



BULLETIN

NO. B-91-2

April 26, 1991

TO: All State-Chartered Banks

FROM: Talmadge B. Gilley, Commissioner *TBG*

RE: Minimum Standards - Directors' Examinations

This Bulletin Supersedes A-86-4, dated December 4, 1986.

An annual directors' examination of each State bank is required by TCA Section 45-2-402. Unfortunately, many of the examination reports received for review by this office continue to reflect a scope of work performed that is inadequate to satisfy the spirit of this statute. It is our judgment that clearly defined standards for such examinations are needed. Accordingly, the enclosed document, "Minimum Standards - Directors' Examinations", has been prepared. These Standards will apply to examinations with a closing date after December 31, 1991.

Please note that these Standards will not apply if your bank chooses to have an annual, full "opinion" audit by a Certified Public Accountant. Also, the minimum audit procedures recommended by the FDIC Policy Statement of January 19, 1990, will be acceptable in lieu of the State standards.

One copy each of the examination or audit report (including comments) and management's response thereto should be submitted to this office for review within 60 days of your receipt of the report.

Any questions should be directed to Program Administrator for Bank Examinations Derek Carrier or Special Examiner Clarence Nixon at 615/741-6013.

/dte

State of Tennessee
Department of Financial Institutions
Minimum Standards - Directors' Examinations

I General

The Minimum Standards for Directors' Examinations may be met by either an external or internal audit. If an internal audit is used, the report must include a statement that the minimum standards were met within the applicable calendar year. The internal auditor must be independent with duties separate and apart from the operations of the bank. Any bank personnel used to assist the auditor cannot be used to audit their own work in any manner. External audits should be performed by persons regularly engaged in the performance of audits, including certified public accountants, public accountants, holding company auditors, correspondent bank auditors, internal auditors of other banks, and bank consultants. An opinion audit by an independent certified public accountant, together with the management letter comments and management's response thereto, may be accepted as satisfaction of the minimum audit requirements. Also, an audit conforming to the FDIC Statement of Policy Providing Guidance on External Auditing Procedures for State Nonmember Banks, together with management's response, will be acceptable.

II Scope

The audit shall include a general review of the bank's operating procedures and system of internal control and the report shall include comments and recommendations resulting from this review. The scope of the audit, the extent to which accounts must be tested, and the audit comments required will vary according to the adequacy of internal controls in place. Board and appropriate Committee minutes should be reviewed along with the most recent regulatory examination report. Circumstances encountered may make it necessary to expand or modify certain test work, apply alternate procedures, or extend audit procedures to additional areas. All work should be performed in accordance with generally accepted auditing procedures.

III Report

The auditor shall make a written report of the findings to the bank's board of directors or the audit committee thereof. The report should include a statement that the minimum standards have been met. All material exceptions found in the course of the audit should be listed along with any significant deficiencies noted in the bank's internal controls. The report and management's response should be reviewed by the board of directors and management's response should be forwarded to the Department of Financial Institutions, Safety and Soundness Division, within sixty days from the date the report is received.

IV Standards

The standards described below are minimum requirements which must be included in the audit program:

- (1) Cash, cash items, clearing and exchanges:
 - a. Count cash and reconcile totals with the general ledger balance. Cash count may be done on test basis if documented internal counts have been performed.
 - b. Examine cash items; investigate any unusual or noncurrent items; balance total to control account.
 - c. Confirm totals of clearing and exchanges direct with drawer or clearing banks; trace disposition of selected return items.

- (2) Due from banks:
 - a. Obtain current statements and cancelled vouchers direct from correspondents; reconcile all statements; check disposition of material exception items; investigate and clear or explain all stale reconciling items. Schedule any unresolved exceptions for management follow-up.
 - b. Review prior reconcilements; determine independence of reconciler; review control procedures for origination of entries and issuance of drafts.

- (3) Investment securities and trading account:
 - a. Balance subsidiary records to the general ledger and verify securities with safekeeping agent; or if held in-house, physically verify and check for proper safeguards.
 - b. Review investment policies and procedures established by the board of directors and test transaction records for compliance.
 - c. Perform test checks of interest income, amortization of premiums, accretion of discount.
 - d. Using independent sources, determine market value of all securities owned. Current price of highly volatile and thinly traded securities (IO's, PO's, CMO's, etc.) should be supported by dealer quotations. Verify that trading account securities and marketable equity securities (mutual funds, preferred stocks) are being carried at lower of cost or market value.

(4) Loans and Discounts:

- a. Balance all subsidiary ledgers and reconcile to the general ledger controls.
- b. Review policies and procedures established by the board of directors and check for compliance including lending authority limits.
- c. Confirm directly with borrowers:
 1. Commercial and real estate loans - 20% of dollar volume, provided that at least 5% of total number of loans are represented (positive or negative verification).
 2. Installment and open-ended loans - 5% of total number of loans outstanding (positive or negative).
 3. Participations purchased and sold - 100% positive verification with participating banks.
 4. Federal funds sold/purchased - 100% positive verification.

