

**IB44****Scope of Directors' Examinations** [Section 11-108-401(8)(e), C.R.S.]

## A. Definitions

For purposes of this Rule the term "reviewer" shall mean such public accountant or other independent person(s) as determined by the Banking Board.

## B. Examination Scope

For the purposes of Section 11-108-401(8)(e), C.R.S., an industrial bank (institution) at a minimum shall perform annually the procedures as set forth in Appendix A as the scope of a directors' examination. The recommended procedures are intended to address the high risk areas common to all financial institutions. However, each institution must review its own particular business and determine if additional procedures are required to cover other high risk areas. The reviewer should be informed of, and permitted access to, all examination reports, administrative orders, and any additional communications between the institution and the Division of Banking, including the Colorado State Banking Board, as well as the appropriate federal regulatory agency. The reviewer should obtain institution management's written representation that he or she has been informed of, and granted access to, all such documents prior to completion of the field work.

## C. Extent of Testing

Where the procedures set forth in Appendix A require testing or determinations to be made, sampling may be used. Both judgmental and statistical sampling may be acceptable methods of selecting samples to test. Sample sizes should be consistent with generally accepted auditing standards, or as agreed upon by the reviewer and the institution client. In any event, the sampling method and extent of testing, including sample size(s) used, should be disclosed in the directors' examination report.

## D. Reports to be Filed with the Division of Banking

After the completion of the procedures or agreed-upon procedures set forth in Appendix A, the independent reviewer should evaluate the results of his/her work and promptly prepare and submit a report addressed to the board of directors of the institution. This report should detail the findings and suggestions resulting from performance of these auditing procedures. Independent reviewers should include in their report, at a minimum:

1. Financial statements (balance sheet and statement of earnings as of the examination date);
2. The accounts or items on which the procedures were applied;
3. The sampling methods used;
4. The procedures and agreed-upon extent of testing performed;
5. The accounting basis, either generally accepted accounting principles (GAAP) or regulatory required accounting, on which the accounts or items being audited are reported;
6. The reviewer's findings; and
7. The date as of which the procedures were performed.

The reviewer should sign and date the report, which should also disclose the reviewer's business address.

The institution must send a copy of the report, the engagement letter, and any management letter or similar letter of recommendation to the Division of Banking and the appropriate federal regulators within thirty (30) days after its receipt, but no later than one hundred fifty (150) days after the date of examination. In addition, each institution should promptly notify the Division of Banking when any reviewer is engaged to perform a directors' examination and when a change in its reviewer occurs.

#### E. References

Generally accepted accounting principles are issued by the Financial Accounting Standard Board which is an arm of the Financial Accounting Foundation, an independently chartered institution.

Section 23A of the Federal Reserve Act, also known as 12 USC 371c, is a law enacted by the United States Congress and administered by the Board of Governors of the Federal Reserve System.

Regulation O of the Board of Governors of the Federal Reserve System, also known as 12 CFR 215, is a regulation enacted by the Federal Reserve Board under the authority granted by the United States Congress and administered by the Board of Governors of the Federal Reserve System.

This Rule does not include amendments to or editions of the referenced materials later than the effective date of the Rule, October 24, 1990.

For more detailed information pertaining to this rule, please contact the secretary to the Colorado State Banking Board at 1560 Broadway, Suite 1175, Denver, CO 80202, 303-894-7584.

### **Appendix A - IB44**

For the purposes of Section 11-108-401(5)(e) an industrial bank (institution), at a minimum, shall have the following procedures performed annually.

