CASE STUDY

IN THE TREND OF FINANCIAL INSTITUTIONS OUTSOURING THEIR INTERNAL AUDIT FUNCTION; SPECIALIZING IN SMALLER TO MID-SIZED BANKS

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A Case Study in the Trend of Financial Institutions Outsourcing Their Internal Audit Function; Specializing in Smaller to Mid-Sized Banks

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Abstract:

Internal audit has gained the reputation of being a "necessary evil." Thus, many firms are looking for alternatives to the traditional audit department. Outsourcing of the internal audit function is an option that has become increasingly popular over the past several years, even though it has been in existence for more than 20 years. Over one-half of the decisions to outsource have been made over the last five years. Financial institutions, specifically, have been one of the most active in the decision to outsource. According to a 1997 survey, over one-third of the industry has out-sourced their internal audit function. This paper investigates several *specific* institutions and their justifications for outsourcing (or not outsourcing), along with interviewing the institutions' outside internal audit service provider. The heart of this case study revolves around small to mid-size banks. Interviews with bank executives have lent credible and relevant knowledge to the study. The root motives behind the outsourcing of the internal audit department among smaller banks is shown to be an interrelated combination among cost *and* quality factors. Furthermore, the choice to outsource (or not to outsource) has clearly been in the best interest of stakeholders. Smaller financial institutions are realizing that in most cases a higher quality end product can be achieved with little additional cost (or even cost savings) when the internal audit department is outsourced to a competent provider.

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Introduction

This study would not have been possible without the advice and guidance of Dr. David Sinason and Northern Illinois University's Department of Accountancy. I would like to express my sincere appreciation for all of his time and input in this case study.

Internal audit departments and internal auditors have come to hold the reputation of being a "necessary evil" (Serafini 1997). Many business entities have been searching for an alternative to this internal department, even though its customer focus and quality of products has vastly improved in more recent years. However, many have hesitated in following through on the outsourcing of the internal audit function for various reasons, including independence concerns and loss of core business knowledge. Financial institutions have been the first industry to widely adopt such outsourcing plans. Individual banks have helped define what will and will not work in establishing and maintaining an outsourced internal audit department. They have also provided guidance for other industries to follow.

Outsourcing of the function has become increasingly popular recently, as 55% of the outsourcing decisions have been made in the past five years (Petravick 1997). Outsourcing is not a new idea, but has been in existence in excess of 20 years. Firms chose to outsource functions that were not core to their business functions and were viewed as general or necessary operations. The firm was forced to perform such activities as check processing or information systems, but could not attain a level of specialization nor economies of scale. Therefore, an outside firm could more effectively and efficiently provide these non-core activities. In this manner, both the initial business and its new outsource provider may enjoy the benefits created through economies of scale. Cost was truly at the heart of many of these first relationships, but firms soon realized that increased quality was another viable by-product. However, businesses outsourced only those functions that were not core competencies and did not represent vital internal activities. Because of this, internal audit was held as just that, internal to the firm. It was viewed as a necessary function that was simply too important and too proprietary to "hand off" to another firm.

The banking industry has been at the forefront in applying outsourcing arrangements to supplement or replace existing in-house functions. Approximately 34% of sampled financial institutions have outsourced internal audit (Petravick 1997). Banks have also made use of outsourcing as an alternative to establishing in-house internal audit departments. Smaller to mid-sized banks have been the most recent participants in this trend.

Large, international and regional banks have the capacity and the range of internal audit needs to warrant an adequately-trained and extensive internal audit staff with a level of specialization. They have the size to effectively create economies of scale and can provide specialized services without acquiring vast increases in costs. Large banks have also participated in the outsourcing trend but unfortunately, cost (as defined by administrative, equipment, and office space) has been the primary driving factor. These institutions had the capacity to withhold a specialized in-house function that created a quality end product, which would rival that of the best outsource provider.

Smaller banks have initiated outsourcing projects often solely because they lack the capacity and resources of big banks. A specialized internal audit function just cannot be maintained affordably. Many firms have held in-house functions for years, but are realizing the benefits of a partial or full outsourcing agreement. They are making use of a "best practice" approach in following a redefined internal audit mission, as defined by the industry. Other banks that have never kept an internal audit function are becoming increasingly interested in mitigating risk. Outsourcing is a viable and effective alternative to establishing a new in-house department.

The expertise and know-how of an outsourcer is vastly above that of a typical bank internal auditor. Small banks can attain both cost and quality improvements through a decision to outsource.

Past outsourcing research has focused around the overall outsourcing trend, with several studies investigating factors relevant to internal audit. However, only a minority of studies has delved into the banking industry's relatively unique internal audit outsourcing reasoning and associated outcomes. The few that have worked with financial institutions have either remained very general in nature or have concentrated on large banks. There has been little to no published research that has specifically investigated small to mid-size banks, in terms of outsourcing the internal audit department.

This study was dedicated solely to the unique factors relating to smaller financial institutions. Research that identified overall outsourcing aspects and trends was reviewed, along with studies that specialized in internal audit outsourcing (both in general and among banks). In addition, interviews were conducted with relevant, knowledgeable professionals in the industry. These professionals are representative of both banking executives and public accountants/ outsource providers. The conclusions and findings derived from this study directly concern smaller financial institutions and are a product of extensive research of prior publications and in-depth interviews with banking professionals in the industry.

Prior Research

Numerous journal articles and studies provided the background and the ideas regarding the outsourcing of the internal audit department, both among banks and other entities alike. The benefits, disadvantages, and trends in the outsourcing of the internal audit department among financial institutions are offered in the following subsection. The characteristics and issues addressed also relate to the application of internal audit outsourcing in other industries, in addition to outsourcing in general.

Advantages and Associated Benefits of Outsourcing

It may be hard to believe, but some banks lack an internal audit department. The shear costs of establishing and maintaining a competent function can simply outweigh the perceived benefits. Outsourcing the internal audit function provides an economical and speedy remedy to the risks and threats associated with no "line of defense" (Barr 1993). An outsource provider can enter the enterprise offering immediate risk mitigation and assistance in establishing internal controls. Small banks may make use of the economies of scale that an outsourcer will have in the realms of expertise, know-how, experience, state-of-the-art equipment, human resource maintenance, and the like. These are efficiencies in which small to mid-size banks lack the resources and the breadth to create. "Sweet deals" made to entice just such financial institutions are used as added incentive to get the sale (Barr 1993). Such deals usually offer the bank a substantial level of savings over the development of an in-house function, in the form of very affordable risk mitigation.

An additional reason to outsource internal audit is that some firms have an in-house function that is either ineffective or unpopular. Some departments are not seen as team players or valuable contributors. They are viewed as an unnecessary level of bureaucracy and red tape. Furthermore, in-house internal auditors can emulate bank regulators and intimidate employees. The bottom line is if an in-house function is not providing talent, is not considered a value-adding function, and appears stale and incompatible to change, it is a prime candidate for outsourcing (Merriam 1996). Outsourcers are in the business of providing quality internal audit services and will assist in alleviating historically problematic areas created by a poor in-house function.

The elimination of non-productive time can be attained through outsourcing the internal audit function. Although it may be less apparent in smaller banks, most departments tend to have some idle time. Such circumstances may arise when senior staff is busy preparing an audit schedule or finalizing reports. Furthermore, banks may view training time as nonproductive (Barr 1993). Financial institutions can minimize these idle hours through effective management, but this inefficiency is almost impossible to eliminate entirely. Outsourcing transfers the inefficiencies of nonproductive time to the outsource provider and thus eradicates wasted in-house internal auditor time, from the viewpoint of the bank. It removes one more human resource management feature of maintaining an in-house staff.

Outsourcing internal audit allows greater flexibility by eliminating a fixed cost and replacing it with a variable cost (Rittenberg 1999). In-house staffs represent necessary fixed overhead, such as salaries, office space, equipment, and administrative costs. Office space must be secured year round, employees need to be retained perpetually, and equipment must be maintained. However, outsourcing the department alters the scenario by transforming previously fixed costs into variable costs. Fees are paid on the basis of how much work the provider performs resulting in a greater level of resource allocation flexibility. Financial institutions are not bound by a level of fixed overhead and are free to decide the dollar amount and the level of internal audit services to be purchased.

