of funds does not occur. The association must control and inspect collateral, because unlike real estate, merchandise is moveable. A financially healthy dealer can deteriorate quickly in an adverse economy. Thus, management should control collateral and carefully inspect it, since it may become the only source of payment.

Many manufacturers of mobile homes and other consumer items may have a variety of dealer financing plans that can distort the true dealer cost through rebates and volume discounts. Lending based on an invoice is, therefore, very risky. If the association finances inventory, the association must be familiar with the current wholesale market value of such inventory. Refer to Thrift Activities Regulatory Handbook Section 216, Floor Plan and Indirect Lending.

Credit Quality Review

Credit quality review, also known as the internal asset review or the internal classification review, is a vital credit quality control program. Refer to Thrift Activities Regulatory Handbook Section 260, Classification of Assets.

Deposit Account Loans

Losses can be serious if the association does not adequately control loans secured by deposit accounts. Lack of control may result in serious problems. These problems include:

- Forged signatures on the loan documents.
- Misapplication of loan proceeds.
- Withdrawal of collateral deposits without paying the loan. Refer to Thrift Activities Regulatory Handbook Section 560, Deposits/Borrowed Funds.

Real Estate Owned and Other Repossessed Assets

The association must establish ownership of real estate, acquired because of debts previously contracted, according to local laws and customs under legal advice. Accounting practices require a prompt appraisal to determine the correct carrying value of the new association asset. Management must periodically inspect properties for needed maintenance to limit deterioration. If properties have material value, the association’s management should bond collection and management agents, or at least ensure that they are bondable. The association should acquire hazard insurance, when available. Refer to Thrift Activities Regulatory Handbook Section 251, Real Estate Owned and Other Repossessed Assets.

Real Estate Held for Investment

Management should control each parcel separately to provide for informed decisions to hold or sell. They must maintain accounting controls to create reliable records. Refer to Thrift Activities Regulatory Handbook Section 230, Equity Investments, for more comments.
Fixed and Other Assets

While these assets may not require as much attention as others, management must maintain routine accounting controls as support for the general ledger and tax returns. Refer to Thrift Activities Regulatory Handbook Section 250, Other Assets/Liabilities, and Section 252, Fixed Assets.

Deposit Accounts

Due to the high volume of activity in deposit accounts, management may streamline routines for convenience and to minimize expense. To limit loss from errors and irregularities, management must ensure that controls are in place to recognize unusual transactions and limit loss. These controls should include:

- Officer approval and reviews for propriety regarding any unusually large transactions.
- Routine procedures and activity reviews that ensure segregation of duties and confirm transactions with customers when they open and close deposit accounts.
- Reconciliation of deposit ledgers to the general ledger daily.
- Testing of interest calculations periodically to ensure correctness.
- Testing of accrued interest accounts for adequacy to ensure no misapplication of funds, or under accrual of expense.
- Dual control of all deposit accounts used as collateral to prevent inappropriate withdrawals.
- Periodic advertisement of unclaimed balances.
- Crediting unclaimed balance accounts to the State according to State escheat laws. (Escheat laws limit the build-up of dormant accounts). Refer to Thrift Activities Regulatory Handbook Section 560, Deposits/ Borrowed Funds.
- Review of check kiting reports.

Service providers normally provide a check-kiting report (for example, “Kiting Suspect Report”) to associations that identifies potential check-kiting situations. The report shows those accounts with activity indicating the drawing upon uncollected funds, and the recurring presence on the report by an account holder could indicate a kiting situation. However, the parameters for these reports may vary depending on whether the service provider allows the association to set up specific parameters; otherwise, a default setting may be used. Most of the account holders identified on the report are not involved in check kiting, but it does provide management with a good overview of the operation and possible check kiting. The service provider usually runs the report on a daily basis. Someone who does not have access to teller operations should review the report.

Deferred Credits

Generally accepted accounting principles require recognition of loan origination fees as income over the life of the loan in accordance with SFAS No. 91. The association should carry such deferred income as a deferred credit. See the Thrift Activities Regulatory Handbook Section 251, Real Estate Owned and Other Repossessed Assets, for comments on accounting conventions for sale of these assets.

Other Liabilities

Management should periodically review miscellaneous accounts to deter misuse. These accounts should be minimal.

Capital (Reserves, Undivided Profits, etc.)

Management must carefully control all changes in the ownership records of the association through the officially designated registrar. Management should report all capital account entries to the board of directors. Refer to Thrift Activities Regulatory Handbook Section 110, Capital Stock and Ownership.
**Letters of Credit**

These credit documents require strict controls similar to loans. Although letters of credit do not appear on balance sheets, they can result in liabilities for payment. A bona fide commitment for a letter of credit generally carries the same contingency for liability as a letter of credit, if the holder can prove the authenticity of the commitment. Refer to the Thrift Activities Regulatory Handbook Section 215, Letters of Credit, for additional discussion.

**Funds Transfer Questionnaire**

The transfer of funds is an essential activity for all depository institutions. It is, however, a source of extreme vulnerability to material loss from mistakes and fraud if not adequately controlled. Control procedures and fidelity bond coverage can limit the risk to capital. However, management should not use the bond deductible and coverage as a substitute for adequate controls. A quick review of the blanket bond deductible and coverage amount and any related policy riders will give you an idea of the reliance the association places on control procedures to limit risk from funds transfer activities.

In your review, you should ascertain the following information:

- Whether the transfers pose risk to capital.
- Whether management prescribes reasonable controls.
- That management confirms or tests the controls periodically.

Use of the Funds Transfer Questionnaire and examination procedures should provide you with enough information to make a reliable judgment on the adequacy of transfer controls.

This Appendix discusses the following:

- Background information.
- The transfer process.
- Common effective control procedures.

**Background Information**

Transfers may originate internally or externally. They can be among internal accounts or external accounts and can involve one customer or many customers. Essentially, all transfers are instructions by an authorizer to debit an account at a institution for credit to another account at either the same or another institution.

For this discussion, funds transfer includes the transfer of control over funds, both internal and external, to an association. Two common examples of internal transfers are: loan fundings and deposit transfers among customers’ accounts in the association. External transfers are payments involving more than one depository institution.

All associations engage in transfers. Most are involved in large transfers relative to their capital accounts, and blanket bond coverage with deductibles. Associations without correspondent banking departments and major corporate deposit accounts may not have a large volume of transactions.

Many routine control procedures exist that can limit risk from funds transfer activities. The procedures in use must be compatible with the following parameters:

- The volume of activity the association expects related to capital.
- Insurance coverage and deductibles.
- The size and diversity of the association’s staff.

