TO: The Board of Directors

FROM: Christopher J. Spoth
Acting Director, Division of Supervision and Consumer Protection

SUBJECT: Final Rule - Amendments 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.

After considering the comments received on its notice of proposed rulemaking published August 2, 2005, the FDIC is amending Part 363 of its regulations, as proposed, to 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.

The final rule also makes certain technical changes to Part 363 to correct outdated titles, terms, and references in the regulation and its appendix.

Concur:

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William F. Kroener, III
General Counsel

The amendments will relieve covered institutions with total assets of less than $1 billion from compliance obligations only as to these provisions of Part 363. These compliance 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 will continue to comply with the remaining provisions in Part 363, including the annual financial statement audit requirement.

Furthermore, these amendments will 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 will benefit most from these amendments.

The final rule will be effective 30 days from the date of publication in the Federal Register, rather than as of December 31, 2005, as proposed. It will apply to Part 363 annual reports with a filing deadline (90 days after the end of an institution's fiscal year) on or after the effective date of these amendments, thereby providing relief to institutions with fiscal years ending on or after September 30, 2005.

As required by Section 36, the FDIC has consulted with the other federal banking agencies on this final rule.

DISCUSSION

Section 112 of the Federal Deposit Insurance Corporation Improvement Act of 1991 added Section 36, "Early Identification of Needed Improvements in Financial Management," to the FDI Act. 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. 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.

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 potential risk to the insurance funds administered by the FDIC. Today, due to consolidation in the banking and thrift industry and the effects of inflation, more than 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 2007 for “non-accelerated filers.” For the Section 404 auditor attestations, the Public Company Accounting Oversight Board’s 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 SEC’s 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 recommends amending 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.

For insured depository institutions that are public companies or subsidiaries of public companies, regardless of size, the FDIC’s amendments 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. 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 recommends amending Part 363 to increase from $500 million to $1 billion the asset size threshold for requiring audit committee members to be independent of management. Conforming changes are being made to Guidelines 27-29 of Appendix A to Part 363. Each insured depository institution with total assets of $500 million or more but less than $1 billion will continue to be required to have an audit committee comprised of outside directors. Consistent with Guideline 29 of Appendix A to Part 363, an outside director is 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 amendment to the audit committee requirements for institutions with between $500 million and $1 billion in total assets will 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.

Discussion of Comments Received on Proposed Amendments

In response to its August 2, 2005, request for comment on the proposed amendments to Part 363, the FDIC received comment letters from 28 different respondents[1]: 15 banking and thrift organizations, 7 bankers' associations, 3 accountants and accounting firms, the FDIC's Office of Inspector General (FDIC-OIG), the Conference of State Bank Supervisors (CSBS), and one other party. Generally, the comment letters expressed support for the proposed amendments. All but one of the respondents favored the proposal to increase the asset-size threshold for internal control assessments by management and external auditors to $1 billion. As for the increase to $1 billion in the asset-size threshold for the members of the audit committee, who must be outside directors, to be independent of management, 24 of the 28 respondents supported this aspect of the proposal, two respondents opposed it, and two respondents did not directly comment on it. Respondents also raised a number of other issues.

In its comment letter on the proposal, the FDIC-OIG recommended that insured institutions with total assets of $500 million or more, but less than $1 billion, that have or receive either a composite rating or Management component rating of 3, 4, or 5, i.e., 3 or lower, under the Uniform Financial Institutions Rating System (also known as the CAMELS rating system) be required to comply with all of the requirements of Part 363 rather than being provided the proposed relief for institutions in this size range. The FDIC-OIG indicated that, as of September 12, 2005, 16 insured institutions with $500 million to $1 billion in assets had less than a satisfactory composite CAMELS rating. Specifically, 11 institutions had a composite rating of 3 and 5 institutions had a 4 rating. The FDIC-OIG also noted that, over the last several months, 15 other insured institutions in this size range with a composite rating of 2 had a Management component rating of 3.

