Preparing for FDICIA

Join us for an on-demand webinar that explains why — as the asset size of banks continues to increase — more and more banks are becoming subject to the regulatory requirements of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA). As your bank approaches the $500 million or $1 billion in assets mark, understanding the many provisions and reporting requirements can help make implementation easier and more efficient.

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Here is a transcription of this session:

Mackenzie Rooney:

All right. Good afternoon. Thank you for joining us today as we discuss preparing for the Federal Deposit Insurance Corporation Improvement Act, most commonly known as FDICIA. Today, myself, David Heneke, and Scott Klitsch will be going through and talking about some of those key items as it relates to FDICIA compliance. I am Mackenzie Rooney. I am a manager at CLA within the financial institutions group. I've been with CLA for a little over nine years, strictly focusing on financial institutions' various consulting and internal audit engagements, as well as FDICIA compliance. With that, I'm going to turn it over to David Heneke and Scott to have them introduce themselves.

David Heneke:

Terrific. Thank you, Mackenzie. As Mackenzie mentioned, my name is David Heneke. I've been with the firm approximately 17 years, working solely with community banks and financial institutions in that time. And as a lot of you on this call or this webinar can probably attest to the fact, is we're getting a lot more questions surrounding FDICIA lately, given the fact that banks' balance sheets have been ballooning because of the government stimulus that has been put into play and whatnot. And so we're looking forward to sharing some insights that we've learned and some experiences we've had throughout the course of assisting clients, going through the process of crossing both the 500 million and the $1 billion threshold. With that, Scott, I'll turn it over to you.

Scott Klitsch:

Hey, thanks, David. Thanks, Mackenzie. My name is Scott Klitsch. I'm a principal within our financial institutions group based out of Boise, Idaho. I'm also a member of our national assurance technical group, and so I work closely with our professionals both from an external audit perspective as our financial institutions are requiring that audit for the first time, as well as working with financial institutions, those community banks, where they have to implement some of these changes that come with crossing that 500 million and billion mark. So looking forward to answering any questions you have today. And with that, we'll kick off the presentation.

Mackenzie Rooney:

Great. Thanks, David and Scott. So, we are going to kick off and jump right in with, does FDICIA apply to me? We have a really nice flow chart here on the next two slides that really help determine those requirements based on your asset size and various other questions. So, as I go through this, please take a moment. We'll try to keep them on here for a little bit longer than a few seconds, so you can really see how that flows. But the first thing you have to consider is really where you're at at the beginning of the fiscal year.

Mackenzie Rooney:

So if you look at this first slide and the flow chart here, the first question you ask yourself is, does your holding company have more than $500 million in consolidated assets? Of course, if you look towards the right, you'll see, if you answer no, the FR Y-6 financial statement requirements and FDICIA do not apply. So you can stop there. At this point, you don't have to worry about FDICIA compliance. Of course, on the other end of the spectrum, if you do answer yes, you have to then ask yourself, does the holding company own a bank charter with more than 500 million in assets? Again, if you look towards that right, you'll see, if you answer no, a consolidated financial statement audit is required per the FR Y-6 instructions, but again, FAIA still does not apply.

David Heneke:

And Mackenzie, I think at that point, it's good to kind of stop to just reiterate that point, that as you're going through that flow chart, that the FDICIA elements that Mackenzie's going to talk about here if she goes through the other parts, the flow chart apply to the institution, so the actual bank itself. Whereas the Y-6 instructions that Mackenzie referred to are a holding company form, and buried within those instructions is the requirement that if that holding company has more than 500 million in assets, a consolidated basis, you have to have a consolidated financial statement audit done. So that could be a situation in which you have multiple bank charters that exist under the same holding company and each of them is 300 million in assets, where the FDICIA elements would not apply, but the requirement for an audit would apply because the consolidated assets are over 500 million. So I wanted to take a moment and just make sure we clarified that point.

Mackenzie Rooney:

Thanks, David. So if we answer yes to the holding company owning a bank charter with more than $500 million in assets, we then move on to the next phase where we ask, does your holding company own a bank charter with more than $1 billion in assets? So that's where we're going to talk about and narrow in a little bit more on that 500 million and that $1 billion threshold. As we go through today's presentation, we'll talk about the differences. We'll talk a lot about similarities between those two thresholds as well, but really want to point out how this flows initially. If you do answer no to whether your holding company owns a bank charter with more than $1 billion in assets, if you are over that $500 million requirement, FDICIA requirements apply. So if you are over $500 million, you will have to comply with those FDICIA requirements, which we'll discuss in more detail.

Mackenzie Rooney:

You'll see here on the slide that the ICOFR requirements do not apply as well. We do get some questions, what does ICOFR? We'll probably mention it a few times today. It's really that internal control over financial reporting. So the control is specifically designed to address risk related to your financial reporting process. Get on the other end of the spectrum, if you're answering yes to whether you're holding company owns a bank charter with more than $1 billion in assets, all FDICIA requirements apply. We will again discuss those in more detail. And additionally, you are required to comply with those ICOFR requirements as well.

