

Breakout 1:
Bank Director 101: Audit Primer

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Bank Director.
#BBTF24



CPAs & BUSINESS ADVISORS

BANK DIRECTOR 101

Audit



DISCLAIMER

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CPAs & BUSINESS ADVISORS

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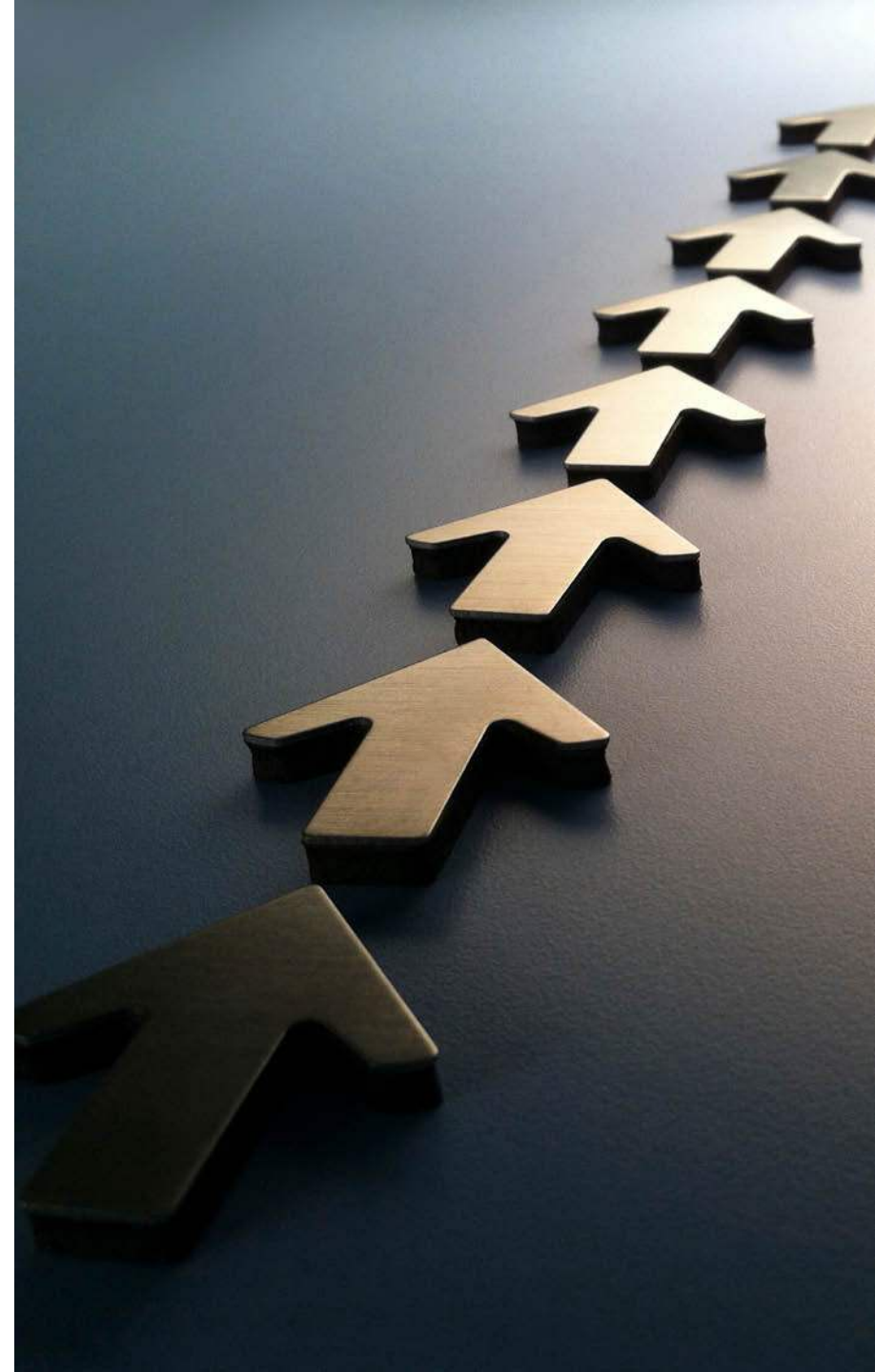
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AGENDA

