Sarbanes – Oxley Act of 2002

Quality Control for Financial Reporting

Sarbox = QC for SEC Registrants

SOX “Titles”

- Title I – Public Company Accounting Oversight Board –PCAOB
- Title II – Auditor Independence
- **Title III – Corporate Responsibility**
- **Title IV – Enhanced Financial Disclosures**
- Title V – Analysis of Conflicts of Interest
- Title IV – Commission Resources and Authority

SOX “Titles”

Continued

- Title VII – Studies and Reports
- Titles VIII – Corporate and Criminal Fraud Accountability
- Title IX – White-Collar Crime Penalty Enhancements
- Title X – Corporate Tax Returns
- Title XI – Corporate Fraud and Accountability

Title III –Corporate Responsibility

Sections

- 301 – Public Company Audit Committees
- 302 – Corporate Responsibility for Financial Reports
- 303 – Improper Influence on Conduct of Audits
- 304 – Forfeiture of Certain Bonuses and Profits
- 305 – Officer and Director Bars and Penalties
- 306 – Insider Trades During Pension Fund Blackout Periods
- 307 – Rules of Professional Responsibility for Attorneys
- 308 – Fair Funds for Investors

Section 301

"Berkshire Hathaway would be more valuable today if I had put in a whistleblower line decades ago."

Warren Buffet

Section 302 – Corporate Responsibility for Financial Reports

The Signing Officers

- Are responsible for establishing and maintaining internal controls
- Have designed such internal controls to ensure that material information relating to the issuer is made known to such officers by others within the entities
- Have evaluated the effectiveness of the issuer's controls as of a date within 90 days prior to the report
- Have presented their conclusions about the effectiveness of their internal controls

Section 302 – Corporate Responsibility for Financial Reports

The Signing Officers

- Have disclosed to the issuer's auditors and audit committee:
  - All significant deficiencies in the design or operation of internal controls which would adversely affect the issuer's ability to record, process, summarize, and report financial data and have identified for the issuer's auditors any material weaknesses in internal controls
  - Any fraud, whether or not material, that involves management or other employees who have a significant rule in the issuer's internal controls
- The report must cover:
  - Significant changes in internal controls or in other factors that could significantly affect internal controls
  - Any corrective actions with regard to significant deficiencies and material weaknesses.

Title IV – Enhanced Financial Disclosures

Sections

- 401 – Disclosures in Periodic Report
- 402 – Enhanced Conflict on Interest Provisions
- 403 – Disclosures of Transactions Involving Management and Principal Stockholders
- **404 – Management Assessment of Internal Controls**
- 405 – Investment Company Exemption
- 406 – Code of Ethics for Senior Financial Officers
- 407 – Disclosure of Audit Committee Financial Expert
- 408 – Enhanced Review of Periodic Disclosure by Issuers

Section 404 (A)

- The commission (SEC) shall require each annual report to contain an internal control report, which shall –
  - (1) State the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and
  - (2) Contain an assessment, as of the end of the most recent fiscal year of the issuer, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting.

Section 404 (B)

- Internal Control Evaluation and Reporting
  - With respect to the internal control assessment required by subsection (a), each registered public accounting firm that prepares or issues the audit report for the issuer shall attest to, and report on, the assessment made by the management of the issuer.

Section 404

“Do the right thing”

Spike Lee

Disclosure of Material Weaknesses

Most Common Material Weakness Disclosures

1. Lease Accounting
2. Accounting Policies, Practices
3. Staff
4. Taxes
5. GAAP Calculations, Policies
6. Revenue Recognition
7. Account Reconciliation
8. Segregation of Duties
9. Information Technology Environment
10. Financial Closing Process

COSO

- Committee of Sponsoring Organizations (COSO) of the Treadway Commission
- A voluntary private sector organization dedicated to improving the quality of financial reporting through business ethics, effective internal control, and corporate governance.
- Formed in 1985 to sponsor the National Commission on Fraudulent Financial Reporting
- Internal Control – Integrated Framework – Report Issued 1992
- Enterprise Risk Management (ERM) – Integrated Framework – Report Issued Sept 2004

Definition of Internal Control

COSO – “A process, effected by an entity’s board of directors, management, and other personnel, designed to provide **reasonable assurance** regarding achievement of objectives in the following categories:

- Effectiveness and efficiency of operations,
- ***Reliability of financial reporting***, and
- Compliance with applicable laws and regulations.”

