Industry Sound Practices for Financial and Accounting Controls at Financial Institutions

Federal Reserve Bank of New York
January 2006

FINANCIAL AND ACCOUNTING CONTROLS:
INDUSTRY SOUND PRACTICES FOR FINANCIAL INSTITUTIONS

1 Importance of Financial and Accounting Controls

Effective financial and accounting controls are critical in presenting fairly an institution's operating results and risk profile. Weaknesses in these controls can contribute to inaccurate or incomplete financial reporting and potentially result in legal fees/fines, significant reputational damage and a loss of business.

Strong financial controls support the supervisory interest of maintaining a safe and sound financial system. The development of a comprehensive financial control framework is a key component for institutions to maintain an effective control environment and is indicative of a corporate culture where management emphasizes the importance of internal controls.

1.1 Safety and Soundness

Supervisory guidance has long emphasized the importance of strong financial controls as a critical component of an overall effective system of internal controls. When financial controls are designed, implemented, and operating effectively, management has accurate financial information to support decisions in line with the institution's risk profile and business strategy. Examiners regularly consider a financial institution's financial control environment in their overall internal control review process.

There also has been an increasing emphasis internationally on financial controls, although specific guidance on how to apply such controls is evolving. The emphasis has been more on asserting the overall importance of a sound internal control environment than on suggesting specific methods to do so. In particular, the Basel Committee on Banking Supervision has issued papers on internal controls and on operational risk, both of which advocate the need for a strong system of internal controls in all areas, including financial controls.

1.2 Financial and Reputational Risk

An institution may be subjected to both financial and reputational risk if accounting data is inaccurate. An adverse impact on share prices and reputation has been noted in prior instances involving major financial restatements by publicly traded corporations. Some of the most notable accounting missteps by corporations have resulted in legal penalties, fines, prison terms, and the downsizing and/or dissolution of the entity. These well-publicized incidents also have led to new legislation and regulatory requirements. New accounting pronouncements as well as the creation of the Public Company Accounting Oversight Board (PCAOB) were responses to highly publicized accounting failures at various public companies.

To date, the majority of known accounting frauds have occurred at non-financial companies, though some financial institutions have had adverse publicity and in some cases restated financial statements due to problems with certain transactions such as securitized assets. The specific financial controls appropriate for financial institutions depend on the organization's size, complexity, and operations. However, as a result of a recent study of financial controls at a number of large, complex banking institutions in the Second Federal Reserve District, we have identified a number of industry sound practices for financial controls that may have a broader relevance for the industry. These practices are discussed in detail in section 4.

2 Existing Laws, Regulatory Requirements, and Supervisory Guidance

Extensive laws, regulations, and supervisory guidance exist that stress the importance of accounting and financial controls. Among the laws are the Federal Deposit Insurance Corporation Act of 1991 (FDICIA) and the Sarbanes Oxley Act of 2002 (SOX). Various regulatory agencies, including the Securities and Exchange Commission (SEC), the Board of Governors of the Federal Reserve System (FRB), and the PCAOB have promulgated rules and regulations and issued guidance concerning accounting and financial controls under these and other laws.[1] In addition, private entities, such as the American Institute of Certified Public Accountants (AICPA) and other non-governmental entities, have issued guidance on this topic. In general, the laws, regulations and guidance emphasize the need for strong financial controls and require companies to devise and maintain an adequate system of internal accounting controls. However, none of the existing laws, regulations or guidance specifically identifies comprehensive sound practices for accounting or financial controls. In this section, we briefly review FDICIA and SOX on accounting and financial controls, and the regulatory and guidance structure that supports those laws.

2.1 FDICIA– Section 112

Since 1993, insured depository institutions with assets in excess of $500 million[2] have been subject to Section 112 of FDICIA (FDICIA 112) which requires annual audited financial statements and an attestation on internal controls over financial

[1] For example, FRB guidance on accounting and financial controls is embedded in guidance for both FDICIA and Sarbanes -Oxley as follows: SR Letter 96-4 – FDIC Amendment to Annual Audit and Reporting Requirements (Part 363); SR Letter 03-5 – Amended Interagency Guidance on the Internal Audit Function and its Outsourcing; and SR Letter 02-20 – The Sarbanes-Oxley Act of 2002.
[2] The asset limit for management and external auditor attestations of internal controls was raised to $1 billion effective for fiscal years ending September 30, 2005.

reporting by management with a sign-off by the external audit firm. As a result of these rules, impacted institutions are required to implement an effective control framework such as COSO. In many cases, institutions have established self-assessment processes to comply with the regulation. Neither FDICIA 112 nor its implementing regulations or accompanying guidance, however, provides details as to what constitutes adequate or sufficient controls over financial reporting.

