October 11, 2007

TO: The Board of Directors

FROM: Sandra L. Thompson
Director, Division of Supervision and Consumer Protection

SUBJECT: Proposed Amendments to Annual Audit and Reporting Requirements (Part 363) and Related Technical Amendment (Part 308, Subpart U)

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 designated laws and regulations, the establishment of independent audit committees, and related reporting requirements. The asset-size threshold for internal control assessments is $1 billion and the threshold for the other requirements 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 staff is proposing to amend Part 363 of the FDIC's 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.

The most significant revisions included in the proposed amendments to Part 363 would:

- Require 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;
- Extend the time period for a non-public institution to file its Part 363 Annual Report by 30 days and replace the 30-day extensions of the filing deadline that may be granted if an institution (public or non-public) is confronted with extraordinary circumstances beyond its reasonable control with a late filing notification requirement that would have general applicability;
- Provide relief from the annual reporting requirements for institutions that are merged out of existence before the filing deadline;

Concur:

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Sara A. Kelsey
General Counsel

- Provide relief from reporting on internal control over financial reporting for businesses acquired during the fiscal year;
- Require management's assessment of compliance with designated safety and soundness laws and regulations to state management's conclusion regarding compliance and disclose any noncompliance with such laws and regulations;
- Clarify the independence standards with which independent public accountants must comply and enhance the enforceability of compliance with these standards;
- Specify that the duties of the audit committee include the appointment, compensation, and oversight of the independent public accountant;
- Require audit committees to ensure that audit engagement letters do not contain unsafe and unsound limitation of liability provisions and require institutions to file copies of these letters;
- Require certain communications by independent public accountants to audit committees and establish retention requirements for audit working papers;
- 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;
- 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 comply with Part 363 at the holding company level; and
- Provide illustrative management reports to assist institutions in complying with the annual reporting requirements.

The FDIC staff is also proposing a minor technical change to its rules and procedures for the removal, suspension, or debarment of accountants and accounting firms from performing audit services required by Section 36 of the FDI Act (Part 308, Subpart U). This change would identify the specific FDIC location where an accountant or accounting firm should file required notices of orders and actions.

DISCUSSION

Section 112 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) added Section 36, "Early Identification of Needed Improvements in Financial Management," to the FDI Act (12 U.S.C. 1831m). Section 36 is generally intended to facilitate early identification of problems in financial management at insured depository institutions above a certain asset size threshold through annual independent audits, assessments of the effectiveness of internal control over financial reporting and compliance with designated laws and regulations, and related reporting requirements. Section 36 also includes requirements for audit committees at these insured depository institutions. 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 staff has performed the required consultation.

Part 363 of the FDIC's regulations (12 CFR Part 363) implements Section 36 of the FDI Act. Until the FDIC Board amended Part 363 in November 2005, each insured depository institution with $500 million or more in total assets (covered institution) was required to submit to the FDIC and other appropriate federal and state supervisory agencies an annual report comprised of

audited financial statements and a management report containing a statement of management's responsibilities, assessments by management of the effectiveness of internal control over financial reporting and compliance with designated laws and regulations, and an auditor's attestation report on internal control over financial reporting. In addition, Part 363 provided that each covered institution must establish an independent audit committee of its board of directors comprised of outside directors who are independent of management of the institution. If certain conditions are met, these audit, reporting, and audit committee requirements can be satisfied by a covered institution's parent holding company rather than by the institution itself. 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.

The November 2005 amendments to Part 363 raised the asset-size threshold from $500 million to $1 billion for the assessments of internal control over financial reporting by management and the independent public accountant. All of the other audit and reporting requirements of Part 363 continued to apply to all institutions with $500 million or more in total assets. Also, for covered institutions with between $500 million and $1 billion in total assets, the amendments required only a majority, rather than all, of the members of the audit committee, who must be outside directors, to be independent of management. At present, approximately 1,300 of the more than 8,600 insured institutions have $500 million or more in total assets and are therefore subject to Part 363. These covered institutions hold approximately 91 percent of the assets of insured institutions. Covered institutions with $1 billion or more in total assets number approximately 650 and hold 88 percent of the industry's assets.

When it amended Part 363 in November 2005, the FDIC noted that it had identified other aspects of Part 363 that may warrant revision in light of changes in the industry and the passage of the Sarbanes-Oxley Act of 2002. The proposed amendments discussed herein address these previously identified aspects of Part 363. The proposed amendments would not change the asset-size thresholds currently contained in Part 363. In addition, for those covered institutions that are public companies, the proposed amendments to Part 363 would not affect their obligations to comply with the federal securities laws, including SOX, and the Securities and Exchange Commission's (SEC) implementing rules that relate to internal control assessments by management, external auditor attestations, audit committee structure, and other SEC reporting requirements.