Internal Control Framework – COSO

EXAMPLE

XYZ BANK
THE SARBANES-OXLEY ACT OF 2002
SUMMARY
DECEMBER 7, 2005

Specific Control Activity grids are as follows:

XYZ BANK
COSO – CONTROL ACTIVITY # 4 - COMMERCIAL LENDING
MANAGEMENT REPRESENTATION OF INTERNAL CONTROLS

The undersigned acknowledge their responsibility for maintaining adequate systems of internal controls and monitoring adherence to such systems of control in our particular areas of responsibility.
The attached "Review of Internal Controls" represents an accurate assessment of the internal controls systems in place as **December 31, 2005** and identifies any areas of weakness, in either such systems or their operation, noted during our self-assessment.
Based upon management's self-assessment, the undersigned believe that systems of control are properly designed and operating effectively in our areas of responsibility to give reasonable assurances that material errors or fraud will be prevented and/or detected.

_____

Signature

_____

Signature

Commercial Lending

For purposes of the discussion that follows, we are specifically referring to the commercial lending function of XYZ (the “Bank”).

The Bank’s loan officers are responsible for generating and maintaining profitable lending relationships, primarily commercial lending, with both existing and new Bank customers. These officers are also responsible for performance monitoring, as well as management of non-performing and potential non-performing loans, and for management and disposition of real estate owned.

The loans originated by these officers are administered (closed, booked, disbursed, and satisfied) by the Loan Operations Department. The Loan Operations Department is also responsible for collateral safekeeping (excluding negotiable collateral which is maintained at the branch) and on-line systems management.

Loans and Commitments

Management considered the following interrelated components in reviewing the internal controls surrounding loans and commitments area within the commercial lending area:

- Control Environment;
- Risk Assessment;
- Control Activities;
- Information & Communication; and
- Monitoring.

Control Environment

The control environment is influenced by a company's history and culture and sets the tone of the organization, influencing the control consciousness of its personnel. It is the foundation for all other components of internal control, providing discipline and structure. The control environment has a pervasive influence on the way business activities are structured, objectives established, and risks assessed. It also influences control activities, information and communication systems, and monitoring activities. Effectively controlled companies strive to have competent people, instill a company-wide attitude of integrity and control consciousness, and set a positive "tone at the top". They establish policies and procedures, including a written code of conduct, which fosters shared values and teamwork in pursuit of the company's objectives. The control environment is evaluated based on the following factors:

- Integrity & Ethical Values;
- Commitment to Competence;
- Board & Audit Committee;
- Management's Philosophy & Operating Style;
- Organization Structure;
- Assignment of Authority & Responsibility; and
- Human Resource Policies and Procedures.

Control Environment (continued)

The control environment was assessed through a two-tiered coverage map that encompasses the entity wide (e.g. XYZ Bank) and activity (e.g. commercial lending) levels.

The entity wide assessment of the control environment appears in Tab A of the Sarbanes-Oxley documentation. This assessment should be reviewed in conjunction with the activity level assessment in considering the macro and micro control environment.

The activity level assessment of the control environment was made through inquiry and observation of Accounting Department personnel. In addition, a survey of the employees of that department was conducted. The results of our inquiries and observations, as well as our survey were found to be consistent with those in the entity wide assessment.

These controls are identified as Control Environment (CE)
(See attached grid)

Risk Assessment

All companies regardless of size, structure, nature, or industry, encounter risks at all levels within their organization. Risks affect each company's ability to survive, successfully compete within its industry, maintain financial strength and positive public image, and maintain the overall quality of its products, service, and people. There is no practical way to reduce risk to zero. Indeed, the decision to be in business creates risk. Management must determine how much risk is to be prudently accepted, and strive to maintain risk within these levels. Objective setting is a precondition to risk assessment. There must first be objectives before management can identify risks to their achievement and take necessary actions to manage the risks. Objective setting, then, is a key part of the management process. While not an internal control component, it is a prerequisite to and an enabler of internal control. The risk assessment component of control is evaluated based upon the following factors:

- Company-Wide Objectives;
- Process-Level Objectives;
- Risk Identification; and
- Managing Change.

