



MARKET SQUARE PLAZA | 17 N SECOND STREET, SUITE 1300 | HARRISBURG, PA 17101-2290
Ph 717.787.2665 Fx 717.787.8773 W www.banking.state.pa.us

September 14, 2007

TO ALL TRUST COMPANIES, BANK AND TRUST COMPANIES, AND SAVINGS BANKS AND SAVINGS ASSOCIATIONS THAT EXERCISE TRUST POWERS:

The purpose of this letter is to clarify the acceptable means by which the required annual audit of trust activities of trust companies, bank and trust companies, and savings banks and savings associations that exercise trust powers (“institutions”) may be accomplished, as required by Section 1407 of the Banking Code of 1965 (the “Banking Code”).¹

As a general matter, Section 1407(a) of the Banking Code states that:

[e]xcept as provided in subsection (c) of this section, the board of directors or trustees shall at least once each year have made, by certified public accountants selected by the institution and satisfactory to the department, an audit of the books and affairs of the institution including such matters as may be required by the department *and including, in the case of a bank and trust company or a trust company, if required by the department, accounts held in a fiduciary or other representative capacity.* The department may by regulation establish minimum standards for audits and reports under this subsection (a).²

The Department has consistently required that audits be performed for fiduciary or other representative accounts held by institutions, which audits should include a review of internal controls of such institutions in regard to such accounts. In order to satisfy the audit requirements of Section 1407(a) of the Banking Code, an institution may employ one of the following three types of audit reviews.

First, consistent with Section 1407(a) and (b) of the Banking Code, the Department will accept an audit by a certified public accountant (“CPA”) that states that the CPA has audited the records of the institution in accordance with auditing standards generally

¹ Savings associations with trust powers are required to obtain an annual audit of fiduciary or other representative accounts held by the savings association in a manner consistent with Section 1407 of the Banking Code. *See* 10 Pa. Code § 31a.5.

² 7 P.S. § 1407(a) (emphasis added).



MARKET SQUARE PLAZA | 17 N SECOND STREET, SUITE 1300 | HARRISBURG, PA 17101-2290

Ph 717.787.2665 Fx 717.787.8773 W www.banking.state.pa.us

accepted in the United States.³ The audit should include both the commercial/corporate aspects of the institution as well as the trust activities. The engagement letter between the institution and the CPA should confirm that both areas have been audited, including a review of internal controls.

Secondly, the Department will accept a financial statement audit of the commercial/corporate side of an institution performed by a CPA that is coupled with an “agreed-upon procedures” engagement concerning the institution’s trust activities which includes an internal controls review. The engagement letter between the institution and the CPA should confirm the “agreed-upon procedures” of the engagement, including a review of internal controls.

Finally, subject to prior Department approval and consistent with Section 1407(c) of the Banking Code, the Department will accept a report of an internal audit control system for those institutions that have internal auditors or that have contractually outsourced the internal trust auditing function to a CPA firm. Attached are the guidelines for Department approval of internal trust audit control programs.

This letter should clarify the position of the Department relating to audits of trust activities of your institution. Should you need additional information or clarification, please contact James A. Acri, Administrator, at 717.783.2251 or jaacri@state.pa.us. In our supervisory and regulatory role, we at the Pennsylvania Department of Banking continue to look forward to working with you to make the Pennsylvania state charter the charter of choice for financial institutions in Pennsylvania.

Sincerely,

Ronald P. Wysochansky
Deputy Secretary of Banking

Attachment

³ Section 1407(d) of the Banking Code provides that “[a]udits and reports shall be deemed to satisfy the requirements of this section to the extent the audits and reports conform to accounting standards and principles applicable pursuant to 12 U.S.C. § 1831n to reports or statements required to be filed with Federal banking agencies.” 7 P.S. § 1407(d).



pennsylvania

DEPARTMENT OF BANKING

MARKET SQUARE PLAZA | 17 N SECOND STREET, SUITE 1300 | HARRISBURG, PA 17101-2290

Ph 717.787.2665 Fx 717.787.8773 W www.banking.state.pa.us

INTERNAL AUDIT PROGRAMS FOR TRUST DEPARTMENTS
SECTION 1407 OF THE BANKING CODE OF 1965

Section 1407 of the Banking Code requires that all state-chartered banks have an annual audit by a Certified Public Accountant or have an internal audit program approved by the Pennsylvania Department of Banking in lieu of the annual audit by the Certified Public Accountant.

For those institutions that choose to satisfy Section 1407 of the Banking Code through an approved internal audit program, the following listed conditions must be satisfied:

Prior to Receiving Department Approval

1. A resolution must be adopted by the Board of Directors to submit a proposed continuous internal audit program to the Department of Banking for approval.
2. Board of Directors must create the position of Auditor if it does not already exist.
3. If necessary, the Board must amend the bylaws to provide for the position of Auditor and the responsibilities of the position. (The duties and the responsibilities of the Auditor must be free of operational duties and the Auditor must not be required to report to operating officers.)
4. The Board of Directors must establish a responsibility line from the Board or its Audit Committee directly to the Auditor and require that the Auditor report only to this committee.
5. The minutes of the Board should be available to the Auditor so that the Auditor is aware at all times of the intention of management and can gear his program to the actions required.
6. Submit the proposed audit program to the Department for review. Submit a certified copy of the Board of Directors' resolution indicated in item 1, above, and a copy of the amendment to the bylaws indicated in item 3, above, if necessary.
7. Submit a copy of the organizational chart showing reporting/responsibility lines of the Audit Department, including reporting of the Auditor to the Board of Directors or its Audit Committee. No operational duties or responsibilities should be assigned to the audit staff.
8. Submit brief resumes of the Auditor and each member of the Audit Department staff (excluding nonprofessional staff) reflecting the educational and experience qualifications of each member.

