REVIEW OF EXTERNAL AUDITOR WORKPAPERS

Core Analysis Procedures

Examiners are to consider these procedures but are not expected to perform every procedure at every institution. Examiners should complete only the procedures relevant for the institution's activities, business model, risk profile, and complexity. If needed, based on other identified risks, examiners can complete additional procedures not included below. References to laws, regulations, supervisory guidance, and other resources are not all-inclusive.

Considerations and Background

External auditing programs of financial institutions, as well as authority for review of auditor workpapers, are governed by Section 36 of the FDI Act, as implemented by Part 363 of the FDIC Rules and Regulations, by FRB Appendix D-1 of Regulation H (12 CFR Part 208). The Interagency Policy Statement on External Auditing Programs of Banks and Savings Associations (Policy Statement) serves as an additional resource.

FDIC: Examiners should consider reviewing workpapers (unless the workpapers for that fiscal year were previously reviewed) in the following circumstances: sudden or unexpected change in the institution's external auditor; significant and unexpected changes in operational results; issues arise that may affect the institution's safety and soundness; or where significant concerns exist about matters that would have fallen within the scope of the work performed by the institution's external auditors, including issues surrounding the auditor's independence or objectivity.

AU-C Section 230, Audit Documentation, establishes standards and provides guidance on audit documentation. AU-C Section 9230 provides interpretations applicable to AU-C Section 230. Audit documentation and workpapers are the property of the auditor and some states recognize such ownership in their statutes. Workpaper reviews are intended for informational purposes and the examiner should remember that the review is being performed to obtain information to aid in the identification and understanding of possible weaknesses, problems, and risks of the institution being examined, not to comment on the work performed by the auditor. The auditor can make copies of workpapers available upon request, but examiners are reminded that workpapers are confidential; so they are encouraged to take notes of needed information and only request copies of workpapers that support significant findings. Examiners should not request copies of all workpapers.

When examiners request access to workpapers, or request copies of audit documentation, the independent accounting firm may request examiners to sign an acknowledgment letter (the CPA letter allowing access to audit documentation). In most cases, these letters indicate that the requester/examiner confirms his or her "understanding and agreement" of the purpose and limitations of an audit, as well as requesting confidential treatment of any information obtained from the workpaper review. <u>Examiners are reminded NOT to sign any agreement with the independent accounting firm with regard to access to or copies of workpapers, confidentiality, purpose, and limitations of an audit, or any other issues.</u>

If examiners have questions about the independent accounting firm's letter, or if the independent accounting firm denies access to the workpapers, examiners should contact their regional accountant (FDIC) or appropriate management staff (FRB) to determine the appropriate steps needed to gain access to the workpapers.

Findings and Conclusions

Document findings and conclusions here, and include a summary of these findings and conclusions in the appropriate Primary or Supplemental modules.

Preliminary Planning

1. **Determine the type of external audit program conducted: financial statement audit, agreed-upon procedures, or director's examination on accounts, elements, or other items.**

2. **Review prior examination reports, correspondence, Uniform Bank Performance Reports, and the prior audit program and/or management letter, if available and applicable. For public companies, obtain the latest 10-Q (Quarterly Report) and 10-K (Annual Report). These public filings are available through the Securities and Exchange Commission (SEC) website (EDGAR).**

3. **Determine the scope of the workpaper review. If the work performed was a full scope audit, identify significant areas of the institution's operations for which a workpaper review may be beneficial to the examination process. Areas to consider include:[1]**
   - **Securities**
   - **Loans and leases**
   - **Allowance for loan and lease losses (ALLL) or ACL for loans and leases[2]**
   - **Derivatives**
   - **Business combinations (including loss-sharing arrangements and push-down accounting)**
   - **Organization structure/affiliates**
   - **Insider transactions**
   - **Other real estate**
   - **Mortgage banking activities**
   - **Taxes and deferred tax assets**
   - **Compensation and other employment arrangements**
   - **Internal controls**
   - **Servicing/other retained interests**
   - **Nontraditional activities**
   - **New products**
   - **Information systems**
   - **Objectives and strategies/business risks**

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[1] **The scope should include a review of the external auditor's audit planning memorandum, internal control assessment, and AU-C Section 240, Consideration of Fraud in a Financial Statement Audit, at every workpaper review for a full scope audit.**

[2] **The allowance for credit losses for loans and leases or ACL for loans and leases is the term used for those banks that adopted ASU 2016-13, replacing the allowance for loan losses used under the incurred loss methodology.**

4. Inform the institution that you will request to review the independent accounting firm's workpapers concerning their external audit program. When applicable, contact and coordinate with the appropriate state and federal banking agencies to inform them of the workpaper review, and invite their participation.