#### A. Loans

1. Determine that the institution has policies that address the lending and collection functions. Read the institution's loan policies to determine whether they address the following items:
  - a. General fields of lending in which the institution will engage and the types of loans within each field;
  - b. Descriptions of the institution's normal trade area and circumstances under which the institution may extend credit to borrowers outside of such area;

- c. Limitations on the maximum volume of each type of loan product in relation to total assets;
  - d. Responsibility of the board of directors in reviewing, ratifying, or approving loans;
  - e. Lending authority of the loan or executive committee (if such a committee exists);
  - f. Adherence to legal limits;
  - g. Types of secured and unsecured loans that will be granted;
  - h. Circumstances under which extensions or renewals of loans are granted;
  - i. Guidelines for rates of interest and terms of repayment for secured and unsecured loans;
  - j. Documentation required by the institution for each type of secured and unsecured loan;
  - k. Limitations on the amount advanced in relation to the value of various types of collateral;
  - l. Limitations on the extension of credit through overdrafts;
  - m. Level or amount of loans granted in specific industries or specific geography locations;
  - n. Guidelines for participations purchased and/or sold;
  - o. Guidelines for documentation of new loans prior to approval and updating loan files throughout the life of the loan;
  - p. Guidelines for loan review procedures by institution personnel including:
    - (1) An identification or grouping of loans that warrant the special attention of management;
    - (2) For each loan identified, a statement or indication of the reason(s) why the particular loan merits special attention; and
    - (3). A mechanism for reporting periodically to the board on the status of each loan identified and the action(s) taken by management.
  - q. Collection procedures, including, but not limited to, actions to be taken against borrowers who fail to make timely payments;
  - r. Guidelines for nonaccrual loans (i.e., when an asset should be placed on nonaccrual, individuals responsible for identifying non-performing assets and placing them on nonaccrual, and circumstances under which an asset will be placed back on accrual.); and
  - s. Guidelines for in-substance foreclosures.
2. Review the board of directors' minutes to determine that the loan policies have been reviewed and approved. Through review of the board of directors' minutes and through inquiry of executive officers, determine whether the board of directors revises the policies and procedures periodically as needed.
  3. Obtain loan committee or, if applicable, board of directors' minutes and through a comparison of loans made throughout the period with lending policies, determine whether loans are being made within the loan authorization policy.
  4. Select a sample of borrowers, including loans from each major category, and determine through examination of loan files and other institution reports whether lending and collection policies are being followed (e.g., type of loan is in accordance with loan policy, funds were not advanced until after loan approval was received from proper loan authorization level, loan is within collateral policies, insurance coverage is adequate, and institution is named as loss payee).
  5. Select a sample of borrowers from each major category of secured loans and determine through examinations of files and other institution reports whether collateral policies are

- being followed (e.g., loan is adequately collateralized, documentation is present and properly prepared, assignments are perfected, and collateral is properly valued, marketable, and has not become susceptible to deterioration in realizable value).
6. Review policies for checking floor plan merchandise, warehouse inventory and accounts receivable by responsible institution personnel and test for compliance.
  7. Determine whether participations purchased and participations sold transactions have been reported to, and authorized by, the board of directors or loan committee, if applicable, through review of appropriate minutes.
  8. On a test basis, review participations purchased to confirm that the institution does its own independent credit analysis. Also, review participation documents and determine that terms and conditions between the lead institution and participants are specified, including:
    - a. Which party is paid first;
    - b. What happens in the event of default;
    - c. How set-offs received by either institution are to be treated;
    - d. How collection expenses are to be divided; and
    - e. Who is responsible to collect the note in the event of default
  9. Confirm sample of participations purchased and participations sold with participating institutions to verify that they are legitimate transactions and that they are properly reflected as being with or without recourse in the institution's records.
  10. Balance detail ledgers or reconcile computer generated trial balances with the general ledger control accounts for each major category of loans, including loans carried as past due or in a nonaccrual status.
  11. Confirm a sample of all loans within each major category; include past due and nonaccrual loans in the verification process.
  12. Review multiple loans to the same borrower with the same person as guarantor to determine if they were made on consecutive days to circumvent the loan authorization policy and to determine whether policies and procedures are designed to assure that all related credits are considered in loan granting and administration. Review these loans for relationships to institution insiders or their related interests.
  13. From reports to the board on the status of loans identified as warranting special attention, review the disposition of a sample of loans no longer appearing on these reports.
  14. Test loan interest income and accrued interest by:
    - a. Determining the institutions method of calculating and recording interest accruals;
    - b. Obtaining trial balances of accrued interest;
    - c. Testing the reconciliation of the trial balances to the general ledger;
    - d. Determining that interest accruals are not made on nonaccrual loans;
    - e. Selecting sample items from each major category of loans:
      - (1) Determining the stated interest rate and appropriate treatment of origination fees and costs;
      - (2) Testing receipt of payments and correctness of entries to applicable general ledger accounts;
      - (3) Calculating accrued interest and comparing it to the trial balance; and
      - (4) Reviewing recorded book value for appropriate accretion of discount (net origination fees) and amortization of premium (net origination costs); and
    - f. Performing an analytical review of yields on each major category of loans for reasonableness.

