



# Audit Committee Guide for Financial Institutions

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McGladrey & Pullen provides professional services to more than 2,000 financial institutions. McGladrey's professionals use a unique combination of industry expertise and computer-based tools to deliver efficient and cost-effective services and value-added recommendations to assist our clients in achieving their goals.

The contents of this guide are not intended, and cannot be considered, as legal advice or a legal opinion.

## Introduction

Dear Clients and Friends of the Firm,

Corporate governance has become an area of focus for stakeholders of financial institutions. The stakeholders want assurance that company management and the board of directors are providing oversight and direction. A strong audit committee, armed with a robust audit committee charter, is an essential part of the governance of a company.

The audit committee provides oversight to the financial reporting process and provides assurance to the board of directors regarding financial reporting integrity. Oversight means that the audit committee needs to understand management's objectives and processes to reach those objectives and ensure that management addresses areas critical to the integrity of the financial reporting process. Oversight is not managing day-to-day activities. Areas of oversight for the audit committee include:

- Financial reporting process
- Control environment
- Risk assessment, including fraud risk
- External audit
- Internal audit
- Regulatory and compliance issues
- Conflicts of interest

Financial institution directors need little introduction to the concept of the audit committee; in fact, financial institutions established audit committees long before most commercial companies. As a standing committee of the board of directors, often with wide-ranging responsibilities in connection with auditing and financial reporting, the audit committee is recognized for its contributions to corporate accountability. The Office of the Comptroller of the Currency (OCC), the Federal Reserve Bank (FRB), the Office of Thrift Supervision (OTS), the Federal Deposit Insurance Corporation (FDIC) and state banking regulators place significant emphasis on the effective execution of the duties of an audit committee.

Audit committees are of particular importance to independent auditors, boards of directors, management, regulators and investors since all of these parties have a common interest in and dedication to the quality of the financial institution's financial reporting. This guide offers our perspective on best practices on the changing role of the audit committee, its value to the company and its present and future functions. The Audit Committee Guide for Financial Institutions is a continuation of our commitment to assist you in understanding the issues and successfully building an effective audit committee.

Sincerely,

McGladrey & Pullen, LLP  
July 2008

## Executive summary

Audit committees help fulfill the board of director's fiduciary responsibility by overseeing the financial reporting process and the audit processes. Audit committees raise the level of confidence in the financial reporting process by successfully achieving the duties delegated to them by the board of directors. An active audit committee, comprised of strong members, will allow the company and its shareholders to benefit from the collective insight and experience of the members of the audit committee.

Each company is unique in its organization and management style. The composition of the board of directors and the audit committee should reflect the unique aspects of the company and its governance policies. One size does not fit all when it comes to audit committee size or structure. A key to an effective audit committee is that the audit committee must have the resources, competence and capacity to be diligent overseers and to spend the time needed to understand and manage the financial reporting process.

The audit committee must have a framework that allows effective oversight. Audit committee members must be willing to listen, ask questions, assess the impact, and challenge answers, and ensure that identified improvements are implemented.

To accomplish their responsibilities, the members of the audit committee must be informed and vigilant overseers of the financial reporting process and of the other participants in that process. The members of the audit committee must understand the business operations, the risks of the business model and the interrelationship between the business operations and financial reporting. Another important role of the audit committee is to select and retain the company's independent audit firm.

The audit committee must be willing to ask probing questions of management, the internal auditor and the independent auditors. But asking the tough questions is only part of their responsibility. Understanding and evaluating the answers are equally important. The audit committee must understand the business risks and rewards that the company management team presents to the board of directors.

The audit committee and board of directors need to establish a "tone at the top" that insists on integrity and accuracy in financial reporting. The tone at the top is set by:

- Requiring accurate and clear financial reporting
- Insisting that the numbers and financial statement disclosures accurately reflect the risks that are being managed
- Challenging management's perspectives about the "why" and "what" behind the numbers and the business operations

This guide discusses the responsibilities of the audit committee and suggests "best practices" by providing a framework for the audit committee to accomplish its responsibilities. We also provide tools for the organization of an audit committee and its operations, including a sample charter, a discussion of audit committee responsibilities, and assessment tools for the assessment of internal audit and the audit committee activities. Sample questions are also provided to assist audit committee members in discharging their responsibilities.

## The audit committee charter

Audit committees should operate with a written charter that provides a clear understanding of the committee's roles and responsibilities. A well-written, detailed charter will provide a framework of the committee's organization and responsibilities that can be referred to by the board, committee members, management, internal auditors, and external auditors.

The audit committee charter should be included in the annual proxy statement for a public reporting company every third year, or when it has revisions. Privately held financial institutions should have an audit committee charter that provides the expectations for performance and incorporates best practices.

The audit committee charter should define:

- Overall purpose, responsibility and authority
- Composition of the committee
- Frequency of meetings
- Scope of responsibilities, including qualifications and terms of office
- Relationship with independent auditors, including pre-approval of services provided
- Relationship with the internal audit function
- Oversight of the corporate compliance function
- Reporting responsibilities
- Authority to conduct special investigations
- Authority to engage experts as needed

The board of directors should review, approve and revise the charter as necessary. In developing a charter, it is important that the committee's activities are not unduly restricted. The committee's duties and responsibilities need to be flexible enough to allow it to operate effectively. The board should ensure that the charter responds to the company's changing needs.

The charter should:

- Serve as a guide in planning the committee's meeting agendas
- Be reviewed annually by the board to ensure that the committee's objectives are met
- Provide a framework for reporting the committee's activities to the board
- Serve as a basis for the audit committee self-evaluation

While no sample charter can encompass all of the activities that an audit committee could be assigned, an illustration of an audit committee charter is included in Appendix I. The charter should set forth board expectations of the performance of the audit committee. In all likelihood, these expectations will vary from company to company.

## Audit committee responsibilities

Audit committee activities have evolved as the business and regulatory environment has changed. Activities that have been identified and held out as “best practices” will also evolve as the business and regulatory environments change. Audit committees should continually monitor changes in order to adopt “best practices”.

The audit committee’s central focus should be protecting shareholders’ interests. A principal activity that assists a shareholder in understanding company financial results is the transparent reporting and disclosure of the risks that the company is managing and the impact those risks have on financial performance. The financial disclosures of a company, which include financial statements, annual reports, call reports and press releases, are the primary means by which the “what” and “why” behind the numbers are explained to users.

Companies should maintain an accounting system that is designed to accurately gather and record transactions. Companies should also maintain a system of internal controls over financial reporting to ensure the system as designed is operating to provide reliable financial statements and related disclosures.

The audit committee should ensure that there are processes in place to monitor internal controls over financial reporting, comply with laws and regulations, and conform to policy and procedure statements established by the board of directors.

The specific responsibilities assigned to the audit committee will vary with the circumstances of each company. The audit committee charter will assign those responsibilities.

In general, the audit committee responsibilities will include:

- Oversight of the adequacy of internal controls and risk management systems
- Oversight of the financial reporting process at interim dates and year end
- Oversight of the audit process
- Selection of the independent auditor

To accomplish the specific responsibilities assigned to the audit committee, members have to understand the industry and the external factors that are driving change in the industry. Issues such as legislation, the regulatory environment, the economy, legal actions and consolidation should be considered in understanding how the company’s operations are affected. Industry studies and surveys from investment banking firms, regulators and trade associations provide a perspective regarding markets, technology developments and human resources.

To accomplish its objectives, the audit committee should obtain an understanding of the company’s:

- Structure and organization
- Major loan and deposit products and services
- Ownership
- Capitalization and financing
- Accounting system
- Financial reporting system
- Significant customers
- Internal audit capabilities
- Attorneys and consultants
- Types of transactions — normal and non-recurring
- Related-party transactions
- Off-balance sheet activities

## Understanding and oversight of the control environment and risk assessment

The audit committee should understand the key components of internal controls, including the factors that could allow fraud to occur and go undetected.

### Control environment

The control environment provides a key element of the company's internal control and establishes the tone at the top of the organization. The control environment includes factors such as:

- Organizational structure
- Level of board oversight of the company's activities
- Management philosophy and operating style
- Human resources policies and procedures
- Assignment of authority and responsibilities
- Financial reporting competencies
- Integrity and ethical values

This tone sets the climate for high-quality financial reporting and addressing issues relating to internal controls. Audit committees should review policy statements and procedure manuals, and have discussions with management to develop an understanding of the company's control environment.

### Risk assessment

The risk assessment of a company relates to the identification, analysis and monitoring of risks that could impact the financial statements and related disclosures. The senior management team should evaluate the enterprise risks of internal and external factors that relate to broad categories of operations as well as specific situations.

Risks relevant to the financial reporting process may affect the company's ability to estimate, record, process and report financial data reliably. Risks can arise or change due to:

- Changes in the business environment
- New personnel
- New or revised information systems
- Rapid growth
- New technology
- New business model, product, service or activity
- Corporate restructuring
- Foreign operations
- New accounting standards or changes in accounting principles
- New or revised regulatory requirements

The current business environment is constantly changing, business transactions are becoming more complex, and information technology changes how transactions are processed. The audit committee must keep informed of the risks that could impact the financial reporting process as well as the controls that management should implement to address those risks. In addition, the audit committee has to understand how the changes impact operations and be alert for either external or internal emerging risks.

