



# Successful Bank Secrecy Act/Anti-Money Laundering Internal Audits

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## SUMMARY

Independent reviews or audits of a BSA/AML program are one of the “four pillars” of compliance. The emphasis regulators placed upon conducting a thorough and rigorous self-audit should not be under-estimated. A proper audit ensures management is aware of a program’s weaknesses and thus prioritizes where corrective efforts should focus and also avoids harsh criticism from the regulators. This paper provides guidance for designing and executing an effective BSA/AML independent audit.

## ABOUT THE AUTHOR

David Caruso, CEO of the Dominion Advisory Group, has more than 15 years of experience creating and implementing comprehensive Anti-Money Laundering (AML) programs. As CEO, David is responsible for providing strategic leadership and industry expertise to ensure clients receive the best possible solution for regulatory compliance issues.

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Every major AML/BSA enforcement action over the past several years required the offending institution to dramatically increase its independent testing or internal audit performance.<sup>1</sup> In some cases regulators have such little faith in the capabilities of the sanctioned institution to perform an audit; they have ordered the institution to retain an outside audit firm.

Effective internal audits are paramount to the success of an AML/BSA program for several reasons. First, they are relied upon by regulators to assist them in their examination. Second, they are often senior management’s only form of information about the adequacy of compliance.

### Examiner’s Use of Internal Audit Reports

Early in an examination, regulators assess an internal audit’s thoroughness and findings, as well as how effectively it tracks management’s corrective action to determine whether they, the examiners, can rely upon the audit group’s results to better scope their work.

For instance, if an examiner concludes an independent audit is effective, they will place some level of reliance on it, and then, they will determine which lines of business, products, and services on which their examination will focus. If the examiner is unable to rely upon the independent audit, then they will have to broaden their scope of review and expand their depth of testing. In other words, a weak internal audit program will mean a lengthier and more detailed regulatory examination conducted by examiners whose first impression of an institution’s AML/BSA compliance program is negative.

### Management’s Use of Internal Audit Reports

Internal audits are vital because, if done properly, they will inform senior management, compliance, the lines of

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<sup>1</sup> The terms “internal audit” and “independent testing,” for the purposes of this paper are synonymous. Some institutions have employees of their internal audit or risk management departments conduct the “independent test” of the BSA program. Other institutions hire outside firms to conduct this work. The FFIEC guidance has been clear that either course is acceptable as long as the audit or testing program is sound.

business and the board of directors of AML/BSA program weaknesses. If management and the board are unaware of deficiencies they are then unable to devote resources necessary to develop and implement correction action to remedy problems.

The weakening of an AML/BSA program can occur rapidly and deterioration is sometimes irreversible without intervention from a regulator. Because so much of AML/BSA compliance is dependent upon day-to-day *operational* tasks being done correctly, (i.e. opening accounts, obtaining customer information, recording customer details for funds transfer or monetary instrument purchases, monitoring transactions, performing investigations, filing SARs etc.) when those tasks fail to be executed properly, the results may produce thousands of compliance exceptions. The increasing numbers of daily failures can be overwhelming. If an audit does not identify these systematic weaknesses and a regulator does, the outcome is almost certain, and unwelcome.

There are eight elements needed for an institution to consistently perform effective internal audits:

1. Comprehensive enterprise AML/BSA risk assessment
2. A properly scoped and document audit plan
3. Determination of the adequacy of a program's written policies and procedures
4. Detailed risk based testing of AML business processes
5. Thorough work paper documentation
6. Proper written and oral reporting of audit results to management and the board of directors
7. Effective tracking and testing of management's corrective actions
8. Hiring the right people with the right skills and experience

## 1. Risk Assessment

Effective planning for internal audits must begin with a review of an institution's AML/BSA risk assessment as called for in the FFIEC Manual. Effective assessments identify and document products, services, customers and geographic locations of customers or bank operations that present a higher risk for money laundering and terrorist financing. This assessment is the foundation of a solid, risk based, audit plan.

If the institution being audited has not conducted an AML/BSA Risk Assessment than, in one regard the auditor's job is easy; the bank fails the audit. Simply put, not having a risk assessment means there is no verifiable way an institution can substantiate its AML compliance program is "risk based."

## 2. Audit Plan

The auditors should use the risk assessment to scope their review by focusing on those products, services, customers and geographies that pose a greater AML/BSA risk - this is what the examiners will do as they scope their work and it is what they would expect an internal audit group to do. This is not to suggest that the only elements of an AML program to be tested are those that present greater than normal risk for AML compliance, but certainly more attention should be focused on those areas where failure's impact could be severe.

