The Relevance of Internal Audit
Demonstrating Value to the Audit Committee

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Love and marriage, love and marriage,
Go together like a horse and carriage.
Dad was told by mother you can't have one, you can't have none.
You can't have one without the other.

OR

Peanut Butter and Jelly

Where we will wander today!
(and not necessarily in the order listed below)

Primary focus
Responsibilities
COSO
SOX
Broad interface
Charters
Assessments
Efforts - interweaving
Findings and tracking
Love and Marriage/Horse and Carriage/Peanut Butter
Corporate - Responsibilities

To manage in such a way to be a quality investment for shareholders by driving efficiencies, identifying strategic opportunities and ensuring leaders are committed to performance. To provide shareholders with honest and clearly understandable information about operations.

Businesses in general have a duty and responsibility to their customers, yet in the financial services area, there are additional responsibilities to customers when acting as agent for customers.

There are also the responsibilities to grow and prosper based on the growth of those employed and to contribute to those efforts that make communities a better place to live and work.

Executive Management – Responsibilities

The executive management team is generally a team of individuals at the highest level of management of an organization who have the day-to-day tasks of managing that organization. They hold specific executive powers delegated to them with and by authority of a board of directors and/or the shareholders. The executive management team typically consists of the heads of a firm's product lines and/or geographic units and of functional executives such as the chief financial officer, the chief operating officer, and the chief technology officer.

Audit Committee – Responsibilities

Responsibilities of the audit committee typically include:

- Overseeing the financial reporting and disclosure process.
- Monitoring choice of accounting policies and principles.
- Overseeing hiring, performance and independence of the external auditors.
- Oversight of regulatory compliance, ethics, and whistleblower hotlines.
There are a variety of views about the roles and responsibilities of a board of directors and most of these views share common themes. Simply put, a board of directors is a group of people legally charged with the responsibility to govern a corporation. In a for-profit corporation, the board of directors is responsible to the stockholders -- a more progressive perspective is that the board is responsible to the stakeholders, that is, to everyone who is interested and/or can be effected by the corporation.

Brenda Hanlon, in *In Boards We Trust*, suggests the following duties:

1. **Provide continuity for the organization** by setting up a corporation or legal existence, and to represent the organization’s point of view through interpretation of its products and services, and advocacy for them.

2. **Select and appoint a chief executive** to whom responsibility for the administration of the organization is delegated, including:
   - to review and evaluate his/her performance regularly on the basis of a specific job description, including executive relations with the board, leadership in the organization, in product/service/program planning and implementation, and in management of the organization and its personnel
   - to offer administrative guidance and determine whether to retain or dismiss the executive

3. **Govern the organization by broad policies and objectives**, formulated and agreed upon by the chief executive and employees, including to assign priorities and ensure the organization's capacity to carry out products/services/programs by continually reviewing its work.

4. **Acquire sufficient resources for the organization’s operations** and to finance the products/services/programs adequately

5. **Account to the stockholders (for-profit) or public (nonprofit) for the products and services of the organization and expenditures** of its funds, including:
   - to provide for fiscal accountability, approve the budget, and formulate policies related to contracts from public or private resources
   - to accept responsibility for all conditions and policies attached to new, innovative, or experimental products/services/programs.
COSO (Committee of Sponsoring Organizations)

History

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.

The COSO framework involves several key concepts:

- Internal control is a **process**. It is a means to an end, not an end in itself.
- Internal control is affected by **people**. It's not merely policy, manuals, and forms, but people at every level of an organization.
- Internal control can be expected to provide only **reasonable assurance**, not absolute assurance, to an entity's management and board.
- Internal control is geared to the achievement of **objectives** in one or more separate but overlapping categories.

The COSO framework defines internal control as a process, effected by an entity's board of directors, management and other personnel, designed to provide "reasonable assurance" regarding the achievement of objectives in the following categories:

- Effectiveness and efficiency of operations
- Reliability of financial reporting
- Compliance with applicable laws and regulations.
- Safeguarding of Assets

Five framework components:

- **Control environment**: The control environment sets the tone of an organization, influencing the control consciousness of its people.
- **Risk assessment**: Every entity faces a variety of risks from external and internal sources that must be assessed.
- **Control activities**: Control activities are the policies and procedures that help ensure management directives are carried out.
- **Information and communication**: Information systems play a key role in internal control systems as they produce reports, including operational, financial and compliance-related information, that make it possible to run and control the business.
- **Monitoring**: Internal control systems need to be monitored—a process that assesses the quality of the system's performance over time.

