Comptroller of the Currency
Administrator of National Banks

A Telephone Seminar for Community Banks

Outsourcing Your Audit Function

Contents

Speaker Biographies

John D. Hawke, Jr.

Zane D. Blackburn

Mark Blair

C. Scott Schainost

Robert T. Riordan

Wynne E. Baker

Electronic Polling Questions

Outsourcing Your Audit Function

Appendixes

Speaker Biographies

John D. Hawke, Jr.

Comptroller of the Currency

John D. Hawke, Jr. was sworn in as the 28th Comptroller of the Currency on December 8, 1998. After serving for 10 months under a Recess Appointment, he was sworn in for a full five-year term as Comptroller on October 13, 1999.

The Comptroller of the Currency is the Administrator of National Banks. The Office of the Comptroller (OCC) supervises about 2,200 federally chartered commercial banks and about 52 federal branches and agencies of foreign banks in the United States comprising more than half of the assets of the commercial banking system. The Comptroller also serves as a Director of the Federal Deposit Insurance Corporation, the Federal Financial Institutions Examination Council, and the Basel Committee on Banking Supervision.

Prior to his appointment as Comptroller, Mr. Hawke served for 3½ years as Under Secretary of the Treasury for Domestic Finance. In that capacity he oversaw the development of policy and legislation in the areas of financial institutions, debt management, and capital markets, and served as Chairman of the Advanced Counterfeit Deterrence Steering Committee and as a member of the board of the Securities Investor Protection Corporation. Before joining Treasury, Mr. Hawke was a Senior Partner at the Washington, D.C., law firm of Arnold & Porter, which he first joined as an associate in 1962. At Arnold & Porter he headed the Financial Institutions practice, and from 1987 to 1995 he served as Chairman of the firm. In 1975 he left the firm to serve as General Counsel to the Board of Governors of the Federal Reserve System, returning in 1978.

Mr. Hawke was graduated from Yale University in 1954 with a B.A. in English. From 1955 to 1957 he served on active duty with the U.S. Air Force. After graduating in 1960 from Columbia University School of Law, where he was Editor-in-Chief of the *Columbia Law Review*, Mr. Hawke was a law clerk for Judge E. Barrett Prettyman on the U.S. Court of Appeals for the District of Columbia Circuit. From 1961 to 1962 he served as counsel to the Select Subcommittee on Education in the House of Representatives.

From 1970 to 1987 Mr. Hawke taught courses on federal regulation of banking at the Georgetown University Law Center. He has also taught courses on bank acquisitions and financial regulation and serves as the Chairman of the Board of Advisors of the Morin Center for Banking Law Studies at Boston University School of Law.

In 1987 Mr. Hawke served as a member of a Committee of Inquiry appointed by the Chicago Mercantile Exchange to study the role of futures markets in connection with the stock market crash in October of that year.

Mr. Hawke has written extensively on matters relating to the regulation of financial institutions, and is the author of *Commentaries on Banking Regulation,* published in 1985. He was a founding member of the Shadow Financial Regulatory Committee, and served on the committee until joining Treasury in April 1995.

Mr. Hawke is a member of the Cosmos Club, the Economic Club of Washington, and the Exchequer Club of Washington.

Born in New York City on June 26, 1933, Mr. Hawke resides in Washington, D.C. He was married in 1962 to the late Marie R. Hawke and has four adult children, Daniel, Caitlin, Anne, and Patrick, and two grandchildren, Spencer Patrick Hawke and Camerynn Marie Hawke.

Zane D. Blackburn

Chief Accountant
Office of the Chief Accountant

Mr. Blackburn is the Chief Accountant of the Office of the Chief Accountant for the Comptroller of the Currency. He is responsible for policy formulation and deliberations with financial institutions and other agencies on bank accounting issues. He also represents the OCC on the Federal Financial Institutions Examination Council's Reports Task Force. Additionally, he serves as the banking agencies' observer on the AICPA's Allowance for Loan Losses task force.

Zane began his career with the accounting firm of Ernst & Young. After serving six years with Ernst & Young, he joined the Securities and Exchange Commission (SEC). Upon completing six years with the SEC, two years were spent at the Department of energy with the Financial Reporting Systems Project. In June 1981, he assumed his current position.

Mr. Blackburn graduated from the University of Maryland with a B.S. degree in accounting. He is also a Certified Public Accountant and a member of the American Institute of Certified Public Accountants.

Wynne E. Baker

Chairman, American Institute of Certified Public Accountants
Financial Services Expert Panel

Wynne is the member in charge of KraftCPAs financial institution industry group. In addition to traditional audit and accounting services, the group provides compliance and loan reviews, directors' exams, stock valuations, analysis of mergers/acquisitions, outsourced internal audit, and a myriad of other services designed to meet the special needs of financial institutions.

He graduated from Tennessee Technological University in 1971 with a bachelor's degree in accounting. As well as being a CPA, Wynne earned the chartered bank auditor certificate (CBA) awarded by the Bank Administration Institute, is a "preferred examiner" under the American Bankers Association Preferred Audit Program, and is a certified financial services auditor (CFSA) awarded by NAFSA.

Wynne was the highest rated speaker at the 1993 AICPA's National Banking Conference; he has done training for the FDIC. In 1989 he was presented Tennessee Society of CPAs' "Public Service Award". He was presented the "Outstanding Speaker Award" by the Florida Institute of CPAs in four consecutive years and has received the same award from the Tennessee Society of CPAs for several years. In 1999 he was presented the Louis B. Johnson "Outstanding Business Alumnus Award" by Tennessee Technological University College of Business. In 2000 he was awarded the "Distinguished Service Award" from the Tennessee Society of CPAs.

He is the author of the AICPA's premier bank course, Introduction to Bank Accounting and Auditing, and was co-editor of the Handbook of Financial Management for Banks published by McGraw Hill. Wynne has assisted clients in buying failed banks from the FDIC and has consulted others who started new banks. He has also served as an expert witness in court cases related to bank failures.

With 30 years of experience serving the financial institution industry, Wynne has a national reputation as an authority in this area. He has conducted seminars across the nation and has published numerous articles on financial institution issues.

Mark E. Blair

National Bank Examiner
Northeastern District

Mark E. Blair is a national bank examiner in the OCC's West Virginia Field Office with over 21 years of experience. He has responsibility for serving as examiner-in-charge of mid-size and community banks in the states of West Virginia and Kentucky. In addition, he has worked extensively with problem banks and participated in or was examiner in charge of credit reviews at several regional institutions.

Mr. Blair was appointed an assistant national bank examiner in 1978 for the OCC with his headquarters in Charleston, WV. He was commissioned in 1981 and transferred to San Antonio, TX, in 1983, where he served as examiner-in-charge of southern Texas community banks, including several problem institutions. In 1985, Mr. Blair left the OCC to accept a position of senior vice president and cashier of Crown Bank, NA, San Antonio, TX, where he supervised loan administration and the bank operations.

In 1987, Mr. Blair returned to the OCC as an analyst in the Houston Field Office, where he oversaw banks located in Austin and Corpus Christi, TX; recommended and drafted administrative actions; and processed various corporate requests. In addition, he was in charge of the field office accounting group and oversaw the quality control program. In 1991, Mr. Blair transferred to the Charleston, WV, field office.

Mr. Blair graduated cum laude and holds a bachelor of science in business administration from West Virginia University, with a concentration in accounting. He also is a Chartered Financial Analyst and Certified Public Accountant. During 1999, Mr. Blair received the Southeastern District's Leadership Award. Mr. Blair is a member of the WV Society of CPAs and the Charleston CPA Chapter.

Robert T. Riordan

National Bank Examiner
OCC District Accountant

Robert Riordan has worked for the OCC for 19 years. His first 15 years were as an examiner in the Midwestern District, with the last four years as a District Accountant. Prior to joining the OCC, he worked as a CPA in a regional accounting firm.

C. Scott Schainost

Assistant Deputy Comptroller
Wichita Field Office

Scott Schainost started his OCC career in Kansas City, MO, in the beginning of the agricultural crises. After getting his commission in 1987, he transferred to Wichita, KS. In addition to the extensive problem community bank work in Missouri and southern Kansas, Scott spent much of his field time in Midwestern regional banks and Northeastern multinational banks assessing problem loan portfolios. Since becoming a manager in 1992 in Wichita, Scott has worked on various national task teams dealing with issues such as revising the community bank procedures for noncomplex banks, implementing supervision by risk, developing the community bank quality assurance program, monitoring agricultural credit risk, developing the sponsor training program for new examiners, and identifying community bank exam efficiencies.

Electronic Polling Questions

Outsourcing Your Audit Function Telephone Seminar
April 2, 2002 and April 3, 2002

Electronic Polling Questions

1. Would you be willing to pay $25 more per telephone seminar to use web conferencing? Examples of web conferencing capabilities include a speaker annotating slides, working with a file, and visiting a web site while presenting material, or using a “white board” to illustrate a concept, or display a diagram.

   Yes, press 1.

   No, press 2.

   No Opinion, press 3.

2. How many people are at your listening site? Press:
   1 for one person
   2 for two people,
   3 for three people,
   4 for four people,
   5 for five people,
   6 for six people,
   7 for seven people,
   8 for eight people, or
   9 for 9 or more people listening at your site.

Comptroller of the Currency
Administrator of National Banks

Outsourcing Your Audit Function

A Telephone Seminar

Tuesday, April 2, 2002
Wednesday, April 3, 2002

Introduction

Today's seminar:

- **Effective and efficient ways banks use outside firms to assist**
- **Statutory requirements**
- **OCC expectations**
- **Initiatives undertaken**

Responsibility for audit & internal control

- **Management and board of directors**

Zane Blackburn

Potential policy changes:

- Interagency policy statement on internal audit (handout)
- SEC independence changes - 2000
- OCC policy change
- Bills before Congress (handouts)
- Additional SEC changes
- AICPA statement
- Community bank concern

Zane Blackburn

Electronic Polling Question

Does your bank currently outsource the internal audit function?

- If "**No,**" press number 1 on your phone.
- If "**Yes, but only partially,**" press number 2.
- If "**Yes, entire function is outsourced,**" press number 3.

Note: Please wait until prompted by the moderator to respond.

Potential benefits of outsourcing:

- **Economic efficiency from using outside experts**
- **Technical expertise for new or highly complex products and services**
- **Assistance in meeting increased or unexpected workload for existing in-house staff**
- **Independent expertise in identifying and profiling audit risks**

Wynne Baker

Electronic Polling Question

If your bank currently outsources any of the internal audit functions, do you use the same firm that conducts the external audit?