An internal audit group should draft a written audit plan defining the policies, procedures and operational processes to be reviewed and tested and the reasons supporting those decisions. Internal auditors should not meander from one business group to the next conducting cursory interviews of staff and performing high level reviews of policy. A defined and written audit plan is necessary and should be presented to an executive management risk committee for review and an audit committee of a board of directors for approval.

The involvement of executive management and the Audit Committee are essential to an audit's success. One reason is simple – the examiners expect it. Regardless of that impetus however, in order for management and the Board to better understand the outcome of an audit, they need to understand its focus and plan prior to commencement. It should also be expected management and the Audit Committee will provide input as to areas they believe should be reviewed. This input may be based in whole or in part on comments made to them by regulators. (Often regulators tell senior management and the Board things they don't tell auditors or compliance officers).

### 3. BSA Policy/Procedure

Internal audits should review bank-wide AML/BSA policy and line of business and operational procedures to ensure each are tailored to the uniqueness of an institution and not so general that they cannot be tested later in the audit. It is important to also review procedures to make sure each contains descriptive language that lists the series of detailed steps or actions that are orderly followed so that AML/BSA policy can be executed. It should be understood that AML/BSA policy and AML/BSA procedures serve two different purposes.

A policy is specific statements of principals or guiding actions that imply clear commitment by an institution. It is a statement of values or intent that provides a basis for consistent decision-making and resource allocation. The foundation of each of the AML/BSA policies is the regulation and laws of the U.S., in this case the BSA and USA PATRIOT Act and regulations administered by the Office of Foreign Assets Control. Policies have widespread application, they change infrequently and contain statements that answer the "what" and/or "why" of a compliance program. For example, a High Risk Policy may state, "Money Service Businesses are high risk because they may often engage in international remittance activity to countries on the FATF NCCT list."

Procedures on the other hand, have a more narrow application, are prone to change more frequently, contain detailed statements that answer the "how," "when," and "who" of a compliance program. Procedures should be viewed as documents that would sit on the desk (or desktop) of someone responsible for executing an AML/BSA compliance function such as a monitoring unit charged with the responsibility to identify MSBs. The procedures should be a set of instructions to tell the user very specifically how to do something, such as, in this case, review wire transfer records to identify incoming or outgoing wires to FATF NCCT countries on behalf of a customer. The procedures may also provide specific steps to follow to identify MSBs through the analysis of cash out activity (i.e. a procedure may tell an analyst to examine cash out activity exceeding \$10,000 each Thursday as a means to identify potential check cashers unknown to the bank).

Procedures should be written in enough detail that if those performing the functions were to leave the bank, the new staff could immediately conduct the responsibilities for which they are now charged – as haphazard as that may be until they are accustomed to their new position. This is not too much to ask for in a procedure, although very few are maintained with such detail.

### 4. Testing of Processes and Controls

Audits need to also focus on detailed testing of the operational processes and controls that are the foundation of AML/BSA program. Often internal audits consist of reviewing policy and procedures and conducting "walk-throughs." Of course it remains important to validate that the written policies and procedures are commensurate with managing risks presented by an institution's products, services, customers and locations of operations, but detailed testing is necessary to determine true compliance.

For example, within the process of account opening, an audit should review and test compliance with Customer Identification Program requirements, due diligence and enhanced due diligence requirements and customer risk rating requirements. The only way to do this is to sample customer records to determine if the processes required

by the AML/BSA program were followed. It would be prudent to sample records of customers who present a higher risk for money laundering and terrorist financing – one more reason why it is so important to have a proper risk assessment prior to starting an audit.

Another example of testing would be to select AML investigation files to determine if they contain written explanations supporting the institution's decision on whether or not to file a SAR and to determine if the investigation files provide documented evidence to support that decision. Simply reading a procedure on how an institution is supposed to conduct an investigation and comparing it to the FFIEC Manual is insufficient; testing is needed. In fact, this is the most important test an auditor can conduct. If an institution cannot properly investigate, document its findings and file SARs accurately and timely, its AML program is a failure. An audit that does not devote significant time to this cannot be considered effective.

