

Regulatory Bulletin

RB 32-25



Handbook: **Thrift Activities**

Subject: **External Audit**

Section: 350

Thrift Activities Regulatory Handbook Update

Summary: This bulletin provides an update to Thrift Activities Regulatory Handbook Section 350, External Audit. Please replace the existing handbook pages with the enclosed revised section.

For Further Information Contact: Your Office of Thrift Supervision (OTS) Regional Office or the Supervision Policy Division of the OTS, Washington, DC. You may access this bulletin at our web site: www.ots.treas.gov.

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SUMMARY OF CHANGES

OTS is issuing an update to Thrift Activities Handbook Section 350. We significantly revised “Review of Audit Work Papers” that begins on page 350.13 so we did not include change bars. We provide a summary of all substantive changes below.

350 External Audit

We changed the section “Review of Audit Work Papers” to place more emphasis on the review of external auditor work papers. We added specific examples of triggers that indicate situations when examiners and other OTS staff should review external auditor work papers.

We more fully discuss the purpose of reviewing external auditor work papers and the benefits gained from reviews.

—Scott M. Albinson

Managing Director, Supervision

INTRODUCTION

Accurate financial reporting is essential to an institution's safety and soundness. The board of directors and the audit committee are responsible for ensuring that their institution operates in a safe and sound manner. To achieve this goal and meet the safety and soundness guidelines implementing Section 39 of the Federal Deposit Insurance Act (FDI Act) (12 USCS 1831p-1) (see 12 CFR 510), the board of directors should ensure that their institution maintains effective internal controls (see Handbook Sections 340, Internal Control, and 355, Internal Audit).

Management is responsible for effectively managing the institution's risks and making sound business decisions. They should also ensure that the financial statements fairly report the savings association's financial condition, results of operations, and cash flows, and that the institution prepares its financial statements in accordance with generally accepted accounting principles (GAAP).

Savings institutions must provide accurate and timely Thrift Financial Reports by law (12 USC 1464(v)). These reports serve an important role in risk-focused supervision programs, by contributing to pre-examination planning, off-site monitoring programs, and assessments of an institution's capital adequacy and financial strength.

The OTS encourages all institutions to have an external audit. Some institutions must have an audit of the institution's financial statements by an independent public accountant (external auditor), or the OTS may require an audit of an institution's financial statements by an external auditor under certain circumstances. All audits of savings associations, regardless of size, must comply with the requirements outlined for management, the board of directors, and the external auditor in the FDICIA-required audit section below.

For institutions that do not have an external audit, other acceptable external auditing programs include:

- A balance sheet audit in accordance with generally accepted auditing standards (GAAS) by an external auditor.
- Attestation procedures that result in an external auditor's report on an institution's internal control over financial reporting (attestation report).
- Agreed-upon procedures or state-required examinations.

FDICIA-REQUIRED AUDIT**Audit of Savings Associations with \$500 Million or More of Total Assets**

Section 112 of the Federal Deposit Insurance Corporation Improvement Act (FDICIA) of 1991 and the Federal Deposit Insurance Corporation's (FDIC) implementing Regulation 12 CFR Part 363 requires savings associations with assets of \$500 million or more to obtain an audit of the financial statements by an independent public accountant.

Savings associations must comply with the provisions of the FDIC Regulation 12 CFR § 363.2, Annual Reporting Requirements. Savings associations should file the required reports with the FDIC and OTS (appropriate Regional OTS Office) in accordance with the provisions of this regulation.

Appendix B of this Section summarizes these provisions, and OTS audit requirements. Specific FDIC provisions in Appendix A of Part 363 are discussed below.

Management:

- Prepare a statement declaring its responsibility for the annual financial statements.
- Establish and maintain an adequate internal control and procedures for financial reporting.
- As of the end of the fiscal year, assess the effectiveness of the internal control and procedures for financial reporting.
- Assess the effectiveness of the internal control and procedures for compliance with federal laws and regulations relating to loans to insiders and dividend restrictions.

Board of Directors:

- Establish an audit committee consisting of outside directors who are independent of management. In no circumstances may an audit committee consist of less than a majority of outside directors. Exceptions to the independent membership requirement should be rare.
- Determine the duties of the audit committee that should, at a minimum, include reviewing the audit reports with the external auditor.

External Auditor:

- Attest to whether management's assertion about the effectiveness of the internal control over financial reporting is fairly stated.
- Participate in a peer review program that is acceptable to the FDIC.

In addition, the FDIC requires the following reports:

- A management report on internal controls (management internal control report).
- An external auditor's attestation report on management's assessment of the effectiveness of internal control over financial reporting in Accordance with Statements on Standards For Attestation Engagements (SSAE) No. 10, Attestation Standards: Revisions and Recodification (AT 101).

Information That Must Be Available to External Auditors

Section 931 of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), (12 USC § 1817(a)), requires FDIC-insured associations that engage the services of an external auditor to audit the association within the past two years to provide copies of the following reports:

- The most recent report of condition, that is, the OTS Thrift Financial Report.
- The association's most recent Report of Examination (ROE).

In addition, savings associations must provide the external auditor with the following information:

- A copy of any supervisory agreement or memorandum of understanding or written agreement between a federal or state banking agency and the association that is in effect during the period covered by the audit.
- A report of any formal action taken by a federal or state banking agency during such period, or any civil money penalty assessed with respect to the association or any association-affiliated party.

Regulatory personnel should determine if the association is in compliance with § 931 of FIRREA and report instances of noncompliance to the Regional Accountant.

Changes in Auditors

The FDIC requires the board of directors to provide a notice of termination or engagement of the external auditor (see 12 CFR §§ 363.2 and 363.4). In addition, the external auditor must provide the notice of termination (see 12 CFR § 363.3(c)) to the FDIC. OTS may request that the institution send notice to the appropriate supervisory office.