Risk Assessment (continued)

Risk was assessed through a two-tiered coverage map that encompasses the entity wide (e.g. XYZ Bank) and activity (e.g. commercial lending) levels.

The entity wide assessment of risk appears in Tab B of the Sarbanes-Oxley documentation. This assessment should be reviewed in conjunction with the activity level assessment in considering the macro and micro risks.

The activity level of risk was made through inquiry and observation of Accounting Department personnel. In addition, a survey of employees of that department was conducted. XYZ Bank conducts an entity wide risk assessment each year (including XYZ Bank) as part of the development of the internal audit plan. This risk assessment is completed at a functional level. In addition, as part of the Sarbanes-Oxley documentation, management maps the significant general ledger accounts, and required disclosures from the Company's 10Q and 10K SEC filings and annual report to each functional area. The significant general ledger accounts and required disclosures mapped to the commercial lending area are comprised of the following:

Account Number	Account Description	Account Type
(to be provided)		

Risk Assessment (continued)

The specific risks present within the commercial lending function were assessed to determine how these risks should be managed. In view of the types of lending handled by commercial lending, the volume of loan transactions, the increased competitive lending environment, as well as the inherent risk associated with commercial lending, this function was determined to be of relatively high risk. As noted in the tables on the following pages, we have documented the objectives and related control activities for the various commercial lending functions.

The level of operating risk present within the commercial lending area was also assessed through review of the following factors:

- Extent of regulatory and/or competitive lending environment affecting lending activity;
- Volume of loan servicing activity;
- Level of related party loan activity; and
- Concentration of loans in a particular industry.

Risk Assessment (continued)

In addition, the following factors, if present, may indicate that controls are not adequate and/or functioning properly (i.e., control risk), thereby, increasing the overall level of risk present in the commercial lending area:

- Failure to define and enforce basic credit policies and procedures including:
  - Adherence to credit limits and underwriting standards; and
  - Procedures for approval of interest rates and fees.
- Growing backlogs of unprocessed loan requests;
- Customer complaints regarding reported loan balances or interest assessments;
- Numerous adjustments to interest computations or outstanding balances;
- Numerous reconciling items between detailed records and related control accounts;
- Numerous suspense account reconciliation exceptions including failure to reconcile suspense accounts on a timely basis;
- Significant changes in unapplied cash balances;
- Lack of segregation between loan processing, loan approval, disbursement, collateral custody, and servicing of the loan;
- Failure to ensure original and continuing perfection of collateral;
- Failure to monitor and comply with regulatory requirements affecting lending activity; and
- Lack of written procedures to instruct staff in complying with policies.

Control Activities

Control activities are policies and procedures used to ensure management directives are met. Control activities vary depending upon the nature of the risk mitigated and are carried out to ensure that the risks are minimized to an acceptable level. Control activities can be divided into three categories, based on the nature of the Company's objectives to which they relate, i.e., operations, financial reporting, or compliance. Depending on circumstances, controls could help to satisfy company objectives in one or more of the three categories. The control activities component of control is evaluated based upon the following factors:

- Policies and Procedures; and
- Control Activities in Place.

The following tables document the control activities that help ensure specific objectives are achieved. In order to properly assess the adequacy of controls, the specific controls within the entity that relate to the specified control activity were reviewed and documented. A separate column has been included in the tables to document the specific controls implemented by management. In order to conclude on the effectiveness of controls, management must test, to the extent deemed necessary, the applicable key controls from those identified in the tables.

In addition, the level of computerized functions within the commercial lending area was considered to determine whether the necessary system controls are in place.

