



Bank Control Quarterly

"Through understanding, your bank can better control its financial performance...."

Nichols, Cauley & Associates, LLC
Certified Public Accountants
www.bankaudit.net

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THE SARBANES-OXLEY ACT – WILL (OR DOES) IT APPLY TO YOUR BANK?

Because of their public trust, financial institutions have been and will continue to be government (both Federal and state) regulated entities. With the services they provide and their role in the local, state, and national economies and the financial services they provide to the small and middle market businesses (the life-blood of job growth and sustainment) the continued role of the regulatory bodies is expected.

Due to recent years' crises, in the financial markets, the SEC and the government have put into effect new rules that must be followed by SEC issuers – under legislation known as the Sarbanes-Oxley Act. The FDIC (see Financial Institution Newsletter – FIL-17-2003) subsequently followed up with rules that require certain non-SEC issuers (those financial institutions with assets >\$500 million) to abide by those rules and encouraged institutions with assets less than \$500 million to consider the rules.

In FIL 17-2003 the FDIC stated "certain provisions of the Sarbanes-Oxley Act mirror existing policy guidance related to corporate governance that the FDIC and the other banking agencies have issued. Other provisions of the Sarbanes-Oxley Act represent sound corporate governance practices".



(Continued on page 2)

COSO – Internal Control Integrated Framework

COSO defines five interrelated components of internal control:

- the control environment,
- risk assessment,
- control activities,
- information and communication,
- and monitoring.

The **Control Environment** is sometimes described as the "conscience" of an organization. This concept refers to the business environment in which individuals with differing responsibilities conduct an organization's business and comply with their internal control obligations.

Risk Assessment requires the identification, assessment and review of relevant risks that an organization does or might face. Organizations will be required, after identifying the relevant risks, to determine if sufficient controls apply to particular risk areas and to correct any inadequate controls.

In this issue of *Bank Control Quarterly*, we will examine the **Control Environment** and **Risk Assessment** components of the COSO framework. We will overview the other components in future issues.

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Where Do We Go From Here?

Sarbanes-Oxley, Section 404, COSO, PCAOB, SEC, Auditing Standard No. 2 – If you are an SEC registrant you probably cuss and cringe at those words. You are thinking "What benefit am I getting out of all this?"; "Its going to cost how much?" and "Because you are my external auditor I can't even ask your opinion!"

If you are a non-SEC bank you are thinking "I don't know what all the fuss is about" or "Thank goodness it's them and not us." However, be careful, what goes around comes around or in the Banking industry trickles down. Remember what they are going through now you will probably go through later.

So, where do we go from here? In my opinion we go back to the common sense way of auditing. The way we have audited since our inception and that is "Risk Based Auditing."

The Risk Based Audit, which focuses on both recorded and unrecorded risk, was designed to improve financial statement assurance and the financial statement reporting process. The Risk Based Audit focuses on business risk and the processes for controlling those risks. Under this common sense approach, the higher the risk area, the more audit time and client controls are required.

WorldCom, Enron and Sarbanes-Oxley changed financial reporting forever and "Risk Based Audit" seemed to be taboo. Back were the days of detailed substantive audit procedures on every financial state-

Risk Based Auditing (Continued on page 5)



Who Are We?

Nichols, Cauley & Associates, LLC is a premier provider of audit and related services for financial institutions. Our team of Certified Public Accountants, Certified Internal Auditors, Certified Valuation Analysts, Certified Financial Planners® and Business and Financial Advisors can assist Financial Institutions with audit and other related issues and questions.

One of the purposes of our newsletter is to exchange information with you in matters that may be beneficial to your financial institution. In this edition and future editions we will include topics that address questions being asked by our financial institution clients.

Should you have questions or comments concerning this newsletter or wish to have a topic covered in future editions please email us at info@bankaudit.com or call us at 800-823-0117. Please visit our websites at www.nicholscauley.com or www.BankAudit.net to learn more about Nichols Cauley and the services we offer.

Sarbanes-Oxley Act (Continued from page 1)

Several state Departments of Banking and Finance are reviewing these rules and are considering some actions that will require or encourage certain regulations of the Sarbanes-Oxley Act to be followed.

One of the most significant and talked about sections of the Sarbanes-Oxley Act is Section 404 – “Management Assessment of Internal Control”. Large financial institutions that are SEC issuers have already been required to implement Section 404 with the remainder being required to implement and report at December 31, 2006.