## Information and communication

Accurate and reliable financial information is needed to manage the daily operations of a financial institution. Pertinent information must be identified, captured and communicated in a form and timeframe that enables company personnel to carry out their responsibilities. Information systems produce reports containing operational, financial and compliance-related information that make it possible to operate and control the business.

Information systems reports include internally generated data and information about external events, activities and conditions necessary for informed business decision-making and external reporting.

Effective communication also must occur in a broader sense - flowing down, across and up the organization to the audit committee and to the board. All personnel must receive a clear message from the board through top management that control responsibilities must be taken seriously. They must understand their own role in the internal control system, as well as how individual activities relate to the work of others. They must have a means of communicating significant information upstream. There also needs to be effective communication with external parties, such as customers, suppliers, regulators and shareholders.

## Monitoring

Monitoring involves assessing the quality of the internal control system's performance over time and taking necessary corrective action when required. Monitoring activities include:

- Comparison of actual results to prior periods, budgets or forecasts
- Effectiveness of the internal audit function
- Independent auditor evaluation of internal controls
- Information from other external parties
- Communication from regulators

The Committee of Sponsoring Organizations of the Treadway Commission (COSO) issued the COSO Report in 1992. The report defines **internal control** as "a process, effected by an entity's Board of Directors, Management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in effectiveness and efficiency of operations, reliability of financial reporting and compliance with applicable laws and regulations." The report's definition of internal control provides a standard against which the audit committee can assess the company's control systems so that, when necessary, they can be improved.

Company management should provide to the audit committee an overview of the company's risk and control environment being managed and its policies, procedures and controls surrounding the integrity of financial reporting.

### COSO Internal Control – Integrated Framework

COSO describes five interrelated components of internal control. The audit committee's thorough understanding of these components will facilitate its evaluation of the company's controls against the COSO benchmark. The five components are:

**Control Environment.** The control environment sets the tone of an organization. It is the foundation for all other components of internal control, providing discipline and structure. Control environment factors include the integrity, ethical values and competence of the entity's personnel.

**Risk Assessment.** Risk assessment is the identification and analysis of relevant risks to the achievement of the entity's objectives and forms a basis for determining how those risks should be managed.

**Control Activities.** Control activities are the policies and procedures that help ensure that the necessary actions are taken to address risks to the achievement of the entity's objectives.

**Information and Communication.** Pertinent information must be identified, captured and communicated in a form and timeframe that enables personnel to carry out their responsibilities. All personnel must receive a clear message that control responsibilities must be taken seriously.

**Monitoring.** The internal control system needs to be monitored to assess its performance over time.

## Fraud risk

The tone set by senior management is the most important factor contributing to the integrity of the financial reporting process because it becomes a core value of the company and a model of appropriate conduct for every level of the organization. To achieve a strong tone at the top, management should:

- Identify and understand the factors that can lead to fraudulent financial reporting
- Assess the risk of fraudulent financial reporting that these factors create within the company
- Design and implement the necessary internal controls for prevention or detection

Statement on Auditing Standards No. 99, *Consideration of Fraud in a Financial Statement Audit*, (SAS 99) establishes standards and provides guidance to external auditors as to their responsibilities in determining that the financial statements are not materially misstated due to error or fraud.

SAS 99 addresses:

- Description and characteristics of fraud
- The importance of professional skepticism
- Discussions among engagement personnel regarding the risks of material misstatements due to fraud
- Obtaining information needed to identify risks of material misstatement due to fraud
- Identifying risks that may result in material misstatement due to fraud
- Assessing the identified risks
- Auditor's response to the assessment of risks
- Evaluating audit evidence
- Communication about fraud to management, the audit committee and others
- Documentation of the auditor's considerations of fraud

Senior management has the responsibility to implement systems to prevent or deter the occurrence of fraud. The audit committee should understand fraud risk factors relevant to the organization and its operations.

Three conditions exist when fraud occurs:

- 1) Incentive or pressure - management or other employees may have an incentive or pressure that provides a reason to commit fraud.
- 2) Opportunity - circumstances exist at the organization (i.e., ineffective or no controls in place, or ineffective oversight) that provide an opportunity for a fraud to be perpetrated.
- 3) Rationalization - some individuals possess an attitude, character, or set of ethical values that allow them to knowingly and intentionally commit a dishonest act.

### National Association of Corporate Directors

The National Association of Corporate Directors Best Practices Council identified four basic principles for protecting shareholders against fraud and other illegal acts:

**Setting the tone at the top through conduct and communication.** Establish a corporate culture committed to ethical, lawful behavior, both inside and outside the Company that begins at the highest level and permeates the entire organization.

**Director commitment and independence.** Form a Board comprised of directors who are willing to devote the necessary time and energy to the job. Directors must be independent in attitude and have no significant affiliations with management or the Company.

**Explicit focus on fraud risk.** Ensure participation in fraud prevention and deterrence by all levels of management.

**Effective communication process.** Ensure open and continuing communication by the Board, CEO, senior managers, other employees and independent auditors.

## Understanding and oversight of the financial reporting process

The financial reporting process is management's summarization of the results of managing risks that impact the company. The reporting process should have a clear, transparent discussion of the accounting policies that impact the way that financial condition and results of operations are reported. Management, of course, is responsible for seeing that this information is collected and reported. Implicit in this responsibility is management's assurance that the information is complete, accurate and reliable. That assurance must go beyond printed financial statements. Today, the internet, which is used to disseminate financial information, should be subjected to the same degree of management oversight and control as information distributed using more traditional means.

Integrity in the financial reporting process is important to maintain public trust and to be successful in the financial and capital markets. Today's business environment and investors' higher expectations create a situation where missing earnings expectations by a small amount can lead to significant decreases in share price and market capitalization. As a result, audit committees should focus on current and emerging issues and the potential impact on financial reporting and disclosure.

The audit committee is responsible for understanding:

- The clarity and completeness of earnings releases, financial statements and financial disclosures
- Management's selection and application of significant accounting principles
- Critical accounting policies
- Significant or unusual transactions and accounting judgments and estimates
- Whether the financial statements present a complete and accurate picture of the financial results
- Whether the financial statements, footnotes and related management discussion provide the reader with a clear understanding of the business risks being managed
- Management's assertion on the controls over financial reporting and disclosure

The audit committee's review of the financial statements is intended to enhance the quality of communication from management to third parties. In addition to analyzing what is in the financial statements, the committee should also explore what is not included, such as disclosures omitted due to immateriality or that are not explicitly required by generally accepted accounting principles. The audit committee should pay particular attention to any items that seem unclear and items affected by subjective judgment. Every audit committee member should exhibit an attitude of healthy skepticism accompanied by due diligence.

The audit committee should consider issuing a report to shareholders to include disclosures that the audit committee has:

- Discussed the financial statements with management. This discussion should include the quality of the accounting principles as applied and significant judgments affecting the company's financial statements
- Discussed with the independent auditor their judgments regarding the quality of the accounting principles as applied and significant judgments
- Discussed the independence of the external auditor
- Recommended to the board of directors that the company's financial statements be included in the annual report

An illustration of such a report, which is required for a public reporting company, is included in Appendix III.

To assist the audit committee, the independent auditor should discuss his/her subjective judgments on the quality and acceptability of the company's accounting principles with the audit committee. The discussion can assist the audit committee in drawing its conclusions about the quality of the accounting principles selected by management. The quality of accounting principles may include the degree of aggressiveness or conservatism of the company's

accounting principles and underlying estimates and the transparency of the financial disclosures in reflecting financial performance.

For public companies, the independent auditor reviews of interim quarterly financial information can be a valuable resource to the audit committee as the committee fulfills its oversight responsibility for financial reporting. The interim review of financial information is performed in accordance with AU Section 722, *Interim Financial Information*, as adopted by the Public Company Accounting Oversight Board.

With an understanding of the company's internal controls, the independent auditor applies knowledge of the company's financial reporting practices to significant matters identified through the limited interim review procedures. The interim review provides the independent auditor with a basis for determining whether or not material modifications are required to interim financial information or statements for the information to be in accordance with generally accepted accounting principles. However, the objective and scope of the review of interim financial information is different from an audit of financial statements and does not provide assurance that the independent auditor will become aware of all significant matters that would be identified through an audit.

## Understanding and oversight of the audit process

A comprehensive audit program typically consists of an internal audit process and an external audit process. The internal auditor continually monitors processes and controls; the independent auditor renders an opinion on the fairness of the financial statements in accordance with generally accepted accounting principles. The audit committee should provide oversight to both the internal and the external audit processes. The committee will have to develop communication processes that minimize duplication of effort between the internal and external audit processes and maximize audit coverage through cost-effective use of company resources.

### Internal audit process

The internal audit process usually focuses on compliance with board-approved policy statements and procedures as well as regulatory guidelines. The purpose of the internal audit function is to provide a broad range of audit coverage and feedback on risk assessments, operations and internal control processes.

In reporting to the audit committee, the internal audit function identifies compliance issues, operational issues, financial issues and control issues that management should address to enhance and enable a strong control environment.