David Heneke:

So, Mackenzie, we did have a question come in just about the interplay between the holding company and the bank of just if you're an institution that does not have a holding company. Well, if you do not have a holding company, then the federal reserve requirements regarding the reporting elements that are outlined in the FR Y-6 would not apply. And you would be just held to the FDICIA requirements of the $500 million related to the bank charter. And so there is really separation between those two elements in regards to the bank versus the holding company, and understanding the requirements in both cases is going to be important.

David Heneke:

We bring that up because when I said the information is buried, it truly is. The instructions of the Y-6, it's outlined in a paragraph in there about the requirement for that consolidated financial audit requirement. And sometimes that can get overlooked, particularly in institutions that may have multiple bank charters underneath the same holding company. So if you're a single bank holding company, they usually work pretty much in concert. If you cross $500 million at the bank as a one bank holding company, you're going to be at a $500 million level on a consolidated basis, and therefore you're going to be aligned in that way.

Scott Klitsch:

Yeah. And just to add to that, David, as, as we continue through the presentation today, and really what we're going to be focusing on here is, the requirements is at the IDI or the insured depository institution level. So kind of to your point, we're trying to get to, does FDICIA apply, but FDICIA is really a requirement at the IDI level? And so that's really what we're going to be focusing on today, is what's really required at that IDI or standalone bank or consolidated bank level is the assets at that individual level.

David Heneke:

Yep, absolutely. And so with that, there may be some of you who are either getting closer or had the privilege of crossing $500 million recently either this year or in prior years. So we want to take a moment here and walk through each of the, I'll say, significant requirements that come along with crossing that $500 million threshold. And as Mackenzie mentioned, that is at the beginning of your fiscal year. So it's effectively, if you're a 12/31 calendar year-end reporting entity, the baseline is as of January 1st of the following year. So if you cross $500 million in the middle of the year, then the requirements of FDICIA will not apply until the next year, provided that you're still over 500 million at that point in time. So it's a point in time, it's not based on average assets or anything of that nature. It's point in time, beginning of the fiscal year, that will dictate whether or not you need to comply with these requirements.

David Heneke:

And the big one that can be challenging to go through if you're not adequately prepared is the fact now that you're going to be subject to an audit of your financial statements. This can be somewhat of a rude awakening for institutions that maybe have not had a lot of accounting work done for them leading up to this point when you were still with a community bank. And so this is something that you want to take seriously and try to get out in front of when it becomes to both selecting an audit firm to do your audit, but then also being aware of the requirements that come with that from a standpoint of how the audit will need to be executed.

David Heneke:

Just for background, when a first year audit is being done, there's a requirement by the auditor that they need to get comfort on the beginning balances of that fiscal year in order to issue an opinion on both the balance sheet and the income statement of the year under audit. And so it's not as simple as just saying, "Well, we need an audit done as of 12/31/2022," if that's the first year that you'll have to have audited. The auditor's also going to have to do work to get comfortable with the balances as of 12/31/2021 in that example, and that's primarily so they can issue an opinion on the income statement. Noting that, the entire financial statement needs to be audited for that first year, which would include balance sheet, income statement, statements of stockholders' equity, statements of cash flows in the footnotes. And that's going to allow the auditor to issue that opinion.

David Heneke:

But it's also important to note that the statements do need to be shown comparatively. So you do need to show the current year and the prior year, but that prior year does not need to be audited from a standpoint of the presentation. So that prior year, it can be shown as unaudited, but the current year needs to be audited, which that then leads us into financial statement auditor independence. This is a little quirky thing that comes specifically with the FDICIA regulation when it comes to auditor independence. Most of the time, if you're not a publicly traded entity, typically you're only required to use AICPA standards as a result of whether or not you're independent. Okay? Now, when you cross this $500 million threshold, the FDICIA requirement requires that you use the most restrictive independence rules that are in existence at that point in time, which could be either AICPA, SEC, PCAOB, or governmental for that matter.

David Heneke:

Typically, when you're dealing with auditor independence, the SEC and PCAOB independence rules are the most restrictive. But what that means is, if you're working with an accounting firm to help you in a variety of capacities, they may not be able to perform your financial statement audit because they would be impaired from an independence perspective from doing that financial statement audit. And a couple of specific things that maybe you wouldn't think of as something that would impair independence are the preparation of individual tax returns for individuals in a financial reporting oversight role. This is specific in the SEC and PCAOB rules that this impairs independence that if your audit firm is doing tax work for those individuals in the financial reporting oversight role.

David Heneke:

So what does that mean? Typically, if we're going to try to keep it really easy is, the financial reporting oversight role is anybody who is involved in the preparation or review of the financial statement process. So it's typically going to be those individuals that are in the C-suite, chief executive officer, chief financial officer, if you have individual, a chief audit officer that could be involved, lending officers, and then also members of the audit committee because the audit committee is going to be those individuals that are actually the people theoretically engaging the audit firm, that those individuals would need to be independent as well. And that can be something that gets tripped up here every once in a while. So you want to make sure you're fully aware of those rules, and that if you're working with an accounting firm, that they're aware of those rules.

David Heneke:

So in the event you move into this place that if they're going to become your auditor, they may have to give up some work that they're doing for you right now. And that can include the preparation of the financial statements. That's another thing that's a big no-no when crossing this level. We have a lot of clients that we audit that are below this threshold that we're allowed under AICPA audit standards to prepare the financial statements as a part of that audit work. But once you cross 500 million, you can no longer do that as the audit firm. So you'd either have to see if you have the talent internally to prepare the financial statements, or you potentially may need to look for another firm to help you with that as you go through this process. So another thing to keep in mind as you're going through it.