2.2 SOX – Section 404

SOX enhanced and expanded regulatory requirements for corporate internal controls over financial reporting to include all public companies, not only banks, while also adding requirements beyond what FDICIA called for in terms of enhanced documentation and testing. In particular, Section 404 of SOX (SOX 404) requires the management of a public company to assess and report on the effectiveness of internal controls over financial reporting and requires the company's external audit firm to express an opinion on management's assessment and to perform its own audit on the effectiveness of internal controls over financial reporting. SOX 404 has resulted in additional work for banking institutions to comply with the rules, such as end-to-end processes reviews, enhanced documentation, and an increase in testing. SOX 404 guidance describes the deliverables but is not specific on how to design financial controls or what constitutes sound practice for effective accounting and financial controls.

3 Scope of FRBNY Project

Over the last two years, the Federal Reserve Bank of New York reviewed financial and accounting controls at a number of large, complex banking institutions to identify industry sound practices. The effort included selected critical financial controls common to financial institutions, such as chart of accounts and account ownership policies, general ledger (G/L) account reconciliations, suspense accounts usage, aging and charge-off policies, month-end closing procedures and intercompany processes. In addition, the project reviewed the independence of the accounting and finance staff, and oversight by the board of directors (Board) and senior management. Industry sound practices identified in this document were derived from effectively designed and operating controls noted at a number of the institutions reviewed, although not all of the institutions had implemented all of the observed practices.

4 Observed Industry Sound Practices for Establishing Effective Financial Controls

4.1 Institutions establish clear accountability for the development, implementation and review of financial controls

The Board and senior management are ultimately responsible for the oversight of and effectiveness of internal controls over financial reporting. This high-level responsibility is explained more in Section 4.11. Senior management ensures that the control processes surrounding accounting and financial data are effective through proactive involvement in financial and accounting matters. Senior management reviews all financial data and assigns accountability to finance staff for specific data. In addition, finance and accounting staff assigned to corporate or individual business lines are expected to have a clear understanding of their roles and responsibilities.

The structure for designing and implementing financial controls depends upon the culture and environment in each institution. Controls can be developed and/or exercised either by centralized accounting functions, in individual business lines, or both. Organizations we reviewed had centralized or decentralized management structures. In a centralized environment, all accounting and finance staff reported to either the CFO or Controller. In a more decentralized environment, business line accounting and finance staff reported to the business line CEO, with indirect reporting lines to the corporate CFO with few functions controlled centrally. In both types of structure, the corporate CFO typically takes the lead in addressing accounting matters.

In the largest institutions we reviewed, the trend is toward a matrixed management structure with the business line CFO or Controller having dual reporting lines to the corporate CFO or Controller and the business line CEO. In this matrixed type of organization, accounting controls are typically applied at both the corporate and business line levels and the responsibility for accounting controls is split accordingly. Business line management is often responsible for the accuracy of financial data emanating from the specific business line, but this is accompanied by appropriate guidance and oversight exercised by the corporate function.

In institutions that follow a more centralized model, a corporate-wide accounting group retains responsibility for most accounting functions and has frequent communication with operating areas. Institutions operating under a decentralized model have a small corporate group, generally including accounting policy staff, and corporate reporting staff, but most finance and accounting staff are assigned to specific business lines. Even in decentralized models, however, corporate accounting groups influence accounting controls including the implementation of accounting policies and the corporate chart of accounts, month-end reporting processes and variance analysis.

The key component of all types of control structures is clear accountability at both the corporate and business line level evidenced by organization charts, job descriptions, process flows and other documentation that clearly illustrates the roles and responsibilities of the respective finance functions.

To ensure consistent accounting and reporting across the organization, institutions often create enterprise wide committees such as reporting or disclosure committees, accounting policy committees, controllers committees, and finance system development committees. While varying in their specific mission, these groups typically address accounting and finance issues such as the appropriate accounting for specific products, new disclosure requirements, potential control issues, or new system requirements.