Outsourcing also helps to assure a quality end product. This is a major "selling point" to potential new clients (Barr 1993). Outsourcing firms have the expertise and access to best practices that will ensure quality service. Furthermore, the staff is extensively trained to handle any range of internal control troubles at a client bank and have access to proven solutions that have succeeded in the past. These circumstances can generate customer satisfaction, at least in terms of quality.

The adoption of an outsourcing plan allows the bank to focus all of its energies on core business activities (Verschoor 1992). In the past, some have argued that internal audit is core to the bank. More recently it has been decided that it is not a matter of who performs the work, but how that internal audit worked is carried out. Therefore, internal audit has been identified as a non-core activity and susceptible to outsourcing. Bank executives have looked at internal audit and recognized that it is not part of their area of expertise (Serafini 1997). In this fashion, the bank can stress more on its core competencies and cut another distracting, extraneous element of its overall business.

Outsourcing internal audit can reduce or eliminate the loss of objectivity among internal auditors. There is less of a chance that an outside auditor can be "bullied" into watering down or hiding findings (Barr 1996). Internal auditors have strong ties to the company and its personnel. They have opportunities to develop strong relationships with fellow employees and may be persuaded by loyalty or request to cover up or reduce the impact of audit findings (Marmon 1999). Outside auditors have no ties to the audited firm and may be less susceptible to such approaches or possibilities for collusion. Their loyalties lie with the outsource provider and the bank's board of directors, not bank personnel. An outsourcing arrangement will allow for honest, forthcoming, and objective internal audit findings. Of course, a fee-based service may also provide for its own loss of objectivity, but the outsourced staff auditors will have decreased interaction and loyalties to clients' employees.

Another, often highlighted, benefit of the outsourcing trend is access to specialized personnel and leading industry practices. Outsource providers can offer a range of expertise and specialization that is too expensive for most financial institutions to maintain internally (Aldhizer 1996). Outsourced auditors have a broad background and access to "best practices" in the industry. They have encountered common issues and concerns at other banks and are prepared to apply previously proven solutions to current clients. This is experience that can be very difficult to generate within smaller financial institutions. Therefore, banks can benefit from the know-how that outsourced auditors have gained from other institutions (their competitors).

A key role for internal audit is in establishing fraud control. Outsourcing the function transfers the performance of the audit work, but also may transfer some of the risk (Aldhizer 1996). The outsourcer inevitably accepts part of the responsibility for detecting and controlling fraud. It also may face the associated litigation that accompanies the discovery of fraud. Furthermore, many outsource providers retain liability insurance to back up the quality of their audit work (Verschoor 1992). This could prove to be a valuable risk mitigation tool, as any blame for breaches of internal control (along with the financial responsibility) may fall in the hands of the outsourcer.

Finally, outsourcing promotes economies of scale. The related cost savings are at the center of why companies outsource. Cost effectiveness is the motive that started the outsourcing trend. Firms specializing in one area of service can attain economies of scale, and thus offer their services at a lower cost than an organization could create on their own. These economies of scale apply not only to administrative and overhead costs, but instill an unparalleled level of expertise and real-world know-how among staff auditors (Rittenberg 1999). The ideal case represents improved services at a lower cost. This case is not uncommon, as many financial intuitions have realized both of these benefits by outsourcing their internal audit function.

Negative Factors and Threats to Outsourcing

The attitudes, expectations, and reactions of bank personnel need to be taken into great consideration prior to a decision to outsource. Outsourcing provides for a possible loss of loyalty among bank employees. It is expected that the staff auditors of outsourcers will hold premier ties with the provider, but that is an expected benefit. The potential for mixed allegiance becomes stronger when considering remaining bank employees that have "survived" outsourcing. It is widely known that an ill-planned and improperly implemented outsourcing arrangement can crush employee morale (Rittenberg 1999). Furthermore, in-house auditors will be more inclined to take the extra initiative to improve the organization's efficiency because he/she is directly affected by the success or failure of the bank (Barr 1993). These factors can undermine an otherwise successful outsourcing agreement.

An in-house audit staff can act as a conduit for future management. The best thing to do with the brightest auditors is to groom them for management positions within the bank (Serafini 1997). Many organizations have used this aspect of an in-house staff as an added benefit. There is probably no better way in which to learn the intricacies of a financial institution than an assignment to the internal audit department. A corporate internal audit experience is viewed by many as an "in-house MBA program" because auditors cover all facets of operations (Barr

1993). A multi-year assignment in internal audit will create a clear picture of the organization in the mind of the auditor. An in-house internal audit arrangement develops interdepartmental relationships and establishes goal congruence, as the mission of the firm is dispersed throughout the company. Outsourcing the staff eliminates these benefits and abolishes an invaluable training ground for future executives.

Outsourcing may create a lack of long-range development, in return for short-range cost savings (Klinkerman 1998). In-house auditors are aware of past, present, and future problematic areas. Their expertise and knowledge of the intricacies of that particular institution are products of their long-term commitment and experience with that one bank. There exists a level of relevant and unique expertise among bank staff auditors that cannot be easily recreated by an outsource provider's internal audit staff. Outsourcing plans often do not allow time for an auditor to develop an in-depth knowledge of the bank's business and its individual and unique risks. Therefore, a valuable long-range planning and risk mitigation tool may be traded for cost savings that are more short-run in nature (Acciani 1995).

The potential loss of independence has been a major concern of outsourcing when using the existing external auditor. A conflict of interest may arise when the external auditor also provides internal audit services (Marmon 1999). Even public firms have expressed their own concerns over possible independence issues where they perform both external and internal audits (Acciani 1995). The AICPA has established that as long as the auditor assumes no responsibility of, nor performs management functions, independence will not be violated. This issue may be eliminated through the use of another firm for outsourcing but many banks wish to make use of the relationship that they have cultivated with their existing external auditor. Furthermore, even if the AICPA's rules are adhered to and no actual loss of independence occurs, the appearance of a lack of independence may remain.

It may become all too apparent that goals of the outsourcer may differ with that of bank management. This can occur through the lack of communication between management and the service provider. Some banks view outsourcing as an arrangement in which the entire function, ranging from planning all the way to follow-ups, is the responsibility of the provider. This incorrect attitude can spell imminent disaster for the arrangement. Many times, the financial institution is expected to retain an internal audit director onboard to oversee the function and to serve as a liaison with bank management (Anderson 1996). This liaison coordinates the efforts of the outsourcer, but also represents a significant fixed cost to the bank.

The contracted internal auditor may merely follow the prescribed business plan, and not seek ways to improve the business (Marmon 1999). Internal audit is the process of proactively seeking ways to improve processes, mitigate risk, reduce costs, and stimulate revenues. If the outsourcer does not adhere to the very foundation behind the existence of an internal audit department, then outsourcing may indeed be an unsuccessful endeavor.

Many recent college graduates begin their careers as staff auditors. As outsourcing internal audit becomes increasingly popular, there will surely be vast internal audit opportunities for these relatively inexperienced, young auditors. How will this new auditor view the internal audit staff?

> [Perhaps as] "a tool for external audit to use to reduce the level of testing? A low-level compliance checking activity, not requiring excessive accounting proficiency, judgment, or business sense? Given the limited exposure of this external auditor to the realms of internal audit, one would perhaps understand if this was the perception that was formed," (Crawford 1996).

This example may be somewhat of an over dramatization, but an outsourcer may make use of inexperienced staff, and a staff that does not understand and value the true purpose of internal audit. Several firms have expressed dissatisfaction with the "inexperience" of many staff auditors performing internal audit work (Chapman 1997). The real intent of internal auditing is the review of operations and control systems and the push towards economy, effectiveness, and accountability. These are internal issues and an overall atmosphere that an inexperienced auditor may miss as an internal audit outsource provider.

The loss of continuous, on-site auditor presence is one concrete disadvantage to outsourcing on which everyone will agree. In-house auditors are available for special assignments anytime throughout the year, not only during scheduled audits or the CPA firm slack season (Verschoor 1992). Furthermore, in-house auditors can monitor policies and employees as concerns arise. They are involved with trouble areas before problems may become overwhelmingly apparent. Outsourcing eliminates a highly useful level of in-house, easily-accessible expertise. It removes the closeness of the audit function to the corporate culture of the financial institution (Crawford 1996).