The testing of controls designed to ensure effective AML/BSA compliance procedures is as vital as transaction testing. All well written and well executed procedures should have controls in place to ensure the actions called for by the procedure are carried out as required. For example, a procedure may require all branches to record each monetary instrument sale greater than \$3,000 on a log and submit that log to a monitoring unit weekly. As part of the internal audit, an auditor should obtain a copy of a month's worth of monetary instrument sales records from the bank's management information system and then select a sample of those exceeding \$3,000 and compare them to the branch logs to ensure they were recorded as required by procedure. Without this level of testing, the level of compliance with the institution's policies and procedures will be unknown.

## 5. Work Paper Documentation

It is essential that there be proper documentation of each audit task, the findings resulting from those tasks, and the evidence needed to support conclusions of an auditor. It is these work papers that an examiner will review to determine the adequacy of the audit. If the work papers are incomplete, not in order, or call into question the thoroughness of an audit it is likely an examiner will find fault with the independent review process. Besides being demonstrative of sloppy work, incomplete audit work papers are likely to lead to an incomplete audit report and prevent management from fully understanding the deficiencies of the compliance program.

Internal Audit departments staffed with experience staff do not often have documentation weaknesses. Unfortunately it is when institutions outsource testing or auditing to consulting firms that documentation failure are most pronounced. There are several reasons for this.

First, many consulting firms do not staff AML audits with people schooled in audits. As silly as this sounds, many consulting firm use what they call "subject matter experts" to conduct audits and many of these people have backgrounds far removed from audit. While their "expertise" may be useful they often do not understand the rigor in which their work much be documented.

Second, as a way to reduce fees, consulting firms often do not budget enough time for documentation requirements. They assume they can document as they go along, but the reality is that documenting findings as "you go along" is only part of what is necessary to conduct a solid audit.

## 6. Management Reporting

The proper reporting of AML/BSA audit findings to management and a board of directors is imperative. Audit reports should reveal areas of weakness and provide sufficient detail as to why they are weak so that senior management, lines of business, compliance, and the board can make informed decisions about where to focus their collective time and efforts. Without proper reporting to these stakeholders, inadequacies identified in the audit will not be corrected, will then likely get worse and thus expose the institution to regulatory action.

Nothing irritates examiners more than poor management reporting and board oversight. Nothing irritates management and a board more than being told they have not been presented with full and complete information from their own staff. What then occurs is that the regulators lose confidence in a bank's management and board, in turn management and the board lose confidence in the auditors and a cycle begins where substantial effort must be invested to correct such a situation (i.e. a lot of time focused repairing something that should have broken in the first place).

## 7. Issue Tracking

Providing honest and, sometimes perhaps, harsh audit results requires management to draft and execute corrective action plans to fix deficiencies. An auditor's job does not stop here. Auditors should ensure they track management's progress with the corrective action plan and test the results of the program enhancements being implemented. This continual review process will make the AML/BSA program stronger throughout the year and also serves to place the proper emphasis on the importance of on-going program improvement.

What to stoke the regulatory fires? Have an audit identify a problem; have management make a promise; have action on that promise fail to materialize; have audit fail to catch it; and, have the regulators catch it. This will make for a very long year.

## 8. Experienced Auditors

Lastly, none of what is describe here as being necessary to effectively conduct an internal audit is possible if those performing the review lack the necessary skills and experience. Often auditors are banking generalists and may not have the type of specialization needed in today's AML/BSA regulatory environment. Unfortunately, reading the FFIEC AML/BSA Examination Manual and reviewing regulatory guidance is not enough to enable inexperienced management and staff to perform an adequate audit. Finding individuals with deep experience in AML/BSA needs to be a priority of every internal audit group.

As noted previously, having a "subject matter expert" in AML is not necessarily the answer either. A good AML audit team will be comprised of someone who is experienced in scoping proper audits (a combination of an auditor and an expert); someone who can test program components (an expert supported by an auditor); someone who is meticulous and oriented towards documentation requirements (an auditor); and someone who can tie together what may be disparate findings into a full view of AML compliance (an expert, an auditor, an audit executive).

If these eight elements are included in an institution's AML/BSA internal audit program it is likely your institution will not endure the fate that has befallen so many financial service institutions over the last three years.

#### **ABOUT THE DOMINION ADVISORY GROUP**

Dominion Advisory Group is the leading provider of comprehensive and sustainable anti-money laundering programs and critical investigations services for top domestic and international financial institutions, law firms, and other organizations. Dominion Advisory Group has 15 years of extensive experience in banking, compliance, law enforcement, regulatory oversight, technology, and consulting to help financial institutions and corporations navigate the complex regulatory environment and address the needs of regulators, customers, and the institution.

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