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AUDIT AND BANK SUPERVISION

By

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Washington, D. C.

before

30TH EASTERN REGIONAL CONVENTION

of

NABAC, THE ASSOCIATION FOR BANK AUDIT, CONTROL, AND OPERATION

at the

Pittsburgh Hilton Hotel
Pittsburgh, Pennsylvania

10:30 A.M.

Monday, May 24, 1965

An address by K. A. RANDALL, Chairman, Federal Deposit Insurance Corporation, Washington, D. C., before the 30th Eastern Regional Convention of NABAC, The Association for Bank Audit, Control and Operation, at the Pittsburgh Hilton, Pittsburgh, Pennsylvania, at 10:30 A. M., Monday, May 24, 1965.

AUDIT AND BANK SUPERVISION

In recent months, the necessity for satisfactory bank auditing procedures has increasingly occupied the attention of the industry, of supervisory authorities, and even of some members of Congress. Nowhere has this been more true than at the Federal Deposit Insurance Corporation, where our concern always has been for a sound banking system.

To me, the American banking system is a great and diverse mechanism which has evolved out of our national needs. Its evolution was not entirely planned, but it has been constructed within a framework of national preferences, to meet the demands of the times, and its fundamental success has been unparalleled in the world.

By the same token, many of the individual attitudes and operating techniques in the banking system have changed or modified to meet additional demands or changes in national patterns. Many of these could be cited, such as the evolutionary approach to lending which has gradually constructed today's typical bank loan portfolio, including business, consumer, mortgage, and other types of loans, some of which were unknown as short a time as 25 years ago.

In this context, it is at least possible to suggest that approaches to auditing also have been evolving, and for the most part improving over the years.

There is nothing in today's world to suggest that this pattern of evolution is not still with us. Indeed, every investigation of our present economy suggests strongly that this evolutionary process is gaining momentum. The demands made by business and by the general public for banking services matches and sometimes exceeds the swift and complex growth of the economy as a whole. Today banks are being asked to undertake, as routine, tasks they barely considered in theory twenty years ago, and new ideas are now being considered which well may be fact in the next decade.

This poses a challenge to bank managements, and to auditing procedures. Without information and knowledge gathered through proper audit procedures banks cannot keep abreast of the total picture of their activities. Without such knowledge it is problematical whether or not banks can keep abreast of the greater and more complex demands for service engendered by today's economy.

We have in the past months faced another problem, in the failures of some banks. In a few of these cases, at least, proper audit techniques such as verification might have uncovered improper procedures in time to avert the failures.

Our total banking system is a reflection of all its parts -- and one of these parts most likely to contribute to the system's continued viability may well be increased and improved use of bank auditing procedures, especially for smaller banks.

The audit challenge is perhaps more important to smaller banks, because most, if not all, of the nation's larger banks have developed workable audit programs. This does not eliminate entirely the necessity for middle-sized or larger banks to consider the status of their audit operations, and to continue to search for better methods or tools.

There seems to be a feeling on the part of some smaller banks that their annual or semi-annual examinations substitute for an audit, and give them the necessary protection and evaluation of their bank's condition. This is not, under present circumstances, true. A bank examination does include some auditing techniques, but these are limited in scope and do not approximate a full audit.

Before turning to an examination of those needs for increased audit procedures which we see, and before reviewing possible supervisory approaches, it might be appropriate to review briefly some of the basic methodology which supervisors look for in any competent bank audit program.

In our view, an internal auditor is essential to any completely satisfactory audit program and should be as free as possible from other assignments. Among the responsibilities which the supervisor considers necessary for such an auditor are:

-- Insuring that a proper accounting system is in effect and is functioning as intended, on a continuing basis.

-- Establishing and periodically reviewing the bank's system of internal controls, including mandatory vacations, dual controls in sensitive areas, rotation of assignments, periodic surprise checks, and others.

-- Auditing accounts systematically with a view toward protecting and safeguarding the bank's assets, and a determination of its liabilities.

-- Determining that all members of the bank's staff are adhering to management policies.

-- Assuring that the bank complies with applicable laws and regulations, State and/or Federal.

-- Preparing and submitting periodic reports to management, assuring management of an accurate and substantive picture of the bank's status.

We consider the independence of the auditor from detail staff work, and his having reporting accessibility to the Board of Directors or a delegated committee, of major importance.

The supervisory authority will encourage some provision for audit, if at all possible through an internal auditor.

The scope of audits, while obviously most important, need not be detailed here, but I would like to stress the importance we place on direct verification, of both assets and liabilities. Direct verification is a key part of the auditing technique.

Shortages in the asset or liability structure are not always disclosed in routine examination procedure. When they are, they come as a result of a procedural by-product.