4.2 Accounting and finance staff are knowledgeable and independent

The accuracy of financial information depends upon knowledgeable, independent accounting staff who accurately report financial data. Accounting and financial staff at the institutions we reviewed possessed such qualities, with accounting staff having direct or indirect reporting lines to the CFO, who in turn is part of senior management. Even in institutions with matrixed reporting lines, accounting and finance staff assigned to a specific business line generally report through the corporate finance function. Accounting staff understand relevant accounting issues and the controls appropriate for the operating environment. Managers in senior positions have appropriate certifications, such as a CPA license. Accounting staff are insulated from any responsibilities for business line results that could compromise their independence. Standard hiring practices generally are in place for finance staff across corporations. In some cases, the corporate accounting function has input into hiring decisions as well as compensation or evaluation decisions for business line financial staff. Even in institutions with matrixed reporting lines, accounting and finance staff assigned to a specific business line generally report through the corporate finance function.

4.3 Institutions develop and periodically update their corporate accounting policies and procedures framework

Institutions have an appropriate corporate accounting policies and procedures framework to ensure that controls are appropriately designed and implemented consistent with their specific management structure and approach. The majority of the institutions develop policies at the corporate level for G/L and chart of accounts management, the intercompany reconciliation process, and the financial statement closing process. Other policies relating to reconciliations, aging and charge-offs, inactive accounts, and suspense accounts are developed at the corporate level, the business line level, or both. Many business lines develop their own policies and procedures to supplement the corporate policies. Procedures are more likely to be at the business line level, although some corporate policies also contain procedural aspects.

Institutions with a decentralized structure for accounting controls have more limited policies at the corporate level delineating the role of finance personnel across the organization. Business line management has the flexibility to develop their own procedures surrounding key controls such as reconciliation procedures, aging and charge-off procedures, and detailed month-end closing procedures. In a more centralized environment, the corporate function provides detailed guidance on how business lines should perform key control functions. However, business lines engaged in different activities can develop specific controls geared to their operating environment as long as these controls are in line with corporate policies.

Corporate accounting policies and procedures reflect changes in the control environment when institutions have major organizational changes, such as mergers or acquisitions. Revisions to corporate policies typically take place following major system changes. Most institutions periodically review and update accounting policies and procedures even in the absence of major organizational changes.

4.4 Institutions have processes and competent staff in place to ensure that relevant accounting standards are reviewed and implemented throughout the organization

The institutions we reviewed have established appropriate processes designed to ensure that financial statement presentation remains current with changes in accounting and disclosure standards. This requires ongoing review of proposed accounting standards, responsiveness as prudent to various accounting governance bodies, analysis of the impact of new standards on financial disclosures and associated control processes, and appropriate implementation of these standards.

The majority of the institutions reviewed have specific corporate accounting policy groups (APGs) responsible for analyzing new and proposed accounting pronouncements, although smaller institutions may assign the responsibility to the CFO or Controller. APGs respond to proposed changes by standard setters, disseminate relevant accounting data throughout the institution, and work with accounting staff assigned to specific business lines to ensure that they understand and implement pronouncements, as necessary, in individual business lines. APGs may also provide guidance to business managers on the appropriateness of the accounting for specific transactions, particularly with respect to new products.

Policy staff attain a good understanding of new and emerging accounting standards through interaction with standard setters, accounting firms, and peers at other financial institutions. APGs typically disseminate information internally through newsletters, meetings, conference calls, or direct interaction with business line finance staff. Global institutions often have accounting staff in major locations to ensure that accounting applications are accurate and in accordance with local requirements.

Varying models for assessing new standards and implementing needed policies are used depending upon how the institutions are organized. In one model, all policy staff are assigned to a single corporate function though they are given specific responsibility for individual products and business lines. A second model places most policy staff at the corporate level, but a few staff are directly assigned to specific business lines with more complex accounting issues. A third model has a small central staff with most accounting policy staff embedded in individual business lines. In the first model, all accounting policy staff report through corporate accounting while in the second and third models, business line accounting policy staff had a direct line to business line management and a dotted line to the corporate accounting policy group.