David Heneke:

One thing that is allowed, because I just see we had a question come in, the audit firm is allowed to prepare the bank's corporate tax return. That is an allowable service where you can get a little bit dicey there, this is primarily more on the lines that if you're a C corp bank, is if the audit firm is helping you prepare your deferred tax assets or in your tax provisions and booking your accruals and whatnot. You'll want to be careful there because one of the underlying principles of preserving that independence is ensuring that your auditor is not put in a position to where they're going to be auditing their own work. Okay, so that's something to keep in mind. And so if your audit firm is doing your corporate tax work but then they're also maintaining your deferred inventory, managing all of that, they may be running up against the line to where they wouldn't be independent in performing that service.

David Heneke:

The other thing to be aware of in regards to auditor independence is, now when you cross this threshold, there are audit partner rotation requirements. So the signing partner on an audit engagement, that needs to rotate every five years. So every fifth year, you're going to be having a new signing partner brought into your engagement because this is, once again, SEC, PCAOB rule that requires partner rotation, both in the signing partner as well as the concurring partner of that independent quality check in regards to that.

David Heneke:

So, Mackenzie, I'm actually going to flip back a couple slides to go through a couple of other items here in regards to the requirements. So those are kind of those first two boxes, and I wanted to make sure we hit on three additional boxes here real quick, as far as what auditor reports you're going to receive and what reports management will now be required to do. So as a part of this, now as a part of the audit, you're going to be receiving a governance communication and an internal control communication from your auditor that outlines required communications that your auditor has to communicate to your audit committee about how the audit went and if there were any controlled deficiencies identified as a part of the audit engagement, particularly significant deficiencies and material weaknesses.

David Heneke:

This becomes a much bigger issue when we get to the billion dollar level, which Mackenzie's going to talk about here in a little bit, in regards to what expectations are in regards to control auditing and identification of those deficiencies. And so I'll leave it to McKenzie to talk about that here in a little bit. But in both scenarios, you will receive an internal control communication that outlines if there were any significant deficiencies noted in internal control. Management then, which is primarily the CEO and the CFO, have to sign a report attesting to their responsibilities under the FDICIA requirements about that internal controls are in place to prevent material misstatement of the financial statements amongst other things, as it relates to regulatory compliance and some other items. So just be cognizant of that. The regulation actually has template reports in it that the CEO and CFO have to sign, so just be aware of that.

David Heneke:

The last thing I want to speak on, because this is another thing that can also get institutions tripped up if you're not aware of these requirements, and there's another layer to this when you get to a billion dollars that Mackenzie will speak about, is it's the makeup of your audit committee. So the first step when you're looking at your audit committee, when you cross 500 million is, the first layer is they all have to be outside directors. That's the first layer. The second layer is, then a majority of those directors have to be independent of management. And the regulation outlines a number of items that define if you're independent of management. But the key element is that first one. They all have to be outside directors.

David Heneke:

So what's an example of an outside director that is not independent of management? Well, there could be, say, an individual that was maybe a member of your management team that is retired, that is no longer working for the institution that you're bringing on to the board. They would now technically be considered an outside director because they no longer work with the institution, but they would not be independent of management. Because if you look at the FDICIA regulation, there's a cooling off period to where if you were a member of management for a certain period of time, you are not considered to be independent of management until you've cooled off for that period. And so that's just one example. But just be sure to remember that voting members of the audit committee, they all have to be outside directors, with the majority of them being independent of management upon crossing that $500 million threshold.

David Heneke:

So what does that mean from an implementation plan? We kind of talked about a number of these things as we've gone through it here, but you want to maybe consider either engaging in a balance sheet audit in the year prior to being subject to FDICIA or having agreed upon procedures done in regards to those beginning balances. That will just help with the efficiency of the execution of that audit when the time comes because you'll already have taken care of that beginning balance work. So that may be something to consider. Also, if you engage in a balance sheet audit, the other thing the auditor can do is try to identify any of those controlled deficiencies that may pop up to where there may be a lapse or a lack of internal control over significant audit areas. And those can then be communicated as a part of that process before being subject to FDICIA to give management the time to remediate those controlled deficiencies. So then, if there is a material weakness, for example, it doesn't need to be reported to the regulatory agencies.

David Heneke:

You'll also then want to talk internally about, do we have the talent to prepare the financial statements? Or do we need to potentially look outside to a third party? That's something you'll want to make sure you have handled because the preparation of the financial statements can be a pretty significant undertaking. And you want to make sure you have the resources in place to deal with that. And then we talked about the audit committee composition, making sure that they're all outside directors and the majority of them are independent of management. So we got a few questions that came in about the management attestation. So the management attestation is done as a part of the audit and as a part of getting this packet of information together. Those are submitted to your regulators through the channels that are outlined in the regulation. I think, I believe you can email it. There's a mailing address in the FDICIA regulation, that's what it does. I mean, you get your audit opinion together, the audited financials, the governance communication, any other communication from your auditor that's signed attestation and you provide it to the regulatory agencies.

David Heneke:

The audit committee composition should really be at the level to which the audit is occurring. Now, in most situations that I have dealt with, we're doing a consolidated audit because then you can use that for a variety of different matters, that if you ever plan on doing a debt issuance at some point, and you need an audited financial statement at the consolidated level. And so in most situations, you see the audit committee in question, as far as engaging the auditor is at the holding company level. But you may have committees at both levels, but the engaging party should be the one at which the audit is being conducted.

David Heneke:

Can the beginning balance sheet audit? Yes, the beginning balance sheet audit can be done by the same firm that would be doing the audit of the FDICIA. That does not need to be a different firm. You'll just want to be careful that when they're doing that audit that anything they're helping you with, any services don't bleed into that period in which they'll now be subject to these heightened independent standards. So make sure you're cognizant of that. The cooling off period for management that I spoke of, I believe, is three years. I'm going to go back and double check that, but I believe it's three years. As long as they've been outside of the three-year window of being a member of management, you're all good.

David Heneke:

So, can the financial statement sample come from the company that's doing the audit? The short answer would be, it can, but where you get tripped up is, it needs to be something that is provided to the general public in mass. And so if they're not providing it as a download that's available for anybody to grab, technically speaking, that could let make you run foul with the independent standards because it's something that they put together that they've not made available to everybody, to which then it could be viewed as they're auditing their own work. So that's something to kind of keep in mind as to how, I guess, readily available that template is.

David Heneke:

The Y-6 stuff we talked about before does not relate to any of this as Scott mentioned. This is at the institution level, but you can satisfy the institution level requirements by doing a consolidated audit, which you probably most likely will have to do anyway as a result of the Y-6. So that's where the Y-6 comes in, is that if you have a consolidated entity that is more than 500 million, you have to do a consolidated audit, and then most clients will then just use that to satisfy the requirements of FDICIA, which is at the individual depository institution level. So with that, Mackenzie, I think I'll turn it over to you then to start talking about when we cross a billion.

Mackenzie Rooney:

Thanks, David. Well, the bulk of what David covered really is going to overlap with the $1 billion threshold requirements. However, we do have a few additional items that we need to go through as well. So you'll see this first slide here. We lay out those requirements for the $1 billion threshold. Those include the 500 million threshold requirements just discussed. On top of that, we have a few additional items. So in addition to the auditor reports that we discussed as part of that $500 million threshold, you now have to include that ICOFR opinion. So again, if we go back to what we had discussed a little bit earlier, that ICOFR opinion is internal controls over financial reporting or the controls specifically designed to address risk related to financial reporting. So we want to make sure that that opinion related to those internal controls over financial reporting is included.

Mackenzie Rooney:

As it relates to the management reports at that $500 million threshold, as David mentioned, you're really attesting to those management responsibilities. Additionally, you are going to include, at this point, an assessment of the effectiveness of the internal control structure. So that will be in addition to the $500 million threshold requirement. Any material weaknesses in any of the internal controls that were tested will also need to be disclosed in that management report as well.

Mackenzie Rooney:

And then lastly, the biggest difference is with the audit committee. So as David had mentioned, with a $500 million threshold, all outside directors and a majority independent, once you cross over that $1 billion threshold, you now have to have, again, still all outside directors, but all members must be independent of management at that point. So again, really, that foundation is with the $500 million threshold. However, there are some additional requirements as it relates to the auditor report, the management report, and then lastly, the audit committee make up.

David Heneke:

Mackenzie, if I can confirm for that last session, it is three years. And we have a link on the last slide that you'll see to the actual FDICIA rule that outlines all of these requirements that would dictate whether someone is independent of management. So you can go out and read those on your own time, but it is three years for that, that an individual or an immediate family member has not been an executive officer within any of the institution or any of its affiliates.

Mackenzie Rooney:

So we put together a $1 billion implementation plan here as well. So as part of that, you're really going to start out with the planning phase. It's really important to spend time planning as you're approaching that $1 billion threshold. So, we like to think of this early on. So when you're crossing 700, 800 million, you're really thinking ahead about when you do cross, what the plan is going to look like, what methodology you're going to have in place, which we'll discuss in a little bit more detail as well.

Mackenzie Rooney:

Spending more time on the front end in the planning process includes getting a team together, again, that methodology that you are agreeing to as part of the FDICIA process, really getting an idea of what the stages of the process look like. Again, spending that time on the front end really saves a lot as you move through that process. Some of our discussions include like individuals who say it may be daunting, or they're really worried about what this is going to look like, but if you spend a lot of time on that front end and planning, it really makes that process much easier as you go through the rest of the phases.

Mackenzie Rooney:

We then move towards the documentation of control design. So this is really that second step in the process. Once you've done your planning, determining your team, gone through and determined materiality and scoping of those key areas that are going to be included in the FDICIA engagement, you're really going to then focus in on those specific areas and do walkthroughs. As part of those walkthroughs, you're going to get an idea of the processes involved, but ultimately, key in on the controls that surround those key areas. We will talk a little bit later on about process versus control a little in a little bit of detail, as well as a key control versus a general control. So it's important just to really spend those time or the necessary time in the documentation of control design phase to understand the full process and really have an understanding of what is key and what is not.

Mackenzie Rooney:

Ultimately, when you come out of those walkthroughs for the key areas, you are going to be able to identify the key controls related to those areas. At the end of the day, the key controls are what you're going to test. It's important, when you do go through this process, that you are thinking about key controls as it relates to the financial statements. We will again, in a little bit later in this presentation, talk about key controls, how to identify key control. But at the end of the day, a key control really has an effect on the financial statements or as materials to the financial statements, as it relates to FDICIA.

Mackenzie Rooney:

You've gone through the documentation of control design, done your walkthroughs, identified your key controls, the third phase is testing those. And that involves two periods. So really, it's periodic testing and reporting, and then bridging testing to year end. One of the key things here is really getting started early, testing right away, so that you make sure if there are any deficiencies noted, you have time to remediate those. During that time, so the first part, that periodic testing and reporting, you're really getting a general idea of how those controls operate and are they operating efficiently. At that point, your external auditor will do reperformance and independent testing on those controls as well. And you'll have time to correct any deficiencies that would occur or would've occurred during that time before year end testing begins.

Mackenzie Rooney:

Again, at year end testing, you will have your external auditor reperform and perform independent testing over the FDICIA testing you've already completed and have time to correct any deficiencies at that point. So usually, we see a remediation period after each testing phase. And then lastly, you'll pull together the final reporting. So that's where you're linking back to those requirements for the one billion threshold that we discussed on this previous slide. So including that ICOFR opinion within the audit report and the management assertion on the effectiveness of the internal controls and disclosing any weaknesses. So while this is broken out into five different phases, I like to really consider it as four phases. So really, that planning phase and scoping phase, going through and doing your walkthroughs, documenting the control and design, and then testing those, so that's where it's broken out a little bit, and then lastly, reporting the results of your walkthroughs and your testing.

Scott Klitsch:

Hey, McKenzie, we had a good question that came through as we're talking about the thresholds here of the 500 million and the billion in it. And it really talked about 2020 having an inflated balances. And what I would say to that is, the regulators did come out with essentially a delay because of those inflated balances. So let's say, you were 505 million at the end of 12/31/20, sort of the same as 1/1/21, but then you drop back down, let's say you're 495 million at the end of 12/31/21, FDICIA wouldn't impact you. What we've noticed is, a lot of those inflated balance sheets didn't decline, they've stayed inflated. And so the testing threshold really got just pushed back a year, but we haven't seen too many banks that essentially was able to get back under any threshold. As a result, we're seeing a lot of almost two years worth of institutions now needing help either from an external audit or from a kind of a FDICIA implementation perspective.

David Heneke:

Mm-hmm.

Mackenzie Rooney:

Yeah.

David Heneke:

All right. So then that leads us to... We're not going to spend too much time on this, but we wanted to make you aware of this, for those of you who are getting close to the billion dollar threshold. But I think for those of you who aren't there, but crossing 500 million, there's still some value that can be gained by taking a step back and looking at your internal control framework and structure to really decide if we've got controls implemented in the most effective way possible. As technologies continue to evolve and as processes continue to evolve, I would maybe just say, don't be afraid to try and break things in regards to looking for a better way to execute a process or a control. And that goes for institutions of all asset sizes. And although there's more formality put around the control side of this when you cross a billion dollars as opposed to crossing 500 million, I don't want you to think that some of these concepts don't apply to you and can't provide value to your organization in regards to evaluating your internal control.

David Heneke:

And the reason for that is, whenever something goes wrong at a financial institution, a hundred percent of the time, you can always trace that back to a failure of internal control, whether it's because of a poor design, it wasn't effective, or just a control didn't exist to prevent that risk. Now, that may be for good reason, maybe as a management team you said, "We don't feel this is a significant risk, and therefore we don't want to implement any control to deal with that." But that being said, I want you to keep in the back of your minds that internal control is preventing bad things from happening. And anytime a bad thing happens, that's always because of a control issue in one form or another. And so with that, we're going to step into the internal control framework piece of this.

David Heneke:

Once again, this is really more for when you cross a billion dollars as opposed to 500 million, but it's good to kind of understand the concepts. When you cross a billion, management's required to provide a written assertion that controls are effective over financial reporting, and you must identify the framework that you're using to basically state or how you know your internal controls are operating effectively. And the most common one that we see being used by both banks and non-banks alike, where they have to identify a control framework that they're using, is commonly referred to as COSO. It's the Committee of Sponsoring Organizations of the Treadway Commission, that has released guidance on what you would expect to see in a sound control environment.

David Heneke:

So then, what is COSO? COSO is, as I mentioned, the Committee of Sponsoring Organizations of the Treadway Commission, which is the entities that you outlined there. It was first released in 1992 and was subsequently updated in 2013. But the thing to note about this is, it breaks internal control down into five components. And then within each of those components are 17 principles. Okay? And we're not going to go through each of them individually. You can go out and Google them and find them, but the components and the principles need to be addressed. As Mackenzie was talking about, when you're doing your walkthroughs and evaluating your internal control structure, you need to ensure that you have controls in place to address every one of these principles in every one of these components.

David Heneke:

And that is how then the management team can assert that you have an effective and functioning control environment in accordance with the internal control framework. That's kind of the bridge that brings it all together. That in order for management to assert that it has effective controls, it has to be audited to a framework. And as long as there's controls that are operating in effective, covering each of these principles and these components, management can then assert that we have a functioning control structure over financial reporting in accordance with the coastal framework. So make sure you're aware of that and gain an understanding of that.

David Heneke:

And the last bit here is, we do have the... So this is the coastal cube and the five control components that are outlined here. The one thing to keep in mind when you're going through this process is that FDICIA only cares about the financial reporting sliver that you see on the top there. It only cares about that financial reporting sliver. It does not care about compliance or operations. Although you should have internal audit functions and audit functions around those two slivers and the five components, for FDICIA purposes, we only need to evaluate the key controls over financial reporting. So let me use an example here to show you how the three slivers can get divided up. So if we were looking at overdraft fees as an example, the operational side of overdraft fees and the auditing of operations on overdraft should really be looking at, is there revenue we're losing for one reason or another in regards to how we're charging overdraft fees?

David Heneke:

So that could be something to the effect of, "Well, let's do a summary of all overdraft fees that have been waived by officer or by branch, and see if there's branches or officers that are waving overdraft fees at a higher percentage than the average or a significantly higher percentage than the average," that's what an operational audit would tell you in that we're not operating as efficiently as we could or generating as much revenue as we could from overdraft fees. The compliance side of that would state, "Are we charging fees that are allowed based under current regulatory compliance rules?" And so that's where you'd be auditing to say, "Are we charging more than is allowed by state laws, banking regulations, what have you?" That's what we're looking for on the compliance side.

David Heneke:

The financial reporting side is getting at, "For the amount of overdraft fees that we are showing on our income statement, is that number right?" So that's what we're caring about from that financial sliver, is the amount and the numbers that are flowing to the financial statements, are those materially correct? And so that's just one example of how to divide that out. But as you start to work through that process, make sure you're focusing on those controls that really have an impact on that financial reporting and those financial statements and carve out the operational and compliance side of things when it comes to this process specifically. That's not to say, just to reiterate, you want to have internal control and internal audit functions surrounding all these slivers, but just for compliance with FDICIA, we just want to be focusing on the financial reporting sliver.

David Heneke:

So, now that we've kind of established that framework or the baselines of what is expected of when you cross those various thresholds, we want to now move into some common pitfalls, and I'm going to turn it over to Mackenzie, and she's going to walk through some of those with us. And keep it in mind that although a lot of this is tailored towards institutions that have crossed or are crossing that billion dollar threshold, even for those of you who aren't almost there, once again, just kind of sit back and think about your institution and say, does some of this exist in our institution to where we could have control problems, even if we're not required at this point to attest to the effectiveness of those controls because we haven't quite got to that billion dollar level? So Mackenzie, why don't you talk about some of those things we see as we're working through this with clients.

Mackenzie Rooney:

Perfect. Thanks, David. So as David mentioned, really, you want to focus on, even if you haven't crossed that billion dollar threshold, where you're at within your organization. So you'll see on each of these common pitfalls that we have listed, we have the 500 million and the $1 billion threshold listed and then both. We have check marks next to where it really corresponds. You'll see a number of these have that check box next to both. So again, really wanting to keep these in mind as you are crossing that 500 million and that $1 billion threshold.

Mackenzie Rooney:

So the first common pitfall we have is really a lack of consistent methodology. So management should determine if there is a clear methodology for all of these items listed here. So the risk assessment, applying sample sizes, which sample sizes you're going to use for an annual control or a quarterly control compared to an ongoing or a daily control, how frequent you are testing, who is responsible for testing, really some consistency related to the documentation, as well as how you are evaluating the control deficiencies and remediating those. And then lastly, just communication with governance and your external audit firm are really important to include in that methodology as well.

Mackenzie Rooney:

The methodology should be documented clearly and agreed upon annually by any outsource parties. So if you have a third party coming in and actually performing your FDICIA testing. And then your external audit firm, of course, going through and attesting to that as part of the financial statement audit, you want to make sure that you are in agreement, all parties are coming together to agree on the sample size that you are using, what's included in scope, your risk assessment results. Having everyone on the same page is very, very important. And it's not just upon implementation, it's as you are compliant each year as well.

Mackenzie Rooney:

The next pitfall we have listed is really just assuming the existing internal audit function is already FDICIA compliant. Oftentimes, it's really natural to assume that your existing internal audit is already FDICIA compliant, maybe because you've had internal audits and you haven't had any control issues come up, but really, that isn't always true. A risk assessment should be completed or updated annually to ensure that significant lines of businesses within the bank are being included. So, every year what we do is, when we perform these, is really taking a step back and looking at the risk assessment from a qualitative and a quantitative perspective. So assessing it from the balance side and looking at that materiality, but then also applying qualitative factors to determine if all significant lines of business are being included in the FDICIA scope.

Mackenzie Rooney:

Some of these could change from year to year. So I think of just an example of an OREO account. So sometimes when we go through and perform the risk assessment and really look at those qualitative and quantitative factors, the balance in an OREO account may be insignificant. However, that may change the following year and there may be an increase there, and you really want to make sure that you're assessing those from year to year to ensure that you are including all of the key areas.

David Heneke:

I think-

Mackenzie Rooney:

Another big piece... Oh, go ahead.

David Heneke:

Well, I was just going to add, Mackenzie, I think a common area where we see this one in particular is in the IT area. You may be having a general control review or something to that effect being done. Whereas typically, that is a... Has the control been implemented as opposed to it operating effectively to where you're testing samples over the course of the year to ensure that IT controls are operating. That just tends to be a common one that we see where that really needs some refinement or the need to be revisited in regards to making sure that the audit function surrounding it is sufficient.

Mackenzie Rooney:

Thanks, David. Another part of making sure that your existing internal audit function is already finished at compliant is really evaluating your time, your resources, including the expertise involved to make sure that the existing personnel aren't lacking any skills needed to test for FDICIA, document for FDICIA, or even do the initial scoping for FDICIA. Again, to echo what David said, this is really particular to IT in any specialty areas, just really important no matter what size you are to ensure that the individuals involved in the process know and understand the requirements.

Mackenzie Rooney:

The next common pitfall is testing too many controls. So a lot of times when we're working through this, we'll get a common question of, do you have a listing of controls we can use? Or what is the expected number of controls that we should have listed as key? Unfortunately, there's really not a set number or a set listing of controls that we recommend. It's really important to understand that controls are different for each organization. Where there are some controls that may be the same as you determine the risks you need to address and really look at your overall risk assessment results, taking a clean approach to determining those controls is really important. So oftentimes in cases of uncertainty, general controls and processes are deemed key. So we'll see individuals go through and just label every control that they have noted or even processes as a key control to make sure that they're covering every area.

Mackenzie Rooney:

However, it's important to remember to step back and identify controls as key for FDICIA purposes. Again, as we had mentioned earlier, those that have a direct impact on your financial statements and regulatory reporting. So just some examples here, while treatment of unclaimed funds may be necessary to operations, we don't always see that as key or material to the financial statements, or even something as simple as dormant accounts. While the balance, it may be necessary to monitor those, and of course it's a necessary part of operations, the balance might be small enough where it is not something that would be material to the financial statements.

Mackenzie Rooney:

On the other hand, if you think about the process of boarding a new loan or performing a reconciliation on an investment account that may be more material, those are more likely to have a financial impact on the financial statements. And thus, those controls surrounding those areas would be more likely to be considered key. And as you're designing those, you really want to make sure that when you're designing them, you're thinking about how you're detecting, preventing, and correcting any potential misstatements.

Mackenzie Rooney:

Next, we want to bring up a common fall, not sufficiently testing controls. A common theme over and over is over documenting or under documenting. So sometimes, adding too much information to make sure you're covering all your bases or not including enough information to really get to the heart of that key control. So as part of your testing, you want to first consider the design of the control. Does the design of the control peer proper? Are enhancements needed? Or maybe there are steps, as you're discussing that design of the control, that really need to be enhanced. Are there elements of the control design that you should include? What report are you obtaining? Who is it coming from? What does the actual review of that report look like? What is that report attesting to or the sign off attesting to?

Mackenzie Rooney:

You'll then test how the control actually operates. And as part of that testing, you'll be able to attest to whether that control is operating as intended. Again, during that testing phase, you'll then be able to identify if any gaps exist or enhancements are required as well. Additionally, as you're going through and you're testing those controls, you want to consider completeness and accuracy of the data that you are being provided. So if you do receive a report on new loans to select a sample, you should be able to assess whether that data that you obtained is complete and accurate, such as agreeing the total balance on the loan trial balance to the balance sheet, as an example. And then free of any possible manipulation. This consideration should be included as part of the testing of each control that you really are relying on data for.

Mackenzie Rooney:

Next, we talk about the lack of precision and review. So in many instances, we'll see citing evidence of a reviewer's initial on a reconciliation, for example. This is a common one. So oftentimes, we do rely on reconciliations as part of our key controls or as a key control. And just citing a reviewer's initial on that reconciliation is really not sufficient to conclude that a control is designed and operating effectively. So as you perform that testing and also design that control and the wording of that control, you want to think about the precision involved. When that reviewer is signing off, what are they attesting to? Are they attesting to the fact that they're agreeing a statement to the general ledger? Are they making sure that there are no reconciling items that are outstanding over a certain number of days or over a certain dollar amount? Really getting some of those key items in that control design helps to narrow in on that testing and making sure that that provision precision in your review is occurring. And ultimately, that control is designed and operating effectively.

Mackenzie Rooney:

Oftentimes, we also will see testing that process instead of the control, so it's really common to get lost in the documentation of your process. And if not careful, you really spend time and resources focused on operational processes instead of actually thinking about those internal controls over financial reporting. So as you're going through, you really need to take time to step back and make sure your controls are well defined. Do we have a process here or are we actually documenting the control? What is the control? What is the process? So just some examples here, something that's not sufficient or documentation that's not sufficient is saying something like, "Operations prints and emails are report for review. Okay, great." Understand that maybe the process, but what is the actual control here?

Mackenzie Rooney:

So we could enhance that wording to say something more sufficient like, "Daily, the CFO compares this report to this report or this listing provided by deposit operations and determines if those totals agree." So something a little bit more specific that really gets to the heart of that control. After you go through and identify your controls, it's nice to take that step back and really revisit them to make sure that you've identified the key items and not have too much information in there that really focuses on a process and really narrow in on the wording of the control.

Mackenzie Rooney:

Another common fit pitfall is really having internal audit act as the control. You want to make sure you're avoiding instances where the internal audit function or even your outsourced internal audit firm is actually the control operator. If the function is performing reconciliations or reviewing maintenance changes or assuming responsibility for, a big one we see, employee account review, then it is a control. Because if you are relying on your internal audit or your outsource internal audit, that control is technically not independent. So your bank cannot assert on your own work. Again, one big example I see here is really just having internal audit be that control for employee accounts. Again, that really isn't an independent evaluation of that control. Another one I sometimes see is, the external auditor presents the results of the financial statements. That really isn't a control because you're relying on an outside party to perform that. So we want to make sure that in these instances, you really want to consider that control operator. If you're not independent of your work, your institution cannot assert on your own work.

Mackenzie Rooney:

Another pitfall is waiting too long to start testing. We recommend management begin testing early to allow for any identified control deficiencies. So especially as part of that implementation phase, but even as you are required to be compliant, testing early, detecting any deficiencies in a timely manner helps management identify a root cause, evaluate the deficiency and then correct the actual control environment, and then still have sufficient time during the year to make sure that control operates effectively. So for example, if you have a quarterly control and you don't start testing till September and you determine in September that control really isn't operating effectively, then it's almost too late to really implement that control or the control enhancements. Of course, we want you to do it, but really you're not going to have enough of a testing population that is operating effectively. So if you're waiting until near year end to perform testing, any of those control deficiencies noted may have to be reported because management no longer has enough instances of the control to remediate and then test to conclude that control is operating effectively as well.

Mackenzie Rooney:

Similar to the waiting too long to start, you want to make sure you're not ignoring portions of the year. So while you are attesting to the bank's fiscal year end, so your final reporting is really as of that 12/31 date, you want to make sure you're considering the whole year. So if a key control has not been tested since, for example, March of 2022, when it comes to December of 2022, how can we attest that that control is still operating effectively? There's generally not enough evidence to say that the control is designed and operating effectively as of year end if you haven't tested it since earlier that year. So while it's acceptable to test in year and of course we want you to start earlier and recommend testing a portion of your sample size during quarter two or earlier on in the year, we want to make sure you're still considering those year end samples and making sure that all of the population represents the full year.

Mackenzie Rooney:

All right, we just have a few more here. Lack of audit trail. So you'll see simply here, we have document, document, document. While your bank's controls may be designed properly, there may not be sufficient documentation to show that your controls are actually operating effectively. So I think a general rule of thumb and documentation is that documentation should be the level that a reasonable individual can pick it up and easily understand the control existence. So what you have documented as part of that control design, and then easily perform the testing as well. So two parts there, control design and then that testing reperformance. As part of the testing related to the FDICIA, evidence must be obtained for that testing and insufficient documentation retained to support the testing that occurred. This step is really important as part of the process because at the end of the day, the external editor must reperform a sample of that internal audit work, which really hinges on the existence of the documentation from a controlled design standpoint as well as that testing standpoint.

Mackenzie Rooney:

And then lastly, lack of reporting. We have a few things here. Lack of reporting really increases the potential of the external auditor reporting a significant deficiency or material weakness. We recommend that information be presented quarterly to management, really keeping up to date on where you stand. This would include governance possibly as well and even the external auditor periodically. Having everyone on the same page, understanding any issues or potential weaknesses right away so there's no surprises, deficiencies can be remediated, and then of course, significant deficiencies or material weaknesses hopefully avoided. The impact on having those conversations early on and more frequently is necessary to make sure you have those positive results. Really, what we see is lack of timely reporting increases the potential of that external reporting, those significant or material weaknesses. So having that conversation, those annual presentations, even to the external auditor really helps you avoid those.

Mackenzie Rooney:

All right. So I know we're right at noon or close to. We have some additional resources here. We do have a link to the FDICIA rule. That really includes a lot of detail. And then an article that is on the CLA website that was published by a few CLA individuals on what to expect when your bank reaches a billion really lays out the process in great detail, but also pretty easy to understand. We also have a link here to a FDICIA course that we teach at CLA as well to really dig into a lot of what we discussed in more detail. Great. With that, I think we're going to open it up to any last questions.

Scott Klitsch:

Right.

Mackenzie Rooney:

Right. I'm not seeing anything come through.

Scott Klitsch:

All right. Well, I think we were trying to answer some questions as we went there. And so I appreciate David and McKenzie today. And if any questions come in right at the end here, we'll be happy to respond to those after the fact as well.

Mackenzie Rooney:

All right. I think we have... Well, unless these were already answered.

David Heneke:

I think we did have one come in about what amount can be outsourced to an internal audit service provider. And the short answer is, I mean, pretty much all of it, I mean, outside of the actual execution of the control. But you can have a third-party service provider come in and help you with the testing, basically serve as your internal audit function in order to help you with this if you do not feel you have the capacity to do so internally.

Scott Klitsch:

Right.

Mackenzie Rooney:

Right

David Heneke:

So it looks like we've got them all covered. So I guess, thank you very much for attending. We hope you took a lot out of this in regards to those of you who are getting close to these magical thresholds here. And if there's any way we can be of assistance, we'd be more than happy to help you with the process. As you'll see, our contact information is here on the last slide.

Scott Klitsch:

Thank you.

Mackenzie Rooney:

Thank you.

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