- If “**No,**” press number 1 on your phone.
- If “**Yes,**” press number 2.

Note: Please wait until prompted by the moderator to respond.

Regulatory Background: 12 CFR 30

The internal audit system should include:

- **Adequate monitoring of internal controls**
- **Independent and objective basis**
- **Performance by qualified persons**
- **Adequate testing and review of information systems**
- **Documentation of tests and findings, as well as corrective actions**
- **Verification and review of management actions to address material weaknesses**
- **Review by the audit committee or board of the effectiveness of the internal auditing systems**

Available Resources

(http://www.occ.treas.gov)

Comptroller's Handbooks:

- **Internal and External Audits** (July 2000)
- **Internal Control** (January 2001)
- **Community Bank Supervision** (August 2001)
- **Large Bank Supervision** (May 2001)

Other Issuances:

- **Interagency Policy Statement on Internal Audit and Internal Audit Outsourcing, OCC Bulletin 98-1**
- **Audit Policy Clarification, Memorandum 2001-1**
- **National Bank Director's Toolkit**
- **"efiles"**

Electronic Polling Question

Does your bank plan to initiate a new, or expand an existing, outsourcing program within the next two years?

- If "**No,**" press number 1 on your phone.
- If "**Yes,**" press number 2.

Note: Please wait until prompted by the moderator to respond.

Outsourced Audits

Supervise in the same way as the internal audit function

OCC "Core Assessment"

- **Conduct during each examination cycle**
- **Assess the adequacy of the audit (e.g., testing, control and follow-up)**
- **Leverage resources and assist in setting examination scope**

Mark Blair

Outsourced Audits

The audit structure typically entails:

- **Board/audit committee oversight**
- **Risk assessment**
- **Audit plan/audit frequency**
- **Work programs**
- **Reporting**
- **Follow-up**
- **Written engagement letter**
- **Staffing**

Outsourced Audits

Directors and management are responsible for:

- ***Active* management by board or audit committee**
- **Clear reporting lines**
- **Due diligence on vendor**
- **Independence**

Written contracts with outsourced vendors should:

- Set the scope and frequency
- Detail "how" and "when" results are provided to the board of directors
- Provide for the terms of engagement
- Allow OCC full access to reports and work papers

Mark Blair

Centralized reviews of third party vendors:

- Scope
- Goals of centralized reviews

Mark Blair

Best Practices

Community banks with assets < $100 million

Internal Audit

- Strong internal controls
- Segregation of duties
- Effective loan review
- Effective compliance management program

External Audit

- Directors' exam or financial statement audit
- Expanded scope to include insider transactions and adequacy of internal controls

Best Practices

Community banks with assets of $100 million to $500 million

Internal Audit

- Strong internal controls
- Segregation of duties
- Effective loan review
- Effective compliance management program
- Internal auditor on staff
- Board receives internal audit reports
- Board ensures timely management follow-up

Best Practices

Community banks with assets of $100 million to $500 million

External Audit

- **Directors' exam or financial statement audit**
- **Expanded scope to include insider transactions and adequacy of internal controls**
- **71 percent receive 12 CFR 363 audits**

Scott Schainost

Best Practices

Community banks with assets over $500 million

Internal Audit

- **Strong internal controls**
- **Segregation of duties**
- **Effective loan review**
- **Effective compliance management program**
- **Internal auditor on staff**
- **Board receives internal audit reports**
- **Board ensures timely management follow-up**

Scott Schainost

External Audit

- 12 CFR 363 audits
- A financial statement audit by an independent public accountant
- A management assertion on financial statement controls
- Independent public accountant attestation on management's assertion
- Independent public accountant must follow AICPA and SEC independence rules

Scott Schainost

Overall audit ratings:

- Strong
- Satisfactory
- Weak

Factored into all other ratings

CAMELS, specialty, risk assessment

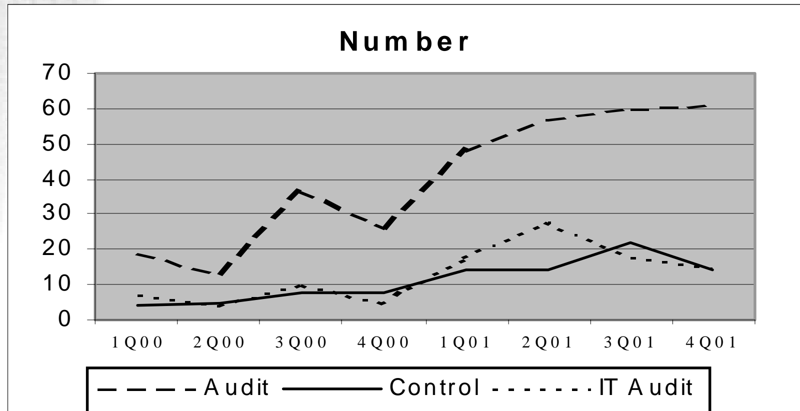
Report comments

Matters requiring attention

Scott Schainost

Examination Conclusions

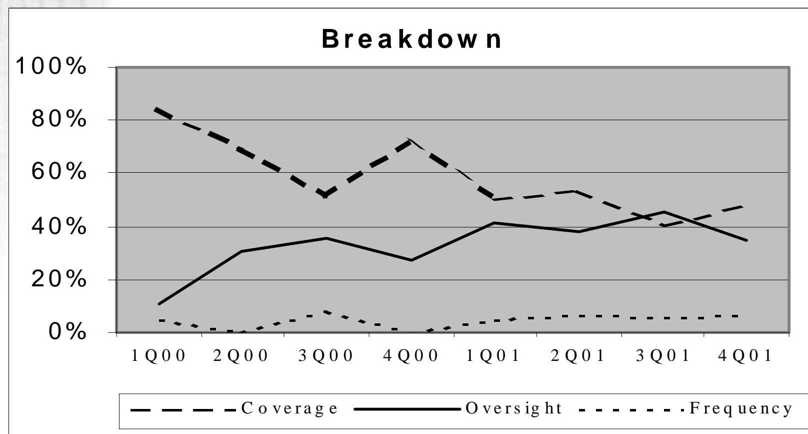
Matters Requiring Attention and Recommendations



Scott Schainost

Examination Conclusions

Matters Requiring Attention and Recommendations



Scott Schainost

Summary Comments

A strong internal audit system is essential to an effective risk management system

Outsourcing *may* be a valuable tool for enhancing the internal audit system

Best practices begin with the board of directors

Rob Riordan

Appendixes

OCC BULLETIN

Comptroller of the Currency
Administrator of National Banks

Subject: Interagency Policy Statement on Internal Audit and Internal Audit Outsourcing

Description: Internal Audit

TO: Chief Executive Officers of National Banks, Department and Division Heads, Examining Personnel and Other Interested Parties

The attached "Interagency Policy Statement on the Internal Audit Function and its Outsourcing" was issued jointly by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision (the agencies) on December 22, 1997

The agencies believe that effective internal control is the foundation for the safe and sound operation of a banking institution. Accordingly, the policy statement provides guidance on the characteristics of an effective internal audit function, including director and senior management responsibilities, the structure of the internal audit department, and procedures for communicating and resolving internal control weaknesses.

The policy statement provides specific guidance on the use of outsourcing vendors for audit activities and how such arrangements may affect an examiner's assessment of internal control. In particular, it discusses the effect an internal audit outsourcing relationship may have on the independence of an external auditor who also provides internal audit services to an institution. It also addresses the steps examiners should take if they have concerns about the external auditor's independence.

The policy statement is effective immediately. It applies to bank holding companies and their subsidiaries, FDIC insured banks and savings associations, and U.S. operations of foreign banking organizations.

For more information, call Thomas Rees, senior accountant, Zane Blackburn, chief accountant, or Bill Morris, national bank examiner, Core Policy Division at (202) 874-5180.

Emory W. Rushton
Senior Deputy Comptroller
for Bank Supervision Policy

Attachment

Date: January 7, 1998

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
FEDERAL DEPOSIT INSURANCE CORPORATION
OFFICE OF THE COMPTROLLER OF THE CURRENCY
OFFICE OF THRIFT SUPERVISION

INTERAGENCY POLICY STATEMENT ON THE INTERNAL AUDIT FUNCTION AND ITS OUTSOURCING

December 22, 1997

INTRODUCTION

Effective internal control[1] is a foundation for the safe and sound operation of a banking institution or savings association (hereafter referred to as institution). The board of directors and senior managers of an institution are responsible for ensuring that the system of internal control operates effectively. Their responsibility *cannot* be delegated to others within the institution or to outside parties. An important element of an effective internal control system is an internal audit function. When properly structured and conducted, internal audit provides directors and senior management with vital information about weaknesses in the system of internal control so that management can take prompt, remedial action. The agencies' long-standing examination policies call for examiners to review an institution's internal audit function and recommend improvements if needed. In addition, more recently, the agencies adopted Interagency Guidelines Establishing Standards for Safety and Soundness, pursuant to Section 39 of the Federal Deposit Insurance Act (FDI Act).[2] Under these guidelines, each institution should have an internal audit function that is appropriate to its size and the nature and scope of its activities.

In addressing various quality and resource issues, many institutions have been engaging independent public accounting firms and other outside professionals (hereafter referred to as outsourcing vendors) to perform work that has been traditionally done by internal auditors. These arrangements are often called "internal audit outsourcing," "internal audit assistance," "audit co-sourcing," and "extended audit services" (hereafter, collectively referred to as outsourcing).

---

1 In summary, internal control is a process, brought about by an institution's board of directors, management and other personnel, designed to provide reasonable assurance that the institution will achieve the following internal control objectives: efficient and effective operations, including safeguarding of assets; reliable financial reporting; and, compliance with applicable laws and regulations. Internal control consists of five components that are a part of the management process: control environment, risk assessment, control activities, information and communication, and monitoring activities. The effective functioning of these components is essential to achieving the internal control objectives.

2 For national banks, Appendix A to Part 30; for state member banks, Appendix D to Part 208; for state nonmember banks, Appendix A to Part 364; for savings associations, Appendix A to Part 570.

Such outsourcing may be beneficial to an institution if it is properly structured, carefully conducted, and prudently managed. However, the federal banking agencies have concerns that the structure, scope, and management of some internal audit outsourcing arrangements may not contribute to the institution's safety and soundness. Furthermore, the agencies want to ensure that these arrangements with outsourcing vendors do not leave directors and senior managers with the impression that they have been relieved of their responsibility for maintaining an effective system of internal control and for overseeing the internal audit function.

This policy statement sets forth some characteristics of sound practices for the internal audit function and the use of outsourcing vendors for audit activities. In addition, it provides guidance on how these outsourcing arrangements may affect an examiner's assessment of internal control. It also discusses the effect these arrangements may have on the independence of an external auditor who also is providing internal audit services to an institution. Finally, this statement provides guidance to examiners concerning their reviews of internal audit functions and related matters. This policy statement applies to bank holding companies and their subsidiaries, FDIC-insured banks and savings associations, and U.S. operations of foreign banking organizations.

THE INTERNAL AUDIT FUNCTION

Director and Senior Management Responsibilities

The board of directors and senior management are responsible for having an effective system of internal control — including an effective internal audit function — and for ensuring that the importance of internal control is understood and respected throughout the institution. This overall responsibility *cannot* be delegated to anyone else. They may, however, delegate the design, implementation and monitoring of specific internal controls to lower-level management and the testing and assessment of internal controls to others. In discharging their responsibilities, directors and senior management should have reasonable assurance that the system of internal control prevents or detects inaccurate, incomplete or unauthorized transactions; deficiencies in the safeguarding of assets; unreliable financial and regulatory reporting; and deviations from laws, regulations, and the institution's policies.

Some institutions have chosen to rely on so-called "management self-assessments" or "control self-assessments," wherein business line managers and their staff evaluate the performance of internal controls within their purview. Such reviews help to underscore management's responsibility for internal control, but they are not impartial. Directors and senior managers who rely too much on these reviews may not learn of control weaknesses until they have become costly problems — particularly if directors are not intimately familiar with the institution's operations. Therefore, institutions generally should also have their internal controls tested and assessed by units without business-line responsibilities, such as internal audit groups.

Directors should be confident that the internal audit function meets the demands posed by the institution's current and planned activities. Directors and senior managers should ensure that the following matters are reflected in their internal audit function.

Structure. Careful thought should be given to placement of the audit function in the institution's management structure. The function should be positioned so that directors have confidence that the internal audit function will perform its duties with impartiality and not be unduly influenced by managers of day-to-day operations. Accordingly, the manager of internal audit should report directly to the board of directors or its audit committee, which should oversee the internal audit function.[3] The board or its audit committee should develop objective performance criteria to evaluate the work of the internal audit function.[4]

Management, staffing, and audit quality. The directors should assign responsibility for the internal audit function to a member of management (hereafter referred to as the manager of internal audit or internal audit manager) who understands the function and has no responsibilities for operating the business. The manager of internal audit should be responsible for control risk assessments, audit plans, audit programs and audit reports.

- A control risk assessment (or risk assessment methodology) documents the internal auditor's understanding of the institution's significant business activities and their associated risks. These assessments typically analyze the risks inherent in a given business line and potential risk due to control deficiencies. They should be updated as needed to reflect changes to the system of internal control or work processes, and to incorporate new lines of business.

- The audit plan is based on the control risk assessment and includes a summary of key internal controls within each significant business activity, the timing and frequency of planned internal audit work, and a resource budget.

- An audit program describes the objectives of the audit work and lists the procedures that will be performed during each internal audit review.

- An audit report generally presents the purpose, scope and results of the audit, including findings, conclusions and recommendations. Workpapers should be maintained that adequately document the work performed and support the audit report.

---

3 Institutions subject to Section 36 of the FDI Act must maintain independent audit committees (i.e., comprised of directors that are not members of management). For institutions not subject to an audit committee requirement, the board of directors can fulfill the audit committee responsibilities discussed in this policy statement.

4 For example, the performance criteria could include the timeliness of each completed audit, comparison of overall performance to plan, and other measures.

The manager of internal audit should oversee the staff assigned to perform the internal audit work and should establish policies and procedures to guide the audit staff.[5] The internal audit function should be competently supervised and staffed by people with sufficient expertise and resources to identify the risks inherent in the institution's operations and assess whether internal controls are effective. Institutions should consider conducting their internal audit activities in accordance with professional standards, such as the Institute for Internal Auditors' (IIA) *Standards for the Professional Practice of Internal Auditing*. These standards address the independence, professional proficiency, scope of work, performance of audit work, and management of internal audit.

Scope. The frequency and extent of internal audit review and testing should be consistent with the nature, complexity, and risk of the institution's on- and off-balance-sheet activities. At least annually, the audit committee should review and approve the internal audit manager's control risk assessment and the scope of the audit plan, including how much the manager relies on the work of an outsourcing vendor. It should also periodically review internal audit's adherence to the audit plan. The audit committee should consider requests for expansion of basic internal audit work when significant issues arise or when significant changes occur in the institution's environment, structure, activities, risk exposures, or systems.[6]

Communication. To properly discharge their responsibility for internal control, directors and senior management should foster forthright communications and critical examination of issues so that they will have knowledge of the internal auditor's findings and operating management's solutions to identified internal control weaknesses. Internal auditors should report internal control deficiencies to the appropriate level of management as soon as they are identified. Significant matters should be promptly reported directly to the board of directors (or its audit committee) and senior management. In periodic meetings with management and the manager of internal audit, the audit committee should assess whether internal control weaknesses or other exceptions are being resolved expeditiously by management. Moreover, the audit committee should give the manager of internal audit the opportunity to discuss his or her findings without management being present.

---

5 The form and content of policies and procedures should be consistent with the size and complexity of the department and the institution: many policies and procedures may be communicated informally in small internal audit departments, while many larger departments require more formal and comprehensive written guidance.

6 Major changes in an institution's environment and conditions may compel changes to the internal control system and also warrant additional internal audit work. These include: (a) new management; (b) areas or activities experiencing rapid growth (c) new lines of business, products or technologies; (d) corporate restructurings, mergers and acquisitions; and (e) expansion or acquisition of foreign operations (including the impact of changes in the related economic and regulatory environments).

U.S. Operations of Foreign Banking Organizations

The internal audit function of a foreign banking organization (FBO) should cover its U.S. operations in its risk assessments, audit plans, and audit programs. The internal audit of the U.S. operations normally is performed by its U.S. domiciled audit function, head-office internal audit staff, or some combination thereof. Internal audit findings (including internal control deficiencies) should be reported to the senior management of the U.S. operations of the FBO and the audit department of the head office. Significant, adverse findings also should be reported to the head office's senior management and the board of directors or its audit committee.

Small Financial Institutions

An effective system of internal control, including an independent internal audit function, is a foundation for safe and sound operations, regardless of an institution's size. As discussed previously in this policy statement, Section 39 of the FDI Act requires each institution to have an internal audit function that is appropriate to its size and the nature and scope of its activities. The procedures assigned to this function should include adequate testing and review of internal controls and information systems.

It is management's responsibility to carefully consider the level of auditing that will effectively monitor the internal control system after taking into account the audit function's costs and benefits. For many institutions that have reached a certain size or complexity of operations, the benefits derived from a full-time manager of internal audit or auditing staff more than outweigh its costs. However, for certain smaller institutions with few employees and less complex operations, these costs may outweigh the benefits. Nevertheless, a small institution without an internal auditor can ensure that it maintains an objective internal audit function by implementing a system of independent reviews of key internal controls. The employee conducting the review of a particular function should be independent of the function and able to report findings directly to the board or audit committee.

INTERNAL AUDIT OUTSOURCING ARRANGEMENTS [7]

Examples of Arrangements

An outsourcing arrangement is a contract between the institution and an outsourcing vendor to provide internal audit services. Outsourcing arrangements take many forms and are used by institutions of all sizes. The services under contract can be limited to helping internal audit staff in an assignment for which they lack expertise. Such an arrangement is typically under the control of the institution's manager of internal audit and the outsourcing vendor reports to him or her. Institutions often use outsourcing vendors for audits of areas requiring more technical

[7] The guidance in the preceding section of this policy statement ("The Internal Audit Function") also applies to internal audit outsourcing arrangements.

expertise, such as those of electronic data processing and capital markets activities. Such uses are often referred to as "internal audit assistance" or "audit co-sourcing."

Some outsourcing arrangements may require an outsourcing vendor to perform virtually all internal audit work. Under such an arrangement, the institution may maintain a manager of internal audit and a very small internal audit staff. The outsourcing vendor assists staff in determining risks to be reviewed, recommends and performs audit procedures as approved by the internal audit manager, and reports its findings jointly with the internal audit manager to either the full board or its audit committee.

Additional Considerations for Internal Audit Outsourcing Arrangements

Even when outsourcing vendors provide internal audit services, the board of directors and senior managers of an institution are responsible for ensuring that the system of internal control (including the internal audit function) operates effectively. When negotiating the outsourcing arrangement with an outsourcing vendor, an institution should carefully consider its current and anticipated business risks in setting each party's internal audit responsibilities. The outsourcing arrangement should not increase the risk that a breakdown of internal control can occur.

To clearly set forth its duties from those of the outsourcing vendor, the institution should have a written contract, often referred to as an engagement letter. At a minimum, the contract should:

- Set the scope and frequency of work to be performed by the vendor;
- Set the manner and frequency of reporting to senior management and directors about the status of contract work;
- Establish the protocol for changing the terms of the service contract, especially for expansion of audit work if significant issues are found;
- State that internal audit reports are the property of the institution, that the institution will be provided with any copies of the related workpapers it deems necessary, and that employees authorized by the institution will have reasonable and timely access to the workpapers prepared by the outsourcing vendor;
- Specify the locations of internal audit reports and the related workpapers;
- State that examiners will be granted immediate and full access to the internal audit reports and related workpapers prepared by the outsourcing vendor;
- Prescribe the method for determining who bears the cost of consequential damages arising from errors, omissions and negligence; and

- State that outsourcing vendors that are subject to the independence guidance below will not perform management functions, make management decisions, or act or appear to act in a capacity equivalent to that of an employee.

Management. Directors and senior management should ensure that the outsourced internal audit function is competently managed. For example, larger institutions should employ sufficient competent staff members in the internal audit department to assist the manager of internal audit in overseeing the outsourcing vendor.

Communication. Communication between the internal audit function and directors and senior management should not diminish because the bank engages an outsourcing vendor. All work by the outsourcing vendor should be well documented and all findings of control weaknesses should be promptly reported to the institution's manager of internal audit. Decisions not to report the outsourcing vendor's findings to directors and senior management should be the mutual decision of the internal audit manager and the outsourcing vendor. In deciding what issues should be brought to the board's attention, the concept of "materiality," as the term is used in financial audits, is generally not a good indicator of which control weakness to report. For example, when evaluating an institution's compliance with laws and regulations, any exception may be important.

Vendor Competence. Before entering an outsourcing arrangement the institution should perform enough due diligence to satisfy itself that the outsourcing vendor has sufficient staff qualified to perform the contracted work. Because the outsourcing arrangement is a personal services contract, the institution's internal audit manager should have confidence in the competence of the staff assigned by the outsourcing vendor and receive prior notice of staffing changes. Throughout the outsourcing arrangement, management should ensure that the outsourcing vendor maintains sufficient expertise to perform effectively its contractual obligations.

Contingency Planning. When an institution enters into an outsourcing arrangement (or significantly changes the mix of internal and external resources used by internal audit), it increases its operating risk. Because the arrangement might be suddenly terminated, the institution should have a contingency plan to mitigate any significant discontinuity in audit coverage, particularly for high risk areas. Planning for a successor to the prospective outsourcing vendor should be part of negotiating the latter's service contract.

Independence of the External Auditor

This section of the policy statement applies only to an outsourcing vendor who is a certified public accountant (CPA) and who performs a financial statement audit or some other service for the institution that requires independence under AICPA rules.[8]

Many institutions engage certified public accounting firms to audit their financial statements and furnish other attestation services requiring independence. A certified public accounting firm that provides other services for its client (such as consulting, benefits administration or acting as an outsourcing vendor) risks compromising the independence necessary to perform attestation services. The professional ethics committee of the American Institute of Certified Public Accountants (AICPA) has issued rulings and interpretations specifically addressing whether a certified public accountant that furnishes both audit outsourcing and external audit or other attestation services to a client can still be considered independent.[9]

Section 36 of the FDI Act and associated regulations require management of every insured depository institution with total assets of at least $500 million to obtain an annual audit of its financial statements by an independent public accountant, report to the banking agencies on the effectiveness of the institution's internal controls over financial reporting and on the institution's compliance with designated laws and regulations (management report), and obtain a report from an external auditor attesting to management's assertion about these internal controls (internal control attestation report). In order to satisfy these requirements, the institution's board of directors must select an external auditor that will satisfy the independence requirements established by the AICPA, and relevant requirements and interpretations of the Securities and Exchange Commission.

Questions have been raised about whether external auditors who perform an audit of the institution's financial statements or provide any other service that requires independence can also perform internal audit services and still be considered independent. The federal banking agencies are concerned that outsourcing arrangements may involve activities that compromise, in fact or appearance, the independence of an external auditor.

The AICPA has issued guidance to CPAs (Interpretation 101-13 and related rulings) on independence that addresses these issues. Under Interpretation 101-13, the CPA's performance of

---

[8] Although outsourcing arrangements involving CPAs who are not performing external audit or attestation services for a client are not subject to this independence guidance, they are subject to the other sections of this policy statement.

[9] In May 1997, the AICPA and the Securities and Exchange Commission announced the formation of the Independence Standards Board (ISB), a private-sector body intended to establish independence standards for auditors of public companies. Any future standards established by the ISB should be considered in initiating or evaluating outsourcing arrangements with CPAs.

services required by the outsourcing arrangement "would not be considered to impair independence with respect to [an institution] for which the [CPA] also performs a service requiring independence, provided that [the CPA or the CPA's firm] does not act or appear to act in a capacity equivalent to a member of [the institution's] management or as an employee." The interpretation lists activities that would be considered to compromise a CPA's independence. Included are activities that involve the CPA "authorizing, executing, or consummating transactions or otherwise exercising authority on behalf of the client."[10]

Also, the AICPA's Ruling No.103 sets forth three criteria for evaluating the independence of a CPA who concurrently provides internal audit outsourcing services and the internal control attestation report under Section 36 of the FDI Act. One criterion requires that management "does not rely on [the CPA's] work as the primary basis for its assertion and accordingly has (a) evaluated the results of its ongoing monitoring procedures built into the normal recurring activities of the entity (including regular management and supervisory activities) and (b) evaluated the findings and results of the [CPA's] work and other separate evaluations of controls, if any." Accordingly, a CPA's independence would be impaired if the CPA provides the *primary* support for management's assertion on the effectiveness of internal control over financial reporting. A copy of the interpretation and rulings is attached to this policy statement.

Agencies' Views on Independence. The agencies believe that other actions compromise independence in addition to those in Interpretation 101-13. Such actions include:[11]

---

10 Other examples of outsourcing activities that would compromise a CPA's independence that are listed in Interpretation 101-13 include:

- Performing ongoing monitoring activities or control activities (i.e., reviewing loan originations as part of the client's approval process or reviewing customer credit information as part of the customer's sales authorization process) that affect the execution of transactions or ensure that transactions are properly executed, accounted for, or both and performing routine activities in connection with the client's operating or production processes that are equivalent to those of an ongoing compliance or quality control function;
- Reporting to the board of directors or audit committee on behalf of management or the individual responsible for the internal audit function;
- Preparing source documents on transactions;
- Having custody of assets;
- Approving or being responsible for the overall internal audit work plan, including the determination of the internal audit risk and scope, project priorities, and frequency of performance of audit procedures;
- Being connected with the client in any capacity equivalent to a member of client management or as an employee (for example, being listed as an employee in client directories or other client publications, permitting himself or herself to be referred to by title or description as supervising or being in charge of the client's internal audit function, or using the client's letterhead or internal correspondence forms in communications).

11 The agencies believe that this guidance is consistent with the AICPA interpretation.

- Contributing in a decision-making capacity or otherwise actively participating (e.g., advocating positions or actions rather than merely advising) in committees, task forces, and meetings that determine the institution's strategic direction; and

- Contributing in a decision-making capacity to the design, implementation, and evaluation of new products, services, internal controls or software that are significant to the institution's business activities.

EXAMINATION GUIDANCE

Review of the Internal Audit Function and Outsourcing Arrangements

Examiners should have full and timely access to an institution's internal audit resources, including personnel, workpapers, risk assessments, work plans, programs, reports, and budgets. A delay may require examiners to widen the scope of their examination work and may subject the institution to follow-up supervisory actions.

Examiners will assess the quality and scope of the internal audit work, regardless of whether it is performed by the institution's employees or by an outsourcing vendor. Specifically, examiners will consider whether:

- The board of directors (or audit committee) promotes the internal audit manager's impartiality and independence by having him or her directly report audit findings to it;

- The internal audit function's risk assessment, plans and programs are appropriate for the institution's activities;

- The internal audit function is adequately managed to ensure that audit plans are met, programs are carried out, and results of audits are promptly communicated to interested managers and directors;

- The institution has promptly responded to identified internal control weaknesses;

- Management and the board of directors use reasonable standards when assessing the performance of internal audit;

- The internal audit plan and program have been adjusted for significant changes in the institution's environment, structure, activities, risk exposures or systems;

- The activities of internal audit are consistent with the long-range goals of the institution and are responsive to its internal control needs; and

- The audit function provides high-quality advice and counsel to management and the board of directors on current developments in risk management, internal control, and regulatory compliance.

The examiner should assess the competence of the institution’s internal audit staff and management by considering the education and professional background of the principal internal auditors.

Additional Aspects of the Examiner’s Review of Outsourcing Arrangements. Examiners should also determine whether:

- The arrangement maintains or improves the quality of the internal audit function and the institution’s internal control;

- Key employees of the institution and the outsourcing vendor clearly understand the lines of communication and how any internal control problems or other matters noted by the outsourcing vendor are to be addressed;

- The scope of work is revised appropriately when the institution’s environment, structure, activities, risk exposures or systems change significantly;

- The directors have ensured that the outsourced internal audit function is effectively managed by the institution;

- The arrangement with the outsourcing vendor compromises its role as external auditor; and

- The institution has performed sufficient due diligence to satisfy itself of the vendor’s competence before entering into the outsourcing arrangement and has adequate procedures for ensuring that the vendor maintains sufficient expertise to perform effectively throughout the arrangement.

If the examiner’s evaluation of the outsourcing arrangement indicates that the outsourcing arrangement has diminished the quality of the institution’s internal audit function, the examiner should consider adjusting the scope of the examination. The examiner also should bring that matter to the attention of senior management and the board of directors and consider it in the institution’s management and composite ratings.

Concerns about Auditor Independence

When an examiner’s initial review of an outsourcing arrangement raises doubts about the external auditor’s independence, the examiner first should ask the institution and the external auditor to demonstrate that the arrangement has not compromised the auditor’s independence. If the examiner’s concerns are not adequately addressed, the examiner should discuss the matter with appropriate agency staff.

If the agency's staff concurs that the independence of the external auditor appears to be compromised, the examiner will discuss his or her findings and the actions the agency may take with the institution's senior management, board of directors (or audit committee), and the external auditor. These actions may include referring the external auditor to the state board of accountancy and the AICPA for possible ethics violations, and barring the external auditor from engagements with regulated institutions. Moreover, the agency may conclude that the organization's external auditing program is inadequate and that it does not comply with auditing and reporting requirements, including Section 36 of the FDI Act and related guidance and regulations.

DRAFT

Outsourcing Internal Audit[*]

Banks are increasingly contracting with independent public accounting firms or other outside professionals to perform work traditionally conducted by internal auditors. These arrangements are frequently referred to as "internal audit outsourcing," "internal audit assistance," "audit integration," "audit cosourcing," or "extended audit services." Banks generally enter into internal audit outsourcing arrangements to gain operational or financial efficiencies by engaging a vendor to:

- Assist internal audit staff when the bank's internal auditors lack the expertise required for an assignment. Such assignments are most often in specialized areas such as information technology, fiduciary, mortgage banking, and capital markets activities. The vendor normally performs only certain agreed-upon procedures in specific areas and reports findings directly to the bank's internal audit manager.

- Perform all or part of internal audit. In these situations, bank's should maintain a manager of internal audit and, as appropriate, an internal audit staff sufficient to oversee outsourcing vendor activities. The vendor usually assists the board and audit manager in determining the critical risks to be reviewed during the engagement, recommends and performs audit procedures approved by the internal auditor, and, jointly with the internal auditor, reports significant findings to the board of directors or its audit committee.

In any outsourced internal audit arrangement, the bank must maintain ownership of the internal audit function and provide active oversight of outsourced activities. The board of directors and management remain responsible for ensuring that the outsourced internal audit function is competently managed. Larger institutions and more formally structured community banks should have internal audit departments or internal audit managers oversee the outsourcing vendor. Small institutions should appoint a qualified and competent employee who is operationally and managerially independent for the areas being audited to act as a point of contact between the bank and the vendor in overseeing the outsourcing vendor (this individual may or may not be a formally designated "audit manager"). This person should report directly to the audit committee for purposes of communicating internal audit issues.

All national banks engaged in outsourcing internal audit activities must execute a written contract governing the terms of the outsourcing arrangement and specifying the roles and responsibilities of both the bank and the vendor. At a minimum, the contract should address the following items:

- Set the scope and frequency of the vendor's work.

- Describe how and when the vendor provides results to the bank's audit manager, senior management, and the board.

---

[*] This document is an excerpt from a working draft of a revised Comptroller's Handbook booklet and may not be exactly the same as the version eventually published.

DRAFT

- Describe how the terms of the engagement can be changed, including how audit services can be expanded when significant issues arise.

- Stipulate that the audit reports are the property of the bank, the bank can get copies of the vendor's work papers when it deems necessary, and employees authorized by the bank have reasonable and timely access to vendor work papers.

- State where internal audit reports and work papers will be stored. For electronic work papers, consideration should be given to including how long the vendor will maintain work papers and associated software to allow review by the bank and examiners.

- Give OCC examiners immediate and full access to all outsourced audit reports, audit programs, audit work papers, and related memorandums and papers.

- Establish a dispute resolution process for determining who bears the cost of consequential damages arising from errors, omissions, and negligence.

Examiners assess outsourced internal audit programs using the same standards applied to internal audit programs. Outsourcing arrangements create a variety of safety and soundness issues that will vary with the size, complexity, scope of activities, and risk profile of the bank , as well as the nature of the outsourcing arrangement. Accordingly, outsourced arrangements should meet the following guidelines:

- ***The arrangement maintains or enhances the quality of a bank's internal audit function and internal controls.*** The directors retain ownership of internal audit and control processes and remain responsible and accountable for ensuring that any outsourcing arrangement does not detract from the scope or quality of a bank's internal audit work, overall internal control structure, or audit and control evaluations. A well-structured quality assurance program is critical to ensuring that vendors perform outsourced internal audit activities in accordance with engagement terms and that the work is consistent with audit policies, audit plans, and board and management expectations with regard to the scope and quality of audit work. The vendor should provide the bank prior written notice of any process, staffing, or other changes affecting contracted work.

- ***Key bank employees and the vendor clearly understand the lines of communication and how the bank will address internal control or other problems noted by the vendor***. The engagement of a vendor should not diminish communication between the internal audit function and a bank's directors and senior management. Results of outsourced work must be well documented, discussed with appropriate audit and line management staff, and reported promptly to the board of directors or its audit committee by the internal auditor, the vendor, or both jointly. The concept of materiality, as used in connection with financial statement audits, may not be a good indicator of which control weaknesses to report (e.g., even if a test of transactions were to reveal a single exception, if that exception represented a violation of law and regulation, such a finding would normally be included in the final report for the audited area). Decisions not to report vendor findings to the board, audit committee, or

DRAFT

senior management should be the mutual decision of the internal audit manager and the vendor.

- ***The board and management perform sufficient due diligence to verify the vendor's competence and objectivity before entering into the outsourcing arrangement.*** The board and management must satisfy themselves that the expertise and quality of the vendor's staff is sufficient to effectively meet contractual obligations. A bank's selection of a vendor should be an informed decision based on review of the vendor's available services (including specialized areas) and work arrangements, staff qualifications and experience, costs and benefits of services to be provided, and ability and flexibility to perform services in a timely manner. The bank also should obtain a list of other clients served by the vendor and check references. All parties should discuss independence, objectivity, integrity, and conflict of interest standards applicable to the engagement, i.e., AICPA, IIA, and SEC.

- ***The bank has an adequate process for periodically reviewing the vendor's performance and ensuring that the outside vendor maintains sufficient expertise to perform effectively throughout the life of the arrangement.*** The board (directly or through its audit committee or internal audit manager) must satisfy itself that a vendor is satisfactorily completing outsourced work. The board of directors should hold the outside provider to the same standards as they would their own internal audit management and staff. The bank should subject the vendor to objective performance criteria, such as whether an audit is completed on time and whether overall performance meets the objectives of the audit plan, to determine the adequacy of the vendor's work and compliance with contractual and coverage requirements. The audit committee or designated bank staff responsible for vendor oversight should perform an assessment on a periodic basis and present findings to the board or audit committee, as appropriate, for review and approval.

- ***The arrangement does not compromise the role or independence of a vendor who also serves as the bank's external auditor.*** The OCC discourages banks from outsourcing internal audit work to the same external audit firm that performs its financial statement audits and other attestation services. When one firm performs both jobs, the firm risks compromising its independence by being placed in a position of appearing to or actually auditing its own work. However, where a small national bank determines that hiring separate firms to perform internal and external audit work is not cost effective, the bank and the external auditor must pay particular attention to preserving the independence of both the internal and external audit functions. Furthermore, bank management may want to discuss the independence issues with its supervisory office before entering such audit arrangement. The OCC will not consider the outsourcing relationship to be acceptable unless bank management:

  - Acknowledges its responsibility in writing to the accounting firm and the bank's audit committee (or its board of directors if there is no such committee) to establish and maintain an effective system of internal accounting controls;

  - Designates a competent bank employee or employees, preferably within senior management, to be responsible for the internal audit function;

DRAFT

– Determines the scope, risk, and frequency of internal audit activities, including those to be performed by the accounting firm;

– Evaluates the findings and results arising from internal audit activities, including those performed by the accounting firm;

– Evaluates the adequacy of the audit procedures performed and the findings resulting from performance of those procedures by, among other things, obtaining reports from the accounting firm; and

– Does not rely on the accounting firm's work as the primary basis for determining the adequacy of the bank's internal controls.

There is another requirement for all national banks required to have independent financial statement audits,[1]. In order for the bank's accountant to remain independent relative to outsourced internal audit work, the accountant must provide no more than 40 percent of the **total** hours (by the bank, the accountant, and anyone else) spent on internal audit matters related to internal accounting controls, financial systems, financial statements, and matters that impact the financial statements.[2]

National banks that are not required to have independent financial statement audits, but choose to do so, should follow the six management requirements and are strongly encouraged to adhere to the 40% limit.

Where a bank has chosen to use its external auditor to perform outsourced internal audit activities, bank management should document their computation showing adherence with the 40 percent limit. If the 40 percent rule is not met, or other factors cause the examiner to believe that the independence of the external auditor is questionable, the acceptability of the bank's outsourced internal audit activities will be in doubt.

[1] National banks whose securities are registered with the OCC and file periodic reports under 12 CFR 11 and 12 CFR 16.20, national banks subject to 12 CFR 363, and any national bank subject to an order or supervisory action requiring an audit of its financial statements by an independent public accountant.

[2] This requirement, as well as the six listed management requirements, is part of the SEC's independence Rule 2-01 (17 CFR 210.2-01), as amended November 21, 2000. This 40% limit SEC requirement is effective August 5, 2002for publicly-registered companies with total assets of $200 million or more.

REQUEST FOR PROPOSAL
FOR INTERNAL AUDIT SERVICES*

Firm Profile:

So that we may evaluate the suitability of your firm in serving as our internal audit service provider we encourage you to provide detailed information on your firm. At a minimum your proposal should answer the following questions in some detail:

1. How is your internal audit practice structured?
2. Do you have publicly traded bank clients? If so please indicate the number of clients you have that are publicly traded and indicate if we will be able to contact them as a reference for your firm.
3. For how many bank clients do you provide substantially all of their internal auditing services? Please indicate the size of the clients and whether or not we will be able to contact them as a reference for your firm.
4. What is the annual turnover rate at your firm at the partner/manager level?
5. What is the annual turnover rate at your firm at the staff/senior level?
6. For the bank regulatory compliance audit work, does your firm utilize a dedicated bank compliance audit group?
7. For how many bank clients do you perform substantially all of their regulatory compliance audit work? Please indicate the size of the clients and whether or not we will be able to contact them as a reference for your firm.
8. Provide information on your firm's continuing education program including specific information on financial industry continuing education.

Risk Based Internal Audit Program:

We have developed the attached risk analysis and audit schedule. Please prepare your proposal assuming that your firm will complete the audits scheduled for 2002 and that the scope for each review will be sufficient to address the areas listed within this document.

As part of the proposal process we would appreciate your challenging the audit scope and planned frequency. In addition to providing a proposal based on our risk analysis and scheduled audits, you should also tell us how your changes, if any, to scope and frequency would affect your proposal.

For each of the audit areas listed please provide the following:

- List audit staff, senior(s), manager(s) and expert(s) who will be assigned to the audit, provide background information on each sufficient for us to determine their education, banking experience and audit experience. The staffing standards included with this request should be considered in assigning personnel to these reviews. Also include information sufficient for us to evaluate the process you would propose for changes in assigned personnel.
- Provide detailed information relating to the hours that you are budgeting for each audit area, including detail for each individually listed function within the scope information.

We request separate proposals for:

- Core Proposal (see listing of audits to be conducted in 2002)
- Compliance (Lending, Deposit, Bank Secrecy Act, Community Reinvestment Act)
- Information Technology

---

* This information is provided as an example and is not endorsed by the OCC. Please be sure to tailor it to your specific needs and obtain appropriate review by counsel.

- Asset / Liability Management
- Retained Interest (Securitized Assets)
- Broker / Dealer Subsidiary

Please consider that your firm may be requested to perform any one or all of the services listed above. If there are efficiencies in your firm providing all or a combination of the services listed, please include detailed information sufficient for us to evaluate this both as a stand-alone engagement as well as combined.

Part of our internal audit process for each audit area includes developing control documentation sufficient to provide the basis for management's required assertions under FDICIA. Your proposal should include preparing this information for each audit area. This documentation should include summary information regarding risks, control processes, internal audit tests performed, testing results and conclusions. This information should be completed during each review and presented in a format suitable for distribution to senior managers in anticipation of their review and acknowledgement that these processes continue to be in place as of year-end. Please provide a sample of the format you would propose for this information as well as the process you use in its development.

Minimum Service Standards

We have established the following minimum service standards and request that your proposal include provisions for meeting each of these:

- Meet requirements of Customer Satisfaction Survey (copy provided)
- Meet requirements of Internal Audit Quality review (copy provided)
- Effectively communicate with line management in planning, conducting, reporting and follow-up of audits including incorporating management's concerns into planned audit steps and including coordinating audit meetings and fieldwork
- Effective process for facilitating risk management, input in developing, review and approval of detailed audit programs (prior to start of fieldwork), draft reports and final reports
- Effective process for facilitating risk management and area management updates during fieldwork
- Proposal flexibility sufficient to incorporate reasonable changes in scope to address line management or risk management concerns
- Plan, conduct and report on the audits undertaken in a manner designed to detect irregularities in bank operations, determine the bank's compliance with applicable laws, rules and regulations, evaluate the adequacy of and adherence to the bank's policies and procedures, and review the overall risk management of the area under audit
- Follow-up on audit findings from previous audits and examinations
- Attend Audit Committee meetings
- Work with risk management in challenging company risk assessments and provide recommendations for changes to the risk assessment documentation
- Clearly document any sampling methods utilized including objectives, basis for using sampling, type of sampling used, population, sample size, and evaluation of sample results
- In conjunction with the receipt of DRAFT reports complete and properly indexed copies of all work papers are to be provided to risk management for our retention
- Provide clearly written reports that address the cause of identified issues as well as practical recommendations for correction. Reports should include an executive summary, scope summary, and should categorize issues by severity
- Provide maximum 24 hour return of phone calls, e-mails or other communications
- Meet deadlines established in detail audit schedule, jointly prepared with risk management and reported to the Audit Committee.

Specific Documents Requested

In conjunction with your proposal please provide:

- Sample report for a financial/operational internal bank audit as well as a regulatory compliance audit
- Copy of your firm's continuing education policy
- If one is prepared for your firm, a copy of the most recent peer review
- References that we can contact
- Information sufficient to determine the financial condition of your firm
- Analysis of your firm's independence with regard to City Holding Company
- Draft engagement letter or contract

It is very important that your proposal include sufficient information to allow us to evaluate and compare your proposal to other firms. Your failure to provide the information as requested may impact our decision.

Audits to be conducted in 2002

Core Proposal:

Commercial Banking
Retail Banking
Bank Operations
Trust
Branch Operations and Administration

Compliance

Lending Compliance
Deposit Compliance
Bank Secrecy Act
Community Reinvestment Act

Asset/Liability Management
Information Technology
Retained Interest (Securitized Assets)
Broker/Dealer
NOTE:
Human Resources and Accounting Operations audits will be conducted in 2003 in place of Deposit Compliance and Branch Operations and Administration. Human Resources and Accounting Operations audits should not be included in the proposal for 2002.A Fair Lending Review is scheduled to be conducted late in 2001 accordingly a Fair Lending Review should not be included in the proposal for 2002.

Internal Audit Service Provider
Staffing Guidelines

Internal Audit Service Providers performing internal audit activities will have the necessary knowledge, skills and competency to execute the audit program in a proficient and professional manner. Personnel will have appropriate education and experience; have organizational and technical skills commensurate with the responsibilities assigned; be skilled in oral and written communications; understand accounting and auditing standards, principles, and techniques; and will be able to recognize existing and potential problems and expand procedures as appropriate.

Internal audits will generally be staffed with a combination of 4 different levels of audit personnel:

Audit Staff – Audit staff assigned to audits will have appropriate training and experience sufficient to allow them to conduct their assigned duties. Any audit staff members assigned with less than 1 year of experience will be limited to clearly defined activities and will be closely supervised by an audit senior or the audit manager.

Audit Senior – Audit seniors will be assigned as required considering the nature and complexity of the area under review. Audit seniors will have a minimum of 2 years of audit experience and have attended a minimum of 40 hours of financial institution and/or audit training. When reviewing compliance related areas the staff will have specific training and/or experience related to the regulations being reviewed.

Audit Manager - An audit manager will be assigned to each significant internal audit to manage the audit from planning to issuance of the final report. The audit manager will have a minimum of 5 years of financial institution experience. When reviewing compliance related areas the manager will have specific training and experience related to the regulations being reviewed. Communications with line management and the Risk Manager throughout the course of the audit will be coordinated through the audit manager. The audit manager will have appropriate continuing education with emphasis in the area being audited.

Audit Expert - Extensive background in the specific area being reviewed. Serves as the specialist when areas of concern arise or in explaining technical concepts.

Prior to the start of an internal audit the internal audit service provider will provide a resume for each of the individuals working on the audit, as well as their assignments, to the Vice President for Risk Management for his approval.

Any firm providing internal audit services shall have formal internal guidelines for professional continuing education.

INTERNAL AUDIT QUALITY REVIEW

AUDIT:	Good	Average	Needs Improvement
1. Were service providers responsive to area management concerns as well as risk management concerns expressed during planning?			
2. Were they responsive to questions and other needs, did they respond in a timely manner and were they accessible?			
3. Were key project dates and requirements met?			
4. Did the audit staff have sufficient training and experience to conduct the audit?			
5. Were work papers sufficient to support the work performed, properly prepared and filed, and did the work papers support the audit findings noted in the audit report?			
6. Were previous audit and examination findings followed up and documented in the work papers?			
7. Were statistical or non-statistical sampling methods appropriately documented including reasons supporting the decision to use either?			
8. Were audit objectives achieved?			
9. Was the audit report written in a clear and fair manner that appropriately addressed the areas of concern?			
10. Did the audit report address the cause of the identified issues or did it report primarily symptoms?			
11. Did the reports include recommendations designed to address the identified issues?			

COMMENTS:

Internal Audit Satisfaction Survey

Your input is an important part of our quality assurance process and will ensure the continued improvement of the internal audit process. Please assign a rating to each of performance indicators below with:

1 – Poor
2 – Below Average
3 – Average
4 - Good
5 – Excellent

Performance Indicator:	1	2	3	4	5
1. Rate the quality of the pre-audit meeting. Including the communication regarding the timing, scope and objectives of the audit. Consider if your concerns were incorporated into the scope of the audit.					
2. Rate the way that the audit was conducted. Consider if the auditors conducted themselves professionally and if they performed their duties with minimal disruption to your operation. Also consider if they kept you informed about the status of the audit and their observations.					
3. Rate the auditors level of knowledge of your risks, processes, and controls. Consider their level of understanding of your business line.					
4. Rate the auditors exit conference. Consider if there were any surprises. Also consider if the observations and recommendations provided realistic and achievable solutions.					
5. Rate the quality of the final audit report. Consider if the report was written clearly and accurately. Also consider if the report added value to your operation.					
Overall Rating:					
6. Rate the overall quality of the internal audit					
7. In comparison to the prior audit of your area, do you believe that the level of internal audit services (check one): ( ) Declined ( ) Stayed the Same ( ) Improved					

Please provide any additional comments regarding internal audit's performance during this review:

Members

Subcommittee Members

LaFalce Statements/ Speeches

Archived News for 106th Congress

Archived Legislation for 106th Congress

Credit Card Alert

Home

News Releases

For Immediate Release: February 28, 2002

Contact: Amy Simmons 202-225-7141

LaFalce, Gephardt, Democratic Leaders Introduce Sweeping Reforms To Prevent Future Enrons

U.S. Rep. John J. LaFalce (D-NY), Ranking Member of the House Financial Services Committee, in conjunction with the House Democratic Leadership -- Minority Leader Richard Gephardt, Minority Whip Nancy Pelosi, Assistant to the Democratic Leader Rosa DeLauro-- and a number of other Financial Services Committee and other Democrats, introduced sweeping legislation aimed at preventing future Enrons and restoring investor confidence in the integrity of our markets. The "Comprehensive Investor Protection Act of 2002," comes as Congress considers solutions to the systemic problems in our financial oversight and disclosure systems- flaws which helped propel the Enron financial collapse. The LaFalce legislation has gained support from the AFL-CIO, consumer groups and former SEC Chief Accountant Lynn Turner (currently Director for the Center for Quality in Financial Reporting) because it offers a substantial and comprehensive solution to the systemic problems which have rocked consumer confidence with Wall Street.

"Enron has made the systemic problems in our system all too clear to everyone," said LaFalce at a news conference to unveil the legislation. "We have an opportunity to adopt serious reforms to correct the weaknesses that are undermining confidence in our capital markets. My bill will significantly enhance the independence and oversight of the accounting industry, improve corporate governance, deter earnings manipulation, ban analysts' conflicts of interest and bring real reform-not meaningless cosmetics."

The "Comprehensive Investor Protection Act of 2002" goes

substantially further in proposing reforms than previous legislative proposals. The legislation ensures that an auditor's first duty is to the public by substantially limiting the non-audit services an auditor may provide to an audit client, and, more importantly, by mandating auditor rotation.

The LaFalce bill creates a Public Accounting Regulatory Board to provide strong and effective oversight of the auditing industry. The LaFalce bill explicitly defines the scope and functions of this new regulator, and arms it with broad oversight authority and a stable funding source to ensure it can take tough action for effective oversight of the auditing industry, including direct inspection of audits.

The "Comprehensive Investor Protection Act of 2002" will:

1. -Corporate Governance

    1. Vest the audit committee with the power to hire and fire its auditors
    2. Require the audit committee to meet quarterly with its auditors and have an opportunity to do so outside the presence of management
    3. Prohibit directors from providing consulting services to the issuer
    4. Prohibit issuer from making charitable contributions to organizations associated with any director
    5. In addition, the bill would require extensive disclosures to make transparent to shareholders and investors the relationships that compromise independence that now prevail on many corporate boarads among officers, directors and affiliates of the issuer.

2. -Regulation of the Auditors (CIPA would create a strong public regulator. The Public Auditing Regulatory Board (PARB), with clearly defined duties and powers mandated by Congress, to provide comprehensive oversight of accountants.

    1. A super majority of a 7-member board would be selected from the public and would represent the interests of shareholders, investors, pension beneficiaries and future retirees.
    2. An Appointment Committee, consisting of the Chairman of the Board, the Chairman of the SEC, and the Comptroller General shall select the 6

remaining Board members from nominations received from groups representing institutional investors and pension funds (public employee pension plans, pension plans organized pursuant to the Taft-Hartley Act (i.e., union-related pension plans), and pension plans organized pursuant to ERISA.)

3. -Auditor Independence Requirement

   1. Require a 4-year rotation of a registrant's auditor, with the possibility of one 4-year extension so long as the Public Accounting Regulatory Board approves such extension, after due review and inspection of the audit.
   2. Require a 2-year cooling off period for certain former auditor employees before they could work for an audit client.
   3. Make it unlawful for the issuer to improperly influence an auditor in the performance of an audit.

4. -Separation of Auditing and Accounting

   CIPA would seek to ensure that an auditor's first duty is to the public by substantially limiting the non-audit services an auditor may provide to an audit client. The prohibited services to an audit client include, among others: (1) bookkeeping; (2) financial information systems design; (3) valuation services and fairness opinions; (4) internal audit services; (5) managerial services (i.e., acting as a director or officer); and (6) broker-dealer, investment adviser or investment banking services. Tax related services and other non-audit services not otherwise enumerated would be subject to the approval of the audit committee, which would evaluatle the effect of the provision of such services on the auditor's independence.

5. -Analyst Conflict of Interest

   CIPA would go beyond the requirements in the recent rulemaking proposed bye NASD and NYSE by (1) banning analysts from holding stock in the companies that they cover; (2) prohibiting analyst compensation from being based wholly or in part on investment banking revenue; and (3) requiring the

NYSE and NASD to establish criteria for evaluating analyst research quality and also requiring analyst compensation to be based principally on the quality of their research.

6. -Expansion of SEC Resources

   CIPA would double the resources for the Divisions of Enforcement and Corporation Finance, as well as the Office of the Chief Accountant. Moreover, CIPA would fund pay parity for the entire Commission staff. The total SEC authorization would amount to $876 million for fiscal 2003.

7. -Restoration of Aiding and Abetting Liability for Accountants and Outside Professionals

   CIPA would provide a private right of action against anyone (auditors, lawyers and other outside professionals) who knowingly or recklessly provides substantial assistance to another person in violation of the securities laws.

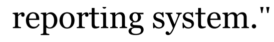
8. -Lockdowns

   CIPA would prohibit stock sales by insiders at any time when employees are subject to a lockdown on their 401(K)s.

9. -Destruction of Records

   CIPA would require auditors to retain certain key files for 7 years relating to an audit so that they would be available for investigations.

LaFalce was a vocal advocate on behalf of investors long before the Enron revelations. In early 2001, shortly after the Committee on Financial Services assumed jurisdiction for securities, he called for a doubling or tripling of the SEC budget, saying "an essential step in restoring the vitality of the financial reporting system is to provide a significant increase in SEC resources. I have been very pleased to see that our Republican colleagues have now heard my year-long calls for a significant increase in SEC resources, but I have been very concerned that the increase that they call for does not provide for pay parity for SEC staff generally. Funding pay parity is essential for the SEC to be able to hire and retain experienced, professional staff needed to restore confidence in our capital markets and our financial



reporting system."

"The LaFalce bill is the right approach," said Frank Torres of the Consumers Union. "This is the way to bring confidence to the markets by making the accounting industry more independent."

CURRENCY

Committee on Financial Services

Michael G. Oxley, Chairman

For Immediate Release:
Wednesday, February 13, 2002

Contact: Peggy Peterson at 226-0471

Oxley, Baker to Introduce Corporate and Auditing Accountability, Responsibility, and Transparency Act

Today, House Financial Services Committee Chairman Michael G. Oxley (OH), along with Capital Markets Subcommittee Chairman Richard H. Baker (LA) will introduce legislation to restore investor confidence in the accounting profession and capital markets in response to the Enron collapse.

“We have before us a challenge to move meaningful reforms, but the scope of the bill and the scope of our work are greater than any one company,” Oxley said. “Our approach is both responsible and responsive. It will help to prevent future Enrons without crushing the entire business sector with endless government. All businesses are not to blame for the excesses of one.”

In brief, the bill – the Corporate and Auditing Accountability, Responsibility, and Transparency Act (CARTA) -- would ensure auditor independence through new firewalls and a public oversight board for accounting of publicly traded companies. Companies would have to provide more public information about their financial health in real time. The legislation would beef up the Securities and Exchange Commission’s (SEC) budget by almost half to enable it to perform more oversight, and it would be directed to step up audit reviews of large companies.

“This bill represents a great first step towards increasing auditor accountability and improving corporate financial reporting, both of which are essential for restoring confidence in the capital markets,” said Baker. “As we move forward, we may need to consider additional measures, but it is crucial that we move quickly with the substantial measures included in this bill.”

Restoring Confidence in Accounting

America needs a strong, vibrant, and healthy accounting industry to keep companies

financially sound and to provide investors with solid information. New firewalls and increased oversight will ensure independent reviews of company books.

- **Auditor Independence.** The bill would prohibit firms from offering certain controversial consulting services to companies they're also auditing.

- **New Oversight Body.** The legislation would establish a new, public regulatory board with strong oversight authority. "Public regulatory organizations" (PROs), which would be under the direct authority of the SEC, would be made up of two-thirds public members (those not associated with the accounting industry).

- **PRO Powers.** A PRO would have to certify any accountant wishing to audit the financial statements required from public issuers of stock. Additionally, publicly traded companies would be responsible for ensuring that their accounting firms were in good standing and for having their financial statements certified by the PRO. An accountant or accounting firm disqualified by a PRO could be prohibited from certifying financial statements. The PRO would have the statutory authority to punish accountants who violate securities laws, standards of ethics, competency, or independence.

Increasing Corporate Disclosure and Responsibility

Because investors of all types rely on information to make their financial decisions, the bill would increase the amount of real-time information made available to American investors, employees, and the public in general.

- **Off-Balance Sheet Disclosure.** Off-balance sheet transactions, such as the special-purpose entities made famous by Enron, would have to be fully disclosed. Corporate insiders would be required to immediately inform the SEC (next business day) and the public (second business day) when they sell their own company stock, rather than waiting up to 40 days as allowed under today's regulations.

- **Real-Time Public Information.** Companies would be required to disclose information about their financial health more quickly and in plain English making it more useful and relevant for investors. Currently such disclosures can take days to become public.

- **No Interference With Audits.** It would be made unlawful for anyone associated with a company to interfere with the auditing process.

Protecting 401(k) Plans

- **No Insider Sales During Blackouts.** Corporate executives would be prohibited from buying or selling company stock during any period where 401(k) plan participants are unable to buy or sell securities, for example during administrative blackout periods.

Strengthening the SEC

- **Budget Increase.** The SEC's budget would be boosted by almost half, increased from $480 million to $700 million, to enable it to perform the additional tasks and oversight required by the bill.

- **More Audit Reviews.** The SEC would be required to conduct regular and thorough reviews of the largest and most widely traded companies. The Commission would also be required to analyze its enforcement actions over the past five years looking for areas of reporting which may be susceptible to fraud or manipulation.

Reducing Analyst Conflicts of Interest

- **SEC Oversight of New Rules.** In two hearings held last summer, Baker's subcommittee questioned market participants, academics, consumer groups, media and industry representatives on analyst independence. The hearings confirmed that Wall Street research practices were in need of reform and that investors were not receiving the unbiased research needed to make responsible investment decisions.

- Following last week's announcement by the NASD and NYSE to require additional disclosures and crack down on conflicts of interest in Wall Street research, the SEC would be required to study the new regulations and report to Congress on the effectiveness of the rules and annually update such review.

Additional Studies

- **Corporate Information Disclosure.** The SEC would study whether additional corporate information disclosures are necessary. The agency would specifically examine where conflicts of interest may exist, which accounting principles are most vital to a company's financial state, and how fair value accounting forecasts are used in complex derivatives transactions.

- **Credit Rating Agencies.** The role of credit rating agencies in the securities markets and whether there are impediments to accurate analysis or conflicts of interest would also to be studied by the SEC.

- **Corporate Governance.** The President's Working Group on Financial Markets would study current corporate governance standards and whether they are sufficiently serving and protecting investors.

###

Chairman Michael G. Oxley
February 13, 2002 CARTA News Conference Talking Points

- Our bill introduction today is the product of months of work by the Financial Services Committee. We already have had three hearings on the Enron collapse. Our committee was the first to have Enron hearings, last December. Dean Powers unveiled his report to the Enron board before us last week.

- We also have taken great care not to interfere with the comprehensive investigations being conducted by the Department of Justice and the SEC. Wrongdoing is determined in the courts, and that's what will happen in the Enron case.

- Our duty in Congress is to fix the problems raised in the cases of Enron, Global Crossing and others.

- Our overall goal is to improve the public's confidence in the capital markets and strengthen the overall financial system. The free market system must emerge stronger from the actions we take. That's what President Bush was talking about in the State of the Union address when he talked about corporate responsibility. And, that's what we're doing today in this bill.

- The legislation we introduce today is a crucial part of our work. But, legislating will not be our only way of addressing these problems. We also need to work directly with the private sector, just as we did last week to help eliminate financial analysts' conflicts of interest.

- We are addressing the core issues that will prevent future Enrons. But, we're not going to crush the entire business sector by putting government in the boardroom. Those who think legislation is the answer to every problem would only gum up the works and make it impossible for the markets to function properly.

- This legislation meets our responsibility to shareholders and employees of publicly traded companies, who deserve to know more---and know it in real time---about a companies' financial health. Let's make solid information available in real time, and everyone can make his own financial decisions from there.

- Our legislation would provide the SEC and a new, public body with direct oversight of the accounting industry, taking care to construct appropriate firewalls to prevent conflicting interests. Let's not forget that we need a strong, healthy, and vibrant accounting industry to provide us with accurate and independent information.

- It's time we get to practical and constructive solutions that will help.

Section-by-Section Analysis

Section 1. Short Title

Designates this title as the "Corporate and Auditing Accountability, Responsibility and Transparency Act of 2002."

Section 2. Auditor Oversight.

The federal securities laws, and the rules and regulations thereunder, require that certain financial statements of public companies be certified by an independent public or certified public accountant and filed with the Securities and Exchange Commission (the "Commission"). Section 2 amends the Securities Exchange Act by inserting after Section 10A (15 U.S.C. 78j-1) a new section, 10B, that requires the establishment of a public regulatory organization ("PRO") to perform certain review and disciplinary functions with respect to accountants who certify those financial statements. Section 2 provides that the Commission shall not accept any such financial statement unless the certifying accountant (1) is subject to a system of review by a PRO established in accordance with the Section and (2) has not been determined in the most recent such review to be not qualified to certify the statements.

Section 2 requires the Commission to adopt rules establishing criteria by which an organization may become a "recognized PRO." Section 2 specifies certain criteria that must be included. The board of any PRO must include members of the accounting profession and "public members" who are not members of the accounting profession. At least two-thirds of the board members must be public members. A PRO must also be organized, and have the capacity, to enforce compliance by accountants, and persons associated with accountants, with the provisions of the Exchange Act, the rules and regulations thereunder, and the PRO's own rules. A PRO must also be organized, and have the capacity, to review accountants' work product and to review potential conflicts of interest involving accountants.

A PRO must have in place procedures to minimize, deter, and resolve conflicts of interest involving its board members. A PRO must also publicly disclose, and make available for public comment, its proposed review procedures and methods. A PRO must consult with State boards of accountancy and must have in place procedures for notifying those boards and the Commission of the results and findings of the PRO's reviews. Finally, a PRO must have in place a mechanism that will allow the PRO to function on a self-funded basis, but that mechanism must not rely principally on the receipt of fees from members of the accounting profession.

An organization that satisfies the criteria to be a recognized PRO is granted the authority to impose sanctions against the accountants it reviews. Those sanctions may include a determination that an accountant is not qualified to certify a financial statement, or certain categories of financial statements, or that a particular person associated with an accountant is not qualified to participate in the certification of a financial statement or certain categories of financial statements. These sanctions may be imposed only after the PRO has conducted a review and provided an opportunity for a hearing and has made any of the following findings: that the accountant or associated person (1) violated professional standards of independence, ethics, or competency; (2) violated the federal securities laws or a rule or regulation thereunder; (3) conducted an audit under circumstances in which independence standards were violated, (including new independence standards which Section 2 requires the Commission to adopt, as discussed below); or (4) impeded, obstructed, or failed to cooperate with the PRO's review.

Section 2 requires the Commission to revise its regulations to provide that, for financial statements required to be certified by an independent public or certified public accountant, an accountant will not be considered independent of its audit client if it provides that client with financial information system design or implementation services or internal audit services. The Commission is required to make such revisions within 180 days of the enactment of Section 2.

Section 2 sets out certain procedures to govern the PRO review and hearing process, and procedures for Commission review of PRO proceedings. A PRO's review proceedings and findings are protected from discovery or use in any federal or state court civil proceeding and are also exempt from disclosure under the Freedom of Information Act before the completion of any Commission review of the findings or the conclusion of the period in

which to seek such review. The Commission is authorized to review PRO findings and sanctions and is authorized to affirm, modify, or set aside the sanctions. Commission review shall include an opportunity for a hearing, though the Commission may limit the hearing solely to consideration of the record before the PRO and the opportunity for the presentation of supporting reasons to affirm, modify, or set aside the sanction.

A recognized PRO is required to file with the Commission any proposed rule or rule change. The Commission shall publish notice of the proposed rule and give interested persons an opportunity to comment. The Commission shall approve any such proposed rule if the Commission finds that the proposal is consistent with the requirements of the Securities Exchange Act and the relevant rules and regulations thereunder. Certain categories of rules may be given effect immediately upon being filed with the Commission, although the Commission has the authority to summarily abrogate any such rule and require that it be filed as a proposed rule for notice and comment. The Commission is also authorized to abrogate, add to, or delete from the rules of a PRO on the Commission's own initiative after publishing notice and giving interested persons an opportunity to submit data, views, and arguments on the proposal.

Section 3. Improper Influence on Conduct of Audits

Section 3 makes it unlawful for any officer, director, or affiliated person of an issuer to take any action, in contravention of rules adopted by the Commission, to unduly or improperly influence, coerce, manipulate, or mislead any independent public or certified accountant engaged in auditing that issuer's financial statements.

Section 4. Real-Time Disclosure of Financial Information.

Section 4 amends Section 13 of the Securities Exchange Act (15 U.S.C. 78m), to require the Commission to adopt rules requiring issuers of securities registered under Section 12 of that Act to make public disclosure, on a rapid and essentially contemporaneous basis, of information concerning the issuer's financial condition and operations. Section 4 provides, however, that any failure to make any such required disclosure shall not, standing alone, constitute a violation of Rule 10b-5 under the Act.

Section 4 also provides that the Commission shall adopt rules providing that any disclosure required by the Federal securities laws, or rules or regulations thereunder, concerning any sale of securities by an officer, director, or other affiliated person of the issuer of the securities shall be made electronically to the Commission before the end of the business day following the day of the transaction, and shall be made available electronically by the Commission before the end of the business day following the day received by the Commission. Any issuer that maintains a corporate web site is also required to publish such disclosure, by any of its officers, directors, or affiliated persons, on its web site by the end of the day following the day the disclosure is received by the Commission. The Commission shall revise its forms and schedules as necessary to facilitate compliance with these requirements.

Section 5. Insider Trades During Pension Fund Blackout Periods Prohibited

Section 5 makes it unlawful for the directors, officers or principal stockholders of an issuer of securities registered pursuant to Section 12 of the Securities Exchange Act of 1934 (15 U.S.C. 78l) to purchase or sell any equity securities of the company during a blackout period. A principal stockholder is one who holds, directly or indirectly, beneficial ownership of more than 10% of any class of equity securities registered pursuant to Section 12.

A blackout period is a period during which the employees of the issuer are not permitted to trade equity securities of the issuer held in an individual account plan of the issuer, as such a plan is defined in Section 3(34) of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1002(34)). A blackout period does not include

periods of restricted trading where express restrictions are incorporated into the individual account plan, and are disclosed in a timely manner to employees before joining the plan, or as a subsequent amendment to the plan.

Section 5 also provides for recovery, by the issuer, of any profit resulting from a trade made in violation of this provision, and permits the Commission to issue rules implementing the section.

Section 6. Improved Transparency of Corporate Disclosures

Section 6 requires the Commission to revise its regulations under Section 13 of the Securities Exchange Act of 1934 (15 U.S.C. 78m), within 180 days, to expand the disclosure requirements for the financial reports and registration statements of public companies, so that they provide adequate and appropriate disclosure of certain of an issuer's off-balance sheet transactions and relationships. Section 6 requires these new disclosures to the extent that the transactions or relationships are not otherwise disclosed in the issuer's financial statements, and are reasonably likely to materially affect the issuer's liquidity or capital resources, or otherwise expose the issuer to material current or possible future liability, obligations, expenses or changes in cash flow, or affect revenue recognition, carrying value, credit ratings, earnings, stock price, or cash flows, or potentially impair assets. Issuers must also disclose relationships and material transactions with related or other persons that involve terms materially different from those that would likely be negotiated with a third party.

The disclosures must include a description of the elements of the transactions necessary to understand their business purpose, economic substance, effect on the financial statements and any special risks or contingencies arising from them.

Section 6 also requires the Commission to conduct an analysis of the extent to which disclosure of additional or reorganized information may be required to improve the transparency, completeness or usefulness of financial statements and other disclosures. In its analysis, the Commission must consider requiring the identification of the key accounting principles that are most important to the issuer's reported financial condition or results of operation, and that require the most difficult, complex or subjective judgments by management. The Commission must also consider requiring an explanation, when material, of how different available accounting principles applied, along with the judgments made in their application and the likelihood of materially different reported results if different assumptions were to prevail. In addition, the Commission must consider requiring an explanation of trading activities were an issuer engages in the business of trading non-exchange traded contracts, accounted for at fair value, but where a lack of market price quotations necessitates the use of fair value estimation techniques. Finally, the Commission must consider establishing requirements relating to the presentation of information in plain language, and requiring any other disclosures in financial statements or other disclosure documents that would improve transparency.

Section 7. Study of Rules Relating to Analyst Conflicts of Interest

Section 7 requires the Commission to conduct a study and review of any final rules by any self-regulatory organization registered with the Commission, related to matters involving equity research analyst conflicts of interest. The study must include a review of the effectiveness of the final rules in addressing matters of objectivity and integrity of equity research analyst reports and recommendations. Section 7 also requires the Commission to submit a report on its study and review to Congress within 180 days of the delivery of the final rules to the Commission, with annual updates thereafter. The report to Congress must include recommendations, including any recommendations for additional self-regulatory organization rulemakings regarding equity research analysts.

Section 8. Oversight of Financial Disclosures

Section 8 requires the Commission to set minimum periodic review requirements to ensure that issuers with the most actively traded or widely held securities, or the largest market-capitalization, will be regularly and thoroughly reviewed by the Commission. Such reviews may include substantive comments, when appropriate, on the issuer's financial statements and other disclosures. The Commission must report annually to Congress on its compliance.

Section 9. Review of Corporate Governance Practices

Section 9 requires the President's Working Group on Financial Markets to conduct a study and review of corporate governance standards and practices, to determine whether they serve the best interests of shareholders. In conducting the study, the Working Group must seek the views of and consult with State securities and corporate regulators, and must report on its analysis to Congress within 180 days of enactment.

The Working Group's study must include an analysis of (1) whether current standards and practices promote full disclosure to shareholders of relevant information; (2) whether corporate codes of ethics are adequate for shareholder protection; (3) the extent to which conflicts of interest are aggressively reviewed; (4) the extent to which sufficient legal protection exists to ensure that any manager who attempts to manipulate or unduly influence an audit is subject to appropriate sanctions and liability; (5) whether the rules, standards and practices relating to determining whether independent directors are in fact independent are adequate; (6) whether rules relating to the independence of directors serving on audit committees are adequate to protect investors and are uniformly applied; (7) whether the duties and responsibilities of audit committees should be established by the Commission; (8) and what further or additional practices or standards might best protect investors and promote the interests of shareholders.

Section 10. Study of Enforcement Actions

Section 10 requires the Commission to review and analyze all of its enforcement actions involving violations of securities law reporting requirements and all restatements of financial statements over the past five years. The purpose of the review is to identify the areas of reporting most susceptible to fraud, inappropriate manipulation or inappropriate earnings management, such as revenue recognition and the accounting treatment of off-balance sheet special purpose entities. The Commission must report its findings to Congress within 180 days of enactment, and use its findings to revise rules and regulations as necessary.

Section 11. Study of Credit Rating Agencies

Section 11 requires the Commission to conduct a study of the role and function of credit rating agencies in the operation of the securities markets, and report on the analysis to the President and Congress within 180 days of enactment. In conducting the study, the Commission must examine (1) the role of credit rating agencies in the evaluation of securities issuers, and the importance of that role to investors and the functioning of the securities markets; (2) any impediments to the accurate appraisal by credit rating agencies of the financial resources and risks of issuers; (3) any measures which may be required to improve the dissemination of information concerning such resources and risks when credit rating agencies announce credit ratings; (4) any barriers to entry into the business of acting as a credit rating agency and measures needed to remove such barriers; (5) and any conflicts of interests in the operation of credit rating agencies and measures to prevent such conflicts or ameliorate their consequences.

Section 12. Reauthorization of Appropriations of the Securities and Exchange Commission

Section 12 aims to increase the Commission's budget in FY 2003 by nearly 50%, authorizing $700,000,000, of which not less than $134,000,000 shall be available for the Division of Corporation Finance and not less than $326,000,000 for the Division of Enforcement.

Section 13. Definition of Securities Laws

Section 13 defines "securities laws" under this Act to mean the Securities Act of 1933 (15 U.S.C. 77a et. seq.), the Securities Exchange Act of 1934 (15 U.S.C. 78a et. seq.), the Trust Indenture Act of 1939 (15 U.S.C. 77aaa et. seq.), the Investment Company Act of 1940 (15 U.S.C. 80a-1 et. seq.), the Investment Advisers Act of 1940 (15 U.S.C. 80b et. seq.), and the Securities Investor Protection Act of 1970 (15 U.S.C. 78aaa et. seq.).