Internal audit coverage could include:

- Review of internal controls
- Compliance testing of the internal control processes
- Assessing compliance with board policy statements
- Completing operational audits that identify lapses in controls and improve business processes
- Special audit coverage for high-risk areas, suspected fraud and special projects requested by the audit committee
- Regulatory compliance
- Monitoring operations for emerging risks

The internal audit function should have a charter that is reviewed and approved by the audit committee. The internal audit charter provides the internal auditors with an understanding of the audit committee's expectations for their performance. Internal audit charters will vary from company to company because of the unique nature of each company's business process and organizational structure. The internal audit charter will evolve as the company grows and becomes involved in new activities, new products or new types of transactions.

The audit committee should discuss with the internal auditor:

- The company's risk assessment process
- The planned scope of internal audit work for the upcoming year
- Areas of planned audit coverage in the prior year that were deferred and why they were deferred
- The time budget to accomplish the audit plan
- How the scope of the internal audit plan was determined
- Areas that require follow-up based on the previous internal audit results and indicate a follow-up audit would be appropriate
- Qualification and training for the internal auditors
- Internal audit coverage of Internet activities and information systems
- Internal audit coverage of off-balance sheet activities

With the focus of attention from regulators and the investing public on control systems, the internal audit function should provide a more consultative service to the company to ensure that risks are identified and controlled.

Given the growing complexity of business transactions and business models, some questions that the audit committee might consider in determining whether adequate resources are allocated to the audit process include:

- Is internal audit a place to train future company leaders?
- Does internal audit have the necessary resources to meet the audit committee expectations?
- Does outsourcing of internal audit impact the audit committee's communication process?
- With the focus on strong control systems, should internal audit perform operational audits to identify profit improvement opportunities?
- Do the internal auditors have the experience and training to provide consultative advice to the department heads regarding internal controls?

The audit committee's responses to these questions will help determine the long-term direction for internal audit.

### **Independent audit process**

Financial statements provide investors with an understanding of the financial results of the risks the company is managing. The independent auditor provides the company and its investors an opinion on the fairness of the company's financial statements and financial disclosures. The opinion provides regulatory agencies with a reasonable level of assurance regarding the reliability of the financial reporting process.

The independent auditor provides the audit committee access to a neutral source of information regarding:

- Emerging accounting issues
- Emerging industry trends and risks
- Tax issues
- Regulatory issues
- General business advice

The audit committee should expect the independent auditor to:

- Recognize that they are accountable to the board of directors and that the audit committee, as the board's representative, is their client
- Maintain open communications with the audit committee and provide timely, open and candid discussions with the committee
- Understand the committee's expectations and design their communications to be responsive to those expectations
- Meet privately with the audit committee on a periodic basis in an executive session, without the presence of management or internal auditors, to provide the audit committee input on matters relating to management or the internal auditors
- Discuss any concerns about financial reporting or financial performance promptly with the audit committee
- Communicate significant issues to the audit committee that have been communicated to management, but have not been adequately addressed
- Advise the audit committee about areas believed to require special attention in order to carry out the committee's oversight responsibilities
- Inform the audit committee about any time pressures exerted by management and the degree of management's cooperation in the audit and their potential effects on the effectiveness of the audit
- Meet with the audit committee for an "exit" conference regarding the audit and findings from the audit

During the executive session with the independent auditor, the audit committee has an opportunity to discuss the independent auditor's assessment of personnel in the financial organization, including number, experience and capabilities for the size and complexity of the company. The audit committee can also discuss the independent auditor's assessment of management's integrity and whether management is actively addressing issues of concern that could have an adverse effect on the financial or operational stability of the company.

## Communications with audit committees

SAS No. 114, *The Auditor's Communication With Those Charged With Governance*, (SAS 114) emphasizes two-way communications between the external auditors and those charged with governance. SAS 114 applies to audits of the financial statements of private companies and establishes a requirement for the external auditor to communicate with those charged with governance certain significant matters related to the audit, including the auditor's responsibilities under generally accepted auditing standards, an overview of the planned scope and timing of the audit, and significant findings from the audit. SAS 114 requires external auditors to communicate to the audit committee matters in the following areas:

- Auditor's responsibility under generally accepted auditing standards
- An overview of the planned audit scope
- Timing of the audit
- Significant accounting policies
- Management's judgments and accounting estimates
- Audit adjustments and uncorrected misstatements
- Disagreements with management
- Management's consultation with other auditors, if any
- Significant issues discussed with management
- Difficulties encountered in performing the audit
- Representations the auditor is requiring from management
- Other findings or issues arising from the audit

AU Section 380, *Communications with Audit Committees*, as adopted by the Public Company Accounting Oversight Board, applies to the audits of the financial statements of public reporting companies and requires many of the same communications as SAS 114.

In addition to these communications, generally accepted auditing standards require the external auditor to communicate to the audit committee certain matters that come to the independent auditor's attention, such as:

- Control deficiencies, significant deficiencies and material weaknesses
- Evidence that fraud may exist
- Information about possible illegal acts
- Information about probable material misstatements in interim financial information filed or to be filed with the regulators

## Selection of an independent audit firm

With audit committees being held more accountable for their role as protector of shareholder interests, the responsibility to select and retain the independent audit firm becomes an important role. The audit committee should be directly responsible for the selection of the company's independent audit firm. Similarly, the audit committee should have the authority and responsibility to evaluate and dismiss the independent audit firm.

To ensure that the audit committee chooses its independent auditor on an informed basis, the audit committee should develop a list of criteria and expectations that they believe the independent auditor should meet. The following matters should be considered when selecting or evaluating the independent audit firm. Answering questions such as these may provide a framework for the selection process:

- What is the independent audit firm's audit process and how do they determine areas that are considered to be a higher audit risk?
- How will the audit firm handle the unique and difficult aspects of the engagement?
- Is the audit firm independent with respect to the company? How does the firm monitor independence?
- What quality control policies and procedures does the independent audit firm have in place?
- What is the audit firm's relevant experience? What is the expertise of the local office that will be responsible for the engagement, including:
  - The importance of the client and industry to the firm and the local office
  - The audit firm's technical and industry resources
  - The availability of other relevant technical expertise locally and nationally
- What is the quality of the firm's audit practice? Consider requesting and calling references. In particular, ask for references about staff turnover, responsiveness to issues, proactiveness in providing ideas and advice, and meeting engagement deadlines. Also, ask what they like most and least about the firm and the partners.
- Which partners will be assigned to the client service team?
  - What is their ability to develop a working relationship with the proposed engagement team?
  - What is the relevant and current industry experience of the client service team on similar clients?
  - What level of involvement will the partner have with the engagement?
  - How does the audit firm share knowledge and expertise within the firm?
- What are the estimated fees; what is the basis for determining them; and how will differences between actual and estimated fees be handled?
- What technology tools are available, and how will they be used in the audit process?
- How will matters related to the internal control process be communicated?

A sample request for proposal letter is at Appendix VII.

## Federal Deposit Insurance Corporation Improvement Act (FDICIA) compliance

The FDICIA (as detailed in Part 363 of the FDIC Rules and Regulations) requires banks and thrifts with assets in excess of \$500 million as of the beginning of the fiscal year to issue a public report on the effectiveness of internal controls over financial reporting and compliance with designated laws and regulations. In addition, FDICIA also establishes auditing, reporting and audit committee requirements.

Audit committee requirements under FDICIA provide that:

- Depository institutions with total assets between \$500 million and \$1 billion as of the beginning of its fiscal year must establish an audit committee in which the majority of the members are independent of management.
- Depository institutions with total assets exceeding \$1 billion as of the beginning of its fiscal year must have an audit committee comprised of outside directors that are independent of management. Under certain circumstances, the banking regulators may, by order or regulation, permit relaxation of this rule.
- The audit committee of any insured depository institution that has total assets of more than \$3 billion, measured as of the beginning of each fiscal year, must include members with banking or related financial management expertise, have access to its own outside counsel, and not include any large customers of the institution. If a large institution is a subsidiary of a holding company and relies on the audit committee of the holding company to comply with this rule, the holding company audit committee shall not include any members who are large customers of the subsidiary institution.

The FDICIA requires the audit committee to review with management and the independent auditor the basis for reports filed by the institution. This may be accomplished by formally reviewing the content and conclusions of each report, including the report of the internal auditor, as applicable.

Other duties an audit committee might consider include:

- Reviewing with management and the independent auditor the significant accounting policies of the institution
- Reviewing the audit conclusions regarding significant accounting estimates
- Reviewing with management and the independent auditor their assessment of the adequacy of internal controls and the resolution of identified material weaknesses and significant deficiencies in the internal controls, including the prevention or detection of management override or compromise of the internal control system
- Reviewing with management and the independent auditor the institution's compliance with laws and regulations
- Discussing with management the selection and termination of the independent auditor
- Reviewing the scope of service required by the audit
- Discussing with management any significant disagreements between the independent auditor and management
- Overseeing the internal audit function

The FDICIA recommends that the audit committee maintain minutes of all meetings and other relevant records of their meetings and decisions.

