2015 CEO & Board University Audit Committee Update

John J. Leonard, CPA
About Wolf & Company, P.C

• Regional firm established in 1911
• Provide Audit, Tax, Business Consulting & Risk Management services
• PCAOB Registered & Inspected
• Member of AICPA Center for Audit Quality
• Member of PKF North America
• 200 Professionals
• Offices located in:
  – Boston, Massachusetts
  – Springfield, Massachusetts
  – Albany, NY
  – Livingston, NJ
Financial Institution Expertise

• Provide services to over 250 financial institutions
  – Approximately 50 FIs with assets > $1 billion
  – Approximately 30 publicly traded FIs
  – Constant regulatory review of our deliverables

• Provide Risk Management Services in 27 states and 2 U.S. territories
  – IT Assurance Services Group
  – Internal Audit Services Group
  – Regulatory Compliance Services Group
  – WolfPAC® Solutions Group
Agenda

• Introduction
• Audit Committee Responsibility – A Refresher
• Auditor Committee Collaboration – A Resource
• Audit Quality Indicators
• 2013 COSO Framework
• Basel III
• Emerging Risks
• Open Forum
Audit Committee Update

Audit Committee Responsibility – A Refresher
Audit Committee Responsibility – A Refresher

- We are continuously asked, “Is_______ the responsibility of the Audit Committee?”
- Fill in the blank.
- But the answer is more often than not, “Yes!”
- Today’s Audit Committees have increasingly been asked to take on more and more oversight responsibilities.
- More so than ever with the flurry of new regulatory requirements, accounting and auditing rules.
• The audit committee assists the board in its oversight of:
  – Integrity of the company’s financial statements
  – Internal controls including internal control over financial reporting
  – Independent auditor’s qualifications, independence, and performance
  – Internal audit function’s qualifications, independence, and performance
  – The company’s risk management and overall governance process
  – The company’s ethics and compliance program, which includes legal and regulatory requirements

• Specific responsibilities assigned to an audit committee are set forth in an audit committee charter that is approved by the board of directors. An audit committee charter should address processes, procedures, and responsibilities.

Source The AICPA Audit Committee Toolkit
Internal and External Audits – OCC Handbook, April 2013

• Audit committee responsibilities should encompass:
  – Reviewing and approving audit strategies, policies, programs, and organizational structure, including selection/termination of external auditors or outsourced internal audit vendors.
  – Establishing schedules and agendas for regular meetings with internal and external auditors. The committee should meet at least four times a year.
  – Supervising the audit function directly to ensure that internal and external auditors are independent and objective in their findings.
OCC Guidance
Audit Committee Responsibilities

- Working with internal and external auditors to ensure that the bank has comprehensive audit coverage to meet the risks and demands posed by its current and planned activities.

- Significant input into hiring senior internal audit personnel, setting compensation, reviewing annual audit plans/schedules, and evaluating the internal audit manager’s performance.

- Retaining auditors who are fully qualified to audit the kinds of activities in which the bank is engaged.
• Meeting with bank examiners, at least once each supervisory cycle, to discuss findings of OCC reviews, including conclusions regarding audit.

• Monitoring, tracking, and, where necessary, providing discipline to ensure effective and timely response by management to correct control weaknesses and violations of law or regulation noted in internal or external audit reports or in examination reports.
12 CFR 363 – Annual Independent Audits and Reporting Requirements

• Applies to banks, thrifts, and holding companies having $500 million or more in total assets. Measured at the beginning of the year.

• Establishes requirements for independent financial statement audits; timing, contents, and types of management and auditor reporting; and the board of director’s audit committee structure and responsibilities.

• Public accountants engaged by banks subject to FDICIA must adhere to independence standards of AICPA, SEC and PCAOB. Most restrictive rule applies.

➤ Result - Stricter independence rule means the bank must prepare the GAAP financial statements and tax accrual.
Audit Committee Update

Auditor Committee Collaboration – A Resource
Governance Leaders Issue “Call to Action” to Enhance the Audit Committee Report

November 20, 2013
A group of nationally recognized U.S. corporate governance and policy organizations is jointly calling on audit committees of public companies of all sizes and industries to proactively consider strengthening their public disclosures to more effectively convey key elements of their critical work to investors and stakeholders.