Another fear of jumping on the outsourcing bandwagon is that providers may command a greater premium for their services as time progresses (Rittenberg 1999). Firms are offering their services at very low prices as an added inducement to banks to accept the outsourcing plan. Some providers are even thought to be providing these services at a loss so as to establish a larger internal audit customer base. This "low-balling" entices banks to abandon their in-house functions because of the enhanced monetary savings (Barr 1993). However, as the relationship solidifies, the provider may indeed raise the fees in order to make a greater profit (or make a profit at all). The bottom line is that outsourcers enter such agreements to make money. It is inconceivable to think that an outsider firm will trim its fees for its clients' benefit (Acciani 1995). After the bank has eliminated its in-house internal audit function, it is almost at the mercy of outsource providers. The time and money to recreate an in-house staff prohibit an expedient and affordable regression.

Finally, the "Chinese Wall effect" is another concern that is raised in opposition of outsourcing internal audit. In cases where the outsource provider is also the external auditor, there is the possibility of the external auditors learning about internal audit issues before management has had a chance to fully address the issue. "Lots of small issues come up in your internal audits that are not truly a problem," according to John Rezich, controller of True North Communications. "We ended up with very excitable external auditors." None of the external staff's concerns proved to warrant changing the scope of the audit (Barr 1996).

Industry Trends

A thorough research study investigating the outsourcing of the internal audit function among financial institutions has been performed through a team-effort between Crowe, Chizek and Company, LLP and the Financial Managers Society. The results of this survey have highlighted several interesting industry trends. Charts and graphs depicting the results of this survey, in addition to a more detailed description of the survey, are included in Appendix I.

Each chart displays significant elements of the internal audit outsourcing revelation among banks, but special attention should be paid to the present percentage of banks that have followed through on an outsourcing decision. The single most important reason that internal audit was outsourced is also of key importance and follows ideas presented in this study.

Finally, the expectation of financial institutions to outsource in the future is presented. This graph highlights the future growth of this already popular trend.

Professional Views

Interviews were conducted with professionals, both in the banking industry and in public accounting. Sampled financial institutions ranged in size from approximately 35 million dollars to almost one billion dollars in asset base. The lone delegate from public accounting represents a regional firm that provides internal audit outsourcing services and external audit services to financial institutions (including 5 of the 6 sampled banks). The views and opinions of professionals relative to internal audit, and the outsourcing of it, are summarized in the following subsections. The following views are not direct quotations, but are paraphrased and written in first person tense.

<u>Co-Sourcing Enabled Us to Get the Job Done</u>

Mr. Joseph O. Gaffino was a corporate auditor of the former Merchants Bancorp Banks headquartered in Aurora, Illinois. Merchants had approximately one dozen branches and a $1 billion asset base prior to its assumption by Old Kent Bank in 2000. Old Kent Bank is the fifth largest bank in the state of Illinois with an asset base in excess of $22 billion.

Historically, Merchants Bank has retained an in-house audit function. We had around a dozen branches (before our subsequent buyout by Old Kent Bank) and were one of the last remaining "hometown, locally-owned" banks in the Aurora area. Outsourcing had really never come up until Coopers & Lybrand tried to sell us on the idea several years ago. At the time, Merchants was committed to holding internal audit as an in-house function. We felt that an outsource provider was only going to "scratch the surface" of issues that our institution felt were important. So at the time, we rejected Coopers & Lybrand's proposal.

Merchants had outsourced areas like data processing previously, but departments closer to the core of the bank (like internal audit) were retained in-house. The outsourcing of internal audit didn't come up again until Merchants purchased a holding company containing three banks that held a combined $150 million of assets. Each of these three institutions had their internal audit departments completely outsourced to Crowe, Chizek and Company, LLP. That fact reprised the discussion of outsourcing internal audit again.

As far as our external auditor, we made use of KPMG Peat Marwick. However, as Peat was a big six firm (now big five), we felt that their scope was simply set too high. Merchants just wasn't big enough to warrant a big six firm. We made a change to Crowe (a regional, mid-tier firm), as far as our external auditing, because we felt our size and goals were closer to being parallel with that of Crowe. That was a decision that Merchants was very satisfied with.

Now when we purchased that three-bank holding company, we kept all of the old staff on board. We had a commitment to the communities that we had become a part of and didn't cut the existing staff. The outsourcing of internal audit among these banks was where things became more complicated. As we further investigated the outsourcing agreements, Crowe's approach began to look more appealing. At the time, our existing audit staff only had so much time to complete projects. Our workloads sometimes didn't allow us to get everything done in a timely fashion. It came down to "knowledge versus time." We had to get the work done and an arrangement with Crowe could help us to attain that goal. Crowe has a lot of experience in banking and a lot of experienced auditors. They were already our external auditors and they knew their stuff. As a result of our need to get our internal auditing done in a more timely fashion and the experience and expertise that Crowe has in the industry, we entered into a co-sourcing agreement with them.

This arrangement allowed us to retain our existing internal auditors, but enabled us to use Crowe in areas where our staff lacked expertise, or time. We knew that the outsourced auditors that came in to assist us would be experienced because we had a chance to see their resumes firsthand. The co-sourcing agreement allowed us to use the expertise of Crowe on an as-needed basis. We really didn't see any effects on cost because our own internal audit function eased up. Merchants also made a good training ground for Crowe's junior auditors. They got a chance to see how things should be done, as we were small enough to allow them to see the whole business. In retrospect, Crowe's services were "top-notch." Merchants entered into this "team" agreement with Crowe three years ago.

The level of recent mergers in the industry displays how banks can combat shrinking profits by gaining economies of scale and eliminating "backroom staff." This was the fate that Merchants met. Old Kent Bank purchased us and consolidated most of our administrative function with that of their own, resulting in the elimination of many jobs. Internal audit was one of the lost departments, as Old Kent already had a full-outsourcing agreement in place with Arthur Anderson.

"But That Isn't Worth Fifty-Thousand Bucks a Year"

Mr. Joachim "Jock" J. Brown is president and CEO of the First National Bank of Ottawa. This is a locally-owned bank with four branch offices in Ottawa, Illinois. The First National Bank was founded in 1865 and has an asset base of $230 million.

I've only been at the First National Bank for about four months now. No public firms have tried to "sell" me on the idea of outsourcing internal audit, but I suspect that will change. The financial institutions that I have worked at previously all had their internal audit functions outsourced. Banks outsource for cost savings and improved services, not one or the other. We have considered outsourcing internal audit in the past and it will definitely be coming up in the future.

Crowe, Chizek and Company, LLP is our current external auditor and we have chosen to keep our internal audit function in-house thus far. Our current department is made up of two full-time auditors and one full-time loan review officer. However, I am not satisfied with our current scenario. Internal audit is not aligned with the shareholders' interests and they have no concern for earnings and growth. Internal audit intimidates our employees, creates a level of bureaucracy, and emulates bank regulators. Regulators are, in effect, working for an insurance company who sets the standards, so they have a right to use a level of discretion. However, our own internal staff is on our side and should not create tension to such an extent.

Outsourcing would alleviate many of the problems that our own internal audit department has created. Outsourced auditors would "quit picking on the little stuff" and focus more on larger, more material issues. Outsourcing would also save the First National Bank approximately $50 thousand annually. But, following through on an outsourcing agreement requires that we have sound procedures in place. Outsourced internal auditors need to check risks as we go, and not at year-end when the external auditors visit.

We really aren't concerned with the outsourcing of our local jobs. Our internal audit department isn't focused on our core competency. We also aren't concerned with the time requirements around the job. The outsource providers would come in at various times throughout the year. The only reservation I have about that set-up is that nobody will be here "to count the cash when somebody steals." We will be losing a level of in-house expertise and we won't have auditors on-site to see what is going on everyday. We would lose those benefits and that know-how, "but that isn't worth 50 thousand bucks a year."

We probably would have already outsourced the function except that I am not satisfied with Crowe's (and other firms') statistical sampling methods. They would rely on 6% of loans to pass judgment on the whole. However, that 6% could miss the three biggest loans that we have. As a smaller bank, we can't just miss risks that great. The statistical sample claims to provide broad coverage and to alleviate risk, but I am not convinced. A more judgmentally selected sample would help to minimize this risk. An outsourcer providing a hierarchy of risk would make me feel better, but would require them to alter the scope of the audit. The outsourcing of the internal audit department will come up in the future. If Crowe (or some other firm) agrees to a plan outlining increased testing, we will probably agree to outsource our internal audit function.