9. Department will review the proposed audit program in detail and make suggestions to correct any weaknesses, if necessary.
10. Under most conditions, prescheduled personal visitation by the responsible member of the Department's staff will be made to the institution to meet with the Auditor and other applicable bank officials.
11. When the proposed audit program meets the Department's audit coverage requirements, an official approval letter will be issued.

Following Department Approval

12. The Auditor and/or Audit Committee must submit to the Board of Directors an annual summary report of the audits conducted during the year as required by Section 1407(c) of the Banking Code.
13. The summary report must state the degree of compliance with the approved audit program.
14. The summary report must include the Auditor's opinion on the adequacy of those internal control functions, as listed under "Minimum Requirements for an Approved Program," that are appropriate to the subject institution.
15. A copy of the summary report must be filed with the Department promptly after submission to the Board of Directors.
16. All proposed revisions in the approved audit program must be submitted to the Department for approval prior to adoption.
17. Department bank examiners at each examination will test check the program and the records maintained thereon to ascertain the degree of adherence to the approved program. All approved revisions will be test checked by the bank examiners.

Minimum Requirements and Audit Coverage by an Approved Internal Audit Program

The Auditor must have substantial independence in the areas being audited. More specifically, the Auditor should functionally report directly to the Board of Directors or the Audit Committee of the Board of Directors.

A detailed audit manual must be developed and include: (1) a description of the function or area to be audited; (2) a description of the internal controls applicable to the targeted function or area; and (3) procedures to be followed to accomplish the audit.

The audit program should include procedures to give reasonable assurance to management and the Department of Banking that there are controls in place to assure compliance with the laws and regulations and management objectives.

The functions or areas to be covered should include the general areas listed below. Specific functions will vary between institutions to conform to their individual requirements.

All activities require authorization. Audit procedures should give reasonable assurance that the following listed objectives are complied with:

1. The types of trust services to be rendered, the trust customers to be solicited and the terms and conditions for providing the trust services are authorized by management.
2. Amounts, timing and decisionmaking responsibilities of investment of funds should be authorized within the parameters established by management and authority granted in the controlling instrument.
3. Disbursements and distributions of cash or assets should be authorized by those officers and employees granted authority to do so in accordance with criteria established by management and the controlling instrument.
4. Each criterion established by management for authorizing adjustments is defined, communicated and complied with. This includes routine items as well as less common adjustments.
5. Proper control must be maintained over the development, documentation, testing and installation of new or revised processing procedures. Also, no procedures should be added, altered or deleted without proper authorization.

All functions of an administrative nature, as well as other transactions, once authorized, require monitoring and control. Audit procedures to test administrative and other transactions' compliance should include the following:

6. On new accounts, review documentation, proper authorization, verification of critical details on forms or data-based management systems and exception reporting procedures on proffered accounts that do not meet criteria as established in item 1, above.
7. Evaluation of techniques used to provide reasonable assurance that the description and amounts of trust assets on new accounts are entered accurately and promptly into the trust accounting records.
8. Fees and commissions charged should be in conformance with management's fee schedule, should be accurately computed and promptly billed and should be transferred to the bank's profit accounts in the correct accounting period.
9. Evaluate the techniques employed in the investment function to provide reasonable assurance that only those investment transactions that meet criteria established by management and the terms of the governing instrument are approved.
10. Evaluate techniques employed to provide reasonable assurance that approved purchases and sales of trust investments are accurately and promptly reported.
11. Determine adequacy of procedures and controls that ensure proper recognition and reporting of income on trust investments.

12. Evaluate the techniques employed in the investment function to provide reasonable assurance that the disbursement of funds (and corresponding delivery of securities) are made only for transactions based upon a recognized contractual obligation and that the transaction is promptly reported.
13. Distributions and disbursements of principal and income from trusts to beneficiaries must meet management's criteria (as established under guidelines of item 3, above) and the terms of the controlling instrument.
14. Evaluate techniques employed to ensure the accurate and prompt reporting of distributions to beneficiaries.
15. Determine that the reporting function provides reasonable assurance that transactions and adjustments are promptly and accurately classified, summarized and reported. This includes data to be posted to Trust General Ledger and the bank's General Ledger (such as cash and fees).
16. Test and evaluate procedures used to group summaries of individual trust transactions and to classify the summary totals for posting to Trust General Ledger. The procedure should also provide assurance as to accuracy of the postings.
17. Review controls over accumulation of data not derived directly from trust records that are required for disclosure in reports, such as market value of securities, adequacy of assets pledged to secure funds on deposit, etc.
18. Evaluate methods that are to ensure accuracy and promptness of management reports, customer statements and required filings and reports to government agencies required of the various accounts.
19. Evaluate procedures and controls used to detect errors and omissions and to ensure reported balances are evaluated realistically under conditions existing as of a reporting date.
20. Review and appraise policies and procedures designating responsibility for assets, procedures for reporting and investigating discrepancies and policies and procedures used to control physical access to trust assets.
21. Appraise techniques used to communicate responsibility for and access to critical forms, records, processing areas and processing procedures.

The audit procedures to accomplish the above-listed goals will be at the discretion of the Auditor, subject to review and approval of the Banking Department.

The audit should include physical verification of assets, either on a cycle basis not to exceed five (5) years or through the use of an accepted statistical sampling procedure on an annual basis.

The Auditor will present an annual summary report to the Board of Directors or the Audit Committee of the Board of Directors and will include a statement, based upon the above tests, as to the adequacy of the internal controls.

Questions should be directed to James A. Acri, Administrator – Bureau of Supervision and Enforcement, at (717) 787-7333.