Work Paper Reviews

The FDIC's policy is to review the audit work papers of Part 363 institutions that have been as-

signed, or expect to be assigned, a composite CAMELS rating of 4 or 5. The FDIC will coordinate the review with the institution's supervisory agency. For additional information on work paper reviews, see the discussion under Regulatory Concerns in this Handbook Section.

Peer Review Reports

FDICIA requires that firms performing audits on institutions with assets in excess of \$500M enroll in a peer review program, and that each firm files a copy of its peer review report with the FDIC. In a peer review program, one accounting firm basically examines another firm's quality control for accounting and auditing practices on selected engagements and functional areas. This review encompasses the organizational structure of the policies adopted and the procedures established by a firm to provide it with reasonable assurance that it complies with professional standards.

The Chief Accountant's office obtains copies of the peer review reports from the FDIC, and maintains an updated database that it periodically distributes to the Regional Accountants. OTS will make copies of the reports available upon request. If any firm has significant deficiencies noted in its peer review report, OTS staff will notify the Regional Accountant for further action.

OTS-REQUIRED AUDIT

Audit of Savings Association Holding Companies with \$500 Million or More of Total Assets

Under 12 CFR § 562.4, OTS requires a savings association holding company to obtain an audit of the financial statements by an external auditor when the total assets of the consolidated savings association subsidiary(ies) are \$500 million or more. The holding company should comply with the reporting requirements at Item 21, Financial Statements in the H-(b)11 Annual Report.

Modification or Waiver

OTS may grant a savings association holding company's request for a modification or waiver of

the external audit requirement under any of the following circumstances:

- The savings association holding company engages in very limited activities other than control of subsidiary savings association(s) and it submits the subsidiary savings association's separate external audited financial statements.
- The accounting basis of the holding company makes consolidated financial statements or an external audit impractical.
- The external audit would represent an unusual and unreasonable regulatory burden.

The savings association holding company must make a written request for a waiver to OTS's Regional Director or designee. The request must describe the circumstances that the savings association holding company believes warrant the proposed modification or waiver.

Audit of Savings Associations That Receive a Composite CAMELS Rating of 3, 4, or 5

OTS requires savings associations, without regard to size, that receive a composite CAMELS rating of 3, 4, or 5, as of its most recent safety and soundness examination, to obtain an audit of its financial statements by an external auditor.

Required Reports

In addition to the audited financial statements, the savings association must submit:

- Any audit-related reports including, but not limited to, internal control reports from the external auditor that contain conclusions and recommendations related to the audit.
- Any other OTS-requested supplemental information, or schedules.

OTS accepts the audited consolidated financial statements of the savings association holding company in lieu of separate audited financial statements of the savings association.

Filing Requirements

If OTS requires a savings association to obtain an audit, it must forward three copies of the required reports to the Regional Director or designee within 90 days of the fiscal year-end, or within 15 days of receipt, whichever is earlier.

When a savings association with a composite CAMELS rating of 3, 4, or 5 has assets of \$500 million or more, it must file either the required savings association audit report, or the consolidated savings association holding company audit report, with both the FDIC and OTS. The filings should comply with FDIC Regulation Part 363 and FDIC guidelines at Appendix A to Part 363.

Waivers

A savings association may dispense with an audit if OTS determines that an audit is not the most effective means to address the safety and soundness concerns that caused the composite CAMELS rating of 3, 4, or 5. The waiver provision only applies to OTS required audits. It does not apply to audits required by public securities filing requirements, or § 112 of FDICIA and the FDIC implementing Regulation 12 CFR Part 363. The savings association must make a written request for a waiver to the OTS Regional Director or designee. The written request must include:

- The basis for the composite CAMELS rating of 3, 4, or 5, and the specific reasons why the savings association believes an audit would not address the source of the safety and soundness concerns in the most effective manner; and
- As an alternative, specify procedures and describe how they will address the source of the safety and soundness concerns identified by the examination; or
- Indicate the reasons why they consider an alternative to an audit as unnecessary.

OTS will respond to a timely request for an audit waiver from the savings association.

Safety and Soundness Considerations for Granting Waiver Requests

OTS may grant a savings association's request for a waiver of the external audit requirement if the CAMELS rating of 3, 4, or 5 is due to safety and soundness concerns that an external audit would not effectively address.

Safety and soundness concerns may include areas of supervisory judgment. Often the association cannot reduce these areas to objective criteria that can be audited effectively. Safety and soundness concerns may represent areas in which you have specialized knowledge and expertise; or the concerns may represent areas normally not included in the scope of an external audit.

Under such circumstances, you may consider requesting specific procedures to address these areas. You may also rely on your judgment about other procedures that will specifically address your supervisory concerns. Examples of these areas include the following circumstances:

- Adequacy of capital levels.
- Deficient credit underwriting policies and loan documentation that management is correcting.
- Low level of earnings or poor quality of earnings whose source the examiners investigated in a recent examination and management is correcting.
- Liquidity, interest rate risk, and other safety and soundness or compliance matters.

While recognizing the limits of an external audit, there are circumstances when pervasive safety and soundness concerns warrant an external audit. These include, but are not limited to the following concerns:

- Identified weakness in the internal audit function or the internal control structure and procedures for financial reporting.
- Lack of confidence in the board of directors or management with regard to integrity, ethical values, competence, operating philosophy, and

overall corporate governance exercised by the board.

- Questionable transactions with affiliates.

Case-by-Case Safety and Soundness Required Audit

OTS may require at any time, for any safety and soundness reasons identified by the Director, an independent audit of the financial statements of, or the application of procedures agreed-upon by OTS to, a savings association, savings association holding company, or affiliate by an external auditor.

Audit of De Novo Savings Associations

OTS generally requires an external audit as a condition of approval for de novo savings associations. The conditions of approval will describe the reporting and filing requirements.

Notification by OTS of Audit Requirement

When OTS requires an entity to obtain an external audit for reasons other than its CAMELS rating or size, OTS's Regional Director will notify, in writing, the savings association or savings association holding company.