Association management must ensure that staff encrypts all data transmissions using algorithms. This protects information from improper disclosure or alteration. You can find additional text on electronic funds transfer systems in Section 10 of the Federal Financial Institutions Examination Counsel (FFIEC) Information Systems (IS) Examination Handbook used by OTS. However, it does not address control procedures required by funds transfer activities.
Transfer Process

Associations execute internal transfers through the accounting system. Internal transfers may be initiated on paper, by direct key entry, or through other computer links.

Associations may execute external transfers through any of the following means:

- Official (drawn on us) checks
- Drafts on correspondent accounts
- Customer depository transfer checks
- Customer checks or drafts
- Computer link to independent transfer systems
- Direct computer link to a correspondent
- Voice telephone (voice transmission) call to a correspondent.

Transfers may use various transmission mediums such as:

- Dial-up common carrier lines (telephone, telex, electronic mail)
- Dedicated lines
- Hard-wire terminals requiring no dial up
- Paper text
- Electronically transmitted-image facsimile (FAX)
- Voice
- Encrypted data.

These mediums may use various technologies such as wires, radio phone, cellular radio telephone, microwave, or fiber optic lines, each with different security and vulnerability. There are several wire transfer service providers:

- Fedwire
- CHIPS
- SWIFT
- The Federal Home Loan Banks
- Other correspondent banks
- Electronic mail services.

Each medium, method, technology, and service has strengths and weaknesses, and none are perfect.

Common Effective Control Procedures

A customer or association employee may initiate a transfer, which debits the customer’s account. Appropriate association personnel must verify that the account holder authorized the customer debit. Management must ensure that authorizations include a written contract specifying how, when, and who can initiate transfers. A depository contract on a signature card may also detail authorizations. Authorizations may be specific or general. General authorizations may be blanket for any amount or repetitive for the same amount. A general authorization must include who may make transfers, how much the transfers can be, and when the transfer can occur.

Appropriate staff should record general authorizations in system controls for automatic confirmation of authorization. General authorization controls may require initiator and sender identification codes, unique passwords, cipher codes, set procedures, and limited channels of communication. Appropriate staff must initiate requests for transfers using contractually agreed upon means permitting confirmation before execution.

Preferably, before a sender executes any transfer requests originating in the association, appropriate association personnel must verify the initiator’s authorization and provide an approval to the sender. Management should segregate the duties of initiating and executing a transfer. If prior approval is not practical, then management should establish a transaction ceiling – an amount above which a lack of prior approval will stop the transfer.

After execution of the transfer, appropriate association personnel should send notice of transfers...
to the account holders’ address of record. Someone other than the initiator or executor should send the confirmation to prevent tampering. The initiator or another person should review transfer accounting entries for authenticity by comparing the transfer accounting entry with the approved request.

It is very important that funds transfer approval levels increase proportionately with the amount of the transfer. For example, for transfers less than $10,000, staff members or junior officers may make approval. For amounts of $50,000 to $100,000, a junior officer may authorize the transfer once they determine the transfer is valid. For amounts greater than $100,000, the association should require dual officer approval. For amounts greater than $1 million, dual senior level officers should approve the transfer with required callbacks from the receiving bank.

An example of a typical transfer is a customer phoning a request to transfer funds from a savings account to a checking account. The customer is an authorized drawee on both accounts. This is not problematic provided control procedures ensure that the authorizing customer is a drawee on both accounts. Management should instruct association employees to verify that a drawee authorized, in writing, any requested transfer from one customer’s account to another customer’s account, prior to making the transfer. Large or unusual transfers should require higher level or approval before execution. Subsequent controls should include either a review of debits to ascertain that the debit and credit are between accounts with a common drawee, or that both an initiator and an approver have confirmed the drawee’s authorization of the transfer.

To avoid misunderstandings with multiple drawee accounts, a drawee should sign a written authorization indicating that the association should honor telephone requests for transfers between accounts. Management should ensure that employees maintain a file of the written authorizations.

A typical two-party transfer is a debit to a checking account and credit to a utility or other creditor for a monthly billing. The appropriate employee executes the transfer using a draft supported by an authorization. Another typical two-party transfer is a debit to a loan or loans process account and a credit to a supplier or contractor. For all transfers from one drawee’s account to another drawee’s account, the association should have a written authorization or request from a drawee. The written authorization or request should specify the following information:

- The amount the drawee wants transferred.
- The account to debit (charge, or transfer money from).
- The account to credit (transfer money to).

The authorization may cover several specific transfers, a series of transfers, or one transfer.

Follow-up controls should include confirmation of signatures on authorizations or requests. A person independent of the initiation of a request should be involved in either the approval or the confirmation process. This assures segregation of duties and limits opportunities for collusion. For example, the initiator and sender of transfers should be separate; one individual should initiate the securities transaction while another individual executes it. Payment (settlement) should only occur upon confirmation of the initiated order to the executed trade ticket.

Transfers of funds outside of the association (external transfers) must be through accounts of the association at correspondents. The appropriate association personnel should initiate the transfer through regular communication channels.

Daylight overdrafts are overdrafts existing between the daily closing of accounting records. Even when daylight overdrafts are properly controlled, they are a credit risk. If inadequately controlled, daylight overdrafts may be a very serious transfer risk. When a correspondent permits daylight overdrafts, funds available for transfer may be virtually unlimited and may be unrecoverable. To facilitate maximum volume of transactions, controls on daylight overdrafts usually do not prevent excessive overdrafting; instead, they stop continued overdrafting after the association exceeds a certain limit. For this reason, internal controls on external transfers must
be rigid and subject to frequent testing and review to discourage and prevent loss.

Refer to Thrift Activities Regulatory Handbook Section 580, Payments System Risk, for discussion of the setting of limits for daylight overdrafts.

A low-volume voice transmission operation must also have rigid controls. Voice recognition alone is unacceptable as a control. Generally, there is no witness to verify recognition and no call back to verify the location of the caller. Typical controls require a four party callback or confirmation process on all external transfers. For example, once the association receives a customer request, appropriate personnel must confirm the request as authorized in writing by the customer, and approve it as confirmed. The sender then executes the request by transmission to a correspondent. The usual means is by a telephone call. The correspondent receiver hangs up the phone, and has an approver confirm the transfer request with a separate confirmer at the association, usually by a telephone call back. This process must involve four persons (two at each institution) to be a valid control procedure. It relies on segregation of duties to prevent collusion at either institution.

Management should implement the following additional steps:

- Provide each person with a recognizable identity such as a name, code word, or number.
- Identify each transfer by sequence number known to both the sender and receiver.
- Record all calls.

Segregation of duties requires that wire transfer senders not be initiators or approvers. Senders should always look for the required approvals before sending a message. To control wire transfers, someone not involved in either initiating, approving, or sending messages should frequently review all messages. In low-volume PC operations, daily review of an unbroken printout of all messages (comparing the record of messages with the approved request forms) is a common control review.

