

June 23, 2005

TO: The Board of Directors

FROM: Michael J. Zamorski
Director, Division of Supervision and Consumer Protection

SUBJECT: Proposed Amendment to Annual Audit and Reporting Requirements (Part 363) to Raise the Asset Size Threshold for Assessments of Internal Control over Financial Reporting and for Independent Audit Committees from \$500 Million to \$1 Billion

SUMMARY

In June 1993, the FDIC adopted 12 CFR Part 363 in consultation with the other federal banking agencies to implement Section 36 of the Federal Deposit Insurance Act (FDI Act). Part 363 requires each insured depository institution with \$500 million or more in total assets (“covered institution”) to satisfy certain standards in its financial management and reporting. Specifically, each covered institution must have an annual independent audit of its financial statements; provide a management report concerning the effectiveness of the institution’s internal control over financial reporting and its compliance with designated safety and soundness laws; and obtain an independent public accountant’s attestation on management’s internal control assertion. Section 36 also requires each covered institution to have an independent audit committee. The FDIC has discretion under Section 36 to set the asset size threshold for compliance with these statutory requirements, but the threshold cannot be less than \$150 million.

The proposed amendment to Part 363 would raise the asset size threshold from \$500 million to \$1 billion for:

- Internal control assessments by management and external auditor attestations of these management assessments; and
- Members of the audit committee, who must be outside directors, to be independent of management.

This proposal would relieve covered institutions with total assets of less than \$1 billion from compliance obligations only as to these provisions of Part 363. These compliance

Concur:

William F. Kroener, III
General Counsel

obligations are growing considerably as a result of the Sarbanes-Oxley Act, the Securities and Exchange Commission's (SEC) implementing rules, new auditing standards, and expected revisions in attestation standards. As a result, covered institutions, particularly smaller nonpublic institutions, are experiencing increasing compliance and cost burdens.

All covered institutions, regardless of size, would continue to comply with the remaining provisions in Part 363, including the annual financial statement audit requirement. (Additional amendments are being planned for a later rulemaking covering other aspects of Part 363).

Furthermore, this proposal would not relieve public covered institutions from their obligations to comply with Sarbanes-Oxley Act and the SEC's implementing rules on internal control assessments by management, external auditor attestations, and audit committee structure. Effectively, therefore, nonpublic covered institutions with less than \$1 billion in total assets would benefit most from this proposal.

These amendments are proposed to take effect December 31, 2005.

DISCUSSION

Section 112 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) added Section 36, "Early Identification of Needed Improvements in Financial Management," to the FDI Act (12 U.S.C. 1831m). Section 36 is generally intended to facilitate early identification of problems in financial management at insured depository institutions above a certain asset size threshold through annual independent audits, assessments of the effectiveness of internal control over financial reporting and compliance with designated laws and regulations, and related requirements. Section 36 also includes requirements for audit committees at these insured depository institutions. Section 36 grants the FDIC discretion to set the asset size threshold for compliance with these statutory requirements, but it states that the threshold cannot be less than \$150 million.

In June 1993, the FDIC published 12 CFR Part 363 to implement the provisions of Section 36 of the FDI Act. Under Part 363, the requirements of Section 36 apply to each insured depository institution with \$500 million or more in total assets at the beginning of its fiscal year (covered institution). Often referred to as the "FDICIA reporting requirements," Part 363 requires each covered institution to submit to the FDIC and other appropriate federal and state supervisory agencies an annual report that includes audited financial statements, a statement of management's responsibilities, assessments by management of the effectiveness of internal control over financial reporting and compliance with designated laws and regulations, and an auditor's attestation report on internal control over financial reporting. In addition, Part 363 provides that each covered institution must establish an independent audit committee of its board of directors comprised of outside directors who are independent of management of the institution. Part 363 also includes Guidelines and Interpretations (Appendix A to Part 363), which are intended to assist institutions and independent public accountants in understanding

and complying with Section 36 and Part 363. Covered institutions may satisfy the audited financial statements requirement of Part 363 at the holding company level. Subject to certain conditions, the other requirements of Part 363 may be satisfied at the holding company level.