The following sections of this memorandum discuss the principal proposed revisions to each of the major subject areas within Part 363.

Annual Reporting Requirements – Audited Financial Statements, Standards for Internal Control, Management Reports, Merged Institutions, and Internal Control of Acquired Businesses

Audited Financial Statements

Consistent with sound management practices and the objective of internal control over financial reporting, the FDIC staff is proposing to amend Part 363 to require that the annual financial statements reflect all material correcting adjustments identified by the independent public

accountant. Covered institutions that are public companies or subsidiaries of public companies are already subject to such a requirement pursuant to Section 401 of SOX.

Standards for Internal Control

At present, the guidelines to Part 363 provide that each institution should determine its own standards for establishing, maintaining, and assessing the effectiveness of its internal control over financial reporting. However, the guidelines do not describe the characteristics of a suitable internal control framework. Accordingly, the FDIC staff is proposing to amend the guidelines to describe the attributes of a suitable framework. Recognizing that a significant percentage of institutions subject to Part 363 or their parent holding companies are also subject to the internal control reporting requirements of Section 404 of SOX, the attributes described in the proposed amendment are consistent with those the SEC described in the preamble to the SEC's Section 404 final rule release. The FDIC staff believes that a framework with these attributes is appropriate for all institutions whether or not they are public companies.

Management Reports

Based on its review of the Part 363 Annual Reports filed with the FDIC by covered institutions, the FDIC staff has noted differences in the content of the management reports included in these annual reports, insufficient disclosures regarding the results of the assessments that management must perform (compliance with laws and regulations and, if applicable, internal control over financial reporting), and inconsistencies between the level at which the components of the management report are being satisfied (insured depository institution versus holding company) and the corporate level of the officers who sign the management report. For example, identified material weaknesses in internal control over financial reporting or instances of noncompliance with designated safety and soundness laws and regulations have not always been disclosed, the assessment of the effectiveness of internal control over financial reporting often fails to disclose the internal control framework used to perform the assessment, and it is not always evident whether controls over the preparation of regulatory financial statements have been included within the scope of the assessment of internal control over financial reporting.

The omission of this information from the 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. Therefore, the FDIC staff is proposing to amend Part 363 to 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. These sound disclosure practices are consistent with the SEC's regulations implementing Section 404 of SOX. The proposed amendments would also require management's assessment of compliance with the designated safety and soundness laws and regulations to include a clear statement as to management's conclusion regarding compliance and disclose any instances of noncompliance with such laws and regulations.

Regarding management's assessments of internal control over financial reporting, the FDIC staff and the SEC staff have on several occasions publicly advised covered institutions that are public companies or subsidiaries of public companies that they have considerable flexibility in determining how best to satisfy both the SEC's and the FDIC's similar but separate requirements for these assessments under Section 404 of SOX and Part 363, respectively. To codify this reporting flexibility, the FDIC staff is proposing to describe the two options for complying with the filing requirements regarding management's report on internal control over financial reporting in the guidelines to Part 363. The first option involves the preparation of two separate reports to satisfy the FDIC's and the SEC's respective requirements and the second option involves the preparation of a single report that satisfies all of the FDIC's and the SEC's requirements.

If an insured depository institution with consolidated total assets of less than $1 billion is a public company or a subsidiary of a public company, the 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 in the SEC's rules implementing Section 404 of SOX. Since management's findings and conclusions with respect to internal control over financial reporting provide information that would aid in meeting the objective of Section 36 of the FDI Act, the FDIC staff is proposing to require such an institution to submit a copy of management's internal control assessment together with, but not as part of, its Part 363 Annual Report.

Since Part 363 and its guidelines provide only limited guidance concerning the contents of the management report and its signature requirements, institutions and auditors have expressed interest in examples of acceptable reports. In response, to assist managements of insured depository institutions in complying with these requirements, the FDIC staff is proposing to add an appendix that describes reporting scenarios that satisfy the annual reporting requirements of Part 363 and contains illustrative management reports and an illustrative cover letter for use when an institution complies with the annual reporting requirements at the holding company level.