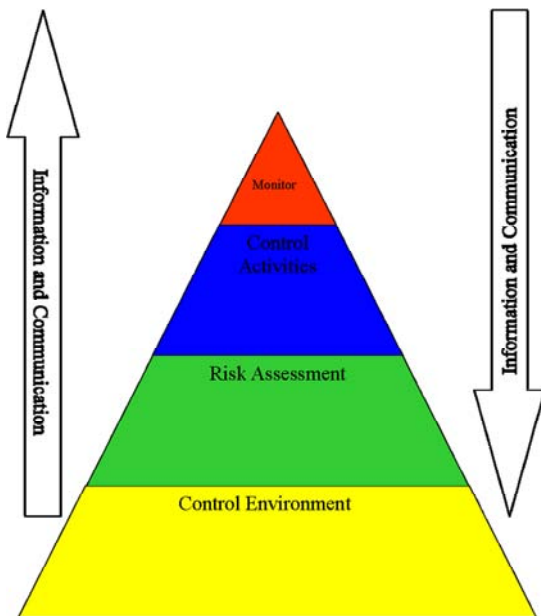
Under Section 404 there are many requirements that must be followed on both an annual and quarterly basis. Preparation time for all issuers is extensive and a top-down look at the control environment in which the entity operates is required.

From our prospective, the immediate benefit of the Sarbanes-Oxley Act and specifically Section 404 is the heightened awareness of internal controls – not only for SEC issuers but also for nonpublic entities. A properly functioning internal control environment will strengthen the quality of the financial information provided to management and the board of directors for making business decisions.

Is compliance with Section 404 of the Sarbanes-Oxley Act going to meet its objective? Will the Act or certain sections be modified? Will there be a “trickle down” effect to other entities and non-SEC issuers? Will regulated entities that are non-SEC issuers be required (rather than encouraged) to follow the Act or certain sections of the Act?

These are questions which remain to be answered at this time.

COSO (Continued from page 1)



Five Components of Internal Control

- Organizational structure
- Delegation or assignment of responsibilities
- Commitment to Competence

Material deficiencies in the control environment are hard to overcome with entity or activity level controls.

Risk Assessment – Your Objectives and the Risk of Achieving or Not Achieving those Objectives

Risk assessment first begins with management determining the specific business objectives at the entity level and the business process level. Once those objectives are established the risk associated with achieving or not achieving those objectives is established. Risk is assessed by management by considering the consequences of the risk and the likelihood of the specifically identified risk occurring. Areas with increased risk in your financial institution may include business processes that require an estimate (such as allowance for loan losses), a financial statement line item that is material or could be material to the overall financial condition of your bank, areas with limited segregation of duties, etc.

To assess where your bank is at in the COSO – Internal Control Integrated Framework you must consider all components and realize that a “cookie cutter” approach will not work in all areas of your bank. If, based on your initial assessment, you are deficient in or have not considered certain of the components we would encourage you to take actions to strengthen the component.

Control Environment – The Foundation of Internal Controls

The control environment is often referred to as “The tone at the Top”. The control environment is initially set when the organization is formed and it sets the foundation for all other controls. The following is an example of what is included in the control environment:

- The vision and values of the entity as **communicated** (verbally and non-verbally) by the board of directors and management.
- Integrity, ethical values and management philosophy.
- Operating style of the board of directors and management.
- Personnel and Human Resource policies and strategies.

If your bank has an adequate internal control structure you should consider:

- Are you adequately monitoring your control activities to determine the effectiveness of your internal controls?
- Have you considered the business objectives and assessed the risk associated with those objectives?
- Are you communicating effectively to your employees and colleagues their role in the internal control structure?
- Are you educating your employees on why controls are important and what are some of the controls that are applicable to your bank?

Audit Risk Alert—Tool for Audit Concerns

The Bank, Credit Union, and Other Depository and Lending Institution Industry Developments – 2004/05 – Audit Risk Alert provides a valuable tool for banking management to address areas of audit concern. This paperback booklet issued by the AICPA helps to identify significant business risks that may be incurred and provides information about emerging practice issues and current accounting, auditing and regulatory developments.