When it adopted Part 363 in 1993, the FDIC stated that it was setting the asset size threshold at \$500 million rather than the \$150 million specified in Section 36 to mitigate the financial burden of compliance with Section 36 consistent with safety and soundness. In selecting \$500 million in total assets as the size threshold, the FDIC noted that approximately 1,000 of the then nearly 14,000 FDIC-insured institutions would be subject to Part 363. These covered institutions held approximately 75 percent of the assets of insured institutions at that time. By imposing the audit, reporting, and audit committee requirements of Part 363 on institutions with this percentage of the industry's assets, the FDIC intended to ensure that the Congress's objectives for achieving sound financial management at insured institutions when it enacted Section 36 would be focused on those institutions posing the greatest risk to the insurance funds administered by the FDIC. Today, due to consolidation in the banking and thrift industry and the effects of inflation, approximately 1,150 of the 8,900 insured institutions have \$500 million or more in total assets and are therefore subject to Part 363. These covered institutions hold approximately 90 percent of the assets of insured institutions.

Assessments of Internal Control Over Financial Reporting

An effective internal control structure is critical to the safety and soundness of each insured institution. Given its importance, internal control is evaluated as part of the supervision of individual institutions and its adequacy is a factor in the management rating assigned to an institution. Furthermore, in the audit of an institution's financial statements, the external auditor must obtain an understanding of internal control, including assessing control risk, and must report certain matters regarding internal control to the institution's audit committee.

An institution subject to Part 363 has the added requirement that its management perform an assessment of the internal control structure and procedures for financial reporting and that its external auditor examine, attest to, and report on management's assertion concerning the institution's internal control over financial reporting. Until year-end 2004, external auditors performed their internal control assessments in accordance with an attestation standard issued by the American Institute of Certified Public Accountants (AICPA) known as "AT 501."

The Sarbanes-Oxley Act was enacted into law on July 30, 2002. Section 404 of this Act imposes a requirement for internal control assessments by the management and external auditors of all public companies that is similar to the FDICIA requirement. These requirements took effect at year-end 2004 for "accelerated filers," i.e., generally, public companies whose common equity has an aggregate market value of more than \$75 million, but they will not take effect until 2006 for "non-accelerated filers." For the Section 404 auditor attestations, the Public Company Accounting Oversight Board's

(PCAOB) Auditing Standard No. 2 (AS 2) applies. AS 2 replaces the AICPA's AT 501 internal control attestation standard for public companies, but AS 2 does not apply to nonpublic companies. The Securities and Exchange Commission's (SEC) rules implementing the Section 404 requirements for management and the provisions of AS 2 for Section 404 audits of internal control establish more robust documentation and testing requirement than those that have been applied by covered institutions and their auditors to satisfy the internal control reporting requirements in Part 363.

For internal control attestations of nonpublic companies, the AICPA is currently developing proposed revisions to AT 501 that are expected to bring it closer into line with the provisions of AS 2. The revisions also are likely to have the effect of requiring greater documentation and testing of internal control over financial reporting by an institution's management in order for the auditor to perform his or her attestation work.

As the environment has changed and continues to change since the enactment of the Sarbanes-Oxley Act, the FDIC staff has observed that compliance with the audit and reporting requirements of Part 363 has and will continue to become more burdensome and costly, particularly for smaller nonpublic covered institutions. Thus, the FDIC staff has reviewed the current asset size threshold for compliance with Part 363 in light of the discretion granted by Section 36 that permits the FDIC to determine the appropriate size threshold at which insured institutions should be subject to the various provisions of Section 36. Based on this review, the FDIC staff is proposing to amend Part 363 to increase the asset size threshold for internal control assessments by management and external auditors from \$500 million to \$1 billion.