A product of the Audit Committee Collaboration, Enhancing the Audit Committee Report: A Call to Action is built on the premise that those with a stake in our financial markets should understand and have confidence in the audit committee’s work. The report includes examples of emerging, voluntary practices of strengthened audit committee disclosures, and cites studies that have examined recent trends in these practices.
Governance Leaders Issue “Call to Action” to Enhance the Audit Committee Report

In the paper, these organizations issued the following Call to Action:

“We believe that greater transparency about the audit committee’s roles and responsibilities is one way of increasing investor confidence, and an opportunity to communicate more clearly to shareholders about audit committee-related activities. To this end, we believe that public company audit committee reporting can and should be strengthened, and we encourage all public company audit committees to renew their focus on this important issue.”
October 2, 2014
The Center for Audit Quality (CAQ) shared an educational video promoting the auditor assessment tool (the “tool”), an important tool for audit committees that the CAQ has developed with its Audit Committee Collaboration partners.

The Collaboration is made up of nationally recognized corporate governance and policy organizations that have come together to expand audit committee member access to useful tools and materials with the goal of strengthening audit committee oversight of financial reporting, which in turn may enhance audit quality.

http://www.auditcommitteeecollaboration.org/
Audit Committee Update

Audit Quality Indicators
Audit Quality Indicators

• In 2013 the PCAOB began an initiative to develop audit quality indicators (AQI), which the staff defines as measures that provide insight into financial statement audit quality

• The Center for Audit Quality (CAQ) has provided input as well

• The discussions focused on which measures might be most helpful to audit committees and other stakeholders when evaluating audit services at the engagement team or firm level
The PCAOB is a nonprofit corporation established by Congress to oversee the audits of public companies in order to protect the interests of investors and further the public interest in the preparation of informative, accurate and independent audit reports. The PCAOB also oversees the audits of broker-dealers, including compliance reports filed pursuant to federal securities laws, to promote investor protection.

http://pcaobus.org/Pages/default.aspx
The Center is an autonomous, nonpartisan, nonprofit group based in Washington, D.C. It is governed by a Board that comprises leaders from the public company auditing firms, the American Institute of CPAs and three members from outside the public company auditing profession. The organization is affiliated with the American Institute of CPAs. 

http://www.thecaq.org/about-us

**CAQ Vision**

- The Center for Audit Quality is dedicated to enhancing investor confidence and public trust in the global capital markets by:
- Fostering high quality performance by public company auditors;
- Convening and collaborating with other stakeholders to advance the discussion of critical issues requiring action and intervention;
- Advocating policies and standards that promote public company auditors’ objectivity, effectiveness and responsiveness to dynamic market conditions.
Audit Quality Indicators

- On July 1, 2015 The PCAOB issued their Concept Release on Audit Quality Indicators
- Seeking public comment on the content and possible uses of AQI
- The CAQ is meeting to address their position on the Concept Release
The indicators are a potential portfolio of quantitative measures that may provide new insights about how to evaluate the quality of audits and how high quality audits are achieved.

Taken together with qualitative context, the indicators may inform discussions among those concerned with the financial reporting and auditing process, for example among audit committees and audit firms.

Enhanced discussions, in turn, may strengthen audit planning, execution, and communication.
Audit Quality Indicators –
The Portfolio of AQI

AUDIT PROFESSIONALS

Availability
1. Staffing Leverage
2. Partner Workload
3. Manager and Staff Workload
4. Technical Accounting and Auditing Resources
5. Persons with Specialized Skill and Knowledge

Competence
6. Experience of Audit Personnel
7. Industry Expertise of Audit Personnel
8. Turnover of Audit Personnel
9. Amount of Audit Work Centralized at Service Centers
10. Training Hours per Audit Professional

Focus
11. Audit Hours and Risk Areas
12. Allocation of Audit Hours to Phases of the Audit
Audit Quality Indicators – The Portfolio of AQI

AUDIT PROCESS

Tone at the Top and Leadership
13. Results of Independent Survey of Firm Personnel

Incentives
14. Quality Ratings and Compensation
15. Audit Fees, Effort, and Client Risk

Independence
16. Compliance with Independence Requirements

Infrastructure
17. Investment in Infrastructure Supporting Quality Auditing, Monitoring and Remediation
18. Audit Firms' Internal Quality Review Results
19. PCAOB Inspection Results
20. Technical Competency Testing
Audit Quality Indicators – The Portfolio of AQI