Other common control safeguards include the following procedures:

- Limited signing authorities.
- Dual controls over forms.
- Supervisor’s key controls on computer terminals.
- Unique passwords for transfer clerk (sender) and releaser.

It is common for institutions to number each message with an encoded sequence number and require use of a confidential test key to decode the number. For this control procedure to have integrity, the holders of the test key should not have the ability to send or receive messages.

Management may require additional controls, such as limiting the funds available for transfer. Correspondent banks require this procedure for extremely weak institutions to prevent daylight overdrafts on respondent accounts. A correspondent relationship may also require that the institution make all outgoing transfers from one specific account not used for incoming transfers. In addition, the correspondent banks may not permit daylight overdrafts. This procedure requires the sending association (respondent) to transfer funds from an operating account at the correspondent to a transfer account before transferring funds to another institution. The first transfer request makes funds available for transfer. The second transfer request executes the external transfer.

Someone without signature authority should control supplies of negotiable forms such as single signature official checks and drafts. This person must require an authorized voucher for release of a check or draft, preferably after it is prepared for signature. The appropriate staff should reconcile paid official checks to accounting records of vouchers and review them for authorized signatures.

Whenever check-signing procedures use signature machines, the signature plates should be under key control at all times, with dual control on dual signature machines and plates. Daily control procedures should include reconciling the signature
counter totals to the number of check authorizations to ascertain that no one signed extra checks.

Daily independent reconcilement of wire transfers with correspondent accounts and general ledger accounts is an essential control to ensure detection of any errors or misapplications of funds. Any chances of retrieval of missent funds diminish quickly. You should check whether the institution has routines that require action by two people to complete a transfer, one to receive or initiate the request and another to confirm authenticity. If the association makes transfers to offshore privacy havens, determine how management investigates the transfer for legitimacy.

Due to the detail involved, you should review the internal controls on funds transfers by interview and observation rather than by audit methods. Any procedures allowing one person to remove unlimited funds from an account without immediate detection should receive report comment and follow-up at the next examination. Initiate enforcement action to correct unsafe and unsound operating procedures whenever association management is uncooperative in resolving inadequate controls.
INTERNAL CONTROL QUESTIONNAIRE
Preliminary Examination Response Kit
Office of Thrift Supervision

Docket #: >
Institution Name: >
Examination As of Date: >

A management official of the association should complete this questionnaire. If the association lacks an effective system of internal audit or control, the examiner should verify appropriate responses and initial in the verified column. The flagged questions are the suggested minimum verifications. Management must provide the examiner with an adequate written explanation of all “No” answers, with an appropriate reference to the question, and supply copies of applicable written procedures. If a question is not applicable to the association, respond with NA.

Internal Audit

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<tr>
<th>Verified by Examiner</th>
<th>Yes</th>
<th>No</th>
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<td>1. Does the association have an internal audit program?</td>
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<td>2. Do the internal audit programs contain written, specific instructions for audit procedures for the internal auditor to perform?</td>
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<td>3. Does the board of directors or the audit committee review internal audit reports?</td>
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<td>4. Does the audit committee consist only of outside directors?</td>
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<td>5. Do internal audit reports suggest actions to correct internal control or procedural deficiencies?</td>
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<td>6. Is there a subsequent review to ascertain that the association implemented suggestions for corrective actions?</td>
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<td>7. Does the internal auditor report to or receive salary reviews by the audit committee or board of directors?</td>
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<td>8. Did the external auditor communicate any reportable conditions, either orally or in writing, to management, the board of directors, or the audit committee?</td>
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INTERNAL CONTROL QUESTIONNAIRE
Preliminary Examination Response Kit
Office of Thrift Supervision

Docket #: >
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Examination As Of Date: >

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<thead>
<tr>
<th>Verified By Examiner</th>
<th>Yes</th>
<th>No</th>
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**General Items**

9. Does the association reconcile the following accounts to the general ledger at least daily (if activity is minimal, weekly or monthly reconciliations may be appropriate)?
   - Loans in process
   - Suspense accounts
   - Accounts out of balance

10. Does the association reconcile the following accounts to the general ledger at least monthly?
   - Loans
   - Investment securities
   - Real estate owned
   - Borrowings
   - Checking and deposit accounts

11. Does a person not involved in general ledger entries perform the reconciliations?
   - Person responsible?

12. Does a person not involved in the transactions periodically review and investigate activity on exception and/or large items report(s)?
   - Person responsible?

13. Does the association perform a regular review of insider activity for unusual activity and compliance with Regulation O?

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**INTERNAL CONTROL QUESTIONNAIRE**

**Preliminary Examination Response Kit**

**Office of Thrift Supervision**

<table>
<thead>
<tr>
<th>Verified By Examiner</th>
<th>Yes</th>
<th>No</th>
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<tbody>
<tr>
<td>14. Does the association appropriately capitalize and expense all items?</td>
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<tr>
<td>15. Does the association periodically review deferred asset and liability accounts?</td>
<td></td>
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<tr>
<td>16. Does the association clearly show the nature and purpose of each entry to the deferred asset and liability accounts?</td>
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<tr>
<td>17. What is the name and position of the person authorized to make entries to the deferred asset and liability accounts?</td>
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<tr>
<td>Person responsible?</td>
<td></td>
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<tr>
<td>Position of person?</td>
<td></td>
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<tr>
<td>18. Does the association balance and reconcile to third-party reports monthly any association assets that others service or hold in safekeeping?</td>
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<tr>
<td>Person responsible?</td>
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</table>

**Cash and Cash Items**

| 19. Does the association reject checks when the collected balance of the customer’s demand deposit account is not sufficient to cover the item? |   |   |
| 20. Are all personnel who have cash approval and disbursement authority required to take annual vacations of at least two consecutive weeks? |   |   |
| 21. Does an independent officer review all overdraft activity? |   |   |
| Person responsible? |   |   |
| 22. Are controls in effect to prevent withdrawals of uncollected funds? |   |   |
| 23. Does the association promptly record on the books returned items previously deposited? |   |   |
### INTERNAL CONTROL QUESTIONNAIRE

