**[XXXX-XX-X]**

**FEDERAL DEPOSIT INSURANCE CORPORATION**

**12 CFR Parts 308 and 363**

**RIN: 3064-AD21**

# Annual Independent Audits and Reporting Requirements

**AGENCY**: Federal Deposit Insurance Corporation (FDIC)

**ACTION**: Final rule.

**SUMMARY**: The FDIC is amending part 363 of its regulations concerning annual independent audits and reporting requirements for certain insured depository institutions, which implements section 36 of the Federal Deposit Insurance Act (FDI Act), largely as proposed, but with certain modifications made in response to the comments received. The amendments are designed to further the objectives of section 36 by incorporating certain sound audit, reporting, and audit committee practices from the Sarbanes-Oxley Act of 2002 (SOX) into part 363 and they also reflect the FDIC's experience in administering part 363. The amendments will provide clearer and more complete guidance to institutions and independent public accountants concerning compliance with the requirements of section 36 and part 363. As required by section 36, the FDIC has consulted with the other federal banking agencies. The FDIC is also making a technical amendment to its rules and procedures (part 308, subpart U) for the removal, suspension, or debarment of accountants and accounting firms.

**EFFECTIVE DATES**: Except as noted below, the final rule is effective [INSERT DATE 30 DAYS FROM DATE OF PUBLICATION IN THE FEDERAL REGISTER]. Part 363 Annual Reports with a filing deadline on or after the effective date of these amendments should be prepared in accordance with the final rule.

The compliance date for the provision of the final rule that directs covered institutions' boards of directors to develop and adopt an approved set of written criteria for determining whether a director who is to serve on the audit committee is an outside director and is independent of management (guideline 27) is delayed until December 31, 2009. The provision of the final rule that requires the total assets of a holding company's insured depository institution subsidiaries to comprise 75 percent or more of the holding company's consolidated total assets in order for an institution to be eligible to comply with part 363 at the holding company level (§ 363.1(b)(1)(ii)) is effective for fiscal years ending on or after June 15, 2010.

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**SUPPLEMENTARY INFORMATION:**

## I. Executive Summary

Section 36 of the Federal Deposit Insurance Act (FDI Act) and the FDIC's implementing regulations (part 363) are generally intended to facilitate early identification of problems in financial management at insured depository institutions with total assets above certain thresholds through annual independent audits, assessments of the effectiveness of internal control over financial reporting and compliance with laws and regulations pertaining to insider loans and dividend restrictions, the establishment of independent audit committees, and related reporting requirements. The asset-size threshold for an institution for internal control assessments is $1 billion and the threshold for the other requirements generally is $500 million. Given changes in the industry; certain sound audit, reporting, and audit committee practices incorporated in the Sarbanes-Oxley Act of 2002 (SOX); and the FDIC's experience in administering part 363, the FDIC is amending part 363 of its regulations. These amendments are designed to further the objectives of section 36 by incorporating these sound practices into part 363 and to provide clearer and more complete guidance to institutions and independent public accountants concerning compliance with the requirements of section 36 and part 363.

After making certain modifications to the proposed amendments to part 363[1] in response to the comments received, the most significant revisions to existing part 363 that are included in the final rule will: (1) extend the time period for a non-public institution to file its Part 363 Annual Report by 30 days and replace the 30-day extension of the filing deadline that may be granted if an institution (public or non-public) is confronted with

[1] 72 FR 62310, November 2, 2007.

extraordinary circumstances beyond its reasonable control with a late filing notification requirement that would have general applicability; (2) provide relief from the annual reporting requirements for institutions that are merged out of existence before the filing deadline; (3) provide relief from reporting on internal control over financial reporting for businesses acquired during the fiscal year; (4) require management's assessment of compliance with the laws and regulations pertaining to insider loans and dividend restrictions to state management's conclusion regarding compliance and disclose any noncompliance with such laws and regulations; (5) require an institution's management and the independent public accountant to identify the internal control framework used to evaluate internal control over financial reporting and disclose all identified material weaknesses that have not been remediated prior to the institution's most recent fiscal year-end; (6) clarify the independence standards with which independent public accountants must comply and enhance the enforceability of compliance with these standards; (7) specify that the duties of the audit committee include the appointment, compensation, and oversight of the independent public accountant, including ensuring that audit engagement letters do not contain unsafe and unsound limitation of liability provisions; (8) require certain communications by independent public accountants to audit committees; (9) establish retention requirements for audit working papers; (10) require boards of directors to adopt written criteria for evaluating an audit committee member's independence and provide expanded guidance for boards of directors to use in determining independence; (11) provide that ownership of 10 percent or more of any class of voting securities of an institution is not an automatic bar for considering an outside director to be independent of management; (12) require the total assets of a holding company's insured depository institution subsidiaries to comprise 75 percent or more of the holding company's consolidated total assets in order for an institution to be eligible to comply with part 363 at the holding company level; and (13) provide illustrative management reports to assist institutions in complying with the annual reporting requirements.

The FDIC is also amending its rules and procedures (part 308, subpart U) for the removal, suspension, or debarment of accountants and accounting firms from performing audit services required by section 36 of the FDI Act to specify where an accountant or accounting firm should file required notices of orders and actions with the FDIC.

## II. Background

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 reporting 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. Sections 36(d) and (f) also obligate the FDIC to consult with the other federal banking agencies in implementing these sections of the FDI Act, and the FDIC has performed the required consultation.

Part 363 of the FDIC's regulations (12 CFR part 363), which implements section 36 of the FDI Act, was initially adopted by the FDIC's Board of Directors in 1993. At present, part 363 requires each insured depository institution with $500 million or more in total assets (covered institution) to submit to the FDIC and other appropriate federal and state supervisory agencies an annual report (Part 363 Annual Report) comprised of audited financial statements, and a management report containing a statement of management's responsibilities and an assessment by management of compliance with laws and regulations pertaining to insider loans and dividend restrictions. The management report component of the annual report for an institution with $1 billion or more in total assets must also include an assessment by management of the effectiveness of internal control over financial reporting and an independent public accountant's attestation report on internal control over financial reporting. In addition, part 363 provides that each covered institution's board of directors must establish an independent audit committee comprised of outside directors. For an institution with between $500 million and $1 billion in total assets, part 363 requires a majority of the members of the audit committee to be independent of management of the institution. For a larger institution, all of the members of the audit committee must be independent of management. 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.

## III. Discussion of Proposed Amendments and Comments Received

On October 16, 2007, the FDIC's Board approved the publication of proposed amendments to part 363 and part 308, subpart U, of the FDIC's regulations, which were published in the **Federal Register** on November 2, 2007, for a 90-day comment period (72 FR 62310). The comment period closed on January 31, 2008.

Given the number and extent of changes to part 363 and its Guidelines and Interpretations and to enable readers to more easily understand the context of the changes, this notice includes the entire text of part 363 as amended, not just the amended text. Also, the following "Table of Changes to Part 363 and Appendices" is intended to assist readers in determining which sections of part 363 are affected by the final rule.

| Table of Changes to Part 363 and Appendices | | | | |
|---|---|---|---|---|
| | **Unchanged** | **Revised** | **New** | **Reserved** |
| **Part 363 – Annual Independent Audits and Reporting Requirements** | | | | |
| **Table of Contents** | | X | | |
| **OMB Control Number**<br>§ 363.0 | <br>X | | | |
| **Scope and Definitions** | | | | |
| § 363.1(a) | | X | | |
| § 363.1(b)(1) | | X | | |
| § 363.1(b)(2) | | X | | |
| § 363.1(b)(3) | X | | | |
| § 363.1(c) | | | X | |
| § 363.1(d) | | | X | |
| **Annual Reporting Requirements** | | | | |

| | | | | |
|---|---|---|---|---|
| § 363.2(a) | | X | | |
| § 363.2(b) | | X | | |
| § 363.2(b)(1) | | X | | |
| § 363.2(b)(2) | | X | | |
| § 363.2(b)(3) | | X | | |
| § 363.2(c) | | | X | |
| **Independent Public Accountant** | | | | |
| § 363.3(a) | X | | | |
| § 363.3(b) | | X | | |
| § 363.3(c) | | X | | |
| § 363.3(d) | | | X | |
| § 363.3(e) | | | X | |
| § 363.3(f) | | | X | |
| § 363.3(g) | | | X | |
| **Filing and Notice Requirements** | | | | |
| § 363.4(a) | | X | | |
| § 363.4(b) | | X | | |
| § 363.4(c) | | X | | |
| § 363.4(d) | X | | | |
| § 363.4(e) | | | X | |
| § 363.4(f) | | | X | |
| **Audit Committees** | | | | |
| § 363.5(a) | | X | | |
| § 363.5(b) | | X | | |
| § 363.5(c) | | | X | |
| | | | | |
| **Appendix A to Part 363 – Guidelines and Interpretations** | | | | |
| **Table of Contents** | | X | | |
| **Introduction** | X | | | |
| **Scope (§ 363.1)** | | | | |
| Guideline 1 | X | | | |
| Guideline 2 | X | | | |
| Guideline 3 | | X | | |
| Guideline 4 | | X | | |
| Guideline 4A | | | X | |
| **Annual Reporting Requirements (§ 363.2)** | | | | |
| Guideline 5 | | X | | |
| Guideline 5A | | | X | |
| Guideline 6 | | X | | |
| Guideline 7 | | X | | |
| Guideline 7A | | | X | |
| Guideline 8 | | X | | |
| Guideline 8A | | | X | |
| Guideline 8B | | | X | |
| Guideline 8C | | | X | |

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|---|---|---|---|---|
| Guideline 9 | | X | | |
| Guideline 10 | | X | | |
| Guideline 11 | | X | | |
| Guideline 12 | | | | X |
| **Role of Independent Public Accountant (§ 363.3)** | | | | |
| Guideline 13 | | X | | |
| Guideline 14 | | | | X |
| Guideline 15 | | X | | |
| Guideline 16 | | | | X |
| Guideline 17 | X | | | |
| Guideline 18 | | X | | |
| Guideline 18A | | | X | |
| Guideline 19 | X | | | |
| Guideline 20 | | X | | |
| Guideline 21 | X | | | |
| **Filing and Notice Requirements (§ 363.4)** | | | | |
| Guideline 22 | | | | X |
| Guideline 23 | | X | | |
| Guideline 24 | X | | | |
| Guideline 25 | | | | X |
| Guideline 26 | | X | | |
| **Audit Committees (§ 363.5)** | | | | |
| Guideline 27 | | X | | |
| Guideline 28 | | X | | |
| Guideline 29 | | | | X |
| Guideline 30 | | X | | |
| Guideline 31 | | X | | |
| Guideline 32 | | X | | |
| Guideline 33 | X | | | |
| Guideline 34 | X | | | |
| Guideline 35 | | X | | |
| **Other** | | | | |
| Guideline 36 | | X | | |
| | | | | |
| **Table 1 to Appendix A Designated Federal Laws and Regulations** | | X | | |
| | | | | |
| **Appendix B – Illustrative Management Reports** | | | X | |

In response to its request for comments, the FDIC received 23 comment letters that addressed the proposed amendments to part 363. These commenters represented 12 financial institutions; 3 bankers' trade organizations; 4 accounting firms; 1 accountants' trade organization; 1 state regulatory organization; and 2 law firms.

Regarding the technical amendment to part 308, Subpart U, the FDIC did not receive any comments on its proposal to specify the location where an accountant or accounting firm should file required notices of orders and actions regarding removal, suspension, or debarment.

With respect to the comments received on the proposed amendments to part 363, eight commenters expressed general support for the proposal, seven commenters were generally not supportive, and eight commenters did not express an overall view on the proposal. While comments were received on almost every aspect of the proposed amendments, no commenter specifically commented on each aspect. However, eleven commenters expressed concerns regarding the regulatory burden associated with various aspects of the proposal. In addition, commenters expressed concerns about the following aspects of the proposed amendments:

- Disclosure of noncompliance with the designated laws and regulations,
- Insured depository institution percentage-of-consolidated-total-assets threshold for eligibility to comply with part 363 at a holding company level,
- Management's report on internal control over financial reporting,
- Independent public accountant's report on internal control over financial reporting,
- Independent public accountant's communications with audit committees,

- Time period for the retention of the independent public accountant's working papers,
- Independence standards applicable to independent public accountants,
- Filing requirement for and public availability of AICPA peer review reports and PCAOB inspection reports on independent public accountants,
- Filing requirement for and public availability of audit engagement letters, and
- Audit committee member independence.

The following sections discuss the proposed amendments and the comments and concerns raised by the commenters, including the responses received on two specific aspects of the proposed amendments for which the FDIC specifically requested comments: (1) disclosure of noncompliance with the designated safety and soundness laws and regulations pertaining to insider loans and dividend restrictions, and (2) the 75 percent of total assets threshold for eligibility to comply with the requirements of part 363 at the holding company level.

**A. Scope and Definitions (§ 363.1 and Guidelines 1-4A)**

*1. Applicability*

The FDIC proposed to amend § 363.1(a) to more clearly state that part 363 applies to any insured depository institution that has consolidated total assets of $500 million or more at the beginning of its fiscal year.

One commenter that represents over 30 community banks recommended that the FDIC raise the asset size threshold from $500 million to $1 billion for requiring compliance with part 363. In November 2005, when the FDIC increased the asset size threshold for assessments of internal control over financial reporting from $500 million to $1 billion, it concluded that exempting all institutions below this higher size level from all of the 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. The federal banking agencies rely upon financial information to evaluate the condition of insured depository institutions and to determine the adequacy of regulatory capital. Accurate and reliable measurement of an institution's loans, other assets, and earnings has a direct bearing on the determination of regulatory capital. The agencies are able to place greater reliance on measurements contained in financial statements that have been subject to an independent audit. Independent audits help to identify weaknesses in internal control over financial reporting and risk management at institutions and reinforce corrective measures, thus complementing supervisory efforts in contributing to the safety and soundness of insured depository institutions. Therefore, after considering this comment, the FDIC has determined that, except where a $1 billion or higher asset threshold already applies, the $500 million asset size threshold continues to be the appropriate level for requiring compliance with part 363.

*2. Compliance by Subsidiaries of Holding Companies*

At present, an insured depository institution that is a subsidiary of a holding company may use consolidated holding company financial statements to satisfy the audited financial statements requirement of part 363 regardless of whether the assets of the insured depository institution subsidiary or subsidiaries of the holding company represent substantially all or only a minor portion of the holding company's consolidated total assets. When the assets of insured depository institution subsidiaries do not comprise a substantial portion of a holding company's consolidated total assets, the FDIC staff has found that the holding company's consolidated financial statements, including the accompanying notes to the financial statements, do not tend to provide sufficient information that is indicative of the financial position and results of operations of these institutions. Also, when the insured depository institution subsidiaries do not contribute significantly to the holding company's financial position and results of operations, the extent of audit coverage given to these institutions in the audit of the consolidated holding company may be limited. Such limited audit coverage would not be consistent with the purpose and intent of section 36 of the FDI Act, which focuses on insured depository institutions rather than holding companies. In this situation, the assurance that would be provided by an independent audit performed substantially at the level of the insured depository institution subsidiaries is not otherwise available.

Therefore, given the differing characteristics of the holding companies that own insured depository institutions as well as the relationship of an insured depository institution's total assets to the consolidated total assets of its parent holding company, and in keeping with the intent and purpose of section 36 of the FDI Act, the FDIC proposed to amend §§ 363.1(b)(1) and (2) by revising the criteria for determining whether the audited financial statements requirement and the other requirements of part 363 may be satisfied at a holding company level. More specifically, in order for a covered institution to be eligible to comply with the requirements of part 363 at the top-tier or any other mid-tier holding company level, the FDIC proposed that the consolidated total assets of the insured depository institution (or the consolidated total assets of all of the holding company's insured depository institution subsidiaries, regardless of size, if the top-tier or mid-tier holding company owns or controls more than one insured depository institution) must comprise 75 percent or more of the consolidated total assets of the top-tier or mid-tier holding company. The FDIC believes that this percentage-of-assets threshold should ensure that the extent of independent audit work performed at the insured depository institution level is sufficient to satisfy the intent of section 36 of the FDI Act, that is, the early identification of needed improvements in financial management at insured institutions. The FDIC also believes that this threshold will continue to provide flexibility to the vast majority of covered institutions that are part of a holding company structure with respect to the level at which they may comply with part 363.

When determining an appropriate percentage-of-assets threshold for compliance with part 363 at a holding company level, the FDIC considered the range of percentage-of-assets ratios for covered institutions that are part of a holding company structure. The vast majority of insured institutions subject to part 363 that are in a holding company structure are subsidiaries of organizations where the assets of the insured depository institution subsidiaries of the holding company comprise 90 percent or more of the holding company's consolidated total assets. Of the remaining institutions subject to part 363 that are in a holding company structure, most are subsidiaries of organizations where the assets of the insured institutions comprise either from 75 to 90 percent or less than 25 percent of the top-tier parent company's consolidated total assets. Smaller numbers of institutions are subsidiaries of organizations where the assets of the insured institutions comprise from 25 to 50 percent or from 50 to 75 percent of the top-tier parent company's consolidated total assets. However, in a number of cases where the insured institution subsidiaries comprise less than 75 percent of the top-tier holding company's consolidated total assets, the insured institution subsidiaries that are subject to part 363 currently comply with the regulation at a mid-tier holding company level where the assets of the insured institution subsidiaries comprise 90 percent or more of the mid-tier holding company's consolidated total assets. Thus, these institutions would not need to change how they comply with part 363 in response to the establishment of the proposed 75 percent threshold, provided they continue to comply at the same mid-tier holding company level and this holding company continues to meet the 75 percent threshold.

To assist it in considering the costs and benefits of a threshold, the FDIC specifically requested comment as to whether 75 percent or more of consolidated total assets is an appropriate threshold. Six commenters expressed views that the 75 percent threshold is reasonable, is in the public's best interest, and provides ease of application while obtaining appropriate audit coverage of the insured depository institutions.

Three commenters were opposed to the proposed 75 percent threshold. These commenters expressed the following concerns:

- The goal is reasonable but the proposed 75 percent threshold may not be appropriate. Instead, lower the threshold and require institutions that are below the threshold to consult with the FDIC prior to reporting at the holding company level.
- Compliance at the holding company level should not be dependent on the aggregate size of the subsidiary insured depository institutions relative to the holding company.
- Institutions should have until the end of their first full fiscal year after the FDIC promulgates the final rule to comply with the proposed change.
- The 75 percent threshold is arbitrary and may result in treating very similar institutions differently. An objectives-based approach should be used.

The FDIC continues to recognize that those institutions currently complying with part 363 at the holding company level that will not meet the proposed 75-percent-of-consolidated-total-assets threshold will incur additional costs from having to comply with the regulation at the institution level or at a suitable mid-tier holding company level. Requiring institutions that do meet the 75 percent threshold, or a lower percentage threshold, to consult with the FDIC prior to reporting at a holding company level would add a new element of regulatory burden and would not provide certainty nor contribute to the ease of application of the 75 percent threshold. The FDIC has concluded that the 75-percent-of-assets threshold strikes an appropriate balance between insured institution financial data and audit coverage and the cost of compliance with part 363.

The FDIC agrees with the comment that institutions that currently report at the holding company level, but do not meet the 75-percent-of-consolidated-total-assets threshold, should be afforded sufficient time to comply with this new requirement. Accordingly, the FDIC has decided to delay the effective date for implementing this threshold until fiscal years ending on or after June 15, 2010. Thus, for fiscal years ending on or before June 14, 2010, all insured depository institutions may continue to satisfy the audited financial statements requirement of part 363 at a holding company level whether or not the institution's consolidated total assets (or the consolidated total assets of all of its parent holding company's insured institutions) comprise 75 percent or more of the holding company's consolidated total assets at the beginning of the fiscal year.

Guideline 3 to part 363, *Compliance by Holding Company Subsidiaries*, states that when a holding company submits audited consolidated financial statements and other reports or notices required by part 363 on behalf of any subsidiary institution, an accompanying cover letter should identify all subsidiary institutions to which the statements, reports, or other notices pertain. Because many cover letters received by the FDIC have not sufficiently identified these subsidiary institutions, the FDIC proposed to amend guideline 3 to clarify what information should be included in the cover letter. No comments were received on this aspect of the proposal.

*3. Financial Reporting*

The FDIC proposed to add a new § 363.1(c) and a new guideline 4A, *Financial Reporting*, to specify that "financial reporting" includes both financial statements prepared in accordance with generally accepted accounting principles and those prepared for regulatory reporting purposes. Also, as proposed, guideline 4A clarifies that financial statements prepared for regulatory reporting purposes consist of the schedules equivalent to the basic financial statements that are included in an institution's appropriate regulatory report and that financial statements prepared for regulatory reporting purposes do not include regulatory reports prepared by a non-bank subsidiary of a holding company or an institution.

One commenter recommended that the FDIC further clarify the definition of financial reporting for purposes of part 363 to more clearly align it with current reporting practices. This commenter also stated that, when reporting at a holding company level, "regulatory reporting" would not extend to assertions about internal control over financial reporting at the subsidiary institution level. Another commenter, an accountants' trade organization, stated that the proposed amendment seems to imply that institutions' regulatory reports may not be prepared in conformity with generally accepted accounting principles (GAAP). This commenter recommended that the FDIC clarify the definition of financial reporting to state that both financial statements and the regulatory reports be prepared in accordance with GAAP to make it consistent with current practice.

While the FDIC believes that the proposed amendments are consistent with explanatory guidance it issued on this subject in December 1994,[2] the FDIC has decided to modify the proposed definition of financial reporting set forth in § 363.1(c) and guideline 4A, *Financial Reporting,* to state more clearly that, when reporting at a holding company level, it includes the financial statements and regulatory reports of an institution's holding

[2] See FDIC Financial Institution Letter (FIL) 86-94, dated December 23, 1994.

company. The modified definition would also state that, for recognition and measurement purposes, regulatory reporting requirements shall conform to GAAP.

*4. Definitions*

The FDIC proposed to add § 363.1(d), *Definitions*, to define several common terms used in part 363 and the guidelines and received no comments on these definitions.

**B. Annual Reporting Requirements (§ 363.2 and Guidelines 5-12)**

*1. Audited Financial Statements*

Consistent with sound management practices and the objective of internal control over financial reporting, the FDIC proposed to amend § 363.2(a) to require that the annual financial statements reflect all material correcting adjustments identified by the independent public accountant. Financial statements issued by insured depository institutions that are public companies or by their parent holding companies that are public companies are already subject to such a requirement pursuant to section 401 of SOX. The FDIC believes this requirement should also apply to institutions subject to part 363 that are not public companies.