Merged Institutions

Currently, Part 363 does not exempt an institution that is merged out of existence after the end of its fiscal year but before the filing deadline from filing a Part 363 Annual Report for that year. Such institutions typically submit a written request for relief from this filing requirement, which the FDIC approves. To reduce regulatory burden and provide certainty, the FDIC staff is proposing to amend the guidelines to explicitly exempt an institution that is merged out of existence after the end of its fiscal year, but before the deadline for filing its annual report, from the annual report filing requirements.

Internal Control of Acquired Businesses

Part 363 requires both management's and the related independent public accountant's evaluation of an institution's internal control over financial reporting to include controls at an institution in its entirety, including businesses that were acquired during the fiscal year. The SEC staff has

issued guidance regarding the exclusion of an acquired business from the internal control evaluations required by Section 404 of SOX. Since the issuance of this SEC guidance, the FDIC staff has received and granted several written requests from institutions subject to the internal control reporting requirements of Part 363 concerning their ability to exclude acquired businesses from the scope of management's internal control assessment as of the end of the year of the acquisition. Consistent with this SEC guidance and to reduce regulatory burden and provide certainty, the FDIC staff is proposing to add a guideline to Part 363 to explicitly provide relief from the requirement to evaluate the internal control over financial reporting of a business acquired during an institution's fiscal year. As proposed, this guideline would permit management's assessment of internal control over financial reporting to exclude the acquired business's internal control provided management's assessment report includes certain disclosures about the acquired business.

Independent Public Accountant – Independence, Peer Reviews, Communications with Audit Committees, Retention of Working Papers, and Internal Control Attestation Reports

Independence

Section 36 of the FDI Act states that an "independent public accountant" must perform the required audit and attestation services, but it does not define "independent." As adopted by the FDIC Board in 1993, the guidelines to Part 363 identify the independence standards applicable to accountants performing services under Section 36 and Part 363. In 2003, the agencies jointly issued rules of practice to implement the enforcement provisions of Section 36, which authorize the agencies to remove, suspend, or bar an accountant, for good cause, from performing such services for institutions subject to Section 36 and Part 363. To enhance the enforceability of the independence standards with which an accountant must comply, the FDIC staff is proposing to move the independence requirements for independent public accountants from the guidelines to a new subsection of Part 363. This new subsection would also clarify that the accountant must comply with the independence standards and interpretations of the Public Company Accounting Oversight Board (PCAOB) that the SEC has approved as well as those of the American Institute of Certified Public Accountants (AICPA) and the SEC.

Peer Reviews

Section 36 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 and to file the peer review report with the FDIC. The FDIC must make the report available for public inspection. At present, the guidelines to Part 363 provide 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 or their parent holding companies. The PCAOB issues reports on its inspections, which serve a similar purpose as peer reviews. In response to this development and in light of the agencies' issuance of rules implementing the enforcement provisions of Section 36, the FDIC staff is proposing to move the requirements for peer reviews, retention of peer review working papers, and the filing of peer review reports from the guidelines to a new subsection of Part 363. This subsection would also clarify that acceptable peer reviews include peer reviews performed in accordance with the

AICPA's Peer Review Standards and inspections conducted by the PCAOB. It would also provide that the FDIC would not make available for public inspection any nonpublic portion of a peer review report and inspection report.

Auditor Communications with Audit Committees

To strengthen the relationship between the audit committee and the accountant, Section 204 of SOX and the SEC's implementing rules require an accountant to report to a public company's audit committee on the company's critical accounting policies, alternative accounting treatments discussed with management, and written communications provided to management, such as a management letter or schedule of unadjusted differences. Auditing standards applicable to accountants who audit non-public entities include similar, but not identical, communication requirements. Consistent with current best practices and auditing standards, the FDIC staff is proposing to amend Part 363 to set a uniform minimum requirement for auditor communications with audit committees that would cover the information identified in Section 204 of SOX.

Retention of Working Papers

Section 36 of the FDI Act requires an independent public accountant who performs audit services required by Section 36 to agree to provide related working papers to the FDIC, any appropriate federal banking agency, and any state bank supervisor. However, the FDIC staff has previously encountered situations where the working papers had been retained for only a limited number of years. The SEC's rules and the PCAOB's auditing standards now specify a 7-year retention period for audit working papers. The AICPA's auditing standards provide that audit working papers should be retained for a period not shorter than five years. Because the FDIC staff believes that a uniform working paper retention period should apply to audits of all institutions (public and non-public) subject to Part 363, the FDIC staff is proposing to add such a requirement to Part 363 that would direct independent public accountants to retain audit working papers for seven years.