B. Allowance for Loan Losses

1. Test charge-offs and recoveries for proper authorization and/or reporting by reference to the board of directors' minutes. Review charged-off loans for any relationship with institution insiders or their related interests.
2. Review the institution's computation of the amount needed in the allowance for loan losses as of the end of the most recent quarter. Documentation should include consideration of the following matters:
  - a. General, local, national, and international (if applicable) economic conditions;
  - b. Trends in loan growth and depth of lending staff with expertise in these areas;
  - c. Concentrations of loans (e.g., by type, borrower, geographic area, and sector of the economy);
  - d. The extent of renewals and extensions to keep loans current;
  - e. The collectibility of nonaccrual loans;
  - f. Trends in the level of delinquent and classified loans compared with previous loan loss and recovery experience;
  - g. Results of regulatory examinations; and
  - h. The collectibility of specific loans on the "watch list" taking into account borrower financial status, collateral type and value, payment history, and potential permanent impairment.

C. Securities

1. Review the investment policies and procedures established by the institution's board of directors. Review the board of directors', or investment committee, minutes for evidence that the policies and procedures are periodically reviewed and approved. The policies and procedures should include, but not be limited to:
  - a. Investment objectives, including use of "held for sale" and trading activities;
  - b. Permissible types of investments;
  - c. Diversification guidelines to prevent undue concentration;
  - d. Maturity schedules;
  - e. Limitation on quality ratings;
  - f. Hedging activities and other uses of futures, forwards, options, and other financial instruments;
  - g. Handling exceptions to standard policies;
  - h. Valuation procedures and frequency;
  - i. Limitations on the investment authority of officers; and
  - j. Frequency of periodic reports to the board of directors on securities holdings.
2. Test the investment procedures and ascertain whether information reported to the board of directors, or investment committee, for securities transactions is in agreement with the supporting data by comparing the following information on such reports to the trade tickets for a sample of items, including futures, forwards, and options:
  - a. Descriptions;
  - b. Interest rate;
  - c. Maturity;
  - d. Par value, or number of shares;
  - e. Cost; and

- f. Market value on date of transaction, if different than cost.
3. Using the same sample items, analyze the securities register for accuracy and confirm the existence of the sample items by examining securities physically held in the institution and confirming the safekeeping of those securities held by others.
4. Balance investment subledger(s) or reconcile computer-generated trial balances with the general ledger control accounts for each type of security..
5. Review policies and procedures for controls that are designed to ensure that unauthorized transactions do not occur. Ascertain through reading of policies, procedures, and board of directors minutes whether investment officers and/or appropriate committee members have been properly authorized to purchase/sell investments and whether there are limitations or restrictions on delegated responsibilities.
6. Obtain a schedule of the book, par, and market values of securities, as well as the rating classifications. Test the accuracy of the market values of a sample of securities and compare the ratings listed to see that they correspond with those of the rating agencies. Review the institution's documentation on any permanent declines in value that have occurred among the sample of securities to determine that any recorded declines in market value are appropriately computed. Examine the institution's computation of the allowance account for securities, if any, for proper presentation and adequacy.
7. Test securities income and accrued interest by:
  - a. Determining the institution's method of calculating and recording interest accruals;
  - b. Obtaining trial balances of accrued interest;
  - c. Testing the reconciliation of the trial balances to the general ledger;
  - d. Determining that interest accruals are not made on defaulted issues;
  - e. Selecting items from each type of investment and money market holdings:
    - (1) Determining the stated interest rate and most recent interest payment date of coupon instruments by reference to sources of such information that are independent of the institution;
    - (2) Testing timely receipt of interest payments and correctness of entries to applicable general ledger accounts;
    - (3) Calculating accrued interest and comparing it to the trial balance; and
    - (4) Reviewing recorded book value for appropriate accretion of discount and amortization of premium; and
  - f. Performing an analytical review of yields on each type of investment and money market holdings for reasonableness.
8. Review investment accounts for volume of purchases, sales activity and length of time securities have been held. Inquire as to the institution's intent and ability to hold securities until maturity. If there is frequent trading in an investment account, such activity may be inconsistent with the notion that the institution has the intent and ability to hold securities to maturity. Test gains and losses on disposal of investment securities by sampling sales transactions and:
  - a. Determining sales prices by examining invoices or brokers' advices;
  - b. Checking for the use of trade date accounting and the computation of book value on trade date;
  - c. Determining that the general ledger has been properly relieved on the investment, accrued interest, premium, discount and other related accounts;
  - d. Recomputing the gain or loss and compare to the amount recorded in the general ledger; and