In response to a commenter's recommendation, the FDIC revised this proposed requirement to provide additional context regarding the phrase "material correcting adjustments identified by the independent public accountant" by explaining that these adjustments should be those that are necessary for the financial statements to conform with GAAP.

*2. Part 363 Management Report Contents*

The FDIC has noted differences in the content of the management reports included in Part 363 Annual Reports and the adequacy of the information in these management reports regarding the results of management's assessments of the effectiveness of internal control over financial reporting and compliance with the laws and regulations pertaining to insider loans and dividend restrictions. Identified material weaknesses in internal control over financial reporting and instances of noncompliance with insider lending requirements and dividend restrictions have not always been disclosed.

In addition, management's assessment of internal control over financial reporting has often failed to disclose the internal control framework used to perform the assessment of the effectiveness of these controls and to clearly state whether controls over the preparation of the regulatory financial statements have been included within the scope of management's assessment. The omission of this information from an institution's management report reduces the usefulness of the report as a means of identifying needed improvements in financial management, which is the objective of section 36 of the FDI Act. The regulations adopted by the Securities and Exchange Commission (SEC) in 2003 implementing the requirement in section 404 of SOX for a management report on internal control over financial reporting requires management to identify the internal control framework it used to evaluate the effectiveness of these controls and to disclose any identified material weakness.

To provide clearer guidance on the information that should be included in the management report, the FDIC proposed to expand § 363.2(b) to require management's assessment of compliance with the laws and regulations pertaining to insider loans and dividend restrictions to include a clear statement as to management's conclusion regarding compliance and to disclose any noncompliance with such laws and regulations. In addition, the proposed amendment to § 363.2(b) would require management's assessment of internal control over financial reporting to identify the internal control framework that management used to make its evaluation, include a statement that the evaluation included controls over the preparation of regulatory financial statements, include a clear statement as to management's conclusion regarding the effectiveness of internal control over financial reporting, disclose all material weaknesses identified by management, and preclude management from concluding that internal control over financial reporting is effective if there are any material weaknesses.

The FDIC specifically requested comment as to whether the disclosure in the management report of instances of noncompliance with the laws and regulations pertaining to insider loans and dividend restrictions should be made available for public inspection or be designated as privileged and confidential and not be made available to the public by the FDIC. Three commenters supported public availability only for disclosures of "material" noncompliance and twelve commenters were not supportive of public availability of disclosures of noncompliance. These commenters were concerned that minor errors may be mistaken for a systemic compliance failure and stated that noncompliance should be addressed through the examination process.

The FDIC has considered these comments and notes that all insured depository institutions, regardless of size, are required to comply with the designated safety and soundness laws and regulations that deal with insider loans and dividend restrictions. Moreover, these laws and regulations have not substantially changed since part 363 was first implemented in 1993. Thus, well before an insured depository institution reaches $500 million in total assets and becomes subject to part 363, it should already have appropriate policies, procedures, controls, and systems in place to monitor insider lending activities and assess its dividend-paying capacity and thereby ensure compliance with the safety and soundness laws and regulations in these two designated areas. Public availability of disclosures of instances of noncompliance with these designated laws and regulations should act as a further stimulus to management's efforts to ensure that its policies, procedures, controls, and systems are sound and operating effectively. Therefore, the FDIC has concluded that, to reinforce the importance of management's responsibility for complying with the laws and regulations pertaining to insider loans and dividend restrictions, instances of noncompliance with these laws and regulations should be disclosed in management's assessment (that is included in the management report) and made available to the public.

Nevertheless, based on the comments it received on this issue, the FDIC believes it would be useful to provide further guidance regarding disclosure of noncompliance with the designated safety and soundness laws and regulations. Accordingly, the FDIC is adding guideline 8C, *Management's Disclosure of Noncompliance with Designated Laws and*

*Regulations,* to Appendix A to part 363. This guideline states that management is not required to specifically identify the individual or individuals (e.g., officers or directors) who were responsible for or were the subject of any such noncompliance and provides general parameters for making the disclosure. For example, the disclosure should include appropriate qualitative and quantitative information to describe the nature, type, and severity of the noncompliance. Also, similar instances of noncompliance may be aggregated.

While the majority of commenters did not comment on the proposed revisions applicable to management's report on internal control over financial reporting, four commenters expressed concerns or made recommendations as follows:

- The report is not necessary, its costs exceed the benefits derived, and it is difficult for small community banks to recruit personnel with the level of training and experience necessary to implement the accounting and reporting rules.
- Consider a "delayed phase-in" of the requirements for assessing internal control over financial reporting similar to the phase-in utilized by the SEC in its rules implementing section 404 of SOX.
- Raise the asset size threshold for this requirement from $1 billion to $3 billion to ease regulatory burden.
- The requirement to disclose all identified material weaknesses in internal control over financial reporting in management's report should be clarified as to whether the disclosure covers all identified material weaknesses, regardless of their status as of

the institution's fiscal year-end, or only those in existence as of the end of the fiscal year that have not been remediated prior to that date.

Management has been required to assess and report on the effectiveness of an institution's internal control over financial reporting since part 363 was first implemented in 1993. In November 2005, when the FDIC increased the asset size threshold for internal control assessments from $500 million to $1 billion, it concluded, and continues to believe, that the $1 billion asset size threshold is appropriate for requiring assessments and reports on internal control over financial reporting. Therefore, the FDIC has decided to retain the $1 billion asset size threshold for requiring assessments and reports on internal control over financial reporting. Also, for the reasons previously stated, the FDIC does not believe that a "delayed phase-in" of the requirement for assessing and reporting on internal control over financial reporting is necessary or appropriate. Moreover, a phase-in of the requirement for management to assess and report on internal control over financial reporting in effect already exists because this requirement takes effect only when an institution's total assets exceed $1 billion, not when the institution first becomes subject to the other audit and reporting requirements of section 36 and part 363 when its assets reach $500 million.

With respect to management's reporting on the material weaknesses it has identified in the management report component of its Part 363 Annual Report, the FDIC notes that section 36 of the FDI Act requires management to perform an assessment of internal control over financial reporting as of year-end. Therefore, to clarify management's reporting responsibility, the FDIC has revised § 363.2(b)(3)(iii) to explain that management must disclose all material weaknesses in internal control over financial reporting that it has identified and that have not been remediated prior to the end of the institution's fiscal year.

Because part 363 and its guidelines provide only limited guidance concerning the contents of the management report and the related signature requirements for this report, institutions and auditors have expressed interest in examples of acceptable reports. Therefore, to assist managements of insured depository institutions in complying with the annual reporting requirements of § 363.2, the FDIC proposed to add "*Appendix B to Part 363 – Illustrative Management Reports*." Appendix B provides guidance regarding reporting scenarios that satisfy the annual reporting requirements of part 363, illustrative management reports, and an illustrative cover letter for use when an institution complies with the annual reporting requirements at the holding company level. The FDIC also states in Appendix B that the use of the illustrative management reports and cover letter is not required. The FDIC encourages the managements of insured depository institutions to tailor the wording of their management reports to fit their particular circumstances, especially when reporting on material weaknesses in internal control over financial reporting or noncompliance with designated laws and regulations.

Two commenters stated that the illustrative management reports are helpful and will mitigate regulatory burden. Another commenter suggested that the illustrative management reports would be better suited in an accounting and auditing guide that could be updated regularly to reflect changes in professional standards or other requirements that would affect these reports and that the accounting and auditing guide could illustrate the differences in reporting under AICPA and PCAOB standards. This commenter also stated that the illustrative management report on internal control over financial reporting at the holding company level is inconsistent with current practice and that it does not clearly and appropriately describe the scope of the internal control assessments by management or the independent public accountant. This commenter added that the language in the illustrative management report on internal control at the holding company level does not make it clear to a reader whether management has separately assessed the effectiveness of internal control over financial reporting at each subsidiary institution listed in the report.

The FDIC has considered this commenter's suggestion that the illustrative management reports would be better suited in an accounting and auditing guide. In this regard, the FDIC notes that auditing and attestation standards require auditors to evaluate the elements that management is required to present in its report on its assessment of internal control over financial reporting, but these standards do not fully address the requirements of part 363 for management reports on internal control nor do they provide guidance to management regarding the preparation of management reports for part 363 purposes. Given the varying degrees of familiarity of institution management with professional auditing and attestation standards as well as the lack of availability of illustrative management reports that satisfy the requirements of part 363, the FDIC has determined that the illustrative management reports should be provided in Appendix B to part 363.

However, in response to this commenter's statements concerning the illustrative management reports on internal control over financial reporting at the holding company level, the FDIC has revised the text of these illustrative management reports, which are presented in sections 5(c) and (d) and 6(b) of Appendix B. More specifically, the sample text in these illustrative reports that identifies the subsidiary institutions that are subject to part 363 has been revised by removing the language stating that these institutions are included in the scope of management's assessment of internal control over financial reporting. The FDIC believes that the revised illustrative management reports on internal control over financial reporting at the holding company level are consistent with current practices and professional auditing and attestation standards.

Regarding management's responsibility for assessing compliance with the laws and regulations pertaining to insider loans and dividend restrictions, the FDIC proposed to revise and update Table 1 to Appendix A of part 363 to reflect changes in these laws and regulations that have occurred since this table was last revised in 1997. The FDIC received no comments on the revised and updated Table 1.

*3. Management Report Signatures*

Section 36(b)(2) of the FDI Act requires an institution's management report to be signed by the chief executive officer and the chief accounting officer or chief financial officer. In its reviews of management reports, the FDIC has noted that these reports are often not signed by the officers at the appropriate corporate level when the audited financial statements requirement is satisfied at the holding company level or when one or more of the components of the management report is satisfied at the holding company level and the remaining components of the management report are satisfied at the insured depository institution level. Therefore, the FDIC proposed to add § 363.2(c) to specify which corporate officers must sign the management report and also the level of the corporate signers (i.e., insured depository institution level or the holding company level). No comments were received on this aspect of the proposal.

*4. Institutions Merged Out of Existence*

To reduce regulatory burden and provide certainty for merging institutions, the FDIC proposed to add guideline 5A, *Institutions Merged Out of Existence*, to explicitly provide relief from filing a Part 363 Annual Report for an institution that is merged out of existence after the end of its fiscal year, but before the deadline for filing its Part 363 Annual Report. However, a covered institution that is acquired after the end of its fiscal year, but retains its separate corporate existence rather than being merged out of existence, would continue to be required to file a Part 363 Annual Report for that fiscal year. Three commenters commented in support of this aspect of the proposal, one of whom stated that the proposed amendment will reduce both regulatory burden and uncertainty.

*5. Management's Assessment of the Effectiveness of Internal Control Over Financial Reporting*

The FDIC has publicly advised institutions with $1 billion or more in total assets that are public companies or subsidiaries of public companies that they have considerable flexibility in determining how best to satisfy the SEC's requirements for management's assessment of internal control over financial reporting which implement section 404 of SOX, and the FDIC's requirements in part 363.[3] The reporting flexibility available to institutions subject to both the section 404 and the part 363 requirements was initially described in the preamble to the SEC's section 404 final rule release (68 FR 36642, June 18, 2003). This final rule release explained that the flexible reporting approach described in the preamble had been developed by the SEC staff in consultation with the staff of the federal banking agencies. To codify this reporting flexibility in part 363, the FDIC proposed to add guideline 8A, *Management's Assessment of the Effectiveness of Internal Control Over Financial Reporting*. For an institution with $1 billion or more in total assets that is subject to both part 363 and the SEC's rules implementing section 404 of SOX (or whose parent holding company is subject to section 404 and the condition in § 363.1(b)(2) is met), the proposed guideline describes two options for complying with the filing requirements regarding management's report on internal control over financial reporting. These options are to prepare (1) two separate reports, one to satisfy the FDIC's part 363 requirements and another to satisfy the SEC's section 404 requirements, or (2) a single report that satisfies all of the FDIC's part 363 requirements and all of the SEC's section 404 requirements. No comments were received on proposed new guideline 8A.

*6. Internal Control Reports for Acquired Businesses*

[3] 70 FR 71231, November 28, 2005; 70 FR 44295, August 2, 2005; FDIC Financial Institution Letter (FIL) 137-2004, December 21, 2004.

Currently, under the reporting requirements of part 363, both management's and the independent public accountant's evaluation of an institution's internal control over financial reporting must include controls at an institution in its entirety, including all of its consolidated businesses, including businesses that were recently acquired. However, like the SEC staff, the FDIC recognizes that it may not always be possible for management to conduct an evaluation of the internal control over financial reporting of an acquired business in the period between the consummation date of the acquisition and the due date of management's internal control evaluation. The SEC staff has provided guidance to public companies stating that the staff would not object to the exclusion of the acquired business from management's evaluation of internal control over financial reporting, provided certain disclosures are made and other conditions are met.[4] The FDIC has received and granted several written requests from institutions subject to the internal control reporting requirements of part 363 to exclude recently acquired businesses from the scope of management's internal control evaluation.

To reduce regulatory burden, including the burden of submitting written requests to the FDIC, and provide certainty to institutions, the FDIC proposed to add guideline 8B, *Internal Control Reports for Acquired Businesses*, to explicitly provide relief from the reporting requirements regarding internal control over financial reporting related to business acquisitions made by an institution during its fiscal year. As proposed and consistent with the SEC staff's guidance, guideline 8B would permit management's

[4] See Question 3 in the SEC staff's *Frequently Asked Questions on Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports* at www.sec.gov/info/accountants/controlfaq1004.htm.

evaluation of internal control over financial reporting to exclude internal control over financial reporting for the acquired business, provided management's report identifies the acquired business, states that the acquired business is excluded from management's evaluation of internal control over financial reporting, and indicates the significance of the acquired business to the institution's consolidated financial statements. Also, proposed guideline 8B would clarify that if the acquired business is an insured depository institution that is subject to part 363 and it is not merged out of existence before the deadline for filing its Part 363 Annual Report, the acquired business (institution) must continue to comply with all of the applicable requirements of part 363. One commenter commented on this aspect of the proposal and supported the amendment as proposed, stating that it will reduce both regulatory burden and uncertainty.

*7. Standards for Internal Control*

At present, guideline 10, *Standards for Internal Control,* provides that each institution should determine its own standards for establishing, maintaining, and assessing the effectiveness of its internal control over financial reporting, but it does not describe the characteristics of a suitable internal control framework. The FDIC proposed to amend guideline 10 to provide guidance regarding the attributes of a suitable internal control framework. The proposed attributes are consistent with the attributes the SEC described in the preamble to the SEC's section 404 final rule release (68 FR 36648, June 18, 2003). The FDIC believes that a framework with these attributes is appropriate for all institutions whether or not they are public companies. No comments were received on this aspect of the proposal.

## C. Independent Public Accountant (§ 363.3 and Guidelines 13-21)

*1. Internal Control Over Financial Reporting*

As with its experience in reviewing the portion of the management report in which management provides its assessment of the effectiveness of the institution's internal control over financial reporting, the FDIC has found some independent public accountants' internal control attestation reports to be less than sufficiently informative. Such attestation reports are, therefore, inconsistent with the objectives of section 36 of the FDI Act. As a consequence, the FDIC proposed to amend § 363.3(b), which governs the independent public accountant's report on internal control over financial reporting, to specify that, consistent with generally accepted standards for attestation engagements, the Public Company Accounting Oversight Board's (PCAOB) auditing standards, and related PCAOB staff implementation guidance, the accountant's report must:

- Not be dated prior to the date of management's report on its assessment of the effectiveness of internal control over financial reporting;
- Identify the internal control framework that the accountant used to make the evaluation (which must be the same as the internal control framework used by management);
- Include a statement that the accountant's evaluation included controls over the preparation of regulatory financial statements;
- Include a clear statement as to the accountant's conclusion regarding the effectiveness of internal control over financial reporting;
- Disclose all material weaknesses identified by the accountant; and

- Conclude that internal control is ineffective if there are any material weaknesses.

The FDIC also proposed to amend guideline 18, *Attestation Report*, to be consistent with § 363.3(b)(2) by reiterating that the attestation report on internal control over financial reporting should include a statement as to regulatory reporting.

The majority of commenters did not comment on the independent public accountant's report on internal control over financial reporting. However, four commenters expressed concerns or made recommendations as follows:

- Since the AICPA Auditing Standards Board's proposed revisions to the attestation standards for nonpublic companies will likely be similar to the requirements for public companies, and based upon the experiences of public companies complying with SOX 404, the requirement for the independent public accountant to examine, attest to, and report on management's assertion concerning internal control over financial reporting for both GAAP and regulatory reporting purposes will be too costly. Instead of having the accountant examine internal control, banking regulators should assess the adequacy of internal control over financial reporting as part of the examination process.
- The requirements that the independent public accountant's report on internal control over financial reporting identify the internal control framework used, state that the evaluation included controls over the preparation of regulatory financial statements, express the accountant's conclusion as to whether internal control is effective, and

disclose all material weaknesses can be deleted because they are already addressed by the AICPA and PCAOB standards. The rule should instead refer to the professional auditing and attestation standards.

- The FDIC should consider a delayed phase-in of the requirement for the independent public accountant to assess internal control over financial reporting similar to the phase-in set forth in the SEC's rules implementing SOX 404.
- The requirement to disclose material weaknesses in internal control over financial reporting in the independent public accountant's report should be clarified as to whether the disclosure covers all identified material weaknesses, regardless of their status as of the institution's fiscal year-end, or only those in existence as of the end of the fiscal year that have not been remediated prior to that date, which is the disclosure requirement in the professional auditing and attestation standards.

Independent public accountants have been required to examine, attest to, and report on management's assertion concerning the effectiveness of an institution's internal control over financial reporting since part 363 was first implemented in 1993. This requirement is also set forth section 36 of the FDI Act. In November 2005, the FDIC increased the asset size threshold for internal control assessments from $500 million to $1 billion for both management and the independent public accountant. At that time, the FDIC noted that recent and impending changes to the auditing and attestation standards governing internal control assessments that were making them more robust had and would continue to increase the cost and burden of the audit and reporting requirements of part 363. The FDIC concluded then that the increase to a $1 billion asset size threshold for requiring assessments and reports on internal control over financial reporting achieved an appropriate balance between burden reduction and maintaining safety and soundness for institutions subject to part 363. The FDIC continues to believe today that $1 billion remains a suitable size threshold for internal control assessments. Also, for the reasons previously stated in Section III.B.2, the FDIC does not believe that a "delayed phase-in" of the requirement for the independent public accountant to report on management's assertion regarding internal control over financial reporting is necessary or appropriate. Additionally, the FDIC notes that under the SEC's most recent amendments, a non-accelerated filer need not file the auditor's attestation report on internal control over financial reporting until it files an annual report for a fiscal year ending on or after December 15, 2009. Since part 363 has long required such internal control audits, the FDIC believes that it would be contrary to the objectives of section 36 of the FDI Act to allow institutions subject to part 363 with $1 billion or more in total assets, that are not accelerated filers or subsidiaries of accelerated filers for federal securities law purposes, to discontinue undergoing assessments of the effectiveness of their internal control over financial reporting by their external auditors until the SEC requires such audits for non-accelerated filers.

In response to the comments regarding the disclosure of material weaknesses in internal control over financial reporting, the FDIC has revised § 363.3(b)(3) to clarify that the independent auditor's internal control report must disclose all material weaknesses that the independent auditor has identified and that have not been remediated prior to the end of the institution's fiscal year.

The FDIC has considered the suggestion that the rule be revised to refer to the existing standards of the auditing standard setters rather than including specific requirements in the rule. In this regard, both the current and proposed rule state that the independent public accountant's attestation and report on internal control over financial reporting shall be made in accordance with generally accepted standards for attestation engagements. However, as previously noted, the FDIC has found some independent public accountants' internal control attestation reports to be less than sufficiently informative, and given the varying degrees of familiarity of institution management and audit committee members with professional auditing standards, the FDIC has decided to retain the specific requirements set forth in the proposed rule. The FDIC also believes that including these requirements in the proposed rule will assist audit committee members in the performance of their duties regarding the oversight of the external auditor. However, the FDIC has revised § 363.3(b) to clarify that the auditor's report on internal control over financial reporting should satisfy the requirements set forth in both part 363 and applicable professional standards. In this regard, and consistent with guidance the FDIC issued in February 2008,[5] the FDIC has also revised § 363.3(b) and added guideline 18A to clarify that the attestation report on internal control over financial reporting may be made in accordance with the PCAOB's auditing standards even if the institution is a nonpublic company or a subsidiary of a nonpublic company.

*2. Communications with Audit Committee*

[5] See FDIC Financial Institution Letter (FIL) 5-2008, dated February 1, 2008.

According to section 204 of SOX, an accountant who audits a public company's financial statements should report on a timely basis to the company's audit committee: (1) all critical accounting policies, (2) alternative accounting treatments discussed with management, and (3) written communications provided to management, such as a management letter or schedule of unadjusted differences. The FDIC has encouraged institutions, regardless of whether they are public companies, to arrange with their accountant to institute these reporting practices.[6] Requirements that are similar, but not identical, to those set forth in section 204 apply to accountants who audit the financial statements of entities that are not public.[7] Therefore, consistent with current best practices and standards for audits of both public and non-public entities, the FDIC proposed to amend part 363 by adding § 363.3(d), *Communications with audit committee,* to set a uniform minimum requirement for such communication. As proposed, § 363.3(d) would require the independent public accountant to report the information identified in section 204 of SOX to the audit committee.

While the majority of commenters did not comment on the independent public accountant's communications with audit committees, three commenters expressed the following concerns:

- The communication requirements for auditors of nonpublic entities are included in the AICPA's standards and those for auditors of public companies are established by the PCAOB and the SEC. Rather than memorializing these communication

[6] See FDIC Financial Institution Letter (FIL) 17-2003, dated March 5, 2003.
[7] See Statement on Auditing Standards No. 114, *The Auditor's Communication With Those Charged With Governance*, December 2006.

requirements in the rule, refer to the existing standards of the AICPA, the PCAOB, and the SEC.

- The proposed amendments overlap the requirements of the AICPA standards and do not align with the communication required by SEC rules and regulations and may cause confusion as to the required communications. The requirements should either be removed in their entirety or clarified and aligned.
- SOX practices and principles regarding audit committee communications should be restricted to publicly held banks.
- Auditors should not be required to report critical accounting policies, alternative accounting treatments, and schedules of unadjusted differences to the audit committee. Management should have discretion as to whether these communications should be reported to the audit committee.