In reaching this decision, the FDIC staff concluded that raising the \$500 million asset size threshold to \$1 billion and exempting all institutions below this higher size level from all of the reporting requirements of Part 363 would not be consistent with the objective of the underlying statute, i.e., early identification of needed improvements in financial management. In contrast, the FDIC staff believes that relieving smaller covered institutions from the burden of internal control assessments, while retaining the financial statement audit and other reporting requirements for all institutions with \$500 million or more in total assets, would strike an appropriate balance in accomplishing this objective. If the FDIC were to raise the size threshold for internal control assessments to \$1 billion, about 600 of the largest insured institutions with approximately 86 percent of industry assets would continue to be covered by the internal control reporting requirements of Part 363. At the same time, the managements of covered institutions would remain responsible for establishing and maintaining an adequate internal control structure and procedures for financial reporting and all institutions with \$500 million or more in total assets would continue to include a statement to that effect in their Part 363 annual report.

The proposed amendment to Part 363 to increase the asset size threshold for internal control assessments by management and external auditors to \$1 billion is proposed to take effect December 31, 2005. For insured institutions (both public and non-public) with calendar year fiscal years that had \$500 million or more in total assets, but less than \$1 billion in total assets, on January 1, 2005, this proposal would mean that the Part 363

annual report for 2005 that they submit to the FDIC and other appropriate federal and state supervisory agencies would need to include only audited financial statements, statements of management's responsibilities, an assessment by management of the covered institution's compliance with laws and regulations, and an auditor's report on the financial statements.

For insured depository institutions that are public companies or subsidiaries of public companies, regardless of size, the FDIC's proposed amendment to Part 363 would not relieve public companies of their obligation to comply with the internal control assessment requirements imposed by Section 404 of the Sarbanes-Oxley Act in accordance with the effective dates for compliance set forth in the SEC's implementing rules.

Composition of the Audit Committee

Currently, Part 363 requires each covered institution to establish an independent audit committee of its board of directors comprised of outside directors who are independent of management of the institution. The duties of the audit committee include reviewing with management and the institutions' independent public accountant the basis for the reports included in the Part 363 annual report submitted to the FDIC and other appropriate federal and state supervisory agencies. The FDIC's Guidelines to Part 363 provide that, at least annually, the board of directors of a covered institution should determine whether all existing and potential audit committee members are "independent of management of the institution." The guidelines also describe factors to consider in making this determination.

Section 36 provides that an appropriate federal banking agency may grant a hardship exemption to a covered institution that would permit its independent audit committee to be made up of less than all, but no fewer than a majority, of outside directors who are independent of management.

Notwithstanding this exemption provision of Section 36, the FDIC staff has observed that a number of smaller covered institutions, particularly those with few shareholders that have recently exceeded \$500 million in total assets and become subject to Part 363, have encountered difficulty in satisfying the independent audit committee requirement. To comply with this requirement, these institutions must identify and attract qualified individuals in their communities who would be willing to become a director and audit committee member and who would be independent of management.

To relieve this burden, but also recognizing that the FDIC has long held that individuals who serve as directors of any insured depository institution should be persons of independent judgment, the FDIC staff is proposing to amend Part 363 to increase from \$500 million to \$1 billion the asset size threshold for requiring audit committee members to be independent of management. Each insured depository institution with total assets of \$500 million or more, but less than \$1 billion, would continue to be required to have an audit committee comprised of outside directors. Conforming changes would be made to

Guidelines 27-29 of Appendix A to Part 363. An outside director would be defined as an individual who is not, and within the preceding year has not been, an officer or employee of the institution or any affiliate of the institution. This proposed amendment to the audit committee requirements for institutions with between \$500 million and \$1 billion in total assets would allow an outside director who is, for example, a consultant or legal counsel to the institution, a relative of an officer or employee of the institution or its affiliates, or the owner of 10 percent or more of the stock of the institution to serve as an audit committee member.

The proposed amendment to Part 363 to raise the asset size threshold from \$500 million to \$1 billion for the members of the audit committee, who must be outside directors, to be independent of management is proposed to take effect December 31, 2005.

Technical Changes

The FDIC staff also proposes to make certain technical changes to Part 363 to correct outdated titles, terms, and references in the regulation and its appendix.

RECOMMENDATION

DSC recommends that the Board of Directors approve the publication of the attached Federal Register notice of proposed rulemaking to amend Part 363 for a 45-day public comment period.

Concur:

Jodey C. Arrington
Chief of Staff