Control Activities (continued)

The following represent common management controls over the commercial lending function which enhance the specific control activities included in the tables on the following pages:

- Management review of average loan balances and average rates earned;
- Regular comparison by management of rates and fees earned with market indicators;
- Procedures employed by management to monitor interest rate and maturity gaps;
- Procedures in place to monitor compliance with applicable regulatory requirements;
- Approval and timely resolution of holdover, suspense and other exception items;
- Management review of reconciliation between general ledger accounts and detail transaction listings;
- Management monitoring of changes made to standing data (e.g., interest rates, credit limits, fee schedules), and
- The Bank has invested significant resources in acquiring experienced senior and mid-level managers to direct its commercial lending activities, and has structured its management organization to provide controls throughout the entire organization. The relatively small size of these departments allows the management team the ability to provide close daily oversight and guidance to their personnel.

Control Activities

In assessing the adequacy of the control activities within the commercial lending loan area, the existence of an adequate segregation of duties between the following functions was considered:

- Loan approval;
- Funds disbursement;
- Loan generation and relationship management;
- Credit monitoring;
- Loan charge-offs;
- Collection;
- Ledger posting;
- Reconciliation;
- Custody of collateral; and
- Responsibility for posting in the loan system is segregated from general ledger functions.

In order to properly assess the adequacy of controls, the specific controls within the entity that relate to the specified control activity were reviewed and documented. A separate column has been included in the tables to document the specific controls implemented by management. In order to conclude on the effectiveness of controls, management must test, to the extent deemed necessary, the applicable key controls from those identified in the tables.

These controls are identified as Control Activities (CA)

Those specific controls designated with ** are considered key controls and will be tested by Internal Audit for their presence.
(See attached grid)

Information and Communication

Pertinent information must be identified, captured, and communicated in a form and time frame that enables people to carry out their responsibilities. Information gathering mechanisms produce reports containing operational, financial reporting, and compliance related information that makes it possible to run and control the business. They deal not only with internally generated data, but also with information about external events, activities, and conditions necessary for informed business decision-making and external reporting. Effective communication also must occur in broader sense, flowing down, across, and up the organization. All personnel must receive a clear message from 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. The information and communication component of control is evaluated based upon the following factors:

- Quality of Information; and
- Effectiveness of Communication.

Information and Communication (continued)

Information and communication was assessed through a two-tiered coverage map that encompasses the entity wide (e.g. XYZ Bank) and activity (e.g. commercial lending) levels.

The entity wide assessment of information and communication appears in Tab D of the Sarbanes-Oxley documentation. This assessment should be reviewed in conjunction with the activity level assessment in considering the macro and micro information and communication.

The activity level assessment of information and communication was made through inquiry and observation of Accounting Department personnel. In addition, a survey of the employees of that department was conducted. Finally, within the following tables a separate column (COSO component) has been included to designate the specific controls that address control activities as well as information and communication controls.

These controls are identified as Information and Communication (IC).
(See attached grid)

Monitoring

Internal control systems need to be monitored – a process that assesses the quality of the system's performance over time. This is accomplished through on-going monitoring activities, separate evaluations or a combination of the two. On-going monitoring occurs in the course of operations. It includes regular management and supervisory activities, and other actions personnel take in performing their duties. The scope and frequency of separate evaluations (audits) will depend primarily on assessment of risks and the effectiveness of on-going monitoring procedures. Internal control deficiencies should be reported upstream, with serious matters reported to senior management and the board. The monitoring component of control is evaluated based upon the following factors:

- On-going Monitoring;
- Separate Evaluations; and
- Reporting Control and Process Deficiencies.

Monitoring (continued)

Monitoring was assessed through a two-tiered coverage map that encompasses the entity wide (e.g. XYZ Bank) and activity (e.g. commercial lending) levels.

The entity wide assessment of monitoring appears in Tab E of the Sarbanes-Oxley documentation. This assessment should be reviewed in conjunction with the activity level assessment in considering the macro and micro monitoring.

The activity level assessment of monitoring was made through inquiry and observation of Accounting Department personnel. In addition, a survey of the employees of that department was conducted. Finally, within the following tables a separate column (COSO component) has been included to designate the specific controls that address control activities as well as monitoring controls.

These controls are identified as Monitoring (M).
(See attached grid)

Evaluation of Internal Controls

Management, using the above COSO-based approach to evaluating internal controls, concludes that the internal control structure of commercial lending is adequately designed and functioning effectively in order to prevent errors or fraud before they become material to the financial statements taken as a whole.

The following tables document the control activities that help ensure specific objectives are achieved.