WHY STRESS INTERNAL CONTROLS AND AUDITING?

(Remarks of C. Canby Balderston, Vice Chairman, Board of Governors of the Federal Reserve System, at the meeting of the Philadelphia Chapter, National Association of Bank Auditors and Comptrollers, on February 11, 1958.)

The very abundance with which this nation has been blessed has permitted it to overcome, time after time, the mistakes caused by lack of financial understanding. But if we are to have an economy that yields the social values we desire for this generation and succeeding ones, we must somehow become more economically literate. This is a responsibility devolving upon all who occupy key positions in education and business and are, therefore, in a position to know how vital it is in this perilous age to carry on our economic activities with intelligence. Of course our citizens must earn a living for themselves and their families, and in so doing, learn to guide their private affairs with prudence. But they also need to understand the lessons of history if leadership in public affairs is to be intelligent.

In economic matters Americans are perhaps less literate than citizens of countries like Great Britain who understand from experience what it means to have costs rise so that they cannot export, or to have their currencies lose their value in the markets of the world. The British, like the Belgians, Danes, and Dutch, know that if they do not export they do not live,--or at least do not live well. The need for such literacy has become especially great in the United States because of the position of world leadership it has achieved. The economic savvy that it displays in the future will influence not only the jobs and the savings of its own people, but of those beyond the sea. Any serious blunders by us are likely to be tragic for them as well as for us.

That the technical know-how of Americans has not always had its counterpart in their understanding of economics and finance is clear from the booms and busts through which they have passed. Our economy has grown by fits and starts. Our expansion has been driven forward by optimism pyramiding into excessive ebullience; then there has often followed the cold realistic awakening accompanied by pessimism verging on despair.

It is superfluous to cite the historic cases of the bulbs of Holland, or the Mississippi bubble, or the railroad boom that preceded 1893, because there have been more recent crises. There were the inventory collapse of 1921, and the Florida land boom ending in 1926. There was the stock market boom that was ballooned skyward by billions of dollars of credit until its sudden return to earth after October 1929. There were the difficulties encountered by the plan to merchandise mortgages during the 1920's. The latter illustrates how a scheme calculated to meet a definite need (and which would have contributed to the financial advancement of its time) was spoiled by a too-liberal appraisal of real estate values, and by the lack of appropriate amortization.

Economic literacy includes an understanding of the current mixture of economic and governmental activities. Believing that the free enterprise system should be preserved as fully as possible, I believe also in the free market. But the latter is impinged upon by those individuals and groups who wish protection. Some wish tariff protection; others, price supports; still others, loan guarantees. Outside of the Federal Government's budget, there were in 1957 direct Federal loans and investments, and loan insurance and guarantees of over $73 billion. One can readily marshal arguments in support of many of the separate projects for which the aggregate commitment looms so large. It is a matter of simple arithmetic, however, that under the free enterprise system not all groups can be especially sheltered. If inflation is to be avoided, whatever special advantage is given to one industry or group must be taken away from other industries or groups.

The importance of economic literacy leads me to a related topic: the advance of business morality. The encroachment of government upon business activities may be hastened if business does not develop and abide by ethical standards that are acceptable to the general public. This observation has particular relevance to the banking industry because it deals with money, which pervades all economic activities and affects people's lives so directly.

For similar reasons the Federal Reserve System is confronted with problems akin to those of your institutions. As a result, there is strong and continuing concern throughout its Banks and branches as well as at the Board of Governors that its millions of transactions should be handled efficiently and without cause for criticism. The mere volume of checks and currency creates the need for unceasing vigilance. Not only should care be directed to the prevention of malfeasance; intelligent thought needs to be given to misfeasance. Consequently, the Federal Reserve System has evolved a procedure that it hopes will be adequate for both purposes.

In each Reserve Bank there is an internal auditing department headed by a General Auditor who reports, not to any operating official, but to the Board of Directors. Although the auditing department is in constant touch with those responsible for operations, the auditors are free from domination and their reports to the Board of Directors are direct and frequent even though they have observed nothing to give the directors particular concern.

In addition to this internal audit, the Board of Governors in Washington has an Examination Division of its own. These examiners travel steadily and visit the Banks and branches once a year in order to provide both the Board of Governors and the Directors of each Bank with an outside check; the examiners of course lean heavily upon the system of internal control and auditing. Consequently, one of the points upon which the examiners report to each board is the thoroughness of the internal audit program.

A third line of defense is provided by the review by a public accounting firm of the procedures used in examining the Reserve Banks. This firm reports directly to the Board of Governors.