Audit of Trust Activities

Audit requirements for institutions with permission to exercise fiduciary powers are in 12 CFR §§ 550.440 through 550.480. Those institutions should also refer to the Trust and Asset Management Regulatory Handbook for audit requirements, policies, and procedures.

OTS-REQUIRED AGREED-UPON PROCEDURES

OTS may require a savings association, savings association holding company, or affiliates to obtain the services of an external auditor to perform agreed-upon procedures to address certain aspects of an entity's operations, operations at outside servicers, adherence to specified laws, regulations, policies and accounting principles, or other specific concerns.

OTS may require an entity to obtain specified procedures, under any of the following conditions:

- When the examination process will not address supervisory concerns for the specified element, account, items of the financial statements, outside servicer, or other matters.
- When the specified procedures could supplement the examination process.
- When an external audit is not the most effective means to address the specified element, account, items of the financial statements or other matters of supervisory concern.
- When identified or suspected insider abuses exist.
- When there is identified or suspected defalcation.
- When there is identified or suspected criminal activity.
- When objective criteria exist for reasonably measuring compliance with specified laws, regulations, and policies.

Notification by the OTS

OTS's Regional Director, or designee, will notify the entity in writing, when we require it to engage the services of a qualified external auditor to perform agreed-upon procedures.

Required Procedures and Reports

Once you determine that agreed-upon procedures are an effective means to address the safety and soundness concerns, identify the specific elements, accounts, items of the financial statements, or other matters that the external auditor and the institution must address.

OTS generally requires the external auditor to perform the procedures. The external auditor must report in accordance with GAAS for attestation engagements. OTS may also provide such procedures directly, or develop procedures in consultation with the external auditor.

Filing Requirements

If OTS requires an entity to obtain agreed-upon procedures, the institution must forward three copies of the specified procedures report to the Regional Director, or designee, within 30 days of receipt of the report, or 30 days from the date of the procedures, whichever is less. The entity must also forward a copy of the signed engagement letter to the Regional Director, or designee, before the external auditor conducts fieldwork.

Auditor Requirements For Required Audit or Required Agreed-Upon Procedures

The external auditor or other qualified person who performs the audit or the agreed-upon procedures must meet the following minimum requirements at OTS Regulation § 562.4(d)(1), (2), (3), and (4):

- Be registered or licensed to practice as a public accountant, and maintain good standing, under the laws of the state or other political subdivision of the United States where the home office of the entity is located.
- Agree in the engagement letter to provide copies to OTS of any work papers, policies, and procedures relating to services performed pursuant to § 562.4. See Appendix D for a sample letter to request audit work papers.
- Comply with the American Institute of Certified Public Accountants (AICPA) Code of Professional Conduct, and meet the Securities and Exchange Commission's (SEC) independence requirements.
- Receive, or be enrolled in, a peer review. The OTS accepts the following peer review guidelines:
 - The external peer review should be generally consistent with AICPA standards.
 - An organization independent of the auditor or firm being reviewed should conduct the review.
 - The organization should conduct a review at least as frequently as is consistent with AICPA standards.

- The external peer review should include, if available, at least one audit of an insured depository institution or consolidated depository institution holding company. (The external auditor should make the peer review report available to the OTS upon request).
- The auditor or firm under review should take corrective action required under any qualified peer review report on a timely basis.

AUDITS REQUIRED BY SEC AND OTS FOR PUBLIC SECURITIES FILING PURPOSES

Holding companies of savings associations and subsidiaries of savings associations (service corporations and operating subsidiaries) that offer public securities must register and file appropriate documents with the SEC. If a savings association, rather than a holding company or subsidiaries, lists securities on a stock exchange and has more than 500 stockholders, it must register the securities, and file its reporting documents, with OTS under Section 12 of the Securities Exchange Act of 1934 ('34 Act). Section 12(i) of the '34 Act assigns the reporting functions to OTS for thrift securities and grants OTS the power to make rules and regulations to execute these functions. Section 3(a)(5) (15 USC § 77c(a)(5)) of the Securities Act of 1933 ('33 Act) exempts thrift securities from registration with the SEC under the '33 Act. The rules and regulations for public offerings of a savings association are in 12 CFR Part 563g.

Regulations under 12 CFR Part 563c establish the qualifications and independence requirements for an external auditor engaged to perform services for companies with a class of securities registered pursuant to the Securities Exchange Act of 1934. The qualifications and independence requirements in 12 CFR Part 563c are generally consistent to those issued by the SEC.

To perform these services, the external auditor should be registered and in good standing under the laws of the place of his or her residence or principal office. Neither the external auditor nor the associated auditing firm should have acquired,

or have a commitment to acquire, any direct financial interest or any material indirect financial interest in the company. In addition, neither should be connected to the company as a promoter, underwriter, voting trustee, officer, or employee. At least annually, the external auditor should disclose to the audit committee in writing the relationship between the auditor and its related entities that, in the auditor's professional judgment, may reasonably bear on independence. The external auditor should further state that he or she is independent of the company, as well as discuss independence with the audit committee.

If the institution produces interim financial reports, the external auditor must review the financial statements prior to inclusion in the quarterly 10-Q reports using procedures in Statement on Auditing Standards (SAS) No. 71, *Interim Financial Information*. SAS No. 71, as amended by SAS No. 90, requires the external auditor to discuss the quality of the institution's accounting principles with the audit committee before filing the information. The auditor can limit the quarterly discussion to the impact of significant events, transactions, and changes in accounting estimates the auditor considered in performing the review procedures.

The audit committee has several responsibilities with regard to the external audit for public filing savings associations. For listed companies with a market capitalization above \$200 million, the audit committee, as part of proxy and information statements for meetings at which directors are elected, must report whether the audit committee performed the following functions:

- Reviewed and discussed audited financial statements with management.
- Communicated with the company's external auditor any matters required to be discussed under SAS No. 61, *Communications with Audit Committees*. SAS No. 61, as amended by SAS Nos. 89 and 90, requires the external auditor to discuss the "quality, not just the acceptability" of a company's accounting principles with the audit committee. The discussion must be "open and frank, and generally should include such matters as the consistency of the entity's accounting policies

and their application, and the clarity and completeness of the entity's financial statements, which include related disclosures."