The FDIC-OIG indicated that, in reviewing past failures of insured institutions, it had observed that weak corporate governance, including financial reporting problems and the lack of independence of the board of directors from institution management, was often a factor in the failure of these institutions and contributed to material losses ($25 million or more) to the deposit insurance funds administered by the FDIC. The FDIC-OIG also stated that maintaining the full requirements of Part 363 for less that satisfactory institutions would help to address potential concerns about deficiencies by the board of directors and in internal control, internal audit, and external audit and thereby mitigate the possibility of institution failure.

Institutions that have a composite rating of 3 or lower are already subject to increased supervisory scrutiny and are normally subject to formal or informal supervisory actions (e.g., Memorandum of Understanding or Cease and Desist Order) to address the need for corrective actions for identified weaknesses and deficiencies. In reviewing the institutions cited in the FDIC-OIG's comment letter, all of the institutions with a composite rating of 3 or lower are subject to formal and/or informal supervisory actions

[1] The FDIC received 58 comment letters, which included 20 identical letters from individuals at one institution and 12 identical letters from individuals at another institution.

and all of the institutions with a composite rating of 2 and a Management component rating of 3 or lower are subject to supervisory actions.

The examination staffs of the FDIC and the other federal banking agencies look to the assessments by management of internal control over financial reporting and the independent auditors' attestation reports on those assessments as one source of information on the existence of any significant deficiencies and material weaknesses in this internal control structure. Nevertheless, the agencies' examiners are expected to perform their own evaluation of an institution's internal control environment and audit programs when determining the condition of the institution and the need for and degree of any supervisory action. Moreover, the examiners' assessment of the internal control environment encompasses not only internal control over financial reporting, but also internal control as it relates to the effectiveness and efficiency of the institution's operations and to its compliance with laws and regulations.

The agencies' examination staffs consider many factors in determining an institution's composite rating and individual component ratings, including the Management component. While these factors include the capability and performance of management and the board of directors (including the board's committees such as the audit committee), they also include the adequacy of, and conformance with, appropriate internal policies and controls addressing the operations and risks of significant activities; the accuracy, timeliness, and effectiveness of management information and risk monitoring systems; the adequacy of audits and internal control, including internal control over financial reporting; compliance with laws and regulations; and the overall performance of the institution and its risk profile.

As a consequence, when an institution is assigned a composite rating or a Management component rating of 3 or lower, its federal banking agency's supervisory response, which may include formal or informal enforcement actions, is tailored to the specific weaknesses, deficiencies, and problems identified by the examination staff and seeks appropriate and timely corrective action by management and the board of directors. The factors contributing to such a less than satisfactory rating may or may not have included ineffective internal control over financial reporting and/or unacceptable audit committee oversight and performance. In this regard, although the FDIC-OIG reported in its comment letter that 15 institutions with $500 million to $1 billion in assets had recently been assigned a composite rating of 2 and a Management component rating of 3, the majority of these institutions received this Management rating for reasons unrelated to deficiencies in internal control over financial reporting (e.g., the reasons were related to compliance with the Bank Secrecy Act). Given that each institution with $500 million to $1 billion in assets with a composite rating or Management component rating of 3 or lower is receiving closer than normal supervisory attention focused on identified problem areas, imposing additional requirements for internal control assessments by management and the external auditor and for the replacement of any audit committee members who are not independent of management would levy burdens on all such institutions, regardless of whether this burden would address weaknesses identified in a given institution.

Moreover, under the final rule, each institution with $500 million to $1 billion in assets must continue to undergo an annual audit of its financial statements. In a financial statement audit, the external auditor must obtain an understanding of internal control and must report certain matters regarding internal control to the institution's audit committee. The AICPA Auditing Standards Board recently proposed to improve its auditing standard on this communication to the audit committee by requiring the auditor to communicate, in writing rather than orally, to management and the board of directors and/or the audit committee significant deficiencies and material weaknesses in internal control of which the auditor becomes aware. Under Part 363, covered institutions must submit these written reports on significant weaknesses and material deficiencies to the FDIC and other appropriate federal and state supervisory agencies.

Additionally, as a practical matter, if an institution with $500 million to $1 billion in assets experienced a downgrading of its composite rating or Management component rating from a 1 or 2 rating to a 3 or lower rating, the institution may find it extremely difficult to replace any existing outside directors who were serving as audit committee members, but were not independent of management, with qualified outside directors who are independent of management and would be willing to serve on the audit committee.