## FDICIA annual reporting requirements

For insured depository institutions with assets in excess of \$500 million, FDICIA requires the following:

- Management must prepare annual financial statements in accordance with generally accepted accounting principles which must be audited by an independent auditor
- Management must prepare a management report signed by its CEO and chief accounting or chief financial officer that contains:
  - A statement of management's responsibilities for establishing and maintaining an adequate internal control structure and procedures for financial reporting. The term financial reporting is not defined by regulation but is deemed to encompass the institution's annual financial statements, interim financial statements and bank Call Reports or Thrift Financial Reports
  - A statement of management's responsibility for, and an assessment of the institution's compliance with designated laws and regulations relating to safety and soundness which are designated by the FDIC and the appropriate federal banking agency during the most recent fiscal year

In addition, insured depository institutions with assets in excess of \$1 billion must include the following:

- Management must make their assessment of the effectiveness of the institution's internal control over financial reporting as of the end of the fiscal year
- The independent auditor must issue an attestation report on management's assertions concerning the institution's internal control over financial reporting

Institutions must file an annual report with the FDIC, its primary banking regulator and any appropriate state bank supervisor within 90 days of each fiscal year end. This report, which will become public information, will contain:

- The institution's financial statements prepared in accordance with generally accepted accounting principles
- The independent auditor's report on the financial statements
- The institution's management report, signed by the CEO and CFO, which includes all management statements and assessments listed above
- For insured financial institutions with assets in excess of \$1 billion, the external auditor's attestation report on management's assertions on the internal control over financial reporting

In addition, any management letter or other report prepared by the external auditor must also be filed with the appropriate regulatory banking agencies.

Institutions must also provide the FDIC with written notice within 15 days of the engagement of an external auditor or the resignation or dismissal of the external auditor.

Section 404 of the Sarbanes-Oxley legislation requires management of public reporting companies to assess the effectiveness of their internal control over financial reporting. This requirement is more stringent than the evaluation required for FDICIA. An institution that has to comply with Section 404 can use that evaluation to comply with FDICIA as long as both the FDIC's requirements and the SEC's requirements are met.

## Internal control reporting requirements of the Sarbanes-Oxley Act of 2002

While the Sarbanes-Oxley legislation does not directly impact privately held financial institutions, banking regulators may consider some of the legislation a "best practice" for the industry. The FDICIA reporting requirements noted on pages 15-16 impact all insured depository institutions with assets exceeding \$500 million, with additional requirements for those with assets exceeding \$1 billion. Section 404 of the Sarbanes-Oxley legislation is applicable to all public reporting entities, although compliance with certain aspects of the law has been deferred for smaller reporting companies until 2009.

Section 404 of the Sarbanes-Oxley Act requires public reporting companies to include in their annual report a report of management on the company's internal control over financial reporting. The internal control report must include:

- A statement of management's responsibility for establishing and maintaining adequate internal control over financial reporting;
- A statement identifying the framework used by management to evaluate the effectiveness of the internal controls over financial reporting;
- Management's assessment of the effectiveness of internal control over financial reporting as of the end of the most recent fiscal year, including a statement as to whether or not internal control over financial reporting is effective; and
- A statement that the registered public accounting firm that audited the financial statements has issued an opinion on the effectiveness of internal control over financial reporting as of the end of the most recent fiscal year.

Internal control is a process established by a company's management and other personnel that creates parameters related to business activities. These processes should be designed to ensure that:

- Operations are effective and efficient
- Transactions are recorded accurately
- Financial reporting is reliable
- The company complies with applicable laws and regulations

The corporate scandals in recent years have identified members of management or the board of directors who were unaware of off-balance sheet partnerships, off-shore tax shelters or improper recognition of revenues that existed. The Sarbanes-Oxley legislation makes CEOs and CFOs explicitly responsible for establishing, evaluating and monitoring the effectiveness of internal control over financial reporting and disclosures.

The SEC rules have proven to be complicated, and the implementation is both time-consuming and costly. However, there are some bright spots:

- Most public reporting companies now have documented internal controls in place
- Most companies have been able to tailor their existing processes to comply with new rules
- A rigorous control structure provides other benefits such as:
  - Better information to make business decisions
  - Better control over and allocation of internal resources
  - Better identification of risk factors as the business environment changes

The Sarbanes-Oxley legislation has fundamentally changed the business and regulatory environment, and public companies need to plan for ongoing compliance with provisions of the law.

## Quarterly and annual certifications of CEOs and CFOs

While the press has focused on certification requirements of CEOs and CFOs for public reporting companies, the fact that financial institution directors certify Call and Thrift Financial reports has been obscured. While the focus of the Sarbanes-Oxley legislation is on public reporting companies, it can provide board members with best practices to consider as they certify Call and Thrift Financial reports.

Section 302 of the Sarbanes-Oxley Act requires CEOs and CFOs to individually and personally certify that disclosure controls and procedures have been implemented and evaluated. Disclosure controls and procedures are designed to ensure that the information required to be disclosed by a company on the reports filed under the SEC rules is recorded, processed, summarized and reported within the time periods specified by the SEC.

With each quarterly and annual filing, both the CEO and CFO must certify that:

- They have reviewed the report
- The report does not contain any material untrue statements or material omissions necessary to make the statements not misleading
- The financial statements fairly present the company's financial condition and the results of operations in all material respects
- They are responsible for establishing and maintaining internal controls
- They have designed controls to ensure that material information is made known to them
- They have evaluated the effectiveness of the internal controls each quarter
- They have presented their conclusions about the effectiveness of internal controls
- They have disclosed to the audit committee and the independent auditor all significant deficiencies, material weaknesses and acts of fraud that involve management or other employees who have a significant role in the company's internal control
- They have disclosed any significant changes in internal controls or other factors that could significantly affect internal controls subsequent to the date of their evaluation, including corrective actions for significant deficiencies and material weaknesses

Section 906 of the Sarbanes-Oxley Act requires CEOs and CFOs to provide a written statement with each periodic report that the financial statements fully comply with the SEC reporting requirements and that the information contained in the financial statements fairly presents, in all material respects, the financial condition and results of operations of the issuer.

The certification required by Section 906 is different from the certification required by Section 302 and carries fines of up to \$5 million and imprisonment for up to 20 years for known or willful failure to comply with its requirements.

Companies that prepare FDICIA internal control documentation and/or internal control assessments under Section 404 of the Sarbanes-Oxley Act should use this data as a basis for the certifications. Effective oversight of the internal controls and the financial reporting process by the audit committee will provide a basis to allow the CEO and CFO to make these certifications.

## Code of ethics

While the audit committee is not directly responsible for establishing, monitoring or enforcing the company's code of ethics, many companies have delegated oversight responsibilities to the audit committee. The board of directors should evaluate the audit committee charter to determine if the audit committee should be involved with this aspect of corporate governance.

Even though many companies had a code of ethics in place prior to the Sarbanes-Oxley Act, Section 406 of the Act requires public reporting companies to disclose whether they have adopted a written code of ethics that applies to their principal executive officers, principal financial officers, principal accounting officers or controllers or persons performing similar functions. If a written code of ethics has not been adopted, the board must explain the reasons.

Section 406 defines a code of ethics as a written standard that is reasonably designed to deter wrongdoing and 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 that a registrant files with, or submits to, the SEC and in other public communications made by the registrant
- Compliance with applicable governmental laws, rules and regulations
- The prompt internal reporting of violations to appropriate parties
- Accountability for adherence to the code of ethics

Public reporting companies are required to include a code of ethics disclosure in their annual reports filed on Form 10-K. In addition, a company is also required to make its code of ethics publicly available, but may choose among three alternative methods for doing so. It may:

- File a copy of its code of ethics with the SEC as an exhibit to its annual report
- Post the text of its code of ethics on its website, provided that the website address and the intention to provide disclosure in this manner is set forth in its annual report on Form 10-K
- Indicate in its annual report that it will provide a copy of its code of ethics to any person, without charge, upon request

U.S. registrants, other than registered investment companies, are required to make immediate disclosure on Form 8-K or on their websites of any changes to or waivers of the five code of ethics provisions referenced in the rule, and the extent to which the waiver or amendment relates to the CEO or senior financial officers. A company choosing to provide the required disclosure on Form 8-K must do so within four business days after it makes an amendment to its code of ethics or grants a waiver. A company can provide the required disclosure on its website only if it disclosed, in its most recent annual report filed with the SEC, its website address and its intention to disclose these events on its website.

The code of ethics should be tailored to fit the specific circumstances of a company's structure and organization. The following topics are commonly covered in the code of ethics:

- Holding outside employment
- Using corporate assets, information or position for personal advantage
- Receipt of gifts, trips, or entertainment from customers or suppliers
- Personal use of customer information
- Participation in political or community activities
- Adherence to policies and procedures
- Compliance with internal controls

- Financial or other conflicts of interest;
- Related-party transactions
- Racial, sexual, or other types of harassment
- Use of drugs and alcohol
- Procedure for evaluating situations that may create a conflict of interest
- Procedure for communicating potential violations of the code of ethics
- Process for communicating the code of ethics to all employees
- Process for obtaining acknowledgment of receipt and understanding of the code of ethics
- An annual certification that the employee has not violated the code of ethics

While these comments focus on public-reporting companies, they represent “best practices” for all financial institutions.

## Resources for the audit committee

The following list of various references may help the members of the audit committee understand their roles and responsibilities, changes in corporate governance, and how those changes affect their duties.

### Publications

American Bar Association, *Corporate Director's Guidebook*, Fourth Edition

American Institute of Certified Public Accountants, Statement on Auditing Standards No. 114, *The Auditor's Communications with Those Charged with Governance*, January 2007

American Institution of Certified Public Accounts, AU Section 380, *Communications with Audit Committees*, April 1998, as adopted by the Public Company Accounting Oversight Board

Committee of Sponsoring Organizations of the Treadway Commission, *Internal Control - Integrated Framework*, 1994

Committee of Sponsoring Organizations of the Treadway Commission, *Internal Control over Financial Reporting – Guidance for Smaller Public Companies*, June 2006

National Commission on Fraudulent Financial Reporting, *Report of the National Commission on Fraudulent Financial Reporting*, 1987

### Internet Resources

[www.sec.gov](http://www.sec.gov) provides press releases, final rules, proposed rules and comment letters

[www.financialexecutives.org](http://www.financialexecutives.org) provides tools, resources and links to other financial reporting websites

[www.nyse.com](http://www.nyse.com) and [www.nasdaq.com](http://www.nasdaq.com) provide rules for corporate governance for listed companies

[www.nacdonline.org](http://www.nacdonline.org) provides publications, surveys, research, and answers to questions asked by directors

[www.boardmember.com](http://www.boardmember.com) and [www.bankdirector.com](http://www.bankdirector.com) provide information for board members and audit committee members

[www.realcorporatelawyer.com/secreform.html](http://www.realcorporatelawyer.com/secreform.html) provides links to legal interpretations of the various provisions of the Sarbanes-Oxley Act of 2002

[www.conference-board.org](http://www.conference-board.org) provides information on corporate governance

[www.ethics.org](http://www.ethics.org) provides leading-edge expertise on business and organizational ethics

### Regulatory Agency and Trade Association Resources

Board of Governors of the Federal Reserve System [www.federalreserve.gov](http://www.federalreserve.gov)

Federal Deposit Insurance Corporation [www.fdic.gov](http://www.fdic.gov)

Federal Financial Institutions Examination Council [www.ffiec.gov](http://www.ffiec.gov)

Office of the Comptroller of the Currency [www.occ.treas.gov](http://www.occ.treas.gov)

Office of Thrift Supervision [www.ots.treas.gov](http://www.ots.treas.gov)

Bank Administration Institute [www.bai.org](http://www.bai.org)

American Bankers Association [www.aba.com](http://www.aba.com)

Independent Community Bankers of America [www.icba.org](http://www.icba.org)

## How can McGladrey & Pullen help?

We are often asked to provide advice on the appropriate roles and responsibilities of audit committees and general corporate governance issues. In our role as the independent auditor for over 2,000 financial institution clients, we work closely with audit committees and have assisted them in implementing governance practices that suit their circumstances.

We have assisted with director education programs aimed at enhancing the director's understanding of risk management and financial reporting. We have governance specialists who can assist your company in assessing its corporate governance practices and developing an action plan to strengthen the effectiveness of those practices.

We welcome the opportunity to assist you and your company in developing and maintaining an effective audit committee. We would be happy to meet with you to discuss how we can assist you.

# Appendices

## Appendix I. Audit committee charter

*This audit committee charter should be tailored to fit the unique needs of each company. This sample is not a form that can be copied and applied to every situation. Prior to adopting an audit committee charter, your company should gather input and advice from its legal counsel and independent auditor. The audit committee charter is a "living" document that will need to be revised as external and internal factors change.*

### Membership

All members of the audit committee shall be independent of the management of the company and free of any relationship that, in the judgment of the board, would interfere with their exercise of independent judgment as audit committee members. Each member of the audit committee must satisfy all applicable membership and independence requirements established by the agencies whose regulations are applicable to the company. The board must make any affirmative determinations concerning the issue of independence of any director required under the rules and regulations of the applicable exchange.

Audit committee members will not have an interest in the company or engage in related-party transactions that would have a material adverse effect on their independence or ability to act in the best interest of the shareholders.

If there is any basis for believing an audit committee member is not independent, the facts and circumstances should be reported to the general counsel and the board, and no action should be taken until the board, or the Nominating/Governance Committee thereof, has determined that the audit committee member is truly independent.

Audit committee members cannot vote on any matter in which they, directly or indirectly, have a material interest.

### Frequency of meetings

The committee shall meet as frequently as circumstances dictate, but no less than four times annually. The board shall name a chairperson of the committee, who shall prepare and/or approve an agenda in advance of each meeting. A majority of the members of the committee shall constitute a quorum. The committee shall maintain minutes or other records of meetings and activities of the committee.

The committee shall, through its chairperson, report regularly to the board following the meetings of the committee, addressing such matters as the quality of the company's financial statements, compliance with legal or regulatory requirements, the performance and independence of the independent auditors, the performance of the internal audit function or other matters related to the committee's functions and responsibilities.

### Responsibilities of the audit committee

The audit committee shall be directly responsible for the appointment, dismissal, compensation, and oversight of the company's independent auditor, and may not delegate any of such responsibilities to others. The audit committee shall assist the board in its oversight of:

- The integrity of the company's financial statements
- The company's compliance with legal and regulatory requirements
- The independent auditor's qualifications and independence
- The performance of the company's internal audit function and the company's independent auditor

The audit committee shall also prepare the report to be included in the company's annual proxy statement.

The audit committee shall assist the board in fulfilling its oversight responsibilities by:

- Reviewing the company's financial information that will be provided to its shareholders
- Working with management to establish, subject to the approval of the board, the systems of internal controls
- Reviewing the systems of internal controls and reports of variance from those controls
- Reviewing all audit processes and results of internal audits
- Reviewing the company's accounting, reporting and financial practices

The responsibilities of a member of the audit committee are in addition to responsibilities as a member of the board. Each member of the audit committee will be compensated separately for service on the audit committee. The audit committee shall direct the company's general counsel to prepare or obtain from the company's outside counsel a memorandum on a regular basis setting forth the standards applicable to the members of the audit committee under applicable laws and regulations.

The audit committee does not prepare financial statements on behalf of the company or perform the company's audits, and its members are not the company's auditors and do not certify the company's financial statements. These functions are performed by the company's management and the independent auditor.

The audit committee shall perform such other functions as are required by law, the company's articles of incorporation or bylaws, or the board of directors.

### **Responsibilities and duties**

The audit committee:

- Shall meet at the request of the chief financial officer or the independent auditor and shall meet at least once every quarter in regular session, or more frequently as circumstances dictate
- Shall meet with the chief financial officer separately at least once every quarter to review the accounts of the company
- Shall meet with the internal auditor at least once every quarter
- Shall recommend to the board whether the audited financial statements should be included in the company's annual report on Form 10-K
- Shall prepare the audit committee report to be included in the company's annual proxy statement
- May conduct or authorize investigations into any matters within its scope of responsibilities
- Shall review and discuss earnings press releases and financial information and earnings guidance provided to analysts and ratings agencies
- Shall review and discuss with management the policies and guidelines for risk assessment and management
- May take any other action permitted by applicable laws, rules and regulations necessary to accomplish any action authorized by this charter or to further the goals of the audit committee as set forth in the charter
- Shall report its actions and budget to the board

All meetings of the audit committee required by this charter shall be held without any other members of the board present. Portions of all meetings with independent accountants and internal audit officers shall be held without any other members of management present. Meetings may be held in person or by telephone at the discretion of the chair of the audit committee.

## Assistance from others

The audit committee may request reports from the chief executive officer, chief financial officer or vice president – finance and taxation. The audit committee may retain (and determine the funding for) experts to advise or assist it, including outside counsel, accountants, financial analysts or others, and the company shall provide sufficient funding therefore.

## Relationships with independent auditors

To retain independent auditors to audit the records and accounts of the company, the audit committee shall:

- Have the sole authority to appoint and dismiss independent auditors to conduct company audits or to perform permissible non-audit services, with the independent auditor ultimately accountable to the audit committee with respect to audit and related work, and to oversee the performance of services by the independent auditor
- Review the independent auditor's audit plan prior to the commencement of the audit
- Determine the scope of the audit and the associated fees to be paid to the independent auditor for both audit and permissible non-audit work
- Discuss with the independent auditor any relationships that may affect the auditor's independence
- Confirm and oversee the independence of the auditor
- Establish policies for the company's hiring of employees or former employees for the auditor

In its review of the independent auditor, the audit committee shall:

- Review the qualifications and experience of senior members of the audit team
- Ensure that the independent auditor provides the audit committee (for their review) with timely reports of (1) all critical accounting policies and practices, (2) all alternative treatments of financial information within generally accepted accounting principles that have been discussed with management, effects of using such alternatives, and the treatment preferred by the independent auditing firm, and (3) other material written communications between the independent auditor and management
- Review the independent auditor's reports on the adequacy of the company's internal controls, including computerized information system controls and security
- Obtain and review annually a report from the independent auditor describing (1) the auditing firm's internal quality control procedures, (2) any material issues raised by its most recent quality control review or investigation within the preceding five years and steps taken to resolve those issues, and (3) all relationships between the independent auditor and the company

Prior to the release or filing thereof, the audit committee shall review documents containing the company's financial statements, including the interim financial reports and filings with the SEC or other regulators. The audit committee shall specifically review:

- With the independent auditor and management, their processes for assessment of material misstatements and identification of the notable risk areas, and their response to those risks
- With management and the independent auditor, the company's annual and quarterly financial statements and related footnotes as well as all of the company's securities filings prior to their filing and release, paying particular attention to disclosures under "Management's Discussion and Analysis of Financial Condition and Results of Operations"
- The independent auditor's audit of and report on the financial statements and the company's internal controls

- With the independent auditor, any additions or changes in auditing or accounting principles suggested by the independent auditor, management or the internal auditor
- With the independent auditor, the control deficiency letter provided by the independent auditor and the company's response
- The independent auditor's qualitative judgment about the appropriateness, and not just the acceptability, of accounting principles, use of estimates, basis for determining the amounts of estimates, and financial disclosures
- With the independent auditor, any significant difficulties or disputes with management encountered during the course of the audit
- Any material financial or non-financial arrangements of the company that do not appear on the financial statements of the company and their related risks
- With management and the independent auditor, the effect of regulations, accounting principles and their alternatives that have a significant effect on the company's financial statements
- Any transactions or courses of dealing with parties related to the company that are significant in size or involve terms or other aspects that differ from those that would likely be negotiated with independent parties, or that are relevant to an understanding of the company's financial statements
- Any other matters related to the annual company audit, including those matters that are required to be communicated to the audit committee under applicable law and generally accepted auditing standards

#### **Approval of services provided by independent auditors**

The audit committee shall approve any audit services and any permissible non-audit services prior to the commencement of the services. In making its pre-approval determination, the audit committee shall consider whether providing the non-audit services is compatible with maintaining the auditor's independence. If this pre-approval is delegated to an audit committee member or members, such member or members shall present a report of actions or decisions at the next scheduled audit committee meeting.

#### **Prohibited non-audit services**

The following services may not be provided by the independent auditor contemporaneously with the audit:

- Bookkeeping or other services related to the accounting records or financial statements of the company
- 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-dealer, investment adviser, or investment banking services
- Legal services
- Expert services unrelated to the audit
- Any other service that the SEC or Public Company Accounting Oversight Board determines is impermissible

## Relationships with the internal audit function

The audit committee shall:

- Be solely and directly responsible for the appointment, replacement, reassignment or dismissal of the company's internal auditors
- Establish procedures to assess the effectiveness and performance of the internal auditors
- Establish and control the compensation and benefits of company employees who report directly to the audit committee
- Take steps that are, in the sole judgment of the audit committee, reasonable or necessary to ensure that the internal auditors are competent and objective, and the compensation and benefits allocated to the internal auditors are not subject to review or termination without the consent of the audit committee

The audit committee shall consider and review with management and the internal audit leader:

- The company's risk assessment process
- The company's internal control structure and procedures for financial reporting and disclosure
- The results of internal audits, recommendations, reports of variance from the company's internal controls and report of the internal auditor
- Significant findings during the year and management's responses to them
- Significant difficulties encountered during the course of their audits, including any restrictions on the scope of their work or access to required information
- Changes required in the planned scope of their audit plan
- The internal auditing department's compliance with the Institute of Internal Auditors' *Standards for the Professional Practice of Internal Auditing*

## Oversight of corporate compliance function

The audit committee shall:

- Discuss significant risk exposures periodically with the independent auditor, management and internal auditors
- Review the steps and programs that management and the internal auditors have taken to identify, monitor, control and report such exposures
- Establish procedures whereby employees can confidentially and anonymously submit to the audit committee concerns or issues regarding the company's accounting or auditing matters
- Establish procedures for the receipt, retention and treatment of complaints regarding accounting or auditing matters, including their controls
- Review any transactions with related parties and the procedures used to identify related parties
- Periodically require management, the internal auditor and the independent auditor to review, report and comment on significant company risks or exposures and actions needed to minimize such risks or exposures
- Review the company's code of ethics and recommend any changes or additions
- Discuss periodically with management and evaluate the effectiveness of the program that management establishes to monitor compliance with the company's code of ethics and laws and regulations
- Review with management the company's policies to encourage the reporting of potential illegal acts and questionable accounting or auditing matters
- Review management's recommendations to the board for changes that respond to changes in law or policy
- Review with the company's outside legal counsel any legal matters that may materially affect the company
- Consider any emerging issues with which the audit committee should become involved in the future

## **Audit committee formalities and charter**

The audit committee shall:

- Review and reassess annually the adequacy of this audit committee charter and recommend any changes to the board
- Report periodically to the board on the audit committee's activities and findings, including any issues regarding the quality or integrity of the company's financial statements, compliance with legal or regulatory requirements, the performance and independence of the company's independent auditor, or the performance of the internal auditors
- Keep appropriate minutes, with the advice of counsel
- Take action to assess its own performance on an annual basis, such as retaining counsel, the independent auditor or other consultants for the purpose of reviewing its performance

## Appendix II. Items to consider in planning the audit committee agenda

In planning the audit committee meeting agenda, consideration should be given to the unique needs of the audit committee members. In some circumstances, background information may need to be furnished to assist the audit committee members in understanding the risks involved. This planner provides an example of the format that may be used to coordinate communications and should be modified for each audit committee to meet the unique needs of each group.

The audit committee meeting planner contemplates audit committee chair leadership (with input from management and the auditors) in developing a detailed agenda for each meeting and keeping lines of communications open among the board, external auditors, and the committee members. The audit committee chair may represent the entire committee in order to facilitate conducting these reviews on a timely basis.

### Quarterly: Discussions

Planned	Completed	Action
		Discuss with management any changes in internal controls, accounting principles or business activities
		Review Form 10-Q and the call report and assess the transparency and clarity of the financial disclosures
		Discuss Form 10-Q with the independent auditor
		Discuss any changes in internal controls with the internal auditor and independent auditor
		Discuss the financial statement impact of any changes in accounting principles or in the application of accounting principles with the independent auditor
		Discuss with senior management any significant variances from the budget
		Report any significant findings to the board

### Annually: Internal audit

Planned	Completed	Action
		Review and revise the internal audit charter, if necessary
		Review and approve the scope of internal audit coverage
		Discuss staffing levels of internal audit with lead internal auditor
		Discuss compliance with rules and regulations with lead compliance officer
		Discuss assistance/coordination of internal audit efforts with the audit process of the independent auditor
		Discuss participation in documenting, evaluating and testing internal control processes

## Independent audit

Planned	Completed	Action
		Discuss with the engagement partner the capabilities of the client service team assigned to the annual audit
		Discuss with the engagement partner the process used by the independent audit firm to ensure the independence of all client service team members and the firm
		Discuss with the engagement partner the scope and timing of quarterly reviews and annual audit
		Discuss with the engagement partner the coordination of internal audit and internal loan review with the annual audit
		Review and sign the engagement letter for the annual audit
		Discuss the annual audit plan and areas the independent auditor has identified as critical
		Discuss the process for the attestation regarding internal controls over financial reporting
		Discuss with the engagement partner the process for pre-approval of non-audit related services
		Discuss results of the annual audit, where there were variances from the audit plan, and why those variances occurred
		Discuss critical accounting estimates and accounting policies
		Review Form 10-K and discuss with the audit partner
		Discuss the contents of the auditor's communication with the audit committee
		Discuss uncorrected misstatements identified by the annual audit
		Discuss letters from the independent auditor to management
		Discuss any other issues that arise from the annual reporting, including:
		Quality of accounting principles used
		Assistance of financial personnel
		Condition of records
		Process control issues
		Business process improvement opportunities

## Management

Planned	Completed	Action
		Discuss with senior management the company risk profile and how those risks are managed
		Discuss with senior management the monitoring system in place to ensure all risks are being identified
		Discuss significant accounting estimates, unusual major accounting transactions, related-party transactions, and off-balance-sheet activities
		Discuss critical accounting estimates and accounting policies with management including MD & A disclosure prior to the release of the annual report and Form 10-K
		Discuss management's response to letters to management from the independent auditor
		Discuss changes in accounting principles, policies or practices to understand the reason and preferability of the change

## Audit committee activities

Planned	Completed	Action
		Prepare an audit committee report for the proxy statement
		Prepare a report on the annual audit for the board, including SAS 114 or SAS 61 communication and letter to management
		Prepare a report for the board regarding the attestation of internal controls over financial reporting and financial disclosures
		Discuss with the board a recommendation for retention (or selection) on the independent auditor
		Prepare a report for the board regarding internal audit coverage and activity
		Prepare an evaluation of the internal audit function
		Prepare a self-evaluation of the audit committee's effectiveness
		Obtain an understanding from the board regarding their expectations of the audit committee

## Executive sessions

The audit committee should have executive sessions as circumstances require with:

Planned	Completed	Action
		Management
		CEO
		CFO
		CIO
		Internal auditor
		Independent auditor

## Appendix III. An illustration of a report of the audit committee

### Report from the audit committee

The audit committee provides oversight of the company's financial reporting process on behalf of the board of directors. Management is responsible for the financial statements and the financial reporting process, including internal controls. In fulfilling its oversight responsibilities, the committee discussed the financial statements in the annual report with management, including a discussion of the quality, not just the acceptability, of the accounting principles; the reasonableness of significant judgments; and the clarity of disclosures in the financial statements.

The audit committee discussed with the independent auditors, who are responsible for expressing an opinion on the conformity of those audited financial statements with generally accepted accounting principles, their judgments as to the quality, not just the acceptability, of the company's accounting principles and such other matters as are required to be discussed with the committee under generally accepted auditing standards. In addition, the committee has discussed with the independent registered public accounting firm the auditors' independence from management and the company, including the matters in the written disclosures required by the Independence Standards Board and considered the compatibility of non-audit services with the auditors' independence.

The audit committee discussed with the company's internal and independent auditors the overall scope and plans for their respective audits. The committee meets with the internal auditors and independent registered public accounting firm, with and without management present, to discuss the results of their examinations, their evaluations of the company's internal controls, and the overall quality of the company's financial reporting.

Based on these discussions, the audit committee has recommended to the board of directors (and the board has approved) that the audited financial statements be included in the annual report on Form 10-K for the year ended December 31, 20XX, for filing with the Securities and Exchange Commission.

April 1, 20XX

/s/ This report should be signed by all members of the audit committee.

## Appendix IV. Example questions for audit committee members

### Financial reporting – inquiry with management

What are the most critical accounting policies (i.e., most complex, subjective, or ambiguous decisions or assessments) that have the greatest effect on the company's financial position? Was the accounting treatment conservative or aggressive, and how does it compare to previous periods?

When identifying unusual or nonrecurring items for disclosure, are both gains and losses given equal prominence?

To what extent was the timing of transactions managed in order to occur (or not occur) in the period being reported upon? What was the purpose of managing that timing? How did it affect reported results?

Do reported results provide a view to investors of how market events and significant transactions affected the institution?

What areas of the financial reporting are most influenced by your judgment? How does the information in the financial statements allow the reader to understand those aspects and management's assumptions?

What information in the financial statements communicates the significant estimates and assumptions used to develop the financial information? What is the range of possible outcomes, and how is that range communicated to the investors?

### Oversight of internal accounting controls

Do the internal control processes provide reasonable assurance that fraudulent financial reporting will be prevented or subject to early detection?

Are the internal control processes periodically reviewed? By whom?

How are controls over computer-generated financial information tested?

Have the firewalls surrounding the Internet site been subjected to testing?

Have any significant deficiencies or material weaknesses been identified in the internal accounting controls?

What were the most significant events of the past year and how are these communicated to investors? Are both positive and negative events presented?

How do you assess whether the accounting principles selected will appropriately convey the economics of the transaction? What accounting principles changed during this past year and how were they assessed?

What changes have there been in accounting policies or in the application of the policies and the use of estimates and judgments?

Do the disclosures go beyond complying with minimum generally accepted accounting principles requirements?

Did you identify any weaknesses in the company's internal control over financial reporting?

Are there any material risks and uncertainties that have not been disclosed?

What is your overall evaluation of the degree of comparability of this year's financial statements with prior years? What were the causes of significant differences? What reclassifications, if any, were made to prior years' reported amounts?

What audit tests were performed to compensate for the absence of these controls?

Have the department heads evaluated their department's compliance with the institution's policy statements and control processes? How has that evaluation been documented?

How are changes in the internal control processes made? Is internal audit involved in the process?

How do we put controls and policies in place over new services/products?

## Review of internal audit department

Does the internal audit department have a written charter? When was it last evaluated?

Does the internal audit department have the resources to accomplish its objectives?

Does the department appear to be using its time and resources effectively and efficiently?

Are the internal audit personnel well-trained in application of audit procedures in a financial institution? Do they understand day-to-day business activities?

Is the experience level of the internal auditors adequate?

Does the internal audit department have a continuing education program?

Does the internal audit department have a risk-based focus in its frequency schedule?

Does the internal audit department use written audit plans?

Does the internal audit department conduct its work in an objective and competent manner?

## Selection of the independent auditor

Is the firm independent relative to the institution?

What are the firm's independence policies? How is adherence to that policy determined?

What are the firm's quality control practices?

What is the firm's level of specialization in financial institutions?

How are members of the audit team selected? Who are the members and what is their experience level?

How much partner attention is focused on client service?

What other services could the firm provide without affecting its independence?

What level of communication will the firm have with management, the board of directors and the audit committee?

Does the internal audit department perform any operational duties that would impair its objectivity?

Does the internal audit department reporting process provide for reporting directly to the audit committee?

What types of reports are issued by the internal audit department, and to whom?

Are the internal audit reports issued on a timely basis? Do these reports include sufficient detail for effective action by management and/or the audit committee?

Does management respond appropriately and in a timely manner to significant recommendations and comments made by the internal auditors?

Are there department members with sufficient information systems auditing expertise to address the level of technology used by the company?

Was the department's involvement in the annual audit effective? What could be done in the future to maximize its effectiveness and efficiency?

What is the audit process and what areas receive primary emphasis?

How does the audit team determine the critical audit areas?

What level of reliance will the firm have on the internal audit and internal loan review functions?

What steps does the audit team follow if there are problems identified in the audit process?

How does the firm use technology in its audit process?

Does the firm have a peer review? What was the result of the latest review?

## Review of the audit plan with independent auditors

What are the critical audit areas this year? How does that compare to prior years?

What is the process you used to determine our exposure to fraud risk?

What do you consider to be our high-risk areas?

How are the data processing, wire transfer, ACH and internet activities included in the audit process?

Which locations will the audit team be visiting this year? What audit work will they do at each location?

How was the audit work coordinated with internal audit, internal loan review and the CFO?

What are your plans to identify and report on control deficiencies, significant deficiencies and material weaknesses?

How will you address general comments to management?

Will you have an exit conference before your audit team leaves?

Will your audit team be able to meet our deadlines for the financial statements?

What changes in accounting rules and regulations have occurred and how does that impact the financial statements?

What is the process for discussing issues that might require potential adjusting entries?

## Executive session with the independent auditor

Were personnel cooperative (e.g., did they answer your questions; did you have to push for answers)? Were any other difficulties encountered during your audit?

Were there time pressures on your work, including pressures on the timing of the audit procedures? If so, what was the effect on your audit?

Are the internal auditors or financial management — at both the corporate and division levels — qualified for what we are asking them to do? Do we need to hire any specialists, such as an information systems auditor for the internal audit department?

Do you have any other concerns about financial management?

Did management adequately respond to your suggestions for improvement in operations and controls?

Does financial management have adequate resources (e.g., experienced personnel and technology resources)?

For any proposed adjustments that were not recorded this year by management, does management have a reasonable plan to record those adjustments in subsequent periods?

What is your assessment of the risks of material financial statement fraud or misstatement and your understanding of the controls designed to mitigate such risks?

What is (are) the area(s) of greatest concern to you? And, has (have) the area(s) been sufficiently covered with the committee in another context (e.g., audit committee meeting and/or written materials)?

Were any changes made in your scope or in planned procedures because of changes in your risk assessments? If so, why did they occur?

In addition to the matters discussed in your communication to the audit committee as required by AU Section 380, are there any other matters that you want to bring to our attention?

## Review of regulatory examination reports

How did the examiners arrive at their conclusions in management, liquidity, capital, asset quality, earnings, and interest rate risk?

Were there any significant violations of regulations or statutes?

Were there any recurring violations that needed to have immediate attention?

Does management agree with the examiner's assessment of problem assets?

Did the examination process identify any differences in classification of loans from the internal loan classification system?

Does the process used to establish the level of allowance for loan losses meet the FFIEC policy guidelines?

## Appendix V. Questionnaire for assessing audit committee effectiveness

A. Understanding the structure, roles and responsibilities of the audit committee	Effective	Needs Improvement	Suggestions for Improvement
The responsibilities of the audit committee are set forth in an audit committee charter which is approved by the board.			
The audit committee annually reviews the charter and suggests changes to the board of directors.			
The experience and qualifications of audit committee members are compatible with the duties of the committee, including the ability to understand financial reporting.			
The size of the audit committee is appropriate for the complexity and operations of the company.			
The members of the audit committee are independent of management.			
The audit committee completes a self-evaluation on its performance and recommends changes to the board.			
The audit committee plans an agenda for each meeting to ensure that it addresses:			
Matters to be discussed at each meeting during the annual cycle			
Communication between the audit committee (or chair) and the independent auditors before the release of financial data			
General topics to be discussed each meeting			
Meeting agendas are prepared and distributed in advance together with sufficient background information to allow the committee members to prepare for meetings.			
Minutes of meetings are taken and circulated to members after the meeting.			
The audit committee members attend training sessions on accounting, auditing and financial reporting developments and current business and industry issues.			
Audit committee members ask tough questions, listen to answers and challenge responses to ensure that they understand the business and financial impact.			
The audit committee encourages a "tone at the top" that conveys basic values of ethical integrity as well as legal compliance and strong financial reporting and control.			
The audit committee obtains information on leading practices and other developments in corporate governance and considers ways to improve.			

	Effective	Needs Improvement	Suggestions for Improvement
<b>B. Understanding the business operations</b>			
The audit committee understands the company's organizational structure and the revenue drivers of the business.			
The audit committee discusses their evaluation of the controls over the financial reporting and disclosure process with management, the internal auditors and independent auditors.			
The audit committee evaluates whether management exhibits the proper "tone at the top" and fosters a culture and environment that promotes high-quality financial reporting, including appropriate attention to internal control issues.			
The audit committee evaluates management's procedures for monitoring compliance with the company's code of ethics.			
The audit committee discusses with the internal auditors their adequacy of the company's regulatory compliance programs.			
The audit committee receives the internal and independent auditors' assessments of the risks of fraud and is alert for risk factors that lead to potential fraudulent financial reporting.			
The audit committee is made aware of reports or other communications received from regulators, and updates from the general counsel on legal and regulatory matters, that may have a material effect on the financial statements, or that may affect related company compliance policies, or the financial stability or profitability of the company.			

**C. Understanding risk management**

The audit committee receives regular updates from management on operating risks and is involved in risk management by being an advocate for the adoption of a risk and control system for effective risk management.			
The audit committee has discussions with the CIO to understand the company's technology strategy, information systems and measures taken to protect resources devoted to information technology.			
The audit committee has discussions with the senior management team to understand emerging business risks.			

	Effective	Needs Improvement	Suggestions for Improvement
<b>D. Understanding financial reporting</b>			
The audit committee reviews financial statements with senior management and discusses the transparency and clarity of the financial reporting and disclosures with the company's internal and independent auditors.			
The audit committee develops an understanding of the business purpose and economic substance of major or unusual transactions.			
The audit committee evaluates the quality of earnings and considers any "red flags" that may indicate that earnings are being managed.			
The audit committee discusses the selection, application and disclosure of the company's critical accounting policies with management, the internal auditor and the independent auditor before releasing the annual report.			
The audit committee reviews the financial statement disclosures and Management's Discussion and Analysis to determine that the information is not inconsistent with information in the financial statements or elsewhere in the annual report and that the disclosure provides the reader a concise understanding of the risks being managed.			
The audit committee discusses any uncorrected misstatements with management and the auditors, determines why they were not recorded, and evaluates the impact on the financial statements and earnings per share if all or only certain misstatements were recorded.			

<b>E. Understanding interim financial reporting</b>			
The audit committee is provided with material to review prior to the earnings release, including a draft earnings press release and key performance measures.			
The audit committee (or the committee chairperson) discusses and reviews the interim financial statements with management and the independent auditors, at least via conference call, prior to filing the company's Form 10-Q.			
The audit committee is briefed by management on how management develops and summarizes quarterly financial information and how the quarterly financial close process may differ from the annual financial close process.			
The audit committee reviews with management any significant year-end issues that may impact the financial integrity of interim accounting and reporting practices.			

F. Understanding the audit process	Effective	Needs Improvement	Suggestions for Improvement
The audit committee understands how an internal audit is conducted and understands the independent audit process.			
The audit committee reviews any significant control deficiencies identified by the internal or independent auditors, as well as management's plan and timetable to address those recommendations.			
The audit committee reviews the internal audit charter on an annual basis and evaluates it against the current expectations and needs.			
The internal audit function reports to the audit committee.			
The audit committee reviews the quality, experience and objectivity of the internal auditors.			
The audit committee annually reviews the performance of the independent auditor, including the auditor's responsiveness to the audit committee's expectations, and recommends to the board of directors the retention (selection) of the company's independent auditor.			
The audit committee discusses audit plans and scopes of internal and independent auditors, the results of their work, any changes in the plans, the extent of control testing to be performed, and the extent of the coordination of their activities to ascertain whether the audit coverage is adequate.			
The audit committee reviews the independence of the independent auditor and discusses the processes used by the audit firm to monitor the independence of the members of the client service team.			
The audit committee approves and signs the engagement letter for the annual audit and approves the audit fee.			
The audit committee has a process to identify and approve non-audit services to be delivered by the independent audit firm.			

**G. Development of a communication process**

	Effective	Needs Improvement	Suggestions for Improvement
The audit committee provides a report to the board of directors after each committee meeting.			
The audit committee meets in an executive session, as circumstances require, with the senior management team members.			
The audit committee obtains a written report from management on the effectiveness of internal control over financial reporting, or written representations from management regarding management's responsibility for integrity of internal control and the financial reporting systems and processes, and management's beliefs about the quality of controls and financial reports.			
The audit committee has executive sessions with the internal and independent auditors as circumstances require.			
The audit committee reviews management's response to audit recommendations and whether follow-up audits indicate that corrective action is timely and effective.			
The independent auditor provides to the audit committee their assessment of the personnel in the financial organization, including the number, experience and capabilities of such personnel for the size and complexity of the company.			

## Appendix VI. Questionnaire for assessing internal audit

	Effective	Needs Improvement	Comments
Does internal audit operate under a charter that sets forth internal audit authority, reporting responsibility, operating guidelines?			
Are the competence and objectivity of internal audit staff evaluated annually?			
Does internal audit report directly to the audit committee?			
Does senior management value the perspective and insight of internal audit input?			
Does senior management respond in a timely and appropriate manner to internal audit findings?			
Does internal audit prepare an annual budget for audit coverage?			
Does the internal audit staff obtain required CPE each year?			
Does internal audit include IT specialists? If not, how is the IT internal audit accomplished?			
Does internal audit update (or prepare) a risk assessment for presentation to the audit committee on an annual basis?			
Do internal audit workpapers support the findings and reports?			
Does internal audit provide the audit committee with reports within 60 days of finishing an audit area?			
Does internal audit include management's response to findings in the internal audit report?			
Does internal audit maintain a list of findings that are awaiting management's attention?			
Does internal audit provide the audit committee insights on emerging business risks or problems in monitoring current risks?			
Does internal audit interact appropriately with external audit personnel?			
Does internal audit challenge areas included for audit coverage by external audit?			

## Appendix VII. Sample request for proposal letter

*This sample request for proposal letter provides example information that may be used by the audit committee when seeking a new independent auditor. As such, the sample letter will be subject to the review of and discussion by the audit committee.*

[Company Letterhead]  
[Current Date]

[Partner]  
[CPA Firm]  
[Street Address]  
[Town, State Zip Code]

Dear Sir or Madam:

Management and the audit committee of ABC Bank ("the Bank") are requesting a proposal from your firm for the following services for calendar year 20XX:

- External Audit – Audit services should be in accordance with generally accepted auditing standards. (SEC reporting companies will want to refer to PCAOB audit standards).
- Tax services, including review of the consolidated federal and state income tax returns of ABC Bank and its parent holding company, ABC Corp.

We invite your firm to submit a proposal to us by August 15, 20XX for consideration. Senior management is soliciting the proposals and will arrange for a presentation to the audit committee of the Bank. Note that the audit committee is the decision-maker in the hiring of the Bank's independent auditor.

### Background of ABC Bank

ABC Bank is a wholly-owned subsidiary of ABC Corp. Assets are approximately \$XXX million. The Bank's loan portfolio comprises approximately 55% of its assets. The company employs approximately 200 people at seven branches and its main office located at 800 Bankers' Way. The Bank's core transaction processing is performed internally using Kirchman software (Metavante subsidiary) and Advanced Financial Systems software (Metavante subsidiary) for its item capture and document storage. The Bank has a December 31 year-end, with the usual filing requirements for a state chartered, insured bank.

The Bank has an internal audit staff consisting of Jim Audit and three full-time auditors. The Bank uses a third party to conduct its Internal Audit Information Technology reviews and for assistance with its regulatory compliance auditing as well as an independent contractor who conducts in-depth reviews of commercial loans with regard to collectibility and compliance with established lending policies.

### Relationship with Prior CPA Service Provider

[The audit committee should use this area to describe the relationship with the prior auditor, including information that you are willing to disclose at this time. CPA firms may request additional information.]

### Other Information

[The audit committee may use this space to discuss other information that a CPA firm may need to know to make an informed response to the proposal for services you are requesting.]

## Request for Proposal

Following is a listing of the minimum services that should be addressed in your proposal. The proposal should be one document, with fees indicated separately for each service.

### I. Audit Services

#### *Proposal Requirements*

- Express an opinion on the financial statements of ABC Bank (annual audit).
- Express an opinion on the consolidated financial statements of ABC Corp. (annual audit).
- [Express an opinion on the effectiveness of internal control over financial reporting of ABC Bank.]
- It is important to note that your firm will not be engaged to perform any services prohibited by the Act, the Public Company Accounting Oversight Board (PCAOB), the Securities and Exchange Commission (SEC), or any other regulator as additional rules may continually be issued. In addition, if you wish to propose on any other services to our firm that are not prohibited by the Act, the PCAOB or any other regulator, these services must be pre-approved by the Audit Committee, including tax services.

### II. Tax Services

#### *Proposal Requirements*

- Auditor review of the consolidated federal and state income tax returns for the Bank and holding company. Tax returns are prepared internally. A consolidated federal tax return is prepared and a unitary state tax return is filed.

### III. Firm Profile

[This area should be tailored by the audit committee for the questions applicable to the bank's circumstances.]

### IV. Fees

Please provide an all-inclusive fee quote for the following services, including out-of-pocket expenses, in a format that is responsive to the following items (separate by the Bank and the holding company):

### V. Selection Process

Other firms are being considered for these services. Our desire is to have a draft of your proposals in hand no later than August 15, 20XX. You should be aware that your firm may be asked to make a presentation to management and the audit committee. If selected, a more detailed budget may be required.

For control purposes, we ask that you make all requests for access to the Bank's personnel through our internal auditor. Requests for additional information, visits to our site, review of prior years' financial statements and tax returns, and/or appointments with members of senior management or other decision makers should also be coordinated through our internal auditor.

The audit committee of the Bank will evaluate proposals on a qualitative basis. This includes a review of your firm's formal proposal, interviews with senior engagement personnel to be assigned to this engagement, results of discussions with other clients of your firm, and the firm's completeness and timeliness in its response to us. Please submit a copy of the firm's last peer review report and related material.

If you choose to respond to this request, please do so by August 15, 20XX.

Sincerely,

Audit Committee Chair

Chief Financial Officer

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