- Received the written disclosures and the letter from the external auditor, and discussed the external auditor's independence with the external auditor.
- Recommended to the board of directors that the company's annual report or Form 10K include the audited financial statements.

Savings associations must include certain information about their audit committee in a proxy statement (Schedule A, Item 7). If the registered savings association has an audit committee, the proxy statement should provide the following items:

- Audit committee information required under SEC regulation 17 CFR Part 229.306 (Regulation S-K, Audit Committee Report).
- Board of director adoption of a written charter for the audit committee. The charter should specify the following:
 - The scope of the audit committee's responsibilities, and how it carries out its responsibilities.
 - That the external auditor is ultimately accountable to the board of directors and the audit committee.
 - That the board of directors and audit committee has the authority and responsibility to select, evaluate, and replace the external auditor.
 - A copy of the written charter, if any, as an appendix to the proxy statement at least once every three years.

If there is no audit committee, the names of the board committee performing the equivalent functions or the names of the entire board must appear.

The NYSE, AMEX, and NASD require listed companies to disclose whether audit committee members are independent. Under their rules, if a

member is not independent, then the institution should disclose the nature of the relationship that makes the member not independent, and list the reasons for the board's determination. Even if not listed on one of the above exchanges, the institution should disclose whether audit committee members are independent. In 2000, the above exchanges expanded their definition of independence for audit committee members. In general, membership is precluded from the audit committee if any of the following apply to the individual:

- Is currently employed with the company or an affiliate.
- Is currently employed, or has held employment in the past three years, with the current parent of predecessor company.
- Is currently, or within the past three years, has been a member of the immediate family of a current executive officer of the company or an affiliate.
- Is currently an executive of another business organization where any of the company's executives serve on the organization's compensation committee.
- Is currently a partner, controlling shareholder, or executive officer of a business organization that has a business relationship with the company.
- Currently has a direct business relationship with the company.

These rules also require that at least three audit committee members, each of whom must be, or become, "financially literate," include one member with accounting or financial expertise. To be financially literate, the member should be able to read and understand financial statements, including a balance sheet, income statement, and cash flow statement.

VOLUNTARY EXTERNAL AUDITING PROGRAMS

Audit of Savings Associations with Less Than \$500 Million of Total Assets

Audit Committees

To ensure the adequacy of its internal and external auditing programs, OTS encourages the board of directors of each institution that is not otherwise required to do so to establish an audit committee consisting entirely of outside directors. If this is impracticable, the board should organize the audit committee so that outside directors constitute a majority of the membership.

The audit committee's duties may include reviewing the independence of the external auditor annually, reviewing and approving the annual audit plans and external audit engagement, consulting with management, overseeing performance and setting expectations for the roles of both internal and external audits, seeking an opinion on an accounting issue, and overseeing the quarterly regulatory reporting process.

The audit committee may become involved in emerging issues, key business decisions, ventures, and associated risks. It may also maintain dialog with regulators. The audit committee should report periodically to the full board of directors.

At least annually, the board or audit committee should review the institution's activities that present significant financial reporting risks. The board or audit committee should consider the potential benefits of an audit of the institution's financial statements or the institution's internal control over financial reporting, or both. They should also consider additional procedures for a particular year or several years to cover areas of particularly high risk or special concern. The board should record their reasons supporting their decisions in the minutes.

Based on its review, the board should select an external auditing program that is appropriate for the institution considering its risks, size, and the nature, scope, and complexity of its activities. As an important component of an institution's overall

risk management process, an external auditing program, as discussed in this Section, represents procedures performed, generally by an external auditor, to test and evaluate high-risk areas of an institution's business. The procedures should be sufficient for the external auditor to express an opinion on the financial statements or to report on the results of the procedures performed.

Types of External Auditing Programs for Voluntary Audits

OTS encourages all OTS-regulated institutions to have a full-scope financial statement audit. In lieu of a full-scope financial statement audit, institutions not required to have an audit may elect a balance sheet audit or an attestation report on internal control assertions as the external auditing program. The external auditor performs these types of external auditing programs. Agreed-upon procedures or state-required examinations are also acceptable.

Financial Statement Audit

In a financial statement audit, the external auditor expresses an opinion on the fairness with which the financial statements present, in all material respects, the financial position, results of operations, and cash flows, in conformity with GAAP. The auditor will also state if the audit was in accordance with GAAS. The auditor identifies those circumstances in which the institution did not consistently observe GAAP in the preparation of the financial statements for the current period, and should obtain reasonable assurance that material misstatements are detected.

Balance Sheet Audit

As an alternative, the external auditor may perform a balance sheet audit. A balance sheet audit is an audit of an institution's balance sheet and any accompanying footnotes. The external auditor performs the balance sheet audit in accordance with GAAS. It should be of sufficient scope to enable the auditor to express an opinion on the fairness of the balance sheet presentation in accordance with GAAP.

Attestation Engagement

Another alternative is an attestation engagement. In an attestation engagement, management evaluates and documents its review of the effectiveness of the institution's internal control over financial reporting in the identified risk areas as of a specific report date. Management should prepare a written assertion that specifies the criteria management used to evaluate the effectiveness of the institution's internal control for financial reporting in the identified risk areas. The written assertion should state management's opinion on the effectiveness of internal control for this specified financial reporting. Under SSAE No. 10, if management refuses to provide the external auditor with a written assertion, the auditor should include a reference to a scope limitation, and accordingly, modify his or her engagement report.

In an attestation engagement, the external auditor performs tests on the internal controls of the specified financial reporting in order to attest to management's assertion. If the external auditor concurs with management's assertion, even if the assertion discloses one or more instances of material internal control weakness, the auditor provides a report attesting to management's assertions.