Updated in 2013 to reflect the changes in the business environment since 1992

- Expectations for governance oversight has increased
- Risk and risk-based approaches now receive greater attention
- Globalization of markets and operations has become a mega trend
- Complexity of business and organizational structures have increased
- Technology had evolved dramatically
- Demands and complexities in laws, regulations and standards have all increase
COSO – the Role of Internal Audit

Internal auditors play an important role in evaluating the effectiveness of control systems. As an independent function reporting to the top management, internal audit is able to assess the internal control systems implemented by the organization and contribute to ongoing effectiveness.

Internal audit often plays a significant monitoring role. In order to preserve its independence of judgment, internal audit should not take any direct responsibility in designing, establishing, or maintaining the controls it is supposed to evaluate. It may only advise on potential improvement to be made.
Sarbanes-Oxley Act (SOX)

The Sarbanes-Oxley Act came into force in July 2002 and introduced major changes to the regulation of corporate governance and financial practice. SOX is focused on public companies but many believe that many provisions are “best practices” for both public and private companies.

The Sarbanes-Oxley Act is arranged into eleven 'titles'. As far as compliance is concerned, the most important sections within these eleven titles are usually considered to be 302, 401, 404, 409, 802 and 906.

An over-arching public company accounting board – Public Company Accounting Oversight Board (PCAOB) was also established by the act.

Section 302 - Corporate Responsibility for Financial Reports
Periodic statutory financial reports are to include certifications that:
- The signing officers have reviewed the report
- The report does not contain any material untrue statements or material omission or be considered misleading
- The financial statements and related information fairly present the financial condition and the results in all material respects
- The signing officers are responsible for internal controls and have evaluated these internal controls within the previous ninety days and have reported on their findings
- A list of all deficiencies in the internal controls and information on any fraud that involves employees who are involved with internal activities
- Any significant changes in internal controls or related factors that could have a negative impact on the internal controls

Section 401 – Disclosures in Periodic Reports

Financial statements published by issuers are required to be accurate and presented in a manner that does not contain incorrect statements.

Section 404 – Management Assessment of Internal Controls

Issuers are required to publish information in their annual reports concerning the scope and adequacy of the internal control structure and procedures for financial reporting. This statement shall also assess the effectiveness of such internal controls and procedures. The registered accounting firm shall, in the same report, attest to and report on the assessment on the effectiveness of the internal control structure and procedures for financial reporting.

Section 409 - Real Time Issuer Disclosures

Issuers are required to disclose to the public, on an urgent basis, information on material changes in their financial condition or operations.

Sections 802 and 809 – civil and criminal penalties for altering, destroying or misplacing documents and certifying to false and/or misleading documents.
Internal Audit Department Charter

I. Mission
Example Bank’s Internal Audit Department ("Internal Audit") is an independent and objective assurance and consulting activity designed to add value to the operations of Example Bank, its subsidiaries and its holding company, Example Corporation (collectively, “Example”). Internal Audit’s primary mission is to provide reasonable assurance to Example’s Board of Directors (the “Board”) and Management with regard to Example’s achievement of its objectives that pertain to:

- The effectiveness and efficiency of the organization’s operations, including operational and financial performance goals, and safeguarding of assets against loss;
- Internal and external financial and non-financial reporting, and may encompass reliability, timeliness, transparency, or other terms as set forth by regulators, standard setters or the organization’s policies; and
- The adherence to laws and regulations to which the organization is subject.

Internal Audit helps Example accomplish its objectives through a systematic and disciplined approach to evaluate and improve the effectiveness of its governance, risk management and controls (collectively, “internal control”).

II. Scope of Work
Assurance activity involves Internal Audit’s impartial assessment of evidence to provide an independent opinion or conclusion on the presence and function of Example’s system of internal control as designed and represented by Management. Consulting activity is advisory in nature and shall only be provided by Internal Audit at the specific request of the Board or Management, and where Internal Audit can maintain its objectivity and be consistent with its responsibility and authority. Internal Audit also serves as a knowledge resource for Example Corporation’s other wholly-owned banking subsidiary, Islanders Bank, and its internal audit function.

III. Independence and Objectivity
Internal Audit is established by the Board to effect the program for monitoring Example’s systems of internal control. To provide for the independence and objectivity of Internal Audit, its personnel shall report to the Director of Internal Audit, who will report functionally to the Board’s Audit Committee and administratively to Example Bank’s Chief Executive Officer. As needed, Internal Audit will update the Audit Committee on the independence of its activities and any unwarranted restrictions on scope, communications, access, or resources.