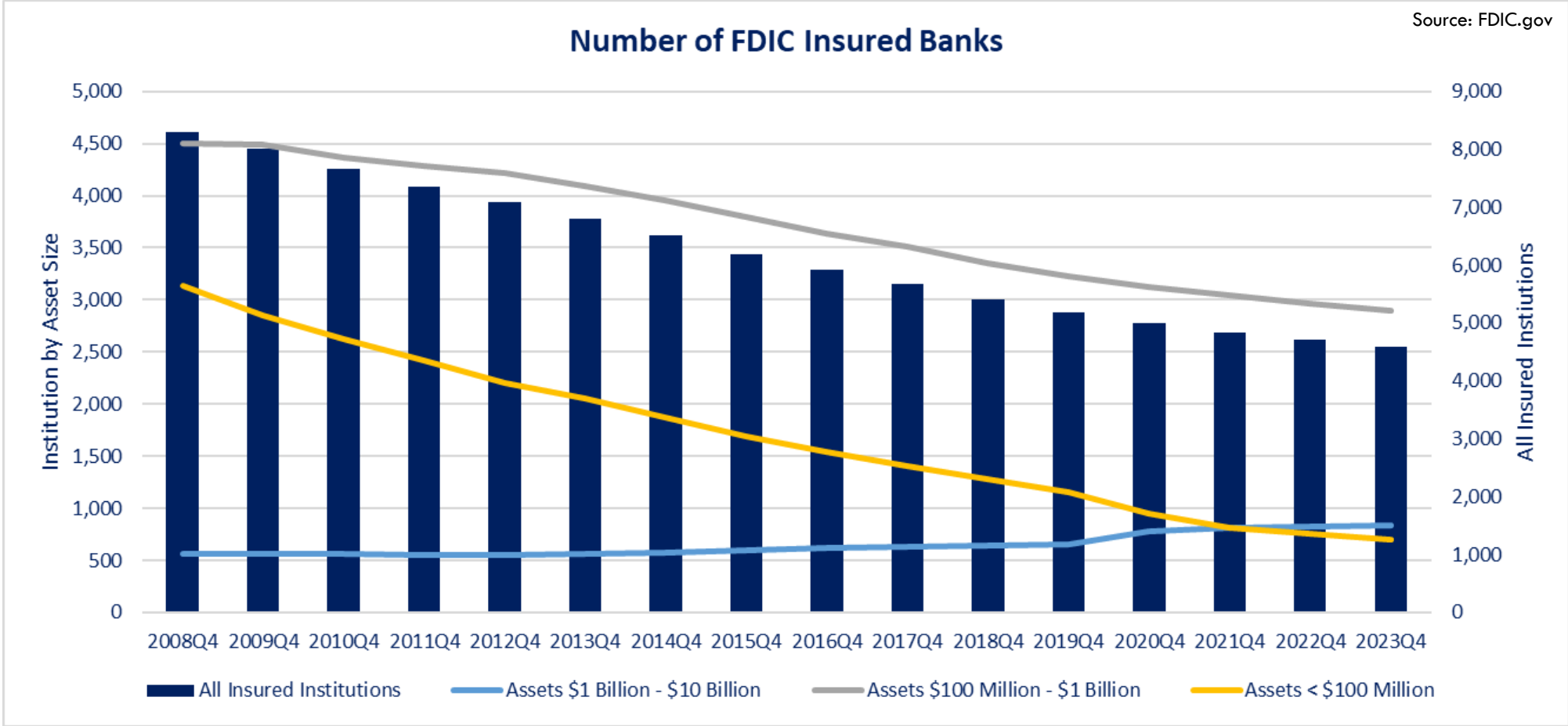
- The Changing Landscape
- FDIC Insurance Act (FDICIA) Part 363
- Federal Reserve Form FR Y-6 Audit Requirement
- Audit – External vs. Internal
- The Board's Role in the Audit Function
- Adding Value as a Board Member