Agreed-Upon Procedures

Agreed-upon procedures are procedures specified by the institution and the external auditor or other qualified person to test activities in certain areas. For state-required examinations, states may specify the procedures and require institutions to have these procedures performed annually by their directors or other independent persons.

Agreed-upon procedures do not involve reporting on the fairness of the institution's financial statements or attesting to the effectiveness of internal control over financial reporting. The external auditor or other qualified person presents the procedures and the findings or results of the procedures to the board or the audit committee so that they may draw their own conclusions regarding work performed.

The board of directors should consider whether an external auditor or other qualified person should

perform the agreed-upon procedures or the procedures required for the state examination. If performed by an external auditor, the auditor must conduct the work under, and may be held accountable for departures from, professional standards. However, agreed-upon procedures engagements require different professional standards than those used for an audit of an institution's financial statements or its balance sheet.

OTS expects institutions that historically have had an audit of their financial statements by an external auditor or other type of external auditing program to continue to do so. For those that have another type of external auditing program, OTS expects them to continue to have the same, or a more extensive, external auditing program in the future.

Requested Reports For Voluntary External Auditing Programs

OTS requests that all savings associations and savings association holding companies that voluntarily obtain an audit of the financial statements, or have some other type of external auditing program performed, file any and all audit-related reports with the appropriate regional office.

OTS also requests that all institutions notify the appropriate supervisory office when they initially engage an external auditor, or when they change or terminate the services of their auditor. See Appendix C, Interagency Policy Statement on External Auditing Programs of Banks and Savings Associations.

The preferable time for an institution to schedule the performance of an external auditing program is as of an institution's fiscal year-end. However, any quarter-end date that coincides with a regulatory report date provides similar benefits.

Generally, check whether the institution has filed its external auditing reports with its supervisory office. If not, you should request a copy of the most recent reports during the periodic safety and soundness examination.

Auditor Selection

OTS requires that an external auditor who meets the minimum requirements described in 12 CFR § 562.4(d)(1), (2), and (3) for required audits conduct the voluntary audit of the financial statements. If an institution chooses a balance sheet audit or attestation engagement as its external auditing program, an external auditor who meets the minimum 12 CFR § 562.4(d)(1), (2), and (3) requirements should also perform these programs. Unlike required audits, the regulations do not require auditors performing voluntary audits to receive, or be enrolled, in a peer review.

Preferably, an external auditor will also perform agreed-upon procedures or procedures for a state-required examination. The external audit firm or other qualified persons selected to conduct an external auditing program and their staff carrying out the work should have experience with financial institution accounting and auditing, or similar expertise, and should be knowledgeable about relevant laws and regulations.

Review of Voluntary External Auditing Programs

In your review of voluntary external auditing programs, you should consider the following factors:

- An institution's size.
- The nature, scope, and complexity of its business activities.
- Its risk profile.
- Actions taken to remedy identified weaknesses.
- The extent of its internal audit program.
- Compensating controls.

You should exercise judgment and discretion in evaluating the adequacy of an institution's external auditing program. Reports from voluntary external audits and external auditing programs should receive the same level and type of review as those submitted pursuant to FDICIA-required and OTS-required audits.

AUDIT OF FINANCIAL STATEMENTS BY AN EXTERNAL AUDITOR (AUDIT)

Objective of Financial Accounting

The fundamental objective of financial accounting is to provide reliable financial information about economic resources and obligations of a business enterprise.

Objective of an Audit

Similar to the objective of financial accounting, the fundamental objective of an audit conducted in accordance with GAAS is to determine whether the financial statements fairly present, in all material respects, the financial position, results of operations, and cash flows of the institution in accordance with GAAP.

The audit should provide reasonable assurance that the financial statements are free of material misstatements, whether caused by error or fraud. Informative disclosures in the financial statements must follow GAAP, or the report must state otherwise.

Audit Standards

External auditors should follow the AICPA Code of Professional Ethics. It requires that auditors perform external audits according to GAAS. GAAS, as distinct from accounting standards, are concerned not only with the auditor's professional qualifications, but also the judgment the auditor exercises in the performance of an audit and with the quality of the audit procedures. There are three categories of GAAS:

- General standards.
- Fieldwork standards.
- Reporting standards.

The general standards require that the person, or persons, who performs the audit meet the following professional qualifications:

- Possess adequate technical training and proficiency.

- Maintain independence in mental attitude.
- Exercise due professional care in the performance of the audit and the preparation of the report.

Fieldwork standards include the following requirements:

- Adequately planned work.
- Properly supervised assistants, if any.
- Proper study and evaluation of existing internal controls to determine audit scope, audit procedures, and the extent of testing.
- Sufficient evidence to formulate an opinion on the financial statements under audit.

Reporting standards require that the external auditor state whether the institution presents its financial statements in accordance with GAAP.

Limitations of Audits and Audited Financial Statements

Although auditing standards require the use of due care and professional skepticism, a properly designed and executed audit does not guarantee that the audit will detect all misstatements of amounts or omissions of disclosures in the financial statements. Moreover, an external audit is not designed or executed for regulatory purposes, and thus, does not guarantee that the auditor addressed OTS safety and soundness considerations. You should be cognizant of these and other limits inherent in an audit. The following examples illustrate some common limitations of audits:

- The auditor is not responsible for deciding whether an institution operates wisely. An unqualified audit report means that the association reports transactions and balances in accordance with GAAP. It does not mean that the transactions make business sense, that the association manages associated risks in a safe and sound manner, or that the association can recover balances upon disposition or liquidation.

- The auditor attempts to understand financial reporting internal controls sufficient enough to plan the audit, and determine the nature, timing, and extent of tests to perform. This does not mean that the external auditor extensively reviews controls over all areas. The external auditor may use various levels of testing depending on the risk of a specific area.
- The auditor's report states that the financial statements present fairly the financial position. This means that, given evidence and current environment, the association can recover reported assets in the normal course of business. It does not mean that underwriting standards, operating strategy, loan monitoring systems, and workout procedures are adequate to mitigate losses if the environment changes.
- GAAP financial statements offer only limited disclosures of risks and uncertainties, and other safety and soundness factors on which an institution's viability depends.