**Preliminary Examination Response Kit**  
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<table>
<thead>
<tr>
<th></th>
<th>Yes</th>
<th>No</th>
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<tbody>
<tr>
<td>24. Are procedures adequate to ensure that the association monitors and clears uncollections?</td>
<td></td>
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<tr>
<td></td>
<td><strong>Person responsible?</strong></td>
<td></td>
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<tr>
<td>25. If the association maintains a petty cash fund, are all additions and withdrawals documented?</td>
<td></td>
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<tr>
<td>26. Does the association balance the petty cash fund periodically?</td>
<td></td>
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<tr>
<td>27. Does the association have procedures that prevent the use of liquid assets as compensating balances or collateral for personal loans of officers, directors, or employees?</td>
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<tr>
<td>28. Does the association record cash items appropriately in the general ledger?</td>
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<tr>
<td>29. Does the association review teller and accounting system override reports and file maintenance summaries for unusual activity on a regular basis?</td>
<td></td>
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<tr>
<td></td>
<td><strong>Person responsible for accounting overrides?</strong></td>
<td></td>
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<tr>
<td></td>
<td><strong>Person responsible for teller overrides?</strong></td>
<td></td>
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<tr>
<td>30. Are loan accounting systems included in the override reports?</td>
<td></td>
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<tr>
<td>31. Are personnel who have control over cash barred from performing overrides?</td>
<td></td>
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<tr>
<td>32. Do only designated personnel who have no control over cash approve and review overrides?</td>
<td></td>
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<tr>
<td>33. Does the association, at both home and branch offices, perform daily cash reconciliations?</td>
<td></td>
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<tr>
<td>34. Does a person without teller responsibilities perform the daily cash counts?</td>
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<tr>
<td>35. Are overages and shortages properly recorded in a cash over and short account?</td>
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</table>
INTRODUCTION TO ACCOUNTING AND FINANCE

Section 340

INTERNAL CONTROL QUESTIONNAIRE
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<tr>
<td>36. Does the association maintain records showing the person involved in the cash over or short situation?</td>
<td></td>
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<tr>
<td>37. Does the association investigate and act upon all cash over and under amounts?</td>
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<tr>
<td>38. Does the association have appropriate controls over unissued deposit certificates, travelers’ checks, savings bonds, food stamps, and other consigned items?</td>
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<tr>
<td>Person(s) responsible? _________________________________</td>
<td></td>
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<tr>
<td>39. Does the association periodically reconcile consigned items?</td>
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<tr>
<td>Person responsible? ___________________________________</td>
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</table>

Association (Official) Checks

40. For checks signed by hand: Are two signatures (signer and approver) required on association (official) checks? |     |    |
| Names of persons authorized to sign? ______________________ |     |    |

41. For checks signed by hand: Are unsigned blank checks in the possession of an officer or employee who does not have singular signature authority? |     |    |
| Responsible officer or employee? ________________________ |     |    |
| Position title? ________________________________________ |     |    |

42. For checks signed by stand-alone mechanical or electronic facsimile check signing machines connected to computers: Is the inventory of unsigned blank checks available verified daily and compared to the work of other positions that issue checks during the day? |     |    |
| Person(s) responsible? _________________________________ |     |    |
43. For checks signed by stand-alone mechanical or electronic facsimile check signing machines connected to computers: Is there an approval process for checks in excess of a certain dollar amount?  
   - If so, what is the amount? ________________________________

44. For checks signed by stand-alone mechanical or electronic facsimile check signing machines connected to a computer: Is the association’s copy of the check voucher initialed by the person preparing the check and, for those checks in excess of a certain amount, initialed by a person authorized to approve?

45. Does the association have controls in place to ensure that the employee fills out the amount of the check and payee information before the signatures are on the checks?
   - Person responsible? ________________________________

46. Is the supply of unused checks periodically reconciled to the shipping invoice by persons without signature authority?
   - Person responsible? ________________________________
   - How often? ________________________________

47. Does a person independent of the check writing function review the paid (canceled) checks for proper signatures and reconcile the check to vouchers?
   - Person responsible? ________________________________
   - How often? ________________________________

48. Does the association periodically reconcile outstanding checks to vouchers and liability accounts?

49. Does the association periodically transfer all outstanding six-month old association checks to a liability account?
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</table>

_________ 50. Does the association keep the facsimile check writing machine under proper control?

Due From Banks

_________ 51. The association receives bank statements:

Daily _____ Monthly _____ Quarterly _____

_________ 52. Does the association reconcile bank accounts on a regular and timely basis?

_________ 53. Are there any unreconciled bank accounts?

If so, what is the date of the latest reconciliation? ___________

_________ 54. Are there any out of balance accounts?

If so, what is the date the association expects it to be reconciled?

_________ 55. Is the person who reconciles the bank statements independent of the deposit and check writing process?

Person responsible? ________________________________

_________ 56. Do checks drawn on bank accounts need more than one signature?

_________ 57. Does a person who does not have signature authority periodically reconcile unsigned checks to the shipping invoice?

Person responsible? ________________________________

How often? ________________________________
## Appendix A: Internal Control

### Section 340

#### INTERNAL CONTROL QUESTIONNAIRE

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</table>

### Investments and Securities

1. Is documentation supporting account entries, broker’s advice, and journal entries received and maintained by a person independent of the authorized trading officer?

2. Does the association maintain an investment security ledger or worksheet that details all securities held and all security transactions?

3. Are the security ledger totals for principal and accrued interest, balanced to the general ledger at least monthly by an independent person?

   Person responsible: ________________________________

4. Does the association have procedures to ensure that they collect all income due on the investment security portfolio promptly?

5. Does the association have procedures that will indicate any relationship between brokers who purchase securities for the association and association officers, directors, or employees?

6. If the board of directors authorized an officer to have sole authority to purchase and sell securities, is the authority limited to fixed dollar amounts, above which a second officer must approve the transaction before its commitment?

   Authorized person(s): ________________________________

   Limits: ________________________________

7. Does the association prohibit broker/dealers from having discretionary trading authority?

8. Does the association place all orders only with broker/dealers not affiliated with investment advisors retained by the association?

9. Does the association engage in reverse repurchase agreements and lending of securities only with firms designated by the Federal Reserve Board as primary dealers in government securities?
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<tr>
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<tbody>
<tr>
<td>67.</td>
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<tr>
<td>Does a person who does not execute or book transactions receive confirmations from the broker/dealer?</td>
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<tr>
<td>Person responsible?</td>
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<td>68.</td>
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<tr>
<td>Does a person without transaction authority receive monthly statements direct from the brokerage firm indicating all transactions during the period?</td>
<td></td>
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<tr>
<td>Person responsible?</td>
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<td>69.</td>
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<tr>
<td>Are all securities transactions for delivery versus payment?</td>
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<tr>
<td>70.</td>
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<tr>
<td>Does the association prohibit “free” deliveries in written contracts with depositories and safekeeping agents unless approved by two senior officers?</td>
<td></td>
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<td>71.</td>
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<tr>
<td>Does the association hold securities on the premises under dual control?</td>
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<tr>
<td>72.</td>
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<tr>
<td>Is an independent party performing tests to determine that the yield on investments actually received is in line with the weighted average coupon of such assets?</td>
<td></td>
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<tr>
<td>Name of the independent party:</td>
<td></td>
<td></td>
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<tr>
<td>How often:</td>
<td></td>
<td></td>
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<tr>
<td>Date of last test:</td>
<td></td>
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<td>Period analyzed:</td>
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### General Lending