The FDIC has considered the concerns raised by the commenters, including the suggestion that the rule be revised to refer to the existing standards of the auditing standard setters (AICPA, PCAOB, and SEC) rather than including specific requirements in the rule. Although the existing auditing standards for both public and nonpublic companies set forth the requirements for the independent public accountant's communications with audit committees, the FDIC believes that, given the varying degrees of familiarity of audit committee members with professional auditing standards, setting forth the requirements for the auditor's communications with audit committees in the proposed rule will assist audit committee members in the performance of their duties regarding the oversight of the external auditor. Therefore, the FDIC has decided to retain the requirements set forth in the proposed rule. However, the FDIC has revised § 363.3(d) to clarify that the auditor should satisfy the audit committee communication requirements set forth in both part 363 and applicable professional standards. Also, based on its review of the professional standards regarding auditors' communications with audit committees, the FDIC believes that the revised requirements in the proposed rule are consistent with the existing professional standards.

*3. Retention of Working Papers*

Section 36(g)(3)(A) of the FDI Act states that an independent public accountant who performs audit services required by section 36 must agree to provide related working papers to the FDIC, any appropriate federal banking agency, and any state bank supervisor. The SEC's rules and the auditing standards for public companies specify a 7-year retention period for audit working papers while the auditing standards for nonpublic companies provide that the retention period for audit working papers should not be shorter than five years.[8] The FDIC believes that a uniform retention period should apply to audits of all institutions subject to part 363. Accordingly, the FDIC proposed to amend part 363 by adding § 363.3(e), *Retention of working papers.* As proposed, § 363.3(e) would require the independent public accountant to retain the working papers related to its audit of the financial statements and, if applicable, its evaluation of internal control over financial reporting for seven years.

[8] See Rule 2-06 of the SEC's Regulation S-X, the PCAOB's Auditing Standard No. 3, *Audit Documentation,* June 2004, and the AICPA's Statement on Auditing Standards No. 103, *Audit Documentation*, December 2005.

One commenter stated that the five-year retention period specified by the AICPA's auditing standards is appropriate for nonpublic companies. Another commenter was concerned that the proposed seven-year retention period may cause extra burden and expense for independent public accountants of nonpublic institutions.

Under section 36 and part 363, the requirement for institutions to undergo audits of their financial statements and, if applicable, assessments of their internal control over financial reporting does not depend on whether they are public or nonpublic companies. Thus, the FDIC believes that the retention requirement for the working papers associated with auditors' performance of these services should also be independent of whether institutions are public or nonpublic companies. In this regard, the FDIC notes that the AICPA's auditing standards for nonpublic companies acknowledge that working paper retention periods may exceed five years. After considering the comments, the FDIC continues to believe that a uniform retention period for audit working papers should apply to all institutions subject to part 363. Therefore, the FDIC has decided to retain the proposed seven year retention period for working papers related to audits of financial statements and evaluations of internal control over financial reporting.

*4. Independence*

Section 36 of the FDI Act states that an "independent public accountant" must perform the audit and attestation services required by section 36 but it does not define "independent," leaving this to the FDIC's rulemaking authority. As adopted by the FDIC in 1993, part 363 includes guideline 14, *Independence*, which identifies the independence standards applicable to accountants performing services under section 36 and part 363. This guideline specifies that the independent public accountant must comply with the independence standards applicable to audits of both nonpublic and public companies. In 2003, the agencies jointly issued rules of practice to implement the enforcement provisions of section 36(g)(4), which authorize the FDIC or an appropriate federal banking agency to remove, suspend, or bar an accountant, for good cause, from performing audit and attestation services for institutions subject to section 36 and part 363.[9] To enhance the enforceability of the independence standards with which an accountant must comply for purposes of part 363, the FDIC proposed to move the independence requirements for independent public accountants from guideline 14, *Independence*, to new § 363.3(f), *Independence*. As proposed, § 363.3(f) would retain the original independence concept of part 363, i.e., auditor compliance with the independence standards applicable to both nonpublic and public company audits, by clarifying that the independent public accountant must comply with the independence standards and interpretations of the PCAOB for audits of public companies that have been approved by the SEC in addition to the independence standards and interpretations of the AICPA and the SEC.

Two commenters stated that the proposed amendment with its explicit reference to compliance with the PCAOB's independence standards represents a best practice and that the coordination of the independence standards in part 363 with the independence standards of the AICPA, the SEC, and the PCAOB will reduce uncertainty.

[9] 68 FR 48256, August 13, 2003.

Nevertheless, one commenter recommended that the FDIC clarify whether an independent public accountant should (a) comply with the most restrictive independence requirement addressing a particular matter or (b) comply with the independence requirements that pertain only to public companies. In contrast, six commenters (which included the three bankers' trade organizations and two of the four accounting firms) were opposed to or expressed concerns about the proposed amendment. These commenters stated that:

- The FDIC should individually evaluate and clarify the applicability of each new SEC and PCAOB independence standard.
- The FDIC should revise part 363 to require the auditors of public institutions to meet the independence rules of the SEC and the PCAOB and the auditors of nonpublic institutions to meet only the AICPA's independence rules.
- Applying the independence standards of the SEC and the PCAOB equally to all independent public accountants may prohibit certain independent public accountants from performing engagements for nonpublic institutions subject to part 363.
- Adding the PCAOB's independence rules to the existing requirement for compliance with the independence rules of the SEC and the AICPA could be problematic for some community banks because: (1) some banks may not have ready access to multiple accounting firms that satisfy the independence requirements of the PCAOB, the SEC, and the AICPA; and (2) it creates a third set of standards that the audit committee will need to review on a regular basis in order to fulfill its duties.
- Education efforts to explain the auditor independence requirements of part 363 will be needed because: (1) many institutions subject to part 363 are nonpublic; and

(2) many independent public accountants that provide services to nonpublic institutions are not registered with the PCAOB and may not be familiar with the independence standards of the SEC and the PCAOB.

The foundation for auditor independence standards is the principle that auditors who provide audit services must be independent in fact and appearance with respect to their audit clients. The FDIC notes that the independence rules of the SEC and AICPA have been applicable to audits of both public and nonpublic institutions subject to part 363 since the implementation of part 363 in 1993. More recently, SOX granted additional authority to set independence standards for accounting firms performing audits of public companies (issuers) to the PCAOB. In this regard, the PCAOB's independence standards do not become effective unless and until they are approved by the SEC, which means that they are tantamount to SEC independence standards.

The FDIC acknowledges that both the AICPA's and the SEC's auditor independence standards, including those of the PCAOB, have evolved over time. The FDIC recognizes that the effect of periodic changes in these auditor independence standards carries over to accountants with insured depository institution audit clients subject to part 363 regardless of whether these clients are public or nonpublic institutions. Thus, as the AICPA, the SEC, and the PCAOB periodically revise their auditor independence standards, independent public accountants performing audit and attest services under part 363 must take appropriate steps to ensure that they continue to satisfy the qualifications for accountants with respect to independence that are set forth in part 363. While changes in independence standards can be burdensome to auditors and their clients, given the importance of the independence of the accountants who provide audit services to institutions subject to part 363, which in number comprise the largest 17 percent of the insured depository institutions, the FDIC continues to believe that it is in the public interest for independence standards to apply uniformly to all accountants performing these services. To achieve this objective, auditors of institutions subject to part 363 should continue to comply with all of the independence standards applicable to both nonpublic and public institutions that are established by the AICPA, the SEC, and the PCAOB rather than to comply with these standards on a selective or exclusionary basis. Therefore, the FDIC has decided to proceed with the proposed amendment to the auditor independence provisions of part 363.

However, as recommended by a commenter, the FDIC has revised the proposed rule to clarify that if a provision within one of the applicable independence standards is more restrictive than a provision addressing the same subject matter in one of the other independence standards, the independent public accountant must comply with the more restrictive independence requirement. For example, an external auditor is permitted to provide internal audit outsourcing services to an audit client under the AICPA's independence rules, but the independence rules of the SEC and the PCAOB generally prohibit an external auditor from providing such services to an audit client. In this example, the external auditor would have to comply with the more restrictive independence requirements of the SEC and the PCAOB.

*5. Peer Reviews*

Section 36(g)(3)(A)(ii) of the FDI Act requires an independent public accountant to have received a peer review or be enrolled in a peer review program that meets acceptable guidelines. At present, guideline 15 to part 363 provides that to be acceptable, a peer review should, among other things, be generally consistent with AICPA standards. Since part 363 was originally adopted, the PCAOB has been created and conducts inspections of registered public accounting firms, some of which audit insured depository institutions subject to part 363 or their parent holding companies. These inspections serve a similar purpose as peer reviews. In addition, the PCAOB issues reports on its inspections of these accounting firms.

In response to this development and in light of the agencies' issuance of rules of practice implementing the enforcement provisions of section 36, the FDIC proposed to add new § 363.3(g) on peer reviews. The FDIC proposed to move the requirements for peer reviews, the filing of peer review reports, and the retention of peer review working papers from guideline 15, *Peer Reviews*, and guideline 16, *Filing Peer Review Reports,* to § 363.3(g). As proposed, § 363.3(g) clarified that acceptable peer reviews include peer reviews performed in accordance with the AICPA's Peer Review Standards and inspections conducted by the PCAOB. It also provided that the FDIC would not make available for public inspection the portion of any peer review report and inspection report determined to be nonpublic by the AICPA and the PCAOB, respectively. Finally, the FDIC proposed to revise guideline 15 to explain that to be acceptable a peer review, other than a PCAOB inspection, should be generally consistent with AICPA Peer Review Standards.

In their comments on the proposal, all four accounting firms and the accountants' trade organization did not object to filing the public portions of PCAOB inspection reports, but were opposed to filing the nonpublic portions of these reports. These commenters also expressed the following concerns:

- The proposed requirement is contrary to existing law (SOX) and the professional standards of the PCAOB. An accounting firm should be required to submit the nonpublic portion of a PCAOB inspection report to the FDIC only if it is made public by the PCAOB.
- Pursuant to Section 104(g)(2) of SOX, the PCAOB cannot disclose the nonpublic portion of an inspection report unless criticisms of the accounting firm's quality controls remain unremediated 12 months after the issuance of the report. There are only two exceptions to the statutory prohibition: (1) disclosure to the SEC and state boards of public accountancy, and (2) to a "Federal functional regulator" when the PCAOB Board, in its discretion, determines that disclosure is necessary. The PCAOB has not made such a determination regarding any federal banking agency.
- Since AICPA peer review reports and public portions of the PCAOB inspection reports are available to the FDIC on the AICPA and PCAOB websites, there should not be a requirement for auditors to submit reports directly to the FDIC.

In response to the concerns raised by the commenters, the FDIC has revised the proposed amendment to require independent public accountants to file only the public portions of PCAOB inspection reports. The revised amendment also requires independent public accountants to file previously nonpublic portions of any PCAOB inspection report within 15 days of the PCAOB making such portions public. The FDIC has retained the existing requirement for independent public accountants to file peer review reports, accompanied by any letters of comments, response, and acceptance.

Regarding AICPA peer review reports, the FDIC notes that these reports are publicly available on the AICPA website for some, but not all, independent public accountants and accounting firms. The AICPA's standards for performing and reporting on peer reviews do not require independent public accountants or accounting firms to post their peer review reports on the AICPA website. However, members of the AICPA's audit quality centers and the Private Companies Practice Section post their review reports on the AICPA website, certain firms voluntarily make their peer review reports public, and other firms make some aspects of their peer review reports available when required by a state board of public accountancy or the Government Accountability Office. Furthermore, since section 36 of the FDI Act requires peer review reports to be filed with the FDIC and made available for public inspection, the FDIC cannot override this statutory requirement despite the present availability of most of these reports on the PCAOB and AICPA websites. The FDIC has therefore retained the filing requirement for AICPA peer review reports and the public portions of PCAOB inspection reports.

*6. Notice of Termination*

Guideline 26, *Notices Concerning Accountants*, permits an institution that is a public company or a subsidiary of a public company to satisfy the requirement for filing a notice of termination of its independent public accountant by using its current report (e.g., SEC Form 8-K) concerning a change in accountant to satisfy the similar notice requirements of part 363. To reduce regulatory burden and provide flexibility to the independent public accountant of such an institution, the FDIC proposed to amend guideline 20, *Notice of Termination*, to permit the independent public accountant to satisfy the requirement to file a notice of termination of its services in a similar manner. No comments were received on this aspect of the proposal.

**D. Filing and Notice Requirements (§ 363.4 and Guidelines 22-26)**

*1. Annual Reporting*

At present, the annual reporting requirements of part 363 require each insured depository institution to file its Part 363 Annual Report within 90 days after the end of its fiscal year. Each institution is also required to file the independent public accountant's report on the audited financial statements and, if applicable, the accountant's attestation report on management's assessment of internal control over financial reporting, both of which are components of the Part 363 Annual Report, within 15 days of receipt by the institution, which, at times, has presented a conflict with the annual report filing requirement. The FDIC has also noted that earlier filing deadlines established by the SEC for annual reports filed by certain public companies under the federal securities laws (e.g., SEC Form 10-K) and more robust auditing standards related to internal control over financial reporting have had an impact on the management of institutions, on the resources of independent public accountants, and on auditing costs.

To reduce cost and burden, the FDIC proposed to amend § 363.4(a) by extending the time period within which an insured depository institution that is not a public company or a subsidiary of a public company must file its Part 363 Annual Report from within 90 days to within 120 days after the end of its fiscal year. As proposed, an insured depository institution that is a public company, or that is a subsidiary of a public company that meets certain criteria, would continue to be required to file its Part 363 Annual Report within 90 days after the end of its fiscal year, which is consistent with the maximum time frame that public companies have for filing annual reports under the federal securities laws. The proposed amendment would also eliminate the ambiguity in § 363.4 concerning the filing deadline for the components of the Part 363 Annual Report that are prepared by the independent public accountant.

An insured depository institution with consolidated total assets of less than $1 billion that is a public company or a subsidiary of a public company is required to file management's assessment of the effectiveness of internal control over financial reporting with the SEC or the appropriate federal banking agency in accordance with the compliance dates of the SEC's rules implementing section 404 of SOX. Management's findings and conclusions with respect to internal control over financial reporting, as disclosed in the assessment that management files with the SEC or the appropriate federal banking agency, provide information that would aid in meeting the objective of section 36 of the FDI Act.

Therefore, the FDIC proposed to add a provision to § 363.4(a) that would require an institution of this size to submit a copy of management's section 404 internal control assessment with its Part 363 Annual Report, but this assessment would not be considered part of the institution's Part 363 Annual Report.

Five commenters expressed support for the proposed extension of the filing deadline for the Part 363 Annual Report for an institution that is not a public company or a subsidiary of a public company. These commenters stated that the additional 30 days will help to ensure that auditors are able to devote sufficient resources to the nonpublic engagements, provide nonpublic institutions with the additional time needed to comply with the filing requirements, and may help to reduce the cost of independent audits.

At present, part 363 specifies that the Part 363 Annual Reports and reports on peer reviews shall be available for public inspection. Except for management letters, which are exempt from public disclosure pursuant to existing guideline 18, part 363 does not address the availability of other reports and notifications required to be filed under part 363. Consistent with the FDIC's longstanding practice, the FDIC has revised the proposed rule to clarify that, except for the annual reports, AICPA peer review reports, and PCAOB inspection reports, which shall be available for public inspection, all other reports and notifications required to be filed under part 363 are exempt from public disclosure by the FDIC.

*2. Independent Public Accountant's Reports*

Section 36(h)(2)(A) of the FDI Act and § 363.4(c) require an institution to file a copy of any management letter or other report issued by its independent public accountant that pertains to the financial statement audit and the attestation on internal control over financial reporting within 15 days after receipt by the institution. The FDIC's experience in administering part 363 indicates that institutions are often uncertain as to which types of reports they receive from their independent public accountant must be submitted to the FDIC, the appropriate federal banking agency, and any appropriate state bank supervisor pursuant to this filing requirement. As stated above, this uncertainty extends to this 15-day filing requirement and its relationship to the filing deadline for the Part 363 Annual Report. To clarify the requirements for the filing of accountants' reports, the FDIC proposed to amend § 363.4(c), *Independent public accountant's letters and reports*, by providing examples of the types of reports issued by an institution's independent public accountant, except for the accountant's reports that are required to be included in the institution's Part 363 Annual Report, that are to be filed within 15 days after receipt. As proposed, Guideline 25, *Independent Accountant's Reports*, would be deleted because it would be redundant and no longer needed.

In the *Interagency Advisory on the Unsafe and Unsound Use of Limitation of Liability Provisions in External Audit Engagement Letters*, the federal banking agencies expressed their concerns about limitation of liability provisions included in external audit engagement letters and advised institutions against entering into engagement letters containing such provisions.[10] To enable the FDIC to timely review institutions' engagement letters with their independent public accountants, the FDIC also proposed to amend § 363.4(c) to require institutions to file copies of audit engagement letters, including any related agreements and amendments, with the FDIC, the appropriate federal banking agency, and any appropriate state bank supervisor within 15 days of acceptance by the institution.

Eight commenters (which included two bank trade organizations, three accounting firms, and the accountants' trade organization) opposed requiring institutions to file audit engagement letters and were concerned about their public availability. These commenters stated that:

- It is not essential, practical, or beneficial for an institution to file the audit engagement letter. The requirement for the audit committee to ensure that the letter does not contain any inappropriate limitation of liability provisions is sufficient and appropriate.
- Instead of requiring institutions to file audit engagement letters, the FDIC could require management's report to include a statement that the audit engagement letter has been reviewed for unsafe and unsound limitation of liability provisions.
- The final rule should specify that audit engagement letters filed with the FDIC are "exempt from disclosure" under FOIA.

[10] See 71 FR 6847, February 9, 2006, and FDIC Financial Institution Letter (FIL) 13-2006, issued on the same date.

The FDIC notes that, since the publication of the proposed rule, the AICPA's Professional Ethics Executive Committee has adopted Interpretation No. 501-8, *Failure to Follow Requirements of Governmental Bodies, Commissions, or Other Regulatory Agencies on Indemnification and Limitation of Liability Provisions in Connection With Audit and Other Attest Services*, which became effective July 31, 2008.[11] This ethics interpretation states:

> Certain governmental bodies, commissions, or other regulatory agencies (collectively, regulators) have established requirements through laws, regulations, or published interpretations that prohibit entities subject to their regulation (regulated entity) from including certain types of indemnification and limitation of liability provisions in agreements for the performance of audit or other attest services that are required by such regulators or that provide that the existence of such provisions causes a member to be disqualified from providing such services to these entities. For example, federal banking regulators, state insurance commissions, and the Securities and Exchange Commission have established such requirements.
>
> If a member enters into, or directs or knowingly permits another individual to enter into, a contract for the performance of audit or other attest services that are subject to the requirements of these regulators, the member should not include, or knowingly permit or direct another individual to include, an indemnification or

[11] The full text of the Interpretation can be found on the AICPA's website at the following link:

limitation of liability provision that would cause the regulated entity or member to be disqualified from providing such services to the regulated entity. A member who enters into, or directs or knowingly permits another individual to enter into, such an agreement for the performance of audit or other attest services that would that would cause the regulated entity or a member to be in violation of such requirements, or that would cause a member to be disqualified from providing such services to the regulated entity, would be considered to have committed an act discreditable to the profession.

In consideration of the comments received and the issuance of this ethics interpretation, the FDIC has reevaluated this aspect of the proposal and has decided to remove the proposed requirement to file audit engagement letters, which will eliminate the burden that would have been associated with this filing requirement. However, the FDIC cautions institutions and independent public accountants that including unsafe and unsound limitation of liability provisions in audit engagement letters could result in adverse consequences. For example, the FDIC could determine that an audit of an institution's financial statements and, if applicable, its internal control over financial reporting that has been performed pursuant to an engagement letter containing these unsafe and unsound provisions does not satisfy the requirements of part 363. The institution could then be directed to engage a different independent public accountant to perform another audit. The independent public accountant whose engagement letter contained the unsafe and unsound limitation of liability provisions could also be subject

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http://www.aicpa.org/download/ethics/EDITED_Adopted_501_8_final.pdf.

to supervisory action by the FDIC or the institution's primary federal regulator as well as disciplinary action by the relevant state board of public accountancy and the AICPA for an act discreditable to the profession.

*3. Notification of Late Filing*

Guideline 23, *Relief from Filing Deadlines,* currently provides that in the occasional event that an institution is confronted with extraordinary circumstances beyond its reasonable control that justifies an extension of the deadline for filing its Part 363 Annual Report or another required report or notice, the institution may submit a written request for an extension of the filing deadline of not more than 30 days that explains the reasons for the request. Such a request may be granted for good cause. Over the last several years, the reasons set forth in the requests for extensions of time for filing Part 363 Annual Reports that have been submitted to the FDIC generally did not represent extraordinary circumstances beyond the institution's reasonable control, the standard currently set forth in guideline 23. Also, several extension requests were repeats of requests from the same institutions from the previous year.

Based upon this experience and given the proposed amendment to § 363.4(a) to extend the filing deadline for Part 363 Annual Reports for non-public institutions from 90 to 120 days, the FDIC proposed to replace the extensions of time for filing reports that are available only in extraordinary circumstances under guideline 23 with a new § 363.4(e), *Notification of late filing.* In place of filing extensions that have limited applicability, this new section would be applicable to all institutions and would require an institution that is unable to timely file all or any portion of its Part 363 Annual Report or any other report or notice required to be filed under part 363 to submit a written notice of late filing before the filing deadline for the report or notice. The late filing notice must disclose the institution's inability to timely file all or specified portions of its Part 363 Annual Report or other report or notice, the reasons therefore in reasonable detail, and the date by which the report or notice will be filed.

The FDIC also proposed to amend guideline 23 by changing its focus from extension requests to late filing notices consistent with the approach taken in new § 363.4(e). Amended guideline 23 explains that submitting a late filing notice will not cure the apparent violation of part 363 arising from an institution's failure to timely file a Part 363 Annual Report or any other required report or notice. The supervisory response to such an apparent violation would take into account the facts and circumstances surrounding an institution's delay in filing. As proposed, guideline 23 also provides that, if the late filing applies to only a portion of the Part 363 Annual Report or any other report or notice, the components of the report or notice that have been completed should be filed within the prescribed filing period accompanied by either a cover letter that indicates which components are omitted or a combined late filing notice and cover letter.

One commenter suggested that the FDIC revise the proposed rule to provide for extensions of the filing due date for up to 60 days for institutions that are not public companies or subsidiaries of public companies instead of establishing a late filing notification requirement. In the FDIC's dealings with institutions unable to file their Part

363 Annual Reports by the filing deadline in the current rule, whether they are seeking extensions of the deadline or not, it is not uncommon for institutions to experience delays in their ability to file these reports that extend well in excess of 60 days after the filing deadline. Therefore, the FDIC believes that establishing a late filing notification requirement is a more practical approach for addressing the broad range of situations when institutions are unable to timely file reports required under part 363 than providing for longer extensions of the filing deadline in those cases where an institution meets an extraordinary circumstances standard. Accordingly, the FDIC has decided to adopt this aspect of the rule as proposed without revision.