The Alert includes information on:

- Current Industry and Economic Auditing Considerations
- Mortgage-Backed Securities and Related Products
- Credit Quality and the Variable Rate Receivable
- Loan Commitment Issues
- Purchasing Loans Under SOP 03-3
- Credit Loss Allowance Update
- FASB No 140 Loan Participations and Amendment topic – Mind Your Qs and SPEs
- Fraud, Errors and Illegal Acts
- Regulatory Highlights
- Check 21 – It’s Finally Here
- XBRL Developments
- Deferred Compensation Arrangements

- The Home Mortgage Disclosure Act Update
- The SEC’s Regulation B
- New Accounting pronouncements and Other Guidance

To order the Audit Risk Alert call 888-777-7077 or visit the AICPA store at www.aicpa.org.

New Team Members



Hillary Smith is a native of Warner Robins, GA. She graduated from Houston County High School and is attending Macon State College majoring in Business Finance. She is the Office Assistant for Nichols, Cauley Financial Services, LLC.

Leslie Nichols is from Warner Robins, Georgia. She is attending the University of Georgia and is pursuing a degree in accounting. Leslie is interning in the Warner Robins office.



“Everyday management and Boards of Directors are faced with decisions that will affect the profitability of their bank. Risks are in every segment of a bank's operations. A bank takes risk everyday in its loan portfolio. However, one area that a bank should minimize risk is in its interest rate exposure. You can always have an opinion about which way rates are moving and when - but you never know. Don't risk the bank on this bet.”

- Chris Milton, CPA, CIA, CGAP



The buzz from our financial institutions clients (SEC and non-SEC issuers) is the applicability of a risk assessment model and its uses in developing control activities and aiding in the timing and depth of their monitoring procedures. Financial institution and other businesses understand specific control activities (due to regulations) but are looking for ways to score risk from both an overall basis and specific risk of each transaction cycle or specific account. Risk assessment involves many terms that are familiar and not so familiar to our clients. The FDIC, AICPA, SEC and other regulatory bodies provide definitions and information on various types of risks and their specific applicability to entities.

A risk assessment model for one financial institution will not be the same as other institutions due to differences in the geographical areas of operations, types of customers served, sources of funds and personnel. Overall your risk assessment model should be tailored to your financial institution and should be used in or considered in (not all inclusive):

- Developing control activities - whether board approved policies or management directives.
- Training and retraining efforts of employees.
- Potential changes in your operating structure, environment or products.
- Monitoring aspects of your specific control activities including your scope and timing.

- William C. Sammons, CPA, CFP®



“This past year has been one of change, learning and frustration for many of us in the Banking industry. It does not matter if you are a banker, attorney, certified public accountant or consultant the burden of regulations and standards continues to increase and the cost of compliance taxes the human resources and financial resources of us all. However, I have observed that the vast majority of the folks I work with have managed the change and have continued to provide excellent service to their customers and clients. When our team members are given the opportunity to choose the industry they wish to be a part of

the banking industry is always at the top. This is a testament of the quality of folks working in this industry and I am glad to be a part of the banking industry team.

The audit committee is rapidly becoming one of the most important and time consuming committees that a bank director can serve on. The audit committee duties continue to expand as the committee is expected to become more and more responsible for the financial reporting activities of the Bank. An excellent tool for understanding the duties of the audit committee is the AICPA Audit Committee TOOLKIT. I would suggest that if you serve on the audit committee of your bank you should visit the AICPA website <http://www.aicpa.org/audcommctr/homepage.htm> for a copy.”

- Marlan Nichols, CPA, CVA, CFP®

All in the Family



- Alex Nichols, son of Marlan – WR, & Jonathan Bagley placed 2nd at State Competition for FBLA in Atlanta for Multimedia Presentation.
- Alex and the Odyssey of the Mind team placed 1st in state competition and 16th in World Competition.
- Janie Nichols, wife of Marlan—WR, received an award for Adviser of the Year.
- Brittany Carruolo & Olivia Monroe, both in WR, graduated from Houston County High School on May 28.
- Shaun & Angie Kahrman, Dublin, will be celebrating their 8th wedding anniversary June 21.
- William & Holly Sammons, Atlanta, and Eddie & Jennifer Kramer, Dublin, are expecting babies later this year.
- Courtney Kitchens, daughter of Kenny Kitchens WR was salutatorian of her Senior class at Central Fellowship Christian Academy on May 20th. She will be attending UGA in the fall.
- Jason Nichols, son of Farrell—Dublin, graduated from Carlbrook School in Virginia May 21st and plans to attend Shorter College this Fall.
- Carole Goins, Dublin, will be installed as President of the Pilot Club of Dublin in June.
- Alaina Crow, WR, graduated Summa Cum Laude from Mercer University with a Bachelor of Business Administration in Accounting and Finance on May 14.