4.5 Institutions have comprehensive global General Ledger (G/L) frameworks and a detailed Chart of Accounts

The institutions we reviewed typically have a top level corporate G/L that contains summary account data used to develop consolidated financial statements. Some institutions have multiple G/Ls that feed into and support the top level G/L. The entire process is defined in a General Ledger framework that describes how information is collected and summarized to enable timely and accurate financial reporting. The institutions also have comprehensive policies and procedures surrounding the G/L, with detailed mapping and/or bridging processes and descriptive account information. Where institutions have multiple G/Ls, accounting procedures explicitly state how accounts are mapped from one G/L to another and include sufficient detailed account descriptions for each account in the top level chart of accounts and in subordinate G/Ls to ensure that accounting staff consistently post to specific G/L accounts across the organization. Global institutions with multiple G/Ls typically have plans to consolidate and combine these systems to increase efficiency.

Some institutions have a comprehensive chart of accounts manual which provides a detailed description of each account, identifies how the account is mapped on the G/L and identifies related accounts and sample entries. Other institutions include the detailed description of the account in the G/L system itself if system functionality provides sufficient space for a detailed account description. The ultimate goal of these processes is for accounting staff in business lines to understand account usage and to ensure that account usage is consistent across the organization. Some institutions explicitly state what types of transactions should be posted to accounts such as Other Assets or Other Liabilities where the account title is not descriptive enough to include all the types of transactions that could be included in the account.

4.6 Institutions have formal processes for account openings and closings, and monitoring of inactive accounts

Account Openings/Closings

Institutions establish monitoring procedures for new account openings. A corporate function usually is responsible for developing detailed procedures for opening new accounts requested by business line managers. Monitoring procedures normally require assurance that no existing accounts are capable of handling a particular transaction before a new account is opened.

The majority of institutions also have guidelines as to when an account can or should be closed (e.g., accounts with zero balances that have never been used or have not been used in a specific period of time). Corporate guidelines address how the account is closed – (i.e., blocked from future activity or purged from the chart of accounts). In most cases, institutions block the account and maintain the data as an account history.

Inactive Account Monitoring

Institutions that review inactive accounts usually do so at least annually either as part of the regular account reconciliation process or as a separate review, with the process controlled at either the corporate or business line level. In some institutions, a central technology group produces a list of all inactive accounts and related owners which is distributed to each owner. The account owner verifies whether the account should remain open and provides documentation if the account is to remain open. In other institutions, the central group automatically blocks certain inactive accounts unless the owner documents why they should remain open.

4.7 Institutions have formal account ownership processes and periodically confirm account ownership responsibilities

The reliability of an institution's financial statements depends initially on ensuring that all information input into the G/L is accurate. A key control surrounding this process is assigning each G/L account a designated owner. Institutions have different processes for account ownership, although in most cases the designation of an account owner is at the lowest level of a hierarchy that includes the account, business line, cost center and department. The account owner is responsible for ensuring that the account is reconciled in a timely manner with adequate documentation maintained. At some institutions, accounts have multiple owners, such as a reconciler and a substantiation owner or verifier who reviews the account to ensure that the documentation is adequate.

Most institutions have processes in place to periodically verify that all accounts have owners. Some institutions align the account ownership process with the account opening process described above. In these cases, accounts cannot be opened unless there is a designated owner responsible for either reconciling or overseeing the reconciliation of the account. Several institutions have or are developing an automated account opening process to make assigning an owner more efficient and to enable easier verification that all accounts have owners.

4.8 Institutions have appropriate account reconciliation frameworks based on risk

The institutions we reviewed have formal corporate policies requiring account reconciliations at least monthly, with more frequent reviews for specific types of accounts. Business line management may require more frequent reconciliations based upon the type of the account and account activity. At some institutions, corporate accounting provides detailed guidance on the reconciliation process. In others, business line management develops its own procedures. Corporate accounting guidance addresses the types of accounts to be reconciled (e.g. balance sheet, off-balance sheet and income statement accounts), reconciliation frequency (daily, weekly, monthly), the system to be used (in some instances one or more automated tools are provided by corporate accounting) and the required documentation. In some cases, the guidance also indicates when reporting on unreconciled or unsubstantiated balances is required to be submitted to corporate accounting. Where business line management has the flexibility to establish its own procedures, corporate accounting issues only general guidelines.