IV. Responsibility and Accountability
All Internal Audit personnel shall govern themselves by The Institute of Internal Auditors’ (the “IIA’s”) Code of Ethics. Also, Internal Audit’s responsibility and accountability to the Audit Committee and other stakeholders is set forth in the principles-based guidance of the IIA’s International Standards for the Professional Practice of Internal Auditing (the “Standards”). In carrying out its work under the Standards, Internal Audit will also leverage the IIA’s recommended guidance provided through its Practice Advisories, Position Papers, and Practice Guides, and adhere to Example policies and procedures, as applicable.
The Code of Ethics, Standards and the IIA’s recommended guidance are the components of the IIA’s International Professional Practices Framework (the “Framework”). Internal Audit will use the Framework in conducting both assurance and consulting activity – the Framework constitutes the operating guides and procedures for Internal Audit. Reports issued by Internal Audit will not reference the Framework or any component thereof, though Internal Audit shall address material deviations from such in its reports when applicable.

While the IIA designed the Framework as a coherent yet fluid system to facilitate consistent development, interpretation and application of concepts, methodologies and techniques useful to the discipline and profession of internal auditing, Internal Audit is not to construe information contained in the Framework in a manner that conflicts with applicable laws or regulations.

V. Authority
While the Standards outline the general rights granted Internal Audit by the Audit Committee, Internal Audit is specifically authorized by the Audit Committee to:

☐ Have unrestricted access to any and all records, physical properties and personnel of Example relevant to any function under review.
☐ Have full and free access to the Chairman of the Board and the Audit Committee.
☐ Without encumbrance, allocate resources, set frequencies, select subjects, determine scopes of work and apply the techniques required to accomplish its purpose under the Audit Committee’s oversight, unless otherwise directed by law or regulation.
☐ Obtain necessary assistance of personnel in units of Example where they perform audits, as well as other specialized services within or outside Example.

The Audit Committee does not authorize Internal Audit to:
☐ Perform any duties for Example inconsistent with its charge to provide assurance and consulting services.
☐ Initiate or approve accounting transactions external to Internal Audit.
☐ Direct the activities of any employee not part of Internal Audit, except to such extent management assigns an employee to an auditing team or to otherwise assist Internal Audit.
☐ Approve policy making decisions or the development of internal controls.
Internal Audit Department

Charter

- Mission
- Scope of Work
- Independence and Objectivity
- Responsibility and Accountability
- Authority
- Annual Review of Charter
- Adoption (by the Audit Committee)

Internal Audit Policy

- Purpose
- Internal Control
- Internal Auditing
- Internal Audit Program (risk-based and risk-focused)
- Annual Review of Policy
- Adoption (by Audit Committee)
BANNER CORPORATION
AUDIT COMMITTEE CHARTER

I. Statement of Purpose

The Audit Committee (“Audit Committee” or “Committee”) is a standing committee of the Board of Directors (“Board”) of Banner Corporation and subsidiaries (“Corporation”). The primary function of the Committee is to oversee the accounting and financial reporting processes of the Corporation and subsidiaries and the audits of the Corporation’s financial statements. In addition, the Audit Committee also assists the Board in fulfilling its oversight responsibilities relating to (a) the quality and integrity of financial reports and other financial information provided by the Corporation and the Corporation’s systems of internal accounting and financial controls; (b) the registered public accounting firm (“independent auditor”) and the evaluation of the independent auditor’s qualifications, independence and performance; (c) the performance of the Corporation’s internal audit function; (d) the compliance by the Corporation with legal and regulatory requirements, including disclosure, controls and procedures; and (e) the fulfillment of the other responsibilities set forth herein. The Committee shall also prepare the report of the Committee required to be included in the Corporation’s annual meeting proxy statement.

II. Composition

The Audit Committee shall consist of three or more directors as determined by the Board, each of whom shall be an independent director, and free from any relationships that, in the opinion of the Board, would interfere with the exercise of his or her independent judgment, as a member of the Committee. Members of the Committee shall be appointed and removed by action of the Board. All members of the Committee shall have a working familiarity with basic finance and accounting practices, including being able to read and understand fundamental financial statements, including the Corporation’s balance sheet, income statement and cash flow statement. Member independence, experience and financial expertise will be in conformance with rules established by the SEC, NASDAQ Stock Market, FDIC, PCAOB and the AICPA. The members of the Committee shall be elected by the Board at the annual organizational meeting of the Board and shall serve until their successors shall be duly elected and qualified. Unless a Chair is selected by the full Board, the members of the Committee may designate a Chair by majority vote of the full Committee membership.