- e. Determining that the sales were approved by the board of directors or a designated committee or were in accordance with policies approved by the board of directors.

D. Insider Transactions

NOTE: For purposes of this section of the procedures, insiders include all affiliates of the institution, including its parent holding company, and all subsidiaries of the institution, as those terms are defined in section 23A of the Federal Reserve Act, as well as the institution's executive officers, directors, principal shareholders, and their related interests, as those terms are defined in section 215.2 of Federal Reserve Regulation O.

1. Review the institution's policies and procedures to ensure that extensions of credit to, and other transactions with, insiders are addressed. Ascertain that these policies include specific guidelines defining fair and reasonable transactions between the institution and insiders, and test insider transactions for compliance with these guidelines and statutory and regulatory requirements. Ascertain that the policies and procedures on extensions of credit comply with the requirements of Federal Reserve Regulation O.
2. Obtain an institution-prepared list of insiders, including any business relationships they may have other than as a nominal customer. Also obtain a list of extensions of credit to, and other transactions that the institution, its affiliates, and its subsidiaries have had with, insiders that are outstanding as of the audit date or that have occurred since the prior year's external auditing procedures were performed. Compare these lists to those prepared for the prior year's external auditing program to test for completeness.
3. Review the board of directors' minutes, loan trial balances, supporting loan documentation, and other appropriate institution records in conjunction with the list of insiders obtained from the institution to verify that a sample of extensions of credit to, and transactions with, insiders were:
  - a. In compliance with institution policy for similar transactions and were at prevailing rates and terms at that time;
  - b. Subjected to the institution's normal underwriting criteria and deemed by the institution to involve no more than a normal degree of risk, or present no other unfavorable features;
  - c. Approved by the board of directors in advance with the interested party abstaining from voting; and
  - d. Within the aggregate lending limits imposed by Regulation O or other legal limits.
4. Review the institution's policies and procedures to ensure that expense accounts of individuals who are executive officers, directors, and principal shareholders are addressed and test a sample of the actual expense account records for compliance with these policies and procedures.

E. Internal Controls - General Accounting and Administrative Controls

1. Review the board of directors' minutes to verify that account reconciliation policies have been established and approved and are reviewed periodically by the board of directors. Determine that management has implemented appropriate procedures to ensure the

timely completion of reconciliations of accounting records and the timely resolution of reconciling items.