*4. Place for Filing*

Current guideline 22 identifies the office of the FDIC, the appropriate federal banking agency, and the appropriate state bank supervisor to which reports and notices (other than peer review reports) required by part 363 are to be filed. Nevertheless, the FDIC has found that some institutions submit required reports and notices to incorrect locations. The FDIC staff also receives questions from institutions asking where reports and notices should be filed. To make the information as to where Part 363 Annual Reports, written notices of late filing, and other reports and notices (except peer review reports) are to be filed more prominent, the FDIC proposed to move this information from guideline 22, *Place for Filing*, to a new § 363.4(f), *Place for filing*. No comments were received on this aspect of the proposal.

**E. Audit Committees (§ 363.5 and Guidelines 27-35)**

*1. Composition*

Section 36(g)(1) of the FDI Act and § 363.5(a) require each insured depository institution subject to part 363 to have an independent audit committee comprised entirely of outside directors. As defined in § 363.5(a) (3), in general, an outside director is a director who is not an officer or employee of the institution or any affiliate of the institution. In addition, the outside directors who serve on the audit committee must be "independent of management," although a minority of the audit committee members of institutions with $500 million or more but less than $1 billion in total assets need not be "independent of management." Guideline 27, *Composition*, requires each institution's board of directors to determine at least annually whether existing and potential audit committee members satisfy the requirements governing audit committee composition.

In order for a board of directors to perform its evaluation of audit committee members in a consistent, effective, and reviewable manner, the FDIC believes the board should be guided by an approved policy or set of criteria that identifies the factors to be taken into account by the board. Accordingly, the FDIC proposed to amend guideline 27 to require each institution's board of directors to maintain an approved set of written criteria for determining whether a director who is to serve on the audit committee is an outside director and is independent of management and to apply these criteria, at least annually, to determine whether each existing or potential audit committee member meets the requirements of section 36 and part 363. The proposed amendment to guideline 27 also requires that the results of and basis for the board's determination with respect to each existing and potential audit committee member be recorded in the board's minutes.

Two commenters expressed support for the proposed requirement in guideline 27 for each institution's board of directors to adopt written criteria for determining if audit committee members meet the requirements of section 36 and part 363 and view it as a best practice. One of these commenters also recommended that the FDIC revise or expand § 363.5(b) or guideline 28 to clarify the extent to which audit committee members who meet the SEC's definition of "audit committee financial expert" will be deemed to have "banking or related financial management expertise" for part 363 purposes.

However, three commenters, including one bankers' trade organization, were not supportive of the proposed amendments to guideline 27. These commenters objected to the documentation requirements for audit committee members' independence and the requirements for the board of directors' minutes to reflect the results of and basis for the board's determinations regarding audit committee members' independence. As an alternative, two of these commenters recommended that audit committees be permitted to survey existing and potential members and make the survey available to examiners but not reflect the survey results in the board of directors' minutes.

In addition to being a best practice, the FDIC believes that the adoption and implementation by an institution's board of directors of an approved policy or set of criteria that identifies the factors to be taken into account for evaluating audit committee member independence improves corporate governance. Documenting the results of and basis for determinations with respect to each existing and potential audit committee member in the board's minutes further supports good corporate governance and provides evidence that the board is properly discharging its responsibilities under part 363 in the process for selecting audit committee members. Applying an approved policy or set of criteria and documenting the results provide a more robust and consistent process than having audit committees themselves survey existing and potential committee members for review by examiners, but with no oversight by the entire board of directors. Nevertheless, an annual survey of existing and potential audit committee members by the board may be a useful mechanism for determining whether these individuals satisfy the board's policy or set of criteria. For these reasons, the FDIC has decided to adopt guideline 27 as proposed without any revision.

As to the suggestion regarding clarification of the extent to which audit committee members who have the attributes of an "audit committee financial expert" under the SEC's rules will be deemed to have "banking or related financial management expertise," the FDIC has revised guideline 32, *Banking or Related Financial Management Expertise,* to clarify that such persons will satisfy the criteria set forth in the guideline.

Guideline 30, *Holding Company Audit Committees*, provides guidance for complying with the audit committee requirements of part 363 at the holding company level. The FDIC proposed to amend guideline 30 for consistency with the proposed revisions to the holding company provisions of § 363.1(b) and to reflect the difference in the audit committee composition requirements in § 363.5(a) for institutions with more than and less than $1 billion in total assets. No comments were received on this aspect of the proposal.

*2. "Independent of Management" Considerations*

Guideline 28, *"Independent of Management" Considerations*, identifies five factors for a board of directors to consider when determining the independence of an outside director. Guideline 29, *Lack of Independence*, states that a director who owns or controls 10 percent or more of any class of the institution's voting securities should not be considered "independent of management." The FDIC has found that some of the factors in guideline 28 are so general that they fail to provide meaningful guidance to boards of directors. At the same time, many of the institutions subject to part 363 or their parent holding companies are public companies with securities listed on a national securities exchange. Under the SEC's Rule 10A-3 (17 CFR § 240.10A-3), each audit committee member of a listed issuer must be a director of the issuer and must otherwise be independent. The listing standards of the national securities exchange must set forth the criteria for determining the independence of directors who are to serve on a listed issuer's audit committee.

Based on its review, the FDIC stated in the proposal to amend part 363 that it believed that the independence criteria for audit committee members included in the listing standards of the national securities exchanges, together with the FDIC's existing stock ownership criterion in guideline 29, represented an appropriate framework for determining whether an outside director is "independent of management" for purposes of part 363. Furthermore, for an institution whose audit committee members or whose parent holding company's audit committee members, if the holding company meets the holding company provisions of § 363.1(b), are subject to the listing standards of a national securities exchange, the FDIC observed that allowing the institution to use these standards for part 363 purposes would reduce the institution's burden.

Therefore, the FDIC proposed to combine guidelines 28 and 29 and provide expanded guidance for an institution's board of directors to use in its assessment of an outside director's relationship to the institution for the purposes of making "independent of management" determinations regarding audit committee members. For example, the proposed amendment to guideline 28 included a list of criteria that an institution's board of directors should consider when determining whether an outside director would be considered "independent of management." In developing the proposed list of criteria, the FDIC considered, but did not entirely replicate, the portion of the listing standards of the national securities exchanges that apply to audit committees. An institution's board of directors may also conclude that it should consider additional criteria that may be appropriate in its particular circumstances. As an alternative to these criteria, revised guideline 28 would permit an institution that is a public company or a subsidiary of a public company (when the holding company provisions of § 363.1(b) are met) that is subject to the listing standards of a national securities exchange to apply the audit committee provisions of the listing standards for purposes of determining audit committee member independence. Similarly, all other institutions, including those that are not public companies, may elect, but would not be required, to adopt the audit committee provisions of the listing standards of a national securities exchange or association as their criteria for determining audit committee member independence.

While two commenters supported the proposed amendments regarding audit committee independence, five commenters (which included two bankers' trade organizations and three financial institutions) expressed certain concerns or suggested changes to the proposal. These commenters suggested that:

- Shareholders of closely-held companies should not be automatically prohibited from serving on the audit committee solely because they own 10 percent or more of the institution's voting stock.
- The FDIC should raise the proposed compensation limitation threshold from $60,000 to $100,000.
- The meaning of "financial services" as it relates to indirect compensation should be clarified. Furthermore, the need for "indirect compensation" limits is questionable given all of the other independence requirements.
- Proposed guideline 28(b)(7) should be revised by removing from the definition of "payment" loans and other services extended to directors in the ordinary course of an institution's business as well as payments arising solely from investments in the bank's securities and payments made under non-discretionary charitable contribution matching programs. The $200,000 or 5 percent of gross revenues test in this guideline should be measured against the revenues of the recipient of the payment, and not the outside employer.

- Applying the director independence standards of the national securities exchanges to privately held banks will impose challenges for community banks located in areas where it is difficult to find competent directors to serve on the audit committee.
- Existing guidelines 28 and 29 provide sufficient guidance for institutions to determine the independence of a director.
- Audit committee independence criteria should consider an individual institution's complexity and risk profile. For community banks, audit committee member independence can be difficult to accomplish and maintain.

In response to these comments and concerns, the FDIC has carefully reviewed the provisions of proposed revised guideline 28 on the "independent of management" considerations that should be applied to audit committee members. First, the FDIC has reconsidered the existing 10 percent stock ownership limit for audit committee members. In this regard, the SEC's and the national securities exchanges' rules do not impose such a limit on audit committee members. Therefore, consistent with these entities' rules, the FDIC is revising guideline 28 to provide that ownership of 10 percent or more of any class of voting securities of an institution would not be an automatic bar for considering an outside director to be independent of management. The revised guideline further provides that when an outside director's stock ownership equals or exceeds the 10 percent threshold, the institution's board of directors would be required to determine and document its determination as to whether such ownership would interfere with the outside director's exercise of independent judgment in carrying out the responsibilities of an audit committee member.

Next, the FDIC has reconsidered the compensation limit applicable to audit committee members for direct and indirect compensation and, as suggested by commenters, has revised guideline 28 to increase the compensation threshold from $60,000 to $100,000. Additionally, the comments seeking greater clarity concerning the meaning of indirect compensation and the types of payments deemed to be compensation have merit. Therefore, the FDIC has revised the guideline to provide examples of indirect compensation and to specify that certain payments would not be included within the meaning of the terms direct and indirect compensation.

In response to the suggestion to remove loans and other services extended to directors in the ordinary course of an institution's business as well as payments arising solely from investments in the bank's securities and payments made under non-discretionary charitable contribution matching programs from the definition of "payment," the FDIC has revised and expanded guideline 28(b)(8) to specify what payments are not included within the meaning of the terms direct and indirect compensation and payments. As to the suggestion regarding the basis of the measurement for the $200,000 or 5 percent of gross revenue test, the FDIC has decided to retain this requirement as proposed so as to maintain consistency with the similar requirements set forth in the listing standards of the national securities exchanges and thereby minimize confusion in the application of this requirement.

Based on questions it has received from covered institutions and its experience in administering the criteria set forth the existing guidelines 28 and 29 regarding audit committee member independence, the FDIC concluded that these guidelines did not provide sufficient guidance for institutions to determine the independence of a director for the purposes of serving on an institution's audit committee. Therefore, the FDIC's experience contradicts the views of the commenter who asserted that the existing guidelines provide sufficient guidance.

The FDIC acknowledges that some community banks may encounter challenges in accomplishing and maintaining audit committee member independence. In recognition of these challenges, the FDIC amended the audit committee provisions of part 363 in 2005 to allow a minority of the outside directors who serve on the audit committee of covered institutions with less than $1 billion in total assets not to be independent of management. After reviewing the criteria listed in proposed guideline 28 as they would be modified as discussed above, the FDIC believes that the nature and types of relationships included in the list represent a reasonable framework for evaluating whether outside directors who are candidates for the audit committees of covered institutions of all sizes, both public and nonpublic, are independent of management. Of particular note, the criteria include a $100,000 limit on certain forms of direct and indirect compensation to a director or immediate family members. In contrast, the SEC's and the national securities exchanges' rules currently limit the compensation of audit committee members to fees received as a director and audit committee member and prohibit all other compensation, direct and indirect. The FDIC chose not to impose this prohibition, which applies to audit committee members of certain public companies, on all insured institutions subject to part 363. The absence of this prohibition on compensation from the criteria in guideline 28 should benefit nonpublic community institutions subject to part 363. Similarly, the removal of the 10 percent stock ownership limit from the audit committee independence criteria should benefit community institutions. Therefore, the FDIC believes that the proposed amendments to guideline 28, as modified in response to comments, will provide institutions' boards of directors with appropriate guidance and sufficient flexibility for establishing their institutions' criteria for making "independent of management" determinations for audit committee members.

In light of the revisions to guideline 28 regarding the criteria for determining an audit committee member's independence, boards of directors and audit committee members of covered institutions are reminded that under part 363 the selection of a director to serve as an audit committee member is basically a three step process. The first step is to determine which of the composition requirements set forth in § 363.5(a)(1) and (2) are applicable to the institution's audit committee. The second step is to determine if each director who is to serve on the audit committee is an "outside director" as defined in § 363.5(a)(3). The third step is to determine if each "outside director" is independent of management in accordance with the provisions of guideline 28.

*3. Audit Committee Duties*

According to section 36(g)(1)(B) of the FDI Act and § 363.5(a), an audit committee's duties include reviewing the basis for the Part 363 Annual Report with both management and the independent public accountant. Guideline 31 further provides that the audit committee's duties should be appropriate to the size of the institution and the complexity of its operations and it identifies additional duties that could be appropriate for the audit committee. These additional duties include discussing with management the selection and termination of the institution's independent public accountant. In addition, guideline 26 provides that, before engaging an independent public accountant, an institution should review and satisfy itself that the accountant is in compliance with the required qualifications set forth in guidelines 13 through 15, including the accountant's independence and receipt of a peer review.

Under section 301 of SOX, the audit committee of each public company listed on a national securities exchange or association must be responsible for the appointment, compensation, and oversight of the accounting firm engaged to prepare or issue an audit report or perform related work. As the SEC noted when it adopted its final rule implementing section 301, "the auditing process may be compromised when a company's outside auditors view their responsibility as serving the company's management rather than its full board of directors or audit committee. This may occur if the auditor views management as the employer with hiring, firing and compensating powers. Under these conditions, the auditor may not have the appropriate incentive to raise concerns and conduct an objective review. … One way to help promote auditor independence, then, is for the auditor to be hired, evaluated and, if necessary, terminated by the audit committee." Because the intent and purpose of section 36 of the FDI Act is the early identification of needed improvements in financial management, it is critical for the accountants that perform audit and attestation services for insured depository institutions subject to section 36 to have an appropriate incentive to raise concerns and conduct an objective review. In this regard, the FDIC believes it is a sound corporate governance practice for an institution's audit committee, rather than its management, to be responsible for the appointment, compensation, and oversight of the accountant, regardless of whether the institution is a public company.

Therefore, the FDIC proposed to amend § 363.5(a), *Composition and duties*, and guideline 31, *Duties*, to specify that, in addition to reviewing with management and the independent public accountant the basis for the reports issued under part 363, the duties of the audit committee include the appointment, compensation, and oversight of the independent public accountant who performs services required under part 363. In order to discharge these duties with respect to the independent public accountant, the audit committee should also review and satisfy itself as to the independent public accountant's compliance with the independence, peer review, and other qualifications under part 363. Additionally, the audit committee should be familiar with and ensure management's compliance with the requirement to file notices concerning the engagement, resignation, or dismissal of an independent public accountant. The FDIC proposed to include these duties in guideline 31.

Three commenters expressed support for the proposed amendments regarding the duties of the audit committee and stated that it represents a best practice regardless of an entity's asset size. However, one commenter, who was not supportive of the proposed amendments, recommended that the proposal be revised to remove the mandate for the audit committee to appoint and oversee the independent accountants in cases where the bank is privately-owned, more than 80 percent of the voting shares are owned by a sole owner or the principal owner's immediate family, the shareholders authorize procedures to be followed with respect to the appointment and oversight of the independent accountants, and the bank has a Uniform Financial Institutions Rating of 1 or 2. This commenter also stated that while appointing the independent accountant is expected to be normal for an audit committee of a publicly-owned company, the value for a privately-owned company is less clear. Additionally, this commenter stated that banks that are wholly owned by a single or a few shareholders, who are all immediate family members, do not need a separate board committee to do what they can do directly and that the mandate for a separate audit committee in these cases adds nothing to safety and soundness but adds additional bureaucracy and cost to the bank.

Although the FDIC has considered these comments, this commenter's concerns, in essence, relate to the requirement for covered institutions, particularly for those that are privately-owned, to establish independent audit committees. In response, the FDIC notes that section 36(g) of the FDI Act requires each institution to which section 36 applies to have an independent audit committee made up of outside directors who are independent of management. Consequently, the FDIC lacks the rulemaking authority to permit a covered institution not to have an independent audit committee or to permit a covered institution's entire board of directors to act as an audit committee based on the nature of the institution's ownership. In this regard, in enacting section 36, Congress recognized the significant public interest in sound financial management and controls at covered institutions, including the important role of an independent audit committee, regardless of their ownership structure. Therefore, the FDIC has decided to adopt the proposed changes pertaining to audit committee duties without revision.

*4. Independent Public Accountant Engagement Letters*

In response to an observed increase in the types and frequency of provisions in financial institutions' external audit engagement letters that limit the auditors' liability, the federal banking agencies issued an *Interagency Advisory on the Unsafe and Unsound Use of Limitation of Liability Provisions in External Audit Engagement Letters* (Interagency Advisory) in February 2006.[12] When they issued the Interagency Advisory, the agencies stated their belief that when institutions agree to limit their external auditors' liability in provisions in engagement letters, such provisions may weaken the external auditors' objectivity, impartiality, and performance, which may reduce the reliability of audits and thereby raise safety and soundness concerns. The reliability of audits is central to achieving the intent and purpose of section 36 of the FDI Act. Therefore, the FDIC proposed to add § 363.5(c), *Independent public accountant engagement letters*, and amend guideline 31, *Duties*, to incorporate the principal provisions of the Interagency Advisory.

As proposed, § 363.5(c) and guideline 31 would require the audit committee to ensure that audit engagement letters and any related agreements with the independent public accountant for services to be performed under part 363 do not contain any limitation of liability provisions that: (1) indemnify the independent public accountant against claims made by third parties; (2) hold harmless or release the independent public accountant from liability for claims or potential claims that might be asserted by the client insured depository institution, other than claims for punitive damages; or (3) limit the remedies available to the client insured depository institution. Consistent with the Interagency Advisory, the proposed amendment would not preclude the use of alternative dispute resolution agreements and jury trial waivers. Four commenters expressed support for these proposed amendments to part 363. One of these commenters viewed this audit committee duty as a best practice. The FDIC is adopting these amendments as proposed.

*5. Transition Period for Forming and Restructuring Audit Committees*

When an insured depository institution first exceeds the $500 million total assets threshold and becomes subject to part 363, particularly an institution with few shareholders, the FDIC has observed that, in some cases, such an institution encounters difficulty in satisfying the requirements governing the composition of the independent audit committee. If the board of directors lacks a sufficient number of outside directors who are independent of management to serve on the audit committee, the board members must identify and attract qualified individuals in their community who would be willing to become directors and audit committee members and who would be "independent of management." The lack of guidance in part 363 on the amount of time in which an institution must bring its audit committee into compliance with the requirements

[12] See 71 FR 6847, February 9, 2006, and FDIC Financial Institution Letter (FIL) 13-2006, issued on the

governing its composition when an institution first becomes subject to part 363 further complicates this process. This lack of guidance on the time frame for attaining compliance also affects the other two asset-size thresholds applicable to audit committee composition.

To provide both clarity and regulatory relief, the FDIC proposed to replace outdated guideline 35, which dealt with compliance with the audit committee requirements of part 363 when the regulation took effect in 1993, with a revised guideline 35, "*Transition Period for Forming and Restructuring Audit Committees.*" As proposed, guideline 35 would provide a one-year transition period for forming or restructuring the audit committee when an institution first becomes subject to part 363, when an institution's assets first reach the $1 billion asset-size threshold, and when an institution's assets first reach the $3 billion asset-size threshold. The proposed revised guideline would state that, when an institution first crosses one of these three thresholds based on its total assets at the beginning of its fiscal year, no regulatory action would be taken if the institution forms or restructures its audit committee to comply with the applicable requirements governing the composition of the committee by the end of that fiscal year, provided the institution complied with any applicable audit committee requirements for its preceding fiscal year. The FDIC has also revised guideline 35 to clarify that, when an institution first becomes subject to part 363, this one-year transition period extends to the requirement for an institution's board of directors to develop a set of written criteria for determining whether a director who is to serve on the audit committee is an outside

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same date.

director and is independent of management. Two commenters expressed support for the proposed revisions to guideline 35, which the FDIC is adopting as proposed.

**F. Other Changes to Part 363**

The FDIC also proposed to make other changes to part 363 to improve its clarity, readability, and consistency of language, and to correct or eliminate outdated terms, references, and provisions in the regulation and Appendix A. No comments on the proposal specifically addressed these other changes, which the FDIC is adopting as proposed.

**G. Proposed Amendment to Part 308, Subpart U**

In August 2003, pursuant to section 36(g)(4) of the FDI Act, the FDIC and the other federal banking agencies jointly issued final rules governing their authority to take disciplinary actions against independent public accountants and accounting firms that perform audit and attestation services required by section 36.[13] Under the final rules, certain violations of law, negligent conduct, reckless violation of professional standards, or lack of qualifications to perform auditing services may be considered good cause to remove, suspend, or bar an accountant or firm from providing audit and attestation services for institutions subject to section 36. The rules also prohibit an accountant or accounting firm from performing these services if the accountant or firm has been removed, suspended, or debarred by one of the agencies, or if the SEC or PCAOB takes certain disciplinary actions against the accountant or firm. Additionally, the final rules require an accountant or an accounting firm to provide the agencies with written notification of the accountant's or firm's removal, suspension, or debarment. Part 308, subpart U, of the FDIC's regulations implements the requirements of section 36(g)(4) of the FDI Act for institutions that are supervised by the FDIC. The FDIC proposed to amend § 308.604(c) to identify the FDIC location where an accountant or accounting firm should file required notices of orders and actions regarding removal, suspension, or debarment. The FDIC received no comments on this proposed amendment, which it is adopting as proposed.

## IV. Final Rule

The FDIC has considered the comments received on its proposed amendments to part 363 and is adopting the amendments with the modifications and revisions that are more fully discussed in section III of this notice. The following is a summary of the most significant changes made to the proposal and incorporated into the final rule in response to the comments received:

- To reduce regulatory burden, the proposed requirement to file audit engagement letters within 15 days of acceptance by a covered institution was deleted.
- Guidance was added to the proposed requirement to disclose noncompliance with the designated safety and soundness laws and regulations -- insider loans and dividend restrictions -- to explain the extent of the required disclosure and to clarify that the

[13] See 68 FR 48256, April 13, 2003, and the FDIC's Financial Institution Letter (FIL) FIL-66-2003, dated August 18, 2003.

disclosure applies only to noncompliance with these two designated categories of laws and regulations and not every safety and soundness law and regulation.