III. Meetings

The Committee shall meet as often as it determines, but not less than four times per year. As part of its job to foster open communication, the Committee shall meet periodically with management, the head of internal audit and the independent auditor in separate executive session to discuss any matters that the Committee or each of these groups believes should be discussed privately. In addition, the Committee shall meet with the independent auditor and management quarterly to review the Corporation’s financial statements. The Committee may also meet separately with regulatory examiners.

A majority of the members of the Committee will constitute a quorum. Any act of a majority of the members present at any meeting at which a quorum is present shall be an act of the Committee.
An agenda and supporting materials shall be sent to members prior to each meeting. Minutes will be prepared to document the discharge of the Committee’s responsibilities. The Committee shall make regular reports to the Board of Directors.

IV. Authority

The Audit Committee is directly responsible for the appointment, compensation, retention, termination and oversight of the work of any registered public accounting firm engaged for the purpose of preparing or issuing an audit report or performing other audit, review or attest services for the Corporation, and each such registered accounting firm shall report directly to the Committee. The Audit Committee also has the authority to engage independent counsel and other advisers, as it determines necessary to carry out its duties. The Corporation will provide for appropriate funding, as determined by the Audit Committee, for payment of (1) compensation to any registered public accounting firm engaged for the purpose of preparing or issuing an audit report or performing other audit, review or attest services for the Corporation, (2) compensation to any advisers employed by the Audit Committee; and (3) ordinary administrative expenses of the Audit Committee.

V. Charter

At least annually, this charter will be reviewed and updated, as conditions dictate, with such changes submitted to the Board of Directors for approval.

VI. Responsibilities and Duties

To fulfill its responsibilities and duties, the Audit Committee shall:

**Independent Auditor**

1. Approve all audit engagement fees and terms and all non-audit engagements with the independent auditor. The Committee may delegate authority to pre-approve non-audit services to one or more members of the Committee. If this authority is delegated, all approved non-audit services will be presented to the Committee at its next scheduled meeting.

2. Ensure receipt directly from the independent auditor any and all reports and annually a formal written statement delineating all relationships between the auditor and the Corporation, consistent with Independence Standards Board Standard 1. On an annual basis, the Committee should review and discuss with the auditor any such relationships to determine the auditor’s independence and objectivity. The Committee should take appropriate action to oversee the independence of the auditor.

3. Not less than quarterly, consult with the independent auditor out of the presence of management about internal controls and the completeness and accuracy of the Corporation’s financial statements.

4. Ensure that the lead audit partner of the independent auditor and the audit partner responsible for reviewing the audit are rotated at least every five years or such shorter period as may be required by law, rule or regulation.
Financial Reporting Processes

5. Review and discuss with financial management and the independent auditor the financial statements, including disclosures made in Management’s Discussion and Analysis of Financial Condition and Results of Operations, in the Corporation’s reports on Forms 10-Q and 10-K and annual reports to shareholders prior to any such report’s filing with the SEC or prior to the release of earnings. The Committee shall determine whether or not the audited financial statements should be included in the Corporation’s Form 10-K.

6. Review and discuss with management and the independent auditor the Corporation’s quarterly financial statements prior to the filing of its Form 10-Q, including the results of the independent auditor’s review of the quarterly financial statements.

7. Discuss with management and the independent auditor significant financial reporting issues and judgments made in connection with the preparation of the Corporation’s financial statements, including any significant changes in the Corporation’s selection or application of accounting principles, any major issues as to the adequacy of the Corporation’s internal controls and any special steps adopted in light of material control deficiencies.

8. Review and discuss with management and the independent auditor any major issues as to the adequacy of the Corporation’s internal controls, any special steps adopted in light of material control deficiencies and the adequacy of disclosures about changes in internal control over financial reporting.

9. Review and discuss with management and the independent auditor the Corporation’s internal controls report and the independent auditor’s attestation of the report prior to the filing of the Corporation’s Form 10-K.

10. Review and discuss reports/presentations from the independent auditor on: All critical accounting policies and practices to be used.

   All alternative treatments of financial information within generally accepted accounting principles that have been discussed with management, ramifications of the use of such alternative disclosures and treatments, and the treatment preferred by the independent auditor.

   Other material written communication between the independent auditor and management, such as any management letter or schedule of unadjusted differences.

11. Review and discuss with management the Corporation’s earnings press releases, including the use of “pro forma” or “adjusted” non-GAAP information, as well as financial information and earnings guidance provided to analysts and rating agencies. Such review may be done generally (consisting of discussing the types of information to be disclosed and the types of presentations to be made) and the chair of the Committee may represent the entire Committee for the purposes of this review.

