CORPORATE GOVERNANCE, AUDITS, AND REPORTING REQUIREMENTS

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TO:	CHIEF EXECUTIVE OFFICER (also of interest to Chief Financial Officer and Members of the Board)
SUBJECT:	Effect of the Sarbanes-Oxley Act of 2002 on Insured Depository Institutions
Summary:	*The FDIC is providing guidance to institutions about selected provisions of the Sarbanes-Oxley Act, including the actions the FDIC encourages institutions to take to ensure sound corporate governance. The guidance also discusses the applicability of the auditor independence provisions of the Act and the Securities and Exchange Commission's implementing regulations to institutions with $500 million or more in total assets.*

The provisions of the Sarbanes-Oxley Act of 2002 are primarily directed toward those companies, including insured depository institutions, that have a class of securities registered with the Securities and Exchange Commission (SEC) or the appropriate federal banking agency under Section 12 of the Securities Exchange Act of 1934, i.e., public companies. Since enactment of the Act, the Federal Deposit Insurance Corporation (FDIC) has received questions about the applicability of the Sarbanes-Oxley Act to insured depository institutions. The answers to these questions depend, in large part, on an institution's size and whether it is a public company or a subsidiary of a public company.

FDIC-Supervised Banks That Are Public Companies or Subsidiaries of Public Companies

Some FDIC-supervised banks have registered their securities with the FDIC pursuant to Part 335 of the FDIC's regulations and are, therefore, public companies. Other FDIC-supervised banks are subsidiaries of bank holding companies that are public companies. These public companies and their independent public accountants must comply with the Sarbanes-Oxley Act — including those provisions governing auditor independence, corporate responsibility and enhanced financial disclosures — and the implementing regulations. The SEC is at various stages in the adoption of these regulations. For banks whose securities are registered with the FDIC, Part 335 currently incorporates applicable SEC regulations by reference, but the FDIC expects that certain amendments to Part 335 will be necessary.

Non-public FDIC-Supervised Banks With Less Than $500 Million in Total Assets

FDIC-supervised banks that have less than $500 million in total assets as of the beginning of their fiscal year are **not** subject to the annual audit and reporting requirements of Section 36 of the Federal Deposit Insurance (FDI) Act. Banks in this size range that are not public companies, or subsidiaries of public companies, generally do **not** fall within the scope of the Sarbanes-Oxley Act and the SEC's implementing regulations. Nevertheless, certain provisions of the Sarbanes-Oxley Act mirror existing policy guidance related to corporate governance that the FDIC and the other banking agencies have issued. Other provisions of the Sarbanes-Oxley Act represent sound corporate governance practices.

Attachment I presents a summary of selected provisions of the Sarbanes-Oxley Act that the FDIC believes are of relevance to FDIC-supervised banks with less than $500 million in total assets that are not public companies. The sound corporate governance practices detailed in Attachment I are not mandatory for smaller, non-public institutions; however, the FDIC recommends that each institution consider implementing them to the extent feasible given its size, complexity, and risk profile.

Insured Depository Institutions With $500 Million or More in Total Assets

Institutions that have $500 million or more in total assets as of the beginning of their fiscal year are subject to the annual audit and reporting requirements of Section 36 of the FDI Act as implemented by Part 363 of the FDIC's regulations. Some of these large institutions are public companies or subsidiaries of public companies. Some institutions subject to Part 363 currently satisfy the requirements of this regulation on a holding company basis. The applicability of the Sarbanes-Oxley Act to institutions with $500 million or more in total assets is discussed in Attachment II.

The Sarbanes-Oxley Act can be accessed at http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=107_cong_bills&docid=f:h3763enr.txt.pdf (204KB File - PDF Help or Hard Copy). For further information on the applicability of the Sarbanes-Oxley Act provisions, please contact Examination Specialist Mike Jenkins (202-898-6896) or Senior Staff Accountant Dennis Chapman (202-898-8922) of the Division of Supervision and Consumer Protection's Risk Management Policy and Examination Support Branch.

For your reference, FDIC Financial Institution Letters may be accessed on the FDIC's Web site at http://www.fdic.gov/news/news/financial/2003/index.html.

Michael J. Zamorski

Director

Attachments: Applicability of Selected Provisions of the Sarbanes-Oxley Act of 2002 to FDIC-Supervised Banks With Less Than $500 Million In Total Assets That Are Not Public Companies

Applicability of Selected Provisions of The Sarbanes-Oxley Act of 2002 to Insured Institutions With $500 Million Or More In Total Assets

Distribution: FDIC-Supervised Banks (Commercial and Savings) and Insured Depository Institutions with $500 Million or More in Total Assets

NOTE: Paper copies of FDIC financial institution letters may be obtained through the FDIC's Public Information Center, 801 17th Street, NW, Room 100, Washington, DC 20434 (1-877-275-3342, option 5, or 202-416-6940).

APPLICABILITY OF SELECTED PROVISIONS OF THE SARBANES-OXLEY ACT OF 2002 TO FDIC-SUPERVISED BANKS WITH LESS THAN $500 MILLION IN TOTAL ASSETS THAT ARE NOT PUBLIC COMPANIES

This attachment addresses selected provisions of the Sarbanes-Oxley Act of 2002. For each selected section of the act, a summary of the section, and any implementing regulation, is first presented. Each summary is followed by a description of related policy guidance issued by the banking agencies or comments concerning sound corporate governance practices that banks are encouraged to implement to the extent feasible given the bank's size, complexity, and risk profile.

As used in Attachment I, the term "bank" refers to an FDIC-supervised bank with less than $500 million in total assets that is not a public company or a subsidiary of a public company.

Title I - Public Company Accounting Oversight Board

Section 102. Registration with the Board.

Only an accounting firm or an accountant that has registered with the Public Company Accounting Oversight Board, i.e., a "registered public accounting firm," can audit the financial statements of a public company. This requirement is scheduled to take effect no later than October 23, 2003.

Related Policy Guidance for Banks

The 1999 Interagency Policy Statement on External Auditing Programs of Banks and Savings Associations assigns responsibility to an institution's board of directors for ensuring that the scope of its external auditing program is appropriate for the institution. Under the policy statement, the agencies consider an annual audit of an institution's financial statements to be the preferred type of external auditing program. Acceptable alternatives are a balance sheet audit and an examination of management's assertion on the effectiveness of the institution's internal control over financial reporting. These three types of external auditing programs can only be performed by an independent public accountant. However, when selecting such an accountant, banks are not limited to "registered public accounting firms."

Title II - Auditor Independence

On January 22, 2003, the Securities and Exchange Commission (SEC) adopted final rules implementing the auditor independence provisions of Sections 201, 202, 203, and 206 of Title II of the Sarbanes-Oxley Act and the auditor reporting requirements of Section 204 of Title II.[1]

Section 201. Services Outside the Scope of Practice of Auditors. and Section 202. Preapproval Requirements.

To be considered independent, a registered public accounting firm that audits a public company's financial statements would not be permitted to provide, contemporaneously with the audit, any of the non-audit services listed in Section 201 or any other service the Oversight Board determines by regulation to be impermissible. These prohibited services include:

- Bookkeeping or other services related to the accounting records or financial statements of the audit client;
- Financial information systems design and implementation;
- Appraisal or valuation services, fairness opinions, or contribution-in-kind reports;
- Actuarial services;
- Internal audit outsourcing services;
- Management functions or human resources;
- Broker or dealer, investment adviser, or investment banking services; and
- Legal services and expert services unrelated to the audit.

In general, a registered independent public accountant can provide non-audit services that are not otherwise prohibited, including tax services, to a public company audit client only if the activity is approved in advance by the company's audit committee. Similarly, the audit committee of a public company generally must preapprove all audit and permissible non-audit services to be provided by the company's external auditor.

Sound Corporate Governance Practices for Banks

The FDIC encourages each bank whose financial statements are audited and its accounting firm to follow the internal audit outsourcing prohibition in Section 201. Nevertheless, many banks have determined that the benefits of having a full-time internal auditor do not exceed the costs of such an arrangement. In addition, a bank may find that hiring separate firms to perform internal and external audit work is not cost-effective. In this regard, for a bank with less complex operations and limited staff, the use of the independent public accountant to perform both an external audit and some or all of the bank's internal audit activities may help the FDIC achieve its safety and soundness objectives for the bank.

If a bank is considering engaging its external auditor to perform both of these services, the bank's audit committee (or board of directors if there is no audit committee) and the external auditor should pay particular attention to preserving the independence of both the internal and external audit functions. Furthermore, the audit committee should document both that it has preapproved the internal audit outsourcing to its external auditor and has considered the independence issues associated with this arrangement. In this regard, the audit committee should consider the independence guidance contained in the American Institute of Certified Public Accountants' *Code of Professional Conduct* and the broad principles that the auditor should not perform management functions or act as an advocate for the client. The audit committee should also consider how the bank will oversee the external auditor's performance under the internal audit outsourcing contract. This oversight should be provided by a competent employee who ideally has no managerial responsibility for the areas being audited under the outsourcing contract and who reports directly to the audit committee concerning internal audit issues.

In addition, if a bank is considering having its external auditor perform any of the other non-audit services prohibited by Section 201, the FDIC encourages the bank's audit committee (or board of directors) to discuss the implications of the performance of these services on the auditor's independence.

The FDIC and the other banking agencies are revising the 1997 Interagency Policy Statement on the Internal Audit Function and Its Outsourcing consistent with the discussion above. In addition, as a general corporate governance matter, the FDIC encourages the audit committee (or board of directors) of each bank to preapprove all audit and non-audit services to be provided by its external auditor.

Section 203. Audit Partner Rotation.

A registered public accounting firm would not be considered independent of a public company audit client if the lead audit partner having primary responsibility for the audit, or the concurring audit partner responsible for reviewing the audit, has performed in this capacity for the audit client for five consecutive years. The SEC's final rule on auditor independence requires the lead and concurring partners to rotate after five years and, upon rotation, to be subject to a five-year "time out" period. In addition, the SEC's final rule imposes a seven-year rotation requirement on certain other audit partners on the audit client's engagement team followed by a two-year "time out" period. These partner rotation rules are intended to strike a balance between the need to bring a fresh look to the audit engagement and the need to maintain continuity and audit quality.

The SEC's final rules also contain an exemption from the rotation requirements for small accounting firms, i.e., firms with fewer than five public company audit clients and fewer than ten audit partners, provided an audit quality review condition is met.

Sound Corporate Governance Practices for Banks

When dealing with accounting firms that perform audits of non-public banks, the FDIC considers the SEC's standard of fewer than ten audit partners to be a reasonable boundary for defining an accounting firm to be a small firm. When a bank engages an accounting firm that is not a small firm to perform its external auditing program, the FDIC encourages audit partner rotation and "time out" periods, which may be achieved by incorporating them into the bank's engagement letter with the firm.

Section 204. Auditor Reports to Audit Committees

Each registered public accounting firm that audits a public company's financial statements should report on a timely basis to the company's audit committee:

- All critical accounting policies used by the company;
- Alternative accounting treatments that the accounting firm has discussed with the company's management along with the potential ramifications of using those alternatives, and the treatment preferred by the accounting firm; and
- Other written communications the accounting firm has provided to the company's management, such as a management letter or a schedule of unadjusted differences.

These reporting requirements are intended to strengthen the relationship between the audit committee and the auditor.

Sound Corporate Governance Practices for Banks

Effective communication between an external auditor and a bank's audit committee (or board of directors if there is no audit committee) will assist the audit committee in carrying out its responsibilities. Accordingly, the FDIC encourages each bank to institute these auditor reporting practices by incorporating them into its engagement letter with the auditor.

Section 206. Conflicts of Interest.

A registered public accounting firm would not be considered independent of a public company audit client if the client's chief executive officer, controller, chief financial officer, chief accounting officer or equivalent officer was employed by the accounting firm and participated in the audit of the client during the one-year period before the beginning of the current audit.

Sound Corporate Governance Practices for Banks

The FDIC encourages each bank and its external auditing firm to comply with this conflicts of interest requirement.

Title III - Corporate Responsibility

Section 301. Public Company Audit Committees.

The audit committee of each public company listed on a securities exchange or Nasdaq would be responsible for the appointment, compensation, and oversight of the work of a registered public accounting firm related to issuing audit reports. Each member of such an audit committee must be a member of the board of directors and shall otherwise be independent. In addition, the audit committee member cannot accept any consulting, advisory, or compensatory fee from the public company, other than fees for serving as a board or committee member, or be affiliated with the company or a subsidiary of the company. The audit committee must establish procedures for processing complaints and processing confidential, anonymous submissions by employees regarding accounting, internal control, and auditing matters.

Related Policy Guidance for Banks

The 1999 Interagency Policy Statement on External Auditing Programs of Banks and Savings Associations already encourages the board of directors of each institution that is not otherwise required to do so to establish an audit committee consisting entirely of outside directors. The FDIC continues to encourage institutions to do so. The policy statement defines "outside directors" as 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."

Sound Corporate Governance Practices for Banks

In addition, it is a sound corporate governance practice for a bank to establish procedures for processing complaints and employee submissions. Accordingly, each bank's audit committee should establish a mechanism, appropriate to the size and complexity of the bank, for employees to submit confidentially and anonymously concerns to the committee about questionable accounting, internal accounting control or auditing matters. The audit committee also should set up procedures for the timely investigation of complaints received and the retention for a reasonable time period of documentation concerning the complaint and its subsequent resolution. Where the board of directors fulfills the audit committee responsibilities, the procedures should provide for the submission of employee concerns to an outside director.

Section 302. Corporate Responsibility for Financial Reports.

A public company's principal executive officer and principal financial officer must include a certification in each quarterly and annual report filed under the Securities Exchange Act of 1934. According to the SEC's final rule implementing Section 302,[2] which became effective on August 29, 2002, these officers each must certify that:

- He or she has reviewed the quarterly or annual report;
- Based on his or her knowledge, the report does not contain any untrue statement of a material

fact or omit to state a material fact; and

- Based on his or her knowledge, the financial statements and other financial information included in the report fairly present in all material respects the public company's financial condition, results of operations, and cash flows.

The officers' certifications also must address matters pertaining to disclosure controls and procedures and internal control.

Sound Corporate Governance Practices for Banks

When a bank files its Reports of Condition and Income (Call Report), an authorized officer of the bank must sign a declaration that the reports are true to the best of the officer's knowledge and belief. In addition, two bank directors must declare that they have examined the report and attest to its correctness. Banks that issue audited financial statements to their shareholders or others may also want to consider including with the financial statements a certification by the bank's principal executive officer and principal financial officer. The certification would state that the officers have reviewed the financial statements and, based on their knowledge, the statements are true and fairly present in all material respects the bank's financial condition, results of operations, and cash flows.

Section 303. Improper Influence on Conduct of Audits.

No officer or director of a public company or anyone acting under their direction can mislead, coerce, manipulate, or fraudulently influence a registered independent public accounting firm preparing an audit report for the purpose of rendering it materially misleading.

Sound Corporate Governance Practices for Banks

The FDIC strongly encourages compliance with Section 303 regardless of the type of external auditing program an institution has implemented. Improper influence over external auditing work may be deemed an unsafe and unsound practice.

Title IV - Enhanced Financial Disclosures

Section 401. Disclosures in Periodic Reports.

Financial reports filed with the SEC must reflect material correcting adjustments identified by a registered public accounting firm. The reports shall disclose all material off-balance sheet transactions, arrangements, obligations, and relationships that may have a material current or future effect on the company.[3]

Sound Corporate Governance Practices for Banks

The FDIC strongly encourages banks to make all material correcting adjustments identified by external auditors regardless of the type of external auditing program the bank has implemented. If the bank issues audited financial statements, the FDIC encourages disclosure of material off balance sheet transactions to ensure that examiners and other users of the financial statements are aware of them and can include them in their evaluation of the condition and risk profile of the bank.

Section 402. Enhanced Conflict of Interest Provisions.

Public companies would be prohibited from extending credit in the form of a loan to any director or executive officer. Certain consumer loans are permitted if made in the ordinary course of the consumer credit business of the company, are generally available to the public, and made on market terms. This provision does not apply to any loan made by an insured depository institution if the loan is subject to the insider lending restrictions under section 22(h) of the Federal Reserve Act and Federal Reserve Regulation O.

Related Policy Guidance for Banks

All banks should continue to comply with Regulation O in their lending to directors and executive officers.

Section 404. Management Assessment of Internal Controls.

In their annual reports, public companies must include an internal control report that states that management is responsible for establishing and maintaining an adequate internal control structure and procedures for financial reporting. The report must also contain an assessment, as of the end of the most recent fiscal year, of the effectiveness of the company's internal control structure and procedures for financial reporting. The company's registered public accounting firm must attest to and report on management's assessment.

Related Policy Guidance for Banks

The 1999 Interagency Policy Statement on External Auditing Programs of Banks and Savings Associations identifies a management assessment of internal controls over financial reporting and an independent public accountant's attestation on management's assessment as an acceptable alternative external auditing program for an institution that chooses not to have an audit of its financial statements.

Sound Corporate Governance Practices for Banks

Even when a bank chooses to have a financial statement audit as its external auditing program, which the external auditing policy statement describes as the preferred type of program, the FDIC encourages banks to consider the benefits and costs of supplementing the audit with an internal control assessment by management and an attestation of this assessment by the bank's independent public accountant.

Section 406. Code of Ethics for Senior Financial Officers.

Each public company must disclose in financial reports filed under the Securities Exchange Act of 1934 whether the company has adopted a code of ethics that applies to its principal executive officer, principal financial officer, principal accounting officer, and controller. If not, the company must disclose the reasons why. Disclosure on a current basis is also required of amendments to and waivers from the company's ethics code for senior financial officers. In a final rule adopted on January 15, 2003,[4] the SEC defined the term "code of ethics" to mean written standards that are reasonably designed to deter wrongdoing and to promote:

- Honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships;
- Full, fair, accurate, timely, and understandable disclosure in reports and documents the public company files under the federal securities laws and in other public communications the company makes;
- Compliance with applicable rules and regulations;
- Prompt internal reporting to an appropriate person of violations of the code; and

- Accountability for adherence to the code.

Related Policy Guidance for Banks

The FDIC issued "Guidelines for Compliance with the Federal Bank Bribery Law" in 1987.[5] These guidelines encourage all FDIC-supervised banks to adopt internal codes of conduct or written policies, or amend their present codes of conduct, to include provisions that explain the general provisions of the bank bribery law. The guidelines also encourage banks to prohibit, in their codes of conduct or policies, their bank officials from self-dealing or otherwise trading on their positions with the bank. In addition, the guidelines recommend that bank codes of conduct or policies require that bank officials disclose all potential conflicts of interest, including those in which they have been inadvertently placed due to either business or personal relationships with customers, suppliers, business associates, or competitors of the bank. The guidelines define "bank official" as any employee, officer, director, agent, or attorney of an FDIC-supervised bank.

Sound Corporate Governance Practices for Banks

The FDIC continues to encourage each bank to adopt a code of ethics for senior financial officers. If the bank decides not to do so, the FDIC encourages it to explain, perhaps in the minutes of the board of directors, the reasons why. The FDIC also encourages periodic disclosure of the existence of a code of ethics, or lack thereof, to shareholders.

Section 407. Disclosure of Audit Committee Financial Expert.

Each public company must disclose whether the audit committee is comprised of at least one member who is an "audit committee financial expert." If not, the company must disclose the reasons why. In a final rule adopted on January 15, 2003, the SEC defined the term "audit committee financial expert" as a person who:

- Understands generally accepted accounting principles (GAAP) and financial statements;
- Is able to assess the general application of GAAP in connection with the accounting for estimates, accruals, and reserves;
- Has experience in preparing, auditing, analyzing, or evaluating financial statements of a breadth and complexity comparable to that of the public company's financial statements, or has experience actively supervising one or more persons engaged in such activities;
- Understands internal controls and procedures for financial accounting; and
- Understands audit committee functions.

A person can acquire such attributes through one or more means, including education and experience as, or experience actively supervising, a public accountant, auditor, controller,, principal accounting officer, or principal financial officer.

Sound Corporate Governance Practices for Banks

The extent to which audit committee members (or directors) at public companies will be able to meet the SEC's definition of an "audit committee financial expert" is not known. Although the FDIC does not expect a bank to disclose whether or not it has a financial expert on its audit committee, a bank may choose to make such a disclosure on its own.

[1]The SEC's final rule can be accessed at http://www.sec.gov/rules/final/33-8183.htm.

[2]The SEC's final rule can be accessed at http://www.sec.gov/rules/final/33-8124.htm.

[3]The SEC's final rule on disclosure about off-balance sheet arrangements, which was adopted on January 22, 2003, can be accessed at http://www.sec.gov/rules/final/33-8182.htm.

[4]The SEC's final rule can be accessed at http://www.sec.gov/rules/final/33-8177.htm. This final rule implements both Sections 406 and 407 of the Sarbanes-Oxley Act.

[5]"Guidelines for Compliance with the Federal Bank Bribery Law" can be found on pages 5289-91 of the FDIC's *Laws, Regulations, and Related Acts*.

APPLICABILITY OF SELECTED PROVISIONS OF THE SARBANES-OXLEY ACT OF 2002 TO INSURED INSTITUTIONS WITH $500 MILLION OR MORE IN TOTAL ASSETS

Attachment I summarizes selected provisions of the Sarbanes-Oxley Act. The FDIC is considering possible amendments to Part 363 of its regulations that would extend certain provisions of the Sarbanes-Oxley Act that were described in Attachment I to all insured institutions with $500 million or more in total assets (covered institutions), whether or not they are public companies or subsidiaries of public companies. Any amendments to Part 363 would be developed in consultation with the other banking agencies and would be published in proposed form for public comment in the *Federal Register*.

This attachment discusses the relationship between three elements of the Sarbanes-Oxley Act and the annual audit and reporting requirements of Section 36 of the Federal Deposit Insurance Act and Part 363 of the FDIC's regulations. It then explains how FDIC-supervised covered institutions that are not public companies should view the other provisions of the Sarbanes-Oxley Act.

Auditor Independence

Appendix A to Part 363, Guidelines and Interpretations, presents the views of the FDIC on the interpretation of the annual audit and reporting requirements prescribed by Section 36 of the Federal Deposit Insurance Act. Guideline 14 addresses the qualifications of an independent public accountant engaged by an insured institution subject to Part 363 and states that the accountant should be "in compliance with the AICPA's *Code of Professional Conduct* and meet the independence requirements and interpretations of the SEC and its staff."

Thus, the guidelines provide for each covered institution, whether or not it is a public company, and its external auditor to comply with the SEC's auditor independence requirements (17 C.F.R. Section 210.2-01) that are in effect during the period covered by the audit of the institution's financial statements. If a covered institution satisfies the annual independent audit requirement by relying on the audit of its parent holding company, the holding company's external auditor should meet the SEC's independence requirements. Accordingly, all covered institutions should review the final rules on auditor independence that the SEC adopted on January 22, 2003, and ensure that they and their external auditors take appropriate actions to comply with these rules consistent with the time frames specified in the transition guidance.

The SEC's final rules on auditor independence implement the provisions of Sections 201, 202, 203, and 206 of Title II of the Sarbanes-Oxley Act. In summary, the final rules:

- Revise the SEC's existing regulations related to the non-audit services that, if provided to an audit client, would impair an accounting firm's independence;
- Require that a public company's audit committee pre-approve all audit and non-audit services provided to the company by the auditor of its financial statements;
- Prohibit certain partners on the audit engagement team from providing audit services to the public company for more than five or seven consecutive years, depending on the partner's involvement in the audit, except that certain small accounting firms may be exempted from this requirement; and

- Prohibit an accounting firm from auditing a public company's financial statements if certain members of management of that public company had been members of the accounting firm's audit engagement team within the one-year period preceding the commencement of audit procedures; and
- Provide that an audit partner's receipt of compensation based on the sale of engagements to an audit client for services other than audit, review, and attest services would impair the accountant's independence.

The final rules were published in the *Federal Register* on February 5, 2003, and generally become effective on May 6, 2003 (68 Fed. Reg. 6006).[6] However, the final rules include transition guidance that states that, provided a relationship between an accountant and its audit client that is not acceptable under the final rules did not impair the accountant's independence under the pre-existing independence requirements of the SEC, the Independence Standards Board, or the American Institute of Certified Public Accountants, the accountant's independence will not be deemed to be impaired under the final rule in the following circumstances:

- With respect to prohibited non-audit services under Section 201 of the Sarbanes-Oxley Act, as implemented by Section 201.2-01(c)(4) of the SEC's regulations, an accountant's independence will not be deemed to be impaired until May 6, 2004, if the accountant provides non-audit services prohibited by Section 201.2-01(c)(4) to an audit client pursuant to contracts in existence on May 6, 2003. This portion of the final rule recognizes that audit clients may need a period of time to exit existing contracts with their auditor.
- With respect to the audit committee preapproval requirements under Section 202, as implemented by Section 201.2-01(c)(7) of the SEC's regulations, an accountant's independence will not be deemed to be impaired until May 6, 2003, if the accountant provides services that have not been approved by the audit committee.
- With respect to the audit partner rotation requirements under Section 203, as implemented by Section 201.2-01(c)(6) of the SEC's regulations, an accountant's independence will not be deemed to be impaired until the first day of the public company's fiscal year beginning after:
- May 6, 2004, if a concurring partner provides services to the audit client in excess of those permitted in this regulation; or
- May 6, 2003, if a lead partner or other audit partner provides services in excess of those permitted in this regulation.

The SEC's regulation also explains how to measure a partner's period of service for purposes of determining when a partner becomes subject to the audit partner rotation requirements. This transition guidance is designed to allow accounting firms to establish an orderly transition of their audit engagement teams. In addition, the SEC's regulation exempts accounting firms with fewer than five public company audit clients and fewer than ten audit partners from the rotation requirements provided the Public Company Accounting Oversight Board conducts a review of all of the firm's audit engagements of these public company clients at least once every three years.

For purposes of the FDIC's Part 363 auditor independence guideline, the accounting firm for a covered institution, whether or not it is a public company or a subsidiary of a public company, should meet the SEC's audit partner rotation requirements, unless the SEC's small firm exemption would apply to the firm because it has fewer than five public company audit clients and fewer than ten audit partners.

Management's Responsibility for Financial Reporting and Controls

As noted in Attachment I, Section 302 of the Sarbanes-Oxley Act requires a certification by the principal executive officer and the principal financial officer in each quarterly and annual report that a public company files under the Securities Exchange Act of 1934. The SEC adopted a final rule implementing Section 302 that became effective August 29, 2002.[7] This final rule prescribes the specific wording of the required certification and this wording may not be changed in any respect. In addition, each principal executive officer and principal financial officer of a public company must provide a separate certification.

Section 36 of the FDI Act and Part 363 of the FDIC's regulations require each covered institution must include a management report in the annual report it files with the FDIC, its primary federal regulator (if other than the FDIC), and any appropriate state supervisor. The management report must be signed by the institution's chief executive officer and chief accounting or chief financial officer. It must contain a statement of management's responsibilities for:

- Preparing the institution's annual financial statements;
- Establishing and maintaining an adequate internal control structure and procedures for financial reporting; and
- Complying with designated safety and soundness regulations.

The management report also must include assessments by management of the effectiveness of the internal control structure and procedures for financial reporting as of the end of the fiscal year and the institution's compliance with the designated safety and soundness regulations during the fiscal year.

With certain exceptions, this management report requirement may be satisfied by an insured institution's holding company if the services and functions comparable to those required of the institution by Section 36 and Part 363 are provided at the holding company level.

The content of the certification required by Section 302 is sufficiently different from the content of the management report required by Section 36 and Part 363 that an insured institution that is a public company, or a subsidiary of a public holding company, ***may not*** submit a Section 302 certification in place of the required management report.

Furthermore, in recent reviews of management reports filed by insured institutions subject to Section 36 and Part 363, the FDIC has found that many institutions are failing to fully comply with the requirements governing the content of these reports. Managements of institutions are frequently omitting one or more of the following from these reports:

- The required statement of management's responsibilities for preparing the institution's financial statements;
- The required statement of management's responsibilities for complying with the designated safety and soundness laws and regulations; and
- Management's required assessment of the institution's compliance with the designated safety and soundness laws and regulations during its most recent fiscal year.

The chief executive officer and the chief accounting or chief financial officer of each institution subject to the annual audit and reporting requirements of Section 36 and Part 363 should ensure that their management report has been properly prepared before signing and dating the report. Institutions filing deficient management reports will be directed to revise and resubmit these reports.

Management's Assessment of Internal Controls and Accountant's Attestation on This Assessment

In addition to the management report requirements pertaining to the internal control structure and procedures for financial reporting discussed above, Section 36 and Part 363 require a covered institution's independent public accountant to examine, attest to, and report separately on management's assertion concerning internal control. This attestation report must be included in the annual report the covered institution files with the FDIC, its primary federal regulator (if other than the FDIC), and any appropriate state supervisor.

The language in Section 404 of the Sarbanes-Oxley Act requiring each public company to include an internal control report and an accountant's attestation report thereon in its annual report filed under the Securities Exchange Act of 1934 is substantially similar to the language in Section 36. However, the SEC has yet to prescribe rules requiring the internal control report and accountant's attestation report. After such rules have been adopted by the SEC, the FDIC will review these rules to determine whether covered institutions that are public companies, or subsidiaries of public companies, can use the Section 404 internal control report and accountant's attestation report to satisfy the comparable Section 36 and Part 363 requirement. In the meantime, covered institutions and their independent public accountants must continue to comply with the relevant requirements of Section 36 and Part 363 that pertain to internal control.

Other Provisions of the Sarbanes-Oxley Act

Unless and until the FDIC adopts any amendments to Part 363 in response to other provisions of the Sarbanes-Oxley Act and the SEC's implementing regulations, FDIC-supervised covered institutions that are not public companies should review the guidance in Attachment I concerning corporate governance practices that the FDIC encourages non-public institutions to implement to the extent feasible given the institution's size, complexity, and risk profile.

[6]The SEC's final rule can be accessed at http://www.sec.gov/rules/final/33-8183.htm.

[7]The SEC's final rule can be accessed at http://www.sec.gov/rules/final/33-8124.htm.