REGULATORY CONCERNS

The following documents are part of the supervisory process for monitoring savings associations:

- Audited financial statements along with the external auditor's report.
- External auditor's attestation report on internal control report over financial reporting, if applicable.
- External auditor's management letter.

When OTS or the FDIC requires an external audit, the audit must be completed on a timely basis. The regional office is responsible for determining that each association files a required audit report on a timely basis. The regional office should date stamp the required audit report upon receipt.

For required external audits, OTS policy requires savings associations to submit copies of the audit report, attestation report on internal control over financial reporting, and any other audit-related reports to the regional office. The regional office must maintain one complete set in the supervisory files (supervisory file copy) attached to the com-

pleted Audit-Related Report Checklist found in Appendix A of this Handbook Section. You should receive another set (examination file copy) with a copy of the appropriate checklists.

For all types of audits, required or otherwise, Regional staff should consider maintaining a tracking system of external audits by savings associations, which would include the name of the auditor, and various other information.

When OTS or FDIC requires an audit examination, examination managers are responsible for the review and timely follow-up of the various audit reports and correspondence. They should review audit reports, financial statements, reports on internal control and other audit-related reports within 90 days of receipt. Examination managers should add any items of supervisory interest to the supervisory concerns, objectives, and strategies section of the regulatory profile. Based on this review, the examination manager should take the following steps:

- Set out the timing and nature of any required follow-up as indicated on the checklist.
- Update the activity agenda section of the regulatory profile to reflect any planned actions resulting from the review.
- Consult the Regional Accountant when the follow-up includes issues about GAAP, GAAS, or enforcement matters.

OTS will generally reject, as unsatisfactory, a report of audit disclaiming an opinion on the audited financial statement, unless the reason for the disclaimer is beyond the control of the association or the Regional Accountant approves it.

The regional office is also responsible for requesting external auditing program reports from institutions not required by regulation or otherwise to have an external auditing program.

Chapter 18 of the AICPA Audit and Accounting Guide, Audits of Banks and Savings Institutions (May 1, 2000), and AICPA Statement of Auditing Standards No. 58 describe the standard types of audit reports. The Regional Accountant maintains copies of these materials.

Audit Requirements

Reports from voluntary external audits and external auditing programs should receive the same level and type of review as those submitted pursuant to FDICIA-required and OTS-required audits.

Independence of External Auditor

The audit committee should hire and terminate the external auditor. To maintain independence from management, the external auditor ideally reports to the outside directors of the board. You should question the independence and objectivity of the external auditor when the auditor appears to be reporting to management, appears to be an advocate for management, or generally appears to be working more for management than the board of directors.

Instances in which you should question independence include but are not limited to the following examples:

- Management approves the external auditor's presentations to the board
- Management prevents the external auditor from meeting with the board unless management was present
- The board of directors appears to lack the sophistication to understand or appropriately discuss audit or accounting issues with the external auditor
- The auditing staff does not have unrestricted access to the board or audit committee without management knowledge or approval.

Under these circumstances, you may decide to test the independence of the auditor through reviews of loan listings, contracts, stockholder listings, and other appropriate measures.

See also AICPA Interpretation (101-13) and rulings (101, 103, 104, and 105) regarding independence standards.

You should refer any concerns about independence to the Regional Accountant. The Regional

Accountant may consult with the Chief Accountant.

Review of External Audit Work Papers

Purpose and Benefits

The purpose of reviewing external audit work papers is to gain insight into the scope of the external auditor's work and assessment of the financial condition of the institution. To assess the financial condition of the institution, the external auditor performs procedures that evaluate the reliability of financial statement assertions based on GAAS. A review of the external audit work papers and conversations with the external auditor should provide you insight into the following areas:

- The complexity of an institution's transactions.
- The extent of an institution's transactions that are assumption driven.
- The scope, extent, and depth of the external auditor's external audit work.
- The material weaknesses and reportable conditions regarding an institution's internal control and financial reporting practices.
- The accuracy and completeness of Thrift Financial Report (TFR) information.
- The reliability of the institution's assertions made in the TFR.

A review of the external audit work papers should assist you in the following activities:

- Performing financial analyses of the institution.
- Identifying areas of concern or accounting complexity. For example, the audit work papers may document management's reasons for an aggressive accounting practice. After the review, you should understand management's rationale, and assess whether a less aggressive accounting practice is more appropriate from a safety and soundness standpoint.

- Detecting trends and information not otherwise revealed in the monitoring process.
- Determining the scope of the examination:
 - You may reduce the scope of the examination in certain areas based on the extent, scope, and findings of the external audit work.
 - You may expand the examination scope in certain high-risk areas based on the external audit work.
 - You may expand the scope in certain areas based on the external auditor's findings that disclose matters of supervisory concern.
- Evaluating the institution's internal control over financial reporting. If an association has serious internal control weaknesses or deficiencies, you should discuss the full extent of such problems with the external auditor to determine whether you should expand the scope of the examination.
- Identifying areas where external audit work can supplement examination procedures.
- Identifying external audit work that provides insight into certain financial statement assertions, or that is sufficient to enable you to limit certain examination procedures. For example, the external audit work papers may document management's methodology for assessing the appropriate level of allowance for loan and lease losses or valuation estimates, including the assumptions and methodologies used to value servicing and residual assets. The external audit work papers should document the specific audit procedures performed to test and analyze those estimates. After the review, you should understand management's approach and any exposure areas. If the findings are acceptable for safety and soundness purposes, you may use the information to plan and supplement the examination procedures in this area.

Other benefits realized from external audit work paper reviews are:

- Discovering policy and procedures, or transactions and balances, subject to additional examination procedures.
- Developing an understanding of the external auditor's risk assessment process.
- Developing an understanding of management's support for certain transactions and balances.
- Improving examination focus. You may find that you can concentrate on high-risk areas and de-emphasize areas that have been adequately covered by the audit.