2. Determine whether the institution's policies regarding segregation of duties and required vacations for employees, including those involved in the EDP function, have been approved by the board of directors and verify that these policies and the implementing procedures established by management are periodically reviewed, are adequate, and are followed.
3. Confirm a sample of deposits in each of the various types of deposit accounts maintained by the institution. Inquire about controls over dormant deposit accounts.
4. Test to determine that reconciliations are prepared for all significant asset and liability accounts and their related accrued interest accounts, if any, such as "due from" accounts; NOW accounts; money market deposit accounts; other savings deposits; certificates of deposit; and other time deposits. Review reconciliations for:
  - a. Timeliness and frequency;
  - b. Accuracy and completeness; and
  - c. Review by appropriate personnel with no conflicting duties.
5. Compare a sample of balances per reconciliations to the general ledger and supporting trial balances.
6. Examine detail and aging of a sample of reconciling items from those accounts whose reconciliations have been tested and reviewed and a sample of items in suspense, clearing, and work-in-process accounts by:
  - a. Testing aging;
  - b. Determining whether items are followed up on and appropriately resolved on a timely basis; and
  - c. Discussing items remaining on reconciliations and in the suspense account with appropriate personnel to ascertain whether any should be written off.

Review a sample of charged-off reconciling and suspense items for proper authorization.

7. Verify through inquiry and observation that the institution maintains adequate records of its off-balance sheet activities, including, but not limited to, its outstanding letters of credit and its loan commitments. Review the institution's procedures for monitoring the extent of its credit exposure from such activities to determine whether probable or reasonably possible losses exist.

#### F. Internal Controls - Electronic Data Processing

1. Read the board of directors' minutes to determine whether the board of directors has reviewed and approved the institution's electronic data processing (EDP) policies, including those regarding outside servicers, if any, and the in-house use of individual personal computers (PCs) and personalized programs for official institution records, at least annually, confirm that management has established appropriate implementing procedures, and verify the institution's compliance with these policies and procedures.
  - a. The policies and procedures for either in-house processing or use of an outside service center should include:
    - (1) A contingency plan for continuation of operations and recovery when power outages, natural disasters, or other threats could cause disruption

- and/or major damage to the institution's data processing support, including compatibility of servicer's plan with that of the institution;
- (2) Requirements for EDP-related insurance coverage that include the following provisions:
    - (a) Extended blanket bond fidelity coverage to employees of the institution or servicer;
    - (b) Insurance on documents in transit, including cash letters; and
    - (c) Verification of the insurance coverage of the institution or service bureau and the courier service;
  - (3) Review of exception reports and adjusting entries approved by supervisors and/or officers;
  - (4) Controls for input preparation and control and output verification and distribution;
  - (5) "Back-up" of all systems, including off-premises rotation of files and programs;
  - (6) Security to ensure integrity of data and system modifications; and
  - (7) Necessary detail to ensure an audit trail.
- b. When an outside service center is employed, the policies and procedures should address the following additional items:
- (1) The requirement for a written contract for each automated application detailing ownership and confidentiality of files and programs, fee structure, termination agreement, and liability for documents in transit;
  - (2) Review of each contract by legal counsel; and
  - (3) Review of each third party review of the service bureau, if any.
2. In the area of general EDP controls, determine through inquiry and observation that policies and procedures have been established for:
- a. Management and user involvement and approval of new or modified application programs;
  - b. Authorization, approval and testing of system software modifications;
  - c. The controls surrounding computer operations processing;
  - d. Restricted access to computer operations facilities and resources including:
    - (1) Off-premises storage of master disks and PC disks;
    - (2) Security of the data center and the institution's PCs; and
    - (3) Use and periodic changing of passwords.
3. With respect to EDP applications controls, inquire about and observe:
- a. The controls over:
    - (1) Input submitted for processing;
    - (2) Processing transactions;
    - (3) Output;
    - (4) Applications on PCs, and
    - (5) Telecommunications both between and within institution offices.
  - b. The security over unissued or blank supplies of potentially negotiable items; and
  - c. The control procedures on wire transfers including:
    - (1) Authorizations and agreements with customers, including who may initiate transactions;
    - (2) Limits on transactions; and
    - (3) Call back procedures.