- To provide holding company subsidiary institutions that would not meet the proposed 75 percent of consolidated total assets threshold that permits, but does not require, compliance with part 363 at the holding company level sufficient time to comply at the institution level, the effective date of this threshold was delayed until fiscal years ending on or after June 15, 2010. Until then, institutions may continue to choose to satisfy the requirements of part 363 at a holding company level (to the extent currently permitted by part 363) whether or not the consolidated total assets of the insured depository institution subsidiaries of the holding company comprise 75 percent or more of the holding company's consolidated total assets at the beginning of its fiscal year.
- The proposed requirements regarding the disclosure of material weaknesses in internal control over financial reporting by management and the independent public accountant were clarified and revised for consistency with the applicable auditing standards. The final rule provides that management and the accountant must disclose those material weaknesses in internal control over financial reporting that each has identified that have not been corrected prior to the institution's fiscal year-end.
- The proposed requirements regarding the auditor's communications with audit committees were clarified and revised to explain that auditors must satisfy the communication requirements set forth in the professional standards and those set forth in part 363.

- The proposed requirement that auditors comply with the independence rules of the AICPA, the SEC, and the PCAOB was clarified to require compliance with the more restrictive requirement when a provision within one of the applicable independence standards differs from a provision addressing the same subject matter in one of the other independence standards.
- The proposal was revised to require only the public portions of PCAOB inspection reports to be filed with the FDIC.
- The provision of part 363 stating that an outside director who owns 10 percent or more of an institution's stock is not independent of management was be revised to be consistent with the SEC's and the national securities exchanges' rules. Rather than being an automatic bar for considering an outside director to be independent of management, the rule was revised to require the institution's board of directors to document its determination as to whether an outside director's ownership of 10 percent or more of the institution's stock would interfere with the director's independent judgment in carrying out the responsibilities of an audit committee member.
- The proposed maximum level of compensation, other than director and committee fees, that an audit committee member may receive and be considered independent of management was increased from $60,000 to $100,000.
- Except for the Part 363 Annual Report and the independent public accountants' peer review reports and inspection reports, which the FDI Act requires to be made publicly available, part 363 was revised to exempt all other reports and notifications filed under part 363 from public disclosure by the FDIC.

## V. Effective and Compliance Dates

Except as noted below, the final rule is effective [INSERT DATE 30 DAYS FROM DATE OF PUBLICATION IN THE FEDERAL REGISTER]. Part 363 Annual Reports with a filing deadline on or after the effective date of these amendments should be prepared in accordance with the final rule.

To provide the boards of directors of institutions currently subject to part 363 sufficient time to comply with the new provision of guideline 27 regarding the development of an approved set of written criteria for determining whether a director who is to serve on the audit committee is an outside director and is independent of management, the FDIC has determined that it is appropriate to set a delayed compliance date of December 31, 2009, for developing and adopting these written criteria. However, this delayed compliance date does not apply to the other provisions of guideline 27 regarding the composition of the audit committee, which have not been substantively changed. More specifically, at least annually, the board of each institution should determine whether each existing or potential audit committee member is an outside director and, depending on an institution's size, whether the requisite number of existing and potential audit committee members are "independent of management" of the institution. Also, the minutes of the board of directors should contain the results of and the basis for its determinations with respect to each existing and potential audit committee member.

Also, to provide institutions that currently comply with part 363 at the holding level but would not meet the 75-percent-of-consolidated-total-assets threshold for eligibility to comply at the holding company level set forth in the final rule (§ 363.1(b)(1)(ii)) sufficient time to comply with this new requirement, the FDIC has determined that it is appropriate for the effective date of this provision of the final rule to be delayed until fiscal years ending on or after June 15, 2010. In this regard, § 363.1(b)(1) of the final rule not only specifically provides for this delayed effective date but it also states that, for fiscal years ending on or before June 14, 2010, a covered institution that is a subsidiary of a holding company may continue to satisfy the audited financial statements requirement of part 363 at a holding company level whether or not the covered institution's total assets (or the consolidated total assets of all of its parent holding company's insured depository institution subsidiaries) comprise 75 percent or more of the holding company's consolidated total assets at the beginning of the fiscal year.

**Regulatory Flexibility Act Analysis**

The Regulatory Flexibility Act (RFA) requires an agency that is issuing a final rule to provide a final regulatory flexibility analysis or to certify that the rule will not have a significant economic impact on a substantial number of small entities. See 5 U.S.C. 603 (a) and 5 U.S.C. 603 (b). Under regulations issued by the Small Business Administration (see 13 CFR 121.201), a small entity includes a bank holding company, commercial bank, or savings association with assets of $175 million or less (collectively, small banking organizations). This final rule would modify the audit and reporting requirements applicable to insured depository institutions with total assets of $500 million or more. The FDIC believes that this final rule will not have a significant economic impact on a substantial number of small entities because the final rule expressly exempts insured depository institutions with total assets of less than $500 million. In addition, the FDIC did not receive any comments that the proposal would have a direct significant impact on small banking organizations. Accordingly, the FDIC certifies that this rule will not have a significant economic impact on a substantial number of small entities.

**Paperwork Reduction Act**

This final rule contains modifications to a collection of information that has been reviewed and approved by the Office of Management and Budget (OMB) under control number 3064-0113, pursuant to the Paperwork Reduction Act (44 U.S.C. 3501 et seq). The estimated annual burden for the revisions in this final rule is consistent with the burden estimate for those revisions in the proposed rule, taking into account a reduction in the number of respondents, and approved by OMB. The principal revisions that bear on the collection of information under part 363 are the extension of the filing deadline for the Part 363 Annual Report from 90 to 120 days after the end of the fiscal year for an institution that is not a public company or a subsidiary of a public company, the replacement of 30-day extension requests (when an institution is confronted with extraordinary circumstances beyond its reasonable control) with late filing notices (regardless of the reason), the modification of the criteria governing the acceptability of reports at the holding company level rather than at the institution level, the expanded guidance on the content of the management report and the independent public accountant's internal control attestation report, the board of directors' use of an approved set of written criteria for determining whether an audit committee member is an outside director and is "independent of management," and the new guidelines for institutions merged out of existence and for internal control reports for acquired businesses. It is anticipated that the overall effect of these changes will be a small burden increase for affected insured institutions.

The estimated reporting burden for the collection of information under part 363 is 83,324 hours per year.

*Number of Respondents*: 5,205

*Total Time per Response:* 5.16 hrs

*Total Annual Responses*: 16,163

*Total Annual Burden Hours*: 83,324

**Small Business Regulatory Enforcement Fairness Act [**PLACE HOLDER]

The Small Business Regulatory Enforcement Fairness Act of 1996 (SBREFA) (Title II, Pub. L., 104-121) provides generally for agencies to report rules to Congress and the General Accountability Office (GAO) for review. The reporting requirement is triggered when a Federal agency issues a final rule. The FDIC will file the appropriate reports with

Congress and the GAO as required by SBREFA. The Office of Management and Budget has determined that the rule does not constitute a "major rule" as defined by SBREFA.

**List of Subjects**

**12 CFR Part 308**

Administrative practice and procedure, Bank deposit insurance, Banks, banking, Claims, Crime, Equal access to justice, Investigations, Lawyers, Penalties, State nonmember banks.

**12 CFR Part 363**

Accounting, Administrative practice and procedure, Banks, banking, Reporting and record keeping requirements.

For the reasons set forth in the preamble, the Board of Directors of the FDIC amends title 12, chapter III, of the Code of Federal Regulations as follows:

**PART 308 – RULES OF PRACTICE AND PROCEDURE**

**Subpart U – Removal, Suspension, and Debarment of Accountants From Performing Audit Services**

1. The authority citation for part 308 continues to read as follows:

**Authority**: 5 U.S.C. 504, 554-557; 12 U.S.C. 93(b), 164, 505, 1815(e), 1817, 1818, 1820, 1828, 1829, 1829b, 1831i, 1831m(g)(4), 1831o, 1831p-1, 1832(c), 1884(b), 1972, 3102, 3108(a), 3349, 3909, 4717; 15 U.S.C. 78(h) and (i), 78o-4(c), 78o-

5, 78q-1, 78s, 78u, 78u-2, 78u-3 and 78w, 6801(b), 6805(b)(1); 28 U.S.C. 2461 note; 31 U.S.C. 330, 5321; 42 U.S.C. 4012a; Sec. 3100(s), Pub. L. 104-134, 110 Stat. 1321-358.

2. Revise § 308.604(c) to read as follows:

**§ 308.604 Notice of removal, suspension, or debarment**.

* * * * *

(c) *Timing and place of notice*. Written notice required by this paragraph shall be given no later than 15 calendar days following the effective date of an order or action, or 15 calendar days before an accountant or accounting firm accepts an engagement to provide audit services, whichever date is earlier. The written notice must be filed by the independent public accountant or accounting firm with the FDIC, Accounting and Securities Disclosure Section, 550 17th Street, NW., Washington, D.C. 20429.

3. Revise Part 363 to read as follows:

**PART 363 – ANNUAL INDEPENDENT AUDITS AND REPORTING REQUIREMENTS**

Sec.

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

### § 363.0 OMB control number.

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

### § 363.1 Scope and definitions.

(a) *Applicability.* This part applies to any insured depository institution with respect to any fiscal year in which its consolidated total assets as of the beginning of such fiscal year are $500 million or more. The requirements specified in this part are in addition to any other statutory and regulatory requirements otherwise applicable to an insured depository institution.

(b) *Compliance by subsidiaries of holding companies.* (1) For an insured depository institution that is a subsidiary of a holding company, the audited financial statements requirement of § 363.2(a) may be satisfied:

(i) For fiscal years ending on or before June 14, 2010, by audited consolidated financial statements of the top-tier or any mid-tier holding company.

(ii) For fiscal years ending on or after June 15, 2010, by audited consolidated financial statements of the top-tier or any mid-tier holding company provided that the consolidated total assets of the insured depository institution (or the consolidated total assets of all of the holding company's insured depository institution subsidiaries, regardless of size, if the holding company owns or controls more than one insured depository institution) comprise 75 percent or more of the consolidated total assets of this top-tier or mid-tier holding company as of the beginning of its fiscal year.

(2) The other requirements of this part for an insured depository institution that is a subsidiary of a holding company may be satisfied by the top-tier or any mid-tier holding company if the insured depository institution meets the criterion specified in § 363.1(b)(1) and if:

(i) The services and functions comparable to those required of the insured depository institution by this part are provided at this top-tier or mid-tier holding company level; and

(ii) The insured depository institution has as of the beginning of its fiscal year:

(A) Total assets of less than $5 billion; or

(B) Total assets of $5 billion or more and a composite CAMELS rating of 1 or 2.

(3) The appropriate federal banking agency may revoke the exception in paragraph (b)(2) of this section for any institution with total assets in excess of $9 billion for any period of time during which the appropriate federal banking agency determines that the institution's exemption would create a significant risk to the Deposit Insurance Fund.

(c) *Financial reporting*. For purposes of the management report requirement of § 363.2(b) and the internal control reporting requirement of § 363.3(b), "financial reporting," at a minimum, includes both financial statements prepared in accordance with generally accepted accounting principles for the insured depository institution or its holding company and financial statements prepared for regulatory reporting purposes. For recognition and measurement purposes, financial statements prepared for regulatory reporting purposes shall conform to generally accepted accounting principles and section 37 of the Federal Deposit Insurance Act.

(d) *Definitions.* For purposes of this part, the following definitions apply:

(1) *AICPA* means the American Institute of Certified Public Accountants.

(2) *GAAP* means generally accepted accounting principles.

(3) *PCAOB* means the Public Company Accounting Oversight Board.

(4) *Public company* means an insured depository institution or other company that has a class of securities registered with the U.S. Securities and Exchange Commission or the appropriate federal banking agency under Section 12 of the Securities Exchange Act of 1934 and *nonpublic company* means an insured depository institution or other company that does not meet the definition of a *public company*.

(5) *SEC* means the U.S. Securities and Exchange Commission.

(6) *SOX* means the Sarbanes-Oxley Act of 2002.

**§ 363.2 Annual reporting requirements.**

(a) *Audited financial statements.* Each insured depository institution shall prepare annual financial statements in accordance with GAAP, which shall be audited by an independent public accountant. The annual financial statements must reflect all material correcting adjustments necessary to conform with GAAP that were identified by the 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 that must contain the following:

(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 that are designated by the FDIC and the appropriate federal banking agency;

(2) An assessment by management of the insured depository institution's compliance with such laws and regulations during such fiscal year. The assessment must state management's conclusion as to whether the insured depository institution has complied with the designated safety and soundness laws and regulations during the fiscal year and disclose any noncompliance with these laws and regulations; and

(3) For an insured depository institution with consolidated total assets of $1 billion or more as of the beginning of such fiscal year, an assessment by management of the effectiveness of such internal control structure and procedures as of the end of such fiscal year that must include the following:

(i) A statement identifying the internal control framework[14] used by management to evaluate the effectiveness of the insured depository institution's internal control over financial reporting;

[14] For example, in the United States, the Committee of Sponsoring Organizations (COSO) of the Treadway Commission has published *Internal Control – Integrated Framework*, including an addendum on safeguarding assets. Known as the COSO report, this publication provides a suitable and available framework for purposes of management's assessment.

(ii) A statement that the assessment included controls over the preparation of regulatory financial statements in accordance with regulatory reporting instructions including identification of such regulatory reporting instructions; and

(iii) A statement expressing management's conclusion as to whether the insured depository institution's internal control over financial reporting is effective as of the end of its fiscal year. Management must disclose all material weaknesses in internal control over financial reporting, if any, that it has identified that have not been remediated prior to the insured depository institution's fiscal year-end. Management is precluded from concluding that the institution's internal control over financial reporting is effective if there are one or more material weaknesses.

(c) *Management report signatures*. Subject to the criteria specified in § 363.1(b):

(1) If the audited financial statements requirement specified in § 363.2(a) is satisfied at the insured depository institution level and the management report requirement specified in § 363.2(b) is satisfied in its entirety at the insured depository institution level, the management report must be signed by the chief executive officer and the chief accounting officer or chief financial officer of the insured depository institution;

(2) If the audited financial statements requirement specified in § 363.2(a) is satisfied at the holding company level and the management report requirement specified in § 363.2(b) is satisfied in its entirety at the holding company level, the management report must be signed by the chief executive officer and the chief accounting officer or chief financial officer of the holding company; and

(3) If the audited financial statements requirement specified in § 363.2(a) is satisfied at the holding company level and (i) the management report requirement specified in

§ 363.2(b) is satisfied in its entirety at the insured depository institution level or (ii) one or more of the components of the management report specified in § 363.2(b) is satisfied at the holding company level and the remaining components of the management report are satisfied at the insured depository institution level, the management report must be signed by the chief executive officers and the chief accounting officers or chief financial officers of both the holding company and the insured depository institution and the management report must clearly indicate the level (institution or holding company) at which each of its components is being satisfied.

**§ 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 or the PCAOB's auditing standards, if applicable, 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 GAAP.

(b) *Internal control over financial reporting.* For each insured depository institution with total assets of $1 billion or more at the beginning of the institution's fiscal year, the independent public accountant who audits the institution's financial statements shall examine, attest to, and report separately on the assertion of management concerning the effectiveness of the institution's internal control structure and procedures for financial reporting. The attestation and report shall be made in accordance with generally accepted standards for attestation engagements or the PCAOB's auditing standards, if applicable. The accountant's report must not be dated prior to the date of the management report and management's assessment of the effectiveness of internal control over financial reporting. Notwithstanding the requirements set forth in applicable professional standards, the accountant's report must include the following:

(1) A statement identifying the internal control framework used by the independent public accountant, which must be the same as the internal control framework used by management, to evaluate the effectiveness of the insured depository institution's internal control over financial reporting;

(2) A statement that the independent public accountant's evaluation included controls over the preparation of regulatory financial statements in accordance with regulatory reporting instructions including identification of such regulatory reporting instructions; and

(3) A statement expressing the independent public accountant's conclusion as to whether the insured depository institution's internal control over financial reporting is effective as of the end of its fiscal year. The report must disclose all material weaknesses in internal control over financial reporting that the independent public accountant has identified that have not been remediated prior to the insured depository institution's fiscal year-end. The independent public accountant is precluded from concluding that the insured depository institution's internal control over financial reporting is effective if there are one or more material weaknesses.

(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, the appropriate federal banking agency, and any appropriate state bank supervisor 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. The written notice shall be filed at the place identified in § 363.4(f).

(d) *Communications with audit committee.* In addition to the requirements for communications with audit committees set forth in applicable professional standards, the independent public accountant must report the following on a timely basis to the audit committee:

(1) all critical accounting policies and practices to be used by the insured depository institution,

(2) all alternative accounting treatments within GAAP for policies and practices related to material items that the independent public accountant has discussed with management, including the ramifications of the use of such alternative disclosures and treatments, and the treatment preferred by the independent public accountant, and

(3) other written communications the independent public accountant has provided to management, such as a management letter or schedule of unadjusted differences.

(e) *Retention of working papers.* The independent public accountant must retain the working papers related to the audit of the insured depository institution's financial statements and, if applicable, the evaluation of the institution's internal control over financial reporting for seven years from the report release date, unless a longer period of time is required by law.

(f) *Independence.* The independent public accountant must comply with the independence standards and interpretations of the AICPA, the SEC, and the PCAOB. To the extent that any of the rules within any one of these independence standards (AICPA, SEC, and PCAOB) is more or less restrictive than the corresponding rule in the other independence standards, the independent public accountant must comply with the more restrictive rule.

(g) *Peer reviews and inspection reports.* (1) Prior to commencing any services for an insured depository institution under this part, the independent public accountant must have received a peer review, or be enrolled in a peer review program, that meets acceptable guidelines. Acceptable peer reviews include peer reviews performed in accordance with the AICPA's Peer Review Standards and inspections conducted by the PCAOB.

(2) Within 15 days of receiving notification that a peer review has been accepted or a PCAOB inspection report has been issued, or before commencing any audit under this part, whichever is earlier, the independent public accountant must file two copies of the most recent peer review report and the public portion of the most recent PCAOB inspection report, if any, accompanied by any letters of comments, response, and acceptance, with the FDIC, Accounting and Securities Disclosure Section, 550 17th Street, NW., Washington, DC 20429, if the report has not already been filed. The peer review reports and the public portions of the PCAOB inspection reports will be made available for public inspection by the FDIC.

(3) Within 15 days of the PCAOB making public a previously nonpublic portion of an inspection report, the independent public accountant must file two copies of the previously nonpublic portion of the inspection report with the FDIC, Accounting and Securities Disclosure Section, 550 17th Street, NW., Washington, DC 20429. Such

previously nonpublic portion of the PCAOB inspection report will be made available for public inspection by the FDIC.

**§ 363.4 Filing and notice requirements.**

(a) *Part 363 Annual Report.* (1) 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 its Part 363 Annual Report. A Part 363 Annual Report must contain audited comparative annual financial statements, the independent public accountant's report thereon, a management report, and, if applicable, the independent public accountant's attestation report on management's assessment concerning the institution's internal control structure and procedures for financial reporting as required by §§ 363.2(a), 363.3(a), 363.2(b), and 363.3(b), respectively.

(2) Subject to the criteria specified in § 363.1(b), each insured depository institution with consolidated total assets of less than $1 billion as of the beginning of its fiscal year that is required to file, or whose parent holding company is required to file, management's assessment of the effectiveness of internal control over financial reporting with the SEC or the appropriate federal banking agency in accordance with section 404 of SOX must submit a copy of such assessment to the FDIC, the appropriate federal banking agency, and any appropriate state bank supervisor with its Part 363 Annual Report as additional information. This assessment will not be considered part of the institution's Part 363 Annual Report.

(3) (i) Each insured depository institution that is neither a public company nor a subsidiary of a public company that meets the criterion specified in § 363.1(b)(1) shall file its Part 363 Annual Report within 120 days after the end of its fiscal year.

(ii) Each insured depository institution that is a public company or a subsidiary of public company that meets the criterion specified in § 363.1(b)(1) shall file its Part 363 Annual Report within 90 days after the end of its fiscal year.

(b) *Public availability.* Except for the annual report in paragraph (a)(1) of this section and the peer reviews and inspection reports in § 363.3(g), which shall be available for public inspection, the FDIC has determined that all other reports and notifications required by this part are exempt from public disclosure by the FDIC.

(c) *Independent public accountant's letters and reports.* Except for the independent public accountant's reports that are included in its Part 363 Annual Report, 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 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. Such reports include, but are not limited to:

(1) any written communication regarding matters that are required to be communicated to the audit committee (for example, critical accounting policies, alternative accounting treatments discussed with management, and any schedule of unadjusted differences),

(2) any written communication of significant deficiencies and material weaknesses in internal control required by the AICPA's or the PCAOB's auditing standards;

(3) for institutions with total assets of less than $1 billion as of the beginning of their fiscal year that are public companies or subsidiaries of public companies that meet the criterion specified in § 363.1(b)(1), any independent public accountant's report on the audit of internal control over financial reporting required by section 404 of SOX and the PCAOB's auditing standards; and

(4) for all institutions that are public companies or subsidiaries of public companies that meet the criterion specified in § 363.1(b)(1), any independent public accountant's written communication of all deficiencies in internal control over financial reporting that are of a lesser magnitude than significant deficiencies required by the PCAOB's auditing standards.

(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 resignation or dismissal in reasonable detail.

(e) *Notification of late filing*. No extensions of time for filing reports required by § 363.4 shall be granted. An insured depository institution that is unable to timely file all or any portion of its Part 363 Annual Report or any other report or notice required by § 363.4 shall submit a written notice of late filing to the FDIC, the appropriate federal banking agency, and any appropriate state bank supervisor. The notice shall disclose the institution's inability to timely file all or specified portions of its Part 363 Annual Report or any other report or notice and the reasons therefore in reasonable detail. The late filing notice shall also state the date by which the report or notice will be filed. The written notice shall be filed on or before the deadline for filing the Part 363 Annual Report or any other report or notice, as appropriate.

(f) *Place for filing.* The Part 363 Annual Report, any written notification of late filing, and any other report or notice required by § 363.4 should be filed as follows:

(1) FDIC: Appropriate FDIC Regional or Area Office (Division of Supervision and Consumer Protection), i.e., the FDIC regional or area office in the FDIC region or area that is responsible for monitoring the institution or, in the case of a subsidiary institution of a holding company, the consolidated company. A filing made on behalf of several covered institutions owned by the same parent holding company should be accompanied by a transmittal letter identifying all of the institutions covered.

(2) Office of the Comptroller of the Currency (OCC): Appropriate OCC Supervisory Office.

(3) Federal Reserve: Appropriate Federal Reserve Bank.

(4) Office of Thrift Supervision (OTS): Appropriate OTS District Office.

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

**§ 363.5 Audit committees.**

(a) *Composition and duties.* Each insured depository institution shall establish an audit committee of its board of directors, the composition of which complies with paragraphs (a)(1), (2), and (3) of this section. The duties of the audit committee shall include the appointment, compensation, and oversight of the independent public accountant who performs services required under this part, and reviewing with management and the independent public accountant the basis for the reports issued under this part.