Initially, We Never Maintained an Internal Audit Department

Mr. Richard J. Worzala is the president Mokena State Bank located in Mokena, Illinois. This institution has one office and an asset base of $50 million. However, it is a member of a holding corporation that owns several banks.

We (our holding company) purchased this bank in 1993. At the time, it was failing. We wanted to get the best rating from our regulation agency and we needed an internal audit program to get it. However, Mokena State didn't have the size or the resources to warrant generating an in-house function. We made the choice to outsource our "agreed-upon procedures" four years ago.

You'll find that the bulk of internal audit outsourcing arrangements involve smaller financial institutions. Banks of a greater size have the economies of scale and the financial resources to hold a broad range of expertise in-house. Smaller banks are the ones who turn to outsourcers because we lack the size to justify a large investment in an internal audit function.

Mokena State (along with the other banks in our holding company) uses KPMG Peat Marwick as our external auditors. However, we feel that because Peat is a big five firm, they don't relate with us well. When we began searching for an internal audit outsourcer, we looked to smaller firms. We also wanted to maintain auditor independence in relation to our agreed-upon procedures and our year-end audits. We wanted to have two separate firms performing these duties and totally bypass any possibility of a lack of independence. We solicited bids from several firms (including Crowe, Chizek and Company, LLP) and excluded Peat from this process to maintain both real and apparent independence.

Mokena State ended up choosing Crowe to perform our agreed-upon procedures. We felt that they had the expertise and experience in performing this function. They already perform similar services for many banks our size. Crowe and its auditors tend to be able to "see the forest through the trees."

Our goal for the new arrangement was to create a "good end product." Crowe tests Mokena State's controls and makes recommendations for improvements. Sometimes, as in our case, having a very high level of due control is not feasible. The service that Crowe provides has left us very satisfied. "I can sleep at night!"

As far as setting up our audit schedule, we sit down and discuss what issues are to be investigated. It is really a team effort between the folks here at Mokena State. We submit our requests to Crowe and they develop a proposal from that. Their proposal is then subject to the approval of Mokena State.

Cost was a factor in our decision to outsource internal audit. We didn't perform it at all initially and we couldn't afford (in terms of money and time) to generate an in-house function. Outsourcing provided a fast, affordable solution to investigate our agreed-upon procedures and minimize the risk that we carried in not having an internal audit department.

<u>Our Prospective Outsourcer Recommended We Keep the Function In-House</u>

Mr. Richard J. Katz is president of Resource Bank of DeKalb, Illinois. Resource has five branches within DeKalb County and has an asset base of $175 million. It is also in the process of constructing a new office in the city of DeKalb.

We currently have a one-person internal audit department that is responsible for loan review, regulation compliance, and other internal audit issues. Resource has been moving to more of a risk-based audit approach. Our external auditor, McGladrey and Pullen, LLP, has been assisting us in our transition to this risk-based approach. Our controller is a CPA that came from KPMG Peat Marwick and participated in our cursory examination of an outsourcing arrangement.

When the outsourcing question came up, we turned to our external auditor, McGladrey, for more information. They currently provide internal audit services to a sizable number of financial institutions. Recently, McGladrey took over the entire internal audit function of a larger institution. They also have a stand-alone department that is distinct from their external audit function.

Resource has tried to come up with the best solution in terms of "internal resources, price, and people." Outsourcing would have yielded benefits in the realms of expertise and specialization. However, the aspect of cost was an overwhelming factor. McGladrey couldn't compete with the services that our in-house shop provides for what it costs us. In our case, outsourcing the internal audit department would have increased our costs. McGladrey took a stance opposite to what one may think and advised us to retain our department internally. Via our preliminary discussions, McGladrey admitted that they couldn't be as good a solution for the cost. Overall, we are very satisfied with the work of our internal audit department. "It does a good job."

Our Internal Audit Function Couldn't Keep Pace With Our Rapid Growth

Mr. Kurt R. Stevenson is vice president & controller of Union Bancorp, Inc. Union Bank is headquartered in Ottawa, Illinois and has approximately eight branch offices throughout northern Illinois. Its asset base is in the $700 million range. Furthermore, Union Bank acts as a holding corporation that owns several other Illinois-based banks.

In 1996, we were a two-bank holding company with a three-person internal audit staff (one supervisor and two auditors). By the end of 1996, we had purchased two additional holding companies and jumped from two to nine banks. This transaction also spread Union Bank out over a large geographical area. To further complicate matters, our newly purchased banks were small, independent, and without a system of internal controls. One lone, young and inexperienced auditor served six of these newly acquired banks. We split up our staff in an attempt to cover all of our bases, but our extended risk was great. We simply didn't have the resources or personnel to cover everything and everybody across the state.

Initially, we used McGladrey & Pullen, LLP as our external auditor. However, Union Bank lacked the level of comfort that we felt was necessary to solidify our relationship. That led us to change to Crowe, Chizek and Company, LLP for our external audit services in 1997. When the discussion of outsourcing internal audit came up, I believe that we actually approached Crowe on the matter.

We outsourced our entire internal audit function to Crowe in April of 1998. It finally came down to us admitting that we just couldn't adequately perform the function in-house. Our staff was significantly under-manned and our newly acquired banks lacked knowledge and expertise at the internal audit level. Generating an adequate in-house function was a burden (both financially and administratively) that Union Bank couldn't afford to make.

The full outsourcing arrangement left us with our existing staff. Fortunately, we had other value-adding positions in the company to offer our old internal audit staff. Our two auditors took advantage of these positions and we took advantage of the in-house expertise that they had to offer. This way we used their know-how in other departments within the bank.

We did have some concerns over auditor independence, as Union Bank now used the same firm for both external and internal audits. However, Crowe has a good operation and does a good job of maintaining independence. They have split up their internal and external services and maintain them independently.

Our audit schedule pivots around our liaison with Crowe. Our liaison is an employee of the bank that coordinates the calendar, picks out concerns and issues to be investigated, and facilitates active communication between the audit team and Union Bank. Essentially, our liaison directs the activities of Crowe's staff.

We have been "very pleased with the initial service" of Crowe. They have proven to be quite knowledgeable and personable. The managers and supervisors are experienced in our industry and they have developed a "very hands-on" approach. Union Bank has developed a level of comfort with Crowe (both in internal and external audits), that was something lacking from the relationship with our previous external firm. We now have expertise in internal audit and are covering all of our banks. Furthermore, our relatively young management team realizes that auditors are only here to help. The internal audit function has the shareholders' best interests in mind.

Our only reservation is that Crowe can miss risks that an in-house, on-site function would catch. As we have developed a comfort level with Crowe, we tend to wonder what risks still go unchecked. However, our rapid growth necessitated action, and outsourcing made the most sense. Crowe has met our expectations and Union Bank is very satisfied with their services.

We Lack the Resources to Perform Internal Audits, Period

Mr. Robert E. Harris is president of Twin Oaks Savings Bank located in Marseilles, Illinois. This institution is a local, community bank that has one branch located in downtown Marseilles. They are currently constructing another branch office in Morris, Illinois. Twin Oaks has an asset base of $37 million.

We currently use Crowe, Chizek and Company, LLP as our external auditors. Crowe also has a good internal audit outsourcing service, but our size limits our choices. Twin Oaks is a small, local, community-oriented bank. If we were larger, yes, outsourcing would be a viable choice. Also, as a $35 million shop, we lack the workload to keep an in-house internal audit function busy.

Our current scenario concentrates on controlling costs. We make the best possible use of our external auditors and bank examiners for mitigating risks. Twin Oaks is also very dedicated to the training and development of its employees. We spend a lot of money sending supervisors to seminars and conferences, so they come back to us and perform a better job. Supervisors also assist in doing a lot of the internal checking. Furthermore, those employees bring their newfound knowledge back to the firm and share it with others.

Besides, we are at the mercy of regulators. An outsourcer has no more insight of what changes the future will bring than we do. Having an outstanding internal audit function is not going to ease our adaptations to new regulations and outsourcing isn't guaranteed to provide us a high-quality service. We rely on our in-house expertise to cope with the ever-changing environment.

Our management attends our examiners' exit meetings, so they know their responsibility and what is going on with the bank. We utilize our examiners to make changes for the better. We train our supervisors to assist in checking internal controls and we make use of our external auditors' suggestions to minimize risk. The scrutiny of auditors and examiners makes us a better institution. That is how we survive without an internal audit function (either in-house or outsourced).

