

How to Use This Manual

The *Trust Department Internal Control Manual* has been developed in response to requests by subscribers of other successful trust resource manuals published by Sheshunoff Information Services: *Trust Department Policies and Procedures*, *Trust Department Management Manual*, and *Trust Services Audit Manual*. This manual is a companion product addressing the corporate governance approaches detailed and underscored in the other manuals. Completion of the internal control questionnaires may prompt recommendations for revisions to trust department policies, procedures, and processes that parallel samples provided in these other resources.

This manual represents a compilation of current research and hands-on experience. Numerous financial institutions, and their internal trust department policies and procedures addressing fiduciary activities, have been reviewed and evaluated by Regulatory Compliance Associates, Inc. (REGCOM) staff. Insights gained through helping institutions develop and implement integrated, detailed policies and procedures to not only trust regulatory requirements but also account requirements, are critical background information when compiling a manual such as the *Trust Department Internal Control Manual*. In addition, interaction with various regulators, bankers, and industry experts has provided invaluable insights and experiences to also support the writing of this manual. The compilation of past assignments and current efforts resulted in a handbook of facts, ideas, research, interviews, experiences, and examples.

Trust internal controls programs and related procedures represent a specialized focus; there are other specialized control focuses that management must address, such as information technology, disaster recovery planning, and customer data privacy. While it is critical that trust internal controls have a fundamental foundation with respect to specific procedures, internal guidelines, reporting processes, and tracking of control exceptions, it is important that this specialized focus also be a subset of the institution's overall control environment. Through consistent control approaches, well-founded, basic procedural objectives, and standard programs and processes, the board of directors will receive a consistent overview of all trust activities. Therefore, in developing, implementing, and monitoring trust internal controls, it is important to build off of the basics of a solid total organizational posture.

The first four chapters detail the basic control philosophies and mechanics of a sound internal control environment. These foundations set the standards under which a trust internal controls program should function. The remaining chapters of the *Trust Department Internal Control Manual* build on these standards to design a proactive internal control program.

FOCUS ON INTERNAL CONTROLS

The system of internal controls exists to assure the achievement of intended results, to promote operating efficiency, and to encourage compliance with policies and other established constraints. Management's primary concern must be the continuing effectiveness of the system of internal controls that influence business results. Three important qualities of internal controls must be periodically evaluated: adequacy, effectiveness, and efficiency.

In evaluating *adequacy*, management should ascertain whether systems include design features proper to the circumstances and reasonably sufficient to effect control. The evaluation of adequacy begins with the comparison of "what should be" to "what is." Initial implementation of internal controls systems with respect to supporting proposed procedures, should ensure the adequacy of control within the organizational structure.

In evaluating *effectiveness*, management should ensure compliance with internal control features and the extent to which compliance serves the intended purposes. The question that must be answered is, "Do the controls work?"

In evaluating *efficiency*, management should assess the practicality of controls in terms of their cost relative to their intended benefit. It is not advisable that management judge internal control efficiency in absolute terms. An evaluation of internal control efficiency is restricted to the controls themselves and does not extend to the measures of operating performance associated with the functioning of such controls. In judging efficiency, management should consider whether the benefits provided by the controls exceed their cost.

The systems of internal controls (including procedures) should address the following:

- Provide reasonable assurance that assets are safeguarded, information (financial and other) is timely and reliable, and errors and irregularities are discovered and promptly corrected.
- Promote operational efficiency.
- Encourage adherence to managerial policies, laws, regulations, and sound fiduciary principles.

Members of management who are responsible for policy implementation are also responsible for the design and the maintenance of the systems of control. As a follow-up independent review, internal auditors are responsible for that management function which independently evaluates the adequacy, effectiveness, and efficiency of the systems of controls. Internal auditors should make sure that those who rely on their opinions understand that no practical system can guarantee the quality of future performance.

Internal controls should act as a positive force to facilitate successful operations, as well as a negative one that restricts activities. Accordingly, management should evaluate control systems in terms of the incentives they provide, as well as the sanctions. Safeguarding assets relates to physical, legal, and all other protective means by which the institution assures the full realization of its resources.

All information should be subject to the systems of internal controls. Timely information is a critical monitoring reporting component which anticipates a decision need and is available to the persons who will use it when they need it. Reliable information provides a sound basis for decisions, because of the authenticity of its source, the manner in which it is recorded and the form and content of its presentation.

In addressing key elements of Sarbanes-Oxley Act (SOX), the focus on key best practices is critical to ensure sufficient controls have been implemented to address risk of noncompliance. These best practices include:

- Development and implementation of clearly articulated roles and responsibilities, and the related assigned accountability.
- Creation of fully integrated financial and internal control processes, utilizing both technology and where applicable, manual controls/procedures to address risk points.
- Integration of adaptability and flexibility elements within control structures, to allow response to organizational and regulatory change.
- Construction of supporting controls and procedures schematics to clearly articulate control points, risk areas, and implemented controls/procedures.
- Utilization of structure education and training to reinforce the organization control environment with periodic refresher/reminder training modules.
- Initiation and ongoing support of effective and efficient evaluation testing, remediating, monitoring, and reporting on control processes.

The systems of internal controls must detect and correct errors and irregularities when preventive controls fail. Sound systems of control contain safeguards that will counteract failures in other controls. The systems of controls should promote operational efficiency. The features of control systems that promote operational efficiency include the processes used to:

- Select and train personnel.
- Establish procedures.
- Set performance requirements.
- Measure results.
- Provide incentives.

