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Directors' examinations of banks: September 17, 1990 amendment to AICPA industry audit guide, Audits of Banks

American Institute of Certified Public Accountants. Banking Committee

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**Statement of
Position**

90-6

**Directors' Examinations
of Banks**

September 17, 1990

**Amendment to
AICPA Industry Audit Guide
*Audits of Banks***

**Prepared by the
Committee on Banking**

**American Institute of
Certified Public Accountants**

AICPA

NOTE

This statement of position presents recommendations of the AICPA Committee on Banking regarding the application of generally accepted auditing standards to directors' examinations of banks. Members of the AICPA Auditing Standards Board have found this guide to be consistent with existing standards covered by rule 202 of the AICPA Code of Professional Conduct. AICPA members should be prepared to justify departures from this statement of position.

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Directors' Examinations of Banks

Introduction

1. Appendix C of the AICPA Industry Audit Guide *Audits of Banks* [Bank Audit Guide] includes “Suggested Guidelines for CPA Participation in Bank Directors’ Examinations.” Statement on Auditing Standards [SAS] No. 35, *Special Reports—Applying Agreed-Upon Procedures to Specified Elements, Accounts, or Items of a Financial Statement*, provides the principal guidance to independent auditors who are engaged to perform agreed-upon procedures in connection with directors’ examinations. The Bank Audit Guide states, “The CPA and the board of directors should have a clear understanding of the scope of the CPA’s procedures and the specific responsibilities of each party.”

2. The form and content of reports that are currently prepared by independent auditors in connection with directors’ examinations reflect a diversity of practice. As a result, directors may not understand the fundamental differences between engagements for the application of agreed-upon procedures to specified elements, accounts, or items of a financial statement in connection with a directors’ examination and audits of a bank’s financial statements in accordance with generally accepted auditing standards [GAAS]. This is of particular concern when the limitations of the directors’ examination relate to areas of higher risk in the banking industry. Further, directors may incorrectly assume that the application of agreed-upon procedures included obtaining an understanding of the bank’s internal control structure similar to that obtained in an audit of the bank’s financial statements in accordance with generally accepted auditing standards.

3. The AICPA Committee on Banking [Committee] believes it is desirable to emphasize the limitations on the scope of the independent auditor’s work when independent auditors are engaged to perform directors’ examinations. The Committee has prepared this statement of position to give more prominence to those limitations that affect accounts with higher risk in the banking industry.

Scope

4. This statement of position supersedes the exhibits in appendix C, “Suggested Guidelines for CPA Participation in Bank Directors’ Examinations,” in the AICPA Industry Audit Guide *Audits of Banks*.

5. This statement of position applies to all bank directors’ examinations that are narrower in scope than an audit of financial statements in accordance with generally accepted auditing standards.

Background

6. In some instances, the scope of the independent auditor’s services may not be clear when the auditor is engaged to conduct a directors’ examination. Contributing reasons for this lack of understanding include the following:

- The majority of directors’ examinations are performed for community banks with bank directors and officers who may have a limited knowledge of the differences between an audit in accordance with GAAS and a directors’ examination.
- Engagements may actually be initiated by management acting for the board of directors, and the agreed-upon procedures defined without the directors’ input. Therefore, the board of directors may not be aware of the existence of the engagement letter.
- Generally, directors’ examination reports do not incorporate the financial statements of the bank.
- Although certain states specify minimum scope requirements for directors’ examinations, the requirements of other states are undefined.
- Examinations of banks are conducted regularly by bank regulatory authorities who are principally concerned with the soundness of the loan and investment portfolios. As a result of the regulatory emphasis on loans and investments, the procedures agreed upon by boards of directors and independent auditors may exclude testing of loans and the evaluation of the reasonableness of the allowance for credit losses that has been determined by management, or they may provide for limited procedures [for example, reviewing the adequacy of loan documentation but not the collectibility of loans].