Right now, an internal audit function is not in the best interest of our stakeholders, who are our friends, our relatives, and our neighbors. Twin Oaks strives to invest and better our community. We work to provide the best service possible with the resources that we have. Our goal is to improve and nurture the community in which we, too, are a part. Sacrificing a part of what we do to improve our appearance does not serve our customers.

The Outsourcing of Internal Audit Is Going to Continue

Mr. Robert L. Farrar, CPA is an engagement executive at the public accounting firm of Crowe, Chizek and Company, LLP. Mr. Farrar is based out of Crowe's Oak Brook, Illinois office. Crowe Chizek is a regional, mid-tier accounting firm that also has a large division specializing in the banking industry. Furthermore, Crowe Chizek has an independent internal audit staff that provides outsourcing services to companies, including financial institutions.

Really, Crowe, Chizek and Company, LLP has always provided internal audit services to our clients on some level. Initially, those services focused a lot around "agreed-upon procedures," in which we essentially extended our external audit a little deeper into internal matters (in addition to the fact that we didn't have a differentiated internal audit services team at the time). In cases like these, the client probably didn't have an internal audit department and wanted some additional risk coverage. Crowe didn't start to really "hone in" on internal audit services until 1994 or 1995. It was at this time that we noticed an apparent client need in terms of internal audit, plus regulation compliance and information systems audit. I believe that it was also around that time when the Federal Reserve Board identified that financial institutions should evaluate risks on a grander scale. We also had clients that were experiencing large turnovers within their internal audit staff. They turned to us to provide some continuity in their function.

Our (already large) financial institution client base eased our transition into internal audit outsourcing. We had a staff that was experienced in the industry, plus we hired on additional trained staff. We brought on experienced bank internal auditors and operational employees. We also utilized our financial institution group extensively. A lot of our outsource clients were looking for that kind of expertise in their internal audit function and turned to outsourcing.

Either their current external auditor didn't have that expertise or they wanted to split up the functions from an independence standpoint, but in each circumstance, these financial institutions wound up at Crowe for their internal audit services.

In the case of smaller, community banks, it is usually more cost effective if the internal audit outsourcer and the external auditor are one and the same firm. However, when this circumstance arises, questions of auditor independence may surface. We have strived to alleviate such concerns that our clients may have. First, many of our internal audit customers use Crowe for only that purpose. They have chosen to retain a separate external auditor (for whatever reason) and have bypassed any concerns of independence. Second, we have worked hard to maintain separate staffs and separate teams of auditors. The external and internal audit functions are each independent of one another and in no way should create independence problems. Our internal audit function abides by the AICPA ruling on providing such services. We do not participate in the operations of the client and do not make decisions in their operations. Management can outsource the performance of internal audit, but they can't outsource the responsibility for it. Crowe "comments on controls. We are not the control." All of these factors work to maintain Crowe's independence from the client.

Our internal audit service has spawned from client needs, so we have used our existing external audit customers as a base for new internal audit clients to some extent. We have established a large network in the industry (as we have a specialty in financial institutions) and we get a lot of referrals for our work. We don't "cold call" banks looking for new business, but get our name out through our network of people in the industry. Crowe gets a lot of new internal audit business in just that fashion. And, yes, we do a little marketing of our benefits and expertise, too.

Internal audit outsourcing probably began with "agreed-upon procedures," which are really an extension of a public firm's external audit. Firms extended the scope of their existing external audit to cover some internal issues at the same time. However, a need has arisen for internal audit outsourcing beyond the agreed-upon procedures level. We still perform audits of agreed-upon procedures, but Crowe focuses more on the extension of such a situation. We can provide "specialty" work in areas in which an in-house internal audit staff lacks the know-how. We can help eliminate the difficulties in recruiting knowledgeable in-house internal auditors. Crowe fills the needs of internal audit customers and (in the case of partial outsourcing) helps existing in-house functions achieve their goals. Crowe's services can be used to supplement an existing function, totally replace it, or help create an internal audit function that never before existed.

Our arrangement is simplified through the establishment of a liaison between the client and ourselves. The liaison is an employee of the client, but also works closely with our staff. He/she coordinates the internal audit schedule, determines what issues are to be investigated, and signs off on all of our work. The liaison acts as the "eyes and ears" of internal audit on a year-round basis and scouts for problems as they may occur. Our staff may be on-site only a few times throughout the year so the liaison coordinates our efforts. The success of our internal audit services pivots around our constant communication with the client. The liaison is a part of that communication. Our services are structured so that the client is always aware of the proceedings and findings of our internal audits. Results of the audit are discussed with management **before** our staff leaves the site, usually at the exiting meeting, and issues are discussed as they arise, too. Management is required to respond to issues uncovered during the audit and the liaison must also be satisfied with these recommendations. Many times the liaison assists management in creating responses and formulating recommendations. The arrangement is also based on the timeliness. Crowe's turnaround on the final report is approximately 20-30 days and management generates their responses within 10-15 days.

The decision to outsource is really up to the opinion of senior management. Some want the accessibility and at-hands expertise of an in-house function. Others have come to the conclusion that the most effective solution in terms of cost, expertise, and internal management (recruiting, administrative, etc.) is outsourcing. Smaller banks have been the first to realize that these benefits are hard (but not impossible) to achieve with an in-house function and outsourcing "adds value immediately." So when it comes down to it, the outsourcing choice depends on the audit committee and the "comfort level" of management.

The trend of internal audit outsourcing is going to continue, even with banks that retain an in-house function. Outsourcing will provide financial institutions with specialty needs that are hard to generate, and maintain, in-house. Outsourcing will also continue to supplement existing internal staffs. Many of our internal audit clients contacted **us** about our services and in most cases in which we evaluate their current set-up, there is an apparent need for our services. It is very hard to keep a well-trained internal audit staff in-house. We can provide those services and maintain a well-versed and experienced staff at a competitive price. Many small banks just do not have the breadth (nor the work) to warrant an adequate internal staff and bank internal auditors are typically not specialized. These are all resources that we can provide though an outsourcing arrangement.

A sample engagement letter has been included in Appendix II. Special attention should be paid to the responsibilities of the CPA firm and the bank. These responsibilities outline the necessities of a successful outsourcing arrangement, along with an outline of proposed services.

Summary & Conclusions

The recent phenomenon of outsourcing has truly spread out from non-core, miscellaneous functions, such as check processing and information systems, to more "core" services. This is the direction that an increasing number of internal audit departments are heading: being either partially or totally outsourced. The trend has been most apparent in the banking industry and, as this study has shown, especially in smaller banks. Outsourcing of the internal audit function is a topic that all of the sampled institutions had considered in some respect. Even though all had not adopted the measure, they all had come to conclusions about the adequacy of their own internal audit staff. From the conversations with these professionals, it is safe to say that those that have not yet outsourced may revisit the idea in the future. The concerns and views of these banking professionals were very similar in most respects. However, the following common concerns (or comforts) warrant further review.

Costs have historically been a major driver of outsourcing. This is representative of financial institutions and the reasoning behind outsourcing internal audit. The economies of scale created when a firm specializes and performs a similar service for multiple institutions helps all involved to mitigate costs. However, the expertise and knowledge that such an arrangement provides is an associated benefit that cannot be valued in monetary terms. Outsourcing is known for improving the internal audit function, and it is this aspect for which many banks and outsourcers strive. The monetary savings, though, are often times how the idea is "sold."

An unsatisfactory internal audit department may also be quickly remedied through an outsourcing decision. The time and money to rebuild the function with a new mission and better focus can be transferred to an outsourcer. Furthermore, outsourcing will yield a significantly smaller bill (in terms of both time and money) than if the institution attempts to redirect the internal audit department on its own. A lack of in-house expertise can be remedied in the same fashion and yield identical results.

Risk mitigation is another benefit that outsourcing internal audit will create. Outsourcers will bear some level of responsibility for the services they provide. They often hold insurance for any subsequent litigation that typically follows the discovery of fraud. Because outsource providers have a much broader expertise than in-house auditors and because they hold a position of greater independence, it is more likely that outsourcing will find fraud and render suggestions for improvement consistently.

