Norfolk, City of Virginia Beach, and the counties of James City, Isle of Wight, and Southampton for Individual Assistance and Public Assistance.

All counties within the Commonwealth of Virginia are eligible to apply for assistance under the Hazard Mitigation Grant Program.

(The following Catalog of Federal Domestic Assistance Numbers (CFDA) are to be used for reporting and drawing funds: 83.537, Community Disaster Loans; 83.538, Cora Brown Fund Program; 83.539, Crisis Counseling; 83.540, Disaster Legal Services Program; 83.541, Disaster Unemployment Assistance (DUA); 83.542, Fire Suppression Assistance; 83.543, Individual and Family Grant (IFG) Program; 83.544, Public Assistance Grants; 83.545, Disaster Housing Program; 83.548, Hazard Mitigation Grant Program)

James L. Witt,

Director.

[FR Doc. 99–25175 Filed 9–27–99; 8:45 am]

BILLING CODE 6718–02–P

FEDERAL EMERGENCY MANAGEMENT AGENCY

[FEMA–1293–DR]

Commonwealth of Virginia; Amendment No. 1 to Notice of a Major Disaster Declaration

AGENCY: Federal Emergency Management Agency (FEMA).

ACTION: Notice.

SUMMARY: This notice amends the notice of a major disaster for the Commonwealth of Virginia, (FEMA–1293–DR), dated September 18, 1999, and related determinations.

EFFECTIVE DATE: September 20, 1999.

FOR FURTHER INFORMATION CONTACT: Madge Dale, Response and Recovery Directorate, Federal Emergency Management Agency, Washington, DC 20472, (202) 646–3772.

SUPPLEMENTARY INFORMATION: The notice of a major disaster for the Commonwealth of Virginia is hereby amended to include the following areas among those areas determined to have been adversely affected by the catastrophe declared a major disaster by the President in his declaration of September 18, 1999:

The independent cities of Colonial Heights City and Petersburg City, and the counties of Accomack, Lancaster, Northumberland, Prince George County, Surry, Sussex, and York for Individual Assistance.

The independent cities of Suffolk City and Williamsburg, and the counties of Accomack, New Kent, Northampton, Prince George, Surry, Sussex, Westmoreland, and York for Public Assistance.

(The following Catalog of Federal Domestic Assistance Numbers (CFDA) are to be used for reporting and drawing funds: 83.537, Community Disaster Loans; 83.538, Cora Brown Fund Program; 83.539, Crisis Counseling; 83.540, Disaster Legal Services Program; 83.541, Disaster Unemployment Assistance (DUA); 83.542, Fire Suppression Assistance; 83.543, Individual and Family Grant (IFG) Program; 83.544, Public Assistance Grants; 83.545, Disaster Housing Program; 83.548, Hazard Mitigation Grant Program)

Lacy E. Suiter,

Executive Associate Director, Response and Recovery Directorate.

[FR Doc. 99–25176 Filed 9–27–99; 8:45 am]

BILLING CODE 6718–02–P

FEDERAL FINANCIAL INSTITUTIONS EXAMINATION COUNCIL

Federal Financial Institutions Examination Council

Interagency Policy Statement on External Auditing Programs of Banks and Savings Associations

ACTION: Notice of final interagency policy statement.

SUMMARY: The Federal Financial Institutions Examination Council (FFIEC) on behalf of the Board of Governors of the Federal Reserve System (FRB), the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC), and the Office of Thrift Supervision (OTS), collectively referred to as the ‘‘banking agencies’’ or the ‘‘agencies,’’ is adopting an Interagency Policy Statement on External Auditing Programs of Banks and Savings Associations (Policy Statement). The National Credit Union Administration (NCUA), also a member of the FFIEC, does not plan to adopt the policy at this time. Banks and savings associations (institutions) with $500 million or more in total assets must have an annual audit performed by an independent public accountant under section 36 of the Federal Deposit Insurance Act (FDI Act), as implemented by 12 CFR Part 363. Thus, this Policy Statement applies only to institutions below that threshold that are not otherwise subject to audit requirements.

Accurate financial reporting is essential to an institution’s safety and soundness. To ensure accurate and reliable financial reporting, the agencies recommend that the board of directors of each institution establish and maintain an external auditing program. This Policy Statement provides guidance regarding independent external auditing programs encompassing: responsibilities of boards of directors, audit committees, and senior management; attributes and types of external auditing programs; special situations for institutions that are part of a holding company, newly chartered institutions, and institutions presenting supervisory concern; and examiner guidance for the review of external auditing programs. The Policy Statement also encourages institutions that are not otherwise required to do so, to establish an audit committee. This committee should consist entirely of outside directors, if practicable.

EFFECTIVE DATE: The Policy Statement is effective for fiscal years beginning on or after January 1, 2000.

FOR FURTHER INFORMATION CONTACT: *FDIC:* Doris L. Marsh, Examination Specialist, Division of Supervision, (202) 898–8905, or A. Ann Johnson, Counsel, Legal Division, (202) 898–3573, FDIC, 550 17th Street, N.W., Washington, DC 20429.

FRB: Charles H. Holm, Manager, (202) 452–3502, or Arthur Lindo, Supervisory Financial Analyst, (202) 452–2695, Accounting Policy and Disclosure, Division of Banking Supervision and Regulation, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, N.W., Washington, DC 20551.

OCC: Gene Green, Deputy Chief Accountant, Office of the Chief Accountant, (202) 874–4933, or Bill Morris, Senior Policy Analyst/National Bank Examiner, (202) 874–4915, Core Policy Division, Office of the Comptroller of the Currency, 250 E Street, S.W., Washington, DC 20219.

OTS: Timothy J. Stier, Chief Accountant, (202) 906–5699, or Christine A. Smith, Policy Analyst, (202) 906–5740, Accounting Policy Division, Office of Thrift Supervision, 1700 G Street, N.W., Washington, DC 20552.

SUPPLEMENTARY INFORMATION:

I. Background

An institution’s internal and external auditing programs are critical to its safety and soundness. Many institutions currently have independent external audits. These audits are undertaken voluntarily or are required by section 36 of the FDI Act (12 U.S.C. 1831m) and its implementing regulation, 12 CFR part 363; the Securities and Exchange Act of 1934 (15 U.S.C. 78a); the Federal Reserve bank holding company reporting requirements in the FR Y–6 Annual Report of Bank Holding Companies; or other appropriate laws and regulations. When an institution lacks an internal auditing program or has weaknesses in an existing program, examiners often encourage the institution to have an independent external audit[1] performed. However, some institutions, particularly smaller institutions, still do not have an external audit for various reasons.

The banking agencies believe that an independent external audit provides reasonable assurance that an institution's financial statements are prepared in accordance with generally accepted accounting principles (GAAP). Accordingly, the banking agencies encourage all institutions to obtain external audits. To provide explicit guidance to institutions regarding external audits, the FFIEC has approved a uniform Interagency Policy Statement. The FFIEC recommends to the banking agencies that they individually adopt the policy.

This Policy Statement is generally consistent with the individual policies of the banking agencies. The agencies have provided guidance on external audits to their supervised institutions, but a uniform policy does not exist. For example, the OCC discusses its policies with regard to independent external audits for national banks in the Comptroller's Handbook for National Banks, Section 102, Internal and External Audits, and the Comptroller's Corporate Manual. The FDIC first adopted guidance on this subject in its Policy Statement Regarding Independent External Auditing Programs of State Nonmember Banks in 1988 (53 FR 47871, November 28, 1988) and amended this policy in 1996 (61 FR 32438, June 24, 1996). The OTS's policy on independent external audits is discussed in the Thrift Activities Regulatory Handbook, Section 350, Independent Audits. The FRB sets forth its policy on external audits in the FR Y–6—Annual Report of Bank Holding Companies and Section 1010, ''External Audits,'' of the Commercial Bank Examination Manual.

II. The Proposed Policy Statement

The FFIEC sought public comment on the proposed policy statement on External Auditing Programs of Banks and Savings Associations in February 1998 (63 FR 7796, February 17, 1998). A section-by-section summary of the proposal follows:

[1] An examination of the financial statements of an institution performed by an independent certified or licensed public accountant in accordance with generally accepted auditing standards (GAAS) and of sufficient scope to enable the independent public accountant to express an opinion on the institution's financial statements as to their presentation in accordance with generally accepted accounting principles (GAAP).

Board of Directors' Responsibilities

The proposed policy statement expressed the banking agencies' belief that accurate financial reporting is essential to an institution's safety and soundness. To help ensure accurate and reliable financial reporting, the agencies recommended that the board of directors of each institution consider establishing and maintaining an external auditing program. The banking agencies believe that the board of directors should consider an external auditing program performed by an independent public accountant to be conducive to the safe and sound operation of the institution.

The proposal also encouraged the board of each institution, that is not otherwise required to do so, to establish an audit committee consisting entirely of outside directors, if practicable. It stated that an institution's board of directors or audit committee should consider the appropriateness of an external auditing program for the institution. In addition, the board of directors or audit committee should consider what form of external auditing program would assure that the institution's financial statements and regulatory reports are prepared reliably.

Alternative External Auditing Programs

The proposed policy statement identified a preferred external auditing program—a financial statement audit by an independent public accountant. The proposal also identified two alternatives—a report on the balance sheet audit and an attestation report on an internal control assertion.

The proposal also stated that an institution which is a subsidiary of a holding company may express the scope of its external auditing program in terms of its relationship to the consolidated group. However, the board or audit committee of the subsidiary should determine whether the subsidiary's activities involve unusual risks that are not covered adequately within the scope of the audit of the consolidated financial statements. If so, the proposal suggested that the board or audit committee consider strengthening its internal auditing procedures or implementing an appropriate alternative external auditing program.

Other Matters Concerning an External Auditing Program

The proposed policy statement recommended that an institution's external auditing program be performed as of a quarter-end date that coincides with a regulatory report date. The proposal explained that an independent public accountant should have access to examination reports, other documents, and reports of action related to the supervision of the institution by its appropriate federal or state banking agency.

Examiner Review of the External Auditing Program

The proposal explained that examiners should consider an institution's size, the nature and scope of its activities, and any compensating controls when determining the adequacy of its external auditing program and making recommendations for improvement. Examiners should also consider whether the institution has undertaken a state-required auditing program (the scope of which differs from the preferred and alternative programs set forth in the proposal) when determining whether to make recommendations for improvements to the institution's external auditing program.

Notification and Submission of Reports

In the proposal, the agencies requested that each institution furnish, to its appropriate supervisory office, a copy of any reports by the independent public accountant pertaining to the external auditing program. The proposal also requested each institution to notify its appropriate supervisory office when an independent public accountant is engaged initially or when a change in, or termination of the services of, its accountant occurs.

Special Situations

The proposed policy statement noted that the FDIC Statement of Policy on Applications for Deposit Insurance (57 FR 12822) requires newly insured institutions to adopt an appropriate external auditing program. The proposal also listed some of the conditions that might be present in a problem institution which would warrant imposing requirements for specific external auditing services.

Appendix A—Definitions

Appendix A defined the terms used throughout the proposed policy statement. The agencies intended that these definitions be consistent with those used in current professional accounting and auditing literature and in the report of the Committee of Sponsoring Organizations of the Treadway Commission (COSO Report), ''Internal Control—Integrated Framework.''

III. Discussion of Public Comments

A. General Comments

The FFIEC received approximately 120 letters commenting on the proposed policy statement. Over 90 letters came from depository institutions whose size (based on total assets) ranged from about $2 million to $250 million. Of those letters, 20 percent came from national banks, 70 percent from state nonmember banks, and 10 percent from state member banks. One savings association submitted a comment. The other letters primarily came from national and state bank trade associations, accounting trade associations, accounting firms, and state banking departments. Other commenters included an organization representing state bank supervisory authorities, an attorney, an auditor, a consultant and two bank holding companies with small community banks.

Almost two-thirds of the commenters generally were opposed to the proposed policy statement. They cited the cost of requiring an audit by an independent public accountant as the reason for opposition. Those commenters warned that the cost of a financial statement audit would far outweigh its benefits for most small banks. In addition, over 40 percent of commenters opposed any requirement that each institution have an independent public accountant perform any external auditing program.

A number of commenters suggested that only institutions over a specified threshold be required to have an annual audit. The recommended thresholds ranged from $50 million to $250 million in total assets, with most respondents suggesting either $100 or $150 million in total assets as the appropriate size.

In contrast, most of the state banking departments that commented on the proposal favored it as did three-quarters of the accounting organizations, two banks, and one national bank trade association.

Several commenters questioned the timing of this proposal. Commenters suggested that the FFIEC not make it effective until after institutions had dealt with their Year 2000 computer problems. One state banking regulator suggested that the FFIEC phase in the proposal over a three year period to give states time to make their laws and regulations consistent with the proposed policy statement. Another state banking department recommended that the FFIEC exempt institutions in states with acceptable directors' examination requirements.

B. Changes to the Proposal in Response to Comments

Introduction

Many of the commenters misinterpreted the purpose, effect, and consequences of the proposed policy statement, believing that the agencies were requiring external audits of all institutions. For that reason, the FFIEC has expanded the Introduction to the Policy Statement and revised several parts of the document to better explain the recommendations.

Overview of External Auditing Programs

The FFIEC has revised the overview to set forth the benefits of a strong external auditing program and to discuss the responsibilities of the board of directors and audit committee for such a program. Because of many commenters' misunderstanding that the proposed policy statement requires an audit, the final Policy Statement has been clarified to explain that both an institution's audit committee and the agencies' examiners should consider the size of the institution and the nature, scope, and complexity of its operations when evaluating its external auditing program.

Nevertheless, many institutions already have an annual audit of their financial statements performed by an independent public accountant. In fact, almost 65 percent of institutions with total assets under $500 million either voluntarily or for other reasons have such an audit. More than 85 percent of the institutions with total assets under $500 million either have an audit or another type of external auditing program performed annually by an independent public accountant.[2] Thus, the agencies do not believe that they need to establish a total asset threshold (below the $500 million threshold in 12 CFR 363) at which institutions would be required to have audits. However, the agencies expect those institutions that historically have had annual audits to continue to do so. For those having another type of external auditing program performed by an independent public accountant, the agencies expect them to continue to obtain the same, or a more extensive, external auditing program in future years.

The proposed policy statement encouraged institutions that are not otherwise required to do so to have an audit committee consisting entirely of outside directors, if practicable. However, several commenters argued that small banks in rural communities may find it difficult to obtain knowledgeable persons outside of the institution who are willing to sit on a bank's board of directors. The agencies do not dispute this argument and for that reason, included a practicability exception in the proposal. This exception remains in the Policy Statement. As with the other provisions of this Policy Statement, an institution's board is encouraged to establish an audit committee entirely of outside directors, but is not required to do so.

External Auditing Programs

The final Policy Statement includes a new section which provides an overview of the basic attributes of a sound external auditing program. This section should assist boards and audit committees in determining the type of program that is most suitable for their institution. The final Policy Statement continues to identify a preferred external auditing program (a financial statement audit by an independent public accountant) and two alternative programs (an attestation report on internal control and a report on the balance sheet audit). It includes an explanation of these alternatives.

Several commenters argued that the cost of the balance sheet audit alternative was similar to that of a complete financial statement audit. Others stated that the internal control attestation report alternative is impractical because establishing and maintaining adequate internal control is very difficult in a small bank with few employees. The agencies agree that the cost of a balance sheet report audit may approach the cost of a financial statement audit, but in their opinion, it is a satisfactory alternative for many small banks. The internal control attestation alternative is generally the least costly of the three and may be the most beneficial choice for many small institutions. The agencies understand that small institutions will not have sufficient employees to establish as extensive an internal control system as larger institutions (for example, segregation of duties), but small institutions can use compensating controls to lessen the internal control risk.

[2] Of institutions under $500 million in total assets, annual audits are obtained by approximately 70 percent of national banks, 65 percent of state member banks, and 58 percent of state nonmember banks. If other annual external auditing programs performed by an independent public accountant are included, approximately 90 percent of national banks, 86 percent of state member banks, and 82 percent of state nonmember banks already have external auditing programs that would likely meet the recommendations of the Policy Statement. With regard to all thrift institutions, about 97 percent currently have annual audits and 99 percent have an external auditing program performed by an independent public accountant.

The final Policy Statement discusses the state-required examinations and agreed-upon procedures that are performed annually for some small institutions. The document does not preclude an institution from selecting one of these external auditing programs. The Policy Statement also describes when management should consider expanding the scope of the external auditing program.

This section also recommends that an institution schedule an annual external auditing program as of year-end, or if that is not possible, at a quarter-end date that coincides with a regulatory report date. To minimize expense, several commenters suggested that the FFIEC recommend that external auditing programs be performed every 18 months, every other year, or every third year. The agencies did not change their recommendation, because they believe that external auditing programs are most effective if performed annually.

The Policy Statement encourages institutions to use an independent public accountant to provide a recognized standard of knowledge and objectivity. It has been revised, however, to permit a person other than an independent public accountant to perform agreed-upon procedures/state required examinations when permitted under the appropriate state law or regulations. Nevertheless, the Policy Statement cautions that whoever does such work should have experience with financial institution accounting and auditing and should be knowledgeable about relevant laws and regulations.

Special Situations

This section of the Policy Statement generally is unchanged from the proposal. It continues to address institutions that are holding company subsidiaries, newly insured institutions, and institutions that present supervisory concerns.

Examiner Guidance

This section has been expanded to provide general guidance to examiners who will assess an institution's external auditing program, and to describe the basis for evaluating the institution's performance. For example, examiners are expected to evaluate whether (1) the board or audit committee has reviewed at least annually an institution's external auditing program; (2) the program is appropriate for the size and operations of the institution; (3) the external auditor is independent; (4) the board or audit committee has concluded that the auditor is competent and knowledgeable about banking; and (5) the external auditing program has been monitored properly. Nevertheless, in the agencies' opinion, an examiner should not automatically comment adversely to the board of directors of an institution with an otherwise satisfactory external auditing program merely because it does not engage an independent public accountant to audit its financial statements.

In addition, this section reconfirms that an auditor should have access to examination reports and other communications between regulators and the institution. Institutions also are encouraged to submit, to their appropriate supervisory office on a timely basis, reports issued by their external auditor on the external auditing program. The section also states that the institution should obtain an engagement letter from the auditor which states that examiners will be granted immediate and full access to the external auditing reports and related workpapers prepared by the auditor.

Appendix A—Definitions

Appendix A defines the terms used throughout the Policy Statement. The agencies made revisions only when needed to be consistent with any changes in the final Policy Statement.

C. Other Comments

The agencies encouraged comments on the proposed policy statement from any institution that had its independent public accountant perform one of the proposed alternative external auditing programs, *i.e.*, a report on the institution's balance sheet or an attestation report on internal control over specified schedules of its regulatory reports. Although many commenters objected to those alternatives, no respondents from banking organizations indicated that they had experience with these types of engagements.

In addition, some states have state-required external auditing programs (e.g., directors' examinations) that differ from the types of external auditing programs described in the proposed policy statement. Accordingly, the FFIEC requested comments on the amount of time states needed to modify the agreed-upon procedures in state-required examinations to be consistent with the types of programs set forth in any final Policy Statement. One state suggested three years. Several states indicated that the policy would have little effect because all, or almost all, of the institutions within their states already obtain audits. Since this Policy Statement recommends, but does not require that institutions establish external auditing programs, the agencies are not providing a phase-in period as suggested by some commenters or a specifically defined transition period to allow states to modify their requirements.

Several other state banking departments recommended state-required examinations as an alternative. Since these examinations differ among the states, and the states may, at any time, amend their requirements, the agencies did not believe that they should make any determination as to which state requirements should be considered acceptable. The final Policy Statement does not preclude an institution from using the state-required examination as an alternative. However, as with all other external auditing programs, the institution's board or audit committee should determine whether such an examination meets the institution's needs, considering its size and the nature, scope, and complexity of its business activities.

IV. Paperwork Reduction Act

In accordance with the Paperwork Reduction Act of 1995 (PRA), the Agencies may not conduct or sponsor, and the respondent is not required to respond to, an information collection that does not display a currently valid Office of Management and Budget (OMB) control number. The FFIEC's Proposed policy statement; Request for comment, which was published on February 17, 1998, at 63 FR 7796, fulfilled the first notice requirement required by the PRA. Four comments were received relating to the information collections in the FFIEC Proposed policy statement. Each Agency likely will adopt the Final FFIEC policy statement for its institutions, including the information collections, as appropriate. At that time, each Agency will respond to the comments received and determine what changes, if any, are appropriate for its supervised institutions.

V. Policy Statement

The text of the Interagency Policy Statement follows:

Federal Financial Institutions Examination Council

Interagency Policy Statement on External Auditing Programs of Banks and Savings Associations

Introduction

The board of directors and senior managers of a banking institution or savings association (institution) are responsible for ensuring that the institution operates in a safe and sound manner. To achieve this goal and meet the safety and soundness guidelines implementing Section 39 of the Federal Deposit Insurance Act (FDI Act) (12 U.S.C. 1831p–1),[1] the institution should maintain effective systems and internal control[2] to produce reliable and accurate financial reports.

Accurate financial reporting is essential to an institution's safety and soundness for numerous reasons. First, accurate financial information enables management to effectively manage the institution's risks and make sound business decisions. In addition, institutions are required by law[3] to provide accurate and timely financial reports (*e.g.*, Reports of Condition and Income [Call Reports] and Thrift Financial Reports) to their appropriate regulatory agency. These reports serve an important role in the agencies'[4] risk-focused supervision programs by contributing to their pre-examination planning, off-site monitoring programs, and assessments of an institution's capital adequacy and financial strength. Further, reliable financial reports are necessary for the institution to raise capital. They provide data to stockholders, depositors and other funds providers, borrowers, and potential investors on the company's financial position and results of operations. Such information is critical to effective market discipline of the institution.

To help ensure accurate and reliable financial reporting, the agencies recommend that the board of directors of each institution establish and maintain an external auditing program. An external auditing program should be an important component of an institution's overall risk management process. For example, an external auditing program complements the internal auditing function of an institution by providing management and the board of directors with an independent and objective view of the reliability of the institution's financial statements and the adequacy of its financial reporting internal controls. Additionally, an effective external auditing program contributes to the efficiency of the agencies' risk-focused examination process. By considering the significant risk areas of an institution, an effective external auditing program may reduce the examination time the agencies spend in such areas. Moreover, it can improve the safety and soundness of an institution substantially and lessen the risk the institution poses to the insurance funds administered by the Federal Deposit Insurance Corporation (FDIC).

This policy statement outlines the characteristics of an effective external auditing program and provides examples of how an institution can use an external auditor to help ensure the reliability of its financial reports. It also provides guidance on how an examiner may assess an institution's external auditing program. In addition, this policy statement provides specific guidance on external auditing programs for institutions that are holding company subsidiaries, newly insured institutions, and institutions presenting supervisory concerns.

The adoption of a financial statement audit or other specified type of external auditing program is generally only required in specific circumstances. For example, insured depository institutions covered by Section 36 of the FDI Act (12 U.S.C. 1831m), as implemented by Part 363 of the FDIC's regulations (12 CFR part 363), are required to have an external audit and an audit committee. Therefore, this policy statement is directed toward banks and savings associations which are exempt from Part 363 (i.e., institutions with less than $500 million in total assets at the beginning of their fiscal year) or are not otherwise subject to audit requirements by order, agreement, statute, or agency regulations.

Overview of External Auditing Programs

Responsibilities of the Board of Directors

The board of directors of an institution is responsible for determining how to best obtain reasonable assurance that the institution's financial statements and regulatory reports are reliably prepared. In this regard, the board is also responsible for ensuring that its external auditing program is appropriate for the institution and adequately addresses the financial reporting aspects of the significant risk areas and any other areas of concern of the institution's business.

To help ensure the adequacy of its internal and external auditing programs, the agencies encourage the board of directors of each institution that is not otherwise required to do so to establish an audit committee consisting entirely of outside directors.[5] However, if this is impracticable, the board should organize the audit committee so that outside directors constitute a majority of the membership.

Audit Committee

The audit committee or board of directors is responsible for identifying at least annually the risk areas of the institution's activities and assessing the extent of external auditing involvement needed over each area. The audit committee or board is then responsible for determining what type of external auditing program will best meet the institution's needs (refer to the descriptions under ''Types of External Auditing Programs'').

When evaluating the institution's external auditing needs, the board or audit committee should consider the size of the institution and the nature, scope, and complexity of its operations. It should also consider the potential benefits of an audit of the institution's financial statements or an examination of the institution's internal control structure over financial reporting, or both. In addition, the board or audit committee may determine that additional or specific external auditing procedures are warranted for a particular year or several years to cover areas of particularly high risk or special concern. The reasons supporting these decisions should be recorded in the committee's or board's minutes.

If, in its annual consideration of the institution's external auditing program, the board or audit committee determines, after considering its inherent limitations, that an agreed-upon procedures/state-required examination is sufficient, they should also consider whether an independent public accountant should perform the work. When an independent public accountant performs auditing and attestation services, the accountant must conduct his or her work under, and may be held accountable for departures from, professional standards. Furthermore, when the external auditing program includes an audit of the financial statements, the board or audit committee obtains an opinion from the independent public accountant stating whether the financial statements are presented fairly, in all material respects, in accordance with generally accepted accounting principles (GAAP). When the external auditing program includes

[1] See 12 CFR Part 30 for national banks; 12 CFR Part 364 for state nonmember banks; 12 CFR Part 208 for state member banks; and 12 CFR Part 510 for savings associations.

[2] This Policy Statement provides guidance consistent with the guidance established in the ''Interagency Policy Statement on the Internal Audit Function and its Outsourcing.''

[3] See 12 U.S.C. 161 for national banks; 12 U.S.C. 1817a for state nonmember banks; 12 U.S.C. 324 for state member banks; and 12 U.S.C. 1464(v) for savings associations.

[4] Terms defined in Appendix A are italicized the first time they appear in this policy statement.

[5] Institutions with $500 million or more in total assets must establish an independent audit committee made up of outside directors who are independent of management. See 12 U.S.C. 1831m(g)(1) and 12 CFR 363.5.

an examination of the internal control structure over financial reporting, the board or audit committee obtains an opinion from the independent public accountant stating whether the financial reporting process is subject to any material weaknesses.

Both the staff performing an internal audit function and the independent public accountant or other external auditor should have unrestricted access to the board or audit committee without the need for any prior management knowledge or approval. Other duties of an audit committee may include reviewing the independence of the external auditor annually, consulting with management, seeking an opinion on an accounting issue, and overseeing the quarterly regulatory reporting process. The audit committee should report its findings periodically to the full board of directors.

External Auditing Programs

Basic Attributes

External auditing programs should provide the board of directors with information about the institution's financial reporting risk areas, *e.g.*, the institution's internal control over financial reporting, the accuracy of its recording of transactions, and the completeness of its financial reports prepared in accordance with GAAP.

The board or audit committee of each institution at least annually should review the risks inherent in its particular activities to determine the scope of its external auditing program. For most institutions, the lending and investment securities activities present the most significant risks that affect financial reporting. Thus, external auditing programs should include specific procedures designed to test at least annually the risks associated with the loan and investment portfolios. This includes testing of internal control over financial reporting, such as management's process to determine the adequacy of the allowance for loan and lease losses and whether this process is based on a comprehensive, adequately documented, and consistently applied analysis of the institution's loan and lease portfolio.

An institution or its subsidiaries may have other significant financial reporting risk areas such as material real estate investments, insurance underwriting or sales activities, securities broker-dealer or similar activities (including securities underwriting and investment advisory services), loan servicing activities, or fiduciary activities. The external auditing program should address these and other activities the board or audit committee determines present significant financial reporting risks to the institution.

Types of External Auditing Programs

The agencies consider an annual audit of an institution's financial statements performed by an independent public accountant to be the preferred type of external auditing program. The agencies also consider an annual examination of the effectiveness of the internal control structure over financial reporting or an audit of an institution's balance sheet, both performed by an independent public accountant, to be acceptable alternative external auditing programs. However, the agencies recognize that some institutions only have agreed-upon procedures/state-required examinations performed annually as their external auditing program. Regardless of the option chosen, the board or audit committee should agree in advance with the external auditor on the objectives and scope of the external auditing program.

Financial Statement Audit by an Independent Public Accountant. The agencies encourage all institutions to have an external audit performed in accordance with generally accepted auditing standards (GAAS). The audit's scope should be sufficient to enable the auditor to express an opinion on the institution's financial statements taken as a whole.

A financial statement audit provides assurance about the fair presentation of an institution's financial statements. In addition, an audit may provide recommendations for management in carrying out its control responsibilities. For example, an audit may provide management with guidance on establishing or improving accounting and operating policies and recommendations on internal control (including internal auditing programs) necessary to ensure the fair presentation of the financial statements.

Reporting by an Independent Public Accountant on an Institution's Internal Control Structure Over Financial Reporting. Another external auditing program is an independent public accountant's examination and report on management's assertion on the effectiveness of the institution's internal control over financial reporting. For a smaller institution with less complex operations, this type of engagement is likely to be less costly than an audit of its financial statements or its balance sheet. It would specifically provide recommendations for improving internal control, including suggestions for compensating controls, to mitigate the risks due to staffing and resource limitations.

Such an attestation engagement may be performed for all internal controls relating to the preparation of annual financial statements or specified schedules of the institution's regulatory reports.[6] This type of engagement is performed under generally accepted standards for attestation engagements (GASAE).[7]

Note: For banks and savings associations, the lending, investment securities, trading, and off-balance sheet schedules consist of:

Area	Reports of condition and income schedules	Thrift financial report schedules
Loans and Lease Financing Receivables	RC–C, Part I	SC, CF.
Past Due and Nonaccrual Loans, Leases, and Other Assets	RC–N	PD.
Allowance for Credit Losses	RI–B	SC, VA.
Securities	RC–B	SC, SI, CF.
Trading Assets and Liabilities	RC–D	SO, SI.
Off-Balance Sheet Items	RC–L	SI, CMR.

[6] Since the lending and investment securities activities generally present the most significant risks that affect an institution's financial reporting, management's assertion and the accountant's attestation generally should cover those regulatory report schedules. If the institution has trading or off-balance sheet activities that present material financial reporting risks, the board or audit committee should ensure that the regulatory report schedules for those activities also are covered by management's assertion and the accountant's attestation. See Note above for further information.

[7] An attestation engagement is not an audit. It is performed under different professional standards than an audit of an institution's financial statements or its balance sheet.

These schedules are not intended to address all possible risks in an institution.

Balance Sheet Audit Performed By An Independent Public Accountant. With this program, the institution engages an independent public accountant to examine and report only on the balance sheet. As with the audit of the financial statements, this audit is performed in accordance with GAAS. The cost of a balance sheet audit is likely to be less than a financial statement audit. However, under this type of program, the accountant does not examine or report on the fairness of the presentation of the institution's income statement, statement of changes in equity capital, or statement of cash flows.

Agreed-Upon Procedures/State-Required Examinations. Some state-chartered depository institutions are required by state statute or regulation to have specified procedures performed annually by their directors or independent persons.[8] The bylaws of many national banks also require that some specified procedures be performed annually by directors or others, including internal or independent persons. Depending upon the scope of the engagement, the cost of agreed-upon procedures or a state-required examination may be less than the cost of an audit. However, under this type of program, the independent auditor does not report on the fairness of the institution's financial statements or attest to the effectiveness of the internal control structure over financial reporting. The findings or results of the procedures are usually presented to the board or the audit committee so that they may draw their own conclusions about the quality of the financial reporting or the sufficiency of internal control.

When choosing this type of external auditing program, the board or audit committee is responsible for determining whether these procedures meet the external auditing needs of the institution, considering its size and the nature, scope, and complexity of its business activities. For example, if an institution's external auditing program consists solely of confirmations of deposits and loans, the board or committee should consider expanding the scope of the auditing work performed to include additional procedures to test the institution's high risk areas. Moreover, a financial statement audit, an examination of the effectiveness of the internal control structure over financial reporting, and a balance sheet audit may be accepted in some states and for national banks in lieu of agreed-upon procedures/state-required examinations.

Other Considerations

Timing. The preferable time to schedule the performance of an external auditing program is as of an institution's fiscal year-end. However, a quarter-end date that coincides with a regulatory report date provides similar benefits. Such an approach allows the institution to incorporate the results of the external auditing program into its regulatory reporting process and, if appropriate, amend the regulatory reports.

External Auditing Staff. The agencies encourage an institution to engage an independent public accountant to perform its external auditing program. An independent public accountant provides a nationally recognized standard of knowledge and objectivity by performing engagements under GAAS or GASAE. The firm or independent person selected to conduct an external auditing program and the staff carrying out the work should have experience with financial institution accounting and auditing or similar expertise and should be knowledgeable about relevant laws and regulations.

Special Situations

Holding Company Subsidiaries

When an institution is owned by another entity (such as a holding company), it may be appropriate to address the scope of its external audit program in terms of the institution's relationship to the consolidated group. In such cases, if the group's consolidated financial statements for the same year are audited, the agencies generally would not expect the subsidiary of a holding company to obtain a separate audit of its financial statements. Nevertheless, the board of directors or audit committee of the subsidiary may determine that its activities involve significant risks to the subsidiary that are not within the procedural scope of the audit of the financial statements of the consolidated entity. For example, the risks arising from the subsidiary's activities may be immaterial to the financial statements of the consolidated entity, but material to the subsidiary. Under such circumstances, the audit committee or board of the subsidiary should consider strengthening the internal audit coverage of those activities or implementing an appropriate alternative external auditing program.

Newly Insured Institutions

Under the FDIC Statement of Policy on Applications for Deposit Insurance, applicants for deposit insurance coverage are expected to commit the depository institution to obtain annual audits by an independent public accountant once it begins operations as an insured institution and for a limited period thereafter.

Institutions Presenting Supervisory Concerns

As previously noted, an external auditing program complements the agencies' supervisory process and the institution's internal auditing program by identifying or further clarifying issues of potential concern or exposure. An external auditing program also can greatly assist management in taking corrective action, particularly when weaknesses are detected in internal control or management information systems affecting financial reporting.

The agencies may require a financial institution presenting safety and soundness concerns to engage an independent public accountant or other independent external auditor to perform external auditing services.[9] Supervisory concerns may include:

- Inadequate internal control, including the internal auditing program;
- A board of directors generally uninformed about internal control;
- Evidence of insider abuse;
- Known or suspected defalcations;
- Known or suspected criminal activity;
- Probable director liability for losses;
- The need for direct verification of loans or deposits;
- Questionable transactions with affiliates; or
- The need for improvements in the external auditing program.

The agencies may also require that the institution provide its appropriate supervisory office with a copy of any reports, including management letters, issued by the independent public accountant or other external auditor. They also may require the institution to notify the supervisory office prior to any meeting with the independent public accountant or other external auditor at which auditing findings are to be presented.

[8] When performed by an independent public accountant, ''specified procedures'' and ''agreed-upon procedures'' engagements are performed under standards, which are different professional standards than those used for an audit of an institution's financial statements or its balance sheet.

[9] The Office of Thrift Supervision requires an external audit by an independent public accountant for savings associations with a composite rating of 3, 4, or 5 under the Uniform Financial Institution Rating System, and on a case-by-case basis.

Examiner Guidance

Review of the External Auditing Program

The review of an institution's external auditing program is a normal part of the agencies' examination procedures. An examiner's evaluation of, and any recommendations for improvements in, an institution's external auditing program will consider the institution's size; the nature, scope, and complexity of its business activities; its risk profile; any actions taken or planned by it to minimize or eliminate identified weaknesses; the extent of its internal audit program; and any compensating controls in place. Examiners will exercise judgment and discretion in evaluating the adequacy of an institution's external auditing program.

Specifically, examiners will consider the policies, processes, and personnel surrounding an institution's external auditing program in determining whether:

- The board of directors or its audit committee adequately reviews and approves external auditing program policies at least annually.
- The external auditing program is conducted by an independent public accountant or other independent auditor and is appropriate for the institution.
- The engagement letter covering external auditing activities is adequate.
- The report prepared by the auditor on the results of the external auditing program adequately explains the auditor's findings.
- The external auditor maintains appropriate independence regarding relationships with the institution under relevant professional standards.
- The board of directors performs due diligence on the relevant experience and competence of the independent auditor and staff carrying out the work (whether or not an independent public accountant is engaged).
- The board or audit committee minutes reflect approval and monitoring of the external auditing program and schedule, including board or committee reviews of audit reports with management and timely action on audit findings and recommendations.

Access to Reports

Management should provide the independent public accountant or other auditor with access to all examination reports and written communication between the institution and the agencies or state bank supervisor since the last external auditing activity. Management also should provide the accountant with access to any supervisory memoranda of understanding, written agreements, administrative orders, reports of action initiated or taken by a federal or state banking agency under section 8 of the FDI Act (or a similar state law), and proposed or ordered assessments of civil money penalties against the institution or an institution-related party, as well as any associated correspondence. The auditor must maintain the confidentiality of examination reports and other confidential supervisory information.

In addition, the independent public accountant or other auditor of an institution should agree in the engagement letter to grant examiners access to all the accountant's or auditor's workpapers and other material pertaining to the institution prepared in the course of performing the completed external auditing program.

Institutions should provide reports [10] issued by the independent public accountant or other auditor pertaining to the external auditing program, including any management letters, to the agencies and any state authority in accordance with their appropriate supervisory office's guidance.[11] Significant developments regarding the external auditing program should be communicated promptly to the appropriate supervisory office. Examples of those developments include the hiring of an independent public accountant or other third party to perform external auditing work and a change in, or termination of, an independent public accountant or other external auditor.

Appendix A—Definitions

Agencies. The agencies are the Board of Governors of the Federal Reserve System (FRB), the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC), and the Office of Thrift Supervision (OTS).

[10] The institution's engagement letter is not a ''report'' and is not expected to be submitted to the appropriate supervisory office unless specifically requested by that office.

[11] When an institution's financial information is included in the audited consolidated financial statements of its parent company, the institution should provide a copy of the audited financial statements of the consolidated company and any other reports by the independent public accountant in accordance with their appropriate supervisory office's guidance. If several institutions are owned by one parent company, a single copy of the reports may be supplied in accordance with the guidance of the appropriate supervisory office of each agency supervising one or more of the affiliated institutions and the holding company. A transmittal letter should identify the institutions covered. Any notifications of changes in, or terminations of, a consolidated company's independent public accountant may be similarly supplied to the appropriate supervisory office of each supervising agency.

Appropriate supervisory office. The regional or district office of the institution's primary federal banking agency responsible for supervising the institution or, in the case of an institution that is part of a group of related insured institutions, the regional or district office of the institution's federal banking agency responsible for monitoring the group. If the institution is a subsidiary of a holding company, the term ''appropriate supervisory office'' also includes the federal banking agency responsible for supervising the holding company. In addition, if the institution is state-chartered, the term ''appropriate supervisory office'' includes the appropriate state bank or savings association regulatory authority.

Audit. An examination of the financial statements, accounting records, and other supporting evidence of an institution performed by an independent certified or licensed public accountant in accordance with generally accepted auditing standards (GAAS) and of sufficient scope to enable the independent public accountant to express an opinion on the institution's financial statements as to their presentation in accordance with generally accepted accounting principles (GAAP).

Audit committee. A committee of the board of directors whose members should, to the extent possible, be knowledgeable about accounting and auditing. The committee should be responsible for reviewing and approving the institution's internal and external auditing programs or recommending adoption of these programs to the full board.

Balance sheet audit performed by an independent public accountant. An examination of an institution's balance sheet and any accompanying footnotes performed and reported on by an independent public accountant in accordance with GAAS and of sufficient scope to enable the independent public accountant to express an opinion on the fairness of the balance sheet presentation in accordance with GAAP.

Engagement letter. A letter from an independent public accountant to the board of directors or audit committee of an institution that usually addresses the purpose and scope of the external auditing work to be performed, period of time to be covered by the auditing work, reports expected to be rendered, and any limitations placed on the scope of the auditing work.

Examination of the internal control structure over financial reporting. See Reporting by an Independent Public Accountant on an Institution's Internal

Control Structure Over Financial Reporting.

External auditing program. The performance of procedures to test and evaluate high risk areas of a institution's business by an independent auditor, who may or may not be a public accountant, sufficient for the auditor to be able to express an opinion on the financial statements or to report on the results of the procedures performed.

Financial statement audit by an independent public accountant. See Audit.

Financial statements. The statements of financial position (balance sheet), income, cash flows, and changes in equity together with related notes.

Independent public accountant. An accountant who is independent of the institution and registered or licensed to practice, and holds himself or herself out, as a public accountant, and who is in good standing under the laws of the state or other political subdivision of the United States in which the home office of the institution is located. The independent public accountant should comply with the American Institute of Certified Public Accountants' (AICPA) *Code of Professional Conduct* and any related guidance adopted by the Independence Standards Board and the agencies. No certified public accountant or public accountant will be recognized as independent who is not independent both in fact and in appearance.

Internal auditing. An independent assessment function established within an institution to examine and evaluate its system of internal control and the efficiency with which the various units of the institution are carrying out their assigned tasks. The objective of internal auditing is to assist the management and directors of the institution in the effective discharge of their responsibilities. To this end, internal auditing furnishes management with analyses, evaluations, recommendations, counsel, and information concerning the activities reviewed.

Outside directors. Members of an institution's board of directors who are not officers, employees, or principal stockholders of the institution, its subsidiaries, or its affiliates, and who do not have any material business dealings with the institution, its subsidiaries, or its affiliates.

Regulatory reports. These reports are the Reports of Condition and Income (Call Reports) for banks, Thrift Financial Reports (TFRs) for savings associations, Federal Reserve (FR) Y reports for bank holding companies, and the H–(b)11 Annual Report for thrift holding companies.

Reporting by an independent public accountant on an institution's internal control structure over financial reporting. Under this engagement, management evaluates and documents its review of the effectiveness of the institution's internal control over financial reporting in the identified risk areas as of a specific report date. Management prepares a written assertion, which specifies the criteria on which management based its evaluation about the effectiveness of the institution's internal control over financial reporting in the identified risk areas and states management's opinion on the effectiveness of internal control over this specified financial reporting. The independent public accountant is engaged to perform tests on the internal control over the specified financial reporting in order to attest to management's assertion. If the accountant concurs with management's assertion, even if the assertion discloses one or more instances of material internal control weakness, the accountant would provide a report attesting to management's assertion.

Risk areas. Those particular activities of an institution that expose it to greater potential losses if problems exist and go undetected. The areas with the highest financial reporting risk in most institutions generally are their lending and investment securities activities.

Specified procedures. Procedures agreed-upon by the institution and the auditor to test its activities in certain areas. The auditor reports findings and test results, but does not express an opinion on controls or balances. If performed by an independent public accountant, these procedures should be performed under generally accepted standards for attestation engagements (GASAE).

Dated: September 22, 1999.

Keith J. Todd,

Executive Secretary, Federal Financial Institutions Examination Council.

[FR Doc. 99–25103 Filed 9–27–99; 8:45 am]

BILLING CODE 6210–01–P; 6720–01–P; 6714–01–P; 4810–33–P

FEDERAL RESERVE SYSTEM

Formations of, Acquisitions by, and Mergers of Bank Holding Companies

The companies listed in this notice have applied to the Board for approval, pursuant to the Bank Holding Company Act of 1956 (12 U.S.C. 1841 *et seq.*) (BHC Act), Regulation Y (12 CFR part 225), and all other applicable statutes and regulations to become a bank holding company and/or to acquire the assets or the ownership of, control of, or the power to vote shares of a bank or bank holding company and all of the banks and nonbanking companies owned by the bank holding company, including the companies listed below.

The applications listed below, as well as other related filings required by the Board, are available for immediate inspection at the Federal Reserve Bank indicated. The application also will be available for inspection at the offices of the Board of Governors. Interested persons may express their views in writing on the standards enumerated in the BHC Act (12 U.S.C. 1842(c)). If the proposal also involves the acquisition of a nonbanking company, the review also includes whether the acquisition of the nonbanking company complies with the standards in section 4 of the BHC Act (12 U.S.C. 1843). Unless otherwise noted, nonbanking activities will be conducted throughout the United States.

Unless otherwise noted, comments regarding each of these applications must be received at the Reserve Bank indicated or the offices of the Board of Governors not later than October 22, 1999.

A. Federal Reserve Bank of St. Louis (Randall C. Sumner, Vice President) 411 Locust Street, St. Louis, Missouri 63102-2034:

1. Area Bancshares Corporation, Owensboro, Kentucky; to acquire 100 percent of the voting shares of Dees Bank of Hazel, Hazel, Kentucky, Bank of Livingston County, Tiline, Kentucky; Peoples Bank of Murray, Kentucky, Murray, Kentucky; and Lyon Bancorp, Inc., Eddyville, Kentucky, and its subsidiary bank, The Bank of Lyon County, Tiline, Kentucky.

B. Federal Reserve Bank of San Francisco (Maria Villanueva, Manager of Analytical Support, Consumer Regulation Group) 101 Market Street, San Francisco, California 94105-1579:

1. InterBancorp, Inc., Duvall, Washington; to become a bank holding company by acquiring 100 percent of the voting shares of Inter Bank, Duvall, Washington.

Board of Governors of the Federal Reserve System, September 22, 1999.

Robert deV. Frierson,

Associate Secretary of the Board.

[FR Doc. 99–25102 Filed 9–27–99; 8:45 am]

BILLING CODE 6210–01–F