Managerial policies, laws, regulations, and sound fiduciary principles establish boundaries within which the institution can conduct its business. The features of the internal control system that encourage compliance with these requirements include: the separation of duties, the employment of persons likely to comply, the establishment of authority limits, and the communication of expected conduct.

Underlying Value of Solid Controls

It is critical that a financial institution prepare and present accurate operating results and a risk profile. Unfortunately, weaknesses in these types of controls often contribute to inaccurate or incomplete financial reporting and subsequently, potential legal fines, significant reputational damage, and loss of business.

Strong controls also reflect a primary objective of financial institution regulators. Regulators, in upholding their mission to maintain a safe and sound financial system, assess whether a financial institution has developed and implemented a comprehensive financial control framework.

Internal Controls Change

The Public Company Accounting Oversight Board (PCAOB) streamlined the audit rules that accounting firms must follow when evaluating public company internal controls. The draft statements replace Auditing Standard No. 2 with new standards. The new standards for external firms performing audits of public companies' internal controls over financial reporting, as required by Sarbanes-Oxley Act (SOX) section 404 address cited concerns noted by financial institutions including:

- Extensive reviews often purportedly resulting in overkill audits
- Increased workloads on financial institution staff to cooperate and respond to such reviews
- Unreasonable recommendations for changes in internal controls which often require time to refute
- Significant increases in fees

The PCAOB and SEC approved May 2007 new guidelines to provide for improving the effectiveness and efficiency of the assessment performed by a company's management and its auditor of the effectiveness of internal controls over financial reporting covered under SOX. Referred to as Auditing Standard No. 5 (AS5), An Audit of Internal Control Over Financial Reporting That is Integrated with an Audit of Financial Statements, superseded Auditing Standard No. 2. The adopted AS5 accomplishes positive changes including:

- Aligns key terms and concepts with terms utilized in SEC rules and guidance.
- Focuses auditors on fulfilling objectives that a properly performed walk-through achieves rather than requiring performance of a walk-through, which, under some instances, might lead to a checklist approach.
- Includes discuss of fraud risk and anti-fraud controls within the standard, to emphasize the importance of these controls in assessing risk.
- Emphasizes importance of auditors not to scope the audit to find deficiencies that, individually or collectively aggregated with other exceptions/deficiencies, do not constitute material weaknesses.

- Retains requirements to evaluate all deficiencies that are identified and communicate both material weaknesses and significant deficiencies, in writing, to the audit committee.
- Details how different kinds of entity-level controls have different effects on the selection and testing of controls.
- Empowers auditors to tailor their top-down approach to the circumstances of individual circumstances of individual organizations by removing the requirement to specifically identify major classes of transactions, and significant processes before identifying relevant assertions.

The adoption of AS5 increases the chances that material weaknesses in internal control will be found before they result in material misstatement of a company's financial statements, and yet at the same time, eliminate procedures that are unnecessary. While PCAOB revised AS2 with the release of AS5 to primarily for the benefits of small companies, larger companies also see costs savings up to a 10 percent reduction in their audit bills.

The changes that the PCAOB has drafted should have a positive impact on audit reviews. Nevertheless, audit firms will still take a close look at internal procedures and the overall controls environment of a financial institution.

Top-Level Support¹

Why focus on top-level controls? Because everything flows from the top. Controls at the organizational level can have an encompassing influence over controls at the process, transaction, or application levels. Controls that apply to all locations and business units help to set consistent standards and expectations across the institution.

Organizational-level controls include governance elements that establish the benchmarks or directives at the highest level of the institution. These basic elements include:

- Policies
- Procedures
- Codes of conduct, including details on conflicts of interest
- Assignment of authority and responsibility
- Risk assessment processes
- Identifiable controls that monitor other controls (such as oversight and assessment of the internal audit function; the audit committee; and employee self assessment and fraud prevention activities, such as whistleblower hotlines) which can have an indirect relationship to financial statement misstatement risk

Many institutions have the opportunity to increase their reliance upon organizational-level controls that can directly mitigate financial statement misstatement risk, such as controls over the period-end financial reporting process. Similar controls include monitoring controls, such as analytical review and budgeting, and controls governing centralized processing, such as shared service environments.

To ensure top-level controls or organizational controls are fully implemented, identifiable, and consistently communicated, it is important to undertake a procedural approach to reviewing the present control environment with steps, including:

- Understand the overall design and balance of controls and how they align with financial reporting risks.
- As appropriate, use flexibility to shift focus toward higher risk areas to enhance compliance quality.

1. Adaptation of concepts presented by Deloitte and Touche, LLP, *SOX Optimization: Improving Compliance Efficiency and Effectiveness*, September 2007.

- Support to achieve cost savings by applying more efficient compliance efforts for routine processing-related controls.
- Identify how organization-level (as opposed to individual process-level) controls can be improved to drive compliance efficiencies and to reduce the institution's overall compliance risk profile.

The internal control checklists are a critical tool to assist in the identification of organizational-level controls and areas where further controls will reduce the institution's overall compliance risk profile.

Financial institutions that have instituted successful internal control programs report the following common factors:

- Continuous employee training that integrates institution policies, procedures, and controls
- Review, testing, and enhancement of risk management oversight and related controls
- Automation of controls, processes, and reporting to utilize technology where appropriate
- Documented procedures, including identification of quality assurance checkpoints and internal controls
- Modified policies, procedures, and, if applicable, forms, to incorporate internal controls
- Increased frequency of testing and auditing internal controls

THE COMPANION CD

The manual also includes an accompanying CD. The CD can be used to customize the sample policy, procedures, and training materials. As updates are issued, the CD will also be updated.