The growth in the need of internal audit is and will be another driver of the trend to outsource. Banks are realizing that their internal risks must be mitigated and internal audit is a necessary function. Furthermore, as banks continue to merge and grow, their needs within internal audit are likely to increase proportionally. As these institutions grow (many times quite rapidly), outsourcing provides a means to "keep up" in terms of internal audit.

Outsourcing firms are marketing their services very well. The benefits are highlighted and the disadvantages are diminished. Financial and quality factors are used in the end to sell the job and get the sale.

There were also several key shortcomings that banking professionals identified. The major unanswered questions related to the loss of in-house knowledge and on-site presence. These are the drawbacks that providers have not yet minimized through full outsourcing arrangements. Financial intuitions gain a level of confidence by having an on-site staff. There is always someone around keeping an eye on the business. Furthermore, the level of knowledge held by internal auditors is very helpful to have on hand. These professionals can be utilized year-round in other areas to more effectively establish sound procedures and mitigate risk.

In conclusion, outsourcing has proven to be a viable and beneficial alternative to holding an in-house staff. Its benefits often outweigh its costs (in the banking industry), in terms of both money and quality. However, full outsourcing carries some drawbacks that are of key concern to professionals in the industry. The solution to this uneasiness is partial outsourcing. Financial institutions (such as Merchants Bank) have retained an internal staff within the bank, but have contracted an outsourcing firm to provide for special requests and to help in times of need. The costs of such an arrangement can be no more than that of an internal staff and the "sticky points" that have led many executives to feel uncomfortable with the outsourcing idea are eliminated. In this manner, the positive attributes of both outsourcing and retaining an internal audit staff can be effectively realized.

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Survey Research:

The Financial Managers Society & Crowe, Chizek and Company, LLP 1999 Internal Audit Survey The Gary Siegel Organization, Inc. 1999

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Appendix I

The following charts and statistical data relate to the 1999 Internal Audit Survey. The Financial Managers Society (FMS) and Crowe, Chizek and Company, LLP engaged the Gary Siegel Organization to conduct a survey of community financial institutions. The purpose of the study was to:

- ✓ determine whether internal audit is performed in-house or outsourced
- ✓ determine if a trend towards the outsourcing of the internal audit department exists
- ✓ establish industry standards that provide operational benchmarks for in-house internal audit functions

A questionnaire was created (with input from Crowe Chizek and FMS) and mailed to a random sample of 2,000 financial institutions. Completed, useable surveys were received from 425 participants (a response rate of 21%).

All following information relates to the 425 institutions that participated in the study and is courtesy of Crowe, Chizek and Company, LLP and the Financial Mangers Society.

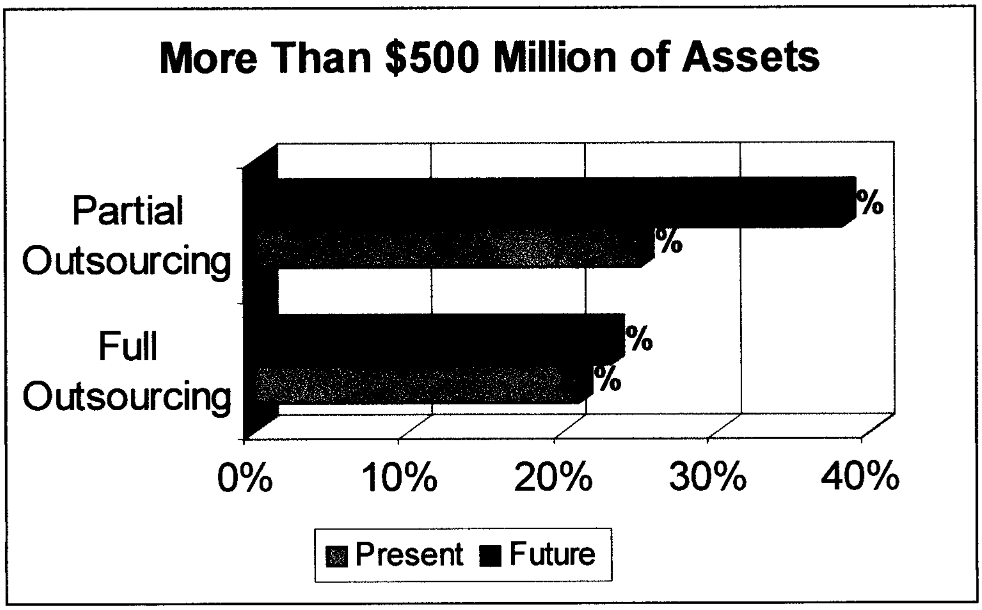
Contents:

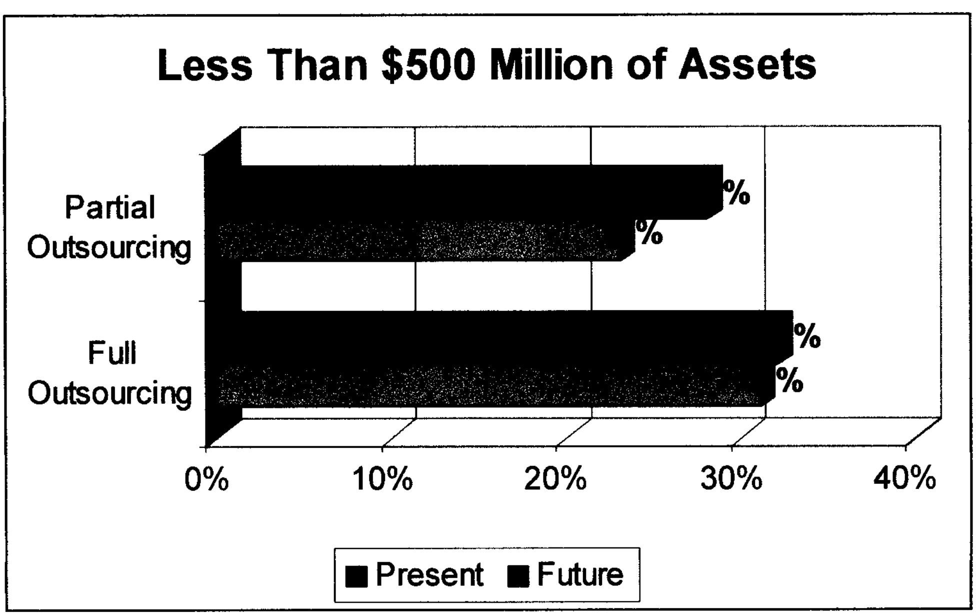
CROWE CHIZEK

&

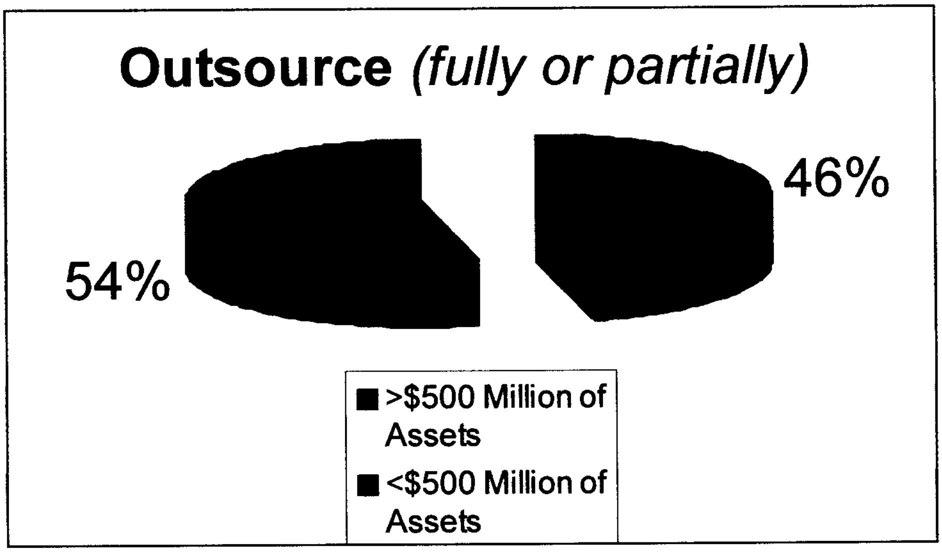
FMS
Financial Managers Society

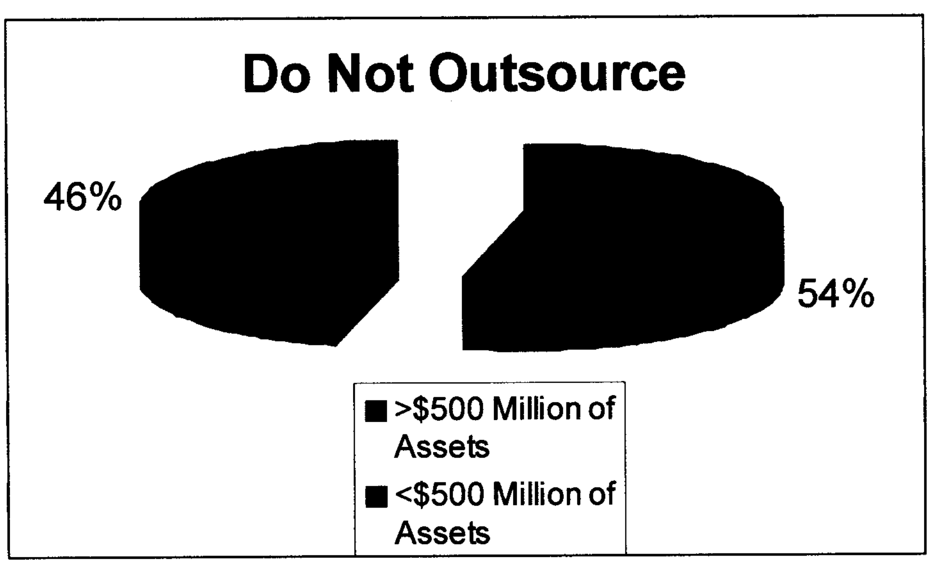
The Trend in Internal Audit Outsourcing



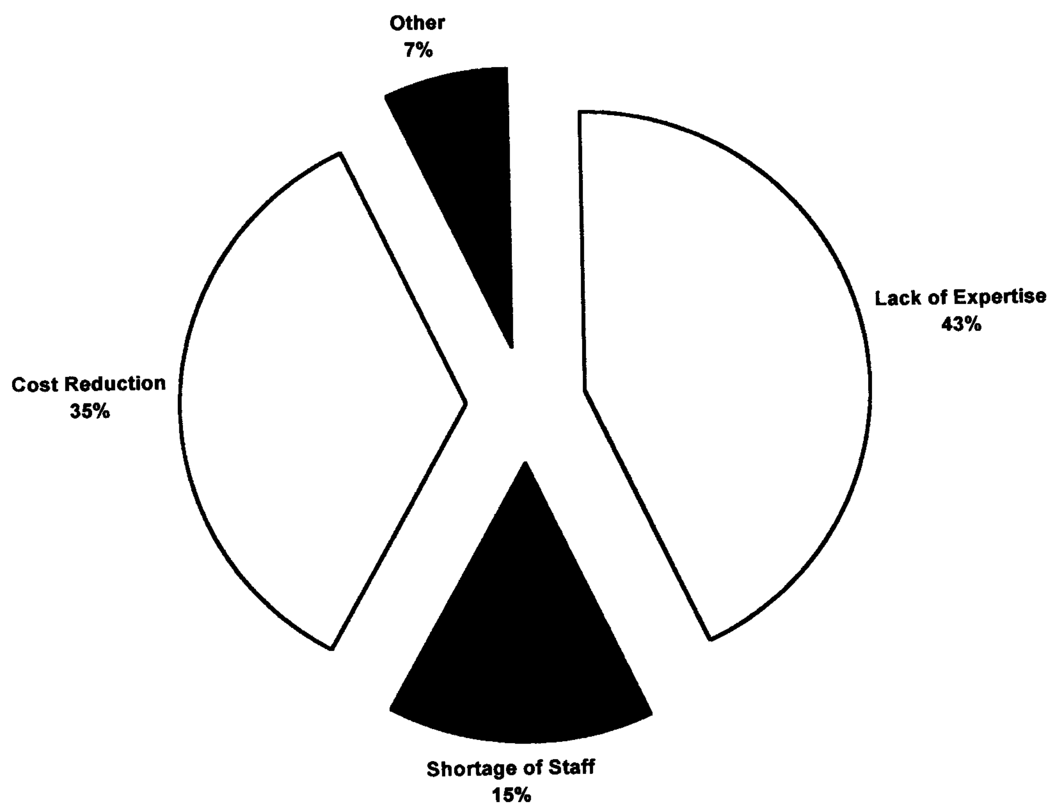


Respondents with an Internal Audit Function



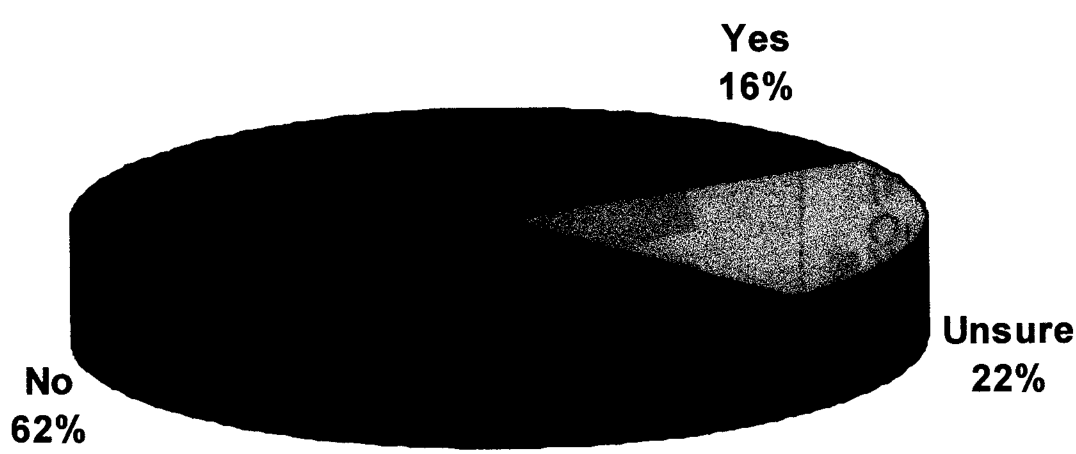


The Single Most Important Reason Internal Audit Was Outsourced



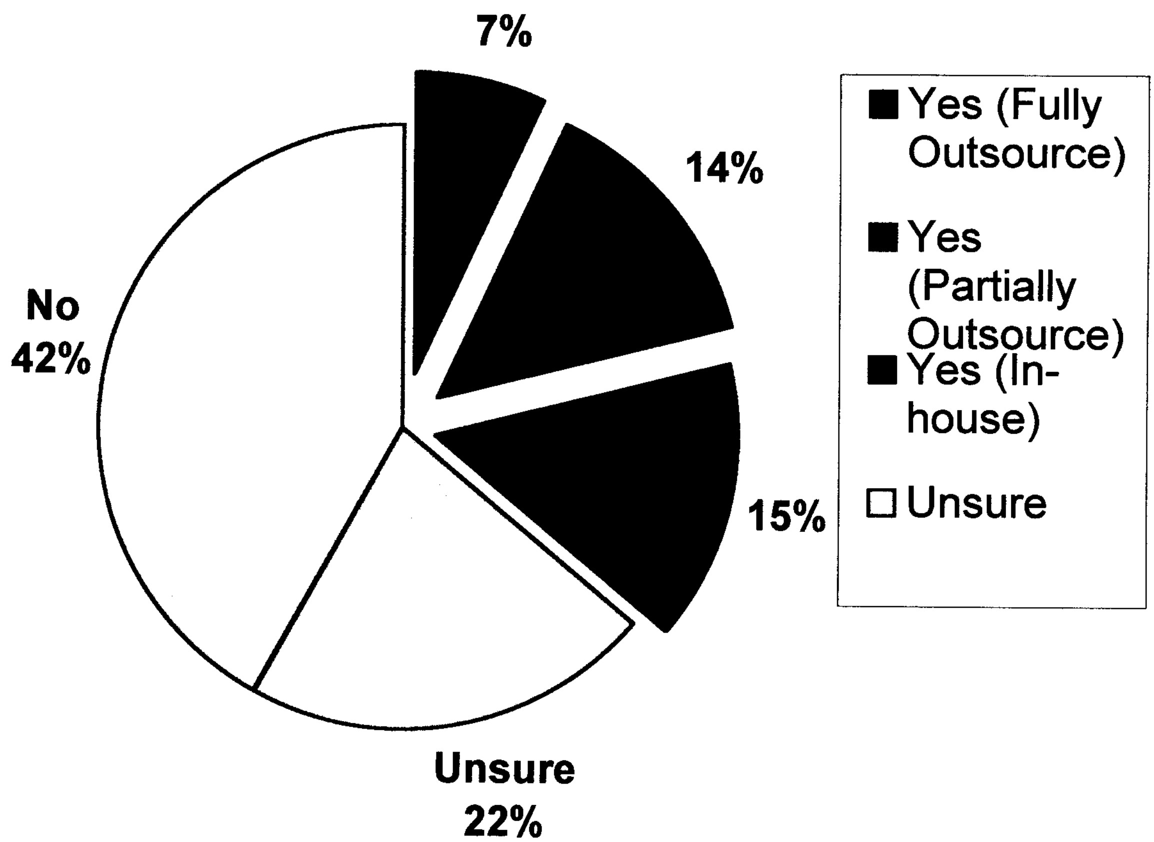
Courtesy of the 1999 Internal Audit Survey
co-sponsored by the Financial Managers Society & Crowe, Chizek and Company, LLP