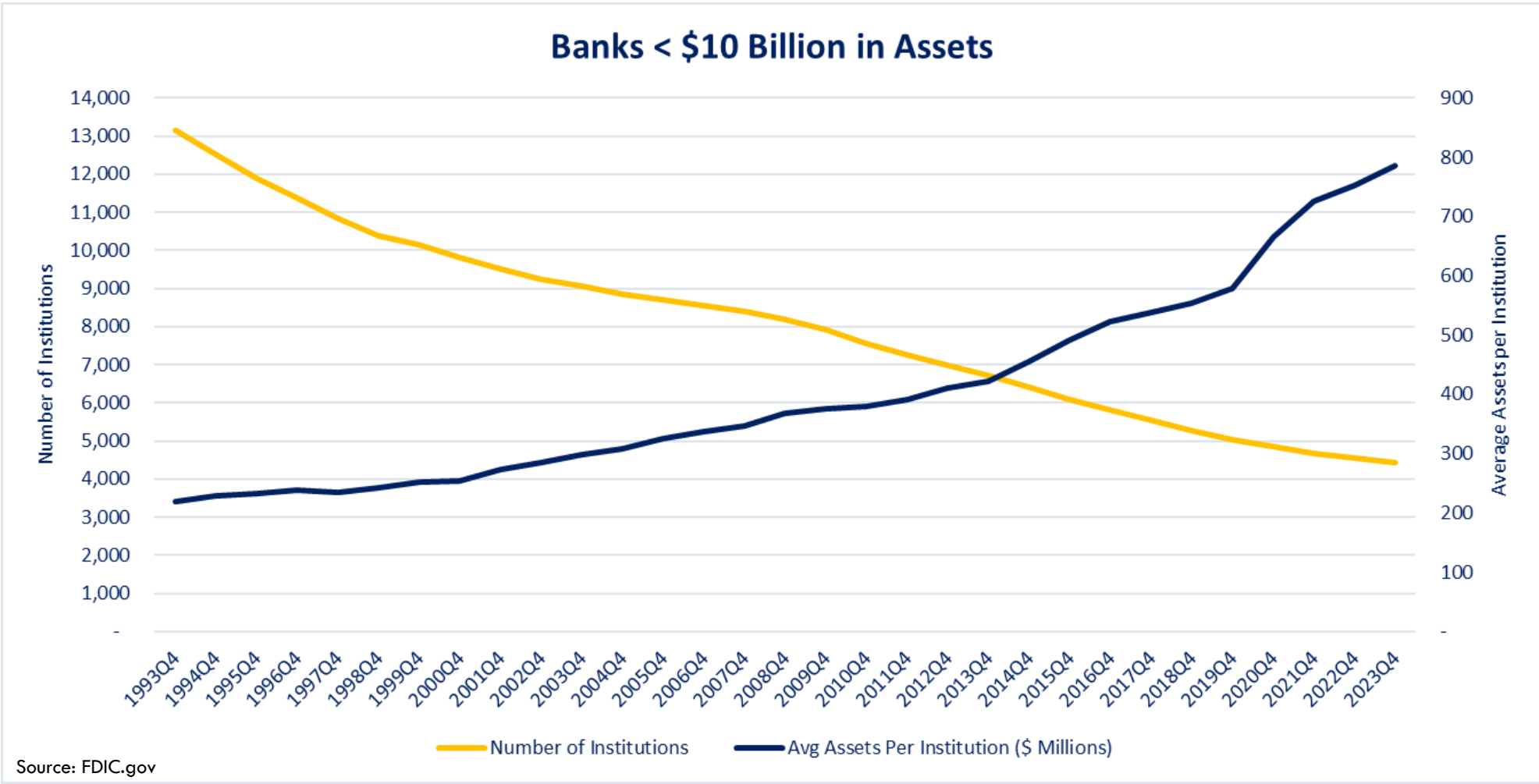


THE CHANGING LANDSCAPE

A STEADY DECLINE IN THE NUMBER OF BANKS



AVERAGE SIZE OF COMMUNITY BANKS INCREASING





Source: Wikipedia



Similar to the magnification levels of a microscope, Part 363 of the FDIC Insurance Act (FDICIA) has three asset thresholds at which the regulatory expectations over financial reporting and internal controls expand.