Internal Control Attestation Reports

Similar to its experience in reviewing reports on management's assessment of the effectiveness of internal control over financial reporting, the FDIC staff has observed that some independent public accountants' internal control attestation reports are less than sufficiently informative and, therefore, inconsistent with the objectives of Section 36 of the FDI Act. In response, and consistent with generally accepted standards for attestation engagements and the PCAOB's auditing standards, the FDIC staff is proposing to amend Part 363 to specify that the accountant's attestation report must identify the internal control framework that the accountant used to make the evaluation, state that the evaluation included controls over the preparation of regulatory financial statements, clearly state 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.

Filing and Notice Requirements – Annual Report Filing Deadline, Late Filing Notice, Independent Public Accountant's Reports, and External Audit Engagement Letters

Annual Report Filing Deadline

The annual reporting requirements of Part 363 currently require each covered institution to file its Part 363 Annual Report within 90 days after the end of its fiscal year. A potentially conflicting provision of Part 363 requires each institution to file the reports by the independent public accountant that are components of the Part 363 Annual Report within 15 days of receipt. The FDIC staff is also aware of the impact 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 on management, the resources of independent public accountants, and auditing costs. To reduce cost and burden, the FDIC staff is proposing to amend Part 363 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. An institution that is a public company, or that is a subsidiary of public company, 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 concerning the filing deadline for the components of the Part 363 Annual Report that are prepared by the independent public accountant.

Late Filing Notice

The guidelines to Part 363 currently provide that, for good cause, the filing deadline for the Part 363 Annual Report and other required reports and notices may be extended for not more than 30 days in the occasional situation when an institution is confronted with extraordinary circumstances beyond its reasonable control. The FDIC staff's experience with extension requests for Part 363 Annual Reports indicates that the reasons for the requests generally do not meet the extraordinary circumstances criterion. Also, several extension requests have been repeats of requests from the same institutions from the previous year. Based upon this experience and given the proposed amendment to extend the filing deadline for non-public institutions, the FDIC staff is proposing to amend Part 363 to replace the availability of extensions of time for filing reports in extraordinary circumstances with a requirement that an institution file a written notice of late filing by the report's prescribed due date. The filing of such a notice would not cure the apparent violation of Part 363 arising from an institution's failure to timely file a Part 363 Annual Report or another 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.

Independent Public Accountant's Reports

Section 36 of the FDI Act and Part 363 require an institution to file a copy of any management letter or other audit-related report issued by its independent public accountant within 15 days after receipt. The FDIC staff'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 and other appropriate federal and state supervisory agencies pursuant to this requirement. The FDIC staff is proposing to clarify this requirement by adding examples to Part 363 of the types of reports issued by an institution's independent public accountant that are to be filed within 15 days after receipt.

External Audit Engagement Letters

In the *Interagency Advisory on the Unsafe and Unsound Use of Limitation of Liability Provisions in External Audit Engagement Letters*, which was issued in 2006, the federal banking agencies expressed their concerns about such limitation of liability provisions and advised institutions against entering into engagement letters containing them. To facilitate the timely review of institutions' external audit engagement letters, the FDIC staff is proposing to amend Part 363 to require that copies of external audit engagement letters, including any related agreements and amendments, be filed with the FDIC, the appropriate federal banking agency, and any appropriate state bank supervisor within 15 days of acceptance by the institution.

Audit Committees – Audit Committee Member Independence, Audit Committee Duties, and Transition Period for Forming and Restructuring Audit Committees

Audit Committee Member Independence

Section 36 of the FDI Act requires each covered institution to have an independent audit committee comprised entirely of outside directors. Directors who serve on the audit committee must be "independent of management," although a minority of the audit committee members at institutions with $500 million or more but less than $1 billion in total assets need not be "independent of management." The guidelines to Part 363 provide that each institution's board of directors is responsible for determining at least annually whether existing and potential audit committee members satisfy these 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 staff 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 staff is proposing to amend the guidelines to state that an institution's board of directors should maintain and use an approved set of written criteria for evaluating audit committee member independence, and should record the results of these determinations in the board's minutes.

Although the guidelines to Part 363 set forth certain factors for boards of directors to consider in determining whether an outside director is "independent of management," the FDIC staff has found that some of these factors are so general that they fail to provide meaningful guidance to boards of directors. Therefore, the proposed amendments would provide expanded guidance for an institution's board of directors to use in its assessment of whether an existing or potential audit committee member is "independent of management." For example, the proposed amendment includes a list of criteria that an institution's board of directors should consider when evaluating an outside director's independence. In developing the proposed list of criteria, the FDIC staff considered 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 their particular circumstances. Additionally, the proposed amendments would provide flexibility by permitting an institution that is a public company or a subsidiary of a public company to apply the audit committee provisions of the listing standards of the national securities exchange on which the public institution or its public parent company is listed for purposes of determining audit committee member independence. Similarly, all other institutions, including those that are not public companies, may elect to use the audit committee provisions of the listing standards of a national securities exchange or association for determining audit committee member independence.