At the Federal Reserve, our attitude has been that the rapidity of technological change has increased the need for caution and for diligence. The three steps I have outlined to you are as complete a program as is feasible with existing techniques. Nevertheless, this problem is a direct responsibility of the Board. Comprehensive as our program may be, it does not eliminate all risk; it is designed to reduce risk to a minimum. More than monetary loss is involved. The Federal Reserve System should be as Caesar's wife. Although we cannot expect perfection, we count any breach of faith as a reflection on our own diligence. Thus, we are so continually aware of the risks that we sympathize with all those who face similar hazards.

Your commercial banks have problems closely akin to those of the Federal Reserve System. But the latter has a much smaller number and variety of accounts than have the larger commercial banks. This creates problems that are even more challenging than those faced by us. The increase in the number and size of embezzlements in recent years underlines the importance of effective programs of internal audit. It is not only that each bank needs to be protected against loss; there is also the injury to public relations and the nullification of advertising effort when embezzlements come to public attention. Not only is the auditing function of importance to the well-being of the individual bank; it is vital to public confidence in the banking industry. The commercial banks of the country have been entrusted with the allocation of the available supply of credit to individuals. It is the American tradition that the allocation of credit should be made by private institutions through the workings of the free market. Our citizens are fortunate that they have a choice among competing banks and need not be at the mercy of a governmental bureaucrat for the credit that they need. A competitive commercial banking system is therefore a bulwark of free enterprise.

But if the public is to continue to permit this heavy responsibility over money to remain in private hands, as I hope and trust it will, the banking industry needs to retain the respect of the whole country for the banking system as a whole and for its constituent parts. Weak or imperfect internal audit programs threaten commercial banking with increased governmental supervision. This line of thinking leads to the suggestion that the maintenance of a sound system of internal controls and internal auditing is a responsibility of top management just as are sound loan policies. Although small banks cannot afford a separate department, they can have a definite program with appropriate checks and balances. In small banks especially, this program should be backed up by an outside firm to offset the close working relationships of those who audit and those whose activities are audited.

If this point of view is accepted, a few questions might be helpful in connection with any self-appraisal.

(1) Are the internal controls and auditing methods sufficiently protective?

(2) Are the activities of the internal auditor entirely divorced from operations?

(3) Does the Board of Directors have a sub-committee charged with particular responsibility over auditing?

(4) Have the bank directors established procedures that adhere to requisite standards?

(5) Does the audit department offer opportunities for able men; i.e., for status, pay and promotion?

It is unnecessary to stress before this group the distinction between internal auditing and bank examination. Contrary to popular belief, the principal function of a bank examiner is not to detect dishonesty on the part of bank officers and employees but to prevent bank failures. This is not to say that a good examiner will not from time to time discover situations that are unsavory. But essentially his job is to judge the assets and operations of banks in the interest of keeping them in a sound condition. The principal causes of bank failure are weaknesses in loan and investment policies, even though losses from defalcations have been significant and growing in number and importance. Therefore, the examiner's primary task, in addition to ascertaining that the statutory and administrative requirements are complied with, is to appraise the lending and investing policies so as to minimize the dangers inherent in hazardous loans and speculative investments.

The increasing size of banks, the number of branches, the increasing volume of transactions, and the greater use of electronic and mechanical equipment suggest the need for banks to reappraise the adequacy of their present programs of internal control and audit.

These developments highlight the vital role of the auditor and cause me to pay a sincere tribute to NABAC for its efforts to promote internal security. As part of their responsibility for preventing and detecting shortages, bank officers need to perfect auditing techniques. Attention to internal control and auditing is a proper responsibility of top management; bank examination should not be looked upon as a substitute. For bank examination to assume the burden would not only mean keeping government men in banks continuously, but would invite more rigid governmental supervision. For the sake of the banking industry itself and of the community at large, the harness of governmental controls should be kept at a minimum.

The problems that I have touched upon exist in all institutions that deal in other people's money. They apply to the Federal Reserve's own operations and to those of commercial banks. They are of long standing and of increasing importance to the good name of banking. They will not be solved easily, nor remain solved without unceasing diligence; in the presence of money, some men give way to human frailty.

What I have tried to stress is that the internal control and auditing is a function that should have the support of top management and such prestige and rewards as will have continuous appeal to men of ability.

And so I close with a question asked in his annual report by a former Philadelphian, President Merle Odgers of Bucknell University:

"Ah! who of us, if self-reviewed,
Can boast unfailing rectitude?"