



Achieving the New Independence Standards for Directors Committees

By Len Filppu

Tough new Sarbanes-Oxley and corporate governance guidelines have forced bank directors to face higher standards of independence, responsibility and liability as applied to their oversight of traditional bank activities. Standard bank committees such as the Directors Audit Committee, the Directors Loan Committee and the Asset Liability Committee are now under increased and sometimes intense scrutiny from regulatory review. But as the bar of oversight independence rises, so does the confusion about how bank directors are to meet the new challenges.

Most banks and bankers are facing the daunting challenge of interpreting the Sarbanes-Oxley and new corporate governance mandates for the first time. The good news is that because banks have always operated in a highly regulated environment, these new guidelines are fairly easy to meet. The bad news is that everyone is wandering around in uncharted terrain, uncertain of what steps to take, and uncomfortably at the mercy of regulatory interpretation that does not yet have an adequate track record.

In this inexact environment, it is critical that banks meet the *spirit* of Sarbanes-Oxley and corporate governance guidelines. Committee directors must make the effort to evaluate their own bank's unique situation, determine a roadmap that promotes policies of greater independent oversight based upon the new guidelines, and then implement concrete forward steps toward the goal.

As an example, since the Directors Audit Committee has felt significant impact from Sarbanes-Oxley and corporate governance issues, let's examine the changing nature of its oversight of the internal audit function. A seasoned interpretive analysis of the tough new regulatory environment suggests that the Directors Audit Committee must pay attention to the following issues regarding internal auditors (in-house or outsourced):

- Steps must be taken to ensure that internal auditors are truly independent of management
- The Audit Committee should review the salaries, contracts and performance of internal auditors
- The Audit Committee should provide the internal auditors full protection from undue management influence
- Only the Audit Committee should be able to hire and fire internal auditors
- Internal auditors should have a direct line reporting structure to the Audit Committee
- The Audit Committee should retain its own legal counsel, independent of the bank's legal counsel.

Most banks have these standards in their audit committee policy, but frankly, few meet these standards in practice. Implementation is a tall order that may require considerable time, expense and institutional change. Let's look at a few practical steps in the spirit of the new guidelines that some bank Directors Audit Committees have taken to strengthen the independence of their oversight of the internal audit function. For example, the Audit Committee:

- Attends a workshop to learn its new responsibilities

- Updates its charter annually to reflect the new policies
- Installs its own thorough, in-depth internal audit program implementing industry standard methodologies
- Ensures that the internal audit program is risk based and covers all major banking functions
- Reviews annually its own performance
- Provides regular private sessions with the internal audit group without management present
- Gives regular and sufficient time to the internal auditor at each Audit Committee meeting to discuss relevant issues
- Invites bank management to committee meetings but does not allow management to participate in the decision making process
- Separates internal audit work from CPA work
- Ensures separation of the internal audit function from operational duties. For example, makes sure the bank's network integrator does not also perform IT audit work.

Good corporate governance is an ongoing journey, not a destination. There is always work to be done, improvements to make, and new regulatory interpretations to consider. The important thing to remember is that bank directors must now take action to get ahead of the curve and begin developing, documenting and implementing processes and procedures that ensure greater independence of oversight within the spirit of the new regulatory guidelines. Perfection may never be attained, but qualitative progress is achievable, step by practical step.

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