Audit Committee Duties

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. Given the intent and purpose of Section 36 of the FDI Act, it is critical for accountants who perform audit and attestation services for covered institutions to have an appropriate incentive to conduct an objective review and raise concerns about the need for improvements in financial management. In this regard, the FDIC staff believes that a sound corporate governance practice that promotes such an incentive is 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 staff is proposing to amend Part 363 and its guidelines to specify that, in addition to reviewing with management and the accountant the basis for the reports issued under Part 363, the audit committee's duties include the appointment, compensation, and oversight of the independent public accountant. In discharging these duties, the audit committee should review and satisfy itself as to the independent public accountant's compliance with the independence, peer review, and other qualifications under Part 363. Consistent with the *Interagency Advisory on the Unsafe and Unsound Use of Limitation of Liability Provisions in External Audit Engagement Letters*, the audit committee would also be expected to ensure that its engagement letters do not contain any such provisions.

Transition Period for Forming and Restructuring Audit Committees

The FDIC staff has observed that when some institutions first exceed the $500 million total assets threshold and become subject to Part 363, particularly institutions with few shareholders, they encounter difficulty in satisfying the requirements governing the composition of the independent audit committee. To comply with these requirements, these institutions must identify and attract qualified individuals who would be willing to become a director and an audit committee member and who would also be independent of management. In addition, Part 363 lacks guidance on the amount of time in which a newly covered institution must bring its audit committee into compliance, which further complicates this process. This lack of guidance on the time frame for attaining compliance also affects the other two asset size thresholds in Part 363 applicable to audit committee composition. To provide both clarity and regulatory relief, the FDIC staff is proposing to amend the guidelines to Part 363 to provide a one-year transition period for forming or restructuring the audit committee when an institution first becomes subject

to Part 363, when its assets reach the $1 billion threshold, and when its assets reach the $3 billion threshold.

Scope – 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 holding company's consolidated 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, the FDIC staff is proposing to revise 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. To comply at a holding company level, the proposal would require the consolidated total assets of a holding company's insured depository institution subsidiaries to comprise 75 percent or more of the consolidated total assets of the holding company. The FDIC staff 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. At the same time, this threshold would 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 staff considered the range of percentage-of-assets ratios for insured 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 between 75 and 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.

The FDIC staff recognizes 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. Nevertheless, the FDIC staff believes that the introduction of this percentage-of-assets threshold strikes an appropriate balance between insured institution financial data and audit coverage and the cost of compliance with part 363.

Other Changes

Scope - Financial Reporting and Common Terms Used in Part 363

The FDIC staff is proposing to amend Part 363 and the guidelines to specify that "financial reporting" includes both financial statements prepared in accordance with generally accepted accounting principles and those prepared for regulatory reporting purposes. The amendments would also clarify 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. These proposed amendments are consistent with explanatory guidance first issued by the FDIC in December 1994.

In addition, the proposed amendments to Part 363 would define several common terms used in the regulation and guidelines. The proposed amendments would also clarify that the requirements specified in Part 363 are in addition to any other statutory and regulatory requirements otherwise applicable to an insured depository institution.

Independent Public Accountant – Notice of Termination

Under Section 36 of the FDI Act and Part 363, both a covered institution and its independent public accountant must notify the FDIC and the appropriate federal banking agency of the termination of the accountant's services. The guidelines to Part 363 permit an institution that is a public company or a subsidiary of a public company to use its current report (e.g., SEC Form 8-K) disclosing the termination of its accountant to satisfy this Part 363 notice requirement. To reduce regulatory burden and provide flexibility to the accountant of such an institution, the FDIC staff is proposing to amend the guidelines to permit the accountant to satisfy its parallel Part 363 notice requirement by (1) submitting the letter describing the termination of its services that it provided to management for filing with the institution's or the holding company's current report or (2) confirming that management has filed the institution's or the holding company's current report, including the accountant's letter, with the FDIC and the appropriate federal banking agency.

Technical Changes

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

RECOMMENDATION

DSC recommends that the Board of Directors approve the publication of the attached Federal Register notice of proposed rulemaking to amend Part 363 for a 90-day public comment period.

ATTACHMENTS:
Resolution
Federal Register Notice