As institutions grow, regulators look deeper into an organization's operations and with increasing scrutiny and higher expectations.





FDIC INSURANCE ACT (FDICIA) PART 363

FDICIA PART 363 – ASSET THRESHOLDS & REQUIREMENTS

\$500 MILLION

- Audited comparative financial statements
- Independent accountant's report on audited financial statements
- Establish an audit committee of the board
 - **Majority independent**
- Management report
 - **Management statement of responsibility over: financial statement preparation, internal controls and compliance with laws and regulations**

\$1 BILLION

- All requirements of \$500 million plus:
- Audit opinion over Internal Controls over Financial Reporting (ICFR)
- All audit committee members must be independent
- Management report includes assessment of the effectiveness of internal controls

\$3 BILLION

- All requirements of \$1 billion plus:
- Audit committee requirements:
 - **Include members with banking or related financial management experience**
 - **Have access to its own outside counsel**
 - **Exclude members that are large customers of the organization**

FDICIA PART 363

- Measured annually as of December 31st
- Annual report filing deadlines: Public within 90 days; Non-public within 120 days
- Auditor Independence Audit committee requirements
 - Initial year of reaching a threshold – changes must be implemented by financial statement audit date
 - Audit committee independence (“Independent of Management”)
 - Ownership less than 10%
 - Other independence considerations for outside directors:
 - Within the last three years been:
 - Consultant, advisor, legal counsel; Employed (or immediate family member); prepared financial statements; internal or external audit partner
- Additional Information and detail on Part 363
 - <https://www.ecfr.gov/current/title-12/chapter-III/subchapter-B/part-363?toc=1>

FDICIA PART 363 – ADDITIONAL ICFR DETAIL

Management's assessment and the independent accountant's report of the effectiveness of ICFR must include the following:

- ✓ Identify the internal control framework used to evaluate the effectiveness of ICFR.
- ✓ Evaluation should include controls over the preparation of regulatory financial statements.
- ✓ Conclusion as to whether internal control over financial reporting is effective as of the institution's fiscal year-end.
- ✓ Disclose all material weaknesses in internal control over financial reporting, if any, not been remediated prior to the institution's fiscal year end.

FDICIA PART 363 – AUDITOR INDEPENDENCE

Prohibited non-attest services

- Bookkeeping
- Financial information systems design and implementation
- Valuation services
- Fairness opinions
- Contribution-in-kind reports
- Actuarial services
- Internal audit outsourcing
- Management functions
- Human resources
- Broker-dealer, investment adviser, or investment banking services
- Legal services
- Expert services unrelated to the audit

Prohibited Financial Relationships

- Creditor/debtor relationships
- Banking
- Broker-dealer
- Futures commission merchant accounts
- Insurance products
- Interests in investment companies





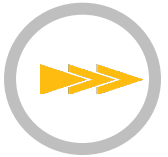
**FEDERAL RESERVE
FORM FR Y-6
AUDIT REQUIREMENT**

FEDERAL RESERVE AUDIT REQUIREMENT

Form FR Y-6



Audit of top-tier holding companies with total consolidated assets of \$500 million by an independent public accountant.



The annual audit requirement, an institution's total assets are measured as of the beginning of its fiscal year.



If also subject to Part 363, the completion of the audit of holding company's financial statements must be accomplished in the time frame allowed in Part 363 of the FDIC's regulations.



Audits performed in satisfaction of the Federal Reserve's audit requirement, but not subject to FDICA Part 363, may be performed under AICPA, and not SEC or PCAOB, independence requirements



AUDIT – EXTERNAL VS. INTERNAL

EXTERNAL VS INTERNAL AUDIT

The Difference is in the Purpose and Focus

External audit is focused on the financial statements and the financial reporting process while internal audit is focused on overall risk management and operational areas across the institution.

External Audit

- ✓ **Focus:** Assurance over financial statements and financial reporting
- ✓ **Timing:** Annual
- ✓ **Scope:** Financial statements, disclosures, controls over reporting
- ✓ **Independence:** Independent public accountant
- ✓ **Regulatory Requirement:** FDICIA Part 363; Fed Reserve FR-Y6
- ✓ **Flexibility:** Very little; determined by independent CPA

Internal Audit

- ✓ **Focus:** Risk management, controls, operations, & compliance
- ✓ **Timing:** Ongoing iterative process throughout the year
- ✓ **Scope:** Operational, controls, processes, risk identification
- ✓ **Independence:** Internal (objective); independent third-party
- ✓ **Regulatory Requirement:** Expectation increase with asset size
- ✓ **Flexibility:** Highly flexible and tailored to risk profile of institution

EXTERNAL AUDIT

- **Provide the bank board and management with:**
 - Reasonable assurance that the financial statements present fairly, in all material respects, the financial position of the bank in conformity with generally accepted accounting principles (GAAP), and, as applicable, that internal controls over financial reporting are operating effectively.
 - An independent and objective view of the bank's financial statements, and, as applicable, the bank's processes related to financial reporting.
 - Timely oral and written communications that are useful to directors and management in maintaining the bank's risk management processes.
- **Minimum audit committee responsibilities:**
 - The appointment, compensation, and oversight of the independent public accountant
 - Reviewing with management and the independent public accountant the basis for their respective reports issued (audited financial statements, management report, ICFR)
 - Review of independence and peer review report of the independent public accountant

EXTERNAL AUDIT – THE AUDIT COMMITTEE

Audit Committee

Evaluation and Selection of an external CPA Firm

- Evaluation of external audit needs and past audit results
- Review of auditor qualifications (if applicable)
- Consideration of new accounting pronouncements
- Approval of auditor compensation

Audit Planning Review

- Review of audit planning information from external auditor:
 - Audit strategy
 - Audit timing
 - Significant risks
 - Use of internal audit work or internal audit personnel

Oversight of Audit

- Generally limited involvement unless there are issues encountered requiring communication or changes in audit strategy

Results of the Audit

- Audited financial statements and auditor's opinion
- Significant risks
- Significant accounting policies, accounting estimates, disclosures, unusual accounting transactions, difficulties encountered
- Uncorrected and corrected misstatements
- Disagreements with management
- Consultations with other accountants

EXTERNAL AUDIT – FINANCIAL STATEMENT OPINIONS

Four Types of Audit Opinions

Unqualified

Qualified

Adverse

Disclaimer

Unqualified Opinion

An unqualified opinion is used when financial statements present fairly, in all material respects, the financial position, results of operations (e.g., earnings), and cash flows of the entity in conformity with GAAP.

Qualified Opinion

A qualified opinion states that, except for the effects of the matter(s) to which the qualification relates, the financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows of the entity in conformity with GAAP.

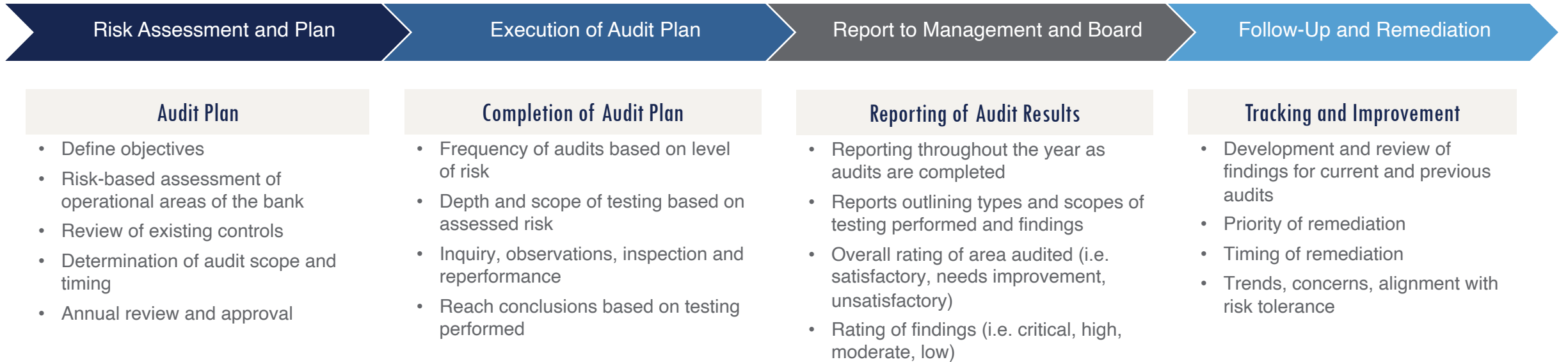
Adverse Opinion

An adverse opinion is used when the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are both material and pervasive to the financial statements. An adverse opinion indicates that the financial statements do not present fairly the financial position, results of operations, or cash flows of the entity in conformity with GAAP.

Disclaimer of an Opinion

A disclaimer of opinion states that the auditor does not express an opinion on the financial statements. Disclaimer of opinion is used when the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, and the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive.

INTERNAL AUDIT – PROCESS AND REPORTING



Internal audit is an ongoing, continuous process because the process of risk management never stops...

Implementation Options

- **In-house** – The internal audit function is implemented internally with employees of the organization who generally report to the board or audit committee.
- **Outsourced** – Hire a third-party CPA firm to implement and perform the internal audit program.
- **Co-sourced** – Hire a third-party CPA firm to assist internal employee(s) in a collaborative approach to the internal audit function.

INTERNAL AUDIT – EXAMPLE DOCUMENTATION

General Risk Areas	Inherent Risk								Mitigating Controls		
	Strategic Risk	Reputation Risk	Legal/ Compliance Risk	Operational Risk	Credit Risk	Market/ Interest Rate Risk	Liquidity Risk	Fraud Risk	Control Activities	Experience/ Turnover	Prior Audit/Exam Findings
Lending/Loan Operations	High	High	High	High	High	High	Moderate	Moderate	Moderate	Moderate	Moderate
Finance and Accounting											
Accounting	Moderate	Moderate	Low	High	N/A	N/A	N/A	Moderate	Moderate	Moderate	Moderate
Investment Securities	Moderate	Moderate	Low	Moderate	Moderate	High	High	Moderate	Moderate	Moderate	Moderate
Correspondent Accounts	Low	Low	N/A	High	Moderate	N/A	High	High	Moderate	Moderate	Moderate
Accounts Payable	Low	Moderate	Low	Moderate	N/A	N/A	N/A	Moderate	Moderate	Moderate	Moderate
Interest Rate and Liquidity Risk	High	High	Low	High	Moderate	High	High	Moderate	Moderate	Moderate	Moderate
HR and Payroll	High	Moderate	High	High	N/A	N/A	N/A	Moderate	Moderate	Moderate	Strong
Operations											
Retail Operations	Moderate	High	Moderate	High	Low	Low	Low	High	Weak	Weak	N/A
Deposits and Deposit Operations	Moderate	High	Moderate	High	Low	High	High	Moderate	Weak	Weak	Moderate
Electronic Banking	High	High	Moderate	High	Moderate	N/A	N/A	High	Moderate	Moderate	Moderate
IT Monitoring	High	High	High	High	N/A	N/A	N/A	High	Moderate	Strong	Moderate



Regulatory Expectation:

An institution should have an internal audit system that is appropriate to the size of the institution and the nature and scope of its activities.

General Risk Areas	Average Inherent Score	Average Control Score	Frequency	Date Last Audited	2023	2024	2025	2026
Lending/Loan Operations	High	Moderate	12 months	2022	X	X	X	X
Finance and Accounting								
Accounting	Moderate	Moderate	24 months	2022	X		X	
Investment Securities	Moderate	Moderate	24 months		X		X	
Correspondent Accounts	Moderate	Moderate	24 months		X		X	
Accounts Payable	Moderate	Moderate	24 months		X		X	
Interest Rate and Liquidity Risk	High	Moderate	12 months	2023	X	X	X	X
HR and Payroll	Moderate	Moderate	24 months	2022		X		X
Operations								
Retail Operations	Moderate	Weak	12 months		X	X	X	X
Deposits and Deposit Operations	Moderate	Weak	12 months	2022	X	X	X	X
Electronic Banking	High	Moderate	12 months	2022	X	X	X	X
IT Monitoring	High	Moderate	12 months	2022	X	X	X	X

INTERNAL AUDIT – ICFR



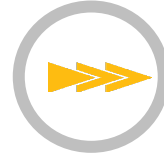
Internal Control Over Financial Reporting

“ICFR is a process designed by, or under the supervision of, the company's principal executive and principal financial officers, or persons performing similar functions, and effected by the company's board of directors, management, and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with GAAP...” – PCAOB

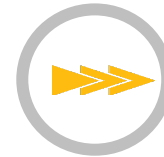
Internal Audit Oversight of ICFR



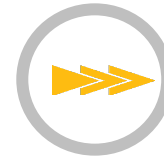
Identification and walkthroughs of key controls



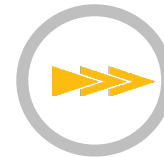
Test operating effectiveness of significant controls



Evaluate effectiveness and form a conclusion



Remediation or redesign of control gaps as needed



Coordination with external auditors



THE BOARD'S ROLE IN THE AUDIT FUNCTION

THE BOARD'S ROLE

The Board of Directors Falls Under Management “M” in the CAMELS Rating System

➡➡➡ “The capability of the board of directors and management, in their respective roles, to identify, measure, monitor, and control the risks of an institution’s activities and to ensure a financial institution’s safe, sound, and efficient operation in compliance with applicable laws and regulations is reflected in the rating.” – FDIC



The Board’s Involvement in Internal & External Audits

Oversight of Audit Function	Review & Approval of Audit Plans	Monitoring of Audit Findings	Risk Management and Compliance	Communication with Auditors
<ul style="list-style-type: none">• Ensure independence and effectiveness of internal and external auditors• Appointment and/or removal of internal auditor and external audit firm	<ul style="list-style-type: none">• Review and approval of the annual internal audit plan• Discuss scope and extent of external audit with independent public accountant	<ul style="list-style-type: none">• Regular review of audit reports and findings• Ensure tracking and timely remediation of issues and findings by auditors	<ul style="list-style-type: none">• Ensure the audit function effectively assesses and reports on risk management and controls• Ensure the level of risks identified align with the strategic direction of the institution	<ul style="list-style-type: none">• Facilitate open and direct communication with auditors• Meet with internal and external auditors without management to discuss any concerns



ADDING VALUE AS A BOARD MEMBER

EXCELING IN YOUR ROLE OVERSEEING AUDIT



➤➤ Communication

“The most important thing in communication is to hear what isn’t being said.”

– Peter Drucker

KEY TAKEAWAYS

Banks face different audit and regulatory requirements based on asset thresholds set by FDICIA Part 363. Requirements increase in complexity as banks grow, particularly at \$500 million, \$1 billion, and \$3 billion asset levels.

Internal audits focus on evaluating risk management, operational controls, and compliance continuously, while external audits provide annual assurance over financial statements conducted by an independent public accountant.

The audit committee plays a critical role in overseeing both internal and external audits, ensuring auditor independence, reviewing audit plans, and monitoring the resolution of audit findings including accountability to remediate findings.

Active involvement from board members in understanding audit processes, regulatory expectations, and financial reporting enhances governance and aligns audit functions with the bank's risk profile and tolerance.



QUESTIONS?

THANK YOU!

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