1993

FDIC Improvement Act implementation issues: update to AICPA Industry audit guide, Audits of banks and AICPA Audit and accounting guide, Audits of savings institutions; Audit risk alerts

American Institute of Certified Public Accountants

Follow this and additional works at: https://egrove.olemiss.edu/aicpa_indev

Part of the Accounting Commons, and the Taxation Commons

Recommended Citation
https://egrove.olemiss.edu/aicpa_indev/691

This Book is brought to you for free and open access by the American Institute of Certified Public Accountants (AICPA) Historical Collection at eGrove. It has been accepted for inclusion in Industry Developments and Alerts by an authorized administrator of eGrove. For more information, please contact egrove@olemiss.edu.
FDIC Improvement Act
Implementation Issues

Update to AICPA Industry Audit Guide
Audits of Banks
and AICPA Audit and Accounting Guide
Audits of Savings Institutions

AICPA
American Institute of Certified Public Accountants
NOTICE TO READERS

This audit risk alert is intended to provide CPAs who serve FDIC-insured depository institutions with an overview of how implementation of the FDIC Improvement Act of 1991 affects the engagements they perform. This document has been prepared by the AICPA staff. It has not been approved, disapproved, or otherwise acted on by a senior technical committee of the AICPA.

James F. Green
Technical Manager, Federal Government Division

Gerard L. Yarnall
Director, Audit and Accounting Guides

Copyright © 1993 by
American Institute of Certified Public Accountants, Inc.
New York, NY 10036-8775

All rights reserved. Requests for permission to make copies of any part of this work should be mailed to Permissions Department, AICPA, Harborside Financial Center, 201 Plaza Three, Jersey City, NJ 07311-3881.

1234567890 AAG 99876543
# Table of Contents

**FDIC Improvement Act Implementation Issues** .................................................. 5  
Introduction ........................................................................................................... 5 
The Law ................................................................................................................... 6 
The Implementing Regulations ............................................................................. 7  
  Reporting Requirements—Section 36 ................................................................. 7  
  Accounting Reforms—Section 37 ........................................................................ 10  
  Prompt Corrective Action—Section 38 ............................................................... 11  
  Internal Control Standards—Section 39 ............................................................. 13  
  Effects on Institutions' Liquidity ........................................................................ 14  
  Qualified-Thrift-Lender Test—Subtitle G ............................................................. 14  
Information Sources .............................................................................................. 15  
Appendix A—Audit and Reporting Requirements ............................................... 17 
Appendix B—Agreed-Upon Procedures .................................................................. 47  
Appendix C—Guidance for Independent Auditors  
  When Required to Provide Access to or Photocopies  
  of Workpapers to Regulators ........................................................................... 57
FDIC Improvement Act
Implementation Issues

Introduction

This document alerts CPAs to how the Federal Deposit Insurance Corporation (FDIC) Improvement Act of 1991 (FDICIA) and its implementing regulations and guidelines affect the engagements they perform. This section of the Audit Risk Alert synthesizes the requirements. Appendix A presents, verbatim, the regulations and guidelines that implement the law. Commentary prepared by the staff of the American Institute of Certified Public Accountants (AICPA) is included to focus on practical matters that the independent accountant should consider when taking action to comply with the requirements. The agreed-upon procedures that must be performed by the independent accountant, as presented in Appendix B, are also reprinted verbatim with AICPA staff commentary. Both appendixes should be read in their entirety.

Independent accountants serving covered institutions will be required—for the first time—to attest to managements' assertions about internal controls over financial reporting and compliance with laws and regulations. Independent accountants should become familiar with the new reporting requirements, particularly those that address the independent accountant's qualifications, exposure to enforcement actions, required communications with client institutions, and interaction with the audit committee. The effects of a number of the law's provisions on a client institution's ability to remain a going concern should also be considered.

This document is not intended to provide comprehensive guidance on implementing the requirements of the law, regulations, and guidelines. This document does, however, focus on several practical matters concerning implementation that the independent accountant should consider in complying with the requirements. In a number of these areas, guidance has not yet been developed and the independent accountant will need to exercise judgment about how to proceed. For example, independent accountants will need to make judgments on practical matters such as the following:

- Performing agreed-upon procedures on internal auditors' workpapers
• Determining sample sizes for agreed-upon procedures
• Defining financial reporting controls
• Reporting on "safeguarding" objectives in the report on management's assertion about financial reporting controls

This Audit Risk Alert should not be substituted for a complete reading of the applicable sections of the law, regulations, and guidelines where appropriate.

The Law

Early in 1991, Congress was informed that the FDIC's Bank Insurance Fund (BIF) would need more money because a record number of banks had failed, and that regulators needed timely information about the financial condition of banks. Legislative proposals coupling additional money for the BIF with an enhanced financial reporting system for federally insured depository institutions became the basis for a number of reforms embodied in the FDICIA. These measures reflect policymakers' emphasis on regulatory solutions to concerns about the depository institutions industry.

Although related legislative proposals that would have expanded bank powers (by permitting interstate activities and new products and services) were ultimately dropped, the reach of the final provisions—which emphasize least-cost resolutions and improved supervision and examinations—surpasses even that of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA).

Signed into law in December 1991, FDICIA spawned a rule making process that, when completed, will alter every major area of existing regulation of banks and thrifts. As discussed below, the effect of FDICIA on practice in the industry and on the current regulatory environment requires heightened awareness among practitioners.

The federal banking regulatory agencies have been carrying out the massive effort necessary to develop regulations to implement the law, including audit provisions that directly affect CPAs. Many provisions of the FDICIA are amendments or additions to the Federal Deposit Insurance Act (FDI Act). Major provisions affecting practitioners who provide services to depository institutions are summarized below. Readers should refer to the law, implementing regulations, and guidelines for a complete discussion of these and other requirements.
The Implementing Regulations

Reporting Requirements—Section 36

New Section 36 of the FDI Act (added by Section 112 of the FDICIA) creates new reporting requirements including, for the first time, reports by managements and independent accountants on internal controls over financial reporting and compliance with certain laws and regulations. It also establishes minimum qualifications for independent accountants serving the affected institutions. The Section 36 provisions, as summarized below, apply to each FDIC-insured depository institution having total assets of $500 million or greater at the beginning of its fiscal year. The reporting requirements are effective for fiscal years ending December 31, 1993, and thereafter. Despite the asset threshold, Section 36 does not override any non-FDICIA requirements for audited financial statements or other requirements that an institution exempt from Section 36 must otherwise satisfy.¹

To implement Section 36, the FDIC has issued both a final regulation² and accompanying guidelines and interpretations (guidelines), which became effective July 2, 1993. The general requirements are summarized below; however, the side-by-side analysis of the detailed regulation and guidelines presented in Appendix A should be read as an integral part of this Audit Risk Alert.

Annual Report. Management is required to prepare, annually, a report that includes the following:³

- Financial statements prepared in conformity with generally accepted accounting principles (GAAP)

¹In FDIC Financial Institution Letter (FIL-43-93), the FDIC noted that, in adopting the final rule implementing Section 36, the Board of Directors of the FDIC reiterated its belief that "every depository institution, regardless of size or charter, should voluntarily have an annual audit of its financial statements by an independent public accountant and establish an independent audit committee."

²The regulation and guidelines implementing FDI Act Section 36 (which have been reproduced in Appendix A) are codified in Section 12 of the Code of Federal Regulations (CFR) Part 363. The regulation was published in the Federal Register on June 2, 1993, and in FDIC FIL-41-93.

³The reporting requirements may be satisfied for certain subsidiaries through reporting by their holding companies. These exemptions are discussed in Section 363.1 of the rule and in guidelines 2–4.
• A written assertion about the effectiveness at year-end of the institution's internal controls over financial reporting
• A written assertion about the institution's compliance during the year with (a) federal laws and regulations relative to insider loans, and (b) federal and state laws and regulations relative to dividend restrictions

Management must also include a statement about its responsibilities for the financial statements, financial reporting controls, and compliance with laws and regulations.

Management must engage an independent accountant to provide the following reports annually:

• An audit report on the GAAP-basis financial statements
• An examination-level attestation report on management's assertion about financial reporting controls

An agreed-upon procedures-level attestation report on management's assertion about compliance with insider loan and dividend restriction laws and regulations is also required, but is not included in the institution's annual report and, therefore, is not publicly available.

The financial statement audit is to be performed in accordance with generally accepted auditing standards (GAAS). The examination of management's assertion about financial reporting controls and the agreed-upon procedures report on management's compliance assertion are to be performed in accordance with the AICPA's Statements on Standards for Attestation Engagements (SSAE).4

The audited financial statements and other reports of management and the independent accountant must be filed with the FDIC and other regulatory agencies within the ninety days following the institution's fiscal year-end. Management must also file any management letter, qualification, or other report within fifteen days following receipt from the independent accountant.

All of management's reports will be made publicly available. The independent accountant's report on the financial statements and attestation report on financial reporting controls will also be made publicly available. The independent accountant's agreed-upon procedures

4SSAE No. 2, Reporting on an Entity's Internal Control Structure Over Financial Reporting, was issued in June 1993. On April 7, 1993, the AICPA's Auditing Standards Board issued an exposure draft of a proposed SSAE, Compliance Attestation, which, when finalized, will provide additional guidance on compliance attestation engagements. A final statement is expected to be issued by year-end 1993.
report and any management letter, while filed with the FDIC, will not be included in the annual report and, therefore, will not be publicly available.

Qualifications of Independent Accountants. Acceptance of an engagement to report under Section 36 is conditioned on the independent accountant being enrolled in a practice-monitoring program. Membership in the AICPA Division for Firms’ SEC Practice Section or Private Companies Practice Section, or enrollment in the AICPA’s Quality Review Program will satisfy this requirement.

Another condition of the engagement is that the independent accountant agree to provide regulators with access to workpapers related to the three engagement reports. Although this condition is not explicitly expressed in the law or regulations, the implementing guidelines also call for providing copies of workpapers to regulators. Independent accountants should read the July/August 1993 Notice to Practitioners (included as Appendix C to this Audit Risk Alert), which provides guidance on complying with requests for access to, and copies of, workpapers when required to do so by contract, law, or regulation.

The accountant must meet the independence requirements and interpretations of the AICPA and the Securities and Exchange Commission (SEC) and its staff.

The implementing regulation requires both management and independent accountants to provide certain notifications of changes in an institution’s independent accountants within specified time periods. An independent accountant must also file a peer review report within fifteen days of acceptance of the report.

Enforcement Actions Against Accountants. Section 36 of the FDI Act also provides for enforcement actions against accountants with respect to the Section 36 requirements. However, the regulatory agencies have not yet proposed or published rules or guidelines to implement this statutory requirement.5

Communication With Auditors. Each subject institution must provide its independent accountant with copies of the institution’s most recent

5Section 36(g)(4) of the FDI Act states that the FDIC or the appropriate federal banking agency may “remove, suspend, or bar an independent public accountant, upon a showing of good cause, from performing audit services” required by Section 36. The federal banking agencies are expected to jointly issue rules to implement this provision.
reports of condition and examination; any supervisory memorandum of understanding or written agreement with any federal or state regulatory agency; and a report of any action initiated or taken by federal or state banking regulators.

**Audit Committees.** Each subject institution must have an independent audit committee made up entirely of outside directors independent of management. One of the audit committee's required duties is to review with management and the independent accountant the reports required under Section 36. A list of other suggested duties is included in the guidelines, some of which relate to the independent accountant. Audit committees of institutions having $3 billion or more in assets must include members with banking or related financial management expertise, have access to their own outside counsel, and not include any large customers of the institution.

**Accounting Reforms—Section 37**

FDI Act Section 37 was added by FDICIA Section 121 to establish accounting objectives, standards, and requirements for regulatory financial reporting, that is, the Federal Financial Institutions Examination Council (FFIEC) Consolidated Reports of Condition and Income (Call Reports) and Thrift Financial Reports (TFRs). Among other provisions, Section 37—

- Requires regulatory financial reporting to be uniform and consistent with GAAP, unless more stringent principles are considered necessary to reflect capital accurately, facilitate effective supervision, or permit prompt corrective action.
- Instructs the regulatory agencies to develop both a method for supplemental disclosures of market values of assets and liabilities (to the extent feasible and practicable) and regulations to ensure adequate reporting of off-balance-sheet transactions (including reporting of contingent assets and liabilities).
- Promotes uniformity of capital and accounting standards among the federal regulatory agencies.

On April 13, 1993, the FFIEC requested comment on a proposed approach to unaudited supplemental fair value disclosures that would use concepts and principles set forth in the Statement of Financial Accounting Standards Board (FASB) Standards Statement No. 107, *Disclosures about Fair Value of Financial Instruments*. No other proposals have been made toward implementation of the Section 37 provisions.
Prompt Corrective Action—Section 38

FDICIA makes capital an essential indicator to be used by regulators in monitoring the financial health of insured depository institutions. Regulatory intervention is focused primarily on an institution's capital levels relative to regulatory standards. Through FDI Act Section 38, FDICIA added a uniform framework for prompt corrective regulatory action to the existing capital adequacy guidelines set forth by each agency for safety and soundness purposes.6

The independent accountant considers regulatory capital from the perspective that noncompliance or expected noncompliance with regulatory capital requirements may be a condition, when considered with other factors, that could indicate substantial doubt about an entity's ability to continue as a going concern. The AICPA's Statement on Auditing Standards (SAS) No. 59, The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern (AICPA, Professional Standards, vol. 1, AU sec. 341) provides guidance in this area.

Capital regulations are complex and their application by management requires a thorough understanding of specific requirements and the potential impact of noncompliance. Accordingly, relevant regulations and regulatory guidance should be referred to by the independent accountant as necessary when considering regulatory capital matters.

Effective December 19, 1992, Section 38 provides for supervisory action at certain institutions based on their capital levels. Each institution falls into one of five regulatory capital categories based primarily on three capital measures: Tier 1 leverage, total risk-based, and Tier 1 risk-based capital. These capital ratios are defined in the same manner for Section 38 purposes as under the respective agencies' capital adequacy guidelines and regulations. For savings institutions, Tier 1 leverage capital is comparable to core capital, as defined.

Regulations also specify a minimum requirement for tangible equity, which is defined as Tier 1 capital plus cumulative perpetual preferred stock, net of all intangibles except limited amounts of purchased mortgage servicing rights (PMSRs). In calculating the tangible equity ratio, intangibles (except for qualifying PMSRs) should also be deducted from the total assets included in the ratio denominator.

6The final rules implementing prompt corrective action were published in the September 29, 1992, Federal Register; in the FDIC's FIL-70-92; and in the Office of the Comptroller of the Currency's (OCC's) Banking Bulletin 92-52 and Banking Circular 268.
An institution may be reclassified between certain capital categories if its condition or an activity is deemed by regulators to be "unsafe or unsound." A change in an institution's capital category initiates certain mandatory—and possibly additional discretionary—action by regulators.

Under Section 38, an institution is considered—

- **Well capitalized** if its capital level significantly exceeds the required minimum level for each relevant capital category.
- **Adequately capitalized** if its capital level meets the minimum levels.
- **Undercapitalized** if its capital level fails to meet the minimum levels.
- **Significantly undercapitalized** if its capital level is significantly below the minimum levels.
- **Critically undercapitalized** if it has a ratio of tangible equity to total assets, as defined, of 2 percent or less, or otherwise fails to meet the critical capital level, as defined.

The minimum levels are defined as shown in the following table:

<table>
<thead>
<tr>
<th>Capital Category</th>
<th>Total Risk-Based (Ratio)</th>
<th>Tier 1 Risk-Based (Ratio)</th>
<th>Tier 1 Leverage (Ratio)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Well capitalized</td>
<td>≥ 10%</td>
<td>≥ 6%</td>
<td>≥ 5%</td>
</tr>
<tr>
<td>Adequately capitalized</td>
<td>≥ 8</td>
<td>≥ 4</td>
<td>≥ 4*</td>
</tr>
<tr>
<td>Undercapitalized</td>
<td>&lt; 8</td>
<td>&lt; 4</td>
<td>&lt; 4*</td>
</tr>
<tr>
<td>Significantly undercapitalized</td>
<td>&lt; 6</td>
<td>&lt; 3</td>
<td>&lt; 3</td>
</tr>
</tbody>
</table>

*3.0 percent for 1-rated institutions under the regulatory CAMEL, MACRO, or related rating system.

As noted in the preceding, critically undercapitalized institutions are those having a ratio of tangible equity to total assets of 2 percent or less.

An institution will not be considered well capitalized if it is under a cease-and-desist order, formal agreement, capital directive, or prompt-corrective-action capital directive.

Actions that may be taken under the prompt corrective action provisions range from the restriction or prohibition of certain activities, such as the payment of dividends, to the appointment of a receiver or conservator.

Regulators will also require undercapitalized institutions to submit a plan for restoring the institution's capital to an acceptable level. For example, each undercapitalized institution is required to submit a plan that specifies the following:

12
• Steps the institution will take to become adequately capitalized
• Targeted capital levels for each year of the plan
• How the institution will comply with other restrictions or requirements put into effect
• The types and levels of activities in which the institution will engage

Savings institutions that are complying with capital plans approved by the Office of Thrift Supervision (OTS) prior to December 19, 1991, are not required to file new plans and are not immediately subject to certain sanctions.

Noncompliance or expected noncompliance with regulatory capital requirements may be a condition, when considered with other factors, that could indicate substantial doubt about an entity's ability to continue as a going concern. The implementation of the prompt corrective action provisions warrants similar attention by auditors when considering an institution's ability to remain a going concern.

**Internal Control Standards—Section 39**

New Section 39 of the FDI Act (as added by Section 132 of the FDICIA) requires the federal banking agencies to prescribe safety and soundness standards for management and operation of insured depository institutions, including standards for internal controls. Implementing regulations will apply to all federally insured institutions and must be finalized by August 1, 1993, to become effective no later than December 31, 1993.

In July 1992, the federal banking agencies jointly published an advance notice of proposed rule making for Section 39 (*Federal Register*, July 15, 1992). In April 1993, the Board of Governors of the Federal Reserve System (FRB) approved a staff proposal for implementation of Section 39. Because the federal banking agencies plan to simultaneously issue their proposals for comment, the FRB proposal was not immediately published for comment. However, the joint proposal is expected to track the FRB's draft.

Among other matters, the FRB draft proposal would require state member banks to have internal controls and information systems that provide for the following:

(a) An organizational structure that establishes clear lines of authority and responsibility for monitoring adherence to prescribed policies
(b) Effective risk assessment
(c) Timely and accurate financial, operational, and regulatory reports
(d) Adequate procedures to safeguard and manage assets
Compliance with applicable laws and regulations

The Section 39 internal control requirements (as proposed in the FRB draft) would exceed the scope of the Section 36 management and independent accountant reports, which are limited to internal controls over financial reporting. Management is not required to make an assertion, nor is the independent accountant required to examine or report on any such management assertion, about the broader internal controls and information systems contemplated by Section 39.

The Section 39 proposal also prescribes standards for operations, management, internal audit, asset quality, earnings, stock valuation, and employee compensation. If an institution fails to meet any of the prescribed standards, it must submit and implement a plan to achieve compliance. Failure to submit or implement the plan could lead to supervisory action.

Effects on Institutions' Liquidity

Several provisions of FDICIA may affect the liquidity of an institution. Specifically, FDICIA places new restrictions on the following:

- Acceptance of brokered deposits by certain institutions
- Availability of borrowings through the discount window
- Exposure to the institution posed by transactions with correspondent banks and related limitations on interbank liabilities

Accordingly, the independent accountant should consider whether the effect on the institution's liquidity, when considered with other factors, could indicate substantial doubt about an entity's ability to continue as a going concern.

Qualified-Thrift-Lender Test—Subtitle G

To be considered a savings institution, an entity must hold a specific portion of its assets in eligible housing-related assets. On July 1, 1991, the required minimum percentage of qualified investments was 70 percent. Subtitle G of the FDICIA modified the qualified-thrift-lender (QTL) test to require that minimum qualified thrift investments equal or exceed 65 percent of assets, as defined, on a monthly average basis in nine out of every twelve months. Subtitle G also expands the definition of qualified thrift investments to include stock of any Federal Home Loan Bank, the Federal Home Loan Mortgage Corporation,

---

7See FDICIA Section 301 and FDIC FIL-3-92.
8See FDICIA Section 142.
9See FDICIA Section 308 and OCC Banking Bulletin 93-3.
and the Federal National Mortgage Association. The amounts of certain assets includable in the numerator and deductible in the denominator of the QTL ratio were also modified (see Federal Register, September 2, 1992).

Noncompliance with the QTL requirement subjects an institution and its holding company, if any, to certain restrictions, among other regulatory actions. An institution that fails the OTS QTL test may also fail the separate Internal Revenue Service (IRS) QTL test.

**Information Sources**

Copies of the FDICIA (stock number 869–015–00242–6) are available from the Government Printing Office (GPO). Call (202) 783–3238, or send an order via fax to (202) 512–2250 (VISA or MasterCard charges only; include expiration date). The price is $4.50.

FDIC policy is communicated in Financial Institution Letters, News Releases, Regional Director Memoranda, updates to the Division of Supervision Manual of Examination Policies, and instructions for FFIEC Consolidated Reports of Condition and Income (Call Reports). For information about ordering these issuances, call FDIC Corporate Communications at (202) 898–6996.

OCC supervisory policies and guidance are issued as Advisory Letters, Banking and Examining Bulletins and Circulars, Memoranda, News Releases, updates to the OCC Policies and Procedures Manual, the Bank Accounting Advisory Series, instructions for FFIEC Call Reports, and other issuances. For information on ordering copies of OCC issuances, call OCC Publications Control at (202) 874–4884.

Information about FRB publications is available through FRB Publications Services at (202) 452–3245.

OTS supervisory policies and guidance are issued in the form of Thrift Bulletins, Regulatory Bulletins, Transmittals, and in guidance provided to examiners through a multivolume set of agency handbooks. For information on ordering OTS publications, call the OTS Controller’s Division at (202) 906–6427.

The Federal Register contains notices about the actions of federal government agencies. It may be purchased from the GPO by calling (202) 783–3238 or by writing to New Orders, Superintendent of Documents, PO Box 371954, Pittsburgh, PA 15250–7954. Most public libraries also have copies of the Federal Register.

* * * *

Additional copies and copies of all AICPA publications may be obtained by calling the AICPA Order Department at (800) TO–AICPA.
# Audit and Reporting Requirements

Reprinted below are 12 CFR Part 363—Annual Independent Audits and Reporting Requirements (left column) and Appendix A to Part 363—Guidelines and Interpretations (center column). The regulation and appendix were published in the June 2, 1993 *Federal Register*. The right column is the AICPA staff’s commentary on the regulation and guidelines.

<table>
<thead>
<tr>
<th>Regulation</th>
<th>Guidelines</th>
<th>Commentary</th>
</tr>
</thead>
<tbody>
<tr>
<td>§363.1 SCOPE</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(a) Applicability. This part applies with respect to fiscal years of insured depository institutions which begin after December 31, 1992. This part does not apply with respect to any fiscal year of any insured depository institution, the total assets of which, at the beginning of such fiscal year, are less than $500 million.</td>
<td>1. Measuring Total Assets. To determine whether this part applies, an institution should use total assets as reported on its most recent Report of Condition (Call Report) or Thrift Financial Report (TFR), the date of which coincides with the end of its preceding fiscal year. If its fiscal year ends on a date other than the end of a calendar quarter, it should use its Call Report or TFR for the quarter end immediately preceding the end of its fiscal year.</td>
<td>• The requirements for independent accountants apply only to accountants serving the subject institutions. If an institution does not fall within the scope of §363, neither the institution nor its independent accountant is subject to the rule or guidelines.</td>
</tr>
<tr>
<td></td>
<td>2. Insured Branches of Foreign Banks. Unlike other institutions, insured branches of foreign banks are not separately incorporated or capitalized. To determine whether this part applies, an insured branch should measure claims on non-related parties reported on its Report of Assets and Liabilities of U.S. Branches and Agencies of Foreign Banks (form FFIEC 002).</td>
<td></td>
</tr>
</tbody>
</table>
### Commentary

- The guidelines use *internal controls* throughout to refer to internal controls over financial reporting. Management and independent accountant reports required by the rule relate only to financial reporting controls—including *safeguarding of assets* as discussed in guideline 9. These controls do *not* extend to compliance with applicable federal, state, and local laws.

<table>
<thead>
<tr>
<th>Regulation</th>
<th>Guidelines</th>
<th>Commentary</th>
</tr>
</thead>
<tbody>
<tr>
<td>(b) Compliance by subsidiaries of holding companies. The audited financial statements requirement of §363.2(a) may be satisfied for an insured depository institution that is a subsidiary of a holding company by audited financial statements of the consolidated holding company. The other requirements of this part for an insured depository institution that is a subsidiary of a holding company may be satisfied by the holding company if: 1. The services and functions comparable to those required of the insured depository institution by this part are provided at the holding company level; and 2. Either the insured depository institution has total assets as of the beginning of such fiscal year of: (i) less than $5 billion; or (ii) more than $5 billion, but less than $9 billion, and</td>
<td>3. Compliance by Holding Company Subsidiaries. Audited consolidated financial statements and other reports or notices required by this part which are submitted by a holding company for any subsidiary institution, should be accompanied by a cover letter identifying all subsidiary institutions to which they pertain. An institution filing holding company consolidated financial statements as permitted by §363.1(b) also may report on changes in its independent public accountant on a holding company basis. An institution that does not meet the criteria in section 36(i) must satisfy the remaining provisions of the statute and this part on an individual institution basis, and maintain its own audit committee. Multi-tiered holding companies may satisfy all requirements of this part at any level.</td>
<td>4. Comparable Services and Functions. Services and functions will be considered &quot;comparable&quot; to those required by this part if the holding company: (a) Prepares reports used by the subsidiary institution to meet the requirements of this part; (b) Has an audit committee that meets the requirements of the part appropriate to its largest subsidiary institution; and (c) prepares and submits the management assessments of the effectiveness of the internal control structure and procedures for financial reporting (&quot;internal controls&quot;), and compliance with the Designated Laws defined in Guideline 12 that are based on</td>
</tr>
</tbody>
</table>
information concerning the activities and operations of all subsidiary institutions within the scope of this part.

local laws and regulations (compliance controls) or controls over effectiveness and efficiency of operations (operational controls).

- See the related commentary on guideline 8. Further guidance is needed on how the independent accountant would report (under SSAE No. 2, Reporting on an Entity's Internal Control Structure Over Financial Reporting) when management applies guideline 4(c) by making an assertion about the financial reporting controls of more than one of its subsidiary institutions within the scope of 12 Code of Federal Regulations (CFR) 363 (a covered subsidiary).

- In applying guideline 4(c) to performance of the compliance attestation procedures, if the independent accountant performs procedures listed in Section I of the attached Appendix B, he
or she could use sample sizes calculated on a consolidated basis for the holding company and all covered subsidiaries of that holding company. Sample sizes for covered subsidiaries that are not being reported on following guideline 4(c) should not be calculated on a consolidated basis.

§363.2 ANNUAL REPORTING REQUIREMENTS

(a) Audited financial statements. Each insured depository institution shall prepare annual financial statements in accordance with generally accepted accounting principles which shall be audited by an independent public accountant.

5. Annual Financial Statements. Each institution should prepare comparative annual consolidated financial statements (balance sheets, statements of income, changes in equity capital, and cash flows, with accompanying footnote disclosures) in accordance with generally accepted accounting principles (GAAP) for each of its two most recent fiscal years. Statements for the earlier year may be presented on an unaudited basis if the institution was not subject to this part for that year and audited statements were not prepared.

6. Holding Company Statements. Subsidiary institutions may file copies of their holding company's audited financial statements filed with the Securities and Exchange Commission (SEC) or prepared for their

7. Insured Branches of Foreign Banks. An insured branch of a foreign bank should satisfy the financial statements requirement by filing one of the following for the two preceding fiscal years:
   (a) Audited balance sheets, disclosing information about financial instruments with off-balance-sheet risk;
   (b) Schedules RAL and L of form FFIEC 002, prepared and audited on the basis of the instructions for its preparation; or
   (c) With written approval of the appropriate federal banking agency, consolidated financial statements of the parent bank.

8. Management Report. Management should perform its own investigation and review of the effectiveness of internal controls and compliance with Designated Laws defined in guideline 12. Management also should

- The guidelines permit insured branches of foreign banks to satisfy the requirement with (a) a balance sheet prepared in conformity with United States GAAP; (b) a schedule prepared on another comprehensive basis of accounting defined in the Federal Financial Institutions Examination Council (FFIEC) Consolidated Reports of Condition and Income (Call Reports) or Thrift Financial Reports (TFRs) instructions; or (c) the parent bank's consolidated financial statements, which may be prepared on a basis other than United States generally accepted accounting principles (GAAP).

- The Statement on Standards for Attestation Engagements (SSAE) No. 2 states “an entity’s internal control
<table>
<thead>
<tr>
<th>Regulation</th>
<th>Guidelines</th>
<th>Commentary</th>
</tr>
</thead>
<tbody>
<tr>
<td>most recent fiscal year, a management report signed by its chief executive officer and chief accounting or chief financial officer which contains: (1) A statement of management’s responsibilities for preparing the institution’s annual financial statements, for establishing and maintaining an adequate internal control structure and procedures for financial reporting, and for complying with laws and regulations relating to safety and soundness which are designated by the FDIC and the appropriate federal banking agency; and (2) Assessments by management of the effectiveness of such internal control structure and procedures as of the end of such fiscal year and the institution’s compliance with such laws.</td>
<td>maintain records of its determinations and assessments until the next federal safety and soundness examination, or such later date as specified by the FDIC or appropriate federal banking agency. Management should provide in its assessment of the effectiveness of internal controls and compliance with the Designated Laws, or supplementally, sufficient information to enable the accountant to report on its assertions. The management report of an insured branch of a foreign bank should be signed by the branch’s managing official if the branch does not have a chief executive or financial officer.</td>
<td>structure over financial reporting includes those policies and procedures that pertain to an entity’s ability to record, process, summarize, and report financial data consistent with the assertions embodied in either annual financial statements or interim financial statements, or both” (paragraph 2). Accordingly, management’s assertion and the independent accountant’s report should relate to the assertions embodied in the annual financial statements required by 12 CFR §363.2(a). The federal banking agencies have not issued guidance about whether Call Reports or TFRs fall within the scope of management’s assertion and the independent</td>
</tr>
</tbody>
</table>
and regulations during such fiscal year.

23

9. Safeguarding of Assets. The FDIC believes “safeguarding of assets,” as the term relates to internal accountant’s report. Call Reports and TFRs are not included in the annual report required by 12 CFR §363.4(1). However, the FDIC staff has stated that management’s assertion will be expected to address call reporting.

• Guideline 8 supports the concept in the exposure draft of the proposed SSAE, Compliance Attestation, issued by the AICPA’s Auditing Standards Board on April 7, 1993, that management’s assertion be specific enough to be capable of evaluation.

• There are projects underway at various banking industry associations to provide guidance on management reporting.

• SSAE No. 2 addresses "safeguarding of assets" as
controls policies and procedures regarding financial reporting, and which has precedent in accounting literature, should be addressed in the management report and the independent public accountant's attestation discussed in guideline 18. It also believes that testing the existence of and compliance with internal controls on the management of assets, including loan underwriting and documentation, represents a reasonable implementation of section 36. Management should therefore address such internal controls as part of its management report, and the accountant should test compliance with them. Recognizing the lack of objective criteria against which the accountant may judge safeguarding of assets, however, the FDIC does not require the accountant to attest to the adequacy of safeguards, but only to determine whether safeguarding policies exist, and whether management has implemented them.1

required by guideline 9.* Management’s assertion about, and the independent accountant’s tests of, financial reporting controls will consider “safeguarding of assets” policies and procedures accordingly.

The independent accountant’s tests of controls over financial reporting of loans, for example, should include tests of whether the institution is executing transactions in accordance with management’s policies for loan underwriting and loan documentation. Such procedures might include, for example, comparing approvals for loan transactions to management’s written policy to ascertain whether the loan was approved by an officer or committee consistent with the authority limits specified for that officer or committee in the policy.
It is management's responsibility to establish underwriting policies and to make credit decisions. The auditor's role is to test compliance with management's policies.

Therefore, such policies and procedures are implicit in management's assertion and the independent accountant's opinion. However, management's assertion and the independent accountant's opinion

*Specifically, paragraph 27 of SSAE No. 2 states:

In the context of an entity's internal control structure, safeguarding of assets refers only to protection against loss from errors and irregularities in the processing of transactions and the handling of related assets. It does not include, for example, loss of assets arising from management's operating decisions, such as selling a product that proves to be unprofitable, incurring expenditures for equipment or material that proves to be unnecessary or unsatisfactory, authorizing what proves to be unproductive research or ineffective advertising, or accepting some level of merchandise pilferage by customers as part of operating a retail business.

See also Appendix D of SAS No. 55, Consideration of the Internal Control Structure in a Financial Statement Audit (AICPA, Professional Standards, vol. 1, AU sec. 319).
Commentary

could explicitly refer to safeguarding of assets, to emphasize that the scope of management's assertion and the attestation report is consistent with, and limited to, safeguarding of assets in the context discussed in paragraph 27 of SSAE No. 2. Further guidance on such report language is needed.

If the scope of management's assertion with respect to safeguarding of assets goes beyond the context discussed in paragraph 27 of SSAE No. 2, management should explicitly describe the scope of its assertion and further guidance would be needed for reporting by the independent accountant.

• SSAE No. 2 establishes conditions for the acceptance of engagements to examine and attest to management assertions about financial reporting controls. One con-
dition is that management evaluate the effectiveness of the institution's financial reporting controls using reasonable criteria for effective internal control structures established by a recognized body. Criteria issued by the AICPA, regulatory agencies, or other bodies that comprise experts who follow due process procedures, including procedures for the broad distribution of proposed criteria for public comment, usually should be considered reasonable criteria for this purpose. For example, the report Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations (COSO) of the Treadway Commission provides reasonable criteria. The Auditing Standards Board has a project under way to conform SAS No. 55 to the COSO report. SAS No. 30, Reporting on Internal Accounting Control; and other internal control standards published by the AICPA, other accounting or auditing professional associations, and financial institution trade associations.
11. Service Organizations. Although service organizations should be considered in determining if internal controls are adequate, an institution's independent public accountant, its management, and its audit committee should exercise independent judgment concerning that determination. On-site reviews of service organizations may not be necessary to prepare the reports required by the Rule, and the FDIC does not intend that the Rule establish any such requirement.

Accounting Control (AICPA, Professional Standards, vol. 1, AU sec. 642), has been superseded by SSAE No. 2.

- SAS No. 70, Reports on the Processing of Transactions by Service Organizations (AICPA, Professional Standards, vol. 1, AU sec. 324), which provides guidance to independent accountants of a service organization on issuing a report on certain aspects of the service organization's internal control structure that can be used by other independent accountants, also provides guidance on how other independent accountants should use such reports. Further, paragraphs 84–87 of SSAE No. 2 discuss the relationship of the practitioner's examination of an entity's internal control structure to the opinion obtained in an audit of financial statements.
12. Compliance with Laws and Regulations. The designated laws and regulations are the federal laws and regulations concerning loans to insiders and the federal and state laws and regulations concerning dividend restrictions, which are more specifically identified in Section I of the Agreed Upon Procedures referred to in guideline 19 (the Designated Laws).

§363.3 INDEPENDENT PUBLIC ACCOUNTANT

(a) Annual audit of financial statements. Each insured depository institution shall engage an independent public accountant to audit and report on its annual financial statements in accordance with generally accepted auditing standards and section 37 of the Federal Deposit Insurance Act (12 U.S.C. 1831n). The scope of the audit engagement shall be sufficient to permit such accountant to determine and report whether the financial statements are presented fairly and in accordance with generally accepted accounting principles.

13. General Qualifications. To provide audit and attest services to insured depository institutions, an independent public accountant should be registered or licensed to practice as a public accountant, and be in good standing, under the laws of the state or other political subdivision of the United States in which the home office of the institution (or the insured branch of a foreign bank) is located. As required by section 36(g)(3)(A)(i), the accountant must agree to provide copies of any workpapers, policies, and procedures relating to services performed under this part.

• If the independent public accountant is a firm, the firm and the signing partner should meet the qualification criteria.

• Practitioners should consult the AICPA Auditing Standards Division's Notice to Practitioners (reproduced as Appendix C to this document) for further guidance on complying with requests for access to workpapers.

With respect to requests for access, the independent accountant should consider asking that the regulators' request be in writing (as discussed in the Notice to Practitioners) and specify the documents sought and
<table>
<thead>
<tr>
<th>Regulation</th>
<th>Guidelines</th>
<th>Commentary</th>
</tr>
</thead>
<tbody>
<tr>
<td>the reason for requesting access. The independent accountant should also consider asking that the request be signed by the highest official responsible for examinations at a state banking regulatory agency or the regional office of a federal regulatory agency. Further, the independent accountant should consider asking that the request acknowledge that the agency requesting access will keep any information obtained from the documents confidential. Agencies with access should be permitted to disclose such information if it is to be used as evidence in a formal proceeding brought by, or on behalf of, the agency against the client or the independent accountant, but only after the independent accountant and the client have received reason-</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
14. Independence. The independent public accountant also should be in compliance with the AICPA's Code of Professional Conduct and meet the independence requirements and interpretations of the SEC and its staff.

15. Peer Reviews. As required by section 36(g)(3)(A)(ii), the independent public accountant must have received, or be enrolled in, a peer review that meets acceptable guidelines. The following peer review guidelines are acceptable:

(a) The external peer review should be conducted by an organization independent of the accountant or firm being reviewed, as frequently as is consistent with professional accounting practices;

(b) The peer review should be generally consistent with AICPA standards;\(^3\) and

\(^3\)These would include Standards for Performing and Reporting on Peer Reviews, codified in the SEC Practice Section Reference Manual; Standards for Performing and Reporting on Quality Reviews, contained in Volume 2 of the AICPA's Professional Standards; or Standards for Performing and Reporting on Peer Reviews, of the AICPA's Private Companies Practice Section.

- Under guideline 14, independent accountants not currently subject to the Securities and Exchange Commission's (SEC's) independence requirements must meet those requirements.

- Guideline 15 acknowledges that certain firms—for example, those that have been recently formed—may be enrolled in a practice monitoring program but may not have yet received a review. It also recognizes that certain firms may not have previously performed audits of depository institution financial statements.

- Current practice, as referred to by guideline 15(a), requires a review once every three years.
Guidelines

(c) The review should include, if available, at least one audit of an insured depository institution or consolidated financial holding company. Peer review working papers are to be retained for 120 days after the peer review report is filed with the FDIC, and be made available to the FDIC upon request, in a form consistent with the SEC’s agreement with the accounting profession.

16. Filing Peer Review Reports. Within 15 days of receiving notification that the peer review has been accepted, or before commencing any audit under this part, whichever is earlier, two copies of the peer review report, accompanied by any letter of comments and letter of response, should be filed by the independent public accountant with the FDIC, Registration and

Commentary

• Guidance on making workpapers available to the FDIC in a form consistent with the SEC’s agreement, as referred to by guideline 15(c), is available from the AICPA’s Quality Review Division to independent accountants who receive such a request from the FDIC.

• Based on footnote 3 to guideline 15, membership in the AICPA’s Division for CPA Firms’ SEC Practice Section or Private Companies Practice Section or enrollment in the AICPA Quality Review Program should satisfy the requirement.

• Consistent with guideline 15, a firm that is enrolled in a practice monitoring program, but has not yet received a report, would not be required to file a report before commencing
Disclosure Section, 550 17th Street, NW, Washington, DC 20429, where they will be available for public inspection. Accountants may elect to file an annual list of their insured depository institution and holding company (identifying any subsidiary institutions subject to this part) audit clients in lieu of copies of peer review reports for each institution they have been engaged to audit. The FDIC has determined that such client lists are exempt from public disclosure. All corrective action required under any qualified peer review report should have been taken prior to commencing services under this part.

17. Information to Independent Public Accountant.
Attention is directed to section 36(h) which requires institutions to provide specified information to their accountants. An institution also should provide its accountant with copies of any notice that the institution's capital category is being changed or reclassified under section 38 of the FDI Act, and any correspondence from the appropriate federal banking agency concerning compliance with this part.

- Section 36(h) referred to by guideline 17 requires an institution to generally provide its independent accountant with copies of the following:
  - The institution's most recent Call Report (or TFR) and report of examination
  - Any supervisory memorandum of understanding and any written agreement between the institution and any federal or state banking agency
  - A report of any action initiated or taken by federal or state banking agencies
(b) Additional reports. Such independent public accountant shall examine, attest to, and report separately on, the assertions of management concerning the institution’s internal control structure and procedures for financial reporting. The accountant shall apply procedures agreed upon by the FDIC objectively to determine compliance by an insured depository institution with designated laws and regulations. The attestations shall be made in accordance with generally accepted standards for attestation engagements.

18. Attestation Reports. The independent public accountant should provide the institution with an internal controls attestation report, a compliance with Designated Laws attestation report, and any management letter, at the conclusion of the audit as required by section 36(c)(1). If a holding company subsidiary relies on its holding company management report, the accountant may attest to and report on the management’s assertions in one report, without reporting separately on each subsidiary covered by this part. One attestation report for compliance with the Designated Laws also may be filed, if all exceptions are listed and the respective institutions to which the exceptions apply are identified. The FDIC has determined that management letters and the Designated Laws attestation report are exempt from public disclosure.

19. Procedures for Determining Compliance with Designated Laws. In order to permit the independent

• Practitioners should consult SSAE No. 2, and the final SSAE on compliance attestation that is expected to be issued by the AICPA by year-end 1993, for guidance on reporting that involves multiple locations.

• The independent accountant’s compliance attestation report and any management letter will not be publicly available.

• Although guideline 19 refers to a determination
public accountant to determine the extent of compliance with the Designated Laws defined in guideline 12 and the related assessment by management, the procedures set forth in schedule A (the Agreed Upon Procedures) to these Guidelines should be applied. The accountant should require all management representations to be in writing, and take appropriate steps to determine that any sampling is reasonably representative. Attestation reports generally should identify all findings from application of the Agreed Upon Procedures which establish any items of non-compliance, note any absence of written policies, and disclose the reasons why any Agreed Upon Procedures were not performed.

20. Reviews with Audit Committee and Management. The independent public accountant should meet with the institution's audit committee to review the accountant's reports required by this part before they are filed. It also may be appropriate for the accountant to review its findings with the institution's board of directors and management.

21. Notice of Termination. The notice required by §363.3(c) should state whether the independent accountant agrees with the assertions contained in any notice filed by the institution under §363.4(d), and whether the institution's notice discloses all relevant reasons.
accountant for an insured depository institution shall notify the FDIC and the appropriate federal banking agency in writing of such termination within 15 days after the occurrence of such event, and set forth in reasonable detail the reasons for such termination.

22. Reliance on Internal Auditors. Nothing in this part or this appendix is intended to preclude the ability of the independent public accountant to rely on the work of an institution's internal auditor.

- The extent to which the independent accountant may consider the work of internal auditors in a financial statement audit is addressed in SAS No. 65, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements* (AICPA, Professional Standards, vol. 1, AU sec. 322). SSAE No. 2 refers the accountant to SAS No. 65 when addressing the competence and objectivity of internal auditors; the nature, timing, and extent of work to be performed; and other related matters in an examination-level attestation engagement (such as a report on the examination of management's assertion about financial reporting controls). With respect to the compliance attestation engagement, the Auditing Standards Board, at its December 1992
meeting, concluded that the external auditor may not use the internal auditor for direct assistance in an agreed-upon procedures engagement to satisfy the FDICIA requirement. As discussed in appendix B, guidance is needed for reporting on procedures performed on internal auditors' workpapers.

§363.4 FILING AND NOTICE REQUIREMENTS

(a) Annual reporting. Within 90 days after the end of its fiscal year, each insured depository institution shall file with each of the FDIC, the appropriate federal banking agency, and any appropriate state bank supervisor, two copies of:

(1) An annual report containing audited annual financial statements, the independent public accountant's report thereon, management's statements and assessments, and the independent public accountant's attestation report

23. Place for Filing. Except for peer review reports filed pursuant to Guideline 16, all reports and notices required by, and other communications or requests made pursuant to, this part should be filed as follows:

(a) FDIC: Regional Director (Supervision) of the FDIC Regional Office in which the institution is headquartered;

(b) Office of the Comptroller of the Currency (OCC): appropriate OCC Supervisory Office;

(c) Federal Reserve: appropriate Federal Reserve Bank;

(d) Office of Thrift Supervision (OTS): appropriate OTS District Office; and

(e) State bank supervisor: the filing office of the appropriate state bank supervisor.

24. Relief from Filing Deadlines. Although the FDIC believes that the deadlines for filings and other notices
concerning the institution’s internal control structure and procedures for financial reporting as required by §§363.2(a) and 363.3(a), 363.2(b), and 363.3(b) respectively; and

(2) the accountant’s attestation concerning compliance with laws and regulations pursuant to §363.3(b).

(b) Public availability. The foregoing annual report in paragraph (a) of this section shall be available for public inspection.

(c) Independent accountant’s reports. Each insured depository institution shall file with the FDIC, the appropriate federal banking agency, and

established by section 36 and this part are reasonable, it recognizes some institutions occasionally may be confronted with extraordinary circumstances beyond their reasonable control that may justify extensions of a deadline. In that event, upon written application from an insured depository institution, setting forth the reasons for any requested extension, the FDIC or appropriate federal banking agency may, for good cause shown, extend the deadline for a period not to exceed 30 days.

25. Public Availability. Each institution’s annual report should be available for public inspection at its main and branch offices no later than 15 days after it is filed with the FDIC. Alternatively, an institution may elect to mail one copy of its annual report to any person who requests it. The annual report should remain available to the public until the annual report for the next year is available. An institution may use its annual report under this part to meet the annual disclosure statement required by 12 CFR 350.3, if the institution satisfies all other requirements of 12 CFR part 350.

26. Independent Public Accountant’s Report. Section 36(h)(2)(A) requires that, within 15 days of receipt by an institution of any management letter or other report, such letter or other report shall be filed with the FDIC, any appropriate federal banking agency and any

- The publicly available annual report contains the independent accountant’s audit report on financial statements and attestation report on management’s assertion about financial reporting controls. The independent accountant’s agreed-upon procedures report is not to be included in the annual report and is not publicly available.
- Note that management must file, within fifteen days of receipt, reports of the independent accountant, even if they will be filed
appropriate state bank supervisor. Institutions and their accountants are encouraged to coordinate preparation and delivery of audit and attestation reports and filing the annual report, to avoid duplicate filings.

• The law, implementing regulations, and guidelines do not eliminate the independent accountant’s responsibility under...
(d) Notice of engagement or change of accountants. Each insured depository institution shall provide, within 15 days after the occurrence of any such event, written notice to the FDIC, the appropriate federal banking agency, and any appropriate state bank supervisor of the engagement of an independent public accountant, or the resignation or dismissal of the independent public accountant previously engaged. The notice shall include a statement of the reasons for any such event in reasonable detail.

27. Notices Concerning Accountants. Institutions should review and satisfy themselves as to compliance with the required qualifications set forth in guidelines 13-15 before engaging an independent public accountant. With respect to any selection, change or termination of an accountant, institutions should be familiar with the notice requirements in guideline 21, and should send a copy of any notice under §363.4(d) to the accountant when it is filed with the FDIC. An institution which files reports with its appropriate federal banking agency under, or is a subsidiary of a holding company which files reports with the SEC pursuant to, the Securities Exchange Act of 1934 may use its current report (e.g., SEC Form 8-K) concerning a change in accountant to satisfy the similar notice requirements of this part.

- "Other report" refers to the reports required by 12 CFR §363.

- The current report filed with regulators (that is, Form F-3 for the FDIC and SEC Form 8-K for others) includes the independent accountant’s response to management’s disclosures. However, it may not include all matters required to be reported under 12 CFR §363.3 (c) and guideline 21.
§363.5 AUDIT COMMITTEES

(a) Composition and duties. Each insured depository institution shall establish an independent audit committee of its board of directors, the members of which shall be outside directors who are independent of management of the institution, and the duties of which shall include reviewing with management and the independent public accountant the basis for the reports issued under this part.

28. Composition. The board of directors of each institution should determine if outside directors meet the requirements of section 36 and this part. At least annually, it should determine whether all existing and potential audit committee members are “independent of management of the institution.” If the institution has total assets in excess of $3 billion, the board also should determine whether members of the committee satisfy the additional requirements of this part. Because an insured branch of a foreign bank does not have a separate board of directors, the FDIC will not apply the audit committee requirements to such branch. However, any such branch is encouraged to make a reasonable good faith effort to see that similar duties are performed by persons whose experience is generally consistent with the Rule’s requirements for an institution the size of the insured branch.

29. “Independent of Management” Considerations. In determining whether an outside director is independent of management, the board should consider all relevant information. This would include considering whether the director:
   (a) Is or has been an officer or employee of the institution or its affiliates;
   (b) Serves or served as a consultant, advisor, promoter, underwriter, legal counsel, or trustee of or to the institution or its affiliates;
   (c) Is a relative of an officer or other employee of the institution or its affiliates;
(d) Holds or controls a direct or indirect financial interest in the institution or its affiliates; and
(e) Has outstanding extension of credit from the institution or its affiliates.

30. **Lack of Independence.** An outside director should not be considered independent of management if such director is, or has been within the preceding year, an officer or employee of the institution or any affiliate, or owns or controls, or has owned or controlled with the preceding year, assets representing 10 percent or more of any outstanding class of voting securities of the institution.

31. **Holding Company Audit Committees.** Members of an independent audit committee of a holding company may serve as the audit committee of any subsidiary institution if they are otherwise independent of management of the subsidiary. This would not, however, permit officers or employees of the holding company to serve on the audit committee of its subsidiary institutions. The audit committee of the holding company may perform all the duties of the audit committee of a subsidiary institution, even though such holding company directors are not directors of the institution.

32. **Duties.** The audit committee should perform all duties determined by the institution's board of directors. The duties should be appropriate to the size of the institution and the complexity of its operations, and include
reviewing with management and the independent public accountant the basis for the reports issued under §363.2(b). Appropriate additional duties could include:

(a) Reviewing with management and the independent public accountant the scope of services required by the audit, significant accounting policies, and audit conclusions regarding significant accounting estimates;

(b) Reviewing with management and the accountant their assessments of the adequacy of internal controls, and the resolution of identified material weaknesses and reportable conditions in internal controls, including the prevention or detection of management override or compromise of the internal control system;

(c) Reviewing with management and the accountant the institution's compliance with laws and regulations;

(d) Discussing with management the selection and termination of the accountant and any significant disagreements between the accountant and management; and

(e) Overseeing the internal audit function.

It is recommended that audit committees maintain minutes and other relevant records of their meetings and decisions.

33. Banking or Related Financial Management Expertise. At least two members of the audit committee of a large institution shall have "banking or related financial management expertise" as required by section 36(g)(1)(C)(i). This determination is to be made by the board of directors of the insured depository institution. A person will be considered to have such required expertise if the person
with banking or related financial management expertise, have access to its own outside counsel, and not include any large customers of the institution.

has significant executive, professional, educational, or regulatory experience in financial, auditing, accounting, or banking matters as determined by the board of directors. Significant experience as an officer or member of the board of directors or audit committee of a financial services company would satisfy these criteria.

34. Large Customers. Any individual or entity (including a controlling person of any such entity) which, in the determination of the board of directors, has such significant direct or indirect credit or other relationships with the institution, the termination of which likely would materially and adversely affect the institution's financial condition or results of operations, should be considered a "large customer" for purposes of §363.5(b).

35. Access to Counsel. The audit committee should be able to retain counsel at its discretion without prior permission of the institution's board of directors or its management. Section 36 does not preclude advice from the institution's internal counsel or regular outside counsel. It also does not require retaining or consulting counsel, but if the committee elects to do either, it also may elect to consider issues affecting the counsel's independence. Such issues would include whether to retain or consult only counsel not concurrently representing the institution or any affiliate, and whether to place limitations on any counsel representing the institution concerning matters in which such counsel previously
participated personally and substantially as outside counsel to the committee.

36. Forming and Restructuring Audit Committees. Audit committees should be formed within four months of the effective date of this part. Some institutions may have to restructure existing audit committees to comply with this part. No regulatory action will be taken if institutions restructure their audit committees by the earlier of their next annual meeting of stockholders, or one year from the effective date of this part.

37. Modifications of Guidelines. The FDIC Board of Directors has delegated to the Director of the FDIC's Division of Supervision authority to make and publish in the Federal Register minor technical amendments to the Guidelines (including the attached Agreed Upon Procedures in schedule A to this appendix), in consultation with the other appropriate federal banking agencies, to reflect the implementation of this part. It is not anticipated any such modification would be effective until affected institutions have been given reasonable advance notice of the modification. Any material modification or amendment will be subject to review and approval of the FDIC Board of Directors.
Agreed-Upon Procedures

Reprinted in the following are the agreed-upon procedures to be performed by the independent accountant in relation to management’s assertion about compliance with dividend restriction and insider loan laws and regulations. The resulting report will not be publicly available (see guideline 18 on page 34. The AICPA staff commentary on the procedures is provided in the fully italicized paragraphs.

Section I—Procedures for Individual Institutions

The following information should be obtained, and the indicated procedures should be performed, by the institution’s independent public accountant in accordance with generally accepted standards for attestation engagements, or by the institution’s internal auditor if the procedures set forth in section II of this schedule are to be performed by the accountant.

Commentary: On April 7, 1993, the Auditing Standards Board published an exposure draft of a proposed Statement on Standards for Attestation Engagements (SSAE), Compliance Attestation. That statement would provide additional guidance on such agreed-upon procedures level attestation engagements. Comments on the exposure draft were due by June 30, 1993. A final statement is expected to be issued by year-end 1993.

Commentary: The following sample sizes have not been objected to by the FDIC, the OCC, or the OTS for purposes of applying those procedures that require sampling:

<table>
<thead>
<tr>
<th>Population Number (N)</th>
<th>Sample Size</th>
</tr>
</thead>
<tbody>
<tr>
<td>100 or greater</td>
<td>60</td>
</tr>
<tr>
<td>50 to 100</td>
<td>25</td>
</tr>
<tr>
<td>0 to 50</td>
<td>N or 20, whichever is smaller</td>
</tr>
</tbody>
</table>

A. Loans to Insiders

1. Designated Laws. The following laws and regulations (Designated Insider Laws) should be read:

\[\text{Reprinted from Appendix A to 12 CFR Part 363. See Federal Register, June 2, 1993.}\]
(a) The laws codified at 12 U.S.C. 375, 375a, 375b, 376, 1468(b), 1828(j)(2), 1828(j)(3)(B), 1817(k), and 1972; and
(b) The regulations set forth at 12 CFR 23.5, part 31, 211.3(b)(4), part 215, 337.3, 349.3, 563.43, and 935.2.

2. **Information and Procedures.** Obtain from management of the institution, and read, the following information for the institution's most recent fiscal year through the date of the attestation report, and perform the procedures indicated with respect to such information:

a. **General Information.** Obtain management's assessment of compliance with the Designated Insider Laws; all minutes (including minutes drafted, but not approved) of the meetings of the board and its committees; reports of examinations, supervisory agreements, and enforcement actions issued by the institution's primary federal and state regulators, if applicable; all public documents filed under the Securities and Exchange Act of 1934 with the FDIC, SEC, Federal Reserve Board, OCC, or OTS and annual reports filed by insiders identifying their related interest as required by 12 CFR 215.7.

   **Procedure:**
   (i) Read the foregoing information.
   (ii) Trace and agree each disclosed insider loan and other extension of credit to see that it is included on the list of Insider Transactions.

b. **Calculations.** Obtain management's calculation of the greater of 5 percent of the institution's year-end capital and unimpaired surplus or $25,000.

   **Procedure:** Recalculate for mathematical accuracy, and trace amounts used in management's calculations to the institution's year-end Call Report or TFR.

c. **Policies and Procedures.** Obtain the institution's written policies and procedures concerning its compliance with the Designated Insider Laws, including any written "Code of Ethics" or "Conflict of Interest" policy statements. If the institution has no written policies and procedures, obtain a narrative from management that describes the methods for complying with such laws, and includes provisions similar to those listed below.

   **Procedure:** Ascertain that the policies and procedures include, or incorporate by reference, provisions consistent with the Designated Insider Laws for:
   (i) Defining terms;
   (ii) Prohibiting and restricting loans to insiders (i.e., directors, executive officers, and principal shareholders and their related interests);
   (iii) Maintaining records of loans to insiders;
   (iv) Requiring reports and disclosures by the institution and by executive officers, directors, and principal shareholders;
(v) Disseminating policy information;
(vi) Revising policies to reflect subsequent changes in the law;
(vii) Educating employees about the legal requirements and management's related policies and procedures;
(viii) Prior approval of the board of directors or its committees, as appropriate; and
(ix) Reporting insider loans to regulatory agencies on the institution's Call Report or TFR.

d. **Insider Transactions.** Obtain a list of loans or other extensions of credit to insiders (including their related interests) during the fiscal year and management's written representations regarding—
   (i) The completeness of the list, and
   (ii) Whether the terms of insider transactions are comparable to those that would have been available to unaffiliated third parties.

   **Procedure:** Select a sample of the insider transactions from the list. For each transaction in the sample selected:
   (1) Ascertain that each executive officer and principal shareholder (or related interest) has reported annually to the board of directors, on or before January 31 of the following year, any indebtedness to correspondent banks, and that such report states:
      (a) The maximum amount of indebtedness during the previous calendar year;
      (b) The amount of indebtedness outstanding 10 days prior to report filing; and
      (c) A description of the loan terms and conditions, including the rate or range of interest rates, original amount and date, maturity date, payment terms, security, and any unusual terms or conditions.
   (2)(a) Trace and agree amounts outstanding by insiders to the schedule aggregating indebtedness of all insiders on the institution's year-end Call Report or TFR;
      (b) Obtain from management documentation that indicates whether the specific extensions of credit, at the option of the institution, will become due and payable at any time that the insider is indebted to any other insured institution in an aggregate amount greater than the amount specified for a category of credit in 12 CFR 215.5(c);
      (c) Obtain from management a copy of the institution's written notification to the insider to ascertain whether the insider has been informed of the reporting requirements relative to insider transactions and has acknowledged such requirements;
      (d) If the credit exceeds the lesser of the calculation obtained in paragraph 2b. or $500,000, read the minutes of the meetings of the board of directors and determine whether the minutes indicate that the credit was approved in advance by the board and the insider abstained from participating directly or indirectly in voting on the transactions; and
(e) Obtain management’s calculated legal lending limit for the credit and ascertain whether the amount of the credit exceeds such limit.

(3) For executive officers, directors, and principal shareholders of the institution included in the sample, obtain a written history of the insider’s overdrafts for the year and obtain management’s representation whether that history is complete. In addition,

(a) Inquire whether cash items for the individual are being held by the institution to prevent an overdraft, and

(b) Trace and agree subsequent payment by the insider of the insider’s overdrafts to records of the account at the institution.

(4) For overdrafts of executive officers and directors included in the sample that are being paid by the institution for the executive officer and director on an account at the institution:

(a) Trace and agree to a written, pre-authorized, interest-bearing extension of credit plan that specifies a method of repayment; or,

(b) Trace and agree to a written, pre-authorized transfer of funds from another account of the insider at the institution; or,

(c) For aggregate amounts of $1,000 or less, obtain a written representation from management that:

(i) It believes the overdraft was inadvertent,

(ii) The account was overdrawn in each case for less than 5 business days, and

(iii) The institution charged the executive officer and director the same fee that it would charge any other customer in similar circumstances.

(5) For extensions of credit to an executive officer selected, ascertain that each credit was:

(a) Preceded by a submission of a financial statement;

(b) Promptly reported to the board of directors; and

(c) Made subject to the condition, as specified in the note or other evidence of indebtedness, that the extension of credit will become, at the option of the institution, due and payable at any time that the executive officer is indebted to other insured institutions in an aggregate amount greater than the executive officer would be able to borrow from the institution.

(6) Based on the types of transactions in the sample selected, select a sample of similar transactions with persons who are not insiders of the institution or its affiliates as of the same dates or within two weeks of the insider transaction. Compare the terms of the transactions with the persons not affiliated with the institution to those with insiders, and note in the findings any material differences in the terms favorable to insiders compared to the terms of the transactions with persons not affiliated with the institution or its affiliates.
Commentary: The independent accountant's selection of "similar" transactions and comparison of terms should only relate to objectively measurable characteristics of the loan (for example, the stated interest rate, or the type of loan).

(7) Aggregate the indebtedness to executive officers, directors, and principal shareholders of the institution and to their related interests from the list obtained as of the end of the fiscal year and one other day selected during the year. Compare this total with 100 percent of the institution's unimpaired capital and surplus at the one day selected during the year and the end of its fiscal year. (The unimpaired capital and surplus calculated from the most recent Call Report or TFR may be used, unless there is reason to believe that a significant change has taken place between the dates.) Report any excess as an exception in the findings.

Commentary: The independent accountant should state his or her objective criterion for "significant change" if applicable.

e. Executive Officers' Reports. Obtain a list of all written reports made by executive officers of the institution concerning debt with other insured institutions, and management's representation concerning the completeness of such list.

Procedure: Select a sample of written reports. For reports selected, note any reported aggregate extensions of credit in excess of the amounts management represents the executive officer would have been able to borrow from the reporting institution and whether the report was made within 10 days of the date the indebtedness reached such a level.

Commentary: The preceding procedures relate to the insider's debt at other institutions. The procedures that follow relate to the insider's debt at the covered institution.

Obtain management's calculation of:
(i) The aggregate amount of loans and other extensions or lines of credit to the executive officer and
(ii) 2.5 percent of the institution's capital and unimpaired surplus.
Recalculate management's computations for mathematical accuracy and trace amounts used in management's computations to the institution's Call Report or TFR. Ascertain whether the aggregate amount of the credits for the executive officer exceeds the greater of 2.5 percent of the institution's capital and unimpaired surplus or $25,000, but in no event more than $100,000, unless such credits are used to finance the
education of the executive officer's children or the officer's principal residence. If the credit extended is a real estate loan, obtain documentation for the credit and note whether such documentation contains representations that:

(i) The purpose of the credit is for the purchase, construction, maintenance, or improvement of the executive officer's principal residence;
(ii) The credit is secured by a first lien on the residence; and
(iii) The executive officer owns or expects to own the residence after the extension of credit.

B. Dividend Restrictions

1. Designated Laws. The following federal laws and regulations (Designated Dividend Laws) should be read:
   (a) The laws codified at 12 U.S.C. 56, 60, 1467(a)(f), 1831o; and
   (b) The regulations set forth at 12 CFR 5.61, 5.62, 6.6, 7.6120, 208.19, and 563.134.

   **Commentary:** The independent accountant should also read any state laws identified by management in its assertion.

2. Information and Procedures. Obtain from management of the institution, and read, the following information for the institution's most recent fiscal year through the date of the attestation report, and perform the procedures indicated with respect to such information:

   a. Management's Assessment. Obtain management's assessment of the institution's compliance with the Designated Dividend Laws and any applicable state laws and regulations cited in management's assessment. Also obtain management's written representation whether dividends declared comply with the legal limitations and any restrictions on dividend payments under any supervisory agreements, orders, or resolution of any regulatory agency (including a description of the nature of any such agreement, order, or resolution).

   b. Policies and Procedures. Obtain the institution's written policies and procedures concerning its compliance with the Designated Dividend Laws. If the institution has no written policies and procedures, obtain from the institution a narrative that describes the institution's methods for complying with Designated Dividend Laws, includes provisions similar to those below.

   **Procedure:** Ascertain whether the policies and procedures include, or incorporate by reference, provisions which are consistent with the Designated Dividend Laws. For banks and savings institutions, these would include capital limitation tests, including section 38 of the FDIC Act, earnings limitation tests, transfers from surplus to undivided
profits, and restrictions imposed under any supervisory agreements, resolutions, or orders of any federal or state bank regulatory agency. For savings associations, include prior notification to the OTS.

c. **Board Minutes.** Obtain minutes of the meetings of the board of directors for the most recent fiscal year to ascertain whether dividends (either paid or unpaid) have been declared.

*Procedure:* Trace and agree total dividend amounts to the general ledger records and the institution's appropriate Call Reports or TFRs filed with regulators.

d. **Calculation.** Obtain management's computation of the amount at which declaration of a dividend would cause the institution to be undercapitalized.

*Procedure:* Recalculate management's computation (for mathematical accuracy) and compare management's calculations to the amount of any dividend declared to determine whether it exceeded the amount.


*Procedure:* Recalculate management's computations (for mathematical accuracy) and compare management's calculations to the standards defined in the test set forth in subsection 2d. above to ascertain whether the dividends declared fall under the permissible level under this standard. If dividends are not permissible under such standard, ascertain if the dividends were declared under approval of the appropriate federal banking agency or any other exception. If not, report the exception in the findings.

f. **Savings Associations.** Obtain management's documentation of the OTS determination of whether the institution is a Tier 1, Tier 2, or Tier 3 savings institution and management's computation of its capital ratio after declaration of dividends under the Tier determined by the OTS. For dividends declared, obtain a copy of the savings institution's notification to the OTS to ascertain whether notification was made at least 30 days before payment of any dividends.

*Procedure:* Recalculate management's computation (for mathematical accuracy) and trace amounts used by management in its calculation to the institution's TFRs.

**Section II—Procedures for Independent Public Accountant**

If the internal auditor has performed the procedures set forth in section I, the following procedures may be performed by the indepen-
dent public accountant if neither the FDIC nor the appropriate federal banking agency has objected in writing. If the procedures in section I have been performed by an internal auditor employed by a holding company, such procedures should be applied to each subsidiary institution (a Covered Subsidiary) subject to this part. The report of procedures performed and list of exceptions found by the internal auditor, identifying the institution with respect to which any exception was found, should be submitted to the audit committee of the board of directors.

A. Review of Designated Laws

The Designated Insider Laws and Designated Dividend Laws applicable to the institution should be read.

B. Information and Procedures

Obtain from management of the institution, and read, the following information for the institution's most recent fiscal year through the date of the attestation report, and perform the procedures indicated with respect to such information:

1. Designated Laws. Read section I of this schedule. Obtain management's assessment contained in its management report on the institution's or holding company's compliance with the Designated Laws.

2. Internal Auditor's Workpapers. If an internal auditor performed the procedures in Section I, obtain the internal auditor's workpapers documenting the performance of those procedures on the institution, including all Covered Subsidiaries, and the chief internal auditor's written representation that:

   (a) The internal auditor or audit staff, if applicable, performed the procedures listed in section I on the institution and each Covered Subsidiary;

   (b) The internal auditor tested a sufficient number of transactions governed by the Designated Laws so that the testing was representative of the institution's or Covered Subsidiary's volume of transactions;

   (c) The workpapers accurately reflect the work performed by the internal auditor and, if applicable, the internal audit staff;

   (d) The workpapers obtained are complete; and

   (e) The internal auditor's report, which describes the procedures performed for the preceding fiscal year as well as the internal auditor's findings and exceptions noted, has been presented to the institution's audit committee.
Procedure: Compare the workpapers to the procedures that are required to be performed under section I, and report as an exception any procedures not documented and any procedures for which the sample size is not sufficient.

Commentary: The independent accountant should compare sample sizes to those in the table on page 47. A subjective determination about the sufficiency of sample sizes is beyond the scope of an agreed-upon procedures attestation engagement.

Compare the exceptions and errors listed by the internal auditor in its report to the audit committee to those found in the workpapers, and report as an exception any exception or error found in the internal auditor's workpapers and not listed in the internal auditor's list of exceptions.

Commentary: The objective of this procedure is to ensure that any findings identified as such by internal auditors in their workpapers are also included in their report to the institution's audit committee.

C. Testing by Independent Public Accountant

The accountant should perform the procedures listed in section I on a representative sample of the transactions of the institution and Covered Subsidiaries to which each of the Designated Laws applies. The sample tested at each institution, or Covered Subsidiary, should be at least 20 percent of the size of the sample tested by the internal auditor at such institution, although samples selected should be from the population at large.

Commentary: The independent accountant should consult any future guidance issued on reporting of procedures performed on internal auditors' workpapers. The independent accountant's sample should be selected from the population at large, not from the internal auditor's sample.

If the testing is being performed on a holding company with more than one Covered Subsidiary, the sample tested for each Designated Law should include transactions from each such subsidiary at least every other fiscal year. If the holding company has more than eight Covered Subsidiaries, the sample of transactions tested for each Designated Law should include transactions from each such subsidiary at least every third fiscal year.
D. Reports Concerning Holding Companies

Only one report of any exceptions noted from application of the procedures in section II performed by the independent public accountant on all Covered Subsidiaries of a holding company should be filed as required by guideline 3, but the report should identify, for each exception or error noted, the identity of the Covered Subsidiary to which it relates.
Guidance for Independent Auditors When Required to Provide Access to or Photocopies of Workpapers to Regulators¹

[This Notice to Practitioners appeared in the July/August 1993 issue of the CPA Letter]

The AICPA AdHoc Task Force on Auditor Workpapers has developed guidance for independent auditors to consider when they are obligated by law, regulation, or audit contract to provide access to or photocopies of audit workpapers to a regulator. This guidance has not been approved, disapproved, or otherwise acted upon by a senior technical committee of the AICPA.

The guidelines that follow were developed to assist auditors in fulfilling these obligations while also maintaining control over the workpapers. (The guidance does not apply to situations involving a request from the IRS, or firm practice-monitoring programs to comply with AICPA or state professional requirements, such as peer or quality reviews, or in response to a subpoena.)

Statement on Auditing Standards (SAS) No. 41, Working Papers, [AICPA, Professional Standards, vol. 1, AU sec. 339] provides auditors guidance on the functions, nature, content, ownership and custody of working papers.² SAS No. 41 observes that working papers are the property of the auditor. However, in some situations, auditors may be obligated to provide access to or photocopies of their workpapers to a regulator.

Providing Access to Workpapers

When the auditor is required by law, regulation, or audit contract to provide the regulator access to workpapers, the auditor should:

- Ensure that the client and the audit team are aware that the workpapers may be reviewed by regulators, and have the client

¹The term “regulator” includes federal, state, and local government officials with legal oversight authority over the entity being audited.

²SAS No. 41 states that “working papers are records kept by the auditor of the procedures applied, the tests performed, the information obtained, and the pertinent conclusions reached in the engagement. Examples of working papers are audit programs, analyses, memoranda, letters of confirmation and representation, abstracts of company documents, and schedules or commentaries prepared or obtained by the auditor.”
acknowledge in the engagement letter that the workpapers are the property of the auditor but the regulator may be provided with access to workpapers, upon request in accordance with the law, regulation, or audit contract.

Sample language which may be included in the engagement letter follows:

The working papers for this engagement are the property of [name of firm] and constitute confidential information. However, as required by [law, regulation, or the terms of the audit contract], we are required to make certain workpapers available to [name of regulator] upon request for their regulatory oversight purposes. Access to the requested workpapers will be provided to [name of regulator] under the supervision of [name of firm] audit personnel and at a location designated by our firm.

• Ensure that a request for access to workpapers by the regulator is in writing. The auditor should communicate specific details (such as date, time, and location) to the client of how access to the workpapers will be provided, and request the client acknowledge to the auditor in writing that the auditor is required to provide such access to the regulator. In the event the client does not comply with this request, the auditor may wish to consult his or her own legal counsel.

• Maintain control over the workpapers at all times. Unless expressly provided for by law, regulation, or audit contract, only workpapers related to specific requests should be made available.

Providing Photocopies of Workpapers

In addition to the above guidelines, when required by law, regulation, or contract to provide a regulator photocopies of workpapers, the auditor should—

• Provide copies of only those specific portions of workpapers that were requested, preferably only requests made during the course of an on-site review.

• Consider asking the client to review requested workpaper copies before they are submitted to the regulator.

• Ensure that control over copies of the workpapers is maintained by having all workpaper copies clearly labeled as confidential and by noting that secondary distribution of the workpapers is not permitted without the written approval of the auditor. Copies should be transmitted to the regulator with a cover letter.
requesting confidential treatment of information contained in the workpapers.

Sample language for the cover letter follows:

These workpapers are submitted as CONFIDENTIAL. Exemption from disclosure to nongovernmental parties of these documents and any copies of them is claimed under the Freedom of Information Act and all other applicable provisions of law and regulation. **Before** any disclosure is permitted of these documents, including any part or copies of them, please provide notice to [insert name, address and telephone number of auditor or his or her representatives].

Members should contact the AICPA's Auditing Standards Division at (212) 596-6036 with questions.