There are certain situations that may necessitate requesting the external audit work papers for review. Situations that might trigger an external audit work paper review include the following examples:

- The institution holds assets and liabilities subject to significant management judgment regarding valuation. Examples include the following assets and liabilities:
 - High-risk loans.
 - Repossessed assets.
 - Debt securities with significant credit loss concerns.
 - Servicing assets, if material.
 - Residual interests from securitizations, in which the carrying value is not readily determined by market quotes.
 - Significant potential losses from litigation.
 - Other off-balance sheet activities.
- New or outstanding securitization activities including private-label securitizations and other complex transactions.
- Material loan amounts serviced by others.
- Significant balances or changes in Other Assets or Other Liabilities.
- Significant business plan changes that affect organizational goals, including new or growing business lines.

- Recent acquisition or disposition transactions, including purchase business combinations.
- Institutions with significant goodwill and other intangible assets.
- Problematic computer processing that reinforces the need for general ledger account reconciliation.
- Large number of adjusting journal entries and/or significant balance sheet changes that would affect general ledger account reconciliation.
- Reported earnings or other financial measures substantially better than peer group.
- Institutions engaging in aggressive income recognition.
- Strained relationship between management and/or the board of directors and the external audit firm.
- Significant changes in the external audit program including recent unexplained or sudden change in external audit firm.
- Recent unexplained delays in issuance of audited financial statements.
- Issues regarding independence, objectivity, or competence of the external auditor.
- Accounting or internal audit staff that is inadequate in relation to the size, nature, complexity, and scope of activities of the institution.
- Recent or significant turnover in accounting or internal audit staff.
- Significant transactions with owners (parent company or stockholders), affiliates, Special Purpose Entities, or other related parties.
- Significant changes in Due To/Due From accounts.
- History of late TFR filings or TFR amendments.
- Significant safety and soundness concerns.

- Large unexplained reserves, suspense accounts, or large tax reserves.

If external audit work papers exist for lower-risk areas, such as confirming loans, and they appear accurate and reliable, you may use them to avoid duplicating efforts to gain the same or similar information. However, when you use external audit work papers in lieu of performing the actual work yourself, you are placing reliance on a work product not necessarily designed for regulatory purposes. In high-risk areas where the external audit work appears reliable, the work papers may be used to design and supplement examination procedures accordingly.

Coordination with Regional Accountant

After reviewing work papers, refer any of the following concerns to the Regional Accountant:

- Regulatory reporting issues.
- The need for expanded verification procedures.
- Questions about the application of GAAP, GAAS or Statements on Standards for Attestation Engagements (SSAE).
- Unacceptable diversity in practices.¹
- Deficiencies, in general.

The Regional Accountant will assist you in choosing a course of action, which may be to discuss the issue with the auditor in an attempt to resolve it. In addition, the Regional Accountant may consult with other appropriate divisions, such as the Chief Accountant, Enforcement, and/or Compliance.

Obtaining External Audit Work Papers

OTS policy requires that the auditor agree in the engagement letter to provide access to and copies of any work papers, policies and procedures related to services performed. (12 CFR § 562.4(d)(2)).

¹ Industry practice may have moved from the acceptable range of GAAP to outside of the range.

If possible, the field manager or the assigned EIC should evaluate the need to review external audit work papers prior to the beginning of the exam. If the institution is known to have activities that trigger a review of external audit work papers, the field manager or EIC should make arrangements for the work papers to be available as soon as possible. This will facilitate using the results to tailor the scope of the examination review.

The request for access to the audit work papers should be in writing and addressed to the external auditor with coordination through the Regional Accountant. While the Regional Accountant need not participate in the audit work paper review, he or she will act as the liaison and participate if necessary. There are instances when the Regional Accountant does not necessarily need to get involved. These would include routine reviews where significant accounting issues are not expected. However, there are times when the Regional Accountant should be actively involved. For example, include the Regional Accountant when reviews involve the implementation of a significant new accounting pronouncement.

Auditors are generally cooperative, as they are interested in assessing the effect of examination concerns on the financial statements. The review of audit work papers and the discussion of significant items and complex transactions with the external auditors can help you assess whether the financial reporting is safe and sound.

The auditor may request that you “acknowledge” certain representations and conditions set forth in a letter from the auditing firm before allowing you access to or releasing to you copies of the work papers. It is not unreasonable for the auditor to request that you acknowledge receipt of documents. This is a common business practice and their proof of compliance with your request. OTS policy allows you to sign a document only to acknowledge receipt of an accounting firm’s letter and any copies of work papers,² policies, and procedures delivered with such letter. However, any

² When OTS requests copies of external audit work papers, the audit firm personnel generally make the photocopies for you. This allows the audit firm to maintain control over the work papers. When you have questions, call your Regional Accountant.

attempt by an auditor to impose conditions, agreements, or understandings on you or OTS is contrary to the auditor’s agreement in the engagement letter. Therefore, do not sign any document that implies that OTS has agreed to any conditions in the letter.

Notify the Regional Accountant if any external auditor seeks to avoid inclusion of the required agreement in the engagement letter under OTS Regulation 12 CFR 562.4(d)(2), or to evade, or impose conditions, on the obligation to provide OTS access to or copies of work papers, policies, and procedures relating to services performed. We provide a sample copy of a letter to request work papers in Appendix D and an acknowledgement letter in Appendix E.

In limited circumstances, a subpoena may be necessary to gain access to the external audit work papers. In these cases, the examination staff and the Regional Accountant will contact Regional Enforcement and arrange for the subpoena. In these cases, you will provide written findings to the Regional Director.

FDIC Policy for Audit Work Paper Review

The FDIC issued guidance stating that it will review audit work papers for each insured institution subject to Part 363 that has been assigned, or expects to be assigned, a CAMELS rating of 4 or 5. In each case, the FDIC will contact the institution’s primary federal regulator to arrange, if possible, a joint review of the work papers. When a savings association is an OTS-supervised institution, the FDIC indicates that it will contact the appropriate OTS supervisory office to determine in what manner, and which agency should notify the institution of the upcoming review. After the OTS supervisory office and the FDIC make that determination, one agency will inform the institution in advance that the agencies are contacting the auditor to request audit work papers. One agency will also notify the holding company.

Communications with Auditors

When conducting an audit of the financial statements of a savings association, the external auditor can consider, in accordance with GAAS,

the regulatory authorities as a source of competent evidential matter. Accordingly, the external auditor may review communications from, and make inquiries of, the regulatory authorities. We encourage savings associations and their auditors to confer with OTS when they consider it appropriate. Such contacts may include meetings with you to assist in planning audits, or auditors may attend examination planning, interim, and exit conferences with association management and examiners. They may also attend other meetings between management or the board of directors (or a committee thereof) and examination personnel when you consider it appropriate.

You should provide associations with advance notice of the starting and completion dates of examinations so management can coordinate the audit fieldwork with the examination. Management should inform auditors in advance of scheduled examinations and meetings.

When requested by the association and the auditor, the examination manager may communicate examination findings prior to the completion of the examination. We encourage the examination manager to comply with such requests. This fosters better communications and improves the quality of financial reports. We also encourage you to communicate with auditors in the field after notifying the examination manager. You should communicate to the auditor all supervisory concerns and information except those involving confidential enforcement actions, such as imminent conservatorships or receiverships. As a general guideline, you should communicate interim examination findings whenever the following occurs:

- The examination process results in substantiated findings that significantly affect the financial information reported by the association.
- The association is about to report quarterly or annual financial information to the OTS or other outside parties, such as shareholders or the general public.

Obviously, under such circumstances, prompt communication is important. Material examination adjustments made shortly after an association

issues a financial statement can cause significant public disclosure and securities problems.

The regional office should make examination work papers available to external auditors upon request. If you have not issued the ROE, stamp any copies of work papers provided to the external auditor as "DRAFT." To access work papers, the external auditor must make the request in writing to the examination manager. The examination manager may decline requests for good cause but such denials should be unusual. A reasonable denial would include the following situations:

- Specific work papers requested contain confidential litigation matters such as criminal referrals.
- Litigation against the auditor is pending or contemplated.

Finally, to obtain access to work papers, the auditor must sign a statement of consent to the Prohibition of Disclosure or Release notice.

Prohibition of Disclosure or Release

The report of examination, regulatory correspondence, and examination work papers are the property of OTS. OTS makes documents available to the independent audit firm for its confidential use relating to its audit of the savings association engaging the audit firm. Neither the audit firm nor any of its employees may disclose or make these documents, or any portion of them, public in any manner.

If an external auditor receives a subpoena or any legal process calling for the production of any OTS documents held by the auditor, the auditor must notify the Regional Director immediately. You should advise the attorney and, if necessary, the court of the above prohibition and refer them to § 510.5 of the OTS regulations.

REFERENCES

Code of Federal Regulations (12 CFR)*FDIC Regulations*

Part 363 Annual Independent Audits and Reporting Requirements

OTS Regulations

Part 510 Miscellaneous Organizational Regulations

§ 562.4 Audit of Savings Associations and Savings Association Holding Companies

§ 563.170(a) Examinations and Audits

§ 563.180 Suspicious Activity Reports and Other Reports and Statements

Part 563c Accounting Requirements

United States Code (12 USC)

§ 1817(a) Report to Independent Auditor

FFIEC Guidance

Interagency Policy Statement on External Auditing Programs of Banks and Savings Associations (September 22, 1999)

American Institute of Certified Public Accountants (AICPA)*Statement on Auditing Standards (SAS)*

No. 54 Illegal Acts by Clients (AU 317)

No. 55 Consideration of Internal Control in a Financial Statement Audit (AU 319)

No. 58 Reports on Audited Financial Statements (AU 508)

No. 60 Communication of Internal Control Structure Related Matters Noted in an Audit (AU 325)

No. 61 Communication With Audit Committees (AU 380)

No. 69 The Meaning of Present Fairly in Conformity with Generally Ac-

cepted Accounting Principles in the Independent Auditor's Report (AU 411)

No. 70 Reports on the Processing of Transactions by Service Organizations (AU 324)

No. 71 Interim Financial Information (AU 722)

No. 79 Amendment to Statement on Auditing Standards No. 58, Reports on Audited Financial Statements (AU 508)

No. 82 Consideration of Fraud in a Financial Statement Audit (AU 316)

No. 89 Audit Adjustments (AU 420)

No. 90 Audit Committee Communications (AU 380)

No. 93 Omnibus Statement on Auditing Standards (AU 315)

No. 94 The Effect of Information Technology on the Auditor's Consideration of Internal Control in a Financial Statement Audit (AU 319)

No. 96 Audit Documentation

Statement on Standards for Attestation Engagements (SSAE)

No. 2 Reporting on an Entity's Internal Control Structure Over Financial Reporting (AT 400)

No. 3 Compliance Attestation (AT 500)

No. 4 Agreed-Upon Procedures Engagement (AT 600)

No. 6 Reporting on an Entity's Internal Control Over Financial Reporting: An Amendment to Statement on Standards for Attestation Engagements No. 2 (AT 400)

No. 9 Amendments to Statement on Standards for Attestation Engagements Nos. 1, 2, and 3 (AT 100, 400, and 500)

No. 10 Attestation Standards: Revision and Recodification (AT 101), supercedes SSAE Nos. 1 through 9

AICPA Code of Professional Conduct (ET)

Sec. 100 Independence, Integrity, and Objectivity

Sec. 100.15 Extended Audit Services (101-13)

Sec. 191 Ethics Rulings on Independence, Integrity, and Objectivity

Sec. 191.206 Member Providing Attest Report on Internal Controls (103)

Sec. 191.208 Member Providing Operational Auditing Services (104)

Sec. 191.210 Frequency of Performance of Extended Audit Procedures (105)