To the examiner and the auditor the tool of direct verification remains the single strongest weapon in the prevention or disclosure of irregularities. Verification is not, of course, a new idea. You are all well versed in the science of verification, and there is no need for us today to discuss the technical aspects of positive versus negative verification, random versus 100 percent, or statistical samplings, and the like. The supervisory authority may have his preferences, but there are cost factors to be considered, and the specific assignment, the frequency of verification, and other factors will govern what approaches are taken.

There is one point I should like to make, however. When some banks resist verification, in the belief that it will disturb customers, in my view they pay a high price in uncertainty about the soundness of their banks and the accuracy of their records. The use of verification for preserving the safety of a bank can be used as a tool for better relations with the customer and the public. It is a rare customer who will be disturbed by the thought that the bank is devoting every effort to keep funds safe and its accounts in accurate condition. Devoted efforts to educate the customer as to the purpose of verification can be made to pay positive dividends for the banks.

From the viewpoint of the Federal Deposit Insurance Corporation, we have a major interest in seeking development of audit programs in banks which have none or which have only the bare beginnings of audit procedures in their operations. We feel most strongly that some effort must be made by every bank, whatever its size. Any bank officer, employee, or director can be utilized to some degree in audit procedures. If size does not permit a full-time auditor, we would prefer a director, or an officer, devoting assigned time to this function. We feel strongly that some positive effort should be made to solve basic audit problems in smaller institutions.

Minimal audit programs in banks with even as few as two employees could prevent defalcations. No bank is so small as to be safe from internal fraud.

Additionally, I feel that some audit programs, whether through a full-time auditor, through the board of directors, or through an outside public accountant, can have helpful by-products which would tend to lessen or eliminate the cost factor. A good audit program, after all, requires the use of accounting techniques, and this in turn gives a bank the tools for cost analysis, and quite probably for cost controls. How many small bankers would find out for the first time the real cost of their many operations? How many would find ways of trimming excess costs, or of improving income patterns?

This, then, is the supervisor's view of what an audit should do, and how audit can be strengthened for the whole banking system, with emphasis on the smaller institutions which lack good programs or which in all too many cases have no program at all. From this discussion we can turn to the supervisor's present role in this area, and some thinking on possible developments within the supervisory structure for better audit procedures for the nation's banks.

Historically, the Federal Deposit Insurance Corporation has drawn a distinction between an audit and an examination. They are not the results of the same processes, and their ultimate goals differ.

The bank audit is a quantitative analysis of a bank's assets and liabilities, its income and expenses, determining what does and what does not belong on the books, and whether or not these transactions are accurately reflected in the bank's records.

The examination, on the other hand, is a primarily qualitative analysis, aimed at developing the value of these holdings, their soundness, the legality of the bank's actions, the soundness of capital, and the quality of management. These, of course, are very broad definitions.

The examiner and the auditor, because of the basic differences in ultimate objectives, do not even approach their tasks from the same point of view. They have been trained to look at the same loan portfolio, the same deposit ledger, from far different perspectives.

Nevertheless, the examiner of today does use some auditing techniques. He will verify and reconcile accounts. He physically counts cash. He proves deposit figures. He checks collateral on loans. He checks and verifies securities owned by the bank. He checks to see if there are notes backing up each ledger in the loan portfolio. He verifies participations and notes out for collection. He proves income and expense, checks the accuracy of the bank's records on a spot basis; on rare occasions he may even use some elements of direct verification. He reviews, although he does not verify, expense accounts of the bank.

Additionally, as a long standing policy, the Corporation has instructed examiners to accord special attention, from an audit standpoint, to one-man banks, banks without mandatory vacation policies, carelessly run banks, and the smaller banks without any audit procedures. In these situations, our Manual of Examination Policies sets forth some specific audit techniques which are to be used, and which are used as a matter of course.

Among other required examination objectives, one of major importance is the evaluation of management. Essential to such an evaluation is a review of the bank's records, its system of internal control, and its audit program, to determine if they are sufficient to safeguard the bank's assets. One page of the examination report is devoted to these areas, and examiners are instructed to emphasize shortcomings in these areas in their examination reports.

In short, it is our view that the examination of a bank, while not necessarily requiring any extended audit checks, should include an appraisal of internal routine and control and of a bank's audit program, and should require more extensive audit test checks in situations where deficiencies exist.

In the context of today's banking system, and of today's economy, we are convinced that more must be done, especially in the field of smaller banks. Accordingly, we have told our examiners to look long and hard at every examined bank's auditing program.

I have stressed verification in this talk, because of our view -- a view shared by the other Federal banking agencies -- that it is becoming increasingly important to all banks, large and small. Accordingly, the Corporation is instructing its examiners to place increased emphasis on the use of verification procedures as part of any acceptable audit program, and, where verification is not being used, to urge management to start a verification procedure.