(1) Each insured depository institution with total assets of $1 billion or more as of the beginning of its fiscal year 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.

(2) Each insured depository institution with total assets of $500 million or more but less than $1 billion as of the beginning of its fiscal year shall establish an audit committee of its board of directors, the members of which shall be outside directors, the majority of whom shall be independent of management of the institution. The appropriate Federal banking agency may, by order or regulation, permit the audit committee of such an insured depository institution to be made up of less than a majority of outside directors who are independent of management, if the agency determines that the institution has encountered hardships in retaining and recruiting a sufficient number of competent outside directors to serve on the audit committee of the institution.

(3) An outside director is a director who is not, and within the preceding fiscal year has not been, an officer or employee of the institution or any affiliate of the institution.

(b) *Committees of large institutions.* The audit committee of any insured depository institution with total assets of more than $3 billion as of the beginning of its 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. If a large institution is a subsidiary of a holding company and relies on the audit committee of the holding company to comply with this rule, the holding company's audit committee shall not include any members who are large customers of the subsidiary institution.

(c) *Independent public accountant engagement letters*. (1) In performing its duties with respect to the appointment of the institution's independent public accountant, the audit committee shall ensure that engagement letters and any related agreements with the independent public accountant for services to be performed under this part do not contain any limitation of liability provisions that:

(i) Indemnify the independent public accountant against claims made by third parties;

(ii) Hold harmless or release the independent public accountant from liability for claims or potential claims that might be asserted by the client insured depository institution, other than claims for punitive damages; or

(iii) Limit the remedies available to the client insured depository institution.

(2) Alternative dispute resolution agreements and jury trial waiver provisions are not precluded from engagement letters provided that they do not incorporate any limitation of liability provisions set forth in paragraph (c)(1) of this section.

**Appendix A to Part 363 – Guidelines and Interpretations**

Table of Contents

4. Comparable Services and Functions

4A. Financial Reporting

*Annual Reporting Requirements (§ 363.2)*

5. Annual Financial Statements

5A. Institutions Merged out of Existence

6. Holding Company Statements

7. Insured Branches of Foreign Banks

7A. Compliance with Designated Laws and Regulations

8. Management Report

8A. Management's Reports on Internal Control over Financial Reporting under Part 363 and Section 404 of SOX

8B. Internal Control Reports and Part 363 Annual Reports for Acquired Businesses

8C. Management's Disclosure of Noncompliance with the Designated Laws and Regulations

9. Safeguarding of Assets

10. Standards for Internal Control

11. Service Organizations

12. Reserved

*Role of Independent Public Accountant (§ 363.3)*

13. General Qualifications

14. Reserved

15. Peer Review Guidelines

16. Reserved

17. Information to be Provided to the Independent Public Accountant

18. Attestation Report and Management Letters

18A. Internal Control Attestation Standards for Independent Auditors

19. Reviews with Audit Committee and Management

20. Notice of Termination

21. Reliance on Internal Auditors

*Filing and Notice Requirements (§ 363.4)*

22. Reserved

23. Notification of Late Filing

24. Public Availability

25. Reserved

26. Notices Concerning Accountants

*Audit Committees (§ 363.5)*

27. Composition

28. "Independent of Management" Considerations

29. Reserved

30. Holding Company Audit Committees

31. Duties

32. Banking or Related Financial Management Expertise

33. Large Customers

34. Access to Counsel

35. Transition Period for Forming and Restructuring Audit Committees

*Other*

36. Modifications of Guidelines

**Introduction**

Congress added section 36, “Early Identification of Needed Improvements in Financial Management” (section 36), to the Federal Deposit Insurance Act (FDI Act) in 1991.

The FDIC Board of Directors adopted 12 CFR part 363 of its rules and regulations (the Rule) to implement those provisions of section 36 that require rulemaking. The FDIC also approved these “Guidelines and Interpretations” (the Guidelines) and directed that they be published with the Rule to facilitate a better understanding of, and full compliance with, the provisions of section 36.

Although not contained in the Rule itself, 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.

Furthermore, upon adopting the Rule, the FDIC reiterated its belief 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 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 the Rule. It is recognized that reliance on the Guidelines may result in compliance with section 36 and the Rule which may vary from institution to institution. Terms which are not explained in the Guidelines have the meanings given them in the Rule, the FDI Act, or professional accounting and auditing literature.

**Scope of Rule and Definitions (§ 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 that are submitted by a holding company for any subsidiary institution should be accompanied by a cover letter identifying all subsidiary institutions subject to part 363 that are included in the holding company's submission. When submitting a Part 363 Annual Report, the cover letter should identify all subsidiary institutions subject to part 363 included in the consolidated financial statements and state whether the other annual report requirements (i.e., management's statement of responsibilities, management's assessment of compliance with designated safety and soundness laws and regulations, and, if applicable, management's assessment of the effectiveness of internal control over financial reporting and the independent public accountant's attestation report on management's internal control assessment) are being satisfied for these institutions at the holding company level or at the institution level. An institution filing holding company consolidated financial statements as permitted by § 363.1(b)(1) also may report on changes in its independent public accountant on a holding company basis. An institution that does not meet the criteria in § 363.1(b)(2) must satisfy the remaining provisions of this part on an individual institution basis and maintain its own audit committee. Subject to the criteria in §§ 363.1(b)(1) and (2), a multi-tiered holding company may satisfy all of the requirements of this part at the top-tier or any mid-tier holding company 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 management's assessment of compliance with the Designated Laws and Regulations defined in guideline 7A and, if applicable, management's assessment of the effectiveness of internal control over financial reporting based on information concerning the relevant activities and operations of those subsidiary institutions within the scope of the Rule.

4A. *Financial Statements Prepared for Regulatory Reporting Purposes*. (a) As set forth in § 363.3(c) of this part, "financial reporting," at a minimum, includes both financial statements prepared in accordance with generally accepted accounting principles for the insured depository institution or its holding company and financial statements prepared for regulatory reporting purposes. More specifically, financial statements prepared for regulatory reporting purposes include the schedules equivalent to the basic financial statements that are included in an insured depository institution's or its holding company's appropriate regulatory report (for example, Schedules RC, RI, and RI-A in the Consolidated Reports of Condition and Income (Call Report) for an insured bank; and Schedules SC and SO, and the Summary of Changes in Equity Capital section in Schedule SI in the Thrift Financial Report (TFR) for an insured thrift institution). For recognition and measurement purposes, financial statements prepared for regulatory reporting purposes shall conform to generally accepted accounting principles and section 37 of the Federal Deposit Insurance Act.

(b) Financial statements prepared for regulatory reporting purposes do not include regulatory reports prepared by a non-bank subsidiary of a holding company or an institution. For example, if a bank holding company or an insured depository institution owns an insurance subsidiary, financial statements prepared for regulatory reporting purposes would not include any regulatory reports that the insurance subsidiary is required to submit to its appropriate insurance regulatory agency.

**Annual Reporting Requirements (§ 363.2)**

5. *Annual Financial Statements.* Each institution (other than an insured branch of a foreign bank) should prepare comparative annual consolidated financial statements (balance sheets and statements of income, changes in equity capital, and cash flows, with accompanying footnote disclosures) in accordance with 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.

5A. *Institutions Merged Out of Existence.* An institution that is merged out of existence after the end of its fiscal year, but before the deadline for filing its Part 363 Annual Report (120 days after the end of its fiscal year for an institution that is neither a public company nor a subsidiary of a public company that meets the criterion specified in § 363.1(b)(1), and 90 days after the end of its fiscal year for an institution that is a public company or a subsidiary of public company that meets the criterion specified in

§ 363.1(b)(1)), is not required to file a Part 363 Annual Report for the last fiscal year of its existence.

6. *Holding Company Statements.* Subject to the criterion specified in § 363.1(b)(1), subsidiary institutions may file copies of their holding company's audited financial statements filed with the SEC or prepared for their FR Y-6 Annual Report under the Bank Holding Company Act of 1956 to satisfy the audited financial statements requirement of § 363.2(a).

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 each of its two most recent 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.

7A. *Compliance with Designated Laws and Regulations.* The designated laws and regulations are the federal laws and regulations concerning loans to insiders and the federal and, if applicable, state laws and regulations concerning dividend restrictions (the Designated Laws and Regulations). Table 1 to this Appendix A lists the designated federal laws and regulations pertaining to insider loans and dividend restrictions (but not the state laws and regulations pertaining to dividend restrictions) that are applicable to each type of institution.

8. *Management Report.* Management should perform its own investigation and review of compliance with the Designated Laws and Regulations and, if required, the effectiveness of internal control over financial reporting. Management 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 the appropriate federal banking agency. Management should provide in its assessment of the effectiveness of internal control over financial reporting, 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 officer or a chief accounting or financial officer.

8A. *Management's Reports on Internal Control over Financial Reporting under Part 363 and Section 404 of SOX*. An institution with $1 billion or more in total assets as of the beginning of its fiscal year that is subject to both part 363 and the SEC's rules implementing section 404 of SOX (as well as a public holding company permitted under the holding company exception in § 363.1(b)(2) to file an internal control report on behalf of one or more subsidiary institutions with $1 billion or more in total assets) can choose either of the following two options for filing management's report on internal control over financial reporting.

(i) Management can prepare two separate reports on the institution's or the holding company's internal control over financial reporting to satisfy the FDIC's part 363 requirements and the SEC's section 404 requirements; or

(ii) Management can prepare a single report on internal control over financial reporting provided that it satisfies all of the FDIC's part 363 requirements and all of the SEC's section 404 requirements.

8B. *Internal Control Reports and Part 363 Annual Reports for Acquired Businesses.* Generally, the FDIC expects management's and the related independent public accountant's report on an institution's internal control over financial reporting to include controls at an institution in its entirety, including all of its consolidated entities. However, it may not always be possible for management to conduct an assessment of the internal control over financial reporting of an acquired business in the period between the consummation date of the acquisition and the due date of management's internal control assessment.

(a) In such instances, the acquired business's internal control structure and procedures for financial reporting may be excluded from management's assessment report and the accountant's attestation report on internal control over financial reporting. However, the FDIC expects management's assessment report to identify the acquired business, state that the acquired business is excluded, and indicate the significance of this business to the institution's consolidated financial statements. Notwithstanding management's exclusion of the acquired business's internal control from its assessment, management should disclose any material change to the institution's internal control over financial reporting due to the acquisition of this business. Also, management may not omit the assessment of the acquired business's internal control from more than one annual part 363 assessment report on internal control over financial reporting. When the acquired business's internal control over financial reporting is excluded from management's assessment, the independent public accountant may likewise exclude this acquired business's internal control over financial reporting from the accountant's evaluation of internal control over financial reporting.

(b) If the acquired business is or has a consolidated subsidiary that is an insured depository institution subject to part 363 and the institution is not merged out of existence before the deadline for filing its Part 363 Annual Report (120 days after the end of its fiscal year for an institution that is neither a public company nor a subsidiary of a public company that meets the criterion specified in § 363.1(b)(1), and 90 days after the end of its fiscal year for an institution that is a public company or a subsidiary of public company that meets the criterion specified in § 363.1(b)(1)), the acquired institution must continue to comply with all of the applicable requirements of part 363, including filing its Part 363 Annual Report.

8C. *Management's Disclosure of Noncompliance with the Designated Laws and Regulations*. Management's disclosure of noncompliance, if any, with the Designated Laws and Regulations should separately indicate the number of instances or frequency of noncompliance with the federal laws and regulations pertaining to insider loans and the federal (and, if applicable, state) laws and regulations pertaining to dividend restrictions. The disclosure is not required to specifically identify by name the individuals (e.g., officers or directors) who were responsible for or were the subject of any such noncompliance. However, the disclosure should include appropriate qualitative and quantitative information to describe the nature, type, and severity of the noncompliance and the dollar amount of the insider loan(s) or dividend(s) involved. Similar instances of noncompliance may be aggregated as to number of instances and quantified as to the dollar amounts or the range of dollar amounts of insider loans and/or dividends for which noncompliance occurred. Management may also wish to describe any corrective actions taken in response to the instances of noncompliance as well any controls or procedures that are being developed or that have been developed and implemented to prevent or detect and correct future instances of noncompliance on a timely basis.

9. *Safeguarding of Assets. "Safeguarding of assets,"* as the term relates to internal control policies and procedures regarding financial reporting and which has precedent in accounting and auditing literature, should be encompassed in the management report and the independent public accountant's attestation discussed in guideline 18. 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. The FDIC expects such internal controls to be encompassed by the assertion in the management report, but the term "safeguarding of assets" need not be specifically stated. The FDIC does not require the accountant to attest to the adequacy of safeguards, but does require the accountant to determine whether safeguarding policies exist.[15]

10. *Standards for Internal Control*. The management of each insured depository institution with $1 billion or more in total assets as of the beginning of its fiscal year should base its assessment of the effectiveness of the institution's internal control over financial reporting on a suitable, recognized control framework established by a body of experts that followed due-process procedures, including the broad distribution of the

[15] It is management's responsibility to establish policies concerning underwriting and asset management and to make credit decisions. The auditor's role is to test compliance with management's policies relating to financial reporting.

framework for public comment. In addition to being available to users of management's reports, a framework is suitable only when it:

- Is free from bias;
- Permits reasonably consistent qualitative and quantitative measurements of an institution's internal control over financial reporting;
- Is sufficiently complete so that those relevant factors that would alter a conclusion about the effectiveness of an institution's internal control over financial reporting are not omitted; and
- Is relevant to an evaluation of internal control over financial reporting.

In the United States, *Internal Control – Integrated Framework,* including its addendum on safeguarding assets, which was published by the Committee of Sponsoring Organizations of the Treadway Commission, and is known as the COSO report, provides a suitable and recognized framework for purposes of management's assessment. Other suitable frameworks have been published in other countries or may be developed in the future. Such other suitable frameworks may be used by management and the institution's independent public accountant in assessments, attestations, and audits of internal control over financial reporting.

11. *Service Organizations.* Although service organizations should be considered in determining if internal control over financial reporting is effective, an institution's independent public accountant, its management, and its audit committee should exercise independent judgment concerning that determination. Onsite reviews of service organizations may not be necessary to prepare the report required by the Rule, and the FDIC does not intend that the Rule establish any such requirement.

12. [Reserved.]

**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 working papers, policies, and procedures relating to services performed under this part.

14. [Reserved.]

15. *Peer Review 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 (other than a PCAOB inspection) should be generally consistent with AICPA Peer Review Standards; and

(c) The review should include, if available, at least one audit on an insured depository institution or consolidated depository institution holding company.

16. [Reserved.]

17. *Information to be Provided to the 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 Report and Management Letters*. The independent public accountant should provide the institution with any management letter and, if applicable, an internal control attestation report (as required by section 36(c)(1)) at the conclusion of the audit. The independent public accountant's attestation report on internal control over financial reporting must specifically include a statement as to regulatory reporting. If a holding company subsidiary relies on its holding company's management report to satisfy the Part 363 Annual Report requirements, the accountant may attest to and report on the management's assertions in one report, without reporting separately on each subsidiary covered by the Rule. The FDIC has determined that management letters are exempt from public disclosure.

18A. *Internal Control Attestation Standards for Independent Auditors*. (a) § 363.3(b) provides that the independent public accountant's attestation and report on management's assertion concerning the effectiveness of an institution's internal control structure and procedures for financial reporting shall be made in accordance with generally accepted standards for attestation engagements or the PCAOB's auditing standards, if applicable. The standards that should be followed by the institution's independent public accountant concerning internal control over financial reporting for institutions with $1 billion or more in total assets can be summarized as follows:

(1)  For an insured institution that is neither a public company nor a subsidiary of a public company, its independent public accountant need only follow the AICPA's attestation standards.

(2)  For an insured institution that is a public company that is required to comply with the auditor attestation requirement of section 404 of SOX, its independent public accountant should follow the PCAOB's auditing standards.

(3)  For an insured institution that is a public company but is not required to comply with the auditor attestation requirement of section 404 of SOX, its independent public accountant is not required to follow the PCAOB's auditing standards.  In this case, the accountant need only follow the AICPA's attestation standards.

(4)  For an insured institution that is a subsidiary of a public company that is required to comply with the auditor attestation requirement of section 404 of SOX, but is not itself a public company, the institution and its independent public accountant have flexibility in complying with the internal control requirements of part 363.  If the conditions specified in § 363.1(b)(2) are met, management and the independent public accountant may choose to report on internal control over financial reporting at the consolidated holding company level.  In this situation, the independent public accountant's work would be performed for the public company in accordance with the PCAOB's auditing standards.  Alternatively, the institution may choose to comply with the internal control reporting requirements of part 363 at the institution level and its independent public accountant could follow the AICPA's attestation standards.

(b) If an independent public accountant need only follow the AICPA's attestation standards, the accountant and the insured institution may instead agree to have the internal control attestation performed under the PCAOB's auditing standards.

19. *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.

20. *Notice of Termination*. The notice of termination 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 for the accountant's termination. Subject to the criterion specified in § 363.1(b)(1) regarding compliance with the audited financial statements requirement at the holding company level, the independent public accountant for an insured depository institution that is a public company and files reports with its appropriate federal banking agency, or is a subsidiary of a public company that files reports with the SEC, may submit the letter it furnished to management to be filed with the institution's or the holding company's current report (*e.g.*, SEC Form 8-K) concerning a change in accountant to satisfy the notice requirements of § 363.3(c). Alternatively, if the independent public accountant confirms that management has filed a current report (*e.g.*, SEC Form 8-K) concerning a change in accountant that satisfies the notice requirements of § 363.4(d) and includes an independent public accountant's letter that satisfies the requirements of § 363.3(c), the independent public accountant may rely

on the current report (*e.g.*, SEC Form 8-K) filed with the FDIC by management concerning a change in accountant to satisfy the notice requirements of § 363.3(c).

21. *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)**

22. [Reserved.]

23. *Notification of Late Filing*. (a) An institution's submission of a written notice of late filing does not cure the requirement to timely file the Part 363 Annual Report or other reports or notices required by § 363.4. An institution's failure to timely file is considered an apparent violation of part 363.

(b) If the late filing notice submitted pursuant to § 363.4(e) relates only to a portion of a Part 363 Annual Report or any other report or notice, the insured depository institution should file the other components of the report or notice within the prescribed filing period together with a cover letter that indicates which components of its Part 363 Annual Report or other report or notice are omitted. An institution may combine the written late filing notice and the cover letter into a single notice that is submitted together with the other components of the report or notice that are being timely filed.

24. *Public Availability*. Each institution's Part 363 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 Part 363 Annual Report to any person who requests it. The Part 363 Annual Report should remain

available to the public until the Part 363 Annual Report for the next year is available. An institution may use its Part 363 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.

25. [Reserved.]

26. *Notices Concerning Accountants*. With respect to any selection, change, or termination of an independent public accountant, an institution's management and audit committee should be familiar with the notice requirements in § 363.4(d) and guideline 20, and management should send a copy of any notice required under § 363.4(d) to the independent public accountant when it is filed with the FDIC. An insured depository institution that is a public company and files reports required under the federal securities laws with its appropriate federal banking agency, or is a subsidiary of a public company that files such reports with the SEC, may use its current report (*e.g.*, SEC Form 8-K) concerning a change in accountant to satisfy the notice requirements of § 363.4(d) subject to the criterion of § 363.1(b)(1) regarding compliance with the audited financial statements requirement at the holding company level.

**Audit Committees (§ 363.5)**

27. *Composition.* The board of directors of each institution should determine whether each existing or potential audit committee member meets the requirements of section 36 and this part. To do so, the board of directors should maintain an approved set of written criteria for determining whether a director who is to serve on the audit committee is an outside director (as defined in § 363.5(a)(3)) and is independent of management. At least

annually, the board of each institution should determine whether each existing or potential audit committee member is an outside director. In addition, at least annually, the board of an institution with $1 billion or more in total assets as of the beginning of its fiscal year should determine whether all existing and potential audit committee members are "independent of management of the institution" and the board of an institution with total assets of $500 million or more but less than $1 billion as of the beginning of its fiscal year should determine whether the majority of all existing and potential audit committee members are "independent of management of the institution." The minutes of the board of directors should contain the results of and the basis for its determinations with respect to each existing and potential audit committee member. Because an insured branch of a foreign bank does not have a separate board of directors, the FDIC will not apply the audit committee requirements to such branch. However, any such branch is encouraged to make a reasonable good faith effort to see that similar duties are performed by persons whose experience is generally consistent with the Rule's requirements for an institution the size of the insured branch.

28. *"Independent of Management" Considerations.* It is not possible to anticipate, or explicitly provide for, all circumstances that might signal potential conflicts of interest in, or that might bear on, an outside director's relationship to an insured depository institution and whether the outside director should be deemed "independent of management." When assessing an outside director's relationship with an institution, the board of directors should consider the issue not merely from the standpoint of the director himself or herself, but also from the standpoint of persons or organizations with which the director has an affiliation. These relationships can include, but are not limited to,

commercial, banking, consulting, charitable, and family relationships. To assist boards of directors in fulfilling their responsibility to determine whether existing and potential members of the audit committee are "independent of management," paragraphs (a) through (d) of this guideline provide guidance for making this determination.

(a) If an outside director, either directly or indirectly, owns or controls, or has owned or controlled within the preceding fiscal year, 10 percent or more of any outstanding class of voting securities of the institution, the institution's board of directors should determine, and document its basis and rationale for such determination, whether such ownership of voting securities would interfere with the outside director's exercise of independent judgment in carrying out the responsibilities of an audit committee member, including the ability to evaluate objectively the propriety of management's accounting, internal control, and reporting policies and practices. Notwithstanding the criteria set forth in paragraphs (b), (c), and (d) of this guideline, if the board of directors determines that such ownership of voting securities would interfere with the outside director's exercise of independent judgment, the outside director will not be considered "independent of management."

(b) The following list sets forth additional criteria that, at a minimum, a board of directors should consider when determining whether an outside director is "independent of management." The board of directors may conclude that additional criteria are also relevant to this determination in light of the particular circumstances of its institution. Accordingly, an outside director will not be considered "independent of management" if:

(1) The director serves, or has served within the last three years, as a consultant, advisor, promoter, underwriter, legal counsel, or trustee of or to the institution or its affiliates.

(2) The director has been, within the last three years, an employee of the institution or any of its affiliates or an immediate family member is, or has been within the last three years, an executive officer of the institution or any of its affiliates.

(3) The director has participated in the preparation of the financial statements of the institution or any of its affiliates at any time during the last three years.