NOTE: A valid statistical sampling method, based on analysis of internal controls, may be employed where less than 100% verification is required. Justification for, and parameters of, the method used must be included in the report.

- d. Review established procedures for receipt, custody, substitution, and release of collateral. On a sample basis, test loans for completeness of note, collateral and supporting documentation, and disbursement of proceeds.
- e. Review accounting and control procedures for income and related items, including accrued interest, unearned interest, interest and fees received (including compliance with FASB 91), collection of past due charges, and rebates on prepaid loans. Test compliance on sample loans.
- f. Review procedures for segregating past-due loans and regularly reporting to officers and to the board of directors; test compliance. Schedule by name, amount and collateral security all loans in excess of \$1,000 over 90-days past-due, including all non-accrual loans.

This schedule, along with management's comments on collection activity, should be made a part of the examination report.

- g. Review established authorization procedures for capitalization of interest on single pay loans and extensions on installment loans. Test for compliance.

(9) Savings, Certificates of Deposit, and other Time Deposits.

- a. Balance all subsidiary records and reconcile to general ledger control accounts.
- b. Confirm directly with customers a minimum of 10% of deposits of each category (both by number of accounts and dollar volume).
- c. Test interest paid/accrued on all categories for accuracy.
- d. Review procedures for classification and control of dormant accounts.
- e. Review procedures for issuance of certificates of deposit and control of blank forms.

(10) Official Checks

- a. Balance outstanding items in all categories and reconcile to general ledger control accounts.
- b. Test for timely credit to general ledger for checks issued; review procedures for issuance of checks and control of blank forms.

(11) Capital Accounts and Reserves

- a. Capital and Preferred Stock - balance stock ledgers to general ledger control and account for all stock certificates used, voided, cancelled and/or unused since previous audit; balance stock register to number of shares outstanding.
- b. Capital notes and debentures - balance to general ledger control; verify changes to account since previous audit; test check interest paid and interest expense accrued as applicable.
- c. Surplus and Capital Reserves - review entries made since previous audit for proper authorization.
- d. Undivided profits - verify accuracy of entries made at close-out periods since previous audit and check all material interim entries for authorization and proper accounting treatment.
- e. Valuation Reserves - balance to general ledger; review all entries since previous audit for proper authorization. Determine that the Board is reviewing the loan loss reserve for adequacy on a quarterly basis.

- (12) Other Liabilities - balance to general ledger; verify and review balances in other large liability accounts and test for propriety.
- (13) Income and Expense Accounts - for all material income and expense accounts not elsewhere mentioned, review accounts as to source and authorization of entries and test to ascertain that income is being properly recorded and that expenses are supported with adequate documentation. Test major income and expense categories for reasonableness.
- (14) Interoffice, Clearing, and other Suspense Accounts -
- a. Review for proper origination and authorization of entries.
 - b. Balance accounts to general ledger; review outstanding items for stale or suspicious items.
 - c. Review regular balancing/reconciling procedures including appropriate follow up and management reporting of irregular or stale items.
- (15) Off-Balance Sheet Items
- a. Consigned items - count and confirm inventory of U.S. savings bonds, travelers checks, and other consigned items. Review regular security, balancing and remittance procedures.
 - b. Letters of Credit (Commercial and Standby) - balance outstanding liabilities to control accounts. Test for appropriate documentation and collateral.
 - c. Loan Commitments - Obtain from management a schedule of unfunded loan commitments; review approval and reporting procedures and test for compliance.
 - d. Charged-off Assets - review accounting procedures and internal controls related to charged-off assets and recoveries.
 - e. Safe Deposit - review contracts, access records and rent collection procedures on test basis; review safeguards for handling of keys and for control of drilled boxes.
- (16) Obtain a letter from the bank's attorney covering the status of all pending litigation in which the bank is a defendant.
- (17) Trust Department (if applicable)
- a. Review and test policies and procedures established by the board of directors and trust committee for compliance.
 - b. Reconcile uninvested cash.

- c. Inspect or confirm all trust assets and determine that proper dual control measures have been established in the acceptance and custody of trust assets.
- d. Test trust fees, income from investments, rental income, and all other income accounts.
- e. Review and test policies and procedures for opening and closing of trust accounts.
- f. Test management of fiduciary accounts in accordance with governing instruments and in conformity with applicable laws and regulations.
- g. Determine that all assets in each trust account have been satisfactorily reviewed by the appropriate committee of the board at least once during each calendar year.
- h. Review and test procedures for timely distribution of uninvested cash.
- i. Test supporting documentation of real estate and mortgages, including insurance and appraisals.