Expectations of Outsourcing More Internal Audit Functions Over the Next Two Years



Institutions That Currently Lack an Internal Audit Function

Plans to Establish an Internal Audit Function in the Next Two Years?



Appendix II

(Sample of an engagement letter outlining the internal audit arrangement)

CROWE CHIZEK

August 26, 1999

Audit Committee

Dear Committee Members:

This letter confirms our understanding of the arrangements for Crowe, Chizek and Company LLP ("Crowe Chizek") to provide extended audit services in the mortgage banking area of (the "Bank").

AUDIT SERVICES

<u>Our Responsibilities</u>

Crowe Chizek will meet with your management and assist in developing a risk based extended audit plan for the mortgage banking area. This plan will be approved by management and/or the Audit Committee and executed by us. We will direct, review and supervise the day to day performance of the audit program. However, we cannot perform management functions, make management decisions or give the appearance of acting in a capacity equivalent to a member of bank management or as an employee. In this regard, while we may advise, we cannot act in a decision making capacity in committees and meetings that determine the institution's strategic direction or act in a decision making capacity as to the design, implementation, and evaluation of internal controls, new products, services, or software that are significant to the institution's business activities. Additionally, we cannot be involved in activities such as authorizing, executing, or consummating transactions or otherwise exercising authority on behalf of the Bank. Accordingly, we cannot perform ongoing monitoring activities or control activities, prepare source documents on transactions, or have custody of bank assets.

We will submit a report within four weeks after the conclusion of our fieldwork on the results of our extended audit services. We will meet with your coordinator to discuss the specific procedures performed and our detailed findings so that our report will summarize only those findings your coordinator believes warrant review by the Audit Committee. We will discuss significant matters that come to our attention with appropriate bank management representatives. We will also issue our report in draft form before we issue our final report. This will allow bank management time to review these matters in advance and determine whether they wish to engage us to perform extended procedures in response to the identified matters. Our report will summarize the areas covered and our findings and recommendations.

CROWE, CHIZEK AND COMPANY LLP
ONE MID AMERICA PLAZA POST OFFICE BOX 3697 OAK BROOK, ILLINOIS 60522-3697 630 574 7878 FAX 630 574 1608

The extended audit services contemplated within the context of this engagement letter include the concepts of selective testing and sampling. Accordingly, these services would of necessity not include all aspects of the Bank's internal controls nor would they include a detailed examination of all transactions. Therefore, they cannot be relied upon to disclose all errors or irregularities that may exist. These services would also not ordinarily address abuses of management discretion.

We agree to allow the Bank and its bank regulatory examiners to have reasonable and timely access, under our supervision, to the extended audit services workpapers and reports which, when not on-site with us at the Bank, will be located in our office in Oak Brook, Illinois.

The Bank's Responsibilities

The Bank is responsible for designating a competent individual preferably within senior management, to be responsible for and oversee the extended audit function. This individual will be the liaison with Crowe Chizek and will be the coordinator for all extended audit activities and services. The coordinator will work with Crowe Chizek and other members of bank management and be responsible for control risk assessments, audit plans, audit programs and audit reports. The coordinator will be responsible for determining and approving the risk, scope, and frequency of extended audit activities.

The Audit Committee should review and approve the risk assessment and scope of the audit plan prepared by the coordinator. The Audit Committee should also consider the coordinator's requests for expansion of basic extended audit services when significant issues arise or when significant changes occur in the institution's environment, structure, activities, risk exposures, or systems. Major changes in an institution's environment and conditions may lead to changes in the internal control system and may warrant additional extended audit services. These major changes include: (a) new management; (b) areas or activities experiencing rapid growth; (c) new lines of business, products, or technologies; and (d) corporate restructurings, mergers, and acquisitions.

The coordinator will be the primary person responsible for evaluating the findings and results arising from extended audit activities. The coordinator will be responsible for reporting internal control deficiencies to the appropriate level of bank management as soon as they are identified and, for significant matters, to the Audit Committee.

The coordinator will be the principal person responsible for reporting extended audit activities to the Audit Committee. We can plan to meet with the Audit Committee and assist the coordinator in this regard, but we cannot report to the Audit Committee on behalf of management or the coordinators. The Audit Committee should assess whether internal control weaknesses or other exceptions are being resolved expeditiously by bank management.

Bank management is responsible for establishing and maintaining effective internal controls and for ensuring that the importance of internal control is understood and respected throughout the institution. Effective internal controls reduce the likelihood that the following will occur and remain undetected: inaccurate, incomplete, or unauthorized transactions; deficiencies in the safeguarding of assets; unreliable financial and regulatory reporting; and deviations from laws, regulations, and the institution's policies. However, it does not completely eliminate that possibility. Our work does not guarantee that errors or irregularities will not occur and may not detect errors or irregularities should they occur. Bank management will perform periodic reviews to determine, and shall be solely responsible for determining, when, whether, and how the recommendations suggested by Crowe Chizek under this engagement are to be implemented.

Bank management has the responsibility to determine whether the Bank's systems, or any other systems such as those of the Bank's vendors, service providers, or any other third parties, are Year 2000 compliant and to determine whether the Bank has addressed or will be able to address all of the affected systems on a timely basis. Our extended audit services conducted in accordance with generally accepted auditing standards are not designed to detect whether such systems are Year 2000 compliant.

The Bank will provide reasonable work space for Crowe Chizek personnel at the audit locations. Bank management will also insure that all information provided to us is accurate and complete in all material respects, contains no material omissions, and is updated on a prompt and continuous basis. Bank management will also assume responsibility for obtaining all third-party consents required to enable us to access and use any third-party products necessary to the performance of the audit plan.

During the engagement term, the Bank will cause its Audit Committee and/or management team to meet with Crowe Chizek personnel at such times as Crowe Chizek may from time to time reasonably request. Without limiting the generality of the foregoing, Crowe Chizek shall have full and regular access to the Bank's Audit Committee and/or management team and shall be entitled to meet with the Audit Committee in private without any member of bank management being present. Crowe Chizek shall report solely to the Bank's audit coordinator or management and/or the Audit Committee with respect to the performance of its obligations under this engagement letter.

The Bank shall indemnify and hold harmless Crowe Chizek and its personnel from and against any payment, loss, cost, or expense (including reasonable attorney's fees) paid or incurred by Crowe Chizek at any time and in any way relating to claims by any of the Bank's employees or former employees, except to the extent finally determined to have resulted from the gross negligence or willful misconduct of Crowe Chizek personnel. This provision shall survive the termination of this engagement letter.

The Bank agrees that Crowe Chizek shall not be required to undertake any task or function which Crowe Chizek determines would impair its independence under the Code of Professional Conduct of the AICPA, any pronouncements of banking regulators and the United States Securities and Exchange Commission, or other relevant rules.

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Billings for our services will be This fee includes out-of-pocket expenses. Billings will be submitted on a monthly basis and are due upon receipt. Fees and expenses for any additional projects or services will be agreed to and billed separately. We will, of course, discuss any changes to our extended audit services with your coordinator prior to performing any additional work.

Please sign and return the enclosed copy of this letter to indicate that it is in accordance with the Bank's understanding of the arrangements outlined above and to designate the Bank's extended audit coordinator.

Very truly yours

Crowe, Chizek and Company LLP