7. The scope of an independent auditor’s services regarding a directors’ examination, especially as it relates to areas of higher risk,

is also subject to misinterpretation by others, including regulatory authorities. This is of particular concern because regulators increasingly rely on the results of directors' examinations or audits of the bank's financial statements in accordance with GAAS to determine the frequency and scope of their examinations.

8. The principal modifications to the exhibits in appendix C recommended by this statement of position include—

- a.* Incorporation of a statement in the illustrative engagement letter and illustrative report that identifies the omission of certain procedures relating to accounts with higher risk [for example, reviewing the collectibility of loans, the adequacy of collateral thereon, or the reasonableness of the allowance for credit losses] that are normally performed during an audit of the financial statements in accordance with GAAS.
- b.* Expansion of the accounts identified in the supplement to the engagement letter to include those accounts with higher risk, such as loans and the allowance for credit losses.
- c.* Substitution of a description of the procedures relating to "Loans" for the procedures relating to "Cash and Due From Banks."

Effective Date

9. The recommendations in this statement of position should be applied to directors' examinations commenced after December 31, 1990.

**Illustrative Engagement Letter
Services Other Than Financial Statement Audits**

**Audit Committee
XYZ Bank**

[Date]

This letter is to confirm our understanding of the terms and objectives of our engagement and the nature and limitations of the services we will provide to [name of bank] for the year ending [date].

We will apply certain procedures to selected records and transactions for the purpose of helping you to complete your directors' examination.

The procedures to be performed are summarized in the supplement to this letter. Because those procedures will not constitute an audit made in accordance with generally accepted auditing standards, we will not express an opinion on any of the items specified in the supplement or on the financial statements of the bank taken as a whole. The scope of this examination as outlined in the supplement does not include an evaluation of all areas which generally are of higher risk in the banking industry, such as securities held or the collectibility of loans, the adequacy of collateral thereon, or the reasonableness of the allowance for credit losses.

Our engagement will not include a detailed examination of all transactions and cannot be relied on to disclose errors, irregularities, or illegal acts, including fraud or defalcations, that may exist. However, we will inform you of any such matters that come to our attention.

We direct your attention to the fact that management has the responsibility for the proper recording of the transactions in the accounting records and for preparation of financial statements in conformity with generally accepted accounting principles.

Certain of the procedures described in the supplement to this letter will be applied on a surprise basis during the year after we consult with the appropriate supervisory agencies to ensure that the date selected will not conflict with their examinations.¹

Our report will include a summary of the accounts and elements subject to our examination and the procedures performed.²

¹Some directors' examinations may not be conducted on a surprise basis or include consultation with supervisory agencies.

²In certain instances, the independent auditor may not be able to discuss the procedures to be performed with all the parties—for example, bonding companies—that will receive a copy of the report. In these circumstances, the auditor should satisfy the requirements of paragraph 2 in SAS No. 35, *Special Reports—Applying Agreed-Upon Procedures to Specified Elements, Accounts, or Items of a Financial Statement* by applying alternate procedures in order that the parties involved be made aware of the procedures applied before the report is issued.

This report will be issued solely for the information of the bank's board of directors and management and appropriate supervisory agencies [*or other specified third parties*]; it is not to be used by any other parties because of the restricted nature of our work. Our report will also contain a paragraph indicating that had we performed additional procedures or had we made an audit of the financial statements in accordance with generally accepted auditing standards, other matters might have come to our attention that would have been reported to you.

Our fees are based on the time required by the individuals assigned to the engagement, plus direct expenses. Individual hourly rates vary according to the degree of responsibility involved and the skill required. Interim billings will be submitted as services are rendered and as expenses are incurred.

We will be pleased to discuss this letter with you at any time. If the foregoing is in accordance with your understanding, please sign the copy of this letter in the space provided and return it to us.

Sincerely yours,

[*Signature of independent auditor*]

Acknowledged:

[*Name of bank*]

[*Signature of bank director*]^{3,4}

[*Date*]

³Preferably, the chairman of the bank's audit committee or an outside director should acknowledge the procedures to be performed.

⁴The independent auditor should consider reviewing the engagement letter with the board [or with its committee] in order to allow the directors' participation in defining the scope of the examination.

**Supplement to Illustrative Engagement Letter
Procedures to Be Performed
in Connection With a Director's Examination**

[Name of Bank]

In connection with our engagement, the procedures to be performed are summarized as follows:

1. General
 - a. Start the engagement on a date selected by us without prior notification of bank personnel, officers, or directors. Obtain immediate control [*seal vault, etc.*] of assets and records and maintain control until applicable procedures have been completed. The surprise procedures will cover the main office and [*the following*] branches.
 - b. Review reports of examination by, and correspondence with, supervisory agencies.⁵
 - c. Review minutes of meetings of the board of directors and of committees reporting to the board.
 - d. Review entries to selected general ledger accounts in excess of \$ _____.
 - e. Review accounting procedures for handling nonledger assets, such as loan charge-offs and recoveries, loan commitments, loans, "participated" to and services for others, standby letters of credit, collection items, travelers' checks, and U.S. savings bonds.
 - f. Obtain letters concerning litigation, claims, and assessments from legal counsel.
 - g. Obtain a management representation letter.

Procedures to be performed with respect to individual accounts or elements should be listed in detail, including number and types of confirmations, extent of tests of revenue and expense, and types of sampling methods to be used. Individual accounts and elements to which other procedures are applied generally include:

1. Cash, cash items, and clearings and exchanges
2. Due from banks
3. Securities
4. Federal funds sold [*purchased*]
5. Loans and leases
6. Real estate owned

⁵Independent auditors should refer to the policies of regulatory agencies on the use of supervisory information.

Note: This Supplement is for illustrative purposes only and, therefore, is not considered to be an all-inclusive list of accounts that may be examined and procedures that may be performed. The illustrative procedures listed may or may not be relevant to a particular engagement. The independent auditor should describe those accounts examined and procedures relevant to the specific engagement.

**Illustrative Report Services
in Connection With Directors' Examinations**

**Audit Committee
XYZ Bank**

We have applied certain agreed-upon procedures, as discussed in the attached supplement, to selected accounting records and transactions of the [name of bank] as of [examination date]. These procedures were performed in accordance with the arrangements set forth in our letter to you dated [date].

The procedures we performed, the accounts we examined, and the findings we obtained are summarized in the attached supplement, which is an integral part of this report. Because our procedures do not constitute an audit made in accordance with generally accepted auditing standards, we do not express an opinion on any of the accounts or items referred to in the supplement.

In connection with the procedures referred to in the attached supplement, no [the following] matters came to our attention that caused us to believe that the specified [the following] account[s] should be adjusted. Had we performed additional procedures or had we conducted an audit of the financial statements in accordance with generally accepted auditing standards, matters might have come to our attention that would have been reported to you. The scope of the engagement also does not include an evaluation of areas which generally are of higher risk to the bank, such as an evaluation of securities held or of the collectibility of loans, the adequacy of collateral thereon, or the reasonableness of the allowance for credit losses.

This report relates only to the accounts and items specified in the attached supplement and does not extend to any financial statements of [name of bank] taken as a whole.

This report is intended solely for the use of management [or specified regulatory agency or other specified third party] and should not be used for any other purpose.

[Signature of independent auditor]

[City, State]

[Date]

Supplement to Illustrative Report Loans

We obtained trial balances or subsidiary ledgers of the notes or both from the service center and reconciled the totals to the general ledger in the following amounts:

<i>Account</i>	<i>Amount Outstanding at May 12, 19X0</i>
Commercial loans	\$
Consumer loans	
Real estate loans	
Participation purchased	_____
	\$ _____

Certain [*specify number*] loans, including lines of credit that had not been fully funded, were selected for confirmation directly with borrowers. The results of our confirmation efforts are summarized in Schedule A. Borrowers with lines of credit of \$ _____ or more as of May 12, 19X0, who did not respond to confirmation requests by June 13, 19X0, are listed in Schedule B.

We examined selected loans and loan agreements on hand. Also, readily marketable securities and other collateral recorded as held in respect of certain selected secured loans were inspected.

We obtained the Bank's listing of commercial loans, real estate loans, and participations purchased five days or more past due as of May 12, 19X0, and compared it to a similar listing as of June 13, 19X0. The following loans were listed in both reports:

[*List loans.*]

Similarly, we obtained the Bank's listing of consumer loans ten days or more past due as of May 12, 19X0, and compared it to a like listing as of June 13, 19X0. The following loans were listed in both reports:

<i>Name</i>	<i>Due Date</i>	<i>Amount Outstanding at May 12, 19X0</i>	<i>Amount Outstanding at June 13, 19X0</i>
_____	_____	_____	_____

Note: This Supplement is for illustrative purposes only and, therefore, is not considered to be an all-inclusive list of accounts that may be examined and procedures that may be performed. The illustrative procedures listed may or may not be relevant to a particular engagement. The independent auditor should describe those accounts examined and procedures relevant to the specific engagement. The accounts and procedures described in the report should generally conform to those described in the engagement letter.

Loan participations “sold” and serviced by the Bank were confirmed with the purchasers, without exception.

We obtained the Bank’s listing of overdrafts as of May 12, 19X0, and compared it to a similar listing as of June 13, 19X0. The following overdrafts were listed in both reports:

<u>Name</u>	<u>Date of Overdraft</u>	<u>Amount at May 12, 19X0</u>	<u>Amount at June 13, 19X0</u>

The interest rates and repayment terms of five judgmentally selected loans granted to directors, officers, and other related parties during April 19X0 were compared to the interest rates and repayment terms of similar loans granted to outsiders during the same month. No instances of favorable interest rates or repayment terms being granted to directors, officers, and other related parties were found.

The maturity date and amount of standby letters of credit and loan commitments in excess of \$50,000 were confirmed as of April 19X0 by the customers for whose benefit they were issued, without exception. We judgmentally selected five standby letters of credit and five loan commitments, and tested the computation of deferred fee income with satisfactory results.

Requests for confirmation of loan balances could not be mailed to the following borrowers due to lack of sufficient addresses:

<u>Name</u>	<u>Account Number</u>	<u>Balance as of May 12, 19X0</u>

Lack of Evaluation of Collectibility and Adequacy of Collateral

As noted in our engagement letter and report, we did not evaluate the collectibility of loans or the adequacy of collateral thereon.

Lack of Evaluation of the Allowance for Credit Losses

As noted in our engagement letter and report, we did not evaluate the reasonableness of the allowance for credit losses determined by management.

Note: This Supplement is for illustrative purposes only and, therefore, is not considered to be an all-inclusive list of accounts that may be examined, and procedures listed may or may not be relevant to a particular engagement. The independent auditor should describe those accounts examined and procedures relevant to the specific engagement. Procedures for other accounts should be specified in detail, and differences and subsequent disposition should be reported.

Confirmation Statistics⁶

[*Examination Date*]

	<u>Loans⁷</u>	<u>Checking Accounts</u>	<u>Savings Accounts</u>	<u>Certificates of Deposit</u>
Dollar amounts				
Total				
Circularized				
Percent circularized to total				
Replies received				
to total circularized				
Selected but not circularized				
Not delivered by post office				
Number of accounts				
Total				
Circularized				
Percent circularized to total				
Replies received				
Percent replies received				
to total circularized				
Selected but not circularized				
Not delivered by post office				

Confirmation Requests Not Mailed

	<u>Name and Address</u>	<u>Reason for Not Mailing</u>	<u>Balance as of [Examination Date]</u>
Loans:			
Checking accounts:			
Savings accounts:			
Certificates of deposit:			

⁶An indication of how the samples were selected—i.e., on a random, statistical, or judgmental basis—as well as an indication of the type of confirmation—i.e., positive or negative requests—should be included.

⁷If the loans are categorized by type in the report, similar categories would normally be used in this schedule.

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(1989-1990)

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