In some institutions, a central group at either the corporate or regional level collects data and provides MIS to senior management on the reconciliation process. The MIS usually identifies accounts or parts of accounts that are unsubstantiated and the steps management is taking to reconcile the account. Information on unreconciled balances open beyond a certain timeframe is escalated to senior management within the business line and to corporate accounting.

Institutions vary in terms of which accounts are included in the formal reconciliation process. All institutions require reconciliation of balance sheet accounts, but not all require reconciliation of profit & loss or off-balance-sheet accounts. Most institutions require the reconciliation of zero balance accounts (e.g., accounts with a zero balance at the end of the month that may or may not have had activity during the month). Some institutions have a quality assurance function at either the corporate, regional, or business line level that periodically review selected reconciliations to ensure that the reconciliation process is performed and that adequate documentation exists.

In addition, some institutions have specific procedures for certain types of balance sheet accounts such as suspense accounts[3]. Suspense account reconciliations are sometimes assigned to a corporate or regional group responsible for ensuring that system suspense accounts or all suspense accounts (as defined by the institution) are cleared in a timely manner.

Reconciliation frequency depends upon numerous factors including the expected balance and activity, the volume and type of transactions, and the nature/criticality of the account. All accounts are reconciled at least monthly with more frequent reconciliation for riskier accounts with higher volumes and more complex transactions.

4.9 Institutions establish account aging processes and develop defined write-off guidelines

The validity of financial statements depends on ensuring that all general ledger (G/L) account balances are accurate and that assets are verifiable and collectible. Thus, an important component of a robust financial control process includes policies with respect to aging and charge-off of stale or unreconciled account balances.

[3] Institutions defined suspense accounts in a variety of ways. Some institutions only include as suspense accounts system generated differences that could not be posted to another account and were instead posted to a default account. Other institutions define suspense accounts as certain wash or clearing accounts or accounts where items that could not be identified are temporarily posted.

Institutions have aging and charge-offs policies at either the corporate or business line level. These policies are either broad-based or business-specific depending upon the activities within the institution. Corporate guidelines designate the accounts that should be aged, the aging categories, the required MIS, general timeframes for considering items for charge-off and the process needed to retain a balance past the normal charge-off timeframe. Aging is part of the reconciliation process with timelines for escalation to senior management ranging from 30 to 90 days. Charge-offs are usually required within 90 to 180 days unless documentation is provided as to why the account should not be charged-off (i.e., why the balance is still collectible).

Most institutions have escalation processes where senior management approval is required for larger balances and/or older items. Some institutions have different rules for specific business lines depending upon the type of accounts maintained. Specific business lines that are regulated by Self-Regulatory Organizations (SROs) may have to follow SRO's rules on aging and charge-offs.

4.10 Institutions have processes to facilitate timely, complete and accurate financial statement closings

Month-end Closing

The month-end closing process is one of the most essential components of the entire financial statement preparation and review process. The accuracy of financial statements depends not only on all the information being accurate, but also on all data being recorded in the correct financial statement period. The failure to accurately record financial data can result in inaccurate or misleading financial statements which could cause legal or reputational risk.

All the institutions in the study had formal documented closing processes that included: (1) the specific dates for monthly, quarterly and year-end closings; (2) the information required to be provided to both business line and corporate management; (3) the process for adjusting the data after the books of the corporation are closed, including the level of senior management sign-off on entries during the closing process; (4) the analysis required at both the business line and corporate levels concerning account variances; (5) processes to identify and eliminate open intercompany balances; (6) an assessment of the need for reserve accounts to take into account probable and estimable loss criteria; and (7) the final review process for ensuring that all financial statement data is accurate.

Institutions are automating and accelerating the month-end closing process, with an average of two to five days allocated for the "soft" close – the initial closing of the G/L (entries after that time frame must be posted by corporate accounting) -- and up to fifteen days for the "hard" close[4]. Top side adjustments made after the "hard" close and before

[4] A hard close is the date after which no more entries can be posted even by corporate accounting.

earnings are publicly announced must be approved at the corporate level, with material adjustments requiring the approval of the CFO.

Variance Analysis

Institutions typically require accounting staff to explain period to period as well as actual to budget variances, and in some cases corporate accounting establishes thresholds for staff to use against which to report changes in balances.