12. Discuss with management and the independent auditor the effect of regulatory and accounting initiatives as well as off-balance sheet structures on the Corporation’s financial statements.
13. In coordination and consultation with the Board-level Risk Committee, discuss with management the Corporation’s major financial risk exposures and the steps management has taken to monitor and control such exposures.

14. Discuss with the independent auditor the matters required to be discussed by AU Section 380 relating to the conduct of the audit, including any difficulties encountered in the course of the audit work, any restrictions on the scope of activities or access to requested information, and any significant disagreements with management.

15. Review disclosures made to the Audit Committee by the Corporation’s CEO and CFO during their certification process for the Form 10-K and Form 10-Q about any significant deficiencies in the design or operation of internal controls or material weaknesses therein and any fraud involving management or other employees who have a significant role in the Corporation’s internal controls.

16. Review the minutes of the Corporation’s Disclosure Committee and consider, when practicable, having a member of the Audit Committee attend such meetings.

17. Review the activities of and receive reports from the Compensation Committee to provide support and assurance of compliance with statutory requirements.

Internal Audit Function

18. Review and approve the Internal Audit charter annually.

19. Be responsible for recommendations to Management as to the appointment, annual review, compensation and replacement of the Director of Internal Audit.

20. Review the significant reports to management prepared by the internal auditing department and management’s responses.

21. Review and discuss with the independent auditor and management the internal audit department responsibilities, including approval of the annual internal audit plan and budget, adequacy of staffing and any recommended changes in the planned scope of the internal audit.

22. Ensure there are no unjustified restrictions or limitations on the internal audit function.

23. Review the effectiveness of the internal audit activity.

Compliance

24. Maintain procedures for the receipt, retention and treatment of complaints received by the Corporation regarding accounting, internal accounting controls or auditing matters and the confidential, anonymous submission by employee or others of concerns regarding questionable accounting and auditing matters.

25. Obtain from the independent auditor assurance that, if it detects or becomes aware of any illegal act, to assure that the Audit Committee is adequately informed and to provide a
report if the independent auditor has reached specified conclusions with respect to such illegal acts.

26. Obtain reports from management, the Director of Internal Audit, Senior Risk Management and Compliance Officer, Board-level Risk Committee and the independent auditor that the Corporation is in conformity with applicable legal requirements and the Corporation’s Code of Business Conduct and Ethics, which includes special ethics obligations for employees with financial reporting responsibilities. Advise the Board with respect to the Corporation’s policies and procedures regarding compliance with applicable laws and regulations and with the Corporation’s Code of Business Conduct and Ethics.

27. Ensure that the Corporation conducts on an ongoing basis an appropriate review of all related party transactions and that all such transactions are approved by the Audit Committee or the Board-level Risk Committee and to initiate any special investigations of conflicts of interest and compliance with federal, state, local and foreign laws and regulations, including the Foreign Corrupt Practices Act, as may be warranted.

28. Discuss with management and the independent auditor any correspondence with regulators or governmental agencies and any published reports which raise material issues regarding the Corporation’s financial statements or accounting policies.

29. Review the significant results of regulatory examinations of the Corporation related to the Corporation’s financial statements, internal controls or accounting policies.

30. Discuss with the Corporation’s Legal Counsel, when appropriate, legal matters that may have a material impact on the financial statements or the Corporation’s compliance policies.

Other

31. The Audit Committee shall, in a manner it deems appropriate, evaluate itself annually by comparing its performance with the requirements of the charter. The results shall be reported to the Board.

32. The Audit Committee shall approve all material services to be performed by experts and consultants in support of internal audit activities.

33. Discuss with management any second opinions sought from an accounting firm other than the Corporation's independent auditor, including the substance and reasons for seeking any such opinion.

34. Review the Corporation's policies and procedures for regular review of the expense accounts of the Corporation's executive management.

35. At its discretion, request that management, the independent auditor or the internal auditors undertake special projects or investigations which the Audit Committee deems necessary to fulfill its responsibilities.
36. Perform any other activities consistent with this Charter, the Corporation’s By-laws and governing law; as the Committee or Board deems necessary or appropriate.

VII. Limitations of Audit Committee's Roles

While the Committee has the responsibilities and powers set forth in this Audit Committee Charter, it is not the duty of the Committee to prepare financial statements, plan or conduct audits or to determine that the Corporation's financial statements and disclosures are complete and accurate and are in accordance with generally accepted accounting principles and applicable rules and regulations. These are the responsibilities of management and the independent auditor.