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<thead>
<tr>
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<th>73.</th>
<th>74.</th>
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<tbody>
<tr>
<td>Does the association have and adhere to a written schedule of fees and rates charged on new loans?</td>
<td></td>
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<tr>
<td>Does the association policy limit the number or amount of loans involving any individual borrower or contractor?</td>
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### INTERNAL CONTROL QUESTIONNAIRE

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<td>75.</td>
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<tr>
<td>Is there a procedure of internal review to ensure compliance with the above policy by a person or persons who are independent of the loan approval function?</td>
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<td>76.</td>
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<tr>
<td>Are there procedures, and does staff follow the procedures, to periodically review and document the adequacy of the ALLL?</td>
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<td>77.</td>
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<tr>
<td>Are the persons that periodically review and document the adequacy of the ALLL independent of the loan approval function?</td>
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<td>78.</td>
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<tr>
<td>Does the association defer loan fees in accordance with generally accepted accounting principals (GAAP), and not recognize fees as current-period income?</td>
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<td>79.</td>
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<tr>
<td>Are lending officers prohibited from authorizing loan disbursements?</td>
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<td>80.</td>
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<tr>
<td>Do persons independent of the loan officer obtain or verify credit information?</td>
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<td>81.</td>
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<tr>
<td>Are lending authorities, granted by the board of directors, setting tiered dollar limits for individuals, co-approval limits for committees, and higher limits for approval by the board of directors?</td>
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<tr>
<td>82.</td>
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<tr>
<td>Is there a record system that lists the total of outstanding credits and commitments (direct and indirect) for each borrower?</td>
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**Construction Lending**

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<td>83.</td>
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<tr>
<td>Are inspectors rotated at least every third inspection and for final draws?</td>
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<td>84.</td>
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<tr>
<td>If the association does not rotate inspectors, does the inspector’s supervisor perform review inspections?</td>
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<td>85.</td>
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<td>Is there segregation of duties between inspection and disbursement functions?</td>
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<td>86.</td>
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<tr>
<td>Does the association prohibit disbursing loans in cash or to third parties?</td>
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<tr>
<td>By Examiner</td>
<td>87. Does the association compare paid bills and lien waivers with items listed for disbursements?</td>
<td>_____</td>
</tr>
<tr>
<td>88. Does the association have safeguards to ensure that sufficient funds always remain available to complete construction?</td>
<td>_____</td>
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</table>

Loan Servicing and Recordkeeping Functions

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<tbody>
<tr>
<td>89. Does the association support advances by written evidence or re-inspection of property?</td>
<td>_____</td>
<td>_____</td>
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<tr>
<td>90. Are all notes and other loan documents kept in a vault or fire-resistant cabinet and under a sign-out control system?</td>
<td>_____</td>
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<tr>
<td>91. If the association holds additional collateral, do they safeguard it?</td>
<td>_____</td>
<td>_____</td>
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<tr>
<td>92. Does the association maintain a record of such collateral?</td>
<td>_____</td>
<td>_____</td>
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<tr>
<td>93. Does the association obtain written acknowledgment from the borrower for the pledging of savings accounts or the assignment of life insurance policies?</td>
<td>_____</td>
<td>_____</td>
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<tr>
<td>94. Does the association adequately control advance loan payments if they do not immediately credit the advance to the loan account?</td>
<td>_____</td>
<td>_____</td>
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<tr>
<td>95. Does the association test periodic adjustments to adjustable-rate mortgage loans for compliance with the terms of the note?</td>
<td>_____</td>
<td>_____</td>
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<tr>
<td>96. Does the association have written collection policies and procedures that the board of directors approves?</td>
<td>_____</td>
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<tr>
<td>97. Do collectors document the contact with borrowers and indicate promised action?</td>
<td>_____</td>
<td>_____</td>
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<tr>
<td>98. Are there procedures that ensure the maintenance of necessary hazard, flood, and other insurance coverages throughout the life of the loan?</td>
<td>_____</td>
<td>_____</td>
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<tr>
<td>Question</td>
<td>Description</td>
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<tr>
<td>99.</td>
<td>Does the association perform tests to determine that it is receiving the appropriate interest?</td>
<td></td>
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<tr>
<td>100.</td>
<td>Does a person, independent of the cash receipt and bookkeeping for interest receivable, perform and document an analysis to determine if the yield on mortgages and investments actually received is in line with the weighted-average coupon rate of such assets?</td>
<td></td>
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<tr>
<td>101.</td>
<td>Are accounting entries for accrued interest receivable supported by proper explanations evidencing the nature and purpose of each entry and signed by a responsible individual?</td>
<td></td>
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<tr>
<td>102.</td>
<td>Is each escrow (impound) account analyzed at least once a year to ensure that the payments will cover the disbursement(s)?</td>
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<tr>
<td>103.</td>
<td>If this analysis results in a revision of monthly payments, is the revision made promptly and the borrower notified?</td>
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<tr>
<td>104.</td>
<td>Does the association inform borrowers at least annually of the balance in their account and the most recent year’s transactions in that account?</td>
<td></td>
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<tr>
<td>105.</td>
<td>Do statements indicate that borrower’s disputes regarding the balances of their escrow accounts be sent to internal audit or a department independent of escrow transactions?</td>
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<tr>
<td>106.</td>
<td>Are loans in process reviewed periodically to determine whether the association makes disbursements on a timely basis and in accordance with the terms of loan agreements?</td>
<td></td>
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<tr>
<td>107.</td>
<td>Do personnel not responsible for the loans in process accounts conduct periodic tests to determine propriety of disbursements?</td>
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### Commercial Lending

108. Does the association update borrower’s and guarantor’s financial statements at least annually? [ ] [ ]

109. Do qualified individuals evaluate the collateral? [ ] [ ]

110. Does the association inspect collateral periodically to ensure maintenance of sufficient value? [ ] [ ]

111. Does the association release collateral only upon the approval of an officer or committee having a lending limit greater than or equal to the value of the collateral the association is releasing? [ ] [ ]

112. If the association releases collateral upon payment of the loan, do they release the collateral only upon receipt of collected funds? [ ] [ ]

### Other Loans (unsecured, mobile homes, etc.)

113. Are the association’s procedures adequate to ensure compliance with the requirements of any government agency insuring or guaranteeing the loan? [ ] [ ]

114. Does the association maintain an adequate loan register? [ ] [ ]

The register, as a minimum, should contain the following: loan number, loan amount, date of loan or date of purchase, dealer, recourse or repurchase provisions, interest rate, and term.