## G. Trust Function

1. Supervisory Review
  - a. Determine the significant functions of the department, including areas of responsibility within the department and the financial institution.
  - b. Review the institution's written policies to determine that sufficient guidelines are established to meet fiduciary responsibilities and to comply with applicable laws. Policies should include:
    - (1) Account acceptance;
    - (2) Closed account review;
    - (3) Investments;
    - (4) Account review;
    - (5) Discretionary distributions;
    - (6) Conflicts of interest; and
    - (7) Other, as needed, for the scope of fiduciary activities.
  - c. Ascertain the qualifications of the staff and of the board of directors giving consideration to the nature of the fiduciary responsibilities accepted.
  - d. Determine if board policies are implemented and followed.
2. Accounting and Physical Controls
  - a. Verify account assets. Include a confirmation from holders of assets retained outside the department.
  - b. Determine that the assets are adequately safeguarded, and held separately from other assets of the institution.
  - c. Verify that a vault record of assets under joint custody is maintained.
  - d. Verify prompt ledger control of assets, including worthless assets, received as original and subsequent deposits of assets, including stock splits and dividends.
  - e. Verify that fiduciary cash accounts are regularly and appropriately reconciled to demand deposit or money market account statements.
  - f. Verify that internal balancing control procedures are performed each time account ledgers are posted.
  - g. Verify that suspense or operating accounts are reconciled at least monthly, contain only appropriate items, and are cleared in a timely manner.
  - h. Reconcile or verify the proper reconciliation of each of the following to the department's general ledger at least quarterly:
    - (1) Income cash;
    - (2) Principal cash;
    - (3) Invested income;
    - (4) Invested principal;
    - (5) Each type of investment, such as stock, bonds, real estate loans and real estate; and
    - (6) Investments by issuer.
  - i. If applicable, verify reconcilements or reconcile outstanding bonds for bond trusteeships, or paying agent activities.
  - j. Verify the accurate payment of dividends.
3. Activity Control
  - a. Verify fees paid to the trust company.
  - b. Verify proceeds from sales of assets to brokers' invoices, sellers' receipts, or other evidence of sales price.

- c. Verify payment for purchases of assets to brokers' invoices, sellers' receipts, or other evidence of purchase price.
- d. Verify accuracy of amounts and receipt of income from investments.
- 4. Compliance
  - a. Verify that transactions between fiduciary accounts and directors, officers or employees of the institution, its holding company or other related entity do not constitute self-dealing. In general, self-dealing is considered to exist when the fiduciary uses or obtains the property held in a fiduciary capacity for his or her own benefit.
  - b. Review fiduciary account holdings of the following items in light of self-dealing issues.
    - (1) Stock, obligations, repurchase agreements, or deposit accounts with the institution, its affiliates or other related organizations in which there exists such an interest that might affect the best judgment of the institution.
    - (2) Obligations of directors, officers and employees of the institution, its holding company or affiliates or other entities with whom there exists a connection that might affect the exercise of the best judgment of the institution.
  - c. Verify that all accounts for which the institution has investment responsibilities are reviewed in accordance with Section 11-103-502(4), C.R.S.
  - d. Verify that cash receipts are promptly invested or distributed.
  - e. Verify and review the annual audit of each collective investment fund.
- 5. Administrative Review
  - a. Complete administrative reviews of all major account types, including but not limited to, personal trusts, estates, corporate trusts, collective investment funds, pension trusts and profit sharing trusts. An acceptable administrative review would perform the following practices:
    - (1) Determine that the original or authenticated copy of the governing instrument is on file;
    - (2) Determine that synoptic and history records are current, reliable and comprehensive;
    - (3) Determine that accounts are administered and invested in conformance with management policies, governing instruments, laws, regulations and sound fiduciary principles;
    - (4) Determine that the minutes of the board of directors and committee meetings document the review of trust activities; significant practices for the board of directors' review include the acceptance of new accounts, the closing of accounts and the review of discretionary payments of principal or income; and
    - (5) Test the accuracy of account statements submitted to beneficiaries.

Amended Effective May 30, 2005

Amendments correct minor grammatical and technical errors.

Amended Effective March 1, 2004

Statutory reference amendment to conform Rule to recodified statutes; update terminology to conform to recodified statutes; formatting changes to comply with Colorado Secretary of State guidelines.