There is a serious question as to just how far the supervisory agencies should go in the field of audit. As I outlined at the beginning, this is a question for serious debate. The hearings being conducted by Senator McClellan into recent bank failures -- which I may add, have been most fair and impartial -- have raised some interesting questions.

Many tentative approaches are being debated, and in my view it is necessary for the industry, and for its leadership, to join that debate.

This debate requires that we review our fundamental posture. Why do supervisory agencies examine? Is it our duty, as examiners, to prevent defalcations, or is this a duty of management? We have always felt that our own goals primarily are to determine the soundness of a bank's management, and of its operation. Must we go beyond the necessary analysis of management's capabilities and procedures into a complete verification of the bank's soundness?

If the supervisory role is to be one of prevention of any defalcation, if the supervisor is to substitute for management in this vital area, then of course greater audit techniques by the supervisor are essential. But it seems to me that the supervisor's role is not one of management, that it is improper for the supervisor to assume the manager's duties. We feel it is our duty to act as a guide, as an instructor, as a developer of technique. This is eminently proper. How much more is?

As you may gather by this, I do not want in any way to suggest that any supervisory authority wants to exercise the proper functions of management. And, in our view, to a large degree audit is a management function, or an ownership function. We should not, under the existing system, make judgments which management must make. Nor should we exercise the controls which properly belong to management.

Yet we do have a duty to the industry and to the nation as a whole to make sure that management in this sensitive profession preserves the soundness of the bank and its ability to serve its community. We do have the duty to assure the nation that proper standards are being maintained and that the nation's banks continue sound. Where is the dividing line between management's duties and the supervisor's? These are the questions we must consider.

There are two approaches which I would like to cite, which are under careful consideration by the Federal Deposit Insurance Corporation at this time.

In the first place, we feel strongly that one eventual solution lies in the development of more uniform accounting procedures, and we have publicly and privately urged the industry to assert leadership in developing such procedures.

The Securities Act Amendments of 1964 affects relatively few banks -- some 600. But regulations based on that Act do require more uniform accounting procedures. For example, they require the use of accrual accounting whenever possible, separation of bond losses or gains from interest income, and other standardized techniques.

These regulations currently affect larger institutions only. We feel, however, that with public acceptance of these standards, the tendency will be toward their use by all banks. As these standards and concepts prove their worth the industry can be expected to develop even more refined and accurate methods. In the long run these should also make auditing costs lower. We feel this will be a healthy development for the whole industry, and a material aid to the smaller bank seeking simplified accounting and auditing procedures.

We are seriously studying another program at Federal Deposit Insurance Corporation. This is the possibility of developing an advisory service for the smaller banks which lack audit programs. Our approach here is designed to assist banks in developing sound audit methods.

This service, as we are considering it, would lead to a program of field auditors trained in bank audit technique, and in teaching methods, who would be able to assist banks with a need and a demonstrated interest, in structuring a satisfactory audit program. Varying degrees of assistance would be available, depending upon the inherent skills and procedures possessed by the bank in question.

It would be a means of offering an opportunity for the smaller banks which lack audit and which lack expertise, to draw upon our experience, to create a sound audit program.

We are not committed to this program, but it is under careful study, and we would welcome comments and suggestions. At the present time we are actually exposing selected personnel to bank audit instruction and orientation, and it is our intention to use this pool of trained personnel to extend and intensify the audit phase of our examinations. They could become available for this new program being considered, if the decision is to move ahead with it.

These, then, are the challenges to the banking industry, in development of better, more standardized, and more readily available auditing techniques throughout the total industry, large bank and small alike. No supervisor wants to do what is properly management's function. But the development of the economy, the complexity of need and of bank services, the fast growing pattern of today's world, all impose extra burdens on bankers everywhere. These properly require use of audit, and the day has come when no bank in this country is too small to concern itself with a proper audit program.

There must be leadership in developing this program for smaller banks. There may be a pressing need for new thinking in the audit field, to develop new techniques which are possible for the smaller bank. The supervisory agencies are deeply dedicated to the philosophy that every bank must have some form of audit and some form of direct verification.

Solutions can be imposed. But we like to think that the industry can meet this challenge, as it has met so many challenges in the past, and develop sound, practical solutions, acceptable to and used by the system as a whole. The industry's growth has been in response to other such challenges, and I am sure you are capable of meeting this one successfully. I can pledge that in all such efforts the supervisory agencies will as always cooperate in the closest possible manner in developing lasting and meaningful solutions, to enhance the ability of all our banks and to preserve this vital financial system and the diverse economy it helps support.

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