Team Member Anniversaries at Nichols Cauley during 2nd quarter 2005

Name	# Years	Name	# Years
Holly Collins	3	Lewis Sheffield	2
Bernice Reaves	9	Tim Veal	17

“Financial Institutions and businesses in general are at the pinnacle of a dramatic shift in the manner corporate governance, ethics, risk management, risk assessment, and compliance are viewed. Integrity driven performance is a fundamental component of this shift. The Sarbanes-Oxley Act has established new guidelines that have become accepted standards throughout the business world. Many companies have taken “quick-fix” approaches to compliance with the Act. This approach may save money in the short run, but could prove disastrous in the long run. A proper and cost effective approach must involve automated, streamlined, and secure processes. Nichols, Cauley can not only help you with compliance with the Act, but can also help your company add value as well.”



- Todd Giddens, CPA

AICPA National Banking School

Six of our team members recently attended the 2005 AICPA National Banking School. The course is a perfect blend of technical and practical applications that are invaluable to practicing accountants and bankers. The speakers were all knowledgeable, and their topics were very applicable to the current banking industry and operating environment.

The banking simulation gives a “hands on” experience in running a bank. Through the simulation one learns “by experience” how all the departments of a bank are interrelated and work together. I am a former bank director and served on the executive committee of a small locally owned bank for over 15 years. The simulation is as close to real world banking as you can get without being there. The simulation is a tremendous learning tool. I highly recommend it for bankers of all experience levels.

Running a bank is a team effort. Each simulation bank has a 5 person management team. In order to succeed, your management team must function effectively. Indirectly, the simulation brought home the point that the most important asset in a bank and in any other organization is human capital- *your employees*.

- Todd Giddens, CPA

Risk Based Auditing *(Continued from page 1)*

ment line regardless of the risk or materiality. Also back were large auditing fees with very little perceived value received by the Bank.

There was the impression that auditors under Section 404 and the new PCAOB Auditing Standards No. 2 should apply the provision of the standard in a rigid manner that discourages the use of judgment in the audit.

The Securities and Exchange Commission (SEC) and the Public Company Accounting Oversight Board (PCAOB or Board) however, have been listening and on April 13, 2005, the SEC hosted a Roundtable on Implementation of the Internal Control Reporting Provisions. The roundtable participants expressed concerns about the compliance costs of 404 and offered comments on how the implementation process can be improved.

In response to the April 13, 2005 roundtable the PCAOB issued the staff questions and answers dated May 16, 2005 which is available at www.pcaobus.org. In addition in a simultaneous press release dated May 16, 2005 the SEC issued its response to the roundtable which is available at www.sec.gov/news/press/2005-74.htm.

Key excerpts of the PCAOB and SEC's responses follow:

PCAOB response:

"The Policy Statement expresses the Board's view that, to properly plan and perform an effective audit under Auditing Standard No. 2, auditors should –

- **integrate** their audits of internal control with their audits of the client's financial statements, so that evidence gathered and tests conducted in the context of either audit contribute to completion of both audits;
- **exercise judgment** to tailor their audit plans to the risks facing individual audit clients, instead of using standardized "checklists" that may not reflect an allocation of audit work weighted toward high-risk areas (and weighted against unnecessary audit focus in low-risk areas);
- use a **top-down approach** that begins with company-level controls, to identify for further testing only those accounts and processes that are, in fact, relevant to internal control over financial reporting, and use the risk assessment required by the standard to eliminate from further consideration those accounts that have only a remote likelihood of containing a material misstatement;
- take advantage of the significant **flexibility** that the standard allows to use the work of others; and
- engage in **direct and timely communication** with audit clients when those clients seek auditors' views on accounting or internal control issues before those clients make their own decisions on such issues, implement internal control processes under consideration, or finalize financial reports."

This guidance clarifies the PCAOB's position and allows the Top-down approach sequence in which the auditor focuses early in the process on matters, such as company-level controls, that can have an effect on the auditor's later decisions about scope and testing strategy. This approach also helps the auditor to identify and eliminate from further consideration accounts, disclosures, and assertions that have only a remote likelihood of containing misstatements that could cause the financial statements to be materially misstated.

SEC Response:

"We wish to make clear that these actions are not the end of the process. The Commission staff will continue to monitor the implementation of the internal control reporting requirements, particularly for smaller public com-

panies and foreign private issuers. In addition, because of the importance we place on effective and efficient implementation of Section 404, we believe the following broad concepts bear mention at this time.