Variance analysis provides an overall quality check on the reasonableness of the amounts reported in the financial closing process. It is performed within corporate accounting, the business lines, or both. Institutions also are moving toward using increased automation in variance analysis, in some cases by employing a web-based process that ensures that business line staff are notified of large variances and provide explanations on the variance to a central accounting group. We also noted an increasing emphasis on having a series of meetings between corporate and business line CEOs and CFOs to discuss the results, develop the financial statements, and ensure that results are consistent across the firm. Some institutions also have escalation triggers indicating when business line management must provide explanations of changes in financial data. Periodic changes in balance sheet and/or income statement amounts are usually documented and explained in writing to either business line management, corporate accounting, or both.

Intercompany Balances

The accuracy of financial statement data is also linked to the identification and elimination of unreconciled intercompany balances. The proliferation of global transactions and the splitting of transactions where a transaction may be negotiated in one country, booked in another country, and managed in a third country has resulted in an increase in the number and complexity of intercompany transactions. If transactions with third parties are posted as intercompany balances rather than in the appropriate asset or liability account, an institution's financial statements would be misstated.

Institutions have effective processes in place to investigate and eliminate open intercompany items. Processes are either manual or automated; however, institutions with more automated processes are able to resolve open balances in a more timely manner. Typical practice is for accounting systems to match and eliminate offsetting intercompany entries. Where balances are not automatically eliminated, manual or semi-automated processes enable controllers to match and then eliminate remaining open items. Companies give greater attention to avoidable[5] differences as opposed to unavoidable differences.

[5] Avoidable differences are those arising from errors (e.g., one entity used the wrong entity as the counterparty or posted the transaction to an intercompany account when it involved an unrelated party). Unavoidable differences are where the differences arise because of timing due to geography or different rates used in different locations globally.

4.11 Boards/Audit Committees and senior management exercise effective oversight of financial controls

Law, regulation and guidance task Boards, through their Audit Committees, with exercising oversight over an institution's financial controls. In most cases, the Audit Committee reviews and evaluates financial performance and ensures that senior finance and accounting staff have appropriate knowledge and skills. Boards and Audit Committees are kept informed of current and emerging issues in accounting and financial reporting and regularly discuss their impact on the organization.

Senior management is responsible for developing policies and implementing policies and practices to ensure that financial statements are accurate and internal controls over financial reporting are effective. It gives close attention to accounting control issues and approves corporate-wide policies that define the accounting control framework for the institution. Under Section 302 of SOX, the CEO and the CFO are required to attest that the quarterly financial statements are accurate, and they may be held personally liable if issues are uncovered or the financial statements are restated. As noted above, under SOX 404, senior management is also required to attest to the adequacy of controls over financial reporting.

In general, we found active Board and senior management oversight at institutions in the study and noted that there were proactive processes in place to review and implement changes to the financial control environment. The Boards and Audit Committees actively engaged in a discussion of significant accounting issues and standards. Senior management gave close attention to accounting control issues and approved corporate-wide policies that defined the accounting control framework for the institution.

APPENDIX A

FINANCIAL AND ACCOUNTING CONTROLS

SUMMARY OF INDUSTRY SOUND PRACTICES FOR FINANCIAL INSTITUTIONS[6]

1	Institutions establish clear accountability for the development, implementation and review of financial controls.
2	Accounting and finance staff are knowledgeable and independent.
3	Institutions develop and periodically update their corporate accounting policies and procedures framework.
4	Institutions have processes and competent staff in place to ensure that relevant accounting standards are reviewed and implemented throughout the organization.
5	Institutions have comprehensive global General Ledger (G/L) frameworks and a detailed Chart of Accounts.
6	Institutions have formal processes for account openings and closings and monitoring of inactive accounts.
7	Institutions have formal account ownership processes and periodically confirm account ownership responsibilities
8	Institutions have appropriate account reconciliation frameworks based on risk.
9	Institutions establish account aging processes and develop defined write-off guidelines
10	Institutions have processes to facilitate timely, complete and accurate financial closings
11	Boards/Audit Committees and senior management exercise effective oversight of financial controls

January 25, 2006

[6] These practices were observed during this review and are not meant to be a complete list of all sound practices for financial and accounting controls