AUDIT RESULTS

Financial Statements
21. Frequency and Impact of Financial Statement Restatements for Errors
22. Fraud and other Financial Reporting Misconduct
23. Inferring Audit Quality from Measures of Financial Reporting Quality Internal Control
24. Timely Reporting of Internal Control Weaknesses

Going Concern
25. Timely Reporting of Going Concern Issues Communications between Auditors and Audit Committee
26. Results of Independent Surveys of Audit Committee Members

Enforcement and Litigation
27. Trends in PCAOB and SEC Enforcement Proceedings
28. Trends in Private Litigation
Audit Quality Indicators -- Users

**Audit Committees:**
- Assess reporting risk and audit quality
- Retain and compensate auditors
- Oversee auditors

**Audit Firms:**
- Assess and manage risk
- Improve quality control efforts and, ultimately, audit quality
- Identify root causes of audit deficiencies and remediate weaknesses
Audit Quality Indicators -- Users

Investors
• Assess reporting risk
• Vote shares

PCAOB and other Regulators
• Inform policy-making
• Assist root cause and quality control projects
• Stimulate public discussion of, and market demand for, quality
Audit Committee Update

2013 COSO Framework
The Committee of Sponsoring Organizations of the Treadway Commission (COSO) is a joint initiative of the five private sector organizations below and is dedicated to providing thought leadership through the development of frameworks and guidance on enterprise risk management, internal control and fraud deterrence.

- AICPA
- American Accounting Association (AAA)
- Financial Executives International (FEI)
- Institute of Management Accounts (IMA; CMA)
- Institute of Internal Auditors
COSO was formed in 1985 to sponsor the National Commission on Fraudulent Financial Reporting (the Treadway Commission).

The Treadway Commission, a private-sector initiative, was formed in 1985 to inspect, analyze, and make recommendations on fraudulent corporate financial reporting.

In September 1992, the four volume report entitled *Internal Control—Integrated Framework* was released by COSO and later re-published with minor amendments in 1994.

This report presented a common definition of internal control and provided a framework against which internal control systems may be assessed and improved.
2013 COSO Framework

• COSO’s Internal Control – Integrated Framework
  – Effectively and efficiently develop systems of internal control that adapt to changing business and operating environments
  – Mitigate risks to acceptable levels
  – Support sound decision making and governance of the organization

• Issued May 14, 2013

• Transition period through December 15, 2014
2013 COSO Framework

• COSO will consider the following documents to be superseded after December 15, 2014:
  – 2006 Internal Control over Financial Reporting – Guidance for Smaller Public Companies

• COSO’s 2004 Enterprise Risk Management – Integrated Framework and the 2013 Internal Control – Integrated Framework are considered complementary

• Internal Control- Integrated Framework, Guidance on Monitoring Internal Control Systems will continue to be relevant and useful material for management
• Broad based changes
  – Applies a principles-based approach
  – Clarifies requirements for effective internal control
    • Requires that each of the components and relevant principles be present and functioning and the five components be operating together
  – Expands the reporting category objectives
    • Considers other external reporting beyond financial reporting
      • Internal reporting both financial and nonfinancial
    – Clarifies the role of objective-setting in internal control
    – Considers globalization of markets and operations
2013 COSO Changes

• Broad based changes (concluded)
  – Enhances governance concepts
  – Considers different business models and organizational structures
  – Considers demands and complexities in laws, rules, regulations and standards
  – Considers expectations for competencies and accountabilities
  – Reflects the increase relevance of technologies
  – Enhances consideration of anti-fraud expectations
Overview

Change

Governance oversight

Competency and accountability expectations

Globalization

Anti-fraud expectations

Regulatory change and demands

Technological advancement
Process (components of internal control) set by:

- Board of directors
- Management
- Other personnel

To provide “reasonable assurance” regarding achievement of objectives relating to:

- Operations
- Reporting
- Compliance
COSO Framework

COSO

- Objectives
- Components
- Organizational Structure
Major Changes

• Broad based changes
  – Codifies a principles-based approach – 17 principles
  – Enhances anti-fraud expectations
  – Expands the concept of government oversight
  – Reflects technological changes in business operations
  – Clarifies the role of objective-setting in internal control
  – Clarifies requirements for effective internal control
    • Requires that each of the components and relevant principles be present and functioning and the five components be operating together
  – Expands the reporting category objectives
  – Considers other external reporting beyond financial reporting
  – Internal reporting, both financial and nonfinancial
2013 COSO Framework

Control Environment
1. Demonstrates commitment to integrity and ethical values
2. Exercises oversight responsibility
3. Establishes structure, authority and responsibility
4. Demonstrates commitment to competence
5. Enforces accountability

Risk Assessment
6. Specifies suitable objectives
7. Identifies and analyzes risk
8. Assesses fraud risk
9. Identifies and analyzes significant change

Control Activities
10. Selects and develops control activities
11. Selects and develops general controls over technology
12. Deploys through policies and procedures

Information & Communication
13. Uses relevant information
14. Communicates internally
15. Communicates externally

Monitoring Activities
16. Conducts ongoing and/or separate evaluations
17. Evaluates and communicates deficiencies
The Examiners

Per FDIC RMS Manual of Examination Policies section 4.2:

• The Board of Directors is responsible for ensuring that internal control programs operate effectively.
  – Oversight can be delegated

• Internal Control programs should address the five key components:
  – CONTROL ENVIRONMENT
  – RISK ASSESSMENTS
  – CONTROL ACTIVITIES
  – INFORMATION AND COMMUNICATION
  – MONITORING ACTIVITIES

• Institutions are encouraged to their control program against the COSO framework.
Audit Committee Update

Basel III
Basel III

• The Basel Committee on Banking
• The recent fiscal crisis demonstrated numerous weaknesses in the global regulatory framework and in banks’ risk management practices.
• The new regulations will increase capital and liquidity requirements. Will drive up capital requirements and liquidity costs and increase pressure on banks’ profitability.
• Implementation begins in January 1, 2015 with a phase in period through January 1, 2019.
Basel III – Overview

- Intended to improve both the quality and quantity of capital
- Introduces a new class of capital, Common Equity Tier 1 Capital (CET1)
- Requires greater risk weights on certain assets
- The Tier 1 common capital ratio excludes any preferred shares or non-controlling interests when determining the calculation. This differs from the Tier 1 capital ratio which is based on the sum of its equity capital and disclosed reserves, and sometimes non-redeemable, non-cumulative preferred stock.
## Capital Ratios

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<th>Old Minimum</th>
<th>New Minimum</th>
<th>Old Well Capitalized</th>
<th>New Well Capitalized</th>
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</thead>
<tbody>
<tr>
<td>Leverage Ratio *</td>
<td>4%</td>
<td>4%</td>
<td>5%</td>
<td>5%</td>
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<tr>
<td>(Total capital/avg. assets)</td>
<td></td>
<td></td>
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<tr>
<td>CET1 RBC</td>
<td>N/A</td>
<td>4.5%</td>
<td>N/A</td>
<td>6.5%</td>
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<tr>
<td>(CET1 capital/RWA)</td>
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<tr>
<td>Tier 1 RBC</td>
<td>4%</td>
<td>6%</td>
<td>6%</td>
<td>8%</td>
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<tr>
<td>(Tier 1 capital/RWA)</td>
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<tr>
<td>Total RBC</td>
<td>8%</td>
<td>8%</td>
<td>10%</td>
<td>10%</td>
</tr>
<tr>
<td>(Total capital/RWA)</td>
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</tbody>
</table>

New capital ratios are effective as of January 1, 2015. There is no transition period.

* - eliminated the reduction in the minimum ratio from 4% to 3% for a “1” rated bank
Capital Conservation Buffer

During financial crisis...

dividends and discretionary bonuses continued to be paid to executive officers.
• Reacting to evidence that, during the Financial Crisis, some banking organizations continued to pay dividends and substantial discretionary bonuses as their financial condition weakened, Basel III incorporated the concept of a "capital conservation buffer."

• Subject to a transition period, a banking organization must maintain a capital conservation buffer greater than 2.5 percent in order to avoid limitations on dividend and discretionary bonus payments.

• The transition begins January 1, 2016 and phases in to the full 2.5% on January 1, 2019.
  – 2016 --- 0.625%
  – 2017 --- 1.25%
  – 2018 --- 1.875%
  – 2019 --- 2.50%
CCB is designed to limit capital distributions and discretionary bonuses to executive officers for institutions that don’t maintain a certain amount of capital.

An executive officer is a person who holds the title, or performs one or more of the following positions: president, chief executive officer, executive chairman, chief operating officer, chief financial officer, chief legal officer, chief lending officer, chief risk officer, or head of a major business line, and other staff that the board of directors deems to have equivalent responsibility.
• The limitations take the form of percentage-based reductions in the maximum payout ratio, although supervisors retain the right to grant case-by-case exemptions should they determine that the payment or distribution is not contrary to the purposes of the capital conservation buffer or the safety and soundness of the banking institution.

• Banks that want to distribute capital freely must maintain the buffer.
## Capital Conservation Buffer

<table>
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<tr>
<th>Capital Ratio</th>
<th>Current</th>
<th>Final Rule</th>
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</thead>
<tbody>
<tr>
<td></td>
<td>Minimums</td>
<td>Minimum</td>
</tr>
<tr>
<td>Leverage ratio (Total Cap/Avg. Assets)</td>
<td>4.0%</td>
<td>4.0%</td>
</tr>
<tr>
<td>Common equity tier 1</td>
<td>n/a</td>
<td>4.5%</td>
</tr>
<tr>
<td>Tier 1 (Tier 1/RWA)</td>
<td>4.0%</td>
<td>6.0%</td>
</tr>
<tr>
<td>Total Capital (total/RWA)</td>
<td>8.0%</td>
<td>8.0%</td>
</tr>
</tbody>
</table>
Three components of regulatory capital

CET1

Less: Regulatory deductions and adjustments

Additional Tier 1

Tier 2
Emerging Risks

- OCC Semi Annual Risk Perspective, Spring 2015 – Good Beach Reading
- A good summary of trends and related risks
- Risks and opportunities
Emerging Risks

• Are you concerned?
• As a Director OR an Audit Committee member, what concerns you?
Emerging Risks

- Growth and earnings pressures are causing banks to reevaluate their credit risk tolerances, and many banks are changing their underwriting standards and granting more policy exceptions to bolster their competitive position.

- Competition is resulting in eased underwriting standards across a variety of credit products. Weakening standards are particularly evident in indirect auto and leveraged lending; some easing in underwriting and increased risk layering, however, are also occurring in other types of commercial loans, such as C&I, ABL, and CRE.
Emerging Risks

• The prolonged low interest rate environment continues to lay the foundation for future vulnerability. Some banks have reached for yield to boost interest income with decreasing regard for interest rate or credit risk. Banks that extend asset maturities to pick up yield could face significant earnings pressure and capital erosion, depending on the severity and timing of interest rate moves.

• The complexity of interest rate risk (IRR) management has been compounded by sustained post-crisis bank deposit inflows and shifts in deposit mix, resulting in a considerable amount of funding at historically low rates. Understanding the future behavior of these depositors, including the potential effect on liquidity, is a key component of the IRR modeling process.
Emerging Risks

• Many banks continue to reevaluate their business models, deployment of capital, and risk appetites given the challenging operating environment. Some banks are taking on additional risks by expanding into new, less familiar, or higher-risk products without adequate due diligence or appropriate risk management and controls.

• Some banks are lowering overhead expenses by reducing control functions, exiting less profitable businesses, closing offices, and outsourcing critical control functions to third parties without establishing appropriate risk management processes.
Emerging Risks

- Banks may not incorporate resiliency considerations, including recovery from cyber events, into their overall governance, risk management, or strategic planning processes, increasing their vulnerability.

- Banks and their employees, customers, and third-party service providers continue to be vulnerable to cyber attacks that can compromise data or systems or allow criminals to illegally obtain personally identifiable information.
Emerging Risks

- BSA/AML risks remain high, as technological developments that benefit customers through enhanced products and greater access to financial services are vulnerable to criminals who continue to exploit such innovations. BSA programs at some banks have failed to develop or incorporate appropriate controls as products and services have evolved, and insufficient resources and expertise have been devoted to BSA/AML in some banks.

- As BSA/AML risks continue to increase, banks must properly manage risks associated with customers with higher BSA/AML risk and their transactions by assessing customers on a case-by-case basis and instituting commensurate controls.
Emerging Risks

• The integrated mortgage disclosure requirements, which will apply to loan applications for most closed-end consumer credit transactions secured by real property received on or after October 3, 2015, are expected to pose significant operational and compliance challenges for some banks.

• In implementing the new disclosure requirements in regulations Z and X, compliance risk management should include, as necessary, revisions to policies and processes, technological changes, training, testing, and effective third-party risk management.
Questions?

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