115. Do personnel who do not handle cash process loan applications and initial the notes? [ ] [ ]

116. Do employees not connected with the granting or acquisition of loans collect and process receipts, and prepare delinquency lists? [ ] [ ]

117. Are liens and other documents, including titles, promptly recorded? [ ] [ ]

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<tr>
<td>118. Are there procedures that provide for board of directors approval of charge-offs and subsequent recoveries?</td>
<td></td>
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<tr>
<td>119. If the association holds additional or side collateral for unsecured loans, does the association also adequately document and safeguard the collateral and maintain a proper record?</td>
<td></td>
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<tr>
<td>120. Does the association reference the FHA publication that lists companies and individuals who have not properly performed under FHA programs?</td>
<td></td>
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<tr>
<td>121. Floor planning loans:</td>
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<tr>
<td>- Does the association make unannounced inventory inspections on a rotating basis at least every 30 days?</td>
<td></td>
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<tr>
<td>- Do the inventory inspections include, as a minimum, the following: serial number verification of unit, inventory of equipment and furnishings, condition and location of unit, and units sold out of trust or rented?</td>
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<tr>
<td>- Does the association maintain records of floor plan inspections?</td>
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<tr>
<td>- Does the association actually inspect demos at a subsequent date, if necessary?</td>
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<tr>
<td>- Does the association rotate inspectors or have a supervisor or auditor accompany them?</td>
<td></td>
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</tr>
<tr>
<td>- Does the association inspect and appraise trade-ins for wholesale value?</td>
<td></td>
<td></td>
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<tr>
<td>- Does the dealer submit financial and operating statements monthly?</td>
<td></td>
<td></td>
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<tr>
<td>- Does the association retain title or lien control?</td>
<td></td>
<td></td>
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<tr>
<td>- Do floor plan agreements provide for periodic reductions (curtailments) in outstanding unit loan balances?</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
### Credit Quality Review

<table>
<thead>
<tr>
<th>No.</th>
<th>Question</th>
<th>Yes</th>
<th>No</th>
</tr>
</thead>
<tbody>
<tr>
<td>123</td>
<td>Does the association have a credit quality review program?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>124</td>
<td>Does credit quality review include testing for compliance with regulation, association policy, officer lending limits, and association underwriting standards?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>125</td>
<td>Does credit quality review include classification or grading of assets?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>126</td>
<td>Are the findings of the persons responsible for credit quality review reported directly to the board of directors?</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

### Deposit Account Loans

<table>
<thead>
<tr>
<th>No.</th>
<th>Question</th>
<th>Yes</th>
<th>No</th>
</tr>
</thead>
<tbody>
<tr>
<td>127</td>
<td>Are sufficient controls in effect to prevent a loan approver from disbursing loan proceeds?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>128</td>
<td>Does the association flag pledged deposit accounts to prevent collateral from withdrawal?</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
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<table>
<thead>
<tr>
<th>Verified By Examiner</th>
<th>Yes</th>
<th>No</th>
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</thead>
<tbody>
<tr>
<td>129. Does withdrawal of pledged funds require a supervisory override?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>130. Are procedures in effect to ensure that the total loan and accrued interest does not exceed the balance amount of the deposit account?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>131. Are procedures in effect for initial and periodic positive mail confirmations with deposit loan customers?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>132. Are periodic monitoring reports adequate for the review of savings deposit loan activity?</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Real Estate Owned and Other Repossessed Assets**

<table>
<thead>
<tr>
<th>Verified By Examiner</th>
<th>Yes</th>
<th>No</th>
</tr>
</thead>
<tbody>
<tr>
<td>133. Does the association follow routine legal procedures that will result in a valid title to the property and evidence of such title?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>134. Does the association promptly value real estate that it acquires?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>135. Does the association use a current valuation to establish the sales price of a property?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>136. Does the association physically inspect properties at periodic intervals?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>137. Do such inspections indicate the condition of the property and occupancy status?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>138. Are there maintenance procedures in effect to ensure that properties will retain their market value?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>139. Does the association maintain separate subsidiary records for each parcel showing items capitalized, expenses, rentals, etc.?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>140. Does the association balance subsidiary ledgers for the individual properties to the general ledger at least monthly?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>141. Does the association maintain separate files for each parcel of real estate owned and are such files complete?</td>
<td></td>
<td></td>
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</tbody>
</table>
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<th>No</th>
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</table>

142. Does the association maintain controls over the receipt of rental income? _______  

143. Does the association’s advertising for the sale or rental of real estate owned comply with the provisions contained in the Department of Housing and Urban Development’s advertising guidelines? _______  

144. Are agents who collect rents and manage properties bonded? _______  

145. Are security deposits properly controlled? _______  

146. Does the association have procedures to ensure maintenance of hazard insurance? _______  

Real Estate Held for Investment

147. Does the association maintain separate subsidiary records for each parcel showing items capitalized, expenses, rentals, etc.? _______  

148. Does the association balance subsidiary ledgers for the individual properties to the general ledger at least monthly? _______  

149. Does the association maintain complete, separate files for each parcel of real estate owned? _______  

150. Does the association maintain adequate control over rental income? _______  

151. Are agents who collect rents and manage properties bonded? _______  

152. Are security deposits properly controlled? _______  

153. Does the association maintain adequate controls over all disbursements? _______  

154. Does a senior officer compare disbursements to determine whether they are for budgeted purposes and in line with the overall budget? _______  

155. If not, is the board of directors notified promptly of budget overruns? _______
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</table>

**Fixed and Other Assets**

156. Does the association retain invoices in support of all additions to fixed asset accounts?  

157. Does the association ensure that the accounting department knows about any major retirement of fixed assets?  

158. Does the association keep a detailed record of fixed assets?  

159. Does the association retain depreciation schedules supporting each asset or class of assets?  

160. Does the association charge depreciation and amortization expenses at least quarterly?  

161. Does the association retain evidence of valid titles for all properties owned?  

162. If the association has rented space in its buildings, does it have adequate control over the recording and collection of rental income and the control and recording of expense?  

163. Are there record keeping procedures to ensure that the association maintains adequate supporting documentation for other assets acquired?  

164. Are journal entries prepared that show clearly the nature and purpose of each charge to expense from deferred accounts and evidence of approval by authorized personnel?  