- Although it is not surprising that first-year implementation of Section 404 was challenging, almost all of the significant complaints we heard related not to the Sarbanes-Oxley Act or to the rules and auditing standards implementing Section 404, but rather to a mechanical, and even overly cautious, way in which those rules and standards apparently have been applied in many cases. Both management and external auditors must bring reasoned judgment and a top-down, risk-based approach to the 404 compliance process. A one-size fits all, bottom-up, check-the-box approach that treats all controls equally is less likely to improve internal controls and financial reporting than reasoned, good faith exercise of professional judgment focused on reasonable, as opposed to absolute, assurance.
- In future years we expect the internal control audit to be better integrated with the audit of a company's financial statements. If management and auditors can achieve the goal of integrating the two audits, we expect that both internal and external costs of Section 404 compliance will fall for most companies.
- Internal controls over financial reporting should reflect the nature and size of the company to which they relate. Particular attention should be paid to making sure that implementation of Section 404 is appropriately tailored to the operations of smaller companies. Again, this is an area where reasoned judgment and a risk-based approach must be brought to bear. We continue to be actively engaged in projects to evaluate and assess the effects of the internal control reporting rules on smaller companies. In addition to delaying the implementation of those rules for smaller companies, we have encouraged the Committee of Sponsoring Organizations (COSO) of the Treadway Commission to develop additional guidance in applying its internal control framework to smaller companies. We have established the Commission Advisory Committee on Smaller Public Companies to consider the impact of Commission rules - including the internal control reporting rules - on smaller companies.
- We encourage frequent and frank dialogue among management, auditors and audit committees with the goal of improving internal controls and the financial reports upon which investors rely. Management of all companies - large and small - should not fear that a discussion of internal controls with, or a request for assistance or clarification from, the auditor will, itself, be deemed a deficiency in internal control. Moreover, as long as management determines the accounting to be used and does not rely on the auditor to design or implement the controls, we do not believe that the auditor's providing advice or assistance, in itself, constitutes a violation of our independence rules. Both common sense and sound policy dictate that communications must be ongoing and open in order to create the best environment for producing high quality financial reporting and auditing; communications must not be so restricted or formalized that their value is lost.

The entire financial reporting community, including investors, auditors, management, and regulators, shares the common goal of improving the reliability of financial reporting and the information available to the market. With the experience of the first round of Section 404 implementation, we should continue to focus on the lessons learned and ways to improve the process going forward. Section 404 is too important not to get right, but getting it right requires both effective and efficient implementation."

Section 404 is not going away and will probably be required even in non-SEC Banks. For example Alabama is moving in this direction with some of its banking legislation. Where are we going from here – we are going to a "Risk Based Audit" which addresses business risk.

Please visit www.pcaobus.org for the detailed guidance issued by the PCAOB.

Please visit www.sec.gov/news/press/2005-74.htm for detailed guidance issued by the SEC.



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"Like it or not, the Sarbanes-Oxley Act of 2002 is serious stuff. As this publication goes to press, a jury in Alabama is deliberating the fate of Richard Scrushy, former CEO of Health-South Corp. While Scrushy faces numerous charges, one charge falls under the Sarbanes-Oxley Act of 2002. The charge relates to Scrushy's sign-off on an allegedly false financial statement. This trial marks the first time a chief executive officer has been tried under the Sarbanes-Oxley Act of 2002."

- Cal Brantley, CPA, CVA, CFP®

"With the changes in today's financial and regulatory environment every Bank should have ongoing education for its Directors. On July 15 and 16th, I will be teaching 2 sections at the Community Bankers Association of Georgia's Director's College on "Audit Committee Structure and Responsibility" and "Audit Risk Management". Please consider enhancing your Director's bank knowledge with educational courses through your Banking Associations or with in-house training. We have begun on-going education and training at some of our Bank client's audit committee meetings with positive feedback from management and the Board members. The TONE AT THE TOP is critical in the success of today's financial institution."

- Tim Veal, CPA, CFP®



Seminars

Our Firm will be offering a series of QuickBooks courses and other seminars such as Budgeting in a Strategic Environment. The courses will be offered in Atlanta, Warner Robins and Dublin. These courses may be desired by your customers. If you would like additional information on these courses for employees or customers of your bank please contact us at info@bankaudit.net or 800-823-0117. These courses can be offered at other locations upon request. A schedule of courses can be obtained at www.BankAudit.net.