Furthermore, CAMELS ratings often change during the year as a result of examination findings or other supervisory oversight. The FDIC-OIG's recommendation would subject institutions to uncertainty if the subject provisions of Part 363 would apply immediately during any given year in which an institution's composite or Management component rating fell to 3 or lower. If applied in the year following receipt of the 3 or lower rating, the recommendation would often result in requiring compliance with the subject provisions of Part 363 after the institution had corrected its problems and obtained a higher composite or Management rating. The first of these approaches would be difficult, at best, to plan for and implement on a timely basis, while the alternative (lagging) approach would often impose burden after (the often unrelated) problems had been addressed.

After fully considering the FDIC-OIG's comment and the agencies' supervisory tools and processes for evaluating the soundness of institutions, identifying institutions exhibiting financial and operational weaknesses or adverse trends, and focusing appropriate supervisory attention on such institutions, the FDIC staff recommends against according a different treatment to institutions with $500 million to $1 billion in assets that have a composite rating or Management component rating of 3 or lower.

The CSBS also commented on the proposed increase in the asset-size threshold for audit committee members, recommending that the chairman and a majority of the audit committee members at institutions with $500 million to $1 billion in assets be required to be independent of management. As previously mentioned, Section 36 already permits a covered institution's audit committee to be made up of less than all, but no fewer than a majority of, outside directors who are independent of management. Thus, the solution recommended by the CSBS already exists when an institution is able to show that it has encountered hardships in retaining and recruiting a sufficient number of competent outside directors who are independent of management.

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 establishing an audit committee, all of whose members are independent of management. In its comment letter, the CSBS also acknowledged the difficulties in attaining and keeping a fully independent audit committee, especially in smaller rural communities.

Individuals who serve as directors of insured institutions, whether or not they serve on the audit committee, are expected to be persons of independent judgment. In this regard, another factor that examiners assess when they evaluate the capability and performance of an institution's management and board of directors for purposes of assigning an appropriate Management component rating is the extent to which the management and board members are affected by, or susceptible to, dominant influence or concentration of authority. Hence, the agencies' examination staffs are cognizant of the heightened level of risk presented by the existence of a dominant officer, whether or not outside directors, including those on the audit committee, are independent of management.

At the same time, recognizing the benefits of an audit committee comprised solely of outside directors who are independent of management, the FDIC stated in its proposal that it would encourage each institution with between $500 million and $1 billion in assets to make a reasonable good faith effort to establish such an independent audit committee. This is consistent with the existing hardship exemption for audit committees in Section 36 under which a good faith effort to elect or name additional competent outside directors to the board is one of the factors to be considered in determining whether an institution qualifies for the exemption. The FDIC staff has carefully considered the CSBS's recommendation, but has decided to retain the audit committee relief as proposed.

Six commenters urged the FDIC to approve the proposed amendments to Part 363 as soon as feasible. These commenters further recommended that the FDIC either change the effective date of the amendments from December 31, 2005, as proposed, to September 30, 2005, or grant an institution's primary federal regulator the authority to waive the 2005 internal control assessment requirements for institutions with total assets of $500 million or more but less than $1 billion that have fiscal year-ends other than December 31. The FDIC staff concurs with these commenters' suggestion concerning the effective date and recommends changing the effective date of the amendments to Part 363 from December 31, 2005, to 30 days from the date of the final rule's publication in the Federal Register. The final rule would then apply to Part 363 annual reports with a filing deadline (90 days after the end of an institution's fiscal year) on or after the effective date of these amendments.

The FDIC also received several other recommendations from commenters that the FDIC staff has considered but recommends against implementing as part of the final rule.

RECOMMENDATION

DSC recommends that the Board of Directors approve the amendments to Part 363 as proposed, but with a modified effective date, and the publication of the attached Federal Register notice setting forth the FDIC's final rule amending Part 363.

ATTACHMENTS:
Resolution
Federal Register Notice

Concur:

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Jodey C. Arrington
Chief of Staff