165. Does the association have effective control procedures for all large disbursements to ensure their propriety?  

166. Does the association maintain subsidiary records for the various other asset accounts?
**Deposit Accounts**

167. **Is there any limitation on the amount of withdrawal that employees may pay without officer approval?**

   - If so, what is the amount? ________________

168. **Are procedures in effect to ensure the timely and accurate completion of the appropriate signature cards upon the opening of deposit accounts?**

169. **Does the association segregate duties so that persons opening new certificate accounts do not have sole control over the receipt of cash, account data entry, and the preparation of certificates or receipts?**

170. **Does the association balance the deposit accounts before and after posting of interest to ascertain correctness of total amount posted?**

171. **Does the association maintain general ledger subsidiary accounts for each class of accounts?**

172. **Is an analysis made periodically to determine the adequacy of accrued interest earned and unpaid?**

   - How often? __________________________
   - Last as of date? ________________________
   - Person responsible? ____________________

173. **Does the person who performs the analysis have an account at the association?**

174. **If so, who reviews the account of the person who performs the analysis?**

   - Person responsible? ____________________

175. **Does the association investigate and adjust differences between the accrual balance and the interest paid?**
<table>
<thead>
<tr>
<th>Question</th>
<th>Response</th>
</tr>
</thead>
<tbody>
<tr>
<td>176. Does the association reasonably estimate accruals for reporting purposes?</td>
<td>Yes No</td>
</tr>
<tr>
<td>177. Are policies in effect to maintain compliance with state escheat laws?</td>
<td>Yes No</td>
</tr>
<tr>
<td>178. Does the association flag dormant accounts so they can monitor activity?</td>
<td>Yes No</td>
</tr>
<tr>
<td>179. Does the association waive significant amounts of account fees?</td>
<td>Yes No</td>
</tr>
<tr>
<td>180. Does the association generate a demand deposit overdraft report?</td>
<td>Yes No</td>
</tr>
<tr>
<td>181. Does the demand deposit overdraft report identify the name and position of the person(s) responsible for approving overdrafts?</td>
<td>Yes No</td>
</tr>
<tr>
<td>182. Does the demand deposit overdraft report identify large borrowers and insiders?</td>
<td>Yes No</td>
</tr>
<tr>
<td>183. Do designated personnel review the demand deposit overdraft reports?</td>
<td>Yes No</td>
</tr>
<tr>
<td>Person responsible?</td>
<td></td>
</tr>
<tr>
<td>Approval limits?</td>
<td></td>
</tr>
<tr>
<td>184. Does the association generate a check-kiting report?</td>
<td>Yes No</td>
</tr>
<tr>
<td>185. Is the check-kiting report prepared by an individual who does not have an account with the financial association or is the preparer’s account independently reviewed?</td>
<td>Yes No</td>
</tr>
<tr>
<td>186. Does the check-kiting report identify insiders and major borrowers?</td>
<td>Yes No</td>
</tr>
<tr>
<td>187. Is the person responsible for reviewing check-kiting reports independent of the preparation of the reports?</td>
<td>Yes No</td>
</tr>
<tr>
<td>Person responsible?</td>
<td></td>
</tr>
<tr>
<td>188. How often does the association review check-kiting reports?</td>
<td></td>
</tr>
</tbody>
</table>
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</table>

## Deferred Credits

<table>
<thead>
<tr>
<th></th>
<th>189. Does the association maintain records supporting the recognition of profits resulting from the sale of real estate owned?</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>190. Does the association maintain records supporting loan acquisition credits deferred and earned, by semiannual periods?</td>
</tr>
<tr>
<td></td>
<td>191. Does the association amortize loan origination fees in accordance with FASB 91?</td>
</tr>
</tbody>
</table>

## Other Liabilities

<table>
<thead>
<tr>
<th></th>
<th>192. Does the association maintain a detailed inventory or subsidiary records for the various other liability accounts?</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>193. Does a designated officer make periodic reviews of the activity in other liability accounts?</td>
</tr>
</tbody>
</table>

- Designated officer: ____________________________

## Capital (Reserves, Undivided Profits, etc.)

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<thead>
<tr>
<th></th>
<th>194. Does management review and the board of directors approve all transfers to and from the capital accounts?</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>195. Does the association clearly explain and adequately document all transactions involving the capital accounts?</td>
</tr>
<tr>
<td></td>
<td>196. Does the corporate officer designated in the bylaws or by the board of directors control stockholder records?</td>
</tr>
<tr>
<td></td>
<td>197. Does the association promptly cancel surrendered stock certificates to prevent their reuse?</td>
</tr>
</tbody>
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</tr>
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</table>

198. Does an officer designated in the bylaws or by the board of directors sign stock certificates?  

#### Letters of Credit

199. Does the association have any outstanding unexpired letters of credit?  

200. Has the board of directors adopted a written letter of credit policy?  

201. Does the board review the policy annually and note the review in the minutes?  

202. Does the association maintain a daily transaction journal that summarizes all outstanding letters of credit?  

203. Who is responsible for the preparation and posting of subsidiary records and accounting for fee income?  

- **Person responsible?** ___________________________________
- **Title?** ____________________________________________

204. Has the association made commitments on letters of credit that they have not issued and for which the commitment period is unexpired?  

205. Has the association issued any letters of credit on behalf of directors, officers, employees and their interests, or for other insiders?  

- **If so, please list:** ____________________________________

206. Has the association issued or confirmed letters of credit to officers or directors of another financial institution?  

207. Does the association’s internal loan review process review letters of credit for adequacy of underwriting, documentation, and credit quality?  

208. Are letters of credit of questionable quality listed on the association’s problem asset list?  

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</table>

_______ 209. Has the association had to pay a draft without receiving payment from a customer? _____ _____

_______ 210. Has the association extended any loans because of letters of credit? _____ _____

   List all loans extended because of letters of credit:

   __________________________________________________________________________

_______ 211. Are there any outstanding lawsuits because of letters of credit? _____ _____

Prepared By: ________________________________

Verified By: ________________________________
A management official of the association should complete this questionnaire. If the association lacks adequate internal controls regarding funds transfers, the examiner should verify appropriate responses and initial in the verified column. The flagged questions are the suggested minimum verifications. Management must provide the examiner with an adequate written explanation of all “No” answers, with an appropriate reference to the question, and supply copies of applicable written procedures. If a question is not applicable to the association, respond with NA.

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<thead>
<tr>
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<th>Yes</th>
<th>No</th>
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</table>

**Funds Transfer and Wire Transfer Controls**

1. Indicate the method that the association uses to wire funds:
   - Fedline: ______________________
   - Money Transfer Workstation: ______________________
   - Voice: ______________________

2. Average dollar volume and number of transfers: _______________
   Specify per day, week, month, or other: ______________________

3. Average daily amount available for transfer, if limited: ___________

4. Peak amount available for transfer, if limited: ___________________

5. Does the association have written wire transfer procedures? _____

6. Do personnel consistently follow the procedures? _____

7. Who is responsible for supervising the wire transfer activity to ensure compliance with the written procedures? ______________________

8. Is an internal or independent audit performed of the wire transfer procedures? ______________________

9. Does the association provide adequate training to personnel involved with the wire transfer process? ______________________
### FUNDS TRANSFER QUESTIONNAIRE

