



**RESCINDED**

Office of Thrift Supervision  
 Department of the Treasury  
 1700 G Street, N.W., Washington, D.C. 20552 (202) 906-6003

Richard M. Riccobono  
 Deputy Director

Any attachments to this document are rescinded only as they relate to national banks and federal savings associations.

July 14, 1999

**MEMORANDUM FOR:** Chief Executive Officers

**FROM:** Richard M. Riccobono *Richard M. Riccobono*

**SUBJECT:** Internal Controls

Savings associations facing increased competition often consider implementing new strategies including cutting costs, offering different products, and pursuing other activities that have higher yields. While OTS recognizes that savings associations must adapt to changing business conditions, we want to remind management that maintaining strong internal controls is critically important. The following recent examples of unsafe, unsound, and sometimes fraudulent activities caused associations to suffer significant financial losses due to breakdowns in internal controls:

- Unauthorized and unsupervised overdrafts of customers' checking accounts.
- Unauthorized loans and falsified loan records.
- Employee embezzlements involving check kiting schemes.
- Unauthorized withdrawals from a correspondent account.
- Unreported teller shortages.

Inadequate internal controls also contributed to losses associated with a shift from traditional activities to higher risk commercial and consumer lending. In addition, many savings associations desire to cut costs, particularly in areas not directly tied to income in face of increasing competition and shrinking margins. Savings associations must direct expense control to areas that do not compromise critical policies and procedures governing internal controls.

The Federal Deposit Insurance Corporation Improvement Act of 1991 required the banking agencies to establish certain safety and soundness guidelines. Appendix A of Part 570, Interagency Guidelines Establishing Standards for Safety and Soundness, includes a section on operational and managerial standards. Each savings association must have internal controls and an internal audit appropriate to the size of the association and the nature and scope of its

activities. Savings associations subject to FDIC regulation 12 CFR § 363.5 (Audit committees) must have an audit committee composed of outside directors who are independent of management.

OTS considers the effectiveness of an association's internal control system when it determines the scope and depth of examinations. OTS examiners will be particularly alert to the following situations:

- Management does not implement effective procedures to correct internal control deficiencies noted in reports prepared by internal auditors or the independent accountants.
- Management scales back or suspends the internal audit function.
- The internal auditor has dual, operational responsibilities that compromise the internal audit function.
- The internal auditor reports to management instead of directly to the board of directors or an audit committee.
- The association's independent audit firm does not have bank audit experience. A similar problem may exist when a nationally recognized accounting firm assigns auditors to a savings association audit who are not familiar with banking procedures and practices.
- The association discontinues the annual independent accountant's audit.
- The association does not have proper controls in high risk lending areas (could be the result of poor policies, frequent exceptions to policy, or understaffing).
- The association engages in new lending activities with inadequate or unqualified staff.
- The association often deviates from board approved policies without exception documentation.
- The association fails to effectively segregate duties and responsibilities among employees.
- The association fails to provide adequate reports to the board of directors.

There are common critical components in internal control systems applicable to all savings associations. The Committee of Sponsoring Organizations of the Treadway Commission (COSO) issued a report<sup>1</sup> that identified five critical components of a good internal control framework:

- Control Environment
- Risk Assessment
- Control Activities
- Accounting, Information and Communication Systems
- Self Assessment

COSO defines internal control as a process to achieve the following objectives:

---

<sup>1</sup> Savings associations may obtain the COSO "Internal Control- Integrated Framework" (Product code #990009) from the Order Department, American Institute of Certified Public Accountants, Harborside Financial Center, 201 Plaza Three, Jersey City, NJ 07311-3881. Toll-free telephone 1-888-777-7077; FAX 1-800-362-5066.

- Effectiveness and efficiency of operations including safeguarding assets.
- Reliability of financial reporting.
- Compliance with applicable regulations.

Generally accepted auditing standards incorporate the common critical elements of internal control systems contained in COSO in the AICPA Statement on Auditing Standards No. 78, "Consideration of Internal Control in a Financial Statement Audit". OTS urges savings associations to review at least the major concepts described in the COSO report or other recognized standards and compare them to their association's internal control systems. Remember that good internal control processes are only effective if properly understood and strictly followed. The board of directors must establish internal control systems policy and properly monitor implementation of the policy. Management must properly implement internal control systems in accordance with board policy. In addition, internal and external auditors should vigorously check the appropriateness and effectiveness of savings associations' internal controls.

No system of internal controls is foolproof; however, strong internal control systems can reduce risk and minimize loss. We encourage all savings associations to carefully review and, where appropriate, strengthen their internal control systems.