(4) The director has received, or has an immediate family member who has received, during any twelve-month period within the last three years, more than $100,000 in direct and indirect compensation from the institution, its subsidiaries, and its affiliates for consulting, advisory, or other services other than director and committee fees and pension or other forms of deferred compensation for prior service (provided such compensation is not contingent in any way on continued service). Direct compensation also would not include compensation received by the director for former service as an interim chairman or interim chief executive officer.

(5) The director or an immediate family member is a current partner of a firm that performs internal or external auditing services for the institution or any of its affiliates; the director is a current employee of such a firm; the director has an immediate family member who is a current employee of such a firm and who participates in the firm's audit, assurance, or tax compliance practice; or the director or an immediate family member was within the last three years (but no longer is) a partner or employee of such a firm and personally worked on the audit of the insured depository institution or any of its affiliates within that time.

(6) The director or an immediate family member is, or has been within the last three years, employed as an executive officer of another entity where any of the present

executive officers of the institution or any of its affiliates at the same time serves or served on that entity's compensation committee.

(7) The director is a current employee, or an immediate family member is a current executive officer, of an entity that has made payments to, or received payments from, the institution or any of its affiliates for property or services in an amount which, in any of the last three fiscal years, exceeds the greater of $200 thousand, or 5 percent of such entity's consolidated gross revenues. This would include payments made by the institution or any of its affiliates to not-for-profit entities where the director is an executive officer or where an immediate family member of the director is an executive officer.

(8) For purposes of paragraph (b) of this guideline:

(i) An "immediate family member" includes a person's spouse, parents, children, siblings, mothers and fathers-in-law, sons and daughters-in-law, brothers and sisters-in-law, and anyone (other than domestic employees) who shares such person's home.

(ii) The term affiliate of, or a person affiliated with, a specified person, means a person or entity that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, the person specified.

(iii) The term indirect compensation for consulting, advisory, or other services includes the acceptance of a fee for such services by a director's immediate family member or by an organization in which the director is a partner or principal that provides accounting, consulting, legal, investment banking, or financial advisory services to the institution, any of its subsidiaries, or any of its affiliates.

(iv) The terms direct and indirect compensation and payments do not include payments, such as dividends arising solely from investments in the institution's equity securities provided the same per share amounts are paid to all shareholders of that class; interest income from investments in the institution's deposit accounts and debt securities; loans from the institution that conform to all regulatory requirements applicable to such loans except that interest payments or other fees paid in association with such loans would be considered payments; and payments under non-discretionary charitable contribution matching programs.

(c) An insured depository institution that is a public company and a listed issuer (as defined in Rule 10A-3 of the Securities Exchange Act of 1934 (Exchange Act)), or is a subsidiary of a public company that meets the criterion specified in § 363.1(b)(1) and is a listed issuer, may choose to use the definition of audit committee member independence set forth in the listing standards applicable to the public institution or its public company parent for purposes of determining whether an outside director is "independent of management."

(d) All other insured depository institutions may choose to use the definition of audit committee member independence set forth in the listing standards of a national securities exchange that is registered with the SEC pursuant to section 6 of the Exchange Act or a national securities association that is registered with the SEC pursuant to section 15A(a) of the Exchange Act for purposes of determining whether an outside director is "independent of management."

29. [Reserved.]

30. *Holding Company Audit Committees.* (a) When an insured depository institution satisfies the requirements for the holding company exception specified in §§ 363.1(b)(1) and (2), the audit committee requirement of this part may be satisfied by the audit committee of the top-tier or any mid-tier holding company. Members of the audit committee of the holding company should meet all the membership requirements applicable to the largest subsidiary depository institution subject to part 363 and should perform all the duties of the audit committee of a subsidiary institution subject to part 363, even if the holding company directors are not directors of the institution.

(b) When an insured depository institution subsidiary with total assets of $1 billion or more as of the beginning of its fiscal year does not meet the requirements for the holding company exception specified in §§ 363.1(b)(1) and (2) or maintains its own separate audit committee to satisfy the requirements of this part, the members of the audit committee of the top-tier or any mid-tier holding company may serve on the audit committee of the subsidiary institution if they are otherwise independent of management of the subsidiary institution, and, if applicable, meet any other requirements for a large subsidiary institution covered by this part.

(c) When an insured depository institution with total assets of $500 million or more but less than $1 billion as of the beginning of its fiscal year does not meet the requirements for the holding company exception specified in §§ 363.1(b)(1) and (2) or maintains its own separate audit committee to satisfy the requirements of this part, the members of the audit committee of the top-tier or any mid-tier holding company may serve on the audit committee of the subsidiary institution provided a majority of the institution's audit committee members are independent of management of the subsidiary institution.

(d) Officers and employees of a top-tier or any mid-tier holding company may not serve on the audit committee of a subsidiary institution subject to part 363.

31. *Duties.* The audit committee should perform all duties determined by the institution's board of directors and it should maintain minutes and other relevant records of its meetings and decisions. The duties of the audit committee should be appropriate to the size of the institution and the complexity of its operations, and, at a minimum, should include the appointment, compensation, and oversight of the independent public accountant; reviewing with management and the independent public accountant the basis for their respective reports issued under §§ 363.2(a) and (b) and §§ 363.3(a) and (b); reviewing and satisfying itself as to the independent public accountant's compliance with the required qualifications for independent public accountants set forth in §§ 363.3(f) and (g) and guidelines 13 through 16; ensuring that audit engagement letters comply with the provisions of § 363.5(c) before engaging an independent public accountant; being familiar with the notice requirements in § 363.4(d) and guideline 20 regarding the selection, change, or termination of an independent public accountant; and ensuring that management sends a copy of any notice required under § 363.4(d) to the independent public accountant when it is filed with the FDIC. 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 effectiveness of internal control over financial reporting, and the resolution of identified material weaknesses and significant deficiencies in internal control over financial reporting, including the prevention or detection of management override or compromise of the internal control system;

(c) Reviewing with management the institution's compliance with the Designated Laws and Regulations identified in guideline 7A;

(d) Discussing with management and the independent public accountant any significant disagreements between management and the independent public accountant; and

(e) Overseeing the internal audit function.

32. *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. A person who has the attributes of an "audit committee financial expert" as set forth in the SEC's rules would also satisfy these criteria.

33. *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).

34. *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.

35. *Transition Period for Forming and Restructuring Audit Committees.*

(a) When an insured depository institution's total assets as of the beginning of its fiscal year are $500 million or more for the first time and it thereby becomes subject to part 363, no regulatory action will be taken if the institution (1) develops and approves a set of written criteria for determining whether a director who is to serve on the audit committee is an outside director and is independent of management and (2) forms or restructures its audit committee to comply with § 363.5(a)(2) by the end of that fiscal year.

(b) When an insured depository institution's total assets as of the beginning of its fiscal year are $1 billion or more for the first time, no regulatory action will be taken if the institution forms or restructures its audit committee to comply with § 363.5(a)(1) by the end of that fiscal year, provided that the composition of its audit committee meets the requirements specified in § 363.5(a)(2) at the beginning of that fiscal year, if such requirements were applicable.

(c) When an insured depository institution's total assets as of the beginning of its fiscal year are $3 billion or more for the first time, no regulatory action will be taken if the institution forms or restructures its audit committee to comply with § 363.5(b) by the end of that fiscal year, provided that the composition of its audit committee meets the requirements specified in § 363.5(a)(1) at the beginning of that fiscal year, if such requirements were applicable.

**Other**

36. *Modifications of Guidelines.* The FDIC's Board of Directors has delegated to the Director of the FDIC's Division of Supervision and Consumer Protection authority to make and publish in the Federal Register minor technical amendments to the Guidelines in this Appendix and the guidance and illustrative reports in Appendix B, 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.

Table 1 to Appendix A

| Designated Federal Laws and Regulations Applicable to | | | | | |
|---|---|---|---|---|---|
| | | **National banks** | **State member banks** | **State non-member banks** | **Savings associa-tions** |

| Insider Loans—Parts and/or Sections of Title 12 of the United States Code | | | | | |
|---|---|---|---|---|---|
| 375a | Loans to Executive Officers of Banks | √ | √ | (A) | (A) |
| 375b | Extensions of Credit to Executive Officers, Directors, and Principal Shareholders of Banks | √ | √ | (A) | (A) |
| 1468(b) | Extensions of Credit to Executive Officers, Directors, and Principal Shareholders | | | | √ |
| 1828(j)(2) | Extensions of Credit to Officers, Directors, and Principal Shareholders | | | √ | |
| 1828(j)(3)(B) | Extensions of Credit to Officers, Directors, and Principal Shareholders | (B) | | (C) | |
| **Parts and/or Sections of Title 12 of the Code of Federal Regulations** | | | | | |
| 31 | Extensions of Credit to Insiders | √ | | | |
| 32 | Lending Limits | √ | | | |
| 215 | Loans to Executive Officers, Directors, and Principal Shareholders of Member Banks | √ | √ | (D) | (E) |
| 337.3 | Limits on Extensions of Credit to Executive Officers, Directors, and Principal Shareholders of Insured Nonmember Banks | | | √ | |
| 563.43 | Loans by Savings Associations to Their Executive Officers, Directors, and Principal Shareholders | | | | √ |
| **Dividend Restrictions--Parts and/or Sections of Title 12 of the United States Code** | | | | | |
| 56 | Prohibition on Withdrawal of Capital and Unearned Dividends | √ | √ | | |
| 60 | Dividends and Surplus Fund | √ | √ | | |
| 1467a(f) | Declaration of Dividend | | | | √ |

| | | | | | |
|---|---|---|---|---|---|
| 1831o(d)(1) | Prompt Corrective Action - Capital Distributions Restricted | √ | √ | √ | √ |
| **Parts and/or Sections of Title 12 of the Code of Federal Regulations** | | | | | |
| 5 Subpart E | Payment of Dividends | √ | | | |
| 6.6 | Prompt Corrective Action - Restrictions on Undercapitalized Institutions | √ | | | |
| 208.5 | Dividends and Other Distributions | | √ | | |
| 208.45 | Prompt Corrective Action - Restrictions on Undercapitalized Institutions | | √ | | |
| 325.105 | Prompt Corrective Action - Restrictions on Undercapitalized Institutions | | | √ | |
| 563 Subpart E | Capital Distributions | | | | √ |
| 565.6 | Prompt Corrective Action - Restrictions on Undercapitalized Institutions | | | | √ |

A. Subsections (g) and (h) of section 22 of the Federal Reserve Act [12 U.S.C. 375a, 375b]
B. Applies only to insured federal branches of foreign banks.
C. Applies only to insured state branches of foreign banks.
D. See 12 CFR § 337.3.
E. See 12 CFR § 563.43.

**Appendix B to Part 363 – Illustrative Management Reports**

Table of Contents

5. Illustrative Reports on Management's Assessment of Internal Control Over Financial Reporting
6. Illustrative Management Report – Combined Statement of Management's Responsibilities, Report on Management's Assessment of Compliance with Designated Laws and Regulations, and Report on Management's Assessment of Internal Control Over Financial Reporting
7. Illustrative Cover Letter – Compliance by Holding Company Subsidiaries

1. *General.* The reporting scenarios, illustrative management reports, and the cover letter (when complying at the holding company level) in Appendix B to part 363 are intended to assist managements of insured depository institutions in complying with the annual reporting requirements of § 363.2 and guideline 3, *Compliance by Holding Company Subsidiaries*, of Appendix A to part 363. However, use of the illustrative management reports and cover letter is not required. The managements of insured depository institutions are encouraged to tailor the wording of their management reports and cover letters to fit their particular circumstances, especially when reporting on material weaknesses in internal control over financial reporting or noncompliance with designated laws and regulations. Terms that are not explained in Appendix B have the meanings given them in part 363, the FDI Act, or professional accounting and auditing literature. Instructions to the preparer of the management reports are shown in brackets within the illustrative reports.

2. *Reporting Scenarios for Institutions that are Holding Company Subsidiaries.*

(a) Subject to the criteria specified in § 363.1(b), an insured depository institution that is a subsidiary of a holding company has flexibility in satisfying the reporting requirements of part 363. When reporting at the holding company level, the management report, or the individual components thereof, should identify those subsidiary institutions that are subject to part 363 and the extent to which they are included in the scope of the management report or a component of the report. The following reporting scenarios reflect how an insured depository institution that meets the criteria set forth in § 363.1(b) could satisfy the annual reporting requirements of § 363.2. Other reporting scenarios are possible.

(i) An institution that is a subsidiary of a holding company may satisfy the requirements for audited financial statements; management's statement of responsibilities; management's assessment of the institution's compliance with the federal laws and regulations pertaining to insider loans and the federal and, if applicable, state laws and regulations pertaining to dividend restrictions; management's assessment of the effectiveness of internal control over financial reporting, if applicable; and the independent public accountant's attestation on management's assertion as to the effectiveness of internal control over financial reporting, if applicable, at the insured depository institution level.

(ii) An institution that is a subsidiary of a holding company may satisfy the requirements for audited financial statements; management's statement of responsibilities; management's assessment of the institution's compliance with the federal laws and regulations pertaining to insider loans and the federal and, if applicable, state laws and regulations pertaining to dividend restrictions; management's assessment of the effectiveness of internal control over financial reporting, if applicable;, and the independent public accountant's attestation on management's assertion as to the effectiveness of internal control over financial reporting, if applicable, at the holding company level.

(iii) An institution that is a subsidiary of a holding company may satisfy the requirement for audited financial statements at the holding company level and may satisfy the requirements for management's statement of responsibilities; management's assessment of the institution's compliance with the federal laws and regulations pertaining to insider loans and the federal and, if applicable, state laws and regulations pertaining to dividend restrictions; management's assessment of the effectiveness of internal control over financial reporting, if applicable; and the independent public accountant's attestation on management's assertion as to the effectiveness of internal control over financial reporting, if applicable, at the insured depository institution level.

(iv) An institution that is a subsidiary of a holding company may satisfy the requirements for audited financial statements; management's statement of responsibilities; and management's assessment of the institution's compliance with the federal laws and regulations pertaining to insider loans and the federal and, if applicable, state laws and regulations pertaining to dividend restrictions at the insured depository institution level and may satisfy the requirements for the assessment by management of the effectiveness of internal control over financial reporting, if applicable; and the independent public accountant's attestation on management's assertion as to the effectiveness of internal control over financial reporting, if applicable, at the holding company level.

(b) For an institution with total assets of $1 billion or more as of the beginning of its fiscal year, the assessment by management of the effectiveness of internal control over financial reporting and the independent public accountant's attestation on management's assertion as to the effectiveness of internal control over financial reporting, if applicable, must both be performed at the same level, i.e., either at the insured depository institution level or at the holding company level.

(c) Financial statements prepared for regulatory reporting purposes encompass the schedules equivalent to the basic financial statements in an institution's appropriate regulatory report, e.g., the bank Consolidated Reports of Condition and Income (Call Report) and the Thrift Financial Report (TFR). Guideline 4A in Appendix A to part 363 identifies the schedules equivalent to the basic financial statements in the Call Report and TFR. When internal control assessments and attestations are performed at the holding company level, the FDIC believes that holding companies have flexibility in interpreting "financial reporting" as it relates to "regulatory reporting" and has not objected to several reporting approaches employed by holding companies to cover "regulatory reporting." Certain holding companies have had management's assessment and the accountant's attestation cover the schedules equivalent to the basic financial statements that are included in the appropriate regulatory report, e.g., Call Report and the TFR, of each subsidiary institution subject to part 363. Other holding companies have had management's assessment and the accountant's attestation cover the schedules equivalent to the basic financial statements that are included in the holding company's year-end regulatory report (FR Y-9C report) to the Federal Reserve Board.

3. *Illustrative Statements of Management's Responsibilities*. The following illustrative statements of management's responsibilities satisfy the requirements of § 363.2(b)(1).

(a) Statement Made at Insured Depository Institution Level

**Statement of Management's Responsibilities**

The management of ABC Depository Institution (the "Institution") is responsible for preparing the Institution's annual financial statements in accordance with generally accepted accounting principles; for establishing and maintaining an adequate internal control structure and procedures for financial reporting, including controls over the preparation of regulatory financial statements in accordance with the instructions for the [specify the regulatory report]; and for complying with the federal laws and regulations pertaining to insider loans and the federal and, if applicable, state laws and regulations pertaining to dividend restrictions.

ABC Depository Institution

________________________________ Date:______________

John Doe, Chief Executive Officer

________________________________ Date:______________

Jane Doe, Chief Financial Officer

(b) Statement Made at Holding Company Level

**Statement of Management's Responsibilities**

The management of BCD Holding Company (the "Company") is responsible for preparing the Company's annual financial statements in accordance with generally accepted accounting principles; for establishing and maintaining an adequate internal control structure and procedures for financial reporting, including controls over the preparation of regulatory financial statements in accordance with the instructions for the [specify the regulatory report]; and for complying with the federal laws and regulations pertaining to insider loans and the federal and, if applicable, state laws and regulations pertaining to dividend restrictions. The following subsidiary institutions of the Company that are subject to Part 363 are included in this statement of management's responsibilities: [Identify the subsidiary institutions.]

BCD Holding Company

________________________________ Date:______________

John Doe, Chief Executive Officer

________________________________ Date:______________

Jane Doe, Chief Financial Officer

4. *Illustrative Reports on Management's Assessment of Compliance with Designated Laws and Regulations*. The following illustrative reports on management's assessment of compliance with Designated Laws and Regulations satisfy the requirements of § 363.2(b)(2).

(a) Statement Made at Insured Depository Institution Level – Compliance with Designated Laws and Regulations Pertaining to Insider Loans and Dividend Restrictions

**Management's Assessment of Compliance with Designated Laws and Regulations**

The management of ABC Depository Institution (the "Institution") has assessed the Institution's compliance with the federal laws and regulations pertaining to insider loans and the federal and, if applicable, state laws and regulations pertaining to dividend restrictions during the fiscal year that ended on December 31, 20XX. Based upon its assessment, management has concluded that the Institution complied with the federal laws and regulations pertaining to insider loans and the federal and, if applicable, state laws and regulations pertaining to dividend restrictions during the fiscal year that ended on December 31, 20XX.

ABC Depository Institution

________________________________ Date:______________

John Doe, Chief Executive Officer

________________________________ Date:______________

Jane Doe, Chief Financial Officer

(b) Statement Made at Insured Depository Institution Level – Noncompliance with Designated Laws and Regulations Pertaining to Both Insider Loans and Dividend Restrictions

**Management's Assessment of Compliance with Designated Laws and Regulations**

The management of ABC Depository Institution (the "Institution") has assessed the Institution's compliance with the federal laws and regulations pertaining to insider loans and the federal and, if applicable, state laws and regulations pertaining to dividend restrictions during the fiscal year that ended on December 31, 20XX. Based upon its assessment, management has determined that, because of the instance(s) of noncompliance noted below, the Institution did not comply with the federal laws and regulations pertaining to insider loans and the federal and, if applicable, state laws and regulations pertaining to dividend restrictions during the fiscal year that ended on December 31, 20XX.

[Identify and describe the instance or instances of noncompliance with the federal laws and regulations pertaining to insider loans and the federal and, if applicable, state laws and regulations pertaining to dividend restrictions, including appropriate qualitative and quantitative information to describe the nature, type, and severity of the noncompliance and the dollar amounts of the insider loan(s) and dividend(s) involved.]

ABC Depository Institution

________________________________ Date:______________

John Doe, Chief Executive Officer

________________________________ Date:______________

Jane Doe, Chief Financial Officer

(c) Statement Made at Insured Depository Institution Level – Compliance with Designated Laws and Regulations Pertaining to Insider Loans and Noncompliance with Designated Laws and Regulations Pertaining to Dividend Restrictions

**Management's Assessment of Compliance with Designated Laws and Regulations**

The management of ABC Depository Institution (the "Institution") has assessed the Institution's compliance with the federal laws and regulations pertaining to insider loans and the federal and, if applicable, state laws and regulations pertaining to dividend restrictions during the fiscal year that ended on December 31, 20XX. Based upon its assessment, management has concluded that the Institution complied with the federal laws and regulations pertaining to insider loans during the fiscal year that ended on December 31, 20XX. Also, based upon its assessment, management has determined that, because of the instance(s) of noncompliance noted below, the Institution did not comply with the federal and, if applicable, state laws and regulations pertaining to dividend restrictions during the fiscal year that ended on December 31, 20XX.

[Identify and describe the instance or instances of noncompliance with the federal and, if applicable, state laws and regulations pertaining to dividend restrictions, including appropriate qualitative and quantitative information to describe the nature, type, and severity of the noncompliance and the dollar amount(s) of the dividend(s) involved.]

ABC Depository Institution

______________________________ Date:______________

John Doe, Chief Executive Officer

______________________________ Date:______________

Jane Doe, Chief Financial Officer

(d) Statement Made at Insured Depository Institution Level – Noncompliance with Designated Laws and Regulations Pertaining to Insider Loans and Compliance with Designated Laws and Regulations Pertaining to Dividend Restrictions

**Management's Assessment of Compliance with Designated Laws and Regulations**

The management of ABC Depository Institution (the "Institution") has assessed the Institution's compliance with the federal laws and regulations pertaining to insider loans and the federal and, if applicable, state laws and regulations pertaining to dividend restrictions during the fiscal year that ended on December 31, 20XX. Based upon its assessment, management has determined that, because of the instance(s) of noncompliance noted below, the Institution did not comply with the federal laws and regulations pertaining to insider loans during the fiscal year that ended on December 31, 20XX. Also, based upon its assessment, management has concluded that the Institution complied with the federal and, if applicable, state laws and regulations pertaining to dividend restrictions during the fiscal year that ended on December 31, 20XX.

[Identify and describe the instance or instances of noncompliance with the federal laws and regulations pertaining to insider loans, including appropriate qualitative and quantitative information to describe the nature, type, and severity of the noncompliance and the dollar amount(s) of the insider loan(s) involved.]

ABC Depository Institution

________________________________ Date:______________

John Doe, Chief Executive Officer

________________________________ Date:______________

Jane Doe, Chief Financial Officer

(e) Statement Made at Holding Company Level – Compliance with Designated Laws and Regulations Pertaining to Insider Loans and Dividend Restrictions

**Management's Assessment of Compliance with Designated Laws and Regulations**

The management of BCD Holding Company (the "Company") has assessed the Company's compliance with the federal laws and regulations pertaining to insider loans and the federal and, if applicable, state laws and regulations pertaining to dividend restrictions during the fiscal year that ended on December 31, 20XX. Based upon its assessment, management has concluded that the Company complied with the federal laws and regulations pertaining to insider loans and the federal and, if applicable, state laws and regulations pertaining to dividend restrictions during the fiscal year that ended on December 31, 20XX. The following subsidiary institutions of the Company that are subject to Part 363 are included in this assessment of compliance with these designated laws and regulations: [Identify the subsidiary institutions.]