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<table>
<thead>
<tr>
<th>Verified By Examiner</th>
<th>10.</th>
<th>Does the association segregate securities-transaction-related duties among the buyer/seller, the trader, and settlement clerk?</th>
<th>Yes</th>
<th>No</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>11. Are dual authorizations (maker, approver) required before the sending department acts upon internal wire transfer requests?</td>
<td></td>
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<td></td>
<td></td>
<td>12. Do procedures require that the association actually transfer collected funds out of the customer account before the wire transfer department makes outgoing transfer orders?</td>
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<td></td>
<td></td>
<td>13. Do personnel involved with wire transfers receive proper background screenings, including criminal record investigation?</td>
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<tr>
<td></td>
<td></td>
<td>14. Are sendable funds limited by using separate correspondent accounts to send and to receive funds?</td>
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<td></td>
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<td></td>
<td></td>
<td>15. Are controls to limit daylight overdrafts effective?</td>
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<td></td>
<td></td>
<td><strong>Briefly describe the controls:</strong> ____________________________</td>
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<td>16. Does the association audit the wire transfer log periodically?</td>
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<td></td>
<td></td>
<td>17. Does the association keep a complete log of wire transfer activity for audit?</td>
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<td></td>
<td></td>
<td>18. Does software provide a log of all wire transfer activity?</td>
<td></td>
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<td></td>
<td></td>
<td>19. If a data terminal is used, is an unbroken paper printout copy of all activity reconciled to requests daily?</td>
<td></td>
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<tr>
<td></td>
<td></td>
<td>20. Are interim daily reconcilements and end-of-day reconcilements performed with all reconciling items cleared?</td>
<td></td>
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<tr>
<td></td>
<td></td>
<td>21. Does the association prohibit the person who performs end-of-day balancing from executing wire transfers?</td>
<td></td>
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<td></td>
<td></td>
<td>22. Is the person who executes wire transfers prohibited from access to cash (such as having a teller drawer)?</td>
<td></td>
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</tbody>
</table>

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<thead>
<tr>
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<th>Yes</th>
<th>No</th>
</tr>
</thead>
<tbody>
<tr>
<td>23. Does the association prohibit the person who reconciles the association’s deposit account affected by wire transfer activity from executing wire transfers?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>24. Is a timely reconciliation made, by a person not involved in the wire transfer process, of wire transfer activity statements from a service provider compared with internal wire transfer activity records?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>25. Does the association keep a permanent record of all customer wire transfers listing the date, amount of the transfer, person authorizing the transfer, test code or PIN, and detailed instructions?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>26. Does the association restrict access to test codes to only those employees authorized to handle wire transfer requests?</td>
<td></td>
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<tr>
<td>27. Does the association keep the test codes in a secure place?</td>
<td></td>
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<tr>
<td>28. If the association uses code words do they change them periodically?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>How often?</td>
<td></td>
<td></td>
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<tr>
<td>29. Does the association strictly forbid the transfer of uncollected funds?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>30. Does the association require dual officer approval for large-dollar transfers?</td>
<td></td>
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<tr>
<td>Who is authorized and what are the limits?</td>
<td></td>
<td></td>
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<tr>
<td>31. Does the association require customer and/or bank verification callbacks for voice wire transfers above an established dollar threshold?</td>
<td></td>
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<tr>
<td>Who is responsible for verification?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>32. Does the association make all securities-transaction-related transfers only after the verified receipt of securities (delivery versus payment)?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>33. Does a person independent of the transaction approval or processing balance wire transfers at least daily?</td>
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<tbody>
<tr>
<td>34. Does the association have a dual entry/release system for wire transfers?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>For computerized systems, does one person input transfer instructions and another person verify and release the transfer?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>For associations that call in wire instructions to a correspondent institution that performs the wire transfer, does one authorized person originate the call; then does the correspondent institution have a second person make a callback to a second authorized person to verify the authenticity of the wire instructions?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>35. Has the association made unusual, frequent, or sizable transfers offshore to Privacy Act Havens (such as Panama, Switzerland, the Netherlands Antilles, or the Cayman Islands)?</td>
<td></td>
<td></td>
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<tr>
<td>36. Does the association require that customer wire-transfer requests be in writing and signed by the customer wiring the funds?</td>
<td></td>
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</table>

Wire Transfers Using Personal Computer Systems

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<tr>
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<th>Yes</th>
<th>No</th>
</tr>
</thead>
<tbody>
<tr>
<td>37. Does the association keep the personal computer executing wire transfers in an area that is physically secure from unauthorized employees and the public?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>38. Does each authorized user of the wire transfer system have a unique password known only to that user?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>39. Do separate persons enter and release outgoing transfers with separate unique passwords?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>40. Do employees adequately protect passwords to ensure that only the authorized user is aware of the password?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>41. Does the system require users to change their password periodically?</td>
<td></td>
<td></td>
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42. Are procedures (such as the system requiring two users’ passwords) in place to ensure that one person enters the wire transfer and another person verifies it before releasing the wire transfer? __________

If so, what is the time interval for going into waiting mode? ___

43. When each user finishes a series of transactions, and leaves the wire transfer terminal unattended, does the terminal go into a waiting mode where it is not possible to send outgoing wire transfers? __________

Branch Procedures (Customer-Requested Wire Transfers)

44. Does a branch procedures manual contain a clear and concise description of branch wire transfer procedures? __________

45. Are telephone requests from the branch office to the main office for two-party wire transfers accepted? __________

46. Briefly, describe the procedures the association uses to ensure that such requests are authentic. _____________________________________

47. Does the association identify all transfers by sequential code or encrypted passwords in prearranged order with correspondents? __________

48. Are third-party wire transfers by telephone confirmed by four-person callback procedure (sender, receiver, approver, confirmer)? __________

49. Does the association record all calls? __________

50. Does each participant document callbacks? __________

51. Is a signed customer-authorization form required as a source document and proof of authorization for customer-requested wire transfers? __________

52. Do the forms indicate the date, time of day, wire-from- and wire-to-account instructions, and initials or signatures of personnel who processed the request? __________

53. Does the association retain customer authorization forms? __________
FUNDS TRANSFER QUESTIONNAIRE
Preliminary Examination Response Kit
Office of Thrift Supervision

Docket #: >
Institution Name: >
Examination As Of Date: >

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<tr>
<th>Verified By Examiner</th>
<th>Yes</th>
<th>No</th>
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**Internally Generated Wire Transfers (Department Requests for Wire Transfers)**

54. Does the association require that all departmental wire transfer requests be in writing, on a preprinted form?

55. Does the request form contain all necessary from-account and to-account information?

56. Do departmental request forms indicate the initials or signatures of the initiator and approver who authorized the wire transfer?

57. Do separate persons originate, approve, and send internally generated wire transfers?

58. Do department wire transfer telephone or facsimile requests made from remote locations require a callback to that location to ensure that the wire transfer request actually originated there?

59. Recommend any improvements needed to prevent individuals from transferring funds to another’s account while acting alone.

Prepared By:

Verified By: