

**FEDERAL RESERVE BANK
OF NEW YORK**

AT-10690
February 18, 1994

**Supervisory Guidance on the Implementation of Section 112
of the Federal Deposit Insurance Corporation Improvement Act**

*To the Chief Executive Officers of All State Member Banks,
Bank Holding Companies, and Insured Branches
of Foreign Banks in the Second Federal Reserve District:*

The FDIC's final rule implementing Section 112 of the FDIC Improvement Act of 1991 (FDICIA) became effective July 2, 1993. This section of FDICIA amends the Federal Deposit Insurance Act by adding Section 36, "Early Identification of Needed Improvements in Financial Management." In general, effective with fiscal years beginning after December 31, 1992, the final rule requires State member banks and other insured depository institutions with \$500 million or more in total assets ("covered institutions") as of the beginning of each fiscal year to obtain annual independent audits, submit certain management reports to their regulatory agencies, and establish audit committees of their boards of directors comprised of independent directors. In addition, the final rule establishes certain new requirements for independent auditors (CPAs) of insured depository institutions.

Beginning in 1994, covered institutions are required to submit a copy of the following reports (Section 36 reports) to the Federal Reserve Bank of New York, 33 Liberty Street, New York, NY 10045, ATTN: Joseph L. Galati II, Manager, Specialized Examinations Department, with additional copies to be submitted to the FDIC and the appropriate state regulator, within 90 days after the end of its fiscal year:

- (1) an **annual report** containing audited annual financial statements including the CPA's report thereon, prepared in accordance with generally accepted accounting principles (GAAP);
- (2) a **management report** containing: (i) a statement of management's responsibility for preparing the institution's annual financial statements, establishing and maintaining adequate internal controls for financial reporting, and complying with certain laws and regulations designated by the FDIC and the appropriate federal banking agency; and (ii) management's assessment of the effectiveness of those internal controls and the institution's compliance with the designated laws and regulations; and

(Over)

- (3) a **CPA attestation report** concerning the institution's internal control structure and procedures for financial reporting.

Covered institutions also are required to submit to their primary supervisory agency a report, prepared by their CPA, based upon certain "agreed-upon procedures" performed to determine compliance with designated laws and regulations. However, unlike the above reports, this report is not available for public inspection.

Discussed below are certain implementation issues that recently have come to our attention affecting the nature and scope of the Section 36 reports that will be filed with the Federal Reserve Bank of New York.

1. *Call Reports.* There has been some question regarding whether the internal controls established for the preparation of the Call Report is to be covered by the definition of internal controls for financial reporting. The FDIC staff, together with the staffs of the Federal Reserve and other federal banking agencies, believe the intent of the final rule is to include Call Reports in the definition of internal controls for financial reporting. Therefore, the internal control structure and procedures related to the preparation of the Call Report must be included in management's assessment and the CPA's attestation regarding the effectiveness of the internal control structure and procedures for financial reporting.

2. *Bank Holding Company Filing Requirements.* State member banks covered by the final FDIC rule are required to file their annual Section 36 reports with the appropriate Federal Reserve Bank within 90 days after the end of their fiscal year. In addition, the FDIC rule permits certain insured depository institutions to satisfy their reporting requirements by filing their annual Section 36 reports on a consolidated holding company basis, provided these institutions meet certain functional, size and CAMEL rating criteria. However, the rule does not address the Federal Reserve Board's responsibility as the primary regulator of bank holding companies. To facilitate effective and prudential supervision, bank holding companies that have institutions subject to the final FDIC rule and guidelines must submit one copy of their subsidiary's Section 36 reports to this Bank, regardless of the charter of the subsidiary, unless those subsidiaries have been covered by submission on a consolidated holding company basis.

Enclosed for your further information is the supervisory letter received from the Board of Governors of the Federal Reserve System on this issue, along with a copy of the FDIC's final rule and its accompanying "Guidelines and Interpretations." You are encouraged to share this information with your CPA.

Any questions regarding this matter or the reporting requirements of Section 36 may be directed to Joseph L. Galati II, Manager, Specialized Examinations Department (Tel. No. 212-720-7946).

CHESTER B. FELDBERG,
Executive Vice President.



BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

WASHINGTON, D. C. 20551

SR 94-3 (FIS)

DIVISION OF BANKING
SUPERVISION AND REGULATION

January 13, 1994

TO THE OFFICER IN CHARGE OF SUPERVISION
AT EACH FEDERAL RESERVE BANK

SUBJECT: Supervisory Guidance on the Implementation of Section 112 of the FDIC Improvement Act

The FDIC's final rule implementing Section 112 of the FDIC Improvement Act of 1991 (FDICIA) became effective July 2, 1993. This section of FDICIA amends the Federal Deposit Insurance Act by adding Section 36, "Early Identification of Needed Improvements in Financial Management." Effective with fiscal years beginning after December 31, 1992, the final rule requires state member banks and other insured depository institutions with \$500 million or more in total assets as of the beginning of each fiscal year to obtain annual independent audits, to submit certain management reports to their regulatory agencies, and to establish audit committees of their board of directors comprised of independent directors. In addition, the final rule establishes certain new requirements for independent auditors of insured depository institutions. A copy of the final rule and the accompanying "Guidelines and Interpretations" are attached to this letter.

Beginning in the first quarter of 1994, all state member banks and certain other banks covered by Section 36 will be filing the required reports (see section on "Management Responsibilities") with each Federal Reserve Bank. This letter sets forth the types of reports the Federal Reserve Banks will receive, and provides guidance for the review of these reports. In addition, this letter addresses the impact of the statute and the rule on examinations, including appropriate training for Reserve Bank staff.

Background

The "Guidelines and Interpretations" that accompany the final FDIC rule are designed to aid in the rule's implementation by providing greater clarity to the rule's requirements and by permitting future modification of the guidelines, consistent with practical experiences gained by the FDIC and other federal banking agencies in the administration of the rule. The regulatory scheme now requires new responsibilities of managements, boards of directors, and independent public accountants (CPAs). Although these requirements became

effective as of July 2, 1993, many of the reporting requirements will be effective for the 1993 annual reports. It is expected that reasonable and good faith attempts to comply with the advice contained in the Guidelines will minimize the need for agency enforcement actions.

Management Responsibilities. The rule requires institutions with total assets greater than \$500 million to submit to the FDIC, its primary federal regulator, and appropriate state regulator within 90 days after the end of its fiscal year:

- (1) an **annual report** containing audited annual financial statements including the CPA's report thereon,
- (2) a **management report**, and
- (3) a **CPA's attestation report** concerning the institution's internal control structure and procedures for financial reporting.¹

The financial statements included in the annual report must be prepared in accordance with generally accepted accounting principles (GAAP). The management report must contain: (i) a statement of management's responsibility for preparing the institution's annual financial statements, for establishing and maintaining adequate internal controls over financial reporting, and for complying with certain laws and regulations designated by the FDIC; and (ii) management's assessment of the effectiveness of those internal controls and the institution's compliance with the designated laws and regulations.

Institutions are also required to submit to their primary supervisory agency a report prepared by the CPA based upon the "agreed-upon procedures" performed to determine compliance with designated laws and regulations.² However, unlike the annual report, the management report, and the CPAs attestation report, this report is not available for public inspection.

¹The preamble to the final rule includes the following discussion of internal control structure and procedures for financial reporting. "To comply with the reporting and attestation requirements of the final rule, both management and the independent public accountant should refer to terms, including "internal control structure" and "control procedures," in professional accounting and auditing literature." As an example, current authoritative auditing literature includes the following discussion of internal controls: "In establishing specific internal control structure policies and procedures concerning an entity's ability to record, process, summarize, and report financial data that is consistent with management's assertions embodied in the financial statements, some of the specific objectives management may wish to consider include ... Transactions are recorded as necessary to permit preparation of financial statements in conformity with GAAP or any other criteria applicable to such statements."

²In order to permit CPAs to determine the extent of compliance with the laws and regulations designated by Section 36 and the related assessment by management, the FDIC set forth as separate schedules to the guidelines certain "Agreed-Upon Procedures" regarding loans to insiders and dividend restrictions to be performed by the CPA (or in some cases the bank's internal auditor and the CPA).

There has been some question regarding whether the internal controls over the preparation of the Call Report is covered by the definition of internal controls over financial reporting. The FDIC staff, together with the staff of the Federal Reserve and the staffs of the other federal banking agencies, believes the intent of the final rule is to include Call Reports in the definition of internal controls over financial reporting. Therefore, those controls related to the preparation of the Call Report should be included in management's assessment and the CPAs attestation regarding the effectiveness of the internal control structure and procedures over financial reporting.

Section 36 provides exceptions for certain reporting requirements by an insured depository institution that is a subsidiary of a holding company. First, any such depository institution subject to the requirements of this section may satisfy the annual audit requirement by filing the audited financial statements of the consolidated holding company. Second, the other reporting requirements of Section 36 affecting insured depository institutions that are subsidiaries of a holding company may be satisfied by submitting consolidated holding company reports if:

- (i) the services and functions "comparable" to those required by the largest insured depository institution are provided at the holding company level; and
- (ii) either the insured depository institution has total assets at the beginning of the year of: (a) less than \$5 billion; or (b) more than \$5 billion, but less than \$9 billion, and a composite CAMEL rating of 1 or 2.

Generally, services and functions will be considered "comparable" if the holding company (a) prepares the reports used by the insured depository institution to meet the requirements of Section 36, (b) has an audit committee that meets the requirements of Section 36 appropriate for its largest insured depository institution subsidiary, and (c) prepares and submits the management assessment of internal controls and compliance with designated laws and regulations based on activities and operations of all subsidiaries covered by Section 36.

Finally, each state member bank must provide written notice to the appropriate Reserve Bank within 15 days after the termination, resignation, or engagement of a CPA. In addition, the CPA must provide written notice to the appropriate Reserve Bank within 15 days of their termination of services. The above notices must include a statement describing the reasons for the actions taken.

Audit Committee Requirements. Each institution subject to Section 36 must establish an audit committee comprised entirely of outside directors who are independent of the institution. For "large institutions," that is, institutions with total assets greater than \$3 billion, the audit committee is subject to more stringent requirements. These audit committees must (i) include members with banking or related management experience, (ii) have access to its own outside counsel, and (iii) not include any large customers of the institution. Although the final rule does not define "independent person," "large customer," and "banking and financial management expertise," the guidelines establish circumstances and

criteria that should assist boards of directors in making determinations about the qualifications of audit committee members.

CPA Requirements. CPAs must satisfy certain general qualifications set forth in the Rule and Guidelines in order to be eligible to perform the audit and attest services of Section 36. In addition, the rule provides guidance concerning CPA independence, the CPA's "Peer Review" program, the filing of peer review reports, and information that institutions must provide the CPA. Consistent with the statutory mandate of Section 36, the Rule and Guidelines include a requirement that CPAs make their audit policies, programs, and workpapers available to the regulatory agencies upon request. Lastly, FDICIA Section 112 also grants the federal banking and thrift agencies with expanded enforcement authority over CPAs, including suspension and debarment of accountants from performing Section 36 services. A joint rule establishing such remedies is under consideration as a separate project of the federal banking agencies, but has not yet been issued for public comment.

Reporting Requirements and Review Procedures

Reporting Requirements - State member banks covered by Section 36 are required to file within 90 days after the end of its fiscal year the annual report, the management report, the CPAs attestation report, and the agreed-upon procedures report (collectively; Section 36 reports) with the appropriate Federal Reserve Bank. In addition, the rule also permits insured depository institutions to satisfy Section 36 reporting requirements under the consolidation criteria indicated previously. However, the rule does not address the Federal Reserve Board's responsibility as the primary regulator of bank holding companies. Thus, to facilitate prudential supervision, all bank holding companies shall submit on behalf of their insured depository institution subsidiaries one copy of the reports required by Section 36 for those applicable institutions regardless of the charter of the subsidiary in the holding company. Therefore, Reserve Banks should receive Section 36 reports from all bank holding companies that submit Section 36 reports prepared on behalf of their subsidiaries covered by Section 36, including any subsidiary that did not qualify for the holding company exception.³ A sample transmittal letter to be sent by the Reserve Bank to each bank holding company subject to Section 36 which communicates these reporting requirements is attached.

In addition to the Section 36 reports discussed above, the FDIC rule requires insured depository institutions to submit the management letter, any qualification, and any "other report" prepared by the CPA pursuant to Section 36 within 15 days after receipt. Management should submit any of these other reports that, in their judgment, pertains to the

³For example: A bank holding company may have several subsidiaries between \$500 million and \$5 billion (or \$9 billion if rated CAMEL 1 or 2) and a subsidiary larger than this upper limit. The holding company may file Section 36 reports on a consolidated basis for qualified subsidiaries (accompanied by a cover letter identifying these subsidiaries). However, the subsidiary that does not meet the criteria for the holding company exception would be required to file Section 36 reports independently of the holding company. The appropriate Reserve Bank should receive both sets of reports in the above example.

requirements of Section 36 including opinions on financial reporting or accounting matters, internal controls over financial reporting, and compliance with laws and regulations.⁴

Report Review Procedures - The annual reporting requirements of Section 36 will result in the submission of many reports that will require review by Reserve Bank personnel in late March and April (starting in 1994). Each Reserve Bank should endeavor to see that these reports are reviewed within 45 days of receipt. Accordingly, each Reserve Bank should consider implementing the following two-step process for reviewing Section 36 reports. This review process should lead to effective identification of significant issues, and at the same time minimize the pressure on Reserve Bank resources. Although, the respective Reserve Bank may find the need to modify this suggested approach in view of staffing and other resource considerations, nonetheless it should take the necessary steps to accomplish the objectives and timetable for the preliminary review detailed herein.

- Each Reserve Bank should organize a team of qualified personnel (i.e., that have the experience and skills referred to below) that will be dedicated to the preliminary review of Section 36 reports. (These persons are referred to as the "review team" or the "reviewer" in this SR Letter.) Generally, Section 36 reports will be received from state member banks and bank holding companies during late March and April for those institutions with a calendar year-end. The review team should endeavor to complete their preliminary review of these reports within 45 days of their receipt.

The preliminary review should focus on identifying information within the annual reports that could have a significant impact on the safety and soundness of an institution (for example, if the financial statements indicate significant adverse financial trends, or the report on internal controls over financial reporting identifies a material weakness, etc.). Any Section 36 report that has such a situation identified will be recommended for additional review procedures. Appropriate additional review procedures could require significant professional judgement and should be the responsibility of an appropriate supervisory officer of the reviewing Reserve Bank (for example, discussion with institution management or the CPA, request for documentation from management or the CPA, special examination, etc.). A "Preliminary Review

⁴For example: an institution that contracts its data processing needs out to a servicing organization would normally receive a report from the independent public accountant of the servicing organization on the effectiveness of the service organization's internal controls (AICPA Statement on Auditing Standards (SAS) Number 70 - "Reports on the Processing of Transactions by Service Organizations" provides guidance to CPA's on issuing and using these reports). When this report addresses internal controls that affect the institution's financial reporting, the report should be submitted to the appropriate Reserve Bank.

However, if the servicing organization is a depository institution subject to Section 36, and the system used for servicing customers is independent of its data processing system and the internal controls over financial reporting, any report concerning the effectiveness of these controls would not be required to be submitted in satisfaction of the Section 36 reporting requirements for the servicing organization.

Checklist" to aid in performing this preliminary review is attached (see Attachment 1). The preliminary review checklist assists the reviewer in identifying significant financial and reporting relationships that can "red flag" potential problems that would warrant additional follow-up procedures.

The reviewer should note that in the initial year of implementation of this new rule, there will be an initial period in which institutions and CPAs will need to gain an understanding of the reporting requirements. During this initial review period, the reviewer should describe and discuss any apparent reporting violations with the institution and its CPA. Based upon the reviewer's judgement of the institution's situation, the reviewer should focus on education and making recommendations about compliance, rather than pursuing formal enforcement actions for apparent reporting violations. However, this should not preclude the pursuit of formal enforcement actions, when warranted, such as a flagrant disregard for the reporting requirements. During the first year of implementation, the review checklist should indicate the status of the institution's implementation efforts if the institution is not yet in full compliance with the rule. (This approach is consistent with recent examination guidance issued by the FDIC.)

- After completion of the preliminary reviews all Section 36 reports, together with a copy of the Preliminary Review Checklist and any other pertinent information, should be forwarded to the appropriate supervisory officer (in many cases this will be the examiner in-charge) for each reporting institution. Additional guidance to aid the examiner in applying Section 36 reports to the examination process is currently under development and will be the subject of a subsequent letter. This letter will cover examination planning, review procedures for Section 36 reports which will be performed during the examination, and a method to determine the extent to which detailed examination procedures may be modified. The representations reported by management and the CPA in preparing Section 36 reports may enable the examiner to reduce or supplement examination procedures planned for such areas as internal controls over financial reporting and compliance with designated laws and regulations.

Review team examiners that are performing the preliminary review should possess certain basic skills and experience. For example: (i) these examiners should have sufficient experience to understand overall bank management practices, (ii) be able to identify the risks and analytical relationships in financial statements, (iii) understand the requirements of Section 36, and (iv) have a basic understanding of GAAP, generally accepted auditing standards (GAAS), and the AICPA's Statements on Standards for Attestation Engagements.

In addition, it is recommended that the review of Section 36 reports filed by bank holding companies be performed by the Reserve Bank with supervisory responsibility for that bank holding company. For state member bank subsidiaries located in a Reserve

District different from the parent bank holding company, a copy of the Section 36 reports and a copy of the completed preliminary review checklist should be forwarded to the appropriate Federal Reserve Bank supervisory officer for the state member bank.

As discussed above, Section 36 requires the submission of several additional types of reports, which include, the management letter, or "other reports" issued by the institution's CPA. These reports should be forwarded to the appropriate Federal Reserve Bank supervisory official or examiner that is responsible for the supervision of the particular bank. Reserve Bank personnel should endeavor to complete this review within 30 days of their receipt.

Special attention should be directed to notifications of changes in CPAs (also referred to as "notices" in the FDIC guidelines). Appropriate Reserve Bank personnel (Supervising Officer or examiner-in-charge) should endeavor to review these notices within 15 days of receipt. The reviewer should evaluate the change in CPAs to determine if the reason for such a change has any impact on the credibility of future audit reports. This review should focus on determining whether any differences of opinion on accounting or reporting issues between management and the former CPA influenced the decision to change CPAs. In addition, the review should determine that the successor CPA satisfies the general qualifications and independence requirements of Section 36 and that the successor CPA has a current peer review report on file with the FDIC. The reviewer should also consider discussing the change in CPAs with bank management, the audit committee chairman, the predecessor CPA, and the successor CPA to determine the reasonableness of the change in CPAs. Finally, notices received from institutions with a CAMEL rating of 3 or below should receive closer scrutiny to ensure that the changes were not a result of "opinion shopping" or some other inappropriate or questionable reason.⁵

Impact on Internal Control Review Program

The Staff of the Federal Reserve System is currently developing a comprehensive internal control review program to aid examiners in assessing the effectiveness of an institution's internal controls. The requirements of Section 36 expand the degree of evaluation and reporting required of management and CPAs in the area of internal controls. Clearly, these new requirements should have an impact on the procedures currently performed by examiners. Separate examination guidance to supplement the comprehensive internal control review program is being developed which will aid the examiner in performing an assessment of the effectiveness of the system of internal controls.

⁵The term "Opinion Shopping" usually relates to the situation where management and the CPA have a disagreement on an issue that if not resolved would result in the CPA issuing a qualified or adverse opinion in the audit report. To avoid this qualified opinion, management would seek out a CPA willing to accept their position and issue a clean opinion in the audit report.

Training Requirements

The requirements of Section 36 will have an impact on the basic training needs of Reserve System personnel. Foremost is the need to educate personnel in the requirements of Section 36, including attendant policies and procedures developed to satisfy these requirements. Furthermore, examiners and other personnel that will be reviewing CPA workpapers and reports will need to develop or further refine their knowledge and expertise in the following areas: (i) GAAP, GAAS, and Attestation Standards, (ii) CPA workpaper techniques and related review procedures, and (iii) CPA firm quality review program. Federal Reserve System training programs to address these matters are under development.

Other Considerations

As previously mentioned in the background discussion, Section 36 provides the Federal Reserve and the other federal banking agencies expanded authority to review (1) CPA audit workpapers and programs, and (2) CPA firm "Peer Review" reports (i.e., reports on the quality of a CPA firms audit work). Implementation guidance concerning these areas will be addressed in subsequent SR letters.

Questions regarding the guidance in this letter should be directed to John Frech at (202) 452-2275 or Stephen Mackey at (202) 452-5264. In addition, if state member banks and bank holding companies request a copy of this letter, you may provide them with a copy. Finally, please submit the name of the individual(s) assigned at the Reserve Bank with the implementation responsibility for this section of FDICIA to John Frech as soon as possible.

Sincerely,



Richard Spillenkothen
Director

Attachments

FEDERAL DEPOSIT INSURANCE CORPORATION

12 CFR Part 363

RIN 3064-AA83

Annual Independent Audits and Reporting Requirements

AGENCY: Federal Deposit Insurance Corporation (FDIC).

ACTION: Final rule.

SUMMARY: The FDIC has adopted a final rule to implement section 36 of the Federal Deposit Insurance Act (FDI Act), as added by section 112 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA). The

purpose of section 36 is to facilitate early identification of problems in financial management through annual independent audits, more stringent reporting requirements, and internal controls.

This final rule requires each insured depository institution with \$500 million or more in total assets to have an annual audit of its financial statements by an independent public accountant and an independent audit committee of outside directors. There are more stringent criteria for audit committees of institutions with \$3 billion or more in total assets.

It also requires management of institutions to report on and assess its responsibilities for internal controls and compliance with designated laws and regulations. Independent accountants

must attest to and report on the assertions in management's reports concerning internal controls, and separately on management's assertions concerning compliance with designated laws and regulations.

The FDIC, in consultation with the other federal banking agencies, also has developed guidelines and interpretations (Guidelines), published as an appendix, concerning certain provisions of section 36, including those not addressed specifically in the final rule. It is expected that reasonable and good faith attempts to comply with the advice contained in the Guidelines will minimize the need for agency enforcement actions.

This final rule reflects a number of changes to the proposed rule which address concerns raised by commenters.

EFFECTIVE DATE: July 2, 1993.

FOR FURTHER INFORMATION CONTACT:
Doris L. Marsh, Examination Specialist,
Division of Supervision (202) 898-8905,
FDIC, 550 17th Street NW., Washington,
DC 20429, or Sandra Comenetz, Senior
Attorney, Legal Division, (202) 898-
3582, FDIC, 550 17th Street NW,
Washington, DC 20429.

SUPPLEMENTARY INFORMATION:

I. Paperwork Reduction Act

The collection of information contained in this rule has been reviewed and approved by the Office of Management and Budget under control number 3064-0113, pursuant to section 3504(h) of the Paperwork Reduction Act (44 U.S.C. 3501 *et seq.*). Comments regarding the accuracy of the budget estimate, and suggestions for reducing the burden, should be directed to the Office of Management and Budget, Paperwork Reduction Project (3064-0113), Washington, DC 20503, with copies of such comments sent to Steven F. Hanft, Assistant Executive Secretary (Administration), room F-453, FDIC, 550 17th Street, NW., Washington, DC 20429. This information collection is mandated by section 36 of the FDI Act (12 U.S.C. 1831m), which was added by section 112 of FDICIA (Pub. L. 102-242, 105 Stat. 2242).

It is customary for large financial institutions to have annual audits of their financial statements performed by independent public accountants. Over 96 percent of institutions covered by this regulation report that they already have annual audits of their financial statements. In addition, most institutions have audit committees. It is estimated that approximately 90 percent of institutions covered by this regulation have audit committees already performing many of the functions required by this regulation. The reporting on the effectiveness of internal controls for financial reporting and compliance with designated laws and regulations required by section 36 and this part adds significantly to an institution's reporting burden. However, the FDIC has reduced the reporting burden that would have been created by the proposed rule by raising the size threshold at which an institution is required to report. The final rule requires reporting by only the 1,000 largest institutions, one-third of those required under the proposal. The estimated annual reporting burden for the collection of the additional information required by this regulation beyond the customary practices of these institutions is summarized as follows:

Number of Preparers.....1,000

Number of Policies and Record

Systems Prepared.....	3.19
Total Annual Preparations.....	3,190
Hours Per Policy and Record System.....	21.46
Total Annual Burden Hours.....	68,470

II. Regulatory Flexibility Act

The rule expressly exempts insured depository institutions having assets of less than \$500 million, and, for that reason, is inapplicable to small entities. Therefore, pursuant to section 605(b) of the Regulatory Flexibility Act (Pub. L. 96-354, 5 U.S.C. 601 *et seq.*), it is certified that the rule would not have a significant impact on a substantial number of small entities.

III. Background

In September 1992, the FDIC proposed regulations (57 FR 42516, Sept. 15, 1992) to implement the provisions of section 112 of FDICIA, entitled "Independent Annual Audits of Insured Depository Institutions." The requirements of section 112 apply to fiscal years of insured depository institutions that begin after December 31, 1992.

The new statutory provision, contained in section 36, requires the FDIC, in consultation with the appropriate federal banking agencies, to promulgate regulations requiring institutions over a certain asset size to have an annual independent audit of their financial statements in accordance with generally accepted auditing standards and section 37 of the FDI Act, and the institution's independent public accountant to notify the FDIC upon termination of services. Section 36 also requires the federal banking agencies jointly to issue rules of practice governing enforcement actions against independent public accountants.

IV. Discussion of Final Rule and Public Comments

Section 36 requires the FDIC, in consultation with the other appropriate federal banking agencies, to prescribe regulations concerning only a few specified provisions of the statute. It also permits, but does not require, the FDIC to undertake rulemaking pursuant to its general rulemaking authority concerning other provisions of the statute.

The FDIC has elected to limit, with few exceptions, its rulemaking to a final rule to implement those provisions of section 36 which specifically require rulemaking. It is persuaded that that approach is consistent with the letter and spirit of the law and with comments received, with which the FDIC concurs, that the final rule not impose unnecessary regulatory burdens,

provide appropriate flexibility, and be reasonably cost-effective.

Accordingly, the final rule implements the "Annual Independent Audits of Financial Statements" requirement of section 36(d)(1) of the FDI Act and the "Notice by Accountant of Termination of Services" requirement of section 36(g)(5). The FDIC anticipates that, jointly with the other appropriate federal banking agencies, it promptly will issue rules of practice with respect to removal, suspension or bar of an independent public accountant from performing audit services for insured depository institutions as required by section 36(g)(4).

The final rule also restates, by way of emphasis, selective provisions of the statute. That is not intended, however, to imply that the FDIC does not expect affected insured depository institutions to comply with all provisions of the statute. Instead, it makes clear that the final rule does not expand the scope or interpretation of the statutory requirements.

The FDIC received over 305 comment letters concerning the proposed rule. The largest group of comments, approximately 120, was from banks, about eight percent of which were institutions that were exempt from proposed part 363. Another 23 percent were from bank holding companies, including most of the 25 largest in the United States. Twenty-two letters were from thrifts, four of which are among the ten largest in the country.

The FDIC has reviewed the proposal in light of these comments. The majority of the commenters criticized the proposed requirements, and the cost to comply with the proposed rule. The comments are discussed below.

A. Scope

Section 36 left to the FDIC's discretion whether to exempt institutions having total assets in excess of \$150 million. The FDIC has exercised its discretion to mitigate the financial burden of compliance by raising the threshold from \$150 million to \$500 million, thereby exempting from the final rule approximately two-thirds of institutions that would have been subject to section 36, but which pose less of a risk to the deposit insurance funds, while bringing approximately 75 percent of the banking assets in the U.S. within the scope of the regulation.

More than 96 percent of institutions with \$500 million or more in total assets report they already engage an independent public accountant to perform an annual audit of their financial statements or that their parent company engages an independent

public accountant to do the same for its consolidated statements. All of the remaining institutions in this asset range engage an independent public accountant to provide some audit services. Many of these institutions or their holding companies also have audit committees that comply with the final rule. These facts suggest the final rule will not impose unacceptable burdens on affected institutions.

Compliance by Subsidiaries of Holding Companies

The requirements for an independent audit may be satisfied for subsidiaries of holding companies by an independent audit of the holding company. The other requirements of section 36 may be satisfied for subsidiaries if "services and functions" comparable to those required by the statute are provided at the holding company level, and, either the institution has total assets, as of the beginning of each fiscal year, of less than \$5 billion; or, total assets between \$5 billion and \$9 billion, and it received a CAMEL (or comparable) rating of one or two at its most recent examination.

If a subsidiary meets the foregoing criteria, an independent public accountant may examine and attest to the subsidiary's assertions on the consolidated entity's internal control system, and would not be required to examine and attest to the systems of each subsidiary.

B. Reporting Requirements

1. Definitions

Definitions in the proposed rule have been eliminated in the final rule. Certain relevant terms are already defined in the FDI Act and professional accounting and auditing literature.

2. Annual Report

The final rule requires each covered institution to prepare an annual report containing financial statements prepared in accordance with generally accepted accounting principles (GAAP) that have been audited by an independent public accountant, and to file such report within 90 days after the end of each fiscal year. The FDIC has adopted commenters' suggestions that the language of the final rule more closely track the statute.

The proposal that institutions may use Call Report items or an audit of the Call Report schedules has been deleted as being unnecessarily confusing, and because such schedules do not comply with GAAP. In addition, a proposed provision on consolidation has been eliminated.

Many commenters requested that the FDIC delete the proposed provision

requiring an audited reconciliation of an institution's capital reported under GAAP with the capital calculated under regulatory capital standards. Because this reconciliation is not specifically required by the statute, the FDIC eliminated it from the final rule.

3. Management Report

Internal controls for financial reporting. Section 36 requires that each institution prepare an annual report containing a statement of management's responsibility for establishing and maintaining an adequate internal control structure and an assessment of the effectiveness of internal controls for financial reporting.

To comply with the reporting and attestation requirements of the final rule, both management and the independent public accountant should refer to terms, including "internal control structure" and "control procedures," in professional accounting and auditing literature.

The FDIC sought comment on whether it should leave the development of internal control criteria to institutions. After careful consideration, the FDIC has decided that each institution should determine its own standard for an internal control structure and procedures for financial reporting, but that any assessment by management should include sufficient information to enable the independent public accountant separately to examine and report on management's assessment.

In response to a number of suggestions, the FDIC has removed the proposed requirement that "material matters" be assessed. Nevertheless, an assessment must include all significant items.

Compliance with laws and regulations. Section 36 requires management to assess its own compliance with designated laws and regulations, and to evaluate the effectiveness of the operation of its internal control structure and procedures for compliance with such laws and regulations.

The final rule also requires that a covered institution engage an independent public accountant to report on procedures for compliance with designated laws and regulations. In response to requests from many commenters the proposed requirement that management provide a description of its handling of material weaknesses and inadequacies and other reportable conditions was deleted. Commenters correctly pointed out that these matters should be resolved by the independent public accountant and management

working together to determine the appropriate action to correct any deficiency. The proposal that institutions submit the names and occupations of audit committee members also was deleted because this information is available to examiners.

Many commenters addressed the proposal that an independent public accountant provide negative assurance that an institution has complied with FDIC assessment requirements. They noted section 36 does not require this, and that to require FDIC assessment auditors and independent public accountants to review the assessment calculations is duplicative and would result in unjustifiable additional expense. Accordingly, the FDIC has eliminated the requirement in the final regulation.

Many commenters requested that the accountant's management letter be eliminated from the filing requirement. However, section 36 specifically requires that the management letter, audit report, and any other report provided by the independent public accountant during the year be filed within 15 days of its receipt.

In the final rule, the proposed requirement that institutions retain workpapers documenting management's review of its statements in the management report has been eliminated because it is not required by section 36, and is not essential to the rule.

Notice of engagement or change of accountants. The final rule establishes notice requirements for institutions whenever there is a change of accountant. Several commenters questioned whether institutions had to notify the FDIC and appropriate federal banking agency immediately after the final rule is effective. Those institutions that have already notified the FDIC and the appropriate federal banking agency of their accountant's identity need make no additional notification until there is a change in accountant.

C. Independent Public Accountant Reporting and Notice Requirements

1. Internal Control Attestation

The final rule requires institutions to engage an independent public accountant to perform an examination level attestation and report separately on the assertions contained in management's report regarding management's assessment of the effectiveness of the institution's internal control structure and procedures for financial reporting. The attestation should be as of the date of management's assertions and should be

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in accordance with generally accepted standards for attestation engagements.

2. Compliance With Laws and Regulations Attestation

The final rule requires that each institution engage an independent public accountant to test the institution's compliance with designated laws and regulations through the performance of agreed upon procedures. The Guidelines set forth such procedures.

3. Other Duties of Independent Public Accountants

The proposal required the independent public accountant to inform the appropriate federal banking agency of any apparent criminal violation if management had not already done so. A number of commenters objected to this requirement because it is not specifically mandated by section 36, and it does not allow time for the institution to investigate the alleged violation before it must be reported to regulators. The comments are valid and the provision has been deleted.

4. Notice by Accountant of Termination of Services

The FDIC could not adopt the suggestion of some commenters that the accountant notice provisions be deleted. Section 36 requires such notice. However, the final rule extends from five days to 15 days the period of time within which an independent public accountant must file a termination of services report.

D. Audit Committees

Section 36 requires that each institution have an independent audit committee entirely made up of outside directors who are independent of the institution. For large institutions, as defined in the final rule, there are additional criteria: The large institution's audit committee must include members with banking or related management experience, have access to its own outside counsel, and, not include any large customers of the institution.

The final rule reiterates the requirements of the statute, but does not include specific definitions of "independent person," "large customer," and "banking and financial management expertise". The FDIC expects boards of directors to determine if an outside director meets audit committee requirements. Such a determination will be subject to review by examiners.

The FDIC requested comment on its proposed definition of "large

institution". A large majority of commenters recommended that the proposed large institution asset threshold be increased. After careful consideration, the FDIC has adopted an asset threshold of \$3 billion. With this threshold, fewer than 2 percent of the nation's institutions will be defined as "large", yet more than half of the assets insured by the Bank Insurance Fund and the Savings Association Insurance Fund will receive the additional protection afforded by the presence of independent directors who have banking or financial management expertise, and are not large customers of the institution.

E. Insured Branches of Foreign Banks

A few commenters noted that the proposal did not separately address the responsibilities of insured branches of foreign banks. Application of section 36 statutory requirements to such branches is complicated because, unlike other institutions, they are not separately incorporated or capitalized. The Guidelines facilitate compliance by such branches.

List of Subjects in 12 CFR Part 363

Accounting, Banks, Banking, Reporting and recordkeeping requirements.

For the reasons set forth in the preamble, the FDIC amends chapter III of title 12 of the Code of Federal Regulations by adding part 363 to read as follows:

PART 363—ANNUAL INDEPENDENT AUDITS AND REPORTING REQUIREMENTS

- Sec. 363.0 OMB control number.
- 363.1 Scope.
- 363.2 Annual reporting requirements.
- 363.3 Independent public accountant.
- 363.4 Filing and notice requirements.
- 363.5 Audit committees.

Appendix A to Part 363 Guidelines and Interpretations

Authority: 12 U.S.C. 1831m.

§ 363.0 OMB control number.

The collecting of information requirements in this part have been approved by the Office of Management and Budget under OMB control number 3064-0113.

§ 363.1 Scope.

(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.

(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 a composite CAMEL (or MACRO, or equivalent) rating of 1 or 2.

§ 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.

(b) *Management report.* Each insured depository institution annually shall prepare, as of the end of the institution's 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 and regulations during such fiscal year.

§ 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.

(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.

(c) *Notice by accountant of termination of services.* An independent public accountant performing an audit under this part who ceases to be the 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.

§ 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 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 any appropriate state bank supervisor, a copy of any management letter, qualification, or other report issued by its independent public accountant with respect to such institution and the

services provided by such accountant pursuant to this part within 15 days after receipt.

(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.

§ 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.

(b) *Committees of large institutions.* The audit committee of any insured depository institution that has total assets of more than \$3 billion, measured as of the beginning of each fiscal year, shall include members with banking or related financial management expertise, have access to its own outside counsel, and not include any large customers of the institution.

Appendix A to Part 363—Guidelines and Interpretations

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Introduction

Congress added section 36, "Early Identification of Needed Improvements in Financial Management" (section 36), to the Federal Deposit Insurance Act (FDI Act) as part of the Federal Deposit Insurance Improvement Act of 1991, which became law on December 19, 1991.

The FDIC adopted 12 CFR part 363 of its rules and regulations (this part), effective July 2, 1993, to implement those provisions of section 36 that require rulemaking. Simultaneously, the FDIC Board of Directors approved these "Guidelines and Interpretations" (the Guidelines) and directed that they be published as an appendix to this part to facilitate a better understanding of, and full compliance with, the provisions of section 36.

The Guidelines were developed by the FDIC, in consultation with the other appropriate federal banking agencies, after careful consideration of the comments received on the proposed rule.

Although not contained in this part, some of the guidance offered restates or refers to statutory requirements of section 36 and is therefore mandatory. If that is the case, the statutory provision is cited. The FDIC continues to believe, as stated in its "Statement of Policy Regarding Independent External Auditing Programs of State Nonmember Banks" (Nov. 16, 1988), that every insured depository institution, regardless of its size or charter, should have an annual audit of its financial statements performed by an independent public accountant, and should establish an audit committee comprised entirely of outside directors.

The following Guidelines reflect the views of the FDIC concerning the interpretation of section 36. The Guidelines are intended to

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assist insured depository institutions (institutions), their boards of directors, and their advisors, including their independent public accountants and legal counsel, and to clarify section 36 and this part. It is recognized that reliance on the Guidelines may result in compliance with section 36 and this part which may vary from institution to institution. Terms which are not explained in the Guidelines have the meanings given them in this part, the FDI Act or professional accounting and auditing literature.

Scope of Rule (§ 363.1)

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.

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).

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.

4. Comparable Services and Functions. Services and functions will be considered "comparable" 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 this 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 (internal controls), and compliance with the Designated Laws defined in guideline 12 that are based on information concerning the activities and operations of all subsidiary institutions within the scope of this part.

Annual Reporting Requirements (§ 363.2)

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 FR Y-6 Annual Report under the Bank Holding Company Act of 1956.

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 the Designated Laws defined in guideline 12. Management also should 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.

9. Safeguarding of Assets. The FDIC believes "safeguarding of assets," as the term relates to internal control 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

10. Standards for Internal Controls. Each institution should determine its own standards for establishing, maintaining and assessing the effectiveness of its internal controls.²

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.

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).

Role of Independent Public Accountant (§ 363.3)

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.

14. Independence. The independent public accountant also should be in compliance with the AICPA's *Code of Professional Conduct* and meet the independence

¹ 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.

² In considering what information is needed on safeguarding of assets and standards for internal controls, management may review guidelines provided by its primary federal regulator; the Federal Financial Institutions Examination Council's "Supervisory Policy Statement on Securities Activities"; the FDIC's "Statement of Policy Providing Guidance on External Auditing Procedures for State Nonmember Banks" (Jan. 16, 1990), "Statement of Policy Regarding Independent External Auditing Programs of State Nonmember Banks" (Nov. 16, 1988), and Division of Supervision Manual of Examination Policies; the Federal Reserve Board's Commercial Bank Examination Manual and other relevant regulations; the Office of Thrift Supervision's Thrift Activities Handbook; the Comptroller of the Currency's Handbook for National Bank Examiners; standards published by professional accounting organizations, such as the American Institute of Certified Public Accountants' (AICPA) *Statement of Auditing Standards* 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.

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 standards³; and

(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 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.

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 reports are exempt from public disclosure.

19. *Procedures for Determining Compliance with Designated Laws.* In order to permit the independent 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 in this appendix 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 public 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.

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.

Filing and Notice Requirements (§ 363.4)

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 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 no 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 Reports.* 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 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.

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.

Audit Committees (§ 363.5)

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

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.

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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, or has held or controlled, a direct or indirect financial interest in the institution or its affiliates; and
- (e) Has outstanding extensions 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 within 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 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.

Other

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 in this appendix (including the attached Agreed Upon Procedures in Schedule A to this appendix), in consultation with the other appropriate federal banking agencies, to reflect the practical experience gained from 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.

Schedule A to Appendix A—Agreed Upon Procedures for Determining Compliance With Designated Laws

This schedule A is attached to the Guidelines and Interpretations issued by the FDIC as appendix A to 12 CFR part 363 adopted to implement section 36 of the FDI Act.

The Agreed Upon Procedures set forth in this schedule are referred to in guideline 19. They should be followed by the institution's independent public accountant (or, with respect to the procedures set forth in section I below, by the institution's internal auditor if the accountant is to perform the procedures set forth in section II) in order to permit the accountant to report on the extent of compliance with the Designated Laws (defined in guideline 12, and more specifically identified below) as required by section 36(e) (1) and (2).

Additional guidance concerning the role of the institution, its internal auditor, and its independent public accountant in assessing the institution's compliance with the Designated Laws is set forth in the Guidelines. All terms not otherwise defined in this schedule have the respective meanings ascribed to them in this part, the Guidelines in this appendix, and professional accounting and auditing literature.

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.

A. Loans to Insiders

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

- (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 examination, supervisory agreements, and enforcement actions issued by the institution's primary federal and state regulators, if applicable; all

public documents filed under the Securities Exchange Act of 1934 with the FDIC, SEC, Federal Reserve Board, OCC, or OTS; and annual reports filed by insiders identifying their related interests as required by 12 CFR 215.7.

Procedure:

(1) 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 submission of financial statements;

(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.

(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.

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 that 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. 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

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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), 1831c; and
- (b) The regulations set forth at 12 CFR 5.61, 5.62, 6.6, 7.6120, 206.19, and 563.134.

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 FDI 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 the 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.

e. National and State Member Banks.

Obtain management's computation concerning its compliance with 12 U.S.C. 56, "Capital Limitation Test," 12 U.S.C. 60, "The Earnings Limitation Test," and transfers from surplus to undivided profits after payment of the dividends referenced in paragraph 2c. above.

Procedure: Recalculate management's computations (for mathematical accuracy) and compare management's calculations to the standards defined in the test set forth in paragraph 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 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 independent 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. 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.

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. 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.

By order of the Board of Directors.

Dated at Washington, DC, this 11th day of May, 1993.

Federal Deposit Insurance Corporation.

Hoyle L. Robinson,

Executive Secretary.

[FR Doc. 93-12900 Filed 6-1-93; 8:45 am]

CALLING CODE 6174-01-P