BCD Holding Company

______________________________ Date:______________

John Doe, Chief Executive Officer

______________________________ Date:______________

Jane Doe, Chief Financial Officer

(f) Statement Made at Holding Company Level – Noncompliance with Designated Laws and Regulations Pertaining to Both Insider Loans and Dividend Restrictions

**Management's Assessment of Compliance with Designated Laws and Regulations**

The management of BCD Holding Company (the "Company") has assessed the Company's compliance with the federal laws and regulations pertaining to insider loans and the federal and, if applicable, state laws and regulations pertaining to dividend restrictions during the fiscal year that ended on December 31, 20XX. The following subsidiary institutions of the Company that are subject to Part 363 are included in this assessment of compliance with these designated laws and regulations: [Identify the subsidiary institutions.]

Based upon its assessment, management has determined that, because of the instance(s) of noncompliance noted below, the Company did not comply with the federal laws and regulations pertaining to insider loans and the federal and, if applicable, state laws and regulations pertaining to dividend restrictions during the fiscal year that ended on December 31, 20XX.

[Identify and describe the instance or instances of noncompliance with the federal laws and regulations pertaining to insider loans and the federal and, if applicable, state laws and regulations pertaining to dividend restrictions, including appropriate qualitative and quantitative information to identify the subsidiary institutions of the Company that are subject to Part 363 that had instances of noncompliance and describe the nature, type, and severity of the noncompliance and the dollar amount(s) of the insider loan(s) and dividend(s) involved.]

BCD Holding Company

________________________________ Date:______________

John Doe, Chief Executive Officer

________________________________ Date:______________

Jane Doe, Chief Financial Officer

(g) Statement Made at Holding Company Level – Compliance with Designated Laws and Regulations Pertaining to Insider Loans and Noncompliance with Designated Laws and Regulations Pertaining to Dividend Restrictions

**Management's Assessment of Compliance with Designated Laws and Regulations**

The management of BCD Holding Company (the "Company") has assessed the Company's compliance with the federal laws and regulations pertaining to insider loans and the federal and, if applicable, state laws and regulations pertaining to dividend restrictions during the fiscal year that ended on December 31, 20XX. The following subsidiary institutions of the Company that are subject to Part 363 are included in this assessment of compliance with these designated laws and regulations: [Identify the subsidiary institutions.]

Based upon its assessment, management has concluded that the Company complied with the federal laws and regulations pertaining to insider loans during the fiscal year that ended on December 31, 20XX. Also, based upon its assessment, management has determined that, because of the instance(s) of noncompliance noted below, the Company did not comply with the federal and, if applicable, state laws and regulations pertaining to dividend restrictions during the fiscal year that ended on December 31, 20XX.

[Identify and describe the instance or instances of noncompliance with the federal and, if applicable, state laws and regulations pertaining to dividend restrictions, including appropriate qualitative and quantitative information to identify the subsidiary institutions of the Company that are subject to Part 363 that had instances of noncompliance and describe the nature, type, and severity of the noncompliance and the dollar amount(s) of the dividend(s) involved.]

BCD Holding Company

________________________________ Date:______________

John Doe, Chief Executive Officer

________________________________ Date:______________

Jane Doe, Chief Financial Officer

(h) Statement Made at Holding Company Level – Noncompliance with Designated Laws and Regulations Pertaining to Insider Loans and Compliance with Designated Laws and Regulations Pertaining to Dividend Restrictions

**Management's Assessment of Compliance with Designated Laws and Regulations**

The management of BCD Holding Company (the "Company") has assessed the Company's compliance with the federal laws and regulations pertaining to insider loans and the federal and, if applicable, state laws and regulations pertaining to dividend restrictions during the fiscal year that ended on December 31, 20XX. The following subsidiary institutions of the Company that are subject to Part 363 are included in this assessment of compliance with these designated laws and regulations: [Identify the subsidiary institutions.]

Based upon its assessment, management has determined that, because of the instance(s) of noncompliance noted below, the Company did not comply with the federal laws and regulations pertaining to insider loans during the fiscal year that ended on December 31, 20XX. Also, based upon its assessment, management has concluded that the Company complied with the federal and, if applicable, state laws and regulations pertaining to dividend restrictions during the fiscal year that ended on December 31, 20XX.

[Identify and describe the instance or instances of noncompliance with the federal laws and regulations pertaining to insider loans, including appropriate qualitative and quantitative information to identify the subsidiary institutions of the Company that are subject to Part 363 that had instances of noncompliance and describe the nature, type, and severity of the noncompliance and the dollar amount(s) of the insider loan(s) involved.]

BCD Holding Company

________________________________ Date:______________

John Doe, Chief Executive Officer

________________________________ Date:______________

Jane Doe, Chief Financial Officer

5. *Illustrative Reports on Management's Assessment of Internal Control Over Financial Reporting*. The following illustrative reports on management's assessment of internal control over financial reporting satisfy the requirements of § 363.2(b)(3).

(a) Statement Made at Insured Depository Institution Level – No Material Weaknesses

**Management's Assessment of Internal Control Over Financial Reporting**

ABC Depository Institution's (the "Institution") internal control over financial reporting is a process effected by those charged with governance, management, and other personnel, designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of reliable financial statements in accordance with accounting principles generally accepted in the United States of America and financial statements for regulatory reporting purposes, i.e., [specify the regulatory reports]. The Institution's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the Institution; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with accounting principles generally accepted in the United States of America and financial statements for regulatory reporting purposes, and that receipts and expenditures of the Institution are being made only in accordance with authorizations of management and directors of the Institution; and (3) provide reasonable assurance regarding prevention, or timely detection and correction of unauthorized acquisition, use, or disposition of the Institution's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent, or detect and correct misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies and procedures may deteriorate.

Management is responsible for establishing and maintaining effective internal control over financial reporting including controls over the preparation of regulatory financial statements. Management assessed the effectiveness of the Institution's internal control over financial reporting, including controls over the preparation of regulatory financial statements in accordance with the instructions for the [specify the regulatory report], as of December 31, 20XX, based on the framework set forth by the Committee of Sponsoring Organizations of the Treadway Commission in *Internal Control – Integrated Framework.* Based upon its assessment, management has concluded that, as of December 31, 20XX, the Institution's internal control over financial reporting, including controls over the preparation of regulatory financial statements in accordance with the instructions for the [specify the regulatory report], is effective based on the criteria established in *Internal Control – Integrated Framework.*

Management's assessment of the effectiveness of internal control over financial reporting, including controls over the preparation of regulatory financial statements in accordance with the instructions for the [specify the regulatory report], as of December 31, 20XX, has been audited by [name of auditing firm], an independent public accounting firm, as stated in their report dated March XX, 20XY.

ABC Depository Institution

______________________________ Date:_____________

John Doe, Chief Executive Officer

______________________________ Date:_____________

Jane Doe, Chief Financial Officer

(b) Statement Made at Insured Depository Institution Level – One or More Material Weaknesses

**Management's Assessment of Internal Control Over Financial Reporting**

ABC Depository Institution's (the "Institution") internal control over financial reporting is a process effected by those charged with governance, management, and other personnel, designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of reliable financial statements in accordance with accounting principles generally accepted in the United States of America and financial statements for regulatory reporting purposes, i.e., [specify the regulatory reports]. The

Institution’s internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the Institution; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with accounting principles generally accepted in the United States of America and financial statements for regulatory reporting purposes, and that receipts and expenditures of the Institution are being made only in accordance with authorizations of management and directors of the Institution; and (3) provide reasonable assurance regarding prevention, or timely detection and correction of unauthorized acquisition, use, or disposition of the Institution’s assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent, or detect and correct misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies and procedures may deteriorate.

Management is responsible for establishing and maintaining effective internal control over financial reporting including controls over the preparation of regulatory financial statements. Management assessed the effectiveness of the Institution’s internal control over financial reporting, including controls over the preparation of regulatory financial statements in accordance with the instructions for the [specify the regulatory report], as of

December 31, 20XX, based on the framework set forth by the Committee of Sponsoring Organizations of the Treadway Commission in *Internal Control – Integrated Framework*. Because of the material weakness (or weaknesses) noted below, management determined that the Institution's internal control over financial reporting, including controls over the preparation of regulatory financial statements in accordance with the instructions the [specify the regulatory report], was not effective as of December 31, 20XX.

[Identify and describe the material weakness or weaknesses.]

Management's assessment of the effectiveness of internal control over financial reporting, including controls over the preparation of regulatory financial statements in accordance with the instructions for the [specify the regulatory report], as of December 31, 20XX, has been audited by [name of auditing firm], an independent public accounting firm, as stated in their report dated March XX, 20XY.

ABC Depository Institution

________________________________ Date:______________

John Doe, Chief Executive Officer

________________________________ Date:______________

Jane Doe, Chief Financial Officer

(c) Statement Made at Holding Company Level – No Material Weaknesses

**Management's Assessment of Internal Control Over Financial Reporting**

BCD Holding Company's (the "Company") internal control over financial reporting is a process designed effected by those charged with governance, management, and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of reliable financial statements in accordance with accounting principles generally accepted in the United States of America and financial statements for regulatory reporting purposes, i.e., [specify the regulatory reports]. The Company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the Company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with accounting principles generally accepted in the United States of America and financial statements for regulatory reporting purposes, and that receipts and expenditures of the Company are being made only in accordance with authorizations of management and directors of the Company; and (3) provide reasonable assurance regarding prevention, or timely detection and correction of unauthorized acquisition, use, or disposition of the Company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent, or detect and correct misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies and procedures may deteriorate.

Management is responsible for establishing and maintaining effective internal control over financial reporting including controls over the preparation of regulatory financial statements. Management assessed the effectiveness of the Company's internal control over financial reporting, including controls over the preparation of regulatory financial statements in accordance with the instructions for the [specify the regulatory report], as of December 31, 20XX, based on the framework set forth by the Committee of Sponsoring Organizations of the Treadway Commission in *Internal Control – Integrated Framework.* Based on that assessment, management concluded that, as of December 31, 20XX, the Company's internal control over financial reporting, including controls over the preparation of regulatory financial statements in accordance with the instructions for the [specify the regulatory report], is effective based on the criteria established in *Internal Control – Integrated Framework.* The following subsidiary institutions of the Company that are subject to Part 363 are included in this assessment of the effectiveness of internal control over financial reporting: [Identify the subsidiary institutions.]

Management's assessment of the effectiveness of internal control over financial reporting, including controls over the preparation of regulatory financial statements in accordance with the instructions for the [specify the regulatory report], as of December 31, 20XX, has been audited by [name of auditing firm], an independent public accounting firm, as stated in their report dated March XX, 20XY.

BCD Holding Company

______________________________ Date:______________

John Doe, Chief Executive Officer

______________________________ Date:______________

Jane Doe, Chief Financial Officer

(d) Statement Made at Holding Company Level – One or More Material Weaknesses

**Management's Assessment of Internal Control Over Financial Reporting**

BCD Holding Company's (the "Company") internal control over financial reporting is a process effected by those charged with governance, management, and other personnel, designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of reliable financial statements in accordance with accounting principles generally accepted in the United States of America and financial statements for regulatory reporting purposes, i.e., [specify the regulatory reports]. The Company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the Company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with accounting principles generally accepted in the United States of America and financial statements for regulatory reporting purposes, and that receipts and expenditures of the Company are being made only in accordance with authorizations of management and directors of the Company; and (3) provide reasonable assurance regarding prevention, or timely detection and correction of unauthorized acquisition, use, or disposition of the Company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent, or detect and correct misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies and procedures may deteriorate.

Management is responsible for establishing and maintaining effective internal control over financial reporting including controls over the preparation of regulatory financial statements. Management assessed the effectiveness of the Company's internal control over financial reporting, including controls over the preparation of regulatory financial statements in accordance with the instructions for the [specify the regulatory report], as of December 31, 20XX, based on the framework set forth by the Committee of Sponsoring Organizations of the Treadway Commission in *Internal Control – Integrated Framework.* Because of the material weakness (or weaknesses) noted below, management determined that the Company's internal control over financial reporting, including controls over the preparation of regulatory financial statements in accordance with the instructions for the [specify the regulatory report], was not effective as of December 31, 20XX. The following subsidiary institutions of the Company that are subject to Part 363 are included in this assessment of the effectiveness of internal control over financial reporting: [Identify the subsidiary institutions.]

[Identify and describe the material weakness or weaknesses.]

Management's assessment of the effectiveness of internal control over financial reporting, including controls over the preparation of regulatory financial statements in accordance with the instructions for the [specify the regulatory report], as of December 31, 20XX, has been audited by [name of auditing firm], an independent public accounting firm, as stated in their report dated March XX, 20XY.

BCD Holding Company

______________________________ Date:______________

John Doe, Chief Executive Officer

______________________________ Date:______________

Jane Doe, Chief Financial Officer

6. *Illustrative Management Report – Combined Statement of Management's Responsibilities, Report on Management's Assessment of Compliance with Designated Laws and Regulations, and Report on Management's Assessment of Internal Control Over Financial Reporting,* if applicable. The following illustrative management reports satisfy the requirements of §§ 363.2(b)(1), (2), and (3).

(a) Management Report Made at Insured Depository Institution Level – Compliance with Designated Laws and Regulations Pertaining to Insider Loans and Dividend Restrictions and No Material Weaknesses in Internal Control Over Financial Reporting

**Management Report**

**<u>Statement of Management's Responsibilities</u>**

The management of ABC Depository Institution (the "Institution") is responsible for preparing the Institution's annual financial statements in accordance with generally accepted accounting principles; for establishing and maintaining an adequate internal control structure and procedures for financial reporting, including controls over the preparation of regulatory financial statements in accordance with the instructions for the [specify the regulatory report]; and for complying with the federal laws and regulations pertaining to insider loans and the federal and, if applicable, state laws and regulations pertaining to dividend restrictions.

**<u>Management's Assessment of Compliance with Designated Laws and Regulations</u>**

The management of the Institution has assessed the Institution's compliance with the federal laws and regulations pertaining to insider loans and the federal and, if applicable, state laws and regulations pertaining to dividend restrictions during the fiscal year that ended on December 31, 20XX. Based upon its assessment, management has concluded that the Institution complied with the federal laws and regulations pertaining to insider loans and the federal and, if applicable, state laws and regulations pertaining to dividend restrictions during the fiscal year that ended on December 31, 20XX.

**Management's Assessment of Internal Control Over Financial Reporting**

The Institution's internal control over financial reporting is a process effected by those charged with governance, management, and other personnel, designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of reliable financial statements in accordance with accounting principles generally accepted in the United States of America and financial statements for regulatory reporting purposes, i.e., [specify the regulatory reports]. The Institution's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the Institution; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with accounting principles generally accepted in the United States of America and financial statements for regulatory reporting purposes, and that receipts and expenditures of the Institution are being made only in accordance with authorizations of management and directors of the Institution; and (3) provide reasonable assurance regarding prevention, or timely detection and correction of unauthorized acquisition, use, or disposition of the Institution's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent, or detect and correct misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies and procedures may deteriorate.

Management assessed the effectiveness of the Institution's internal control over financial reporting, including controls over the preparation of regulatory financial statements in accordance with the instructions for the [specify the regulatory report], as of December 31, 20XX, based on the framework set forth by the Committee of Sponsoring Organizations of the Treadway Commission in *Internal Control – Integrated Framework.* Based upon its assessment, management has concluded that, as of December 31, 20XX, the Institution's internal control over financial reporting, including controls over the preparation of regulatory financial statements in accordance with the instructions for the [specify the regulatory report], is effective based on the criteria established in *Internal Control – Integrated Framework.*

Management's assessment of the effectiveness of internal control over financial reporting, including controls over the preparation of regulatory financial statements in accordance with the instructions for the [specify the regulatory report], as of December

31, 20XX, has been audited by [name of auditing firm], an independent public accounting firm, as stated in their report dated March XX, 20XY.

ABC Depository Institution

______________________________ Date:____________

John Doe, Chief Executive Officer

______________________________ Date:____________

Jane Doe, Chief Financial Officer

(b) Management Report Made at Holding Company Level – Compliance with Designated Laws and Regulations Pertaining to Insider Loans and Dividend Restrictions and No Material Weaknesses in Internal Control Over Financial Reporting

**Management Report**

[***Instruction* -** The following illustrative introductory paragraph for the management report is applicable only if the same group of subsidiary institutions of the holding company that are subject to Part 363 are included in all three components of the management report required by Part 363: the statement of management's responsibilities, the report on management's assessment of compliance with the Designated Laws and Regulations pertaining to insider loans and dividend restrictions, and the report on management's assessment of internal control over financial reporting.]

In this management report, the following subsidiary institutions of the BCD Holding Company (the "Company") that are subject to Part 363 are included in the statement of management's responsibilities; the report on management's assessment of compliance with the federal laws and regulations pertaining to insider loans and the federal and, if applicable, state laws and regulations pertaining to dividend restrictions; and the report on management's assessment of internal control over financial reporting: [Identify the subsidiary institutions.]

[***Instruction -*** The following illustrative introductory paragraph for the management report is applicable if the same group of subsidiary institutions of the holding company that are subject to Part 363 are included in the statement of management's responsibilities and management's assessment of compliance with the Designated Laws and Regulations pertaining to insider loans and dividend restrictions, but only some of the subsidiary institutions in the group are included in management's assessment of internal control over financial reporting.]

In this management report, the following subsidiary institutions of BCD Holding Company (the "Company") that are subject to Part 363 are included in the statement of management's responsibilities and the report on management's assessment of compliance with the federal laws and regulations pertaining to insider loans and the federal and, if applicable, state laws and regulations pertaining to dividend restrictions: [Identify the subsidiary institutions.] In addition, the following subsidiary institutions of the Company that are subject to Part 363 are included in the report on management's assessment of internal control over financial reporting:  [Identify the subsidiary institutions.]

## **Statement of Management's Responsibilities**

The management of the Company is responsible for preparing the Company's annual financial statements in accordance with generally accepted accounting principles; for establishing and maintaining an adequate internal control structure and procedures for financial reporting, including controls over the preparation of regulatory financial statements in accordance with the instructions for the [specify the regulatory report]; and for complying with the federal laws and regulations pertaining to insider loans and the federal and, if applicable, state laws and regulations pertaining to dividend restrictions.

## **Management's Assessment of Compliance with Designated Laws and Regulations**

The management of the Company has assessed the Company's compliance with the federal laws and regulations pertaining to insider loans and the federal and, if applicable, state laws and regulations pertaining to dividend restrictions during the fiscal year that ended on December 31, 20XX.  Based upon its assessment, management has concluded that the Company complied with the federal laws and regulations pertaining to insider loans and the federal and, if applicable, state laws and regulations pertaining to dividend restrictions during the fiscal year that ended on December 31, 20XX.

**Management's Assessment of Internal Control Over Financial Reporting**

The Company's internal control over financial reporting is a process effected by those charged with governance, management, and other personnel, designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of reliable financial statements in accordance with accounting principles generally accepted in the United States of America and financial statements for regulatory reporting purposes, i.e., [specify the regulatory reports]. The Company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the Company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with accounting principles generally accepted in the United States of America and financial statements for regulatory reporting purposes, and that receipts and expenditures of the Company are being made only in accordance with authorizations of management and directors of the Company; and (3) provide reasonable assurance regarding prevention, or timely detection and correction of unauthorized acquisition, use, or disposition of the Company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent, or detect and correct misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies and procedures may deteriorate.

Management assessed the effectiveness of the Company's internal control over financial reporting, including controls over the preparation of regulatory financial statements in accordance with the instructions for the [specify the regulatory report], as of December 31, 20XX, based on the framework set forth by the Committee of Sponsoring Organizations of the Treadway Commission in *Internal Control – Integrated Framework*. Based upon its assessment, management has concluded that, as of December 31, 20XX, the Company's internal control over financial reporting, including controls over the preparation of regulatory financial statements in accordance with the instructions for the [specify the regulatory report], is effective based on the criteria established in *Internal Control – Integrated Framework*.

Management's assessment of the effectiveness of internal control over financial reporting, including controls over the preparation of regulatory financial statements in accordance with the instructions for the [specify the regulatory report], as of December 31, 20XX, has been audited by [name of auditing firm], an independent public accounting firm, as stated in their report dated March XX, 20XY.

BCD Holding Company

________________________________ Date:______________

John Doe, Chief Executive Officer

______________________________ Date:_____________

Jane Doe, Chief Financial Officer

7. *Illustrative Cover Letter – Compliance by Holding Company Subsidiaries*. The following illustrative cover letter satisfies the requirements of guideline 3, *Compliance by Holding Company Subsidiaries*, of Appendix A to part 363.

To: (Appropriate FDIC Regional or Area Office)

Division of Supervision and Consumer Protection, FDIC, and

(Appropriate District or Regional Office of the Primary Federal Regulator(s), if not the FDIC), and

(Appropriate State Bank Supervisor(s), if applicable)

Dear [Insert addressees]:

BCD Holding Company (the "Company") is filing two copies of the Part 363 Annual Report for the fiscal year ended December 31, 20XX, on behalf of its insured depository institution subsidiaries listed in the chart below that are subject to Part 363. The Part 363 Annual Report contains audited comparative annual financial statements, the independent public accountant's report on the audited financial statements, management's statement of responsibilities, management's assessment of compliance with the Designated Laws and Regulations pertaining to insider loans and dividend restrictions, and [if applicable] management's assessment of and the independent public accountant's attestation report on internal control over financial reporting. The chart below also indicates the level (institution or holding company) at which the requirements of Part 363 are being satisfied for each listed insured depository institution subsidiary. [If applicable] The Company's other insured depository institution subsidiaries that are subject to Part 363, which comply with all of the Part 363 annual reporting requirements at the institution level, have filed [or will file] their Part 363 Annual Reports separately.

| Institutions Subject to Part 363 | Audited Financial Statements | Management's Statement of Responsibilities | Management's Assessment of Compliance with Designated Laws and Regulations | Management's Internal Control Assessment | Independent Auditor's Internal Control Attestation Report |
|---|---|---|---|---|---|
| ABC Depository Institution | Holding Company Level | Holding Company Level | Holding Company Level | Holding Company Level | Holding Company Level |
| DEF Depository Institution | Holding Company Level | Institution Level | Institution Level | Institution Level | Institution Level |

If you have any questions regarding the annual report [or reports] of the Company's insured depository institution subsidiaries subject to Part 363 or if you need any further information, you may contact me at 987-654-3210.

BCD Holding Company

________________________________ Date:______________

[Insert officer's name and title.]

By order of the Board of Directors.

Dated at Washington, D. C., this __ day of  _________, 2009.

Federal Deposit Insurance Corporation,

Robert E. Feldman

Executive Secretary

(SEAL)