If the institution is subject to Part 363 and the FDIC is not the primary federal regulator, the regional office should consult the primary federal regulator to determine in what manner, and by which agency, the institution should be notified of the upcoming workpaper review.

5. Preliminary contact should be made by phone to the independent accounting firm when requesting access to the workpapers. In most cases, the examiner will be directed to the partner-in-charge of the engagement. Discuss the date or dates of the review and the location of the workpapers. Determine the form in which the workpapers are maintained (electronic or paper). If the workpapers are in electronic form, the examiner should discuss with the partner how the review could be most efficiently conducted. Encourage the partner to have a representative on site during the review to facilitate any questions that may arise during the review.

Subsequent to the initial contact, a formal request should be made in writing to the office of the independent accounting firm indicating the date(s) of the review and the scope. Separate letters inviting participation in the workpaper review should also be sent to the appropriate federal or state banking agency, when applicable. Refer to appropriate agency guidance.[3]

Workpaper Review[4]

6. At the beginning of the workpaper review, meet with a representative or representatives of the accounting firm. Many times the general partner as well as the lead or senior auditor will participate in the meeting. Explain the purpose of the review and discuss areas that are expected to be covered. In addition, verify the accounting firm's requirements regarding the security of the workpapers and/or computer hardware when workpapers are held electronically. Other areas for discussion to consider include:

- **Audit planning, risk assessments, and sampling techniques**
- **Results of significant findings**
- **Reports, management letters, and other communications issued by the firm to the institution**
- **Staff experience and familiarity with banking of those assigned to the audit or other audit program**

[3] Interpretation No. 1 set forth in AU-C Section 9230, Interpretations to AU-C Section 230, states that when regulators request access to audit documentation (workpapers), the auditor should consider notifying the institution that the regulatory agency has requested such access.

[4] These procedures are mainly applicable for workpaper reviews of financial statement audits

7. Become familiar with the organization of the audit firm's workpapers. Workpapers are the property of the independent accountant and should not be marked or altered by examiners.

- **Obtain a complete listing of all items included in the audit workpapers (whether electronically or manually prepared and maintained) for each section to be reviewed, and ensure the workpapers provided correspond with the inventory listing.[5]**
- **Current files contain information pertaining to the current year's audit procedures.**
- **Permanent files, which are retained indefinitely, contain data expected to be useful on future engagements. Items typically found in permanent files include copies of the articles of incorporation and by-laws, organizational charts, long-term contracts such as leases, pension plans, profit sharing and bonus agreements, terms of stock and bond issues, chart of accounts, procedure manuals, and summaries of accounting principles used by the client.**
- **Working or general files hold information that is neither of a permanent nature nor to be included in the completed audit documentation. Items may include the auditor's assessment of the impact of new accounting standards, the institution's new operational areas or plans, or other topics evaluated in the assessment of the risks of the institution.**

8. Review the engagement letter to determine:

- **Whether the institution entered into an external audit arrangement that includes limitation of liability provisions. For information on this topic refer to the February 9, 2006 *Interagency Advisory on the Unsafe and Unsound Use of Limitation of Liability Provisions in External Audit Engagement Letters***
- **Whether the auditor's engagement letter contains appropriate language granting examiner access to workpapers. Refer to requirements contained in 12 CFR Part 363 – *Annual Independent Audits and Reporting, Appendix A – Guidelines and Interpretations, Guideline* 31. Additionally, information on this topic is contained in the September 1999 *Interagency Policy Statement on External Auditing Programs of Banks and Savings Associations***
- **The purpose, fees, and scope**
- **The report(s) expected to be rendered**
- **Whether there are any limitations on the scope of the audit program performed**

9. Review the auditor's planning memorandum, which should reflect the overall strategy for performing the audit.

[5] Auditor workpapers generally contain current files, permanent files, and working or general files.

10.	**Review the auditor's assessment of audit risk and materiality. Audit risk and materiality are affected by the following factors: the size and complexity of the institution, the auditor's experience with the institution, and the auditor's knowledge of the business environment, including internal controls.[6]**
11.	**Review the external auditor's evaluation of the institution's internal control structure. Professional standards require auditors to obtain an understanding of internal controls sufficient to plan the audit. Assess whether the auditor's workpapers related to the institution's internal controls support their conclusions of whether and how a control prevents, detects, or corrects material misstatements on relevant assertions related to transactions, account balances, or disclosures.[7]**
12.	**Review the external auditor's consideration of fraud in a financial statement audit. *AU-C Section 240, Consideration of Fraud in a Financial Statement Audit,* requires auditors to perform various procedures and document those procedures in the workpapers. AU-C Section 240 requires the following documentation:** • **The audit team's brainstorming discussion on fraud** • **Procedures performed to identify the risk of material misstatements due to fraud** • **The risk identified and the auditor's response** • **If revenue recognition is not identified as a risk factor, the reason why** • **Results of procedures related to management overrides** • **Other procedures that led the auditor to perform additional audit procedures** • **Fraud-related communication to management or the audit committee, if applicable**

[6] As stated in the general instructions for the Reports of Condition and Income, materiality is a qualitative characteristic of accounting information which is defined in Financial Accounting Standards Board (FASB) Concepts Statement No. 8 as "the magnitude of an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement." The SEC has addressed the concept of materiality in Staff Accounting Bulletin (SAB) 99, Materiality and SAB 108, Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements, which has been codified as Topic 1.M. and Topic 1.N, respectively, which provides comprehensive guidance for public entities. For purposes of the Reports of Condition and Income, all banks should follow the sound accounting practices described by the SEC. This issue is also addressed in AU-C Section 320, Materiality in Planning and Performing an Audit.

[7] The nature, timing, and extent of further audit procedures depend on whether the auditor is required or decides to test the operating effectiveness of the internal control structure. This overall decision along with the outcome of whether the internal control structure is functioning as designed will determine the extent of the substantive procedures to be performed. The nature, timing, and extent of the audit procedures to carry out the work must be documented and are expected to reduce the audit risk to an acceptably low level.

Filers with $1 billion or more in total assets under 12 CFR Part 363 are required to engage an independent public accountant to provide an attestation on internal controls over financial reporting. The auditor must perform the engagement under generally accepted standards for attestation engagements or the PCAOB's auditing standards, if applicable. Refer to Part 363, Appendix A, Guideline 18A.

13. If the auditor believes fraud may have occurred, determine whether the workpapers contain documentation that the matter was communicated to the appropriate level of management.[8]
14. Determine whether the workpapers contain an attestation report on internal controls over financial reporting. For institutions with total assets of a $1 billion or more, an attestation report on internal control is required by Part 363 or FRB Appendix D-1 of Regulation H (12 CFR Part 208). An attestation report may also be required for institutions less than $1 billion in total assets if they are a public entity and an accelerated filer.[9]
15. If an internal control attestation engagement was conducted, review the workpapers to determine if they provide sufficient evidence that supports the independent accountant's opinion on the institution's internal control over financial reporting.
16. Review the Management Letter. AU-C Section 265, *Communicating Internal Control-Related Matters Identified in an Audit,* AU-C Section 9265 (Interpretations to AU-C Section 265), and AS 5 require the auditor's communication of significant deficiencies and material weaknesses to be in writing. Determine whether thee Management Letter communicates all significant deficiencies and material weaknesses identified during the current audit, in addition to significant deficiencies and material weaknesses communicated in previous audits that have not been remediated.[10]
17. Review documentation contained in the audit workpapers that supports the identification of any significant deficiencies or material weaknesses.

[8] If a fraudulent activity involves a senior management official or has a material effect on the financial statements, it would be most appropriate to communicate that activity directly to the audit committee or board of directors.

[9] Auditing Standard No. 5 - An Examination of an Entity's Internal Control Over Financial Reporting That Is Integrated With an Audit of Its Financial Statements (AS 5), issued by the Public Company Accounting Oversight Board (PCAOB), require internal control attestation engagements to be issued in conjunction with the institution's integrated audit. AS 5 is applicable for larger public entities. When an attestation of internal controls is required for a non-public entity, the independent public accountant is required to follow Statement on Auditing Standards No. 130 (AU-C Section 940), An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements.

[10] The auditor should not issue a written communication stating that no significant deficiencies were identified during the audit.

- **A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affect the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is a more than a remote likelihood that a misstatement in the entity's financial statements that is more than inconsequential will not be prevented or detected.**
- **A material weakness is a significant deficiency, or a combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected.**

18. If audit results indicate the institution has concentrations of assets for which valuation methods are complex or uncertain (for example, subprime residuals), review the testing performed by the independent accountant to assess management's valuations and the evidence obtained to determine the reasonableness of management's assumptions and methodologies used to value the assets.

19. If audit results indicate concerns about fraudulent activities related to loans, securities, deposits, or outstanding debt, review the number and type of verifications sent out by auditors to confirm these assets and liabilities. Determine whether the verifications were sent out by the auditor (or under the auditor's control) and returned directly to the auditor. In addition, consider reviewing such verifications if the institution has a substantial volume of securitized assets that are serviced by others.

20. If audit results indicate the institution has experienced excessive growth, particularly through low quality assets, review the testing performed by the auditor to assess management's valuations of assets and the evidence obtained to determine the reasonableness of management's assumptions and methodologies used to value the assets.

21. If audit results indicate the institution has poor or incomplete documentation of assets or liabilities, review the testing performed by the auditor to determine the existence of the assets. Assess management's valuations of assets and the evidence obtained to determine the reasonableness of management's assumptions and methodologies used to value the assets.

22. If audit results indicate the institution has had significant insider transactions and/or transactions with affiliates, review audit evidence obtained to verify that the institution's reporting of these transactions is in accordance with generally accepted accounting principles (GAAP).

23. Review the work performed by the auditors to assess the appropriateness of the methodology used, documentation maintained, and appropriateness of the ALLL or ACL for loans and leases, as applicable.
24. Determine whether the auditor identified known or likely misstatements based on the audit procedures performed. The auditor must accumulate all known and likely misstatements identified during the audit unless considered immaterial. Based on the findings, determine whether the institution has a bias to misstate all or most of its accounting estimates, particularly those that require significant management judgment.
25. Determine whether the auditor's workpapers discuss any significant matters related to the selection, application, and consistency of GAAP, particularly related to the accounting for complex or unusual transactions or for items dependent on estimates, uncertainties, or management assumptions.
26. Review the Summary of Audit Adjustments and Reclassifications, or other similar document, which includes entries that were booked and those that were passed or waived.[11]
27. Review the audit engagement summary, which addresses the results of procedures performed and conclusions for the major audit areas.
28. Schedule an exit meeting with the audit partner or other representative designated by the firm, Consider discussing with the auditor any material issues disclosed by the workpaper review that were not presented to the institution's board and management through the management letter, adjusting entries, or other manner. Confirm that all workpapers and/or computer hardware equipment that has been provided by the firm has been returned. Request copies of audit workpapers needed to appropriately document the finding of the workpaper review.[12]

[11] Adjusting and reclassifying entries are corrections of the client's accounting errors that are expected to be recorded by the client. The list of adjusting entries may be referred to as "proposed adjusting entries," since there is often discussion and negotiation between the client and auditor. Adjusting entries proposed by the auditor that will not be recorded by the client are often referred to as passed or waived entries. There should be no passed or waived adjustments that have a material effect of the financial statements.

[12] It may be the policy of the independent accounting firm not to release workpapers until cleared by the firm's attorney and marked confidential. Again, the purpose of the workpaper review is not to determine the adequacy of the audit or the competency of the auditor. However, a workpaper review may uncover issues related to possible violations of professional standards. If